How can household wealth be used to stimulate economic growth. The Italian example.

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Introduction

The Eurozone countries share a common currency: the Euro operated and managed by the European Central Bank (ECB). The implications are that savings and wealth levels are also denominated in the same currency.

Does this mean that wealth factors like home equity and pension savings can be transferred between countries?

The simple answer is that homes are located in a particular country and cannot be moved between countries. Savings for future pensions are also made in a particular country, but the investments can be spread over different categories of investments and over different countries. Money is mobile, but the saver usually is not.

In developed countries, like Italy, home equity and pension savings represent a multiple of annual Government revenues. In 2019 pension savings in Italy were €656.6 billion and the country's total home equity can be estimated at €4.3 trillion. With Italy's government revenues in 2019 of €758 billion, the fact that nearly €5 trillion of wealth in aforementioned two categories combined, represents a multiple of 6.6 times the Italian government annual revenues.

In 2019, Italy's government revenues were 42.4% of GDP, ranking it as the fifth highest country out of 35 countries in the OECD ranking of government revenues compared to GDP. On the other hand, households mortgage borrowings were low and stood at 22% of GDP in 2019, or at nearly €390 billion. 72.4% of Italians own their home.

The real question Italy might need to consider is: "How can the Italian economy be stimulated without continuing to rely on more government funding, especially when this funding, due to the corona crisis, has already reached the level of around 135% of GDP?"

A possible answer lies in a different Quantitative Easing type: QEHE, which stands for "Quantitative Easing Home Equity". This system does not need more government borrowing; instead it relies on homeowners to convert some of their home equity savings into cash on a temporary basis. It may need the European Central Bank to co-operate as the currency in use is the Euro. How such system of a: "Savings Release and a Savings Replace Method" could work will be set out in this paper.

1. Italy and its economy

In its country reports, the OECD compares[1] the economic status of each member state. One conclusion in this report states stands out: "Higher growth in Italy is needed to improve the fiscal position in the near term."

In a different OECD report, Italy ranks in 5th highest position[2] out of fifteen European countries when it comes to tax revenues as a percentage of its GDP with a level of 42.4% of GDP. In the category taxes on income and profits the country ranks 7th highest out of the 15 countries compared in 2019. With respect to social security contributions as a percentage of GDP, Italy comes 5th highest with 13.3% of GDP. Finally in property taxes, Italy comes 5th highest with 2.4% of GDP.

In the 2017 worldwide ranking of government debt to GDP level by Wikipedia[3], Italy comes in with the 5th highest ratio among 199 countries at 131.2%, after Japan, Greece, Lebanon and Yemen.

A report from the European Mortgage Federation[4] provides more insight into the actual mortgage activities. Three key items are: "outstanding loans to disposable income ratio" which for Italy showed a ratio of 32.1% and for the combined EU 27 countries one of 62.9%. The second measure of affordability stems from outstanding residential loans per capita over 18 years of age. For Italy it came to €7,480 in 2018 and €7,549 in 2019. For the EU 27 countries the average was €16,165 in 2019. The third measure was the total outstanding residential loans, which for Italy came to €379.054 million in 2018 and €382.583 million in 2019. For the EU 27 countries in 2019 the total mortgage lending was assessed at €5.905 trillion.

If one compares the outstanding home mortgage level in Italy with the outstanding home mortgage levels for the other 26 European countries on a per capita basis (Italy with 60.55 million citizens and the other 26 countries with 453 million citizens) then the Italian mortgage level could have been €789 billion or just more than twice the level of existing home mortgages. This just reflects the average situation and not the highest levels.

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1 http://www.oecd.org/economy/italy-economic-snapshot/
2 http://www.oecd.org/statistics/compare-your-country.htm
3
https://en.wikipedia.org/wiki/List_of_countries_by_public_debt#:~:text=Public%20debt%20as%20%25%20of%20GDP%20%20,%20%20%20%2040%20more%20rows%20
4 https://74a0072f.flowpaper.com/HYPOSTAT2020FINAL/#page=90

The conclusion out of this comparison is that Italy has a much lower home mortgage debt rate per capita than the average 26 other EU countries combined. One explanation could be that in some areas of banking, the Italian banking sector faces more difficulties than in other countries. In Italy, the average length of time to get the courts to agree that a mortgagee has become a doubtful debtor may well take five years or more.

However, the upside is that Italian households have on average a higher level of home equity than in many other European countries.

2. The Italian dilemma

According to the Banks EU[5]: Italy's GDP (nominal GDP 2019) was €1,787.7bln (+0.02%)

Its nominal GDP per Capita was (2019) €29,610 (+0.02%)
Real GDP Growth in 2019 was 0.3 % **(2018: -0.9 %)**

Italy underperformed the European Union in terms of real GDP growth with the average annual differential coming to -0.9% over the past 10 years (2009 - 2019). In 2019 real GDP growth was 0.3%, which was below the Euro Area average (1.2%) and below the European Union average (1.5%).

The dilemma for the current Italian government is that it has inherited a high level of government debt as compared to GDP. Further increases in government debt –even taking into account the negative effects of the corona virus crisis- can only be achieved by moving the debt levels slowly upwards. Italian households tax rates are already on the higher side as compared to other European countries. An increase in "transfer taxes from households to the government" does not necessarily mean more spending on a macro level. An increase in tax levels shows up as a transfer between the private sector and the government. Such a move would be made against the background that if the latter go up, household-spending capacity is likely to come down: an economically unattractive move under the current existing government debt levels.

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5 https://thebanks.eu/countries/Italy/economy#:~:text=In%202019%2C%20nominal%20GDP%20per%20capita%20in%20Italy,over%20the%20past%2010%20years%20%282008%20-%202018%29

Italy is lucky in that it has a major source of wealth, which is incorporated in the housing stock. If Italy had the average mortgage level of the other 26 countries in Europe, it would have a country level of home mortgages of some €789 billion rather than the €383 billion: a €406 billion difference.

2.1 Using the housing stock wealth on a temporary basis

The savings locked up in home equity are unlike savings in bank accounts; access to this source of wealth is generally more difficult. There are a number of reasons for this. The first one is that the starting point in buying a home is that two payment elements are merged into one: a cash equity payment out a household's owns savings and a home mortgage bank loan. The second variable is embedded in the monthly payment to the lender. Such payment nearly always includes the mortgage interest charged and an additional amount that reduces the outstanding mortgage level. The latter element constitutes the savings set aside out of income levels. The loan amount shrinks and the savings amount in the home increases over time.

In a number of countries there are financial institutions that specialize in home equity release. The main drawback of such schemes is that they do not regard home savings equity equal to cash; these companies charge the user for their services as a lender. The owner of the home equity has to pay for the provision of such cash: such a cash conversion reduces the value of the savings. The longer the period of conversion the greater the discount is on the value of the home equity savings.

In a paper on the Italian opportunities for equity release,[6] Dr Claudio Del Giudici sets out the rules and regulations for such release. The fact that only a limited number of Italian banks offer the option shows that these methods are not widely applied in Italy.

There is however the possibility for a different option: The "Home equity savings release and savings replace method"; in short one may call this the Herm method.

3. Why using home equity in Italy?

The corona crisis has delivered an economic blow to nearly all countries in the world. Economic activity in Italy has dropped, so have government tax receipts over 2020. For 2021, one may expect such tax receipts to be lower than in previous years. On the other hand support to vulnerable groups will have increased, making it even harder to reduce the budget deficit.

[6] https://www.italy-uk-law.com/italian-news/italian-property-equity-release-an-outline/

ISTAT (Italy's Statistical Agency) estimates that Italy's GDP has dropped by 8.9% in 2020 and will make a recovery by +4% in 2021. However unemployment levels are forecast to rise to 11% in 2021.[7]

At the beginning of 2015, the ECB did not have any outstanding amounts under its Quantitative Easing programs. The world has since changed dramatically as by end December 2020, the ECB's QE programs had accumulated to an outstanding €3.048 trillion and the trend line has been upwards. In the U.S. the QE program started in 2008[8], when the Fed had a balance sheet total of $870 billion. According to the latest data of January 2021, the current QE outstanding is $7.414 trillion and more QE is planned for 2021. The Fed's share of total outstanding U.S. government debt is now 16.5% up from 0% in 2008.

What all these QE programs have in common is that their focus is on funding government debts. The main drawback is that when government programs help households to increase their consumption levels by giving them government subsidies to do so, these programs have no in-built repayment schedule mechanism, other than relying on increases in future tax intakes.

The two main reasons to utilize a temporary home equity release program in Italy is that further extending existing QE programs to help the poorer sections of the Italian economy, including those sectors strongly affected by the corona virus crisis, will require more QE funding from the ECB. The latter might be unwilling or make more onerous conditions to such funding than is necessary. A related fact is that ultimately such funds need to be repaid by the Italian taxpayers, who currently are already paying some of the highest taxes in the Eurozone.

A alternative is to go for an Italian home equity release program. This is a domestic Italian matter as the home equity savings are incorporated in homes in Italy and nowhere else. If the ECB is prepared to fund such QE program without conditions attached other than that it will be the responsibility of the Bank of Italy to manage the "resavings" out of which the ECB will be repaid, then such system could be set up. If the ECB is unwilling to agree to such terms, the Bank of Italy could go it alone in a QE program, by creating Italian Lira for which the Bank of Italy maintains a fixed rate to the Euro of one to one.

Using home equity to stimulate the Italian economy is a useful tool, as it provides cash to homeowners at times of low economic growth rates. Such cash can be used by households for purchases of goods and services to the liking of the homeowners. Households use their own savings for their own benefits. When good times return, the same household will start to "resave" the amounts back to the original amount and the domestic QEHE will reduce in size.

[7] ISTAT (Italy's Statistical Agency): https://www.istat.it/en/archivio/251218
[8] https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

Such demand injections from QEHE will stimulate economic growth; will increase employment opportunities and will ultimately increase government tax intakes, without having to change the tax rates. This represents a win-win situation for the whole of Italy.

3.1 The TESSA System

The objective of the TESSA system: a Temporary home Equity Spend and Save Again 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 Italian 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, which stands for Quantitative Easing Home Equity.

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, some 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.

The third reason is house price developments and the outstanding mortgage levels. In Italy: 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 the Italian government in spending at a level above its tax revenues; so much so that since the start of the Great Recession (2007), government debt to GDP has increased from 103.9% in 2007 to 134.8% in 2019. The latest preliminary indications are for a further deterioration due to the corona virus crisis.

2. If this TESSA system had been in place in 2008 and if the acceptance level of Italian households would have been sufficient, then the period of adjustment to the Italian economy would have been much shorter and the unemployment levels would have come down faster. Italy'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.

3.2 What are the possible parameters in order to make QEHE work for Italy?

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 Bank of Italy. 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 Bank of Italy 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 Italy 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 Italian 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; 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 Italian economy is showing a satisfactory growth path 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 Italian 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 €44,640[9] or at twice this amount at €95,280. Should there be regional variations between the North and the South in Italy?

11.The Italian government may also need to decide to what extent it wants the TESSA System to contribute to the Italian 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 Bank of Italy 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 Bank of Italy could accept household's applications, but manage the pay-outs in line with the propensity of the commercial sector to absorb the increased demand.

[9] http://www.salaryexplorer.com/salary-survey.php?loc=105&loctype=1

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 Italian 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. One element to facilitate that such disputes can be settled quickly is to draft a special law dealing with such potential situations.

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

16. In order to implement the above, the Italian government may have to draft a new law that gives the powers to the Bank of Italy 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% of households. 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.

4. Concluding Remarks

The aim of this paper has been to demonstrate that there are ways to shorten the adjustment periods after a crisis. The corona virus has created another recession. Therefore the question of what to do and by which Italian 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.

The largest Italian savings schemes are in pension savings and in home equity. By 2019, Italian households had accumulated a pension savings level of €656.6 billion and a home equity level of €4.3 trillion, representing a multiple of 6.3 times Italy's government tax intake in 2019.

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 and that is that Central Banks have nearly all bought their own country's government debt or government related debt.

Japan[10] 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 such government intervention.

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[10] https://www.investopedia.com/articles/markets/052516/japans-case-study-diminished-effects-qe.asp

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