Munich Personal RePEc Archive

Quantitative easing and the U.K. economy

De Koning, Kees

5 November 2022

Online at https://mpra.ub.uni-muenchen.de/115288/
MPRA Paper No. 115288, posted 06 Nov 2022 08:03 UTC

Quantitative Easing and the U.K. economy

Kees De Koning

5th November 2022

Table of Contents

Introduction: Quantitative Easing and the U.K. economy 3.

Facts and figures 4.

The current level of home equity and affordability 4.

The mobilization of home equity in the U.K. 6.

Some conclusions 7.

References 8.

Introduction:

Quantitative Easing and the U.K. Economy

In the U.K. Quantitative Easing saw the daylight in 2009. In its first phase, which ran from 2009 to 2016, the Bank of England bought U.K. Gilts (bonds in other countries) to an amount of £445 billion, of which £435 billion were invested in U.K government Gilts. The second phase which covers the period from 2016 to to-day raised the level to £ 895 billion, of which £ 875 trillion has been invested in U.K. gilts.

The U.K.'s GDP for 2021 was £ 2.141 trillion. In other words, the £895 billion represents nearly 42% of the total U.K.s GDP of 2021. The total Government expenditure over the fiscal year period of ending in 2021 was £1.094 trillion; the £895 billion represents 81.8% of this year's total U.K. government expenditure. One other fact needs to be mentioned and that is that the total U.K. public sector pension liabilities are not funded but are paid for out of the current public purse. The estimate is that the costs of this decision is at current prices £2.4 trillion, which is 1.12 times the 2021 GDP level or nearly 2.2 times the total Government expenditure level of 2021.

In a recent paper by this author about the U.S.A (MPRA Paper 115 113) entitled: "A U.S. Home Equity Withdrawal Scheme" several suggestions were made[1]. One of these was the suggestion to stop QE activities for funding Government expenditure altogether. Instead, the Bank of England could create a different category of QE, -QEHE-, for helping households to use home equity on a temporary basis at a 0% interest rate.

[1] *RePEc:pra:mprapa:115113*

1. Facts and figures

In the U.K., the latest total housing stock values were £7.56 trillion, and the mortgage debt was £1.648 trillion. This put the net housing stock value at £5.9 trillion. On top of this, U.K. households also did save for a pension to the extent of £6.1 trillion as per March 2018. These two savings categories together represent a multiple of 5.6 times U.K's GDP in 2021!!

Hence the suggestion is to make more use of especially the net values of the housing stock as a means of stimulating the U.K. economy.

A simple approach could be to aim for a temporary injection in year one of £500 billion, which represents about half of the current U.K. government expenditure level and represents simultaneously about 8.5% of the total home equity values. Such funds can be created by the Bank of England under its Quantitative Easing exercises at 0% interest. The Treasury can provide a guarantee to the Bank of England for such facility, just like it does for the past QE activities. As this action represents a funding of net home equity, the risks to the banking sector diminishes over its outstanding mortgage loans. To enhance the U.K. banking sector to participate in this exercise, the latter could be paid a one off 25 basis points for the administration for each client interested in participating in such temporary scheme.

1.1 The current levels of home equity and affordability

Savills U.K. keeps track of the values of homes in the U.K.[2] The company estimates that the total current values of all homes in the U.K. was £7.56 trillion as per March 2021. Of these values London and the Southeast account for £3.19 trillion or 42% of all values.

On the 3rd of November 2022, the Bank of England decided to raise its interest rates to 3%[3]. This was the biggest increase since 1989. Many mortgage holders will be severely affected.

The discussions about what to do about these developments could focus on three elements:

One: The option of doing nothing

This option is not a real option as households are forced to allocate a higher percentage of their household's income to both mortgages and increased day to day prices of everyday goods and services. Not doing something will leave many households in a very perilous

[2] https://www.bing.com/search?q=savills+uk+lvalue+of+u.k.+housing+stock&qs=HS&pq=savills+uk+&sk=HS1&sc=10-11&cvid=33326733C8E34295AB3D83A9F26674BA&FORM=QBRE&sp=2

[3] https://www.thetimes.co.uk/article/muddled-message-on-interest-rates-from-the-bank-of-england-5vvxdpj7z

position as home equity will go down, price rises will exceed income levels and unemployment rates will ultimately also go up.

0ption two: Is helping households.

The usual source of support could come from the Treasury. However, the U.K. Treasury will get less tax income because of the deterioration in people's and companies income levels. It is also likely that unemployment rates will rise and that more people will drop out of the labour force altogether.

Option three: making use of past savings levels.

The one entity that has spent more than its income is the U.K. Government itself. This includes the current and the previous ones. The discussion should not be about the allocation of these resources, which reflect political choices, but about the absolute level. The question is how the U.K. government can induce households to spend more of their own savings in these difficult economic times. The choice is between higher interest rates, higher taxes, and smaller government deficits on the one hand, or a Bank of England sponsored Quantitative Easing Home Equity exercise.

As an example, in the U.S. the home equity savings destruction that took place over the period Q4 2005 to Q1 2012 made American households lose $6.1 trillion in home values. This amount represented a 42.4% of the peak value of $14.375 by Q4 2005. Only by Q2 2016 had the home equity level reached the level of Q4 2005 again: an adjustment period of well over 10 years.

What makes option 3 so attractive in economic terms is that such action does not require an increase in government debt levels; it does not need a change in its interest rate policy, and it creates a flexible system to help households to use past savings in home equity, just like the situation as if their savings were stored in bank deposits.

In the introduction it was already mentioned that the two main savings categories: pension savings and home equity ones are together already worth about 5.6 times U.K's GDP level. More importantly such savings can be mobilized.

2. The mobilization of Home Equity in the U.K.

The recommendation to choose home equity over and above pension savings is that the latter constitute the money pot for life in later years. In the U.S., households are allowed from the age of 55 to withdraw 25% of their pension pot in one go and once only. Perhaps the U.K. government could consider a similar mechanism for U.K. households.

The net value of the U.K.'s current housing stock value is £ 5.9 trillion.

A temporary injection of £ 500 billion could be considered in year one. This amount represents about half of the current U.K. government expenditure level. £500 billion constitutes about 8.5% of the total net home equity values. After checking the results of such injection after a year, further plans can be made for the next years.

The funds can be created by the Bank of England under its Quantitative Easing exercises at 0% interest. The Treasury can provide a guarantee to the Bank of England for such facility, just like it does for the past QE activities. As this is a funding of net home equity, the risks to the banking sector does not change much over its outstanding mortgage loans as increased economic activities will reduce the level of risks. To enhance the U.K. banking sector to participate in this exercise, the latter could be paid a one-time fee of 25 basis points for doing the administration for their client base interested in participating in such scheme.

The existing and the proposed scheme

1. The first proposal is to stop with Quantitative Easing as currently operated. This might be done for the following reasons: The amounts spend on QE in its current format has had the effect of postponing tax increases. It is based on a spend-now and collect later philosophy. This applies even more directly to the unfunded obligations on pension payments for civil servants. The Bank of England has set up a subsidiary which deals with QE and the U.K. government has guaranteed to the Bank that any losses made on QE will be covered by the U.K. government.

2. The second proposal is to use QE for home equity (QEHE); the latter reflects the accumulated values of savings flows into the housing stock. The difference between point 1 and 2 is that home equity reflects the money savings made over past periods, while QE and its loan servicing relies on future income flows, which in themselves rely on higher interest rates and higher taxes. As an example, the U.S. QE experience has had a very serious effects on house prices. From the start of the Great Recession by Q4 2005, the recovery period lasted well over 10 years before U.S. households had built up the same level of home equity savings as they had in Q4 2005.

3. The third element is to decide which threshold to apply as cash rich households have generally other means of savings and therefore do not need the QE Home Equity Scheme (QEHE). The proposal is to fix eligibility for households to a maximum gross income of £100,000 per annum. Under current tax rules such households would have a net income of about £ 66,000 per year.

4. The fourth element is to recognize that pension savings are made to cover expenditure levels in the future and are therefore less suitable for bringing payments forward to the current period. In the U.S., households have the right to withdraw 25% of their pension entitlement in a lumpsum payment from the age of 55 years.

3. Some conclusions

The increases in the interest rates and the expected further increases of such rates as set out by the Bank of England will have a serious effect on economic growth levels as well as on maintaining house prices.

The recommendation is therefore to help U.K. households with providing them with cash saved up in their homes through a process of Quantitative Easing Home Equity.

The cash injection for owner occupiers could be set at a 0% interest rate. Such rate will shorten the adjustment period. It will help to provide households with cash to buy goods and services; it will increase tax income for the U.K. government, and it will avoid some of the cumulative negative effects of economic tightening. Even the U.K. government will benefit from the higher spending levels in an indirect manner.

The household group that could be targeted are homeowners' occupiers with a maximum annual gross income of £100,000.

Savings made in the past will be rewarded, rather than being punished as happened in the U.S. over the period 2005 -2015. The latter adjustment period took well over 10 years!

Kees De Koning
Chorleywood U.K.
5th November 2022

References

1. A U.S. Home Equity Withdrawal Scheme; Kees De Koning, 17th October 2022
RePEc:pra:mprapa:115113

2. Savills; Values of U.K. Housing Stock

https://www.bing.com/search?q=savills+uk+lvalue+of+u.k.+housing+stock&qs=HS&pq=savills+uk+&sk=HS1&sc=10-11&cvid=33326733C8E34295AB3D83A9F26674BA&FORM=QBRE&sp=2

3. The Times Newspaper U.K. 4th November 2022

https://www.thetimes.co.uk/article/muddled-message-on-interest-rates-from-the-bank-of-england-5vvxdpj7z