Household Debt in Central and Eastern Europe (CEE)

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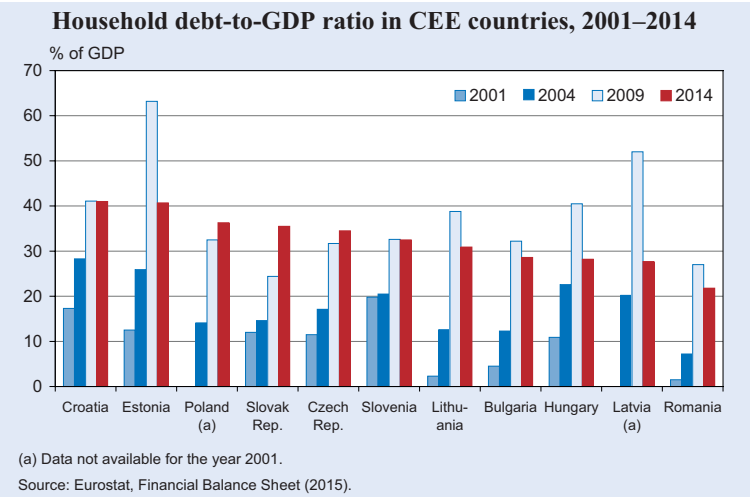
Household debt in the CEE countries

Private household debt in Central and Eastern Europe (CEE) has considerably increased since the early 2000s. Even in countries like Hungary, Lithuania and Bulgaria, which had very low household debt-to-GDP ratios at the beginning of the 2000s, household debt-to-GDP had risen by to 40 percent by 2009. With the onset of the financial crisis the situation was aggravated further, particularly in the Baltic countries. As shown in Figure 1, these countries have managed to reduce their household debt-to-GDP ratio substantially since then. Currently, Croatia and Estonia exhibit the highest household indebtedness level among the CEE countries (Eurostat 2015; European Commission 2014 and 2015).

In spite of the considerable increases, household debt levels in the CEE countries are still lower than in many parts of Western Europe, where countries like Denmark, the Netherlands and Ireland face ratios of above 100 percent.[1] Nevertheless, there are ample reasons for concern: firstly, there are obvious signs that many households in the CEE countries are suffering considerably from their current debt level. In the case of Croatia, for example, the share of non-performing loans among households has reached dramatic levels and a substantial share of the population is in a situation of personal bankruptcy. Secondly, many households in non-euro CEE countries are indebted in foreign currencies like the euro and the Swiss Franc because these loans offered lower interest rates than those in their national currency. In some cases, the majority of private sector debt is held in a foreign currency. In Croatia, for example, over 70 percent of all loans to households, non-financial corporations and financial corporations are denominated in or indexed to a foreign currency, mainly the euro and the Swiss Franc (ESRB 2015). In Bulgaria and Romania around 50 percent of the private sector debt is held in foreign currencies. In Western European countries this ratio is below 5 percent.

One explanation for this phenomenon is that households suffer from an 'exchange rate illusion': by only considering the fact that interest rates on foreign-currency loans are lower than those on domestic currency loans, they ignore the risk of their domestic currency depreciating. This illusion may stem from the exchange rate policies of Central Banks, which often aim to guarantee stability through a quasi-peg to the euro, as in the Croatian case. However, the appreciation of the Swiss Franc after 15 January 2015 illustrates the real risk associated with foreign currency loans. A considerable number of households holding Swiss Franc loans were severely affected by the effective increase in repayments in countries like Poland, Hungary and Croatia (The Economist 2015). The de-

Figure 1



(a) Data not available for the year 2001.
Source: Eurostat, Financial Balance Sheet (2015).

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[1] For a recent overview of household-deb in Europe, see Drometer and Oesingmann (2015).

Table 1

Private insolvency laws in the CEE countries

Country	First effectiveness/ Major reforms	Clusters for duration of discharge period		
		Short (shorter than 3 years)	Medium (between 3 and 5 years)	Long (longer than 5 years)
Bulgaria	*Currently no law*			
Croatia[a)]	*Currently no law*			
Czech Republic[b)]	(1991)/2008		x	
Estonia	2004		x	
Hungary	*Currently no law*			
Latvia	2008/2010	(x)	x	
Lithuania	2013		x	
Poland	2009	(x)	x	
Romania	*Currently no law*			
Slovak Republic	2007		x	
Slovenia	2008		x	

Notes: In Latvia and Poland the discharge period can be shortened when fulfilling special requirements (x percent of all debts must be repaid for example). These shorter periods are shown in brackets.
(a) Proposal to establish a consumer law came into the Croatian parliament in June 2014. On 13 March 2015 the Croatian government endorsed the personal bankruptcy bill (Government of Croatia 2015). But a personal bankruptcy law still has not taken effect as yet.
(b) Prior to 2008 the insolvency law recognised the traditional bankruptcy proceedings for consumers.

Sources: Ramsay (2012); Niemi (2012); authors' research.

preciation of national currencies with respect to the Swiss Franc has made it even more difficult for many households in the CEE countries to service their debts.

Personal bankruptcy laws in the case of over-indebted household

In addition to preventive measures, personal bankruptcy laws are indispensable for dealing with over-indebted households in a market economy. Such laws aim to establish an even, predictable burden-sharing between borrower and lender. On the one hand, they should make it possible to give private persons a 'fresh start' after completing a certain period of repayments, rehabilitating them afterwards by clearing unpayable remaining debts (Christopherson and Abjornsson 2011). On the other hand, personal bankruptcy laws should maintain credit discipline and prevent moral hazard.

For obvious reasons, insolvency laws did not exist in the CEE countries prior to 1990. With the shift to market economies insolvency regulations for firms were introduced, whereas the issue of over-indebted households did not attract much attention. As evident from Table 1, private insolvency laws do not exist in all CEE countries even today, or have only been implemented quite recently. Bulgaria, Croatia, Hungary and Romania are all countries with no legislation in place, whereas Croatia is about to introduce a private insolvency law. The recently introduced laws are characterised by medium discharge periods ranging from three to five years. This reflects the trend towards the Anglo-Saxon model as recommended by institutions like the IMF (Liu and Rosenberg 2013) and allows swift recuperation after bankruptcy.

Consumer protection and risk management for the banking sector

A lack of consumer protection and information on the potential risks of credit, such as the exchange rate risk associated with foreign currency loans, are one explanation for the rising over-indebtedness of many households in CEE countries. Consumer bankruptcy laws should therefore be accompanied by measures aimed at preventing consumer insolvency from the outset. The European Commission has published a proposal for legislation on 'responsible lending and borrowing' on mortgages, which includes a range of preventive measures such as requiring a standardized pre-contractual information sheet, having a mandated period where the borrower has the right to withdraw, regulating advertisement, and verifying creditworthiness (European Commission 2011 and 2013). In the case of loans denominated in a foreign currency, banks could be required to disclose the associated exchange rate risk. Further measures include debt counselling and financial education for individuals, as well as a credit registry for private consumers that enables banks to obtain information about the creditworthiness of borrowers. At the same time, national supervisory authorities should implement policies that prevent banks from excessive lending, for example, the incorporating foreign-currency lending risks in internal risk management systems and in stress tests for banks.

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