How home equity can be used to fight a recession. A U.S. case study

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By

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Table of Contents

Introduction

The corona virus occurrence has and will dramatically change the economic outlook for many countries in the world, including the one for the U.S. Not until a vaccine is produced and accepted as safe for users, will this threat continue to live on. Currently consumer preferences are rapidly changing, including avoiding local and international travel. Supply chains are and will also be seriously affected as some of the most important exporting countries, (China and South Korea) are bearing the brunt of the virus infections.

What has this to do with the subject of this paper: "How home equity can be used to fight a recession". At first glance little, but as will be explained in the paper actually quite a lot.

The likely results of the corona virus in economic terms will be company closures and/or staff reductions, which will be reflected in reduced earnings, both for companies and individual households leading to higher unemployment levels.

Obligations on home mortgages will for quite a few households become a very heavy burden. Home mortgage obligations are currently not linked to income fluctuations, neither in the U.S., nor in any other country.

Secondly the concept of the "Bank of Mums and Dads" can only apply to households where the Mums and Dads are in a sound financial position themselves. The worldwide low interest rates and the expected reduction in pension payouts as a result of falling stock markets will reduce the scope for such financial assistance for many parents.

The proposals, as set out in this paper, directly link income levels with the ability to service mortgage debt.

The second and probably even more important element is to extend the concept of the "Bank of Mums and Dads" to a new government entity: "A Mortgage Debt Stability Fund" (MDSF).

The aim of the MDSF is to facilitate the temporary withdrawal of home equity as and when macro economic situations require it to do so. An MDSF helps fight recessions.

The currently applied system turns such home equity withdrawal into a loan rather than a cash withdrawal from personal bank accounts. The latter involves no charges. The MDSF can have the latter capacity. Federal Reserve funding to the MDSF (another form of QE) can act as the National Bank of Mums and Dads.

1. Threats and opportunities for the U.S. economy

Threats

The most immediate threat to the U.S. economy comes from an illness for which currently there is no cure: the corona virus. It affects the supply chain for goods, especially imported goods from China, South Korea, Japan and other countries where such virus has appeared or still will appear. It is, and will also for some time to come, change the behavioral pattern of households in buying goods and services. The latter involve reduced air travel, hotel stays, holidays, both domestically in the U.S. for U.S. citizens, but perhaps also from overseas visitors. It will also lead to a more intensive use of medical services, which for some American families imply costs for which they do not have insurance.

Another threat has already been realized in that stock markets in the U.S. and overseas have reacted sharply downwards in the expectation that profits for many companies will be less ebullient. Cost levels relative to turnover cannot be adjusted fast enough, as it is still very uncertain for how long the corona virus will influence buyers' economic behavior. To give just one example: in two days U.S. stock markets lost U.S.$ 1.7 trillion in February 2020[1].Black Monday (9th March) saw losses increase to 12% as compared to the highest level for the past year which was reached in February 2020.

American shareholders and those holding U.S. shares from overseas locations may further push shares down.

Uncertainties about the short-term return on U.S. government bonds will not bring any joy to institutional holders, like pension funds with their long-term investment objectives.

Individual households will furthermore be threatened by company adjustments in their staffing levels, with the most likely outcome that more people will lose their jobs.

Lower spending levels and increased levels of unemployment do not help an economy to grow.

[1] https://www.cnbc.com/2020/02/25/coronavirus-wipes-out-1point7-trillion-in-us-stock-market-value-in-two-days.html

Opportunities

In the U.S. there are four main sources of wealth.

The first one is the market capitalization of listed domestic companies as expressed in current U.S. dollars. The World Bank has calculated this value for 2018[2] and the value was $ 30.436 trillion or 148% expressed as a multiple of 2018 GDP. However in the light of recent events these multiples can be expected to be substantially lower.

The second form of wealth is government or companies' debt related paper.

To start with the U.S. Government debt level. It's outstanding debt level as at February 19th, 2020 was $23.4 trillion.[3] Of this amount the Social Security Trust Fund owns about U.S.$ 5.9 trillion or 26% of the debt. This is an intra government type of holding, held on behalf of future pensioners. External U.S. government debt was therefore U.S.$ 17.5 trillion, held among others by overseas governments, like China and by other central banks.

The 2019 GDP level was U.S. 21.49 trillion[4]. This implies a U.S. government debt to GDP level of 81.4%.

The U.S. non-financial companies have an outstanding debt level of U.S.$ 7.1 trillion, while the financial sector have an outstanding debt of U.S. $ 2.2 trillion.[5]

The third type of wealth is in the collective pension savings business in the U.S. In the U.S. the largest 32 private pension schemes had total assets of U.S.$ 2.1 trillion at the beginning of 2019.[6] On top of this the Social Security Trust Fund owns U.S.$ 5.9 trillion in pension savings.

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2 https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS?locations=US&view=chart

3 https://www.thebalance.com/who-owns-the-u-s-national-debt-3306124. `

4 https://tradingeconomics.com/united-states/gdp

5 https://www.spglobal.com/en/research-insights/articles/u-s-corporate-debt-market-the-state-of-play-in-2019

6 https://en.wikipedia.org/wiki/List_of_largest_pension_schemes_in_the_United_States

The fourth and final pillar is enshrined in the net worth of the housing stock. A very recent estimate by Zillow[7] put the value of the total housing stock in the U.S. at U.S.$ 33.6 trillion. If one deducts the collective outstanding mortgage debt, which according to the statistics from the Federal Reserve for households and non-profit organizations[8] stood at U.S.$ 10.524 trillion at the end of the third quarter 2019; then the conclusion can only be that households equity in the housing stock stands at just over U.S.$ 23 trillion. With a GDP figure of U.S.$ 21.44 trillion for 2019, the housing stock net worth is 107.3% of U.S. GDP.

With ample net worth value in the housing stock, the key question should be: "How can such net worth level be used to stimulate the U.S. economy, as and when it is necessary to do so." Without doubt, the current dramatic circumstances on the U.S. stock markets and the event of the corona virus make this the right time to act quickly.

2. A possible action plan

A possible action plan could have two pillars:

Pillar 1: Change the method of cash withdrawal from homes, and

Pillar 2: Establish a special vehicle to service such cash withdrawals.

To start with cash withdrawals, a homeowner has two options: (i) To sell the house and move elsewhere or (ii) to ask his/her bank for an additional mortgage loan.

Option (i) brings with it great costs of a removal. Sales and purchase costs for another home are not insignificant and the removal itself often requires additional spending. In practice this is a nuclear option. It can be done, but it is a highly inefficient manner to obtain funds from a home's net worth.

Option (ii) is the only current option. One has to go to a bank to get an additional mortgage approved and funded. One has to realize what this means. Equity in a home will turned into a loan. An asset will be turned into a liability. This is very different from having cash in a bank, Withdrawal of such cash is free of charge and does not create a future liability.

The "Banks of Mums and Dads" can withdraw cash from their accounts and give it to their children, but this can only be done if parents are wealthy enough to do so. Usually lower income families do not have such wealthy parents.

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[7] https://mortgageorb.com/zillow-u-s-housing-stock-worth-33-6-trillion
[8] https://fred.stlouisfed.org/series/HHMSDODNS

It is here where the U.S. government could step in. It could set up a Mortgage Debt Stability Fund (MDSF), which could fund such cash withdrawals at no cost to the users. It is the U.S. Government acting as the Bank of Mums and Dads.

This leads to option (ii). Why would the U.S. government set up an MDSF?

There are basically three reasons for it:

The first one is macro-economic. An MDSF, once established, is capable of buying up part shares in homes at a speed of its own choosing. In other words, when economic circumstances deteriorate, like in the current climate, it can open the window for households to transfer such home ownership elements to the MDSF. The MDSF can decide on behalf of the government, how much of a money injection into the economy it wants to see. When such level has been reached it can slow down or even close the window again. Rather than expanding government expenditure levels, the request to obtain the facility is made by private households. The latter are only likely to do so if they are in need of immediate cash for current expenditure. Private households will facilitate the boost to an economy, rather than the government.

The second element is linked to the assets that are provided. Quantitative Easing as it has been applied, was directed at purchasing existing securities. This method changed the ownership of such securities from private hands into public ownership. What matters is what the individuals or institutions who owned such securities before would do with the cash received. Most of these holders were or are already cash rich, so their incentive to spend the money received will be less than the one by a group of home owners, who have no other savings than the home net worth savings. This is especially the case for lower and median income families. They should get priority from the MDSF. They are likely to spend their savings element on consumption of goods and services.

The third reason is that Quantitative Easing of this type does not incur costs to a government. The Federal Reserve creates the money. The benefit to the government is indirect. Sales and Income taxes will go up as part and parcel of the additional consumer spending levels. Lower unemployment levels will also help individual households, as greater opportunities will be created from the additional household spending levels.

2.1 Start up and operation of an MDSF

To start with the potential customer base for the MDSF: all households having net equity in their homes are potential clients. However priority need to be given to lower and middle class households, with an income level approximately two times the median household income levels. This amounts to U.S.$ 120,586[9]

All mortgage borrowers are already clients of existing financial institutions. In order to become a client of the MDSF, an agreement need to be made between the MDSF and the financial sector. In the national interest, clients should be free to apply to the MDSF. A fixed fee for loss of earnings for the financial sector might be negotiated. This could be arranged as a temporary lowering of the tax rates for such institutions.

Once a client of the MDSF, the MDSF could offer clients the opportunity to apply for paying a fixed percentage of their income for servicing their outstanding obligation. It is reckoned in the market place that 28% of a household's income would be an acceptable percentage. Such fixed percentage structure is an element that banks cannot offer, as the payments are dependent on the income level of the household. In case of redundancy for instance, the percentage remains the same, but the actual amount of payment is reduced. In case of a promotion and salary increase, the paid amount will increase, but the percentage of the income level stays the same. Macro-economically this system has the advantage that it reduces the fluctuations in spending levels on consumer goods, especially when incomes decline in a recession.

Once a client of the MDSF has fully paid back its obligations, such client could always reapply for a part transfer of home ownership when, at an older age, he/she needs cash for whatever reason.

3. The need to get as many households as possible in a home ownership position.

In previous paper: "Inequality as a Source of Recessions and Poverty"[10] attention was drawn to the fact that households that did not or could not participate in the ownership of their home, did loose a substantial amount of money over their lifetime as compared to their fellow citizens, who did.

Providing equal chances to all could be a government's aim, especially when all who wish to own their home, could be helped with a start up facility of 10% own equity and 10% government grant. Such help could be considered in the light of

[9] https://www.census.gov/quickfacts/fact/table/US/SEX255218
[10] https://mpra.ub.uni-muenchen.de/98684/1/MPRA_paper_98684.pdf

fighting future recessions, when part ownership transfers of homes could help save the U.S. economy from a severe downturn.

In the quoted paper, the long drawn out cycles were described between high levels of home ownership and high levels of tenants. The latest data suggest that there are still over 45 million households renting a home. These households represent about 112 million Americans who do not share in the savings built into their homes. Home ownership is not just an option; it is a remedy to fight recessions!

4 Some conclusions

Fighting recessions cannot be done with the help of the wealth factor of listed domestic companies. For instance the Dow Jones Industrial Average index has dropped from a year high on February 12, 2020 of 29,551 to a year's low of 25,864 on March 9 2020; a drop of 12.5% in values within a month!

Fighting recessions cannot be easily done with the help of issuing more government debt paper, especially as there are limits when government debt to GDP levels are creeping up automatically already once a recession occurs. Also Quantitative Easing has its limits when it buys existing financial instruments from owners who basically are wealthy enough to survive without such funds. Issuing more company debt paper in recession times is not a wise economic strategy either.

Pension savings are already prone to strong fluctuations in share and bond prices, plus such savings are for a particular use: ensuring a reasonable pension pay out to pensioners in future years.

This leaves the wealth accumulated in one's home as the strong favorite to help out in case of a threatened recession. It is therefore of great importance that as many households as possible participate in the process.

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