Like a ton of bricks: what's the deal with the housing market?

June 2023

As we've outlined previously, the Bank of England is likely close to the peak in their interest rate tightening cycle. But the impact of the rapid rise in borrowing costs on the housing market over the past year is becoming clearer and will weigh on economic growth over the year ahead.

Indicators of activity in the housing market show a marked weakening in activity. Transaction volumes were down 19% in March compared to 12 months before and have fallen 57% from their post-COVID peak in June 2021[1]. Furthermore, house prices have fallen from their summer 2022 highs with forecasters expecting declines of approximately 6% in 2023 and 1% in 2024.[2] If realised, these would mark the first annual decline in house prices since 2011.

This note will explore the ways in which an extended decline in prices could dampen economic growth beyond the property sector: notably through a drag on consumer spending, weaker construction, disruption to the financial sector and impacts on the wider economy.

Snapshot of the housing market in 2023

House prices have risen rapidly across the UK since the global financial crisis of 2007-09. After a peak-to-trough of 17% during the global financial crisis, house prices have risen relentlessly since 2012 (in annual terms). Growth accelerated sharply further during the COVID-19 pandemic: house prices grew at an average of 4% per year from 2012 until the end of 2019, before accelerating to 8% between 2020 and 2022. A stronger preference for home working and increased savings rates[3] during the pandemic acted as rocket fuel for the housing market, as low interest rates and a stamp duty holiday served to make housing a desirable asset.

As a result, house prices have risen from an average of £177,000 in January 2007 to £289,000 in December 2022. Average incomes have not kept up with the pace of this increase, and the house price to earnings ratio has risen from 7.2% in 2007 to 8.2% in 2022 in England and Wales.[4] Weak income growth coupled with increasing unaffordability has resulted in housing wealth becoming concentrated among older generations; just 36% of those born in the 1980s owned their own home by age 30, compared with 55% of those born in the 1970s and over 60% for those born in the 1950s and 1960s.[5]

Rising unaffordability has also resulted in a changing mixture of housing tenure even as the proportion of owner-occupied dwellings remained broadly constant between 2012 and 2021 (64%). Within this, the number of homes owned outright rose from 32% to 37%, while the number of homes owned with a mortgage or loan fell from 32% to 26%.[6]

However, with the era of ultra-low interest rates having ended, there are signs the decade-long bull market in the property sector is at an end. The Bank of England base rate has risen from 0.1% in November 2021 to 4.5% by May 2023—the most aggressive tightening since the 1980s. This has fed through to mortgages with the average rate for a 5-year fixed mortgage at 75% LTV rising from 1.3% in October 2021 to 5.6% twelve months later. These higher borrowing costs are weighing on the housing market: annual growth in house prices has slowed from a recent peak of 14.5% in July 2022 to 3.9% in the year to March 2023, with prices down 0.9% month-on-month.[7]

Chart 2 illustrates the shock, showing that the number of mortgage approvals has fallen noticeably from its recent highs in late 2020, with a steep fall in approvals since the "mini"-Budget in September 2022. Moreover, with more than 1.4 million mortgages coming up for renewal, the vast majority of which were fixed when mortgage rates were below 2%,[8] around half of owner occupier mortgages (around 4 million) will be exposed to rate rises over the next year.[9] This will place additional pressure on household finances, alongside the higher cost of servicing other debts like credit cards and personal loans, and broader costs of living pressures.

Why does the housing market matter to the wider economy?

The housing market often serves as a significant channel for the transmission of economic shocks to the wider economy. Changes in interest rates, house prices and rents can have a direct effect on household wealth, incomes and spending. They can also affect residential investment and, therefore, GDP more directly.

Risks from a decline in house prices

Wealth effects

For owner-occupiers, a house is the greatest asset (and liability) they'll ever have (approximately 36% of British wealth is held in property[10]), and so home-owners are highly sensitive to fluctuations in prices. When house prices rise, owners feel better off and more confident. This *wealth effect* is closely linked to higher levels of consumer spending and lower levels of saving.

Some may even borrow against the value of their home, either to spend on goods and services, renovate their home, supplement their pensions, or pay off other debts. A housing downturn reverses that wealth effect and can cause people to defer or abandon spending and consumption plans. The economic impact of this is potentially significant, given that household spending is the largest component of GDP.

Tighter monetary policy weighing on the housing market may cause a negative wealth effect on households. Goldman Sachs estimates[11] that a 100-basis point increase in mortgage rates leads to a roughly 6% fall in house prices, and a 10% fall in housing wealth is associated with a 1.4% fall in consumption. Downstream effects from dampened consumption on GDP, therefore, may adversely impact the wider economy.

Income effects

Higher interest payments have a direct impact on households' disposable income and therefore their spending. The housing market may react to this interest rate shock slowly, as many mortgages were fixed before the recent rate rises. However, as fixed-term mortgage periods end, and mortgage holders move onto higher rates, the impact on both house prices and the wider economy may become more prominent. With 1.4 million mortgages coming up for renewal in 2023, it's expected that the percentage of disposable income spent on debt interest payments will rise from 1.3% in the third quarter of 2021 to 4.9% by 2024.[12] That's money that can't be spent on other goods and services.

A weak housing market, with fewer home sales, will also depress specific sectors of the market. When households move home, they are two to three times more likely to purchase durable goods like fridges, freezers and washing machines, providing a boost to spending. As Chart 3 shows, housing transactions are positively correlated with growth in expenditure on durable and semi-durable items, particularly following periods of weak transaction numbers (for example, the immediate aftermath of the global financial crisis and the COVID-19 pandemic).

Risks to the construction sector

A third impact channel is via activity in the construction sector, which is highly correlated to the housing market. A period of falling house prices is likely to discourage investment and the building of new homes in the UK, which will drag on overall economic growth. Chart 4 illustrates a close relationship between house price growth and the housing activity category of the construction PMI (which measures month-on-month changes in housing construction activity) — as house prices have slipped, the PMI has fallen below the 50 reading, indicating a contraction.

Data from the DLUHC on housing starts suggests that numbers are already falling, reflecting the more challenging macroeconomic environment. There were 39,220 starts (in England) in Q4 2022, a 9% decrease compared with Q3.[13]

Risks to the financial sector

A fall in house prices can affect the stability of the financial sector. When prices are rising rapidly, banks see an improvement in the value of their assets. They feel more confident in increasing lending and reducing their reserve ratio. When house prices decline, the reverse can be true. As lenders, they suffer losses when indebted households face repayment issues. This can result in less credit being available to consumers and businesses.

Similarly, mortgages are the greatest source of debt for UK households. If many people take out large loans compared to their income or the value of their house, this can create a risk for the banking system in the event of an economic downturn, if a large number of households fall into negative equity and homes are repossessed.

It's common for sharp declines in house prices to trigger banking crises. An IMF study into recent banking crises found that more than two-thirds were preceded by boom-and-bust cycles in housing prices.[14] The real costs of such a spillover can be high, for example, the Irish government's bailout of banks following the global financial crisis ate up 40% of GDP.[15]

Risks to renters

A downturn in housing prices also has implications for non-homeowners. While it seems likely that falling house prices will allow more first-time buyers to get onto the property ladder, the coinciding rise in interest rates continues to restrict would-be home owners' affordability.

Furthermore, the behaviour of buy-to-let mortgagors is also likely to have an impact on house prices and renters. There are currently two million buy-to-let mortgages in the UK (around 8% of the total housing stock). These individuals are particularly vulnerable to rate rises as 85% are interest-only mortgages[16], and so tighter financial conditions have a greater proportional impact.

One way these landlords meet increased costs of repayments is to pass them on. The Bank of England has estimated that landlords would need to increase rental incomes by around 20% to offset the projected rise in buy-to-let mortgage costs by the end of 2023.[17] This would increase the cost of living for renters further, affecting their resilience and potentially cause a cut in consumption, amplifying the risks of an economic downturn. Evidence from the ONS suggests that these higher costs are already being pushed onto renters, with private rental prices rising 4.8% in the year to April, up from 2.6% 12 months before, the largest increase since the data series began in 2016.[18]

Altogether, there's evidence that a fall in house prices will drag on growth

The housing market and the wider economy are closely interlinked and rises and falls in one will have noticeable impacts on the other. Chart 5 illustrates this and shows that weakness in the housing market often precipitates weak GDP growth, particularly in 2008 and 2011. Recent outturns in housing prices amidst a slowing economy suggest a similar phenomenon is currently underway – though in this case, lower house prices will likely exacerbate broader economic weakness in the near-term, rather than act as a direct cause.

Previous house price crashes in the UK

To fully understand the impacts of a house price crash, you only have to look back 15 years to the last time we saw an extended period of falling house prices in the UK. Falling house prices contributed to the recession following the global financial crisis of 2008, with house prices dropping 17.5% from highs in September 2007.[19] Seeing a large negative wealth effect, households cut their spending and savings ratios increased, from 7.6% in Q3 2007 to 13.2% by Q1 2010[20], contributing further to the decline in economic activity.

While the 2008 global financial crisis may be a less useful example because of correlation issues between the resulting recession and falling house prices, the early 1990s recession provides a more like-for-like illustration of the impact of rising interest rates on the housing market. The years from 1989 to 1991 also saw a period of increasing rates to tackle inflation, which resulted in house prices falling by 34% after repayments by mortgage holders reached 30% of gross income.[21]

What do we think will happen?

The CBI's own upcoming forecast foresees that we're in the midst of another housing downturn. A combination of falling household incomes, a small rise in unemployment, and higher interest rates will weigh on the housing market, as the data already available suggests signs of a softening.

We expect house prices to fall outright in the second half of this year, with the decline gathering pace in 2024 – a deeper fall than in 2011, but short of the decline in 2008 – with more fixed-rate mortgage holders due to re-mortgage in the coming months, under higher interest rates, and spend an increasing percentage of their income on repayments. This weighs on the wider economy, as potential spending by homeowners and mortgage holders is weaker than if the house price euphoria had continued. We also expect a moderate contraction in household spending this year as sticky – albeit falling – inflation eats into household budgets.

Charts

Chart 1: UK house prices 2007 to present (GBP, SA)

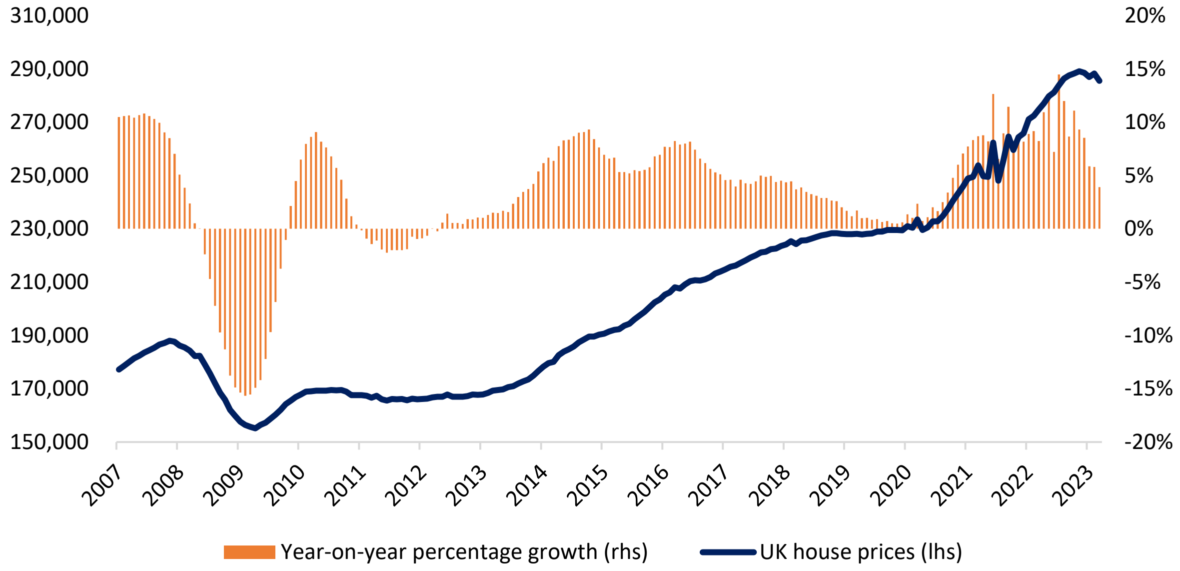


Chart 2: Mortgage approvals and total value 2007 to present

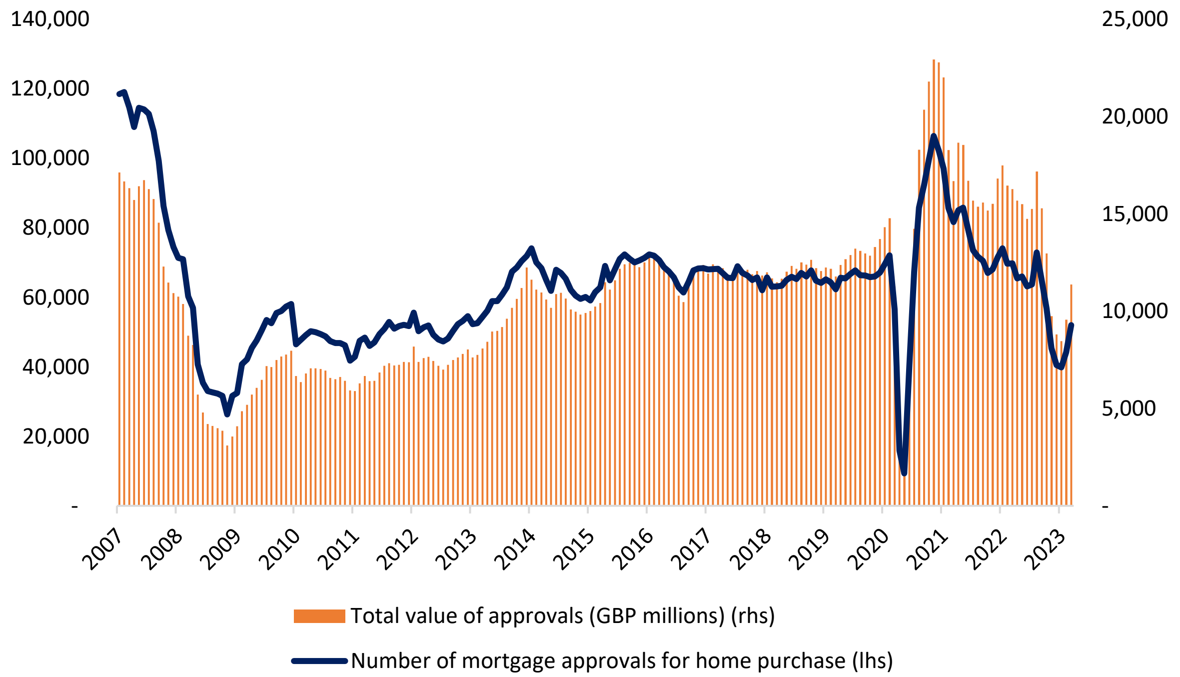


Chart 3: Durables expenditure and housing market transactions 2007 to present

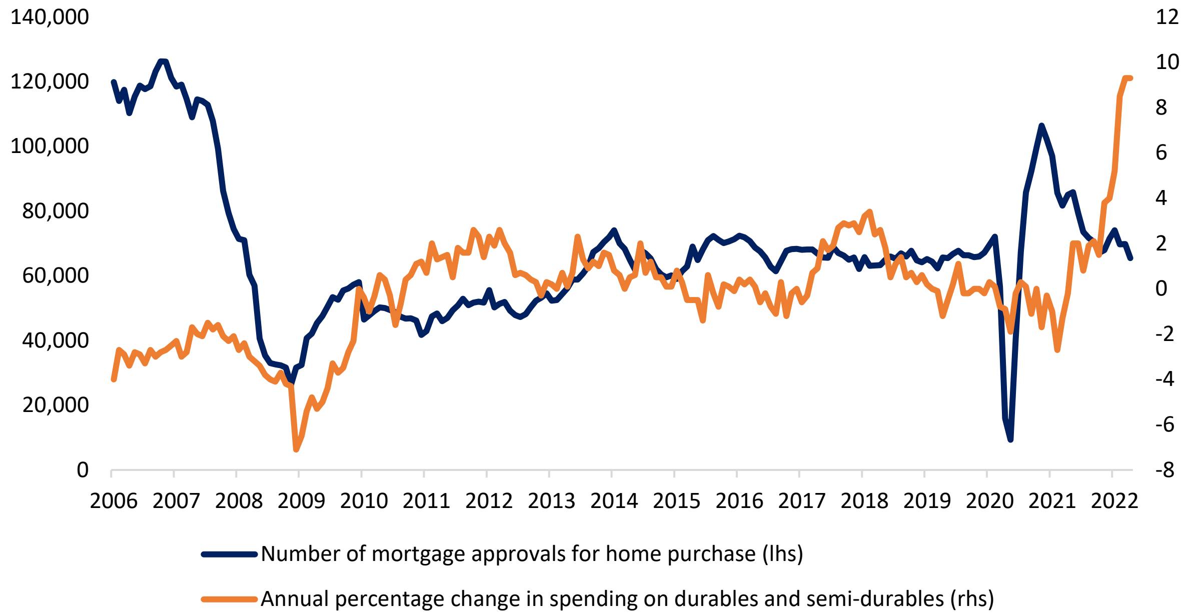


Chart 4: UK house price growth to construction PMI (housing activity) 2007 to present

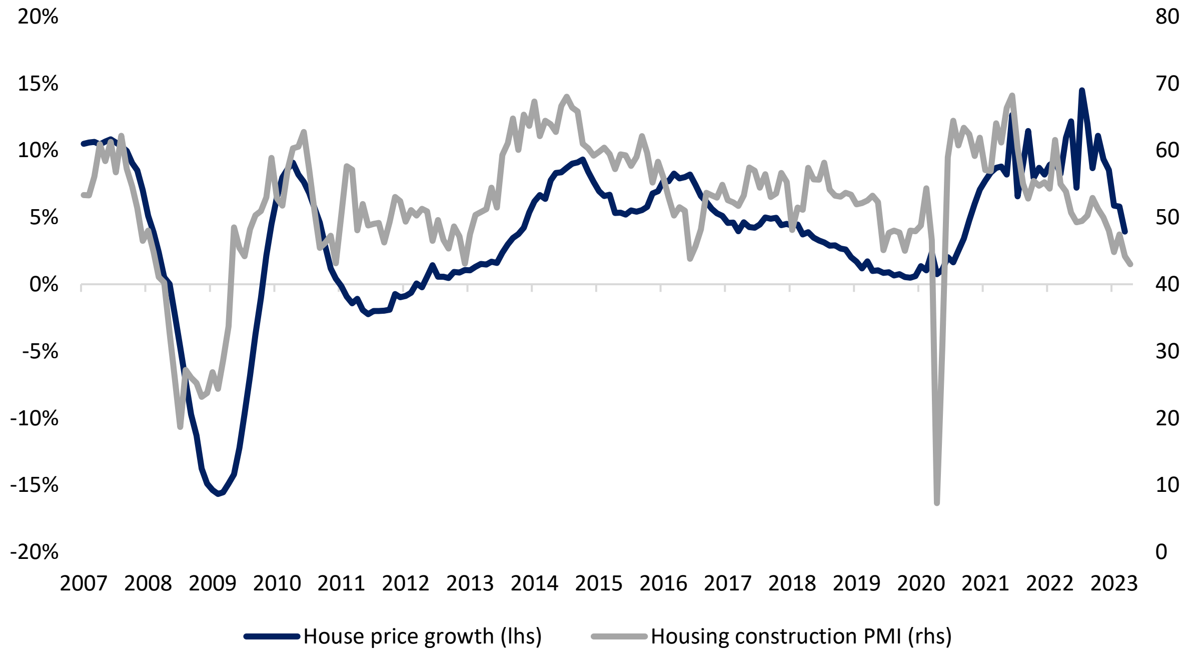
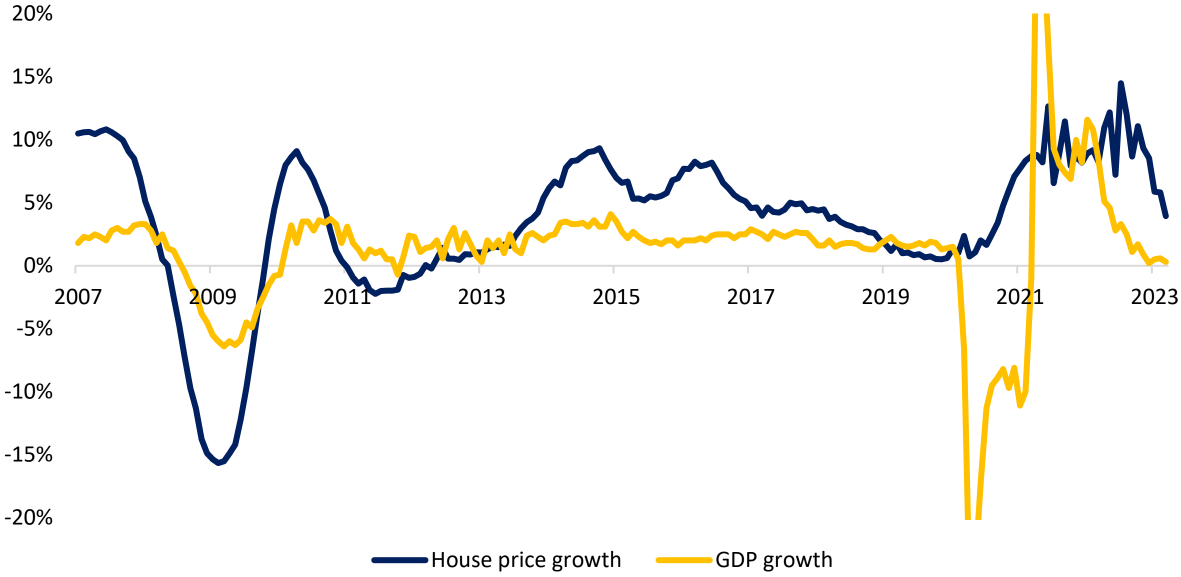


Chart 5: UK house price to GDP growth 2007 to present (monthly y/y% change)



If you have any feedback on this article or would like to share any insights into the trading conditions currently facing your business, please contact us at any of the email addresses below:

Insights@cbi.org.uk

Cameron Martin, CBI Economist
Cameron.Martin@cbi.org.uk

[1] UK monthly property transactions commentary, HMRC, 28th April 2023, at https://www.gov.uk/government/statistics/monthly-property-transactions-completed-in-the-uk-with-value-40000-or-above/uk-monthly-property-transactions-commentary [accessed 11th May 2023]
[2] Forecasts for the UK economy: April 2023, HM Treasury, 26th April 2023, at https://www.gov.uk/government/statistics/forecasts-for-the-uk-economy-april-2023 [accessed 11th May 2023]
[3] The household savings ratio leapt from 5.6% in the fourth quarter of 2019 to 26.8% in the second quarter of 2020.
[4] Housing affordability in England and Wales: 2022, ONS, 22nd March 2023, at https://www.ons.gov.uk/peoplepopulationandcommunity/housing/bulletins/housingaffordabilityinenglandandwales/2022 [accessed 29th March 2023]
[5] Brewer, M., & Wernham, T., Wealth is the growing economic divide in the UK today, IFS, 9th November 2022, at https://ifs.org.uk/news/wealth-growing-economic-divide-uk-today [accessed 29th March 2023]
[6] Subnational estimates of dwellings and households by tenure, England: 2021, 27th February 2023, at https://www.ons.gov.uk/peoplepopulationandcommunity/housing/articles/researchoutputssubnationaldwellingstockbytenureestimatesengland2012to2015/2021 [accessed 29th March 2023]
[7] UK House Price Index: March, ONS, 24th May 2023, at https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/housepriceindex/march2023 [accessed 24th May 2023]
[8] How increases in housing costs impact households, ONS, 9th January 2023, at https://www.ons.gov.uk/peoplepopulationandcommunity/housing/articles/howincreasesinhousingcostsimpacthouseholds/2023-01-09 [accessed 30th March 2023]
[9] Financial Stability Report - December 2022, Bank of England, at https://www.bankofengland.co.uk/financial-stability-report/2022/december-2022 [accessed 15th March 2023]
[10] Household total wealth in Great Britain: April 2018 to March 2020, ONS, 7th January 2022, at https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/totalwealthingreatbritain/april2018tomarch2020#:~:text=2.,2008%2C%20after%20adjusting%20for%20inflation [accessed 18th May 2023]
[11] Moberly, J., et al., 'European Daily: UK – The Housing Channel of Policy Tightening', Goldman Sachs, 21st February 2023
[12] Goodwin, A., 'UK: Looser fiscal policy to prevent 2023 GDP contraction', Oxford Economics, 22nd March 2023 [accessed 16th May 2023]
[13] F3: Housing Market, House of Commons Library, No. 02820, 15th February 2023, at https://researchbriefings.files.parliament.uk/documents/SN02820/SN02820.pdf [accessed 20th February 2023]
[14] Housing Markets, Financial Stability and the Economy, IMF, 11th June 2014, at https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp060514 [accessed 16th May 2023]
[15] Laeven, L. & Valencia, F., Systemic Banking Crises Revisited, IMF, 14th September 2018, at https://www.imf.org/en/Publications/WP/Issues/2018/09/14/Systemic-Banking-Crises-Revisited-46232 [accessed 18th May 2023]
[16] Financial Stability Report - December 2022, Bank of England
[17] Financial Stability Report - December 2022, Bank of England
[18] Index of Private Housing Rental Prices, UK: April 2023, ONS, at https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/indexofprivatehousingrentalprices/april2023 [accessed 24th May 2023]
[19] CBI calculations of Land Registry Data
[20] ONS Households' Saving Ratio
[21] Housing Downturns: 1989-95, BuiltPlace, at https://builtplace.com/subscribers/digging-deeper/housing-downturns/1989-95/#:~:text=Housing%20market%20transactions%20fell%20by,falls%20led%20to%20negative%20equity. [accessed 15th March 2023]