Inequality as a Source of Recessions and Poverty

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Introduction

This paper will focus on the relationship between mortgages and income developments in the U.S.

Individual household's asset values and liabilities obligations are often combined; for instance in home mortgages. The two main sources of savings, built up over a lifetime, are pension savings and the net worth embedded in one's own home.

Pension savings are normally deducted from annual income levels and transferred to specialist collective pension funds or insurance companies; an instant cash transfer. Mortgage borrowings are different in that future income levels are committed in meeting the payment obligations.

The U.S. financial crisis of 2007-2008 was a home mortgage crisis. From 2004, some irresponsible lenders enticed many buyers to acquire homes in the U.S., of which a number of homes were bought for speculative reasons.

In the U.K., the main reason of increasing house prices, above average income growth levels, is that house-building levels have lagged behind population growth levels for at least the last ten years. About only 160,000 homes were built per annum, while the population growth required between 230,000 and 300,000 homes annually.

In the U.S., during the period 2004-2008, the financial sector made a huge collective mistake in assessing what was the appropriate individual mortgage level. The buyers over this period -many of them lower income households- were confronted with large numbers of repossessions after 2008. Heavy job losses occurred.

Where economic theories seem to fail is when liabilities, like a home mortgage, can at the same time represent an asset with an embedded value in a home.

Many households in both the U.S. and the U.K. were and are "displaced", either by repossessions or by the inability to purchase a home.

There exists, as yet, no government institution in either country that is able to replace bank funding, when income levels drop in a recession. High unemployment and falling wage levels reflect recessions. The key is to stabilize mortgage expenditure levels as a percentage of incomes over long periods of time. Banks cannot operate such products; only a government institution can do so.

Why and how such a system can work in the U.S. is explained in this paper.

1. The background settings for the United States

Entering into a mortgage obligation constitutes a long-term obligation for the buyers. As a consequence one should not cheer at short-term gains, especially if such short-term gains are made at a cost to long-term stability.

The first variable to consider is the level of home ownership in the U.S, over the long term. In Q3 1979 a peak was reached when 65.8% of all households owned their home.[1] It took nearly 20 years to Q1 1998 to exceed this level when it reached 66.0%. The long-term peak was reached in Q2 2004 when 69.2% of all households owned their home. The bottom of the long-term trend occurred in Q2 2016 when only 62.9% owned their home. The latest statistic is for Q3 2019, when 64.8% owned their home.

The second variable to consider is the number of households that needed to rent a home. At Q3 1979 the percentage of tenants was 34.2%, as home ownership reached a peak. As stated above, the highest peak of home ownership over the last 40 years was reached by Q2 2004 when tenants "only" constituted 30.8% of all households. The highest level of tenants since 1979 was reached in 2015 when tenants lived in 40.1% of the total number of homes. Since 2015, the shift has changed slightly in favor of home ownership again and by Q3 2019 – according to the latest available data- the percentage of tenants has dropped to 35.2% of all households, with the total number of households reaching 128.580 million, implying that there still are over 45 million households renting.

The third variable to consider is the level of home mortgage loans outstanding.. In Q3 1979 this volume stood at U.S.$ 795.7billion.[2] By Q1 1998, the outstanding volume of home mortgage loans had risen to U.S.$ 1.998 billion. From 1998 to Q2 2004 the level of outstanding mortgages more than tripled to U.S.$ 7.350 billion, in effect more than 3.67 times the 1998 level over a period of just 6 years. This extraordinary expansion in mortgage credits led to the highest level of home ownership by 2005 as compared to the previous 30 years. In 2005 homeowners occupying their own homes constituted 62.1% of all families. In Q1 2008 the level of home mortgages outstanding reached its peak at U.S.$ 10,695 trillion. Ever since Q1 2008, this level has not been exceeded. By Q3 2019 it reached the level of U.S.$10,524 trillion.

The fourth variable is population growth. In 1975 the number of households in the U.S. stood at 71.120 million of which 24.250 million were tenant households. By 2019 Q3, the number of households had increased to 128.580 million, of which 35.2% were tenant households rather than homeowners. Per same date there were 45.260 million tenant households. The total current

[1] https://fred.stlouisfed.org/series/RHORUSQ156N
[2] https://fred.stlouisfed.org/series/HHMSDODNS

value of all U.S. homes is estimated at $31.8 trillion. This can be compared to U.S. GDP for 2019 that is estimated at $21.44 trillion. It can also be compared to the total level of outstanding home mortgages per Q3 2019. This was U.S.$ 10.524 trillion. In the U.S. all homeowners had together a very healthy combined home equity percentage of 66.9%.

What these figures hide is that existing homeowners are generally well off, but that for 45 million U.S. households home ownership remains a distant dream.

2. The economics of renting in the U.S.

In the U.S. there exists, according to my knowledge, no policy objective that focuses on bringing down the level of rent paying households in a direct manner. If there had been one, policy makers would have been rather perturbed that between 2005 and 2015 the number rent-paying households had gone up from 38.413 million to 49.357 million.

Each of these 49.357 million households paid their rent to third parties. By the very nature of renting, no element of savings was included for the renting households in this transfer of income. Third parties take all: the rents and the appreciation in home values.

In the U.S. between Q1 2005 and Q1 2015 median house sales prices went up from U.S.$ 232,500 to U.S.$289.200.[3]

Each renting household would have missed out on U.S.$ 56,700 of savings over this period, had they lived in a median priced home. It is very likely that most rental households are at the lower end of the property ladder, so their savings level would have been somewhat smaller, but such savings would still represent a substantial sum relative to their income levels.

Renting households also pay another price in that rental charges are often linked to house price rises. So, when house prices go up, rental charges are likely to go up as well, especially in the big cities. Normally in the big cities there are more opportunities to earn a higher income. However the chances of creating savings on one's property are restricted to owner-occupiers only.

Why is it so important to create wealth levels through owning one's own home?

In retirement there are in principle three sources of wealth that can be turned into current cash: Pension savings, personal savings in cash and/or in an investment portfolio and thirdly the accumulated savings incorporated in one's own home.

[3] https://fred.stlouisfed.org/series/MSPUS

Most U.S. households have some pension savings. It is beyond the scope of this paper to try to dwell for too long on this important segment of savings. In a Forbes article, written by Andrew Biggs and entitled: "How many Americans are saving for retirement? How many should it be?"[4], he explained that many have some form of savings, including those in the lower quartile of income earners.

The workers within the lower income quartile are the least likely to build up other savings apart from their home property value. Many families within this lower income quartile earn barely enough to survive. Therefore a scheme to help them to stay or keep them on the property ladder would greatly relieve future poverty levels.

3. A proposed policy initiative

Even for the most recent date for which figures are available: Q3 2019, there were still 45.260 million American households that rented their homes. All those households were missing out on the value gains on their homes to be made over time. They missed out on a key savings element that could have helped them in retirement to have a better quality of life. It also would make the need for these households to rely on state support less urgent, once the retirement years start..

Over the long run -1975-2018- the owner-occupants category of family homes has increased from 46.870 million owners in 1975 to 79.360 million as per the end of 2018. This was an increase of 69.3%. The tenant's category of households went up from 25.550 million in 1975 to 48.226 million in 2018. This was an increase of 91.0%. One may conclude from these data that over the last 45 years a substantially lower percentage of households have been able to share in the American dream of owning one's own home, with the implicit conclusion that the wealth creation and wealth benefits from owning one's home have become less equal.

The savings loss to households, that did not own their homes, can be illustrated by the U.S. median house price developments over the period Q4 1975 to Q4 2019.[5]

In Q4 1975 the median house price sold in the housing market was U.S.$ 41,200.
By Q4 1985 it was U.S.$ 86,800.
By Q4 1995 it was U.S$ 138,000.
By Q4 2005 it was U.S.$ 243,600.
By Q4 2015 it was U.S.$ 302,500.
By Q4 2019 it was U.S.$ 324,500

[4] https://www.forbes.com/sites/andrewbiggs/2016/09/20/how-many-americans-are-saving-for-retirement-how-many-should-be/#1279791b6705
[5] https://fred.stlouisfed.org/series/MSPUS

There are some other elements that need to be taken into account before a possible policy instrument could be considered..

Firstly, over the past 25 years, the volume of new U.S. home mortgage lending per annum has not gone up in line with the median household nominal income growth levels. In 1996 the level of new lending was U.S. $ 329 billion and the median household nominal income was U.S. $ 35,492. By 2005, the annual lending volume had gone up to U.S. $ 1.351 trillion and the median income had gone up to U.S.$ 46,201. Incomes did increase by 30.2% over this period, but lending had gone up by 411%. Annual new housing starts went up by 45.5% over this period.

Secondly the notion that more mortgage lending does lead to more households owning their homes does not tally with the facts. One has only to study the levels of new mortgage lending and compare these with the median household nominal income levels and with the increase in actual numbers of households having to opt for renting their homes. Between 2005 and 2015 the owner-occupiers category went up from 74.93 million to 75.23 million, an increase of 30,000 owners. Over the same period the renting number of households went up from 38.413 million to 49.357 million; an increase of no less than 10.944 million households. This, of course, followed the pattern of the number of unemployed persons in the U.S. Between December 2006 and December 2009 8.3 million persons lost their jobs as a consequence of the financial crisis. Even by December 2015 the number of unemployed was still 1.1 million higher than the one by December 2006.[6]

3.1 Policy objectives

A first policy objective could be: "Set targets for lowering the number of families renting a home and instead help them to own one."

The second policy objective could be to "help families to stay in their home, if income levels drop due to unemployment or other reasons."

Both policy objectives have as the overriding aim to help households to benefit from the increases in the values of their home; a savings objective that benefits a government when members of the household reach retirement age.

It may be restated here that a home can be an asset and a liability at the same time. The asset value is the market price of the home and the liability is the mortgage on the home and the ability to continue servicing such a mortgage.

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

3.2 Potential policy delivery system

A different definition of a recession could be formulated if one considers the level of home ownership. In 2005, the highest level of home ownership was reached at 66.1% of all households that owned their home. Not even by 2019 was this level reached again, but at least the levels are improving. The after effects of the 2006-2008 financial mismanagement of home mortgages have lasted much longer than the return to economic growth. For many households the ultimate effects will continue to last.

One has to consider how banks and financial institutions operate in the mortgage market. If a mortgage customer is unable to service his/her debt over a three months period, the financial institution will liquidate the loan by taking possession of the property. Financial institutions are profit driven and they have no or little leeway to act otherwise. The downward cycle starts as owner levels stagnate or drop and tenant levels rapidly increase. In the U.S. this happened from 2006 and continued all the way to 2016.

To shorten such adjustment periods, a new entity may be needed, owned by the U.S. Government. It could be called a Mortgage Debt Stabilization Fund (MDSF).

The one element of servicing a mortgage loan that banks cannot accommodate is to vary the annual mortgage debt servicing according to the changing income levels of their customers, especially when such incomes are dropping. Banks would not know how to account for their profits.

The second main element to reduce the risks for mortgagees is to have the MDSF provide the first 10% of a house price, provided that such price is no more than eight times the income level of the potential mortgagee and that the mortgagee also puts in 10% of the purchase price.

In the above, it has already been described as too how long an economic recovery takes when, in large numbers, homes are repossessed from mortgage debtors. In 2019, 14 years after 2005, the level of home ownership did not yet reach the 2005 level of 64.7% of homes owned by the owner-occupier households.

The difference between a financial sector mortgage loan and an MDSF loan is that in a financial sector's loan, when a debtor falls behind servicing on a mortgage, the sale of the asset is used to recoup the loan amount outstanding. An MDSF loan is based on a fixed percentage of the income level of the mortgagee. In the U.S., experts have worked out that about 28% of a household's income should be devoted to servicing a mortgage. The MDSF should accept as a rule that yearly servicing amounts may vary according to the income level of the mortgagee as long as the 28% rule of income allocated to mortgage servicing will be maintained.

If, for instance, through unemployment, a household cannot keep up with their mortgage payments, the MDSF will buy out the loan at a discount from the financial institution and steps in and services the loan up to its requirements. A contract needs to be in place stating that when circumstances improve over time, the mortgagee will continue to pay MDSF 28% of income earned until the loan has been fully repaid.

As the MDSF will be a government institution it can borrow such funds at government borrowing terms. If the mortgagee cannot repay the full loan amount in his/her lifetime, the MDSF will have a claim on the asset upon the death of the mortgagee. The Federal Reserve may even decide to use its Quantitative Easing activity for partly or fully funding the bonds issued by the MDSF.

In the U.S., there already exists a Consumer Financial Protection Bureau (CFPB) as part of the Office of the Inspector General of the Board of Governors of the Federal Reserve System.

The CFPB was created in 2014 to provide a single point of accountability for enforcing federal consumer financial laws and protecting consumers in the financial marketplace. Before, that responsibility was divided among several agencies. Today, it is its primary focus.

Its work includes:

- Rooting out unfair, deceptive, or abusive acts or practices by writing rules, supervising companies, and enforcing the law
- Enforcing laws that outlaw discrimination in consumer finance
- Taking consumer complaints
- Enhancing financial education
- Researching the consumer experience of using financial products
- Monitoring financial markets for new risks to consumers

One element that the CFPB was not designed for was actually sharing risks and partly funding home mortgages for individual households. Therefore a new institution, a Mortgage Debt Stabilization Fund, is needed that can take up such role. Its potential client base could well be a large number of the 49 million tenant households.

4. Funding the MDSF.

The Federal Reserve has practiced Quantitative Easing since August 2008, when its balance sheet amounted to U.S.$ 909 billion. As of the 12th of February 2020 the balance sheet now stands at U.S.$ 4.182 trillion. It bought up Government securities and some bonds from Government sponsored companies such as Fannie May and Freddy Mac.

In a similar fashion the Fed could fund the MDSF as a tool of monetary policy.

The advantage of the latter funding pattern is that it helps mortgagees to overcome a temporary drop in incomes and thereby avoiding a loss of all or most of the embedded value in their home. It will also help new property owners to get on the property ladder with all its benefits for the U.S. economy. Through the MDSF funding mechanism, the Fed would not just buy up existing debt from current bond holders, but it would help to accommodate new debt titles and directly support the lower income classes to help them to build up savings in their own home.

The advantages in economic terms can be substantial. The mortgagee does not lose the embedded value in the home if his or her income drops due to external economic circumstances. The economy gets a boost in that the income flow for mortgagees allows them to keep up most of their consumer spending. For new homebuyers it will make it easier to get a foothold on the property market, by sharing the down payment equally with the MDSF, within preset limits.

In this way, the Federal Reserve will indirectly help to stabilize and improve home ownership levels and at the same time counteract recessionary pressures put on ordinary households when, like in 2008, financial markets had created havoc with ordinary peoples finances.

Setting up a Mortgage Debt Stability Fund could well be the missing tool for economic management, that will make such policies much more effective. This could apply not only to the U.S., but if other countries follow the U.S. example, it could constitute a major positive change for these other countries.

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