Who manages savings in the U.S and why should they be managed?

De Koning, Kees

3 January 2021

Who manages savings in the U.S. and why should they be managed?

By

Kees De Koning

3rd January 2021

Table of contents

Introduction

In a recent paper: "U.S. households' balance sheet and the link to economic policies" (MPRA Paper 104369), it was illustrated that the Great Recession of 2008 and beyond caused a loss in home equity of $6.1 trillion between Q4 2005 and Q4 2011. It took households until Q2 2016 before the loss had been recovered when the level reached $14.488 trillion again. The $6.1 trillion loss was equal to 90% of the combined 2008, 2009 and 2010 Federal Government tax receipts.

Evidence from the Federal Reserve will be used to show that the bottom 50% of income earners was the group, which suffered most from the Great Recession. Its wealth recovery took from Q1 2007, where the wealth level stood at $1.41 trillion until Q3 2017, to return to wealth level of 2007. Over the same period, the 50-90% of income earners group started of with a savings level of $20.81 trillion and saw their wealth grow over this period to $28.03 trillion. For the top 10% of U.S. households, their wealth grew by 52.8% over this period to reach $67.10 trillion by Q3 2017.

The real cause of this widening gap between the bottom 50% and the top 50% of income earners is linked to savings levels. For the bottom 50% having a job is the single most important element for their economic survival. For them their savings levels are either non-existent or are very low. This group depends on their job's income to survive. For the other two groups, their savings levels helps them to recover from a recession.

The current corona crisis has caused and will cause the same threats to jobs as the Great Recession did. What has changed is that U.S. government debt to GDP has doubled from 62.3% at Q1 2007 to 127.3% at Q3 2020. Furthermore, since 2008, the Fed has injected $6.5 trillion (Q.E.) into the U.S. economy. Both government debt and Q.E. are based on debt levels.

There is a savings based solution: QEHE, which stands for Quantitative Easing Home Equity. Converting such savings temporarily into cash will encourage a higher consumer spending level at a time when it is most needed. Households themselves have the choice of what to buy with their converted money. They do not depend on the government. Macro economically all households will benefit from the increased spending levels.

An equal opportunity strategy!

1. Some economic variables

A purchase of a home in the U.S. -or for that matter in other countries- combines a savings and usually a debt element. In the run up to the Great Recession, U.S. financial institutions became greatly involved in the securitization of such mortgage debt.

According to Investopedia[1]: "Securitization of mortgage debt in bond-like investments such as mortgage-backed securities and collateralized debt obligations was a main cause of the financial crisis. Securitization of home mortgages fuelled excessive risk-taking throughout the financial sector, from mortgage originators to Wall Street banks. When U.S. housing prices began to fall, mortgage delinquencies soared, leaving Wall Street banks with enormous losses on their mortgage-backed securities. By 2005, subprime mortgages represented nearly a third of the total mortgage market up from 10% two years earlier."

When a bubble burst, as it did in 2007 and 2008, there are three types of losers: the first two groups were the lenders and investors. They lost out, but the third group were the home equity savers. On purpose, the word savers rather than borrowers has been used to illustrate that the purpose of taking out a mortgage signifies that nearly all households have as an aim to save up, often over 30 years, the full amount of the home purchase price. It is undeniable that some homebuyers were speculators, but on the whole most of the buyers were owner-occupiers. It was most likely the case that the households who could afford such speculation had sufficient funds; such households were likely to have originated from the upper income and wealth levels.

One clear result from this period (2007-2012)- was a substantial savings loss in aggregate for households. As mentioned in a previous paper: "U.S. Households Balance Sheet and the link to economic policies"[2], U.S. households collectively had a real estate assets market value level of $24.15 trillion in Q4 2006. This level dropped to $17.93 trillion by Q1 2012 and increased to $30.85 trillion by Q3 2020

1https://www.investopedia.com/ask/answers/041515/what-role-did-securitization-play-us-subprime-mortgage-crisis.asp

[2]https://mpra.ub.uni-muenchen.de/104369/

In a recent study by Mr. Mendoz-Carbajo, -a senior researcher at the Federal Reserve Bank in St. Louis- on "How recessions impact household net worth"[3] evidence was provided that during previous recessions, including the 2007-2017 one, the bottom 50% of households did adjust more slowly then the top 50%. The lower income 50% of households suffered much more from the Great Recession and from previous recessions than the top 50%. As will be set out later in this paper, the main reason lies in the difference in savings levels.

One may start with the unemployment experience during the last recession. The starting point was in December 2006, when the unemployment level was 4.4%. It took to April 2017 to return to this level of unemployment.[4] This is just one example of an adjustment period of over 10 years.

Why do the bottom 50% of U.S. households suffer more from a recession than the top 50%. The clear answer lies in the accumulated net wealth factor. The Federal Reserve publishes wealth distribution statistics.[5] For the bottom 50% of households, Q1 2007 showed a peak in wealth terms of $1.41 trillion. It took to Q3 2017 to reach the same amount of wealth again. For the group 50-90% of wealth, their combined wealth at Q1 2007 was $20.81 trillion and by Q3 2017 their wealth had grown to $28.03 trillion. At Q1 2007, the top group of 90-100% of households, had a wealth level of $43.91 trillion, while their wealth level improved to $67.10 trillion by 2017 Q3.

Again, these data clearly demonstrate how different wealth groups have such different adjustment rates. During the Great Recession, for the bottom 50% of households the level of wealth dropped steeply and increased slowly with the ultimate effect of 0% growth over the more than 10-year period. For the 50-90% of households, their wealth levels improved by 34.7%, while for the top 10% their wealth levels improved by 52.8%.

The main conclusion out of the above is that the top 50% of wealth groups in the U.S. can more quickly and more easily adjust to the effects of a recession while the bottom 50% struggled for a long time to get back to the starting point of Q1 2007. For the latter group the struggle took over 10 years. The main difference between the groups was and is: the top 50% usually has wealth and incomes out of wealth, plus often a well-paid job. The bottom 50% needs a job to survive and pay the bills and occasionally has some savings. However most of such savings are often locked up in pension funds and/or into their home equity.

---

[3] https://www.stlouisfed.org/on-the-economy/2020/november/recessions-impact-household-net-worth

[4] https://fred.stlouisfed.org/series/UNRATE/

[5] https://www.federalreserve.gov/releases/z1/dataviz/dfa/distribute/chart/#range:2005.3,2020.3;quarter:124;series:Net%20worth;demographic:networth;population:7;units:levels

2. Shortening the adjustment period for the bottom 50% of households

The corona virus crisis is the most serious threat both to health and in economic terms. One cannot predict how fast the virus will continue to spread and how fast the U.S. population will recover with the help of a vaccine. The latest November data from the Federal Reserve[6] depicted a seasonally adjusted unemployment level of 10.735 million unemployed. Almost the same level was reached in November 2013 at 10.787 million unemployed. If the past has any guidance for the future: in November 2006 the level of 6.872 million unemployed was measured, which might indicate that the current recovery has still a few years to run.

What has changed since 2006 and after the Great Recession? The U.S. House of Representatives and the Senate concluded that substantial changes had to be made.

2.1 The Dodd Frank Wall Street Reform and Consumer Protection Act

The successful initiative of two Congressmen, Senator Dodd and U.S. Representative Frank, showed that in previous years there had been a number of failings in dealing with households' savings levels, mainly by the financial sector and in the oversight role by the Administration.

After substantial discussions in both the House of Representatives and in the Senate the so-called Dodd Frank act was passed. President Obama signed this act on 21 July 2010.

The stated purpose of the law was to create a sound economic foundation to grow jobs, protect consumers, rein in Wall Street, end bailouts, end too big too fail corporations, and prevent another financial crisis.

The comprehensive law provided for new regulations affecting U.S. banking, securities, derivatives, executive compensation, consumer protection and corporate governance. It was estimated that there would be a minimum of 250 new regulations emerging from the Act, as well as 67 reports and studies on various aspects of the financial services industry, and 22 new periodic report requirements.

The law also created the Consumer Financial Protection Bureau, the Office of Financial Research and the Office of National Insurance, all under the auspices of the Department of the Treasury. It also created the Financial Stability Oversight Council, which is chaired by the Federal Reserve Board Chairman.

[6] https://fred.stlouisfed.org/series/UNEMPLOY/

In addition to the new agencies, other federal agencies tasked with creating new rules and conducing studies include the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Federal Reserve, the Federal Trade Commission, the Government Accountability Office, the Department of Housing and Urban Development, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Treasury.

Since 2010, one fact -among many- is that the implementation of the Act very much reduced the excesses of a new home mortgage-lending spree. Less doubtful debtors were registered: an outstanding success!

2.2 What has been done and what action is still missing?

Actions already taken post 2008 recession by the Federal Reserve

The interest rate setting instrument: The Fed funds rate[7] was used quite often over the period from 2004 to August 2020. In May 2004 the level was 1%, in August 2006 it was reset to 5.25%, in November 2008 it was dropped to 0.39%, by January 2010 it was lowered to 0.11%, by April 2019 it was raised to 2.42% and finally by August 2020 it dropped to 0.10%.

Another main activity of the Fed was and is its program of Quantitative Easing (Q.E.) The Fed had a balance sheet total of $870 billion in August 2008. Its latest balance sheet total of 14th December 2020 now stands at $7.362 trillion.[8] It is obvious that Q.E. has totally changed the funding sources for the U.S. government and for the government sponsored mortgage lending institutions like Fannie May and Freddy Mac. What Q.E. helped to achieve was its effect on interest rates; the latter were kept low as the Fed funded part of the demand for U.S. government debt.

Over the last 12 years U.S. government debt increased from 09/30/2008 with an amount of $10.0 trillion to 09/30/2020 outstanding debt of $26.9 trillion.[9] The Fed's share of funding the increase in U.S. government debt or related debt was just over 38% during this period.

[7] https://fred.stlouisfed.org/series/fedfunds
[8] https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm
[9] https://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm

Households

As aforementioned, attention was drawn to the fact that the bottom 50% of households by income level was more vulnerable to fluctuations in economic activities. The top 50% had it easier and gained much more in wealth during their recovery period.

The bottom 50% of U.S. households depend nearly totally on being employed in order to pay for daily outgoings, including mortgage payments. It would be wise to consider an economic set up whereby such employment levels are supported: an equal opportunity strategy, notwithstanding different savings levels.

The key for such a system lies in the wealth distribution among households. Households that have accumulated sufficient wealth in their homes can be offered to spend some of those savings at no cost to the household apart from agreeing to "re-save" such amounts over time. Such a system could be called the TESSA system, which stands for Temporary Equity Spend and Save Again system.

2.3 The TESSA System

The objective of the TESSA system is to help the collective of households to consume more at times of a recession. The basis for such additional consumption is not based on borrowing more –either by a household or by the U.S. government- but in converting some home equity temporarily into cash. Such conversion can be made with the help of a different type of Quantitative Easing: QEHE.

Why a TESSA system?

The first reason is that unemployment represents an economic loss: the higher the level of unemployment the more substantial the economic loss becomes. The second reason is that unemployment does not affect all households equally. Those in the top 50% of the accumulated savings levels have usually a sufficient level of financial resources (savings) to continue their consumption levels, albeit perhaps at a somewhat reduced level. Those becoming unemployed and in the bottom 50% of incomes are usually hit on three fronts:

Firstly, they experience a sharp drop in income from an already modest income level, which often is making it difficult to continue servicing their debts.

Secondly, many of them are forced to move out of their homes either because the mortgage payments or the rent levels become too high compared to their income levels. They often end up in Recreational Vehicle parks or trailer parks of which there are over 100,000 such parks in the U.S according to

Wikipedia. The latest U.S. Census registered more than 20 million persons (6% of the U.S. population) living in trailer parks.

The third reason is house price developments and the outstanding mortgage levels. The Federal Reserve publishes data on the median house price development.[10] The median house price in Q1 2007 was $257.400; by Q1 2009 this median house price had dropped to $208.400 or a drop of 19%. Link the number of people unemployed[11], which in January 2007 stood at 7.116 million and by January 2009 had increased to 15.098 million individuals. For many lower income households, especially for those who had bought a home after 2005, the drop in house prices, the increased mortgage payment levels as a consequence of teaser rates coming to an end, coupled with the substantial rise in unemployment levels was for many the nail in the coffin economically speaking. They had or were forced by the lenders to give up the ownership of their home. Others became late with their rental payments. Many landlords forced them out their rented place.

A TESSA system, if it had been in place in 2009, would have made a difference in a number of ways:

1. Source of funding: Historically the sources of funding to counteract a recession have come from U.S. government spending at a level above its tax revenues; so much so that since the start of the Great Recession government debt to GDP has increased from Q3 2007 at 61.97% to Q3 2020 at 127.3%.[12] As aforementioned the increase in government borrowings since 2008 was for 38% met by the Federal Reserve's Quantitative Easing activities. Neither Government borrowing nor more Quantitative Easing of this type can go on indefinitely. The TESSA system is based on using a different source of savings: use some home equity owned by individual households to be converted by the Federal Reserve into cash on a temporary basis.

2. If this TESSA system had been in place in 2008 and if the acceptance level of U.S. households would have been sufficient, then the period of adjustment to the U.S. economy would have been much shorter and the unemployment levels would have come down much faster. The U.S. government would have borrowed less and see their tax receipts increased. Private sector companies would have had the benefit of a higher turnover level and most likely a higher level of profits, which would have made stock market prices go up, which would have helped the pension funds in their performance.

[10] https://fred.stlouisfed.org/series/MSPUS
[11] https://fred.stlouisfed.org/series/UNEMPLOY/
[12] https://fred.stlouisfed.org/series/GFDEGDQ188S

2.4 What are the possible parameters in order to make QEHE work?

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

2. Requests can also originate from homeowners who rent out properties. However there need to be limits regarding such equity conversion. It is probably wise to limit such cash withdrawal to less than 30% of the net equity position in a home.

3. For homeowners-occupiers the request might not be approved if it lowers the equity level in a home to less than 10% of its value. Any value below 10% might encourage households to walk away from their obligations under the agreement with the Fed. Any value above 10% can potentially be considered, but the combined households 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 house prices might be "affected" by the occurrence of the coronavirus; a non economical influence.

4. Many young persons and low-income earners face the greatest hardship as a consequence of the coronavirus. 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 Fed 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 Federal Reserve may also decide to make Q.E. 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 (about 50% are funded by state sponsored enterprises anyway) 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; in line with the economic growth trajectory.

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.S economy is booming, 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.S. government might need to determine the eligibility of households to participate in the TESSA System. Should the maximum income level eligible for the TESSA System be set at the median income level of $65,000 or at twice this amount at $130,000? Should there be regional variations?

11.The U.S. government may also need to decide to what extent it wants the TESSA System to contribute to the U.S. 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. One has closely to watch to what extend homeowners convert the savings cash received into other savings types. The purpose of the QEHE facility is to increase consumption; not to invest in the stock markets or in additional pension pots.

12. The TESSA System allows the U.S. Fed to turn the tap off when releasing home equity which is no longer needed and turn the tap back on when it judges the economic circumstances are appropriate. Such tap management is an important mechanism for managing inflation levels. In case the amounts provided cannot be absorbed by the commercial sector without causing undue inflation pressures, then the Fed could accept household's applications, but manage the pay-outs in line with the propensity of the commercial sector to absorb the increased demand.

13. The TESSA account could be an account set up by the household's principal bank on the request of the homeowner. 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 Government given that the scheme is in the macroeconomic national interest.

14. Some homeowners might abuse the TESSA account. Therefore, if a homeowner does not fulfil its contractual obligations in "re-saving" the principal amount when due, he or she may be penalized by turning the facility into an ordinary mortgage with penalty interest rates.

15. In line with previous arrangements, the Government could give a guarantee to the Fed for potential losses made on the scheme for 10% of the outstanding amount.

16. In order to implement the above, the U.S. Congress may have to draft a new law that gives the powers to the Federal Reserve to start a QEHE program.

17. The QEHE system allows the economy to be managed by region, by inflation level, and by the state of the economy. It represents economic growth for all, but especially for the bottom 50%. The only additional action needed is to regulate that households cannot use the funds to speculate on the stock markets, as this means moving funds from one savings category into another.

3. Concluding Remarks

The aim of this paper was and is to show that there are ways to shorten the adjustment periods. The corona virus has created another recession. Therefore the question of what to do and by which U.S. institution is a timely question. One does not want another 10 years of economic adjustment, but preferably a much shorter one!

Equal opportunity economics does not mean collective ownership of the means of production. Equal opportunity means stimulating the economy in a manner so that all households can benefit from its economic growth levels. A recent Time Magazine article called it "Economic Dignity economics" written by Gene Sperling.[13]

The largest U.S. savings schemes are in pension savings and in home equity. By 2019, U.S. individual households had accumulated a pension savings level of $32.3 trillion and a home equity savings of a net $19.656 trillion; which together account for $52 trillion. With a U.S. GDP level of $21.427 trillion in 2019 and a U.S. government expenditure level of $7.35 trillion, one may notice the multiples. The two types of savings alone were worth 2.4 times 2019 GDP and over 7 times U.S. government expenditure levels.

Against this background, the current trend of adding government debt over and above the government revenues level is ultimately an untenable position. Such debt represents a future claim on all households. The history of Q.E. has shown that in whatever country it has been applied; U.S., U.K., E.U., Japan there has only been one way that Central Banks have gone; they nearly all bought their own country's government debt or government related debt.

Japan[14] has literally been the birthplace of Quantitative Easing (QE). In an article by Sean Ross for Investopedia and updated on June 25, 2019 it describes the diminishing effects of QE on the Japanese economy. The over 20 years of QE

[13] https://time.com/5923934/unifying-power-economic-dignity/
[14] https://www.investopedia.com/articles/markets/052516/japans-case-study-diminished-effects-qe.asp

experience does not bode well for showing that economic growth levels respond well to larger and larger volumes of QE.

In the U.S., the introduction of a different type of QE, namely QEHE, would pave the way to Equal Opportunity Economics, or in short EOE. It would use existing home equity savings to be converted into cash at a speed that would not encourage increased inflation levels. It's pricing at 0% interest rate is important, so as to provide the savers with the full value of their savings. Existing methods by private financial sector providers do not and cannot supply such funds at 0%, only the Federal Reserve can. As private providers have to borrow the money from the financial markets, their costs of funds make it impossible to offer 0% interest rates. However, households suffer if the full value of their home equity savings is undermined by having to accept a substantial discount due to the interest amounts being charged for the conversion.

There is a way to manage the U.S. economy, by using households own home equity savings.

Let Equal Opportunity Economics be the guide!

Kees De Koning

Chorleywood U.K.

3rd January 2021

References

Investopedia, New York City: What role did securitization play in the U.S. subprime mortgage crisis; updated June 30, 2020 https://www.investopedia.com/ask/answers/041515/what-role-did-securitization-play-us-subprime-mortgage-crisis.asp

De Koning, Kees; U.S. households balance sheet and the link to economic policies; MPRA paper 104369; https://mpra.ub.uni-muenchen.de/104369/

Diego Mendez-Carbajo, Senior economist, Federal Reserve Bank of St. Louis; How recessions impact households' net worth; November 23, 2020
https://www.stlouisfed.org/on-the-economy/2020/november/recessions-impact-household-net-worth

Federal Reserve Bank of St. Louis: Unemployment level statistics: various years;
https://fred.stlouisfed.org/series/UNRATE

Federal Reserve Washington D.C. Net worth distribution by cohorts of U.S. population: 0 to 50%; 50 to 90%; top 10%
https://www.federalreserve.gov/releases/z1/dataviz/dfa/distribute/chart/#range:2005.3,2020.3;quarter:124;series:Net%20worth;demographic:networth;population:7;units:levels

Federal Reserve Bank of St. Louis: Unemployment numbers: various years
https://fred.stlouisfed.org/series/UNEMPLOY/

Federal Reserve Bank of St. Louis: Fed funds interest rates
https://fred.stlouisfed.org/series/fedfunds

Federal Reserve Washington D.C.; Monetary Policies: Quantitative Easing
https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

Federal Reserve Bank of St. Louis: Median house prices in the U.S.
https://fred.stlouisfed.org/series/MSPUS

U.S. Treasury; Washington, D.C. Historical U.S. Government debt levels
https://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm

Federal Reserve Bank of St. Louis: U.S. Government debt to GDP levels
https://fred.stlouisfed.org/series/GFDEGDQ188S

Time Magazine, New York; Gene Sperling; 22/12/2020: "Democrats should unify behind the idea of Economic Dignity"
https://time.com/5923934/unifying-power-economic-dignity/

Investopedia, New York City: Sean Ross; updated June 25, 2019; The diminishing effects of Japan's Quantitative Easing
https://www.investopedia.com/articles/markets/052516/japans-case-study-diminished-effects-qe.asp

.