Household wealth in central bank policy analysis

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The Bank of Italy's experience in household surveys

The Bank of Italy has a long tradition of collecting data on household income and finance. After conducting a series of pilot surveys in 1961-62, the Bank launched its Survey of Household Income and Wealth in 1966. The undertaking was primarily motivated by the need to corroborate findings based on aggregate data with microeconomic information on household structure and behaviour, but also by the need to estimate some aggregates in the financial accounts for the household sector. The survey has been conducted regularly ever since and work for the thirty-first survey is now under way.

The Bank's survey has evolved over time, adapting to changing external circumstances, but it has consistently been a precious source of information for the understanding of the Italian economy and society. The Bank was foresighted in disseminating to external users the micro data collected for research purposes. While certainly not our priority, we should not ignore this important externality – the benefit to the scientific community and the feedback we can get from this research.

The involvement of central banks in wealth data collection

At the time the Bank started its own survey, there was the important example in the United States of the Survey of Financial Characteristics of Consumers sponsored by the Board of Governors of the Federal Reserve System in 1962-63. The involvement of central banks, however, was uncommon. The situation has now changed, as in several countries central banks have conducted or sponsored surveys on household assets and liabilities. These include Australia, Austria, Cyprus, Greece, the Netherlands, Portugal and Spain, in addition to Italy and the United States. In the near future we may see a significant new development if the Eurosystem implements the euro-wide survey on household finance and consumption currently under study – and of which you will hear more tomorrow.

The importance of a survey on household finance with comparable data for the whole euro area can hardly be overstated. Before turning to examples of why microeconomic data are needed, we may ask a different question: why should central banks be involved in such an enterprise?

Historically, shortage of supply has been an important factor. For a number of reasons, national statistical agencies have been reluctant to engage in the collection of micro data on household assets and liabilities. Filling this information gap has been an important driving force for central banks. But there are deeper reasons. As in the case of the Bank of Italy's survey, the direct availability of survey information may sometimes be crucial for estimating some items in the aggregate financial accounts, the production of which is often accomplished by central banks. The value of unincorporated enterprises is a typical case. More importantly, the expertise of central bank economists and statisticians puts them in a strong position to define the policy-relevant questions that need to be specifically addressed in the survey. In many areas, central banks have policy interests and comparative advantages – the analysis of means of payment being a neat example.

Household indebtedness

The availability of detailed information on household wealth can enhance economic analysis and policy formulation in many functions performed by central banks, from monetary policy, to financial stability, to payment systems. In the case of the monetary union, information also needs to be comparable across countries in order to provide an adequate picture of the union as a whole. The importance of these microeconomic data can be better understood with concrete examples. I take here the indebtedness of the household sector.

The increasing level of household debt is an issue of some concern in the euro area, although to a lesser extent than in other advanced economies. As the *Financial Stability Review* released last June by the European Central Bank put it, "… there have been concerns for several years about the sustainability of unprecedented levels of mortgage-related leverage in some countries, especially if households were to be confronted with a more challenging macroeconomic environment". The overall risk for the euro area as a whole is low, but the *Review* notes that "vulnerabilities may be growing for households in those parts of the area where, ceteris paribus, housing valuations appear stretched, where the debt build-up has been most pronounced, and where the majority of debt is financed at variable interest rates". The emphasis is on cross-national variability, but differences within countries matter as well. We need to know the distribution of debt across households with different economic resources to assess the extent to which the level of aggregate debt is critical.

Italian households' debt has also grown rapidly over the last decade, from 25 per cent of disposable income in 1995 to 43 per cent in 2005. The growth has been particularly marked in the case of loans for house purchases. It was fostered by the sharp decline in interest rates and the structural increase in the supply of bank mortgages. Progress in this segment of the market has been considerable: the number of operators has risen, the range of contracts has widened, and the loan-to-value ratio has increased.

Despite these recent developments, household debt in Italy remains low in comparison with other OECD countries. Indeed, in 2004-05 its ratio to disposable income equalled 81 per cent in the euro area, 128 per cent in the United States, and 148 per cent in the United Kingdom. The data assembled by the Luxembourg Wealth Study confirm this pattern and show that it holds across all age cohorts: the fraction of debt-holders is always lowest in Italy, somewhat higher in Germany and Finland, always highest in Sweden, the United Kingdom and the United States. However, the wealth age-profile is not the same in all countries, and it is significantly flatter in Italy than in the other countries. This evidence is admittedly partial and far from fully comparable. Yet, as net worth affects household behaviour differently at different stages of the life cycle, it suggests that looking not only at the level of household debt but also at its distribution would provide a better understanding of the macroeconomic consequences of aggregate shocks as well as of changes in the monetary policy stance.

Low levels of indebtedness in Italy imply that the number of households negatively affected by a rise in interest rates is relatively small. But how severe are the effects for the households concerned? According to the Bank of Italy's survey, in 2004 the service of mortgage loans averaged 14 per cent of disposable income for households purchasing their principal residence. This proportion fell to 11 per cent for households in the top income quartile, which accounted for about 40 per cent of the total value of mortgage loans, but rose to 30 per cent for households in the lowest-income quartile, holding 8 per cent of total mortgage debt. On average, the cost of mortgage loans is estimated to go up for indebted households by about 0.7 per cent of their disposable income for each percentage point rise in interest rates; this increase is twice as sharp in the lowest-income quartile, and it doubles in the case of variable-rate mortgages.

These brief observations confirm that knowledge of how debt is distributed across households is needed not only to evaluate distributive consequences but also to understand the implications for macroeconomic performance and financial stability.

The development of supplementary pension funds

My second example relates to longer-run developments. The Italian labour market has gone through considerable changes in the last decade. One of the results of these changes has been a widening in the earnings differential between old and young workers during the 1990s.[1] The widening, common to all education groups, was mostly caused by a gradual decline in entry wages. On the basis of data for salaried employment in the private sector, the real entry wage of individuals who had their first job at 21-22 grew by 35 per cent between 1976 and 1992 and then declined by 12 per cent from 1992 to 2004, dropping back to levels recorded more than two decades earlier. For more educated workers, who started to work at age 25-26, the fall in the real entry wage was smaller, around 4 per cent. The initial wage loss does not appear to have been offset by a steeper age-earnings profile. These trends affect the current standard of living of younger workers, but I am more concerned here with the long-term evolution.

The reforms of social security enacted in the first half of the 1990s brought about radical changes in the Italian pension system. Once fully implemented, the system will shift from a defined benefit to a defined contribution basis, where each individual holds a notional social security account. Pensions will be related to accumulated contributions and to retirement age, with the aim of mimicking the incentive effects of funded pensions.

In the face of the recent trends in the labour market, the lower real wages of younger cohorts will be reflected in pensions that are relatively lower than those paid to older generations. The development of supplementary pension funds – the "second pillar" of the new system architecture – is then fundamental to guarantee workers adequate pensions. The growth of these funds has, however, been modest so far, well below expectations. The recent introduction of implied consent for the

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[1] A. Rosolia and R. Torrini, "The generation gap: relative earnings of young and old workers in Italy", Banca d'Italia, forthcoming in *Temi di discussione*.

assignment of accruing severance pay to supplementary pension funds and the new form of flexibility in the use of accumulated savings may impart a new impulse, as returns on investments in supplementary pension plans are likely to be better than those on severance pay funds.[2] Improvements on the supply side, in particular greater competition and transparency, may encourage enrolment in supplementary funds. But we also need to investigate the reasons why people have so far been cautious about investing in the new instruments. This is where microeconomic information is necessary.

On the basis of data from the Bank of Italy's survey, there is evidence that participation in private retirement schemes (including occupational pension funds and individual retirement accounts) has increased from 8.5 per cent of households in 1989-91 to 12.2 per cent at the beginning of this decade.[3] Investment in these schemes is significantly more likely among the wealthiest, those with more liquid assets, and the most educated. The saving rate has slightly increased since the end of the 1990s, as might be expected given the large reduction in household permanent income due to the reform of public pensions. However, netting out the effects of the latter, there is little evidence that the regulation of pension funds introduced in the 1990s stimulated personal saving. This outcome is the result of two different effects: an increased amount of saving by the "older" contributors to private retirement schemes – those who were little affected by the reforms of the 1990s – and a lower amount of saving by the "younger" contributors – those subject to the new defined contribution system. Thus, the benefits of improved regulation of supplementary pension funds are exploited less by those who need it most, even after we control for individual socio-economic characteristics. There

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[2] R. Cesari, G. Grande and F. Panetta, "La previdenza complementare in Italia: caratteristiche, sviluppo e opportunità per i lavoratori", Banca d'Italia, *Questioni di economia e finanza*, 8, May 2007.

[3] M. Paiella and A. Tiseno, "Household investment in pension funds: the Italian experience", Banca d'Italia, mimeo.

are important composition effects that can be detected only on the basis of survey data.

This evidence stresses the role of information. If workers are not fully acquainted with the details of the public pension they will receive in the future, they are not in a position to make informed decisions. The greater participation, ceteris paribus, of the more educated points to the importance of enhancing the public's ability to understand complex financial contracts.

A final remark

Until now, I have drawn on research conducted at the Bank of Italy both to emphasize the importance of the analysis of household wealth and to stress the need for reliable cross-country comparable micro data on household behaviour. Comparative research has a distinct value added because the variation in institutional settings can help us to identify the impact of external changes, such as sudden movements in asset prices, on household decisions. The Luxembourg Wealth Study project – which the Bank has consistently supported from the beginning – has shown how cross-border comparability is still limited. The challenge for the Eurosystem project is to design a survey that captures the diversity in institutions, legal systems and social norms, as well as the development of financial markets in the countries of the euro area.

Let me spend my last few words, however, on a more speculative comment. After all, I am in the privileged position of being able to raise questions without having to answer them.

My contention is that wealth, how it is distributed among households and how it is allocated in their portfolios, is of increasing importance. Changes in the functioning of advanced capitalist economies, as well as in the ageing of the population, contribute to shift the emphasis from income to wealth. In a society where employment tends to be permanent and where the welfare state generously supplies education, health and housing benefits, covers against the risk of unemployment and protects old-age income levels, the regularity of actual and expected income flows ensures living standards are maintained and holdings of wealth are less important. When these conditions cease to hold, on account of greater job insecurity or reduced social expenditure, wealth takes on a new significance for household prosperity. Personal wealth has a crucial role in cushioning against life's uncertainties, and the possibility of relying on a buffer stock makes people feel less vulnerable. But the implications are even more far-reaching, as wealth is a crucial determinant of what people can do at the beginning of their lives. For all these reasons, it is imperative that in the future we monitor the evolution of wealth in the same way that we have been monitoring the evolution of income.