U.K.'s economic variables over the last decade in the context of the current corona crisis

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Introduction

In January 2007, U.K. Government debt to GDP stood at 32.5%. By December 2019 it had grown to 89.5% and the latest data from September 2020 show a government debt level of just over £2 trillion, while its debt to GDP level did increase to 103.5%.

The Quantitative Easing program by the Bank of England started in November 2009 with a purchase of £200 billion U.K. gilts. The amounts were increased to £375 billion in July 2012; further to £435 billion by August 2016; to £645 by March 2020 and finally (so far) to £745 billion by June 2020.

The current Bank's base rate is 0.1% and discussions are ongoing about the desirability of introducing a negative base rate in future.

The U.K. households' main net wealth items were and are: private pensions and property wealth. Over the period July 2006-June 2008, property wealth was assessed at £3.537 trillion and private pension wealth at £2.886 trillion. By the period April 2016-March 2018 net property wealth had grown to £5.09 trillion and private pension wealth to £6.10 trillion. These items -together at £11.19 trillion- can be compared with the U.K.'s GDP of 2018 of £2.144 trillion. They show a multiple of 5.2 times GDP. If one includes individual households' financial wealth of £2.12 trillion in 2018, the multiple increases to 6.2 times GDP.

The above data show that collective and individual savings far outweigh GDP levels; in its most extreme case by more than 6 times. This raises the question why not more use is made of such savings. After all, U.K. government expenditure as a share of GDP "only" amounted to 39.4% in fiscal year 2018 to 2019.

One element that will be explored in this paper is the difference between a profit or loss to a household or a company –an income gain or loss now or in the future- and a collective loss or gain. The first one represents the usual principles of profits; the second one can be defined as a country's gain or loss: country profit. The two types of profit often do not overlap.

This paper has as an objective to show that there are ways in which existing savings can be used to stimulate economic growth, without having to rely on increasing government debt levels. Government debt represents a future loss to all households directly or indirectly through companies.

1. What are country profits and losses?

A country loss is the amount that a government borrows on behalf of its citizens. Such loss is the difference between government revenues and its expenditure levels. Households directly and indirectly via the company sector are the ultimate obligors of such government debt levels. Such debt represents a future claim on households' income levels.

The second main element in a country profit or loss assessment is the balance of international trade. In the year ending in August 2020, U.K. exports accounted for £618.3 billion and imports for £613.4 billion. In the third quarter of 2020 the balance of trade in goods and services showed a surplus, equal to 3.6% of GDP.[1]

Normally the main contributor to a country's loss is a government. To take the U.K. as an example, government debt relative to GDP has gone up steeply ever since 2008. In fiscal year 2007-2008 government debt to GDP was 34.1%. At the end of the fiscal year 2019-2020 (5th April 2020), U.K. government debt to GDP reached 87.7% and by the end of September 2020 the government debt to GDP level had reached 103.5% of GDP through a combination of reduced tax receipts and a substantially increased government expenditure level. The main cause was, of course, the corona virus pandemic.

The future claim on households has now exceeded £2 trillion. With 27.8 million households in 2019[2], the current government debt per each U.K. household now stands at practically £ 72,000. The Office for National Statistics assessed the household median income for fiscal year 2020 at £32,100 (after tax and benefits). With a government debt level of just over £2 trillion, the government debt per household represents a government claim of £62,305 on a median income of £32,100. This claim represents nearly two whole years of a median income after tax. Trying to enforce such claim would mean bankruptcy for many households.

U.K. households have been plunged into a major future loss position as a result of the government's actions on borrowings. This is not a criticism about such action, but just a statement of fact. Many governments around the world have done the same as a consequence of the effects of the corona virus pandemic on their economies.

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1 https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/timeseries/d28l/pnbp

2 https://www.gov.uk/government/statistics/families-and-households-in-the-uk-2019

2. The use of U.K. household savings to combat the effects of the corona virus pandemic.

When one studies the main variables in the economic development of the U.K. over the last 14 years, it is striking that the trend lines move basically in one direction. U.K. government debt to GDP levels grew from 32.5% in January 2007 to 103.5% by September 2020. In actual numbers U.K. government debt levels increased from £480 billion in January 2007 to just over £2 trillion by September 2020.

Until 2009, Quantitative Easing by the Bank of England did not exist. Its first activity started with £200 billion in 2009 and ended up (so far) at £745 billion by June 2020. In an article in the Times Newspaper of October 21, 2020, Dr. Vlieghe, a member of the Monetary Policy Committee of the Bank of England, expressed his expectation that another £100 billion QE injection might be approved on the 5th of November 2020.

The volume of QE seems to grow more or less in line with the U.K. Government's outstanding debt level. Plans for a QT (Quantitative Tightening) program have not openly been discussed. So far, since 2009, the direction has been a continuous expansion rather than a retraction. The main purchases were U.K. Gilts.

The official Bank Rate[3] was 5.5% in 2007. Due to the previous financial crisis it was brought down to 0.5% in 2009 and ultimately reduced to 0.1% in 2020.

Consumer price inflation as measured in the CPI Index[4] over the last 10 years started of with a 3.1% change in September 2010, followed by a peak of 5.2% in September 2011, a low of 2.2% by September 2012, an increase to 2.9% by June 2013, an absolute low over the ten year period of 0.0% in March 2015, an increase to 3% by October 2017 and a drop to 0.5% in September 2020.

The effects of the corona crisis, -which started in March 2020 in the U.K.-, are likely to have an unpredictable effect on the CPI Index in the coming periods. Add to this the current uncertainty over a Brexit deal or no deal and this will make the CPI development in the coming year even more unpredictable.

On the other hand, the volume of household savings in pension funds and in home equity could be used in one way or another. As stated in the introduction,

[3] https://www.bankofengland.co.uk/monetary-policy/the-interest-rate-bank-rate

[4] https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/september2020#cpih-12-month-inflation-rate

all savings in these two savings categories did already reach 5.2 times GDP in 2018. If one, for arguments' sake, assumes U.K. government expenditure to be 40% of GDP, then the savings in pensions and homes already represent a 13 times cover over U.K. government expenditure in 2020.

3. The option available: Use of Home Equity

One does not need to subscribe to the concept that the only way to manage an economy is to rely on more and more government debt. There are very substantial savings in many economies, including in the U.K. The question at this stage is how to mobilize such savings in a manner that benefits the country and all households.

The U.K. and other countries have a choice between using pension savings or home equity. The character of pension savings is that it represents a collective obligation to a group of working plus already retired members of a pension fund. Mortality rates are taken into account and therefore the assets cannot be directly linked to an individual household. There are variants, as in the U.S., where 401K pension savings programs are owned directly by an individual household. However the aim of all private pension funds is to provide an income after retirement for as long as members are still alive. The payments usually start in the first month after retirement. For these reasons it is not suggested to use pension savings now or in future to solve the financial crisis that was caused by the huge government debt.

The situation is different for home equity.

3.1 Home ownership in the U.K.

Trading Economics produces statistics on the level of owner occupied properties in the U.K.[5] The highest level since 2007 was reached in 2008 at 73.3%. The lowest level since 2007 was reached in 2017 at 63.4%, while in 2019 the level had improved to 65.2%.

The "Great Recession" which was caused by the financial sector, was strongly linked to home mortgages and mortgage backed securities. Notwithstanding that U.K. home mortgages were only infrequently used as collateral to mortgage backed securities –Northern Rock being the main exception – British banks had substantial exposure to the securitization process through their U.S. operations. Royal Bank of Scotland had to be rescued and other banks had to be given lifelines in order to survive. After 2008, for a few years, home mortgages were harder to obtain as many U.K. banks wanted to repair their balance sheets and limit their exposure to the home mortgage market. Lower house prices are a poor incentive for banks to increase mortgage lending.

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[5] https://tradingeconomics.com/united-kingdom/home-ownership-rate

The Office for National Statistics produces a U.K. house price index.[6] The largest rise in house prices since 1980 was in1988 and the greatest fall was in 2009.

The current corona virus epidemic has changed the U.K. housing market in a fundamental manner. During the lock-downs, incomes and job levels come under severe pressure. Small companies and also some bigger ones, especially in the retail trade, are finding it harder to deliver profits. In an article in the Sunday Times of October 18, 2020: "Plunging valuations fuel house price fears"[7] it was made clear that thousands of mortgages are falling through as lenders are sharply revising their estimation of worth. With many job losses expected in the coming months and with many small companies getting into deep financial trouble, it is likely that banks will become more reluctant to provide home mortgages to all but the best credit risks. If no action is taken, the future is likely to be a repeat of the 2008 housing crisis, but only worse.

3.2 The possible use of home equity

The creation of more government debt to solve the current corona virus epidemic only worsens the future financial position of households. Government debt creation always needs to be followed up by debt settlement, even if it might be postponed for many years.

The use of existing savings may be more promising. U.K. home property wealth was assessed at £5.09 trillion in 2018.

Banks and home equity release companies are profit-based companies. Their funding comes from outside sources and such sources expect remuneration over their lending.

If banks or equity release companies provide a loan to an individual household, their profit concept undermines the concept of savings. This can be explained in the following manner: if an individual household deposits money into their bank account, it implies that in effect the customer lends the money to the bank. It was customary for the banking sector to pay some reward for such funds provided.

In the case of home equity, the money has not been invested in a bank account but in a home. Such equity can be temporarily released. This can be done with

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[6] https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/internationalmigration/articles/housingandhomeownershipintheuk/2015-01-22

[7] https://www.thetimes.co.uk/edition/news/will-house-prices-crash-plunging-valuations-fuel-fears-6kzglptwn

the help of QE. The current method of QE is to allocate funds for buying up existing government debt titles. A more efficient manner is to temporarily buy up home equity as well, so that households have the means to spend more on consumption. Financial markets can fund government expenditure, but home equity conversion into cash has the advantage to empower households to spend more. This in itself will reduce the need for a government to borrow.

Part of the home equity is temporarily transferred from the owner to the Bank of England. In return the Bank provides cash via the banking system to the client. The client is expected to sign an agreement with the Bank of England to "re-save' the cash received over an agreed period, starting a year from the receipt of the QE cash. As future income levels are uncertain, the Bank could agree to a fixed percentage of income as certified by the U.K. tax authorities. In the U.S. the usual percentage is set at 28% of after tax income, but this of course can be varied for the U.K.

The Bank of England could set a collective limit for the use of such facility on a first come first serve basis. To get the facility to a meaningful amount, a limit could be set at say around £100 to £200 billion in year one.

What the Bank of England in effect does is to stimulate the economy, create jobs and help households to overcome the effects of the corona crisis. Funding government debt titles –as the Bank does at the moment- does not change households' financial position. Current period Government handouts do this, but at the expense of more government debt. In future, such debt levels will still need to be repaid by households.

In a previous paper by this author: "Savings: the least understood economic concept" a number of conditions were formulated to turn such QE activities into reality"[8]. It was called the Tessa system that stands for "Temporary Equity Spend and Save Again system". Its rules can be defined as follows:

1. The request for such conversion has to come from an owner-occupier in a home. It is a freedom of choice method.

2. Initially such request cannot come from homeowners who rent out properties as they are basically running a business. This may be reconsidered at a later date.

3. The request cannot be approved if it lowers the equity level in a home to less than 10% of its value. Any value above 10% can potentially be considered, but the collective requests have to fall in line with the government's assessed need for economic stimulus. Any home value assessment should be based on February 2020 data. Any later date would not reflect normal supply and demand levels as

[8] https://mpra.ub.uni-muenchen.de/101878/

house prices might have been "affected" by the occurrence of the corona virus; a non economical influence.

4. Many young persons and low-income earners face the greatest hardship as a result of the corona virus. Parents' help should be encouraged as the latter have had the longest time period to build up their home equity level. Zero tax on such transfers between generations would be an obvious method.

5. The person or family withdrawing the equity from their home will also be responsible for "re-saving" the amount withdrawn. A contract between the Bank of England and the individual household will stipulate such obligation.

6. To enable households to re-save in line with the economic situation, a grace period for such re-saving needs to be set. The Bank of England may decide to make QE funds available at 0% interest rate for the homeowner as the home equity conversion is done in the national macro-economic interest.

7. The re-saving needs to be based on a household's income level. It is suggested to set aside 28% of a household's annual net income for the purpose of re-saving.

8. If, like in many cases, the household still has a mortgage to service, it is suggested that the re-saving gets priority, so as to strengthen the equity base in the home again. It would imply that mortgage lenders could be temporarily paid the interest margin on the mortgage loan only. The principal amount of re-saving could be executed on basis of income levels.

9. Linking the re-saving level with the income level will imply that the re-saving will be done at a slower pace, when the economy is still in a recession period. Only when the U.K economy is booming again, will the speed of re-saving be accelerated until the full amount of home equity that was provided has been replaced. At that moment the outstanding mortgage facility is reinstated to the agreed interest plus principal payment facility.

10. The U.K. government might need to decide about the eligibility of households to participate in the Tessa System. Should the maximum income level eligible for the Tessa system be set at twice the median income level of £35,000 or at a multiple of such amount? Should there be regional variations?

11.The U.K. government may also need to decide to what extent it wants the Tessa System to contribute to the U.K. economy; in other words how large a share of home equity is required to help improve the current situation. If enough money is converted into demand levels, the facility may be closed to newcomers until a new economic crisis occurs.

12. The Tessa system allows the Bank of England to turn the tap off when releasing home equity is no longer needed and turn the tap back on when it judges the economic circumstances require it to do so.

13. The Tessa account could be an account to be setup by the household's principal bank on the request of the homeowner occupier. The costs of maintaining such accounts –over which the banking system does not run a credit risk only an operational one- could be at the costs of the U.K. Government as the scheme is operated in the macroeconomic national interest.

4. Some conclusions

The current situation in the U.K. is one of a fast growing government debt level. Many households have been and others will most likely be hit hard by the severity of the Corona crisis. The banking sector is slowing down its lending programs as the lock-downs might end up with many borrowers in financial trouble and unable to serve their debt obligations. U.K. homeowners have an accumulated equity level in their homes of at least £5 trillion. However, the private financial sector cannot turn such home equity into cash as it pursues a profit objective and thereby undermines the value of the home equity. Only the Bank of England can do so through a Q.E. exercise. It can turn home equity into cash to support the U.K.'s economy.

The Bank's funding of government debt does not help the economy to consume more. Rather than this indirect manner, a direct approach can be more effective as it is not based on debt financing, but on (home) equity financing. Turning such equity into cash in the volume needed to turn the U.K.'s economy around is more straightforward. Adding to household's cash holdings and spending increases will have the ability of overcoming the economic fall out of the corona virus crisis. Banks' risks on households and companies will be reduced and the Government tax receipts will improve, without having to change the tax levels.

Last but certainly not least is that if the Tessa system is accepted; each individual household will have the choice to apply for the facility within the parameters set; use the amounts according to their own wishes and after the grace period is over, start saving again for their own benefit. This is certainly different from a government making all the decisions for them. It should not be an either or choice between a government doing their job or private households doing it for the community and themselves. Providing households with a cash injection from their own savings will improve the U.K.'s economy to the benefit of all.

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