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How efficient is monetary policy transmission in the UK?

A review of the UK mortgage and corporate lending market

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FLASH NOTE

SUMMARY

- The recent shift from floating rate mortgages to fixed rate mortgages in the UK has dampened the pass-through of the Bank of England's monetary policy, with fewer households experiencing an immediate change in interest expenses than before.
- Historically low interest rates on existing mortgages have discouraged UK homeowners to refinance their mortgages, further weakening the transmission of monetary policy.
- The prevalence of fixed-rate mortgages and the relatively low share of homeowners with outstanding mortgages have helped consumer spending remain relatively resilient over the past year. The move away from variable to fixed rate mortgages mitigated the lagging impact of rate hikes on the broad economy since late 2021. The weakening of monetary transmission can also be seen in the relative resilience of corporate lending in changes of policy rate.
- The Bank of England decided to cut its policy rate by 25 basis points in August, following twelve consecutive months of holding the rate steady, bringing it down to 5%. The slow pass-through rate of policy changes to the economy bolsters our case for three cuts in total this year, with the second cut expected to occur in September.

A WEAKENING OF MONETARY POLICY TRANSMISSION

A central bank's monetary policy primarily operates through interest rates, which impact both borrowing and spending behaviour across the economy. One key mechanism by which policy rates impact the broader economy is through mortgages.

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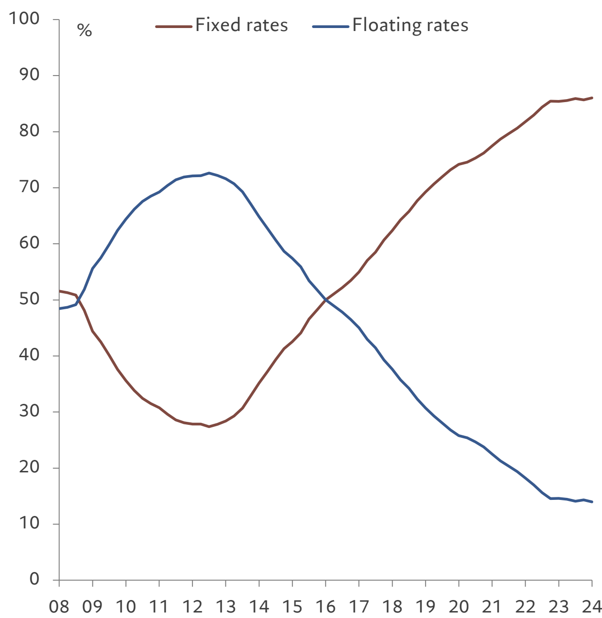
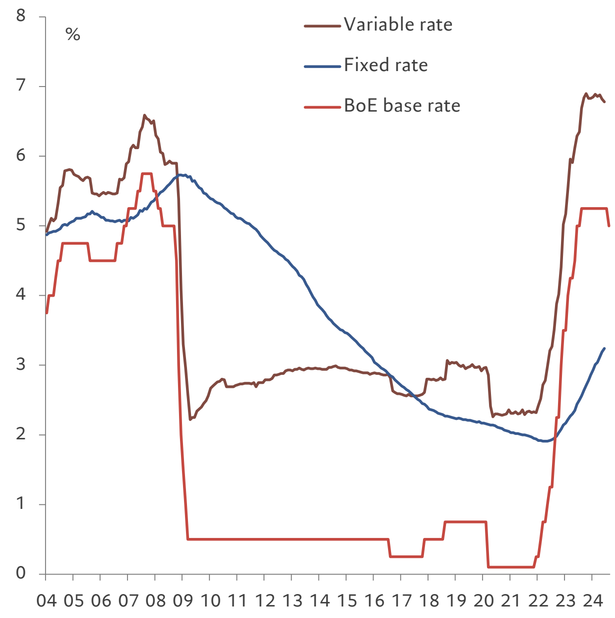
In recent years, the UK has witnessed a shift from floating/variable-rate to fixed-rate mortgages, which had implications for the effectiveness of the Bank of England's (BoE) monetary policy. Since 2008, floating-rate mortgages as a proportion of the total outstanding has more than halved, decreasing from its peak of 72% in 2012 to 14% in 2024 (chart 1). This structural change in the mortgage market has reduced the sensitivity of the economy to changes in the policy rate since fewer households experience an immediate change in their disposable income, through interest expenses, when rates are adjusted.

Chart 1: Share of outstanding UK mortgages at fixed and floating rates



Source: Pictet Wealth Management, BoE, Financial Conduct Authority, as of 06.08.2024

Chart 2: Effective interest rates for households vs. BoE policy rate



Source: Pictet Wealth Management, BoE, as of 06.08.2024

There is a risk that the effectiveness of monetary policy is diluted if changes in the policy rate do not fully propagate through households' consumption via mortgage rates. This responsiveness to changes in UK monetary policy can be observed through the effective rate on outstanding mortgages, both fixed and floating (chart 2). During 2008-09, the mortgage market was particularly sensitive to changes in the Bank of England's policy rate given that loans then were predominantly at a floating rate. As the share of variable-rate mortgages has declined since then, this sensitivity has been reduced. The effective fixed rate on outstanding mortgages has been slow to react to the BoE's latest hiking cycle since late 2021, resulting in a rate significantly lower than both the variable and policy rates.

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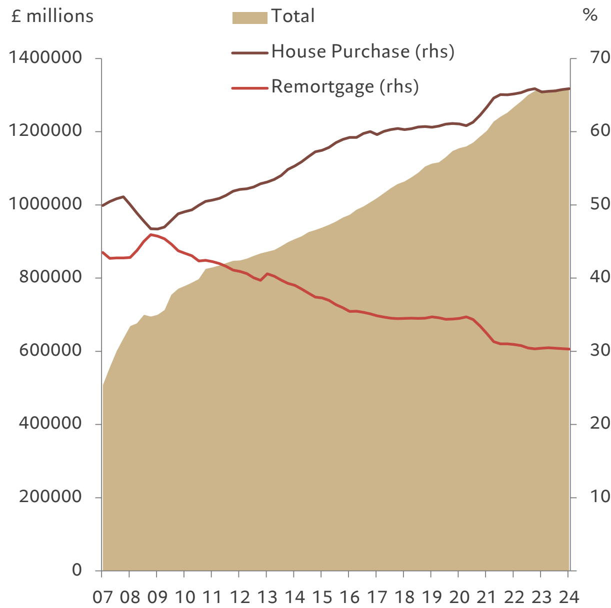
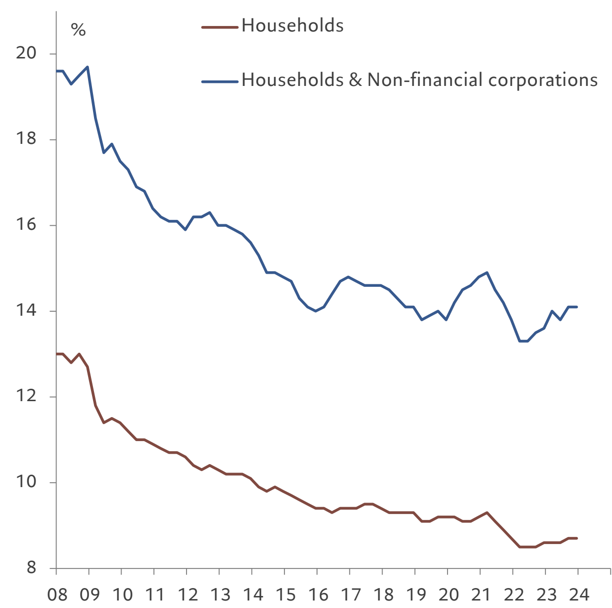
Chart 3: Breakdown of outstanding mortgages



Source: Pictet Wealth Management, BoE, Financial Conduct Authority, as of 06.08.2024

Chart 4: UK debt service ratio



Source: Pictet Wealth Management, Bank for International Settlements, as of 06.08.2024

As a result, households' debt service ratio has been declining since 2008, given the limited pass-through of monetary policy changes to the effective interest rate. Additionally, remortgaging activity has decreased in recent years, indicating that existing homeowners are choosing to stay with their current mortgage deals. With historically low interest rates until late 2021, there was little reason for mortgage holders to refinance, further dampening the pass-through of monetary policy.

HOUSEHOLD CONSUMPTION REMAINS RESILIENT

The rise in fixed-income mortgages has attenuated the impact of rate increases since late 2021 and ensured that household consumption has remained relatively stable in the UK. Higher returns on savings accounts and other fixed-income investments have also helped support spending. In short, the combined effect of stable mortgage payments and higher savings income led to a more resilient consumption pattern. Even as the Bank of England raises rates to combat inflation, the impact on consumers may be muted and delayed, implying a lagging effect of tight monetary policies on prices as well as a cushion against economic slowdown.

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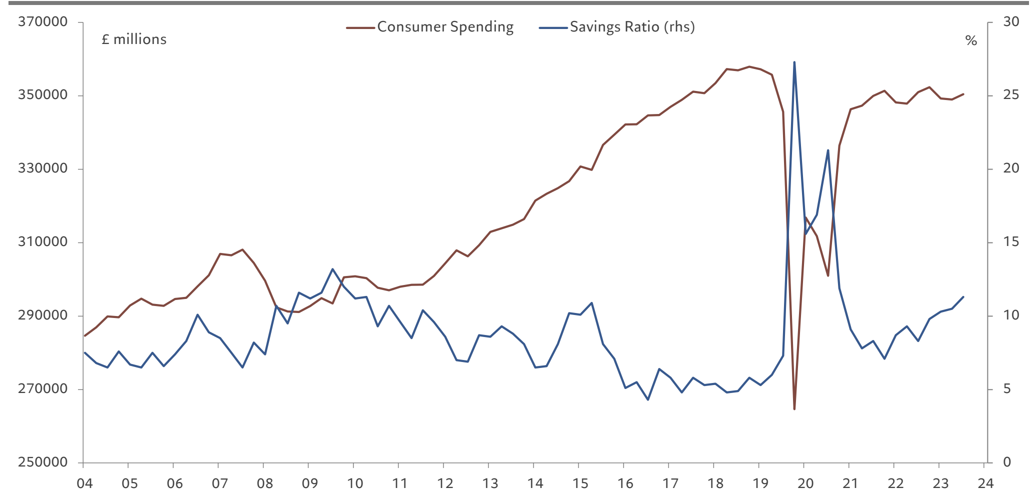
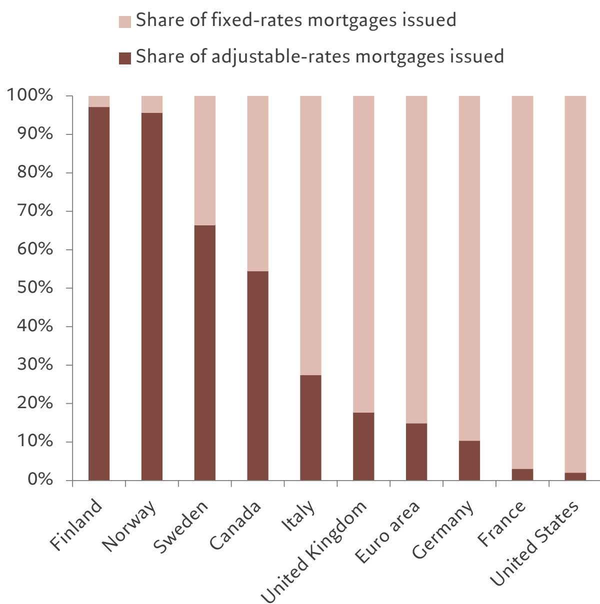
Chart 5: Real UK household consumption expenditure vs. savings ratio



Source: Pictet Wealth Management, Office of National Statistics, as of 06.08.2024

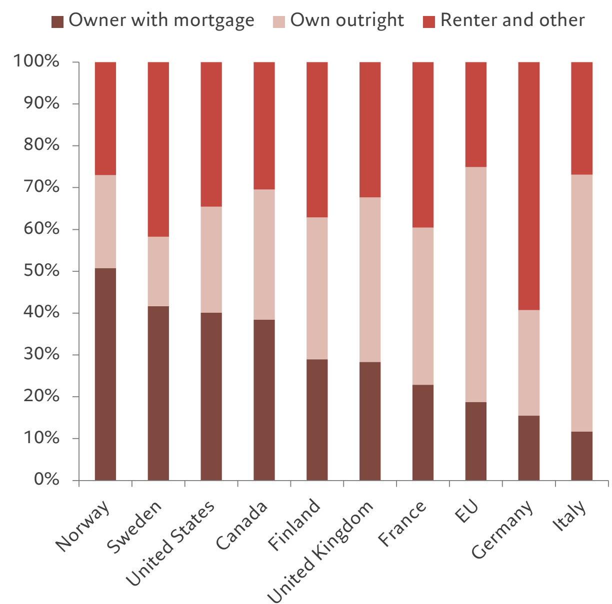
Additionally, homeowners without mortgages typically have lower financial burdens compared to those with mortgages. The former has more income for discretionary spending, thereby supporting robust consumption figures. In the UK, less than 30% of households have a mortgage outstanding, which is lower than in Scandinavia and the US.

Chart 6: Share of adjustable and fixed-rate mortgages issued (2022)



Source: Pictet Wealth Management, OECD, as of 06.08.2024

Chart 7: Share of outright owners, those with a mortgage and renters (2022)



Source: Pictet Wealth Management, OECD, as of 06.08.2024

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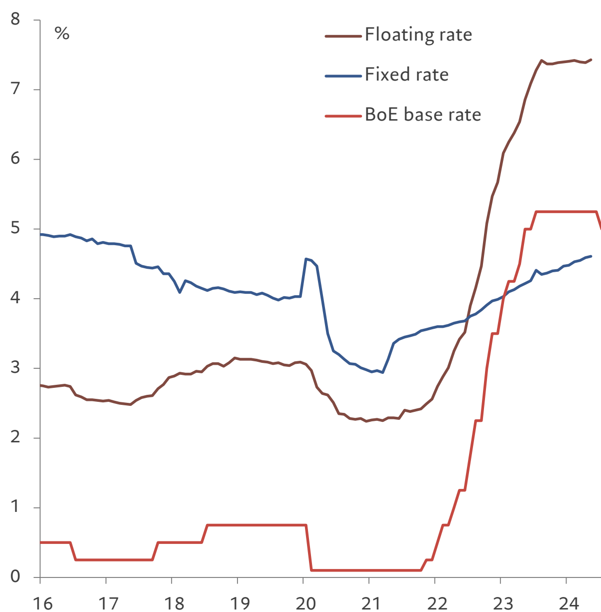
CORPORATE LENDING: A SIMILAR STORY

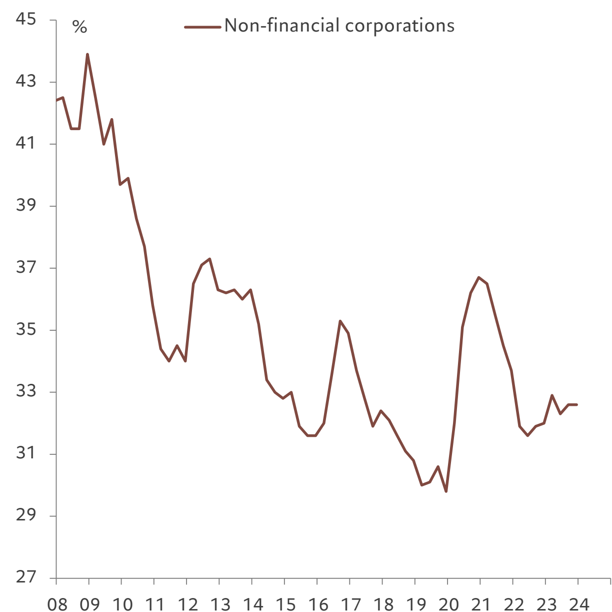
A similar trend towards weaker monetary transmission can be observed in corporate lending. The effective fixed rate on UK corporate loans has been slow to adjust to changes in the policy rate over the past years, resulting in more sluggish adjustments to interest payments (chart 8). Consequently, as with households, the weakening pass-through of monetary policy to effective interest rates means the debt service ratio for non-financial corporations has also been declining (chart 9). This limited responsiveness ultimately impacts the efficiency of the Bank of England's monetary transmission mechanism.

Chart 8: Effective interest rate on loans for non-financial corporations vs. BoE base rate



Source: Pictet Wealth Management, BoE, as of 06.08.2024

Chart 9: UK debt service ratio for non-financial corporations



Source: Pictet Wealth Management, Bank for International Settlements, as of 06.08.2024

IMPLICATIONS FOR THE BANK OF ENGLAND

Overall, the recent shift from floating- to fixed-rate mortgages in the UK has dampened the pass-through of the Bank of England's monetary policy. With fewer households experiencing immediate changes in their disposable income through interest expense, the sensitivity of economic activity to monetary policy has been reduced.

During its August meeting, the Bank of England decided to lower its policy rate to 5%, marking its first rate cut since the last rate hike in the summer of 2023. This decision is an important step in the BoE's easing cycle, as it adopted a "high-for-longer" stance by leaving its base rate unchanged at 5.25% over the past twelve months, supported by a slower monetary policy transmission. Slashing rates by 25 basis points, resulting from a narrow majority vote of 5-4, was justified by receding inflationary pressures as headline inflation fell to its 2% target in both May and June. This decision comes as the impact of recent rate hikes on consumers has been

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both muted and delayed over the past months. We now expect the BoE’s next rate cut to occur in September, with a risk of a delay if domestic inflationary pressures do not recede as expected, although the BoE’s Monetary Policy Committee has exhibited a growing tolerance for sticky services prices.

Whereas the market currently anticipates approximately two rate cuts this year, we expect three 25 basis points cuts for 2024. This expectation is underpinned by the Bank of England's significant flexibility to reduce rates from a relatively high and restrictive starting point, although the exact timing remains uncertain. Eventually, a slower pass-through rate bolsters our case, as the effects of a policy rate change on the economy will not be immediate, in line with our forecast of moderate economic growth this year despite the start of an easing cycle.

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