Rebuilding the European Union Economies after the corona virus pandemic: a new Country by Country Home Equity Release Method: (E.U.HERM)

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by

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Introduction

Among the European Union countries, there are some that already have reached their peak of the corona virus pandemic, while others are still struggling to get a grip on the epidemic. In a number of countries, at the time of writing, a lock down situation is still in place.

How will the economies look like after the pandemic is tamed?

The IMF in its latest blog on the world's financial stability[1] came to the following conclusions:

"Central banks will remain crucial to safeguarding the stability of global financial markets and maintaining the flow of credit to the economy. But this crisis is not simply about liquidity. It is primarily about solvency—at a time when large segments of the global economy have come to a complete stop. As a result, fiscal policy has a vital role to play.

Together, monetary, fiscal, and financial policies should aim to cushion the impact of the COVID-19 shock and to ensure a steady, sustainable recovery once the pandemic is under control. Close, continuous international coordination will be essential to support vulnerable countries, to restore market confidence, and to contain financial stability risks. The IMF is ready to assert the full weight of its resources—first, to help protect the world's most vulnerable economies, and, for the long term, to strengthen the eventual recovery."

In two previous papers by this author: one about the U.S. economy and the other about the U.K.'s one, the author did illustrate that there is a substantial illiquid element of households' savings incorporated in the homes people live in. In these papers, the why and how of turning such savings into cash was demonstrated.

Such conversion of an illiquid asset into current cash can stimulate consumer expenditure, without having to fall back on additional government expenditure to achieve such goal. The help of central banks through Quantitative Easing will be vital. The E.U consists of 27 countries; for 19 countries out of the 27 it has one currency from one Central Bank (ECB). In this paper, the how and why for two countries in particular: Italy and Spain will be set out. This does not imply that the same method cannot be used in all the other E.U countries.

[1] https://blogs.imf.org/2020/04/14/covid-19-crisis-poses-threat-to-financial-stability/

1. The current status in Italy and Spain

Italy and Spain have both been hardest hit by the corona virus pandemic. Both countries, for the moment, rank number two and three in the world with the highest number of casualties. The peak for each country is likely to be reached within the next month. However secondary waves of infections are possible until a vaccine is available to treat the new cases.

Both countries are hindered by relatively high government borrowings compared to GDP levels. In 2019, Italy had the highest level from the two at 134.8% of GDP[2], while Spain had a government debt to GDP ratio of 95.5%.[3]

The corona virus pandemic will hit both countries hard as they both heavily depend on the tourism industry. Unemployment levels are likely to increase substantially over the next few months. The longer the pandemic lasts, the worse the unemployment levels will become and the more small but also some large companies will find it difficult to survive.

On top of this, during the last decade, both Italy and to a somewhat lesser extent Spain have suffered with their industrial base from foreign competition, especially from China and other Far Eastern countries; one has only to think of car, textiles and footwear factories.

In the IMF's latest World Economic Outlook[4] report, the forecasted economic downturn in GDP for Italy in 2020 is expected to be among the highest levels in the world at -9.1%. For Spain, the situation is expected to be only slightly better with a drop in GDP of -8.0%.

Italy

In a very interesting, but regretfully somewhat dated, report by the Swiss National Bank[5], a comparison was drawn between Italian households and the German ones. It reads as follows: "After rumours and big expectations, on the 21st of March 2013, the *Bundesbank* presented its first report on German households' finances and wealth; while, in December one for Italy had been published. According to the German Bundesbank, the European reports showed a median wealth of around 163'400 € in Italy vs. 51'400 € for Germans.

As for **average wealth**, Germans are richer with 195'000 € against 157'000 € for Italy implying that wealth is unequally distributed in Germany and pretty equally

[2] https://tradingeconomics.com/italy/government-debt-to-gdp
[3] https://tradingeconomics.com/spain/government-debt-to-gdp
[4] https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020
[5] https://snbchf.com/italy-euro-exit/european-wealth-italy-germany/

in Italy. Moreover wealth is unevenly distributed between East Germany's average of 67500€ and the West 230240€. As opposed to Italians with 68.4%, less Germans, namely 44.2% own their home."

The report continues: "Where does the Italian Wealth come from?

Household wealth is clearly the result of accumulated savings. At least until the mid 1990s, Italy had one of the highest saving rates of advanced countries (around 20% of disposable income).

Savings in turn, may be allocated to liquid financial resources or invested in real estate and precious objects. The estimates by the Bank of Italy show that in 2007, 50% (53% in 2011) of Italian household total assets are attributable to real estate. This seems a relatively high share compared to other countries, especially compared to Germany that can be explained by looking at Italy's economic history and its socio-cultural traits.

Why Italians Prefer(ed) Real Estate as Investment

First, Italians own their homes and dislike rents. The reasons are manifold: cultural preferences, extensive legal protection of the tenant at the expenses of the landlord, progressive taxation of rent-income and a relatively high property tax. All in all, from an economic point of view, it does not make sense to buy a flat and rent it; hence, the rental market is small, illiquid and expensive. According to the Bundesbank press release, 82% of Spaniards, 69% of Italians, 58%of French, but only 44% of Germans own a home.

Second, Italy's large shadow economy supported by relatively scant control and soft punishment, allowed business people and the self-employed to recycle money into real estate activities."

However, in recent years, the Italian fiscal authorities have substantially intensified their actions against the shadow business operators.

In Italy's Global Property Guide[6], one can find some salient facts about the Italian property markets. It mentions among others that Italy's housing market is now stabilising (situation 2019). Interest rates over one to five years mortgages are currently at 2.5% per annum and over five year mortgages are at 2% per annum. Both are at historical lows.

Notwithstanding these low rates, Italians are very reluctant to take out mortgages. The banking system is also not in the best condition yet with bad loans and long legal processes to recover outstanding mortgages in case of non-payment. The Italian mortgage market is small at €380 billion, which is less than 22% of GDP, while the average level is 47% of GDP for the 27 other members of the E.U. according to the European Mortgage Federation.

[6] https://www.globalpropertyguide.com/Europe/Italy/Price-History

In 2018, around 72.4% of the country's total households were owner-occupiers, an increase from 59% of total households in 1980, according to Eurostat figures.

Spain

In Spain, after a building boom in the run up to 2008, house building came nearly to a total stop. A substantial share of the country's homes was sold to foreigners, who either use their homes as a holiday home or as a permanent residence. The British have been the largest group of buyers, closely followed by other Northern Europeans.

Eurostat publishes regular updates on the tenure status in European countries, which includes both Italy and Spain. The distribution of households as owner-occupiers without a mortgage is one category, those households as owner-occupiers with a mortgage is a second category, tenants at market rates is a third one and tenants at subsidized rates is the fourth category. The latest available data are for 2017[7].

There are quite striking differences between the Northern European countries, like Germany, Sweden and the Netherlands and the Southern ones, like Spain and Italy. Outright ownership is dominant in the South and homes with mortgages as well as rentals are more common in Northern Europe.

2. A cash-flow injection system.

All over the world, the effects of the corona virus pandemic have caused the loss of cash flows for many individual households, but also for many companies, small and large. Of course, governments are also seriously affected by such changes as government expenditures is going up and tax incomes will come down.

In two previous papers, one about the U.K. situation[8] and the other one about the U.S. one[9], the writer explained how home owners with or without a mortgage could help to stimulate their respective economy by temporarily converting an equity share in their home into cash through a new Home Equity Release Method. (U.K. HERM) and (U.S. HERM).

[7] https://ec.europa.eu/eurostat/statistics-explained/index.php?title=File:Fig18_2_1.png
[8] https://mpra.ub.uni-muenchen.de/id/eprint/99683

[9] https://mpra.ub.uni-muenchen.de/id/eprint/99459

Why, one may wonder, is there a need for most countries to change funding patterns with the help of Quantitative Easing (Q.E.)? The first point to make is that QE, as the Fed, the Bank of England, the ECB and the Bank of Japan have used it, has concentrated on buying government bonds and mortgage-backed securities. Both these types of securities are based on loans to respectively governments and to mortgagees. Of course, more money in circulation can have a positive effect and so can lower interest rates as a side effect of QE. But the real question is: how much of these effects positively influence employment and income levels? What do the recipients of the QE programs do with the money received? Does QE –as it is and has been currently applied- really lead to higher incomes and more job opportunities? Would it not be better to focus on a less indirect and a more direct asset category: equity savings in homes? Instead of funding liabilities of governments and mortgagees, one could opt for funding assets –especially savings- incorporated in owner occupied homes. Temporarily converting such part equity into cash will create consumer demand in an economy at the times that it is most needed. Is it not more likely that families, faced with job losses and reduced income levels, would like to use some of their wealth incorporated in their homes? Would it also not be more likely that such savings turned into cash will be spend directly on consumer goods? Higher private sector consumer expenditure will in the current circumstances be the medicine that nearly all world economies need. More jobs, more consumer expenditure is what the world needs and can afford with the help of converting some of the home equity into cash.

There is a second element that needs highlighting. Banks and other financial institutions generally do have the option to fund such home equity cash withdrawals. Banks, being banks, have to satisfy their shareholders and their depositors and therefore they need to turn a cash asset into a home loan. A conversion of an asset into a liability comes with all the extra costs to the homeowner. To withdraw cash from a current account costs nothing, but because the money in a home needs to be funded from a bank's assets; banks have to charge for it. QE does not have this drawback. QE applied to a home equity conversion will in all cases be cheaper than a bank loan.

In this paper, the examples of Italy and Spain will be used to show what can be done, not by their respective governments, but by individual households in utilising their home ownership as a method to inject cash liquidity into their respective economies. One could have written such proposal for Germany or for Holland or for any other European country but the relatively higher levels of home equity in Italy and Spain compare with the rest of Europe provide these countries with a better opportunity to make a success of such a QE scheme.

2.1 The role of the European Central Bank

In Wikipedia the role of the ECB has been well described. Some elements are quoted here:

"In the past, under the guidance of Mr. Mario Draghi[10], the ECB started a program of Quantitative Easing. In December 2011, Draghi oversaw a €489 billion ($640 billion), three-year loan program from the ECB to European banks. The program was around the same size as the US Troubled Asset Relief Program (2008) though still much smaller than the overall US response including the Federal Reserve's asset purchases and other actions of that time.

In February, 2012, a second, somewhat larger round of ECB loans to European banks was initiated under Draghi, called long term refinancing operation (LTRO)..

In July 2012, in the midst of renewed fears about sovereigns in the eurozone, Draghi stated in a panel discussion that the ECB "...is ready to do *whatever it takes* to preserve the Euro. And believe me, it will be enough."[This statement led to a steady decline in bond yields (borrowing costs) for eurozone countries, in particular Spain, Italy and France. In light of slow political progress on solving the eurozone crisis, Draghi's statement has been seen as a key turning point in the fortunes of the Eurozone."

One of the conclusions from this ECB history is that quantitative easing was first aimed at the European banking system, followed by an operation to help governments in buying up government debt titles., including the ones from his home country: Italy, but also from Spain and other E.U. countries.

In a meeting by the Governing Council of the ECB on the 18th of April 2020[11] the following decisions were taken:

"To launch a new temporary asset purchase programme of private and public sector securities to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the outbreak and escalating diffusion of the coronavirus (COVID-19).

This new pandemic emergency purchase programme (PEPP) would have an overall envelope of €750 billion. Purchases would be conducted until the end of

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[10] https://en.wikipedia.org/wiki/President_of_the_European_Central_Bank

[11] https://www.ecb.europa.eu/press/accounts/2020/html/ecb.mg200409_1~baf4b2ad06.en.html

2020 and would include all the asset categories eligible under the existing APP.

For the purchases of public sector securities, the benchmark allocation across jurisdictions would continue to be the capital key of the Eurosystem's national central banks. At the same time, purchases under the new PEPP would be conducted in a flexible manner. This would allow for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions.

A waiver of the eligibility requirements for securities issued by the Greek government would be granted for purchases under the PEPP.

The Governing Council would terminate net asset purchases under the PEPP once it judged that the coronavirus crisis phase was over, but in any case not before the end of the year.

To expand the range of eligible assets under the CSPP to non-financial commercial paper, making all commercial paper of sufficient credit quality eligible for purchase under the CSPP.

To ease the collateral standards by adjusting the main risk parameters of the collateral framework. In particular, the scope of the framework in place for additional credit claims would be expanded to include claims related to the financing of the corporate sector. This would ensure that counterparties could continue to make full use of the Euro system's refinancing operations."

One element that was not discussed by the Governing Council of the ECB, but by the heads of state was: "to what extent a cross border facility could be set up to help those countries and governments that needed financial support for overcoming the expected severe downturn in economic growth." The heads of state could and did agree on a formula, but the Italian President did not accept the formula.

2.2 A new role for the ECB

Quantitative Easing (QE) has now been practised by the central banks of the U.S. (FED), the Bank of England, the ECB and the Bank of Japan.

The focus of QE has been on debt instruments either government bonds, or mortgage bonds from trusted mortgage suppliers. However let us first focus on the definition of QE. Investopedia[12] defines QE as follows: "Quantitative easing (QE) is a form of unconventional monetary policy in which a central bank

12 https://www.investopedia.com/terms/q/quantitative-easing.asp

purchases longer-term securities from the open market in order to increase the money supply and encourage lending and investment. Buying these securities adds new money to the economy, and also serves to lower interest rates by bidding up fixed-income securities. It also greatly expands the central bank's balance sheet.

When short-term interest rates are at or approaching zero, normal open market operations, which target interest rates, are no longer effective. Instead, a central bank can target specified amounts of assets to purchase. Quantitative easing increases the money supply by purchasing assets with newly created bank reserves in order to provide banks with more liquidity."

What this definition seems to exclude is that buying up part assets, for instance savings accumulated as home equity, would not qualify as a category of acceptable purchases.

Government and mortgage debt titles are all acceptable because they are traded in financial markets, but turning actual household savings into cash is not.

As can be seen from the Italian example and reflected in a European Household Wealth Study from ING Bank in the Netherlands[13], Italians are great believers in owning their homes outright, as are the Spanish. According to the study, Italians have the second highest percentage of assets in real estate in Europe as a percentage of disposable incomes: i.e. 385%, while the Spanish have by far the highest level at 539%.

ECB's new role?

What can be the new role for the ECB as a possible answer to the negative economic effects of the corona virus pandemic?

The new role for the ECB could be to accept that funding ultimate loan obligations may be less effective than helping individual households in using their home equity as a source of cash in times of economic distress.

In the E.U. the responsibility for housing is a country national one and not one for the European Commission. However, there is of course the link between the national situations and the common currency.

The ECB could therefore work with National Central Banks (NCB's) to set up a system of Q.E. in which the ECB creates the Euros for allocating to NCB's. The latter will run the domestic system of buying up part equity from homeowners who are owner–occupiers in their homes. Initially homeowners, who rent out

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[13] https://www.ezonomics.com/pdf/Household-wealth-in-Europe.pdf

homes might be excluded from this initiative as the latter operate more as a business, rather than as a private household.

The ECB could set up a country facility for each Eurozone country. The size of the facility could depend on the acceptance of the scheme by households in the respective country, but also on the economic impact that is needed to restart the various E.U. economies. The transfer of funds to each country could be made at 0% interest rate.

That leaves open the question of home valuations. The corona virus pandemic has already had severe repercussions on individual households losing their jobs and incomes, on small but also large businesses and on government expenditure, which has and even more will increase, but with less revenues to collect. It is therefore important to encourage households to participate in the conversion of home equity into cash. The pandemic is reality as it has and will influence many cash flows. However this does not necessarily mean house values. To make the scheme attractive to households, the 2020 February house prices could be used as guidance to valuation.

Each Central Bank in each EU country could operate such scheme. For Italy it will be: Banca d'Italia and for Spain Banco de Espania

2.3 The role of the National Central Banks

The NCB's have to design the structure of buying up part shares in homes under the local legal rules. For instance: if a country utilises home ownership documents (property deeds) and the potential seller would like to use the facility, then the NCB could be handed over the ownership documents and keep them for safekeeping. The structure could also include a minimum share to be held by the homeowner, for instance 10% for younger households and such levels going up with age.

The NCB's could furthermore have to define of how much of equity from various owners can be bought to provide a substantial boost to local demand for consumer goods without accelerating inflation levels.

The NCB's could and should furthermore link the facility of a home equity transfer to a new type of savings scheme for homeowners. The latter need to sign up to an agreement that states that they will basically save back for the full amount that was financed by the ECB directly and the NCB indirectly. In banking practice it is usual to stipulate such amount to be 28% of monthly income. An NCB is a different entity from a normal bank and it can stipulate that such savings can be made dependant on the monthly/annual income level of the seller. When incomes go up, the NCB will receive a higher amount per annum and when incomes go down, like in the current situation, such savings will be replenished over a longer period, probably over 5 or 6 years. Once a household has saved up the principal amount again, the property deeds will be returned.

In this modern world, employers could be asked to deduct such payments from the payroll. For self-employed this could be done via the income declared and accepted by the fiscal authorities. For retired persons, this could be done as a withholding from pension payments. All these payments collected do nothing else other than to bring the personal savings levels back to what they were, before the corona virus pandemic.

If a homeowner fails to replenish his own savings according to the formula set out above, there has to be a penalty clause. Such clause could include that the interest rate applied will no longer be 0%, but will increase to 2% over the 5-year mortgage rate in the market. In case a seller is still unwilling to settle on time, then gradually a larger and larger share of the home will be owned by the NCB. In exceptional cases, this might go on until death of the owner. The Italian Treasury could cover any shortfall after the sales of the home.

On a macro level, the NCB's will have to decide when to encourage the homeowners to sell a part of the house value and when to discourage them or even stop the scheme. The latter will only apply when economies are running at full steam.

For countries, like Italy and Spain, nearly all households own their homes outright. However in other counties, like Germany and the Netherlands, many households have mortgage obligations. In such cases, a deal needs to be struck with their current mortgage providers in order to transfer the whole mortgage to the NCB. The current terms for the remainder for the mortgage amount, not involved in the equity release scheme, could continue, but it is best that the total facility is transferred to the NCB.

For Italy, a very rough calculation might be made to indicate the potential size of the wealth incorporated in homes and the size of QE that may be needed.

In 2018, Italy had a population of 59.3 million inhabitants. With an average household size of 2.6 persons per household, this translates into 22.8 million households. Of those households, 72% were outright homeowners or 16.4 million households. If the average dwelling is 100 square meters with an average price of €2,000 per square meter, then the average house price is €200,000. Of course there are great differences between cities and rural areas and between north and south Italy. A very rough estimate leads to an Italian home equity level of €3.28 trillion. If 50% of the households take up the offer for QE for 20% of their home equity, then the QE needed would be €660 billion. In comparison: Italy's GDP was €1.757 trillion in 2018. Probably a somewhat lower level than 20% might be wise as € 660 billion represents an injection of 37.5% of Italy's GDP. 10% might a better ballpark figure, depending on the take-up.

What is essential, is that the initiative for taking up the offer for Equity Release comes from the homeowner.

3 Some conclusions

The current system of QE relies exclusively of buying up market paper of government debts and of mortgage-backed securities. There is certain reluctance in some quarters to make taxpayers in one country responsible for the fiscal deficits in another country, even when these countries share the same currency. However, in my view, there can be no objections to a scheme that helps a country get back on its feet by using its own savings. Just because 19 EU countries use the same currency, this does not mean that the savings values in one Eurozone country are not real values.

One has to point out that there is a substantial political risk that Italy –one of the founding fathers of the E.U.- may decide to go it alone if the ECB and the E.U. commission do not accommodate a request for saving Italy's economy with the help of its own national savings levels incorporated in its housing wealth.

It would even be better if Italy is just one of the E.U. countries that apply the home equity release method. In this manner, the economic fall-out of the corona virus could be mitigated all over Europe.

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