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Inflation: saving households from insolvency

The sharp price increases plaguing lower-income households could easily be cushioned through state guaranteed loans at a minimal risk

The war in Ukraine and its effects on the global markets for energy, metals and food are putting more and more strain on households. Since the beginning of this year, inflation in the euro area has increased from 5.1 to 8.6 per cent, albeit with considerable regional differences: in the Baltic states, the rate is around 20 per cent, in France only 6.5 per cent.

What is especially worrying is that the wave of inflation is increasingly affecting food prices. For unprocessed food, the eurozone rate reached 11.1 per cent in June. And it is unlikely to have reached its peak, as increases in gas prices in particular are usually passed on to consumers with a time lag.

These developments confront households with serious financial pressures. For Germany, the central association of the housing industry (GdW) expects additional burdens for energy alone in 2022, compared with 2021, of up to €2,749 for single households and €5,074 euro for four-person households.

In December 2021 the inflation rates faced by low-income individuals were 1.4, 1.7 and 0.3 percentage points higher than those faced by high-income individuals in Belgium, Italy and France respectively.

Since low-income households spend a relatively high share of their budget on energy and food, they are particularly affected by the price explosion. As a study by Bruegel shows, in December 2021 the inflation rates faced by low-income individuals were 1.4, 1.7 and 0.3 percentage points higher than those faced by high-income individuals in Belgium, Italy, and France respectively.

These households usually have few savings or are already in debt.

Without state aid, a wave of over-indebtedness among households — bringing serious social consequences — is therefore to be feared.

A financial quick fix

In terms of economic policy, the optimal solution would be temporarily to cushion the price shock as much as possible, through interventions in the energy market and state transfers. Most countries already have corresponding measures and aid packages. But given the extent of the additional financial burden on households, complete state compensation will not be possible.

Therefore, a state loan programme for households should be considered as an accompanying measure. The model is the state-guaranteed loans granted to companies at favourable conditions during the pandemic, to avoid widespread insolvencies. In 2021, even before the energy-price explosion, in Germany for instance 575,000 persons were attending debt-advice centres.

The size of the government guarantee should depend on the number of household members. Taking the high scenario above, for Germany the loan for a one-person household would be €2,750, €4,624 for a three-person household and €5,074 in the four-person case. The loan could be granted at an interest rate of 2 per cent. Repayment (including interest) could be spread over five years, with no payments required for the first two.

The advantage for financially weak households would, on the one hand, be favourable interest rates. This helps to avoid the debt trap, which is caused by the very high interest rates that have to be paid for overdrafts. On the other hand, the availability of additional credit helps when households are credit-constrained — when rising energy costs would otherwise drive them into insolvency.

Since government guarantees do not count towards public debt in the sense of the Maastricht fiscal rules, there would be no negative impact on debt levels.

Disbursement and settlement would take place via the commercial banks, which would receive a state guarantee for this. From the state's point of view, the costs would be minimal, as it can borrow on the capital market at similar rates for this period.

Since government guarantees do not count towards public debt in the sense of the Maastricht fiscal rules, there would be no negative impact on

debt levels. Of course, there would probably be a certain percentage of loan defaults, but this should be limited.

Theoretically, this programme corresponds to the idea that households can borrow over time to cushion shocks. In reality, however, the problem is that many households are facing credit constraints that deprive them of this adjustment option. Government guarantees can remove the friction.

This would save many people the difficult path into insolvency and at the same time enable a stabilisation of private consumption. Yet for the state such guarantees come at virtually zero cost, since it merely passes on its creditworthiness to households.

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