Box C: Increasing mortgage rates, a cost-of-living crisis and stamp duty cut: What's next for the UK housing market?

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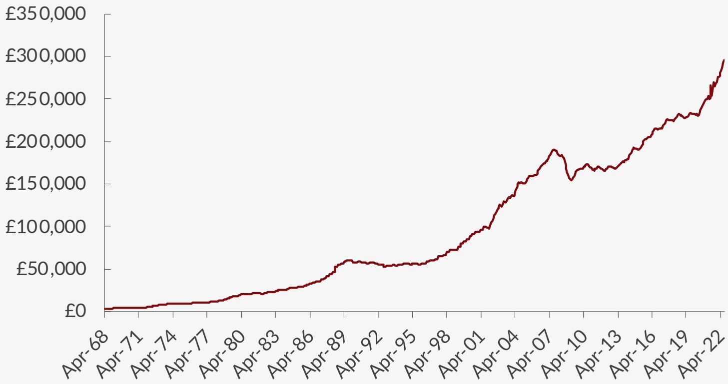
Introduction

Activity in the UK housing market and house prices have remained robust in 2022. Several factors both on the demand and supply sides have kept house prices buoyant (Patel, 2022a), although the growth in house prices has eased this year in part due to the economic turmoil created by the cost-of-living crisis. This Box will evaluate the main data and themes in the UK housing market and explain why we don't think the housing market will collapse, as has been suggested might happen by some.

Recent performance of the housing market

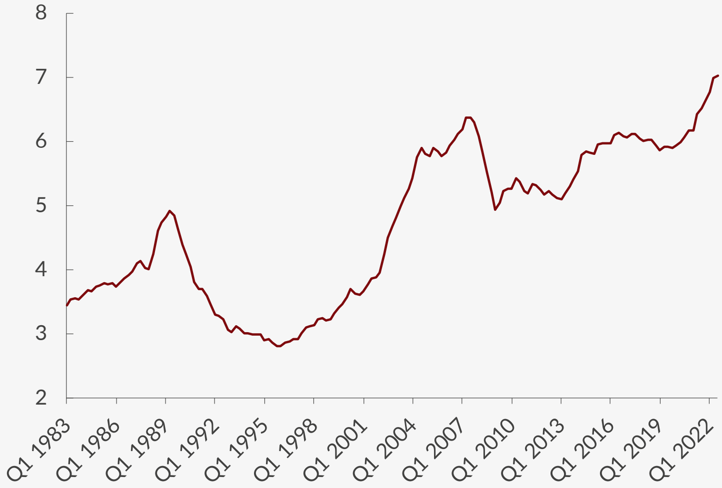
In the United Kingdom, average house prices have surged over the last 50 years (Figure C1). In particular, the growth in house prices has outpaced the growth in household incomes, with the average house price reaching a record of 7 times average income in the third quarter of 2022 (Figure C2). Over time, the substantial growth in house prices can be attributed to multiple factors including, higher household incomes, an increase in joint-income applicants and mortgage availability although, particularly since the global financial crisis (GFC), negative real interest rates have been a key driver. Miles and Monro (2019) find that, since 1985, the decline in index-linked gilt yields and other changes in the cost of home ownership are associated with an increase in house prices of around 90%; income rises account for about a further 80% - between them these factors account for all the observed rise.

Figure C1 Average house price in the United Kingdom



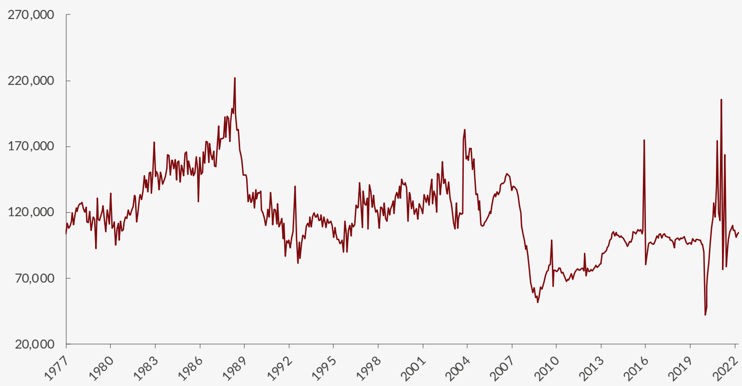
Source: Land Registry.

Figure C2 UK house price to earnings ratio



Source: Nationwide.

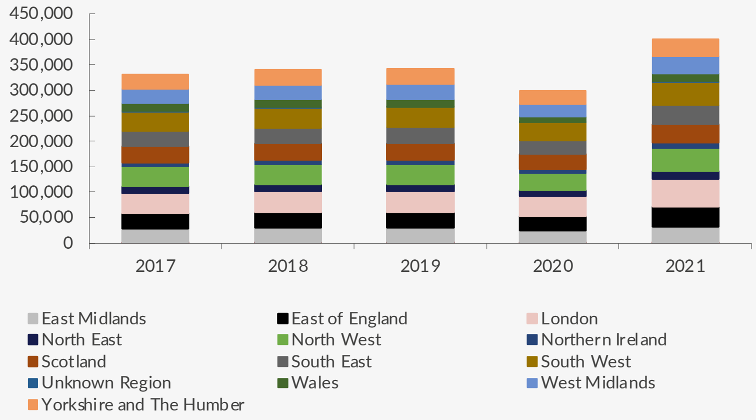
Figure C3 Housing transactions in the United Kingdom



Source: Bank of England.

House price inflation started to accelerate at the end of 2020. In 2020, the average UK house price increased by 2.9 per cent compared with the previous year, and this accelerated to 9.3 per cent in 2021. This resulted from a mixture of lower nominal interest rates, a lack of discretionary spending opportunities during the periods of lockdown helping to boost household savings by around £200 billion, greater demand for larger homes to accommodate remote working, and the Stamp Duty holiday introduced in July 2020 (Patel, 2022b).

Figure C4 Number of new first-time buyers, by region



Source: FCA.

The total amount of first-time buyers joining the property ladder fell in 2020, most likely due to higher risk aversion from the economic impact of the pandemic; however, in 2021 the number of first-time buyers surged by 34 per cent. This increase occurred across all regions of the UK and can be explained by the Stamp Duty holiday provided by then Chancellor of the Exchequer, Rishi Sunak, as well as the underlying change in demand towards larger properties to accommodate remote working.

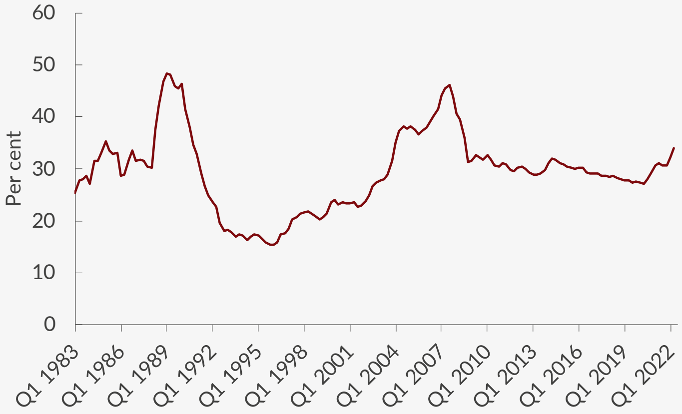
More recently however, the cost-of-living crisis has cooled activity in the housing market. The continued rise in energy and food bills is reducing demand in the housing market in 2022, with housing transactions in the first eight months of 2022 falling by 12 per cent compared with the same period in 2021 (Figure C3). Meanwhile, according to the latest Halifax (2022) House Price Index for September 2022, UK house prices have remained flat since June 2022. The latest S&P Global/CIPS UK Construction PMI suggested that, in September, survey respondents' confidence about the business outlook for the next year fell to its lowest level for over two years, alongside lower purchasing activity because of subdued client demand.

What does the cost-of-living crisis mean for the housing market?

In response to soaring inflation, the Monetary Policy Committee (MPC) of the Bank of England (BoE) continues to tighten the Bank rate, which is now 3.00 per cent. Many interest rates on loans provided by financial institutions, including residential mortgages, follow the Bank rate; subsequently, an increase in Bank rate will be translated into higher mortgage rates, although not necessarily by the same magnitude. The increase in mortgage costs will directly impact variable or tracker rate mortgage holders rather than fixed rate mortgage holders, although buyers applying for a new fixed rate mortgage or existing fixed rate mortgage owners who will be refinancing will also be impacted. That said, as of March 2022, around 60 per cent of current fixed-rate mortgages were on five-year contracts and so would not necessarily be refinancing their mortgage any time soon. Moreover, as of 2020/2021, roughly one third of households are outright owners who will not be affected by higher mortgage rates at all (Department for Levelling Up, Housing & Communities, 2022).

But will higher rates put off first-time buyers? Probably not. 62 per cent of first-time buyers were in the upper two income quintiles in 2020-2021 (Department for Levelling Up, Housing & Communities, 2022). Moreover, 72 per cent of first-time buyers paid a deposit of less than 20 per cent of their property value, while 5 per cent bought their properties outright. Monthly mortgage payments as a percentage of take-home pay for first-time buyers were typically falling after the GFC, though the negative impact of Covid-19 on income levels and economic activity caused this proportion to surge through 2021 to an average of 30.3 per cent from 27.5 per cent in 2020 (Figure C5). Despite this mortgage payments as a percentage of take-home pay remain some 13 percentage points below the peak levels seen during the GFC.

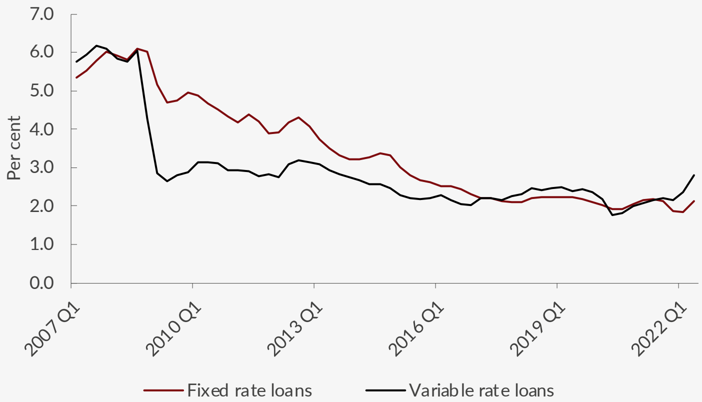
Figure C5 Monthly payments as a percentage of take-home pay, first-time buyers



Source: Nationwide.

Even before the latest policy developments, mortgage rates were already rising for new mortgage holders although at time of writing, they remain lower than historical mortgage rates (Figure C6). In August, the BoE (2022) reported that lending rates for new fixed-rate mortgages rose across all loan-to-value (LTV) ratios by between 8 and 25 basis points, with high LTV mortgage rates returning to peak levels seen during the height of the pandemic.

Figure C6 Overall weighted average interest rate on mortgages

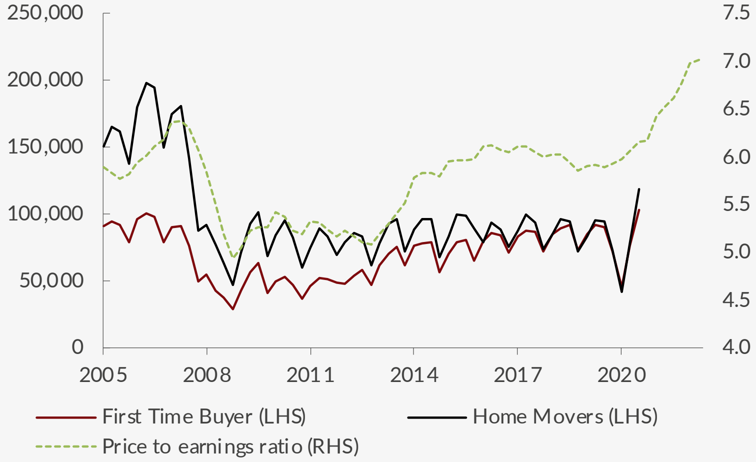


Source: FCA.

A weaker pound will likely add to domestic inflation in the short term and encourage the MPC to raise interest rates higher than was previously expected to bring inflation back to target. Market-implied policy rate expectations have risen since August, now peaking at 4.75 per cent in the summer and autumn of 2023, compared with the August expected peak of 3 per cent.

Consequently, irrespective of the Stamp Duty cut announced in the September mini-budget and confirmed more recently, prospective buyers will be less likely to apply for a mortgage because of rising debt servicing costs, while inflation is eroding real disposable incomes, dampening confidence, and there is greater job insecurity. And this will reduce demand for housing and the growth in house prices. During the GFC, when income levels and house prices declined sharply, new mortgage sales to first-time buyers (as well as existing buyers) plummeted by over 50 per cent (Figure C7). During the height of the pandemic the initial Stamp Duty cut encouraged house purchases because of the change in consumer trends, bolstered savings and, most significantly, the absence of a cost-of-living crisis in the UK.

Figure C7 Mortgage product sales and price-earnings ratio



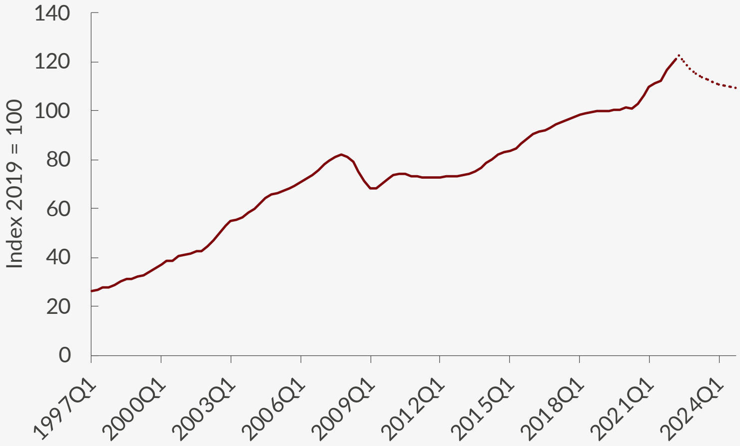
Source: FCA, Nationwide.

Additionally, during periods of economic uncertainty lenders are likely to reduce loan-to-value ratios which would reduce the availability of loans for prospective first-time buyers to get onto the property ladder. Lower loan-to-value ratios would mean buyers may need to increase their deposits which may be difficult with squeezed budgets, thereby constraining housing market activity. In 2020-2021, around 90 per cent of first-time buyers used their savings to fund their deposit but the ongoing cost-of-living crisis is eating into savings; we forecast that, by 2024, the number of people with no savings will double to slightly above 5 million or 20 per cent of households (see NIESR UK Economic Outlook, Summer 2022).

Existing homeowners, who may wish to sell their property and move, may be discouraged from selling their home as they may not want to purchase a property at a higher price when prices are expected to fall. Subsequently, lower property sales may mitigate the fall in demand. This is similar to the experience during the GFC, where the price-to-earnings ratio fell and, in line with this, new mortgages taken out by existing owners plummeted by almost 60 per cent (Figure C7). Lower property sales may also exacerbate supply tightness, further providing underlying support to house prices.

Overall, though we expect house prices to fall over the next couple of years, it is unlikely we will see anywhere near as significant a decline in house prices as we saw in the GFC where, between October 2007 and February 2009, house prices fell by 21 per cent. **We expect UK house prices to fall by a little over 10 per cent between the second quarter of 2022 and the fourth quarter of 2024. But this is only half of the fall experienced in the GFC and would still leave house prices roughly where they were in 2021 (Figure C8).**

Figure C8 Average house price in the UK (including NIESR forecast)



Source: Nationwide, NIESR Calculations.

Conclusion

The cost-of-living crisis is cooling activity in the housing market. The continued rises in energy and food bills are eroding real incomes and consumer confidence, as well as creating economic uncertainty. The likelihood of unemployment rising, and intensifying job insecurity may dent housing market activity further.

The Stamp Duty cut announced in the September mini-budget and confirmed more recently may help encourage some activity in the housing market, particularly in the first-time buyer's category, and therefore support house prices amid higher mortgage rates. That said, first-time buyers may be discouraged from applying for a mortgage irrespective of the Stamp Duty incentive because of the cost-of-living crisis and the risk of banks reducing LTV ratios. Moreover, lower house prices may reduce perceived wealth, particularly in the middle-class, which may even discourage property sales.

Overall, the ongoing fears of a house price and housing market collapse because of higher mortgage rates are unlikely to be proved correct. Not everyone will be affected by rising mortgage rates and a mixture of tight supply of new homes and some support to housing demand provided by the cut in the stamp duty will provide some underlying support to house prices.

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