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The household as a small bank: the structure of the balance sheet of the household sector in the euro area

	1995	2004
Assets	152.6	182.5
Currency and deposits	62.6	60.5
Securities other than shares	20.7	18.6
Loans	0.7	0.3
Shares and other equity *	31.7	47.9
Insurance technical reserves **	33.8	51.0
Other accounts receivable	3.1	4.1
Liabilities	45.7	58.2
Loans	42.2	53.8
Shares and other equity	0.0	0.1
Insurance technical reserves	0.3	0.4
Other accounts payable	3.2	3.9
Net financial wealth	106.8	124.3

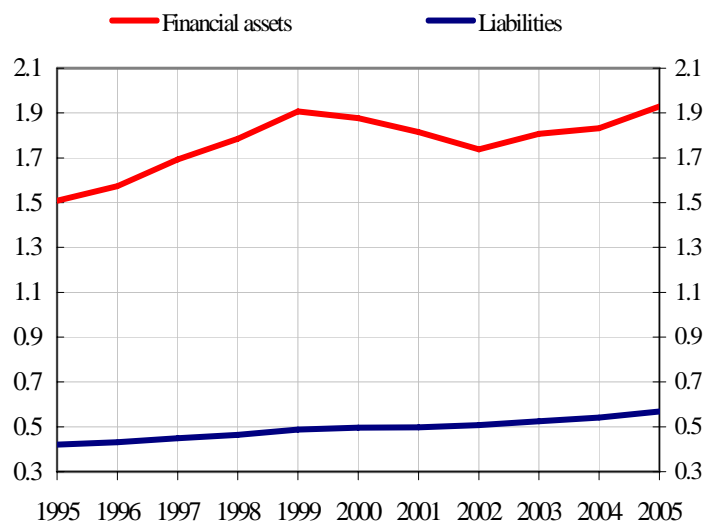
Note: Data in percentage of nominal GDP. Source: ECB. The household sector also includes non-profit organizations and self-employed firms.

* Includes mutual fund shares.

** Includes pension fund shares.

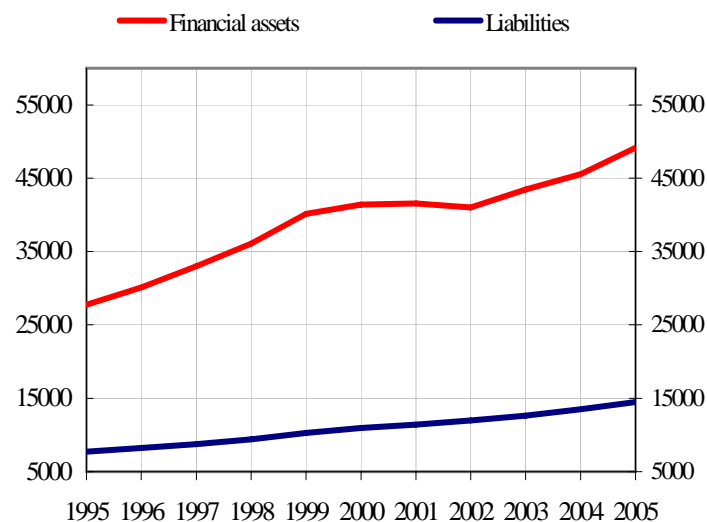
Financial deepening of the household sector in the euro area

Developments in households' financial assets/liabilities to GDP



Source: ECB

Developments in households' financial assets/liabilities per capita (Euro)

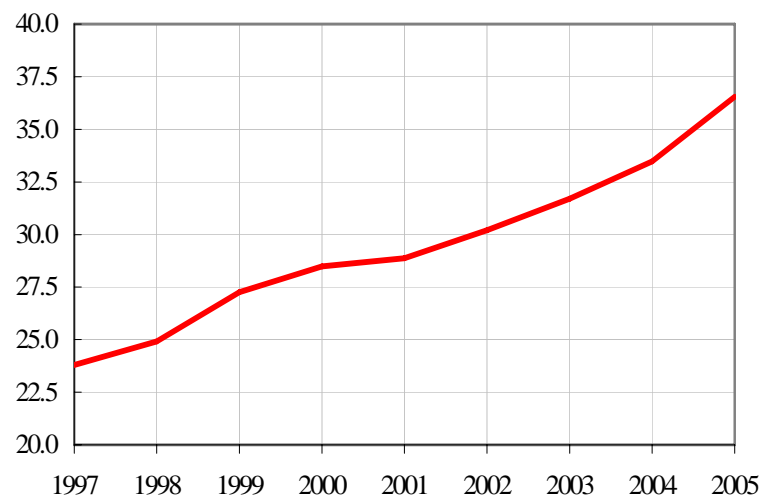


Source: ECB

Spectacular rise in the mortgage debt to GDP ratio in the euro area over recent years, about a third of mortgages at variable rates (estimated) ...

Mortgage debt to GDP

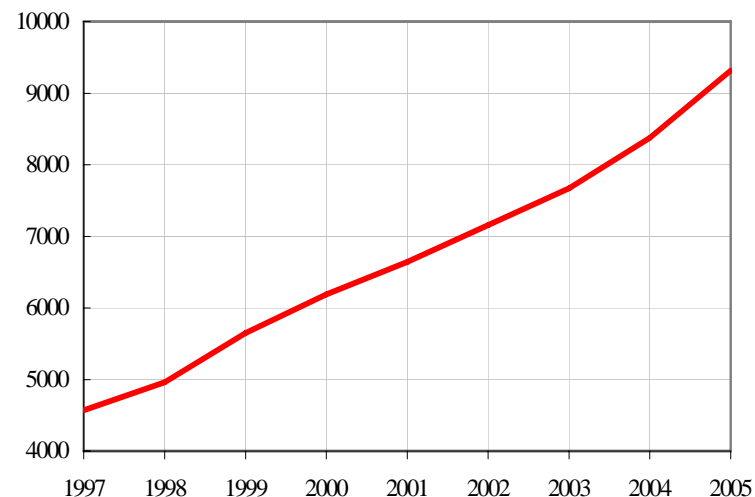
(in percent)



Source: ECB

Mortgage debt per capita

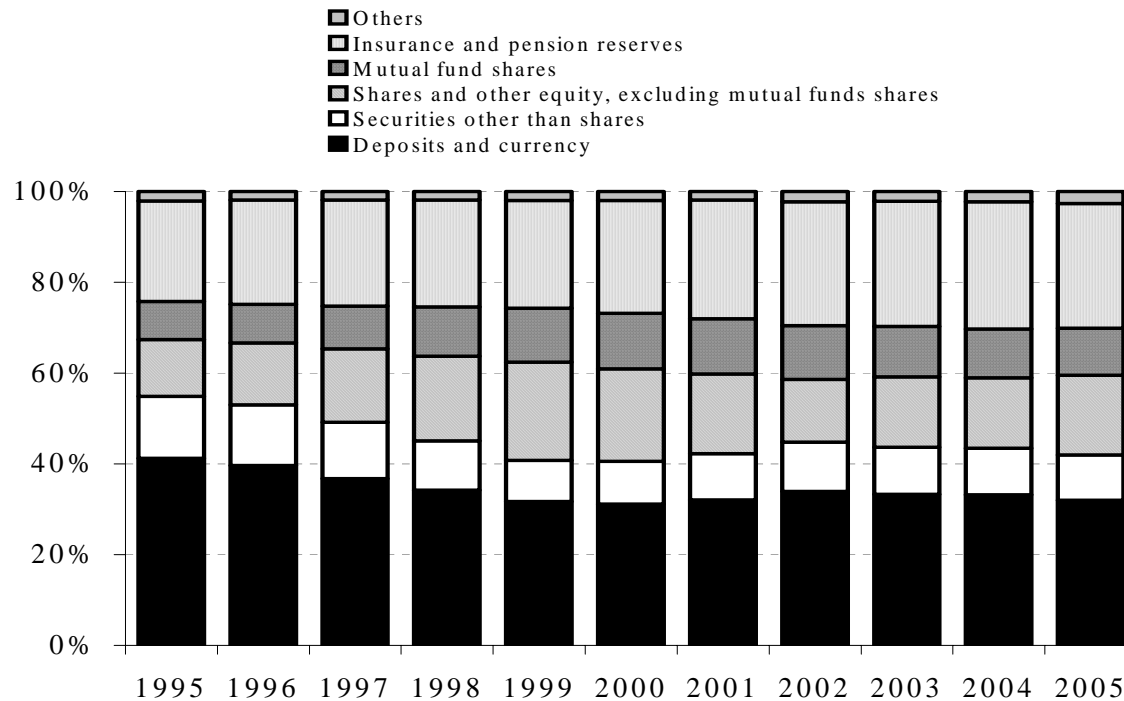
(Euro)



Source: ECB

... and this has been accompanied by a shift in the composition of households' financial portfolios towards risky assets

Composition of household financial wealth in the euro area
(in percent)

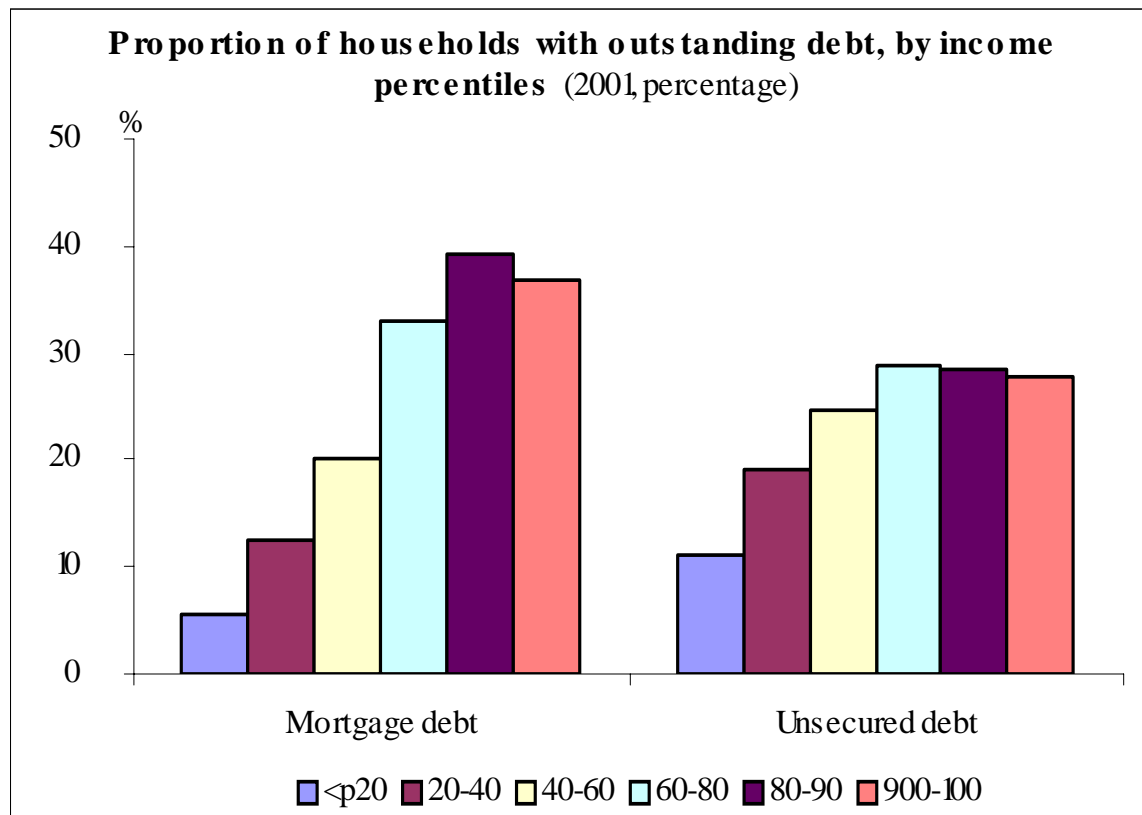


Source: ECB.

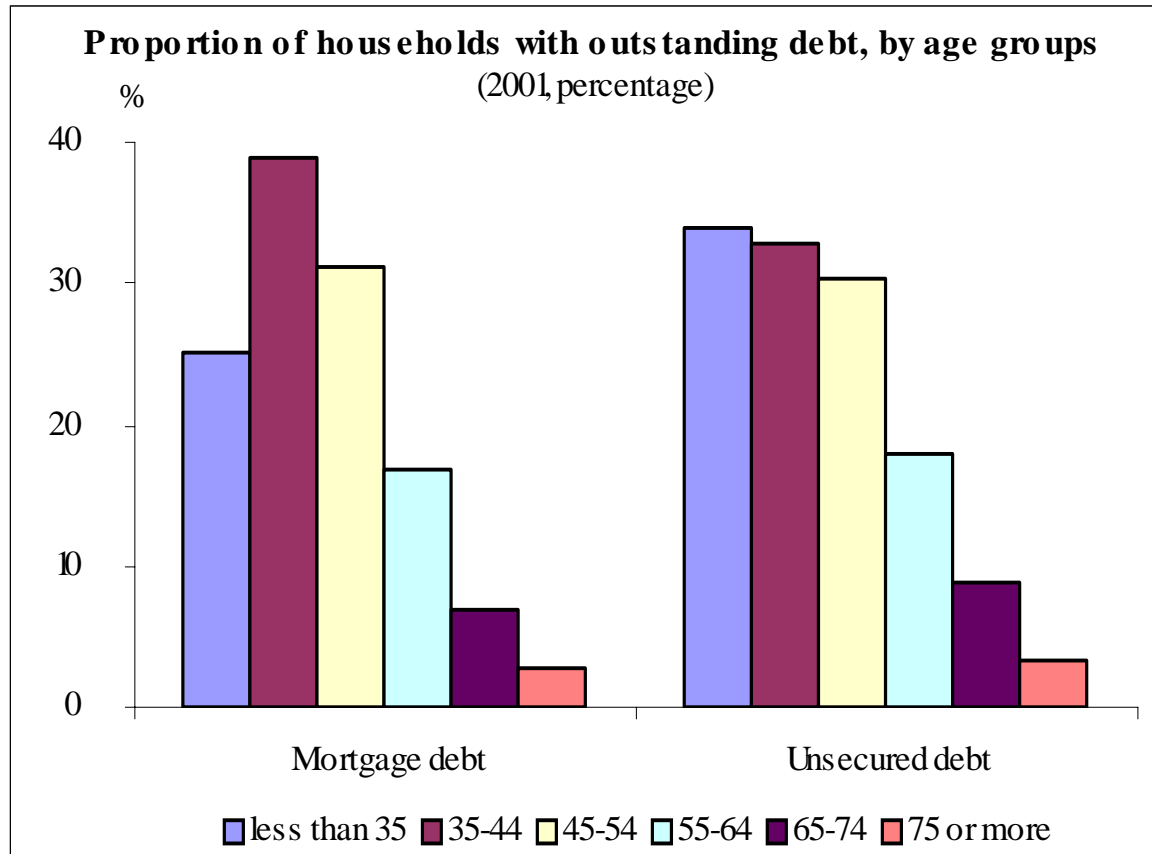
Key drivers of financial deepening

- On the liabilities side, financial innovation and stronger banking competition coupled with low interest rates over the whole yield curve and high property prices ...
- ... which makes it difficult to distinguish between structural and cyclical determinants of household debt
- On the assets side, (still) high propensity to save coupled with the rise of institutional investors which reflects primarily a trend towards private retirement savings in a context of ageing population and concerns about the sustainability of public pension plans ...
- ... and possibly also a tendency to take on a bit more risks in order to achieve decent returns, possibly in part driven by financial intermediaries

Mortgage debt and unsecured debt are distributed quite unevenly across different income groups, as reported in the European Community Household Panel ...



... and are particularly common at relatively younger ages



Financial deepening has clear benefits ...

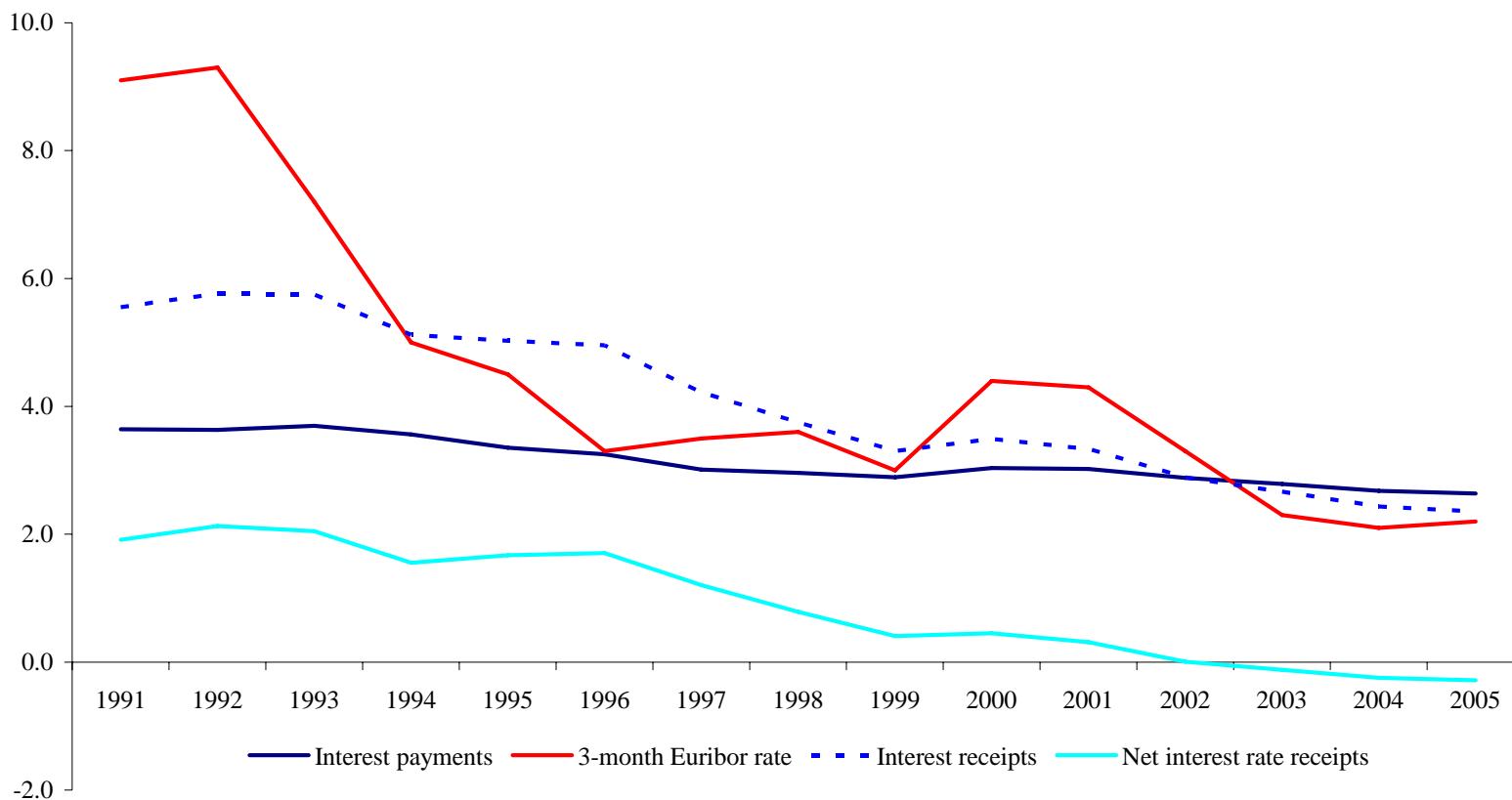
- Primarily, better intertemporal smoothing of lifetime income, for example better housing services for young families
- Better diversification of risks and risk-sharing among different segments of the population (e.g. young with high human capital and low financial wealth, old with low human capital and high financial wealth)
- Possibly higher returns on financial assets, which is very important from the standpoint of saving for retirement
- A better functioning financial market may have a low of positive repercussions on other markets, e.g. labour markets

... but also implies some risks

- Some argue that the household sector is more vulnerable to changes in interest rates, given rising indebtedness
- Attention needs to be paid to the risks related to household balance sheets in evaluating the macroeconomic and financial situation
- What do we know of such risks? In the euro area, we have unfortunately a very incomplete picture, due to the unavailability of full flow of funds data
- We therefore have to rely on scattered pieces of evidence

On aggregate, the interest rate elasticity of household net interest rate receipts is probably positive ...

Interest rate developments and euro area household net interest rate receipts
(Payments and receipts in percentage of GDP)



... but this masks considerable heterogeneity at individual household level

- There is a distributional issue since household debt is probably spread more evenly across households, especially different income groups, than financial wealth
- While we do not have data for the euro area as a whole, but country data, for instance for Italy and Spain, indicate that, on the one hand, the distribution of wealth is more equitable than in the US (and median wealth higher) ...
- ... on the other hand, the debt to income and debt to wealth ratios are typically higher for low income households, which may indicate a greater vulnerability of low income households
- The high dependency of household net worth, again especially at low income levels, on real estate valuations is also of concern

The drawbacks of low financial literacy

- Complex financial instruments now offered by banks (mortgages key example) require sophistication on the side of the client ...
- ... since the possibility, and perhaps only the perception, of being in financial distress may have a number of undesirable consequences ...
- ... for example, lower lifetime income, more risk aversion in the labour market especially by young workers, etc.
- For central banks, a constituency of citizens who understand (and is adequately protected against) financial risk eases the implementation and communication of monetary policy decisions
- Finally, the banking sector “needs” demanding clients to stay competitive and grow

What kind of financial education?

- In my opinion the (primary) education system should take care of providing the whole population with a few basic notions ...
- ... like being aware of the basic risks and not relying blindly on financial intermediaries in the management of household finances
- The existing evidence on financial literacy is certainly not reassuring
- The acceptance of structural reforms could also be fostered if households has a better grasp of their finances and could use financial assets and liabilities as optimal risk management mechanisms

What should financial intermediaries do?

- A first basic, but important, contribution would be to increase transparency in mortgage products, e.g. disclosing effective interest rates on mortgages
- There is an initiative by the European Commission to sponsor a voluntary Code of Conduct on Home Loans
- Transparency is also important from the standpoint of integration of mortgage markets, in which the ECB has a clear interest in the context of its broader objective of promoting financial integration
- Another suggestion is that banks use their latest risk management techniques, like stress-testing exercises that they employ with their institutional clients, also with their smaller clients, to which they could be encouraged not only by competition and demanding clients, but also by regulatory authorities