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# **The risk of a recession period in the U.S. and the possible role of home equity**

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## Introduction

In a fascinating report by the Bank of International Settlement (BIS)<sup>1</sup>, the BIS analysis demonstrates how the inflation levels, especially of food and energy prices, have affected the behaviour of households and workers. This applies not only to the U.S., but it is a widespread phenomenon in many countries. When households' income levels are eroded, households will seek to recover their wage levels either from employers or from a government.

As the BIS mentioned in its report, in many countries the negotiations about the needed higher income levels to overcome the erosion of such levels has only just begun. The BIS concludes that cost plus inflation pressures become stronger when the cake becomes smaller.

The uncertainties in the economic development of the U.S. and in other countries are growing by the day. Governments are being pressured to accept some of the risks for households by increasing allowances. However as is the case in the U.S. and in many other countries government debt levels have already reached historical highs.

In the U.S., the latest data indicate that U.S. government debt levels have risen to 134.2% of GDP, while this debt level was \$9 trillion or 62 % of GDP in 2007. The more than the doubling level of government debt to GDP between 2007 and 2022 constitutes a main obstacle to a further fiscal stimulus.

What seems an overlooked area of study is the development in U.S. house prices between 2006 and 2022. The Great Recession started from a position of households' ownership in home equity as per Q1 2006 of \$14,173 trillion. Only by Q1 2016 did the home equity level reach \$14,051 trillion again. Since that period the move was upward and upward and by Q1 2022 the level reached \$27.770 trillion.<sup>2</sup>

A policy option that so far has been left to the private sector is funding home equity releases. This is a conversion method of turning part home equity into disposable income. The weakness of this conversion method is the level and unpredictability of future interest rates.

A more sensible solution would involve the Federal Reserve; not in its current position as one of the main providers of cash to the U.S. Government, but through a supply program of cash to homeowners. How this could work is explained in this paper.

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<sup>1</sup> Bis Annual Economic Report 2022

<sup>2</sup>

[Owners' Equity in Real Estate, Level \(OEHRENWBSHNO\)](#)

## 1. The U.S. economy and home equity loans.

Households can usually obtain a home mortgage. Lenders usually consider two factors before approving such a loan. The first one is the amount of savings that the future homeowner can contribute towards the home purchase price and secondly the income and earning status of the future homeowner.

What did change since 2007 was the appetite for U.S. households to take on mortgage debt. According to the Fed's Owners' Equity in Real Estate level, over the period Q2 2006 to Q4 2011, U.S. households lost collectively \$5.84 trillion in home equity values. Only by Q1 2016; practically 10 years after Q2, 2006 had households saved enough again to overcome this huge loss. The latest date of Q1 2022 shows that households continued to save and increased their savings with a further \$13.719 trillion in home equity. The latest home equity level stands at \$27.772 trillion as of Q1, 2022.

What is striking is the development of U.S. government debt over the period 2006-2022 as compared to U.S. GDP. In 2006 the government debt as a percentage of GDP was 61.55% and by Q1 2022 the debt level had grown to 124.66% of GDP.<sup>3</sup> Over the year 2021, the U.S. GDP level was estimated at \$23 trillion. Equally striking is -of course- the accumulated home equity level in the U.S. of \$27.772 trillion according to the latest statistics.

Another statistic shows the changes in the Federal Reserve balance sheet from September 1, 2008, and 19<sup>th</sup> July 2022. On the first date, the Fed had an outstanding portfolio of \$905 billion. By the 19<sup>th</sup> of July of 2022 this portfolio had grown to \$8.913 trillion: an \$8 trillion increase. This increase was nearly all caused by Quantitative Easing activities.

What has home equity to do with QE activities? Superficially nothing as most of the QE activities has had the U.S. government as its counterpart. But after further thought, perhaps the link between the future tax obligations of households and QE activities are much stronger than expected. Most of the QE funding provided to the U.S. and State governments has been used already. While some groups of households may have benefitted from the expense programs, directly or indirectly, the fact is that the U.S. government debt level has gone up with some \$8 trillion, to be repaid by taxpayers in future years.

## 2. Home Equity and Pension Savings in the U.S.

When economists and banks discuss home equity, the discussion nearly always focusses on two items: What is the size of a loan that can be granted and what are the prospects for a homeowner to pay off the remaining debt within a manageable period. It is the lending side that get most of the attention in this process. Home equity is rarely discussed in the context of how much home equity households have accumulated. The other question that is rarely

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<sup>3</sup> <https://fred.stlouisfed.org/series/GFDEGDQ188S>

raised is what -on a macroeconomic level- can home equity contribute to an economic recovery.

On top of the collective home equity levels held by U.S. homeowners, households have also accumulated a substantial savings level in pensions provisions. According to the Fed<sup>4</sup>, U.S. households have built up a pension savings volume of \$23.388 trillion as per Q1 2020. Once a person retires, their pension savings are repaid over their lifetime. Such payments are directly linked to the beneficiaries and therefore pension savings do not need a further discussion in this paper.

What is certain is that for many U.S. households the two main savings categories; home equity plus their pension savings constitutes by far the largest share of their net worth.

### 3. A proposal to use home equity as an economic growth tool.

The Fed has as one of its most important tasks to keep inflation levels under control. In doing so, its base rate has been adjusted already and probably needs to rise further. A higher level of Quantitative Easing does not fit easily in such an approach. Buying up more U.S. government debt is becoming more questionable. However, belt tightening for all households and for businesses will slow down demand levels.

A good example is linked to the Great Recession. Looking back to the Great Recession period, perhaps the main mistake which led to a recovery period of nearly ten-years was that the private financial sector was the driver of the “recovery” in the housing market. Households lost over U.\$ 5.84 trillion in this process. Home equity savings were not regarded as a tool to bring lower and median income earners out of poverty.

The current rapid rise in retail prices is forcing households again to look at all their savings. Most or nearly all these savings are locked up in home equity and pension savings. The latter cannot be withdrawn before a retirement date. For 60% to 70% of households the only category of savings to help in the current high inflation environment are home equity savings.

The U.S. government directly and the Federal Reserve indirectly are already heavily involved in the U.S. housing market. Three state owned organizations come to mind: Freddie Mac, Fanny Mae, and Ginny May. Their current roles involve home mortgage lending.

In the current climate of fast rising prices, the general state of household’s finances in the U.S. would benefit from some temporary conversion of such home equity into cash. Not by moving in and out from one home to another, but by staying in the same home and simultaneously being able to get some additional cash support from the stock of wealth accumulated in their home.

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<sup>4</sup> <https://www.federalreserve.gov/releases/z1/20200611/html/l117.htm>

The type of support that the bottom 60% to 70% of U.S. households and homeowners could use is the ability to convert some home equity into cash, not as loan, but as a creator of demand. The main reason to involve the three above-mentioned state-owned organizations is that they are State owned and that they are well versed in advancing sums of money and recouping those sums in future years.

The aim of this type of facility is to transfer -on a temporary basis- a small part of the homeownership savings to any of these organizations with the aim for households to resave in future years as and when the U.S. economy has recovered.

To stimulate the use of such facility, the Fed could decide to make such funds available at a temporary 0% interest rate until the economy has recovered.

A key consideration could be that current home equity levels have been reached after households did pay all types of income and other taxes. Savings in home equity were not made from pre-tax incomes but from incomes after taxes were paid. In the past, various U.S. governments did encourage home ownership with some regulations to stimulate such savings.

Looking back to the Great Recession period, the main mistake which extended the recovery to a nearly ten-year period was that the private financial sector was the driver of the recovery of the housing market. Households lost over U.\$ 5.84 trillion in this process and had to save up this amount again, which they did by Q1 2016.

The proposed solution is not to repeat the mistakes made in the past. For that reason, it is recommended that the private sector does not play a significant role in this type of temporary funding. Main reason is that these private sector lenders need to borrow their funding from the financial markets. When the Fed increases its Fed funds rates, these private sector companies will automatically follow. The implication is that households see the value of their home equity levels drop because of the Fed's increased interest rates. Hence the proposal is for the Fed to eliminate this "penalty" element and provide the temporary home equity conversion at 0% interest rate directly with the help of the three Government owned financial institutions.

### 3.1 The macro-economic benefits of a home equity funding scheme

The reason that a household funding crisis arises can be caused by several factors. The causes of the Great Recession were several factors, and an excellent overview of this period has been given by the Institute for Relations on Labor and Employment at Berkely University<sup>5</sup>. In this paper no further elaboration will be added about the Great Recession crisis.

Two elements stand out in the current period. U.S. Households collectively have accumulated a net home equity level of \$27.772 trillion according to the most recent statistics. The

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<sup>5</sup> <https://irle.berkeley.edu/what-really-caused-the-great-recession/>

mortgage debt outstanding over and above the net home equity level was \$14.7 trillion for the family household's category<sup>6</sup>. Home equity plus the home debt levels already constitute a substantial excess over the latest GDP levels of \$24.85 trillion according to the U.S. Bureau of Economic Analysis.

### 3.2. A proposed home equity funding scheme

There are two ways to fund a conversion of home equity into cash. The first one is with the help of the private sector. Lending money to households on basis of some home equity conversion leads to creating a debt obligation. When interest rates are rising due to the decisions made by the Federal Reserve, the claims on households only grow and diminish the home equity share that households have built up over time. This is an equity into debt conversion at precisely the wrong time for U.S. households -and for households in many more countries for that matter. U.S. households are currently exposed to higher levels of inflation than for many years. The expectation is that the Fed will continue to increase its base rates - probably several times- to try to reduce the inflationary pressures.

The increase in base rates has two side effects: Firstly, its aim is to reduce demand levels to a level that is considered the correct level to slow down inflation levels. One can compare this as a decision to increase costs to all households and businesses without any compensation. Price levels need to be brought down to stabilize the U.S. economy. The tool is influencing the cost of money. Under such scheme it is highly likely that jobs will be lost and that some businesses will see their sales levels dropping or worse going bankrupt.

The second side effect is on households' ability to continue spending. When prices rise rapidly, usually wage levels rise more slowly even when unemployment rates do not increase rapidly.

The key question is: Is there a solution that helps U.S. households to keep up with most of their spending levels by using some of their home equity levels. The privately owned financial sector cannot create such solution as it itself is based on raising and lending funds at market rates. However, the Fed can do so with the help of Quantitative Easing Home Equity (QEHE).

For arguments sake, what would for example a \$2 trillion cash injection at 0% rate do to the state of the U.S. economy?

Households will be better equipped to afford the higher prices of all kinds of products and services. Demand levels will be restored to some extent. Less jobs will be lost. The use of some \$2 trillion represent only 7.2% of the value of the U.S. housing stock.

Using these \$2 trillion in the above-described manner will help house prices not to fall into a forced sales scenario, The latter pattern occurred between the years 2007 and 2016.

A home equity funding scheme funded by the Federal Reserve requires much less cash outlay than the current over \$8 trillion in Government debt funding. The home equity scheme has

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<sup>6</sup> <https://www.federalreserve.gov/data/mortoutstand/current.htm>

another benefit in that it is not based on future increases in tax levels. The savings spend and the savings made are both directly linked with the individual household.

It is for these reasons that a scheme that helps households to get some access to their own home equity savings could work well during this time of rising prices. A 0% price tag could be considered for the duration period that the Fed decides that it is the optimal period. There could also be made a choice of homeowners who have the greatest need to participate in such a scheme; for instance, by restricting access to the scheme for instance for the top 30 to 40% of households by income level and for landlords.

Not charging households for the temporary conversion of some home equity into cash will support the U.S. economy when it is at its most vulnerable to a new Great Recession.

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