Resolution Foundation
Macroeconomic Policy Unit

The Macroeconomic Policy Outlook: Q1 2024

Simon Pittaway

2023 was yet another year of economic stagnation for the UK. By the third quarter of the year, economic activity was only 0.2 per cent higher than at the end of 2022. But forecasts this time last year were far gloomier than the year of stagnation that came to pass. One reason why the UK has so far avoided recession is that, in aggregate, higher interest rates have benefitted households: the gains from higher savings rates have outweighed the extra burden of debt interest. In this edition of the MPO we take a closer look at the recent income boost from higher rates, explore its underlying drivers, and set out what it means for the UK's economic prospects in 2024.

The income boost from higher rates currently being enjoyed by British households is both large and unprecedented. Across all households, annualised real income from savings interest rose £34 billion between Q4 2021, when the Bank of England started raising rates, and Q3 2023. This is almost twice the £18 billion increase in debt interest costs, and the resulting £16 billion net interest income boost amounts to 1 per cent of households' disposable income. Had net interest income not risen, around three-fifths (58 per cent) of disposable income growth over this period would have been wiped out. This is completely unprecedented in recent history: net interest income typically falls when rates rise.

The rise in household net interest income ultimately stems from sluggish pass-through to mortgage rates. Rate rises from the Bank of England have taken time to feed through to Britain's mortgage bills: nearly two-fifths (37 per cent) of households that had a mortgage when the Bank started raising rates have still not reached the end of their fixed-rate deal. And, while savings rates haven't risen in line with Bank Rate, they have increased by more than the average rate on household debt. Moreover, improvements in household balance sheets – first as debt fell after the financial crisis, and then as savings rose in the pandemic – have put households in position to benefit fully from recent interest rate moves. Balance sheet improvements from the pandemic alone have nearly doubled the income boost from higher rates.

Where is this heading next? Unfortunately for British households, the income boost from higher rates isn't set to last. We estimate that net interest income could fall by 0.9 per cent of disposable income as rates fall in 2024, undoing nearly all of the income boost seen to date. This isn't to say that rate cuts will lead to more spending: the distributional impact of lower rates, and their wider effects on the economy, will stimulate activity. But what has been a tailwind to aggregate household income growth is likely to become a headwind in 2024, contributing to a messy economic outlook for the year ahead.[1]

[1] The author would like to thank Torsten Bell, Mike Brewer, Molly Broome, James Smith and Gregory Thwaites for their help in preparing this Outlook.

For the first time ever, higher interest rates have boosted households' net interest income

The past two years have been turbulent for the British economy. The spike in energy prices following Russia's invasion of Ukraine – on top of existing price pressures from global supply chains struggling to keep up with the post-Covid economic recovery – left the UK facing the most severe inflation shock since at least the 1970s. The Bank of England, in response, embarked on the largest and most prolonged series of rate rises in more than three decades.

However, in the face of a once-in-a-generation inflation shock and rapid monetary tightening, economic activity has been surprisingly resilient. Although economic growth was anaemic in 2023, we have (so far at least) avoided the recession predicted by the Bank of England, the Office of Budget Responsibility (OBR), and many others.

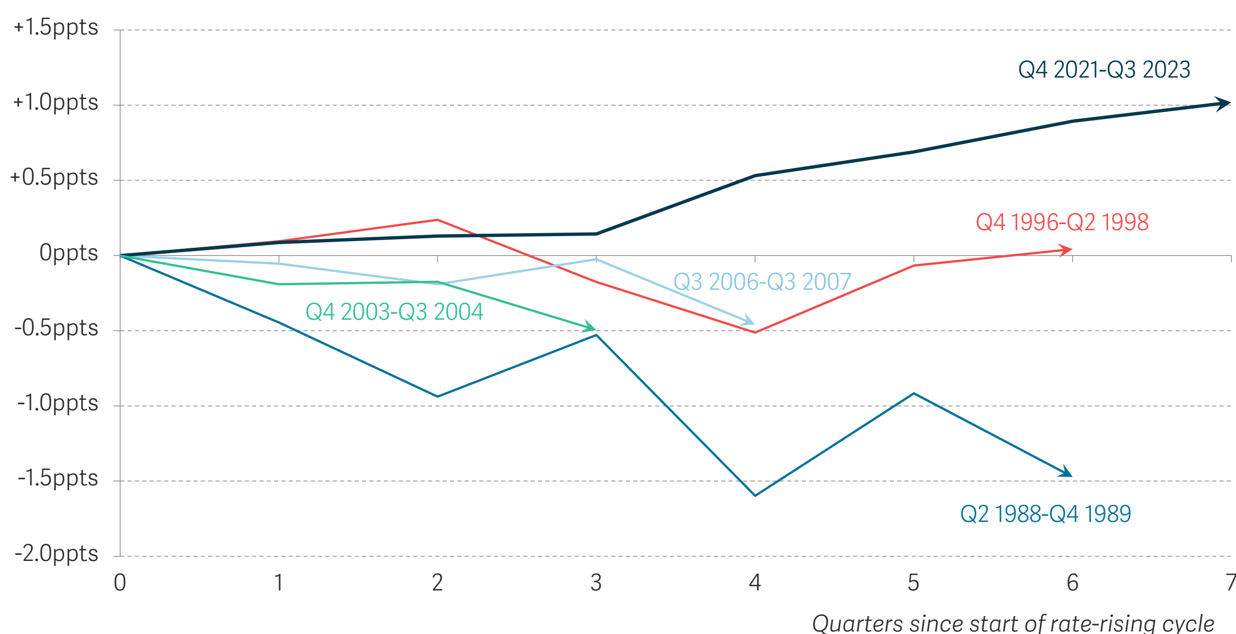
There are a number of reasons why the UK economy exceeded expectations in 2023. A faster-than-expected fall in energy prices is a major one. But a less-discussed factor behind the UK avoiding recession is the unprecedented behaviour of households' interest income and expenses during a rate-rising cycle.

Higher rates directly boost the interest income that households earn on their savings, and increase interest payments on their debts. Monetary policy affects households and the economy in many ways, but the direct impact of higher rates on household cash flows is thought to account for around a quarter of the total impact of rate rises in the UK.

To measure the size of overall impact of higher rates on households' cash flows, we can look at net interest income – that is, interest earned on savings minus interest paid on debts – in the UK Economic Accounts. Typically, when rates rise, net interest income falls. Because households tend to have more debt than interest-bearing savings (as shown in Figure 5 below) an equally-sized increase in rates on both sides of the balance sheet means a bigger cash increase in debt interest than savings income. But, as shown in Figure 1, Britain's latest rate-rising cycle has bucked this trend completely.

FIGURE 1: **For the first time ever, households' net interest income has materially increased during a rate-rising cycle**

Change in household sector net interest income as a proportion of gross household disposable income during rate-rising cycles of at least 1 percentage point and at least six months in duration: UK



NOTES: For each cycle, the line ends in the final quarter in which there was a Bank Rate rise. Net interest income is calculated as interest resources minus interest uses for the household sector. For both resources and uses, the measures used are before financial intermediation services indirectly measured (FISIM) which captures the actual levels of interest paid and received by households. Gross disposable household income is seasonally adjusted.
SOURCE: RF analysis of ONS, Economic Accounts.

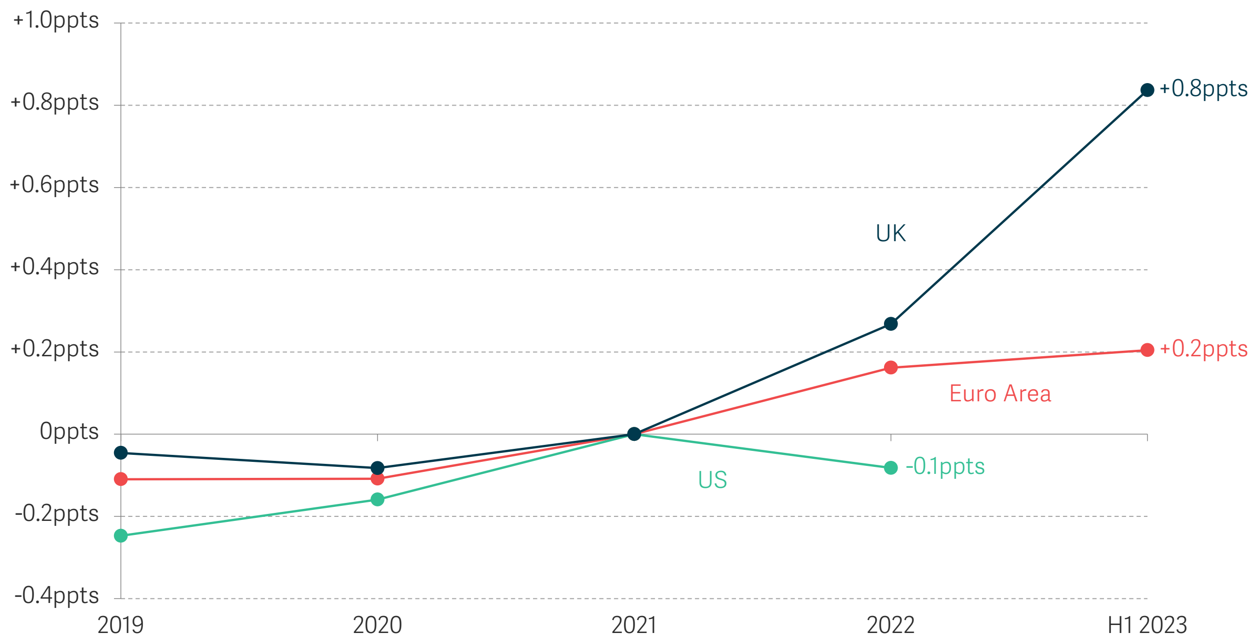
In aggregate, British households have benefitted from a historic improvement in net interest income since the Bank of England started raising rates. Between Q4 2021 and Q3 2023, annualised income from savings interest increased by £34 billion (in Q3 2023 prices), almost double the £18 billion real-terms increase in households' debt interest bill over the same period. The resulting £16 billion increase in net interest income is equal to 1 per cent of households' total disposable income. This boost to household incomes has been mirrored in falling net interest income for financial corporations.

As well as being historically unprecedented within the UK, the boost to household income is not being seen across other major economies. As shown in Figure 2, households – here including non-profit institutions serving households (NPISH) – in the Euro Area have seen net interest income rise by only 0.2 per cent of disposable income between 2021 and the first half of 2023, albeit with significant variation across individual countries.[2] The experience of UK households is even further removed from that of their US counterparts, who saw net interest income fall from 2021 to 2022 due to a surge in non-mortgage interest payments.

[2] NPISH are included to ensure comparable data between the UK, Euro Area and US. In practice, their inclusion makes little difference as the overall households and NPISH sector is dominated by households. For example, in Q3 2023, households accounted for 97% of interest income across households and NPISH in the UK.

FIGURE 2: **The large net interest income boost for UK households is not being enjoyed by their counterparts in the Euro Area and US**

Change in household sector and non-profit institutions serving households (NPISH) net interest income as a share of gross disposable income, relative to 2021: various economies



NOTES: For the UK and Euro Area, net interest income is calculated as interest resources minus interest uses for the household and non-profit institutions serving households (NPISH) sector. For both resources and uses, the measures used are before financial intermediation services indirectly measured (FISIM) which captures the actual levels of interest paid and received by households and NPISH. For the US, net interest income is calculated as monetary interest received by persons minus monetary interest paid by households and non-profit institutions, and is not yet available for 2023. For all three economies, gross disposable household income is seasonally adjusted.
SOURCE: RF analysis of OECD, Quarterly non-financial accounts by institutional sector; Bureau of Economic Analysis, National Income and Product Accounts.

Higher net interest income for UK households accounts for the majority of household disposable income growth since the end of 2021. Real household disposable income grew just 1.8 per cent between Q4 2021 and Q3 2023. Rising net interest income accounts for around three-fifths (58 per cent) of this growth: real household disposable income would have grown by just 0.7 per cent had net interest income remained flat. Furthermore, if net interest income had fallen by the average amount in previous UK tightening cycles (0.6 per cent of disposable income) this would have wiped out all nearly all real income growth since Q4 2021, leaving it at just 0.1 per cent.

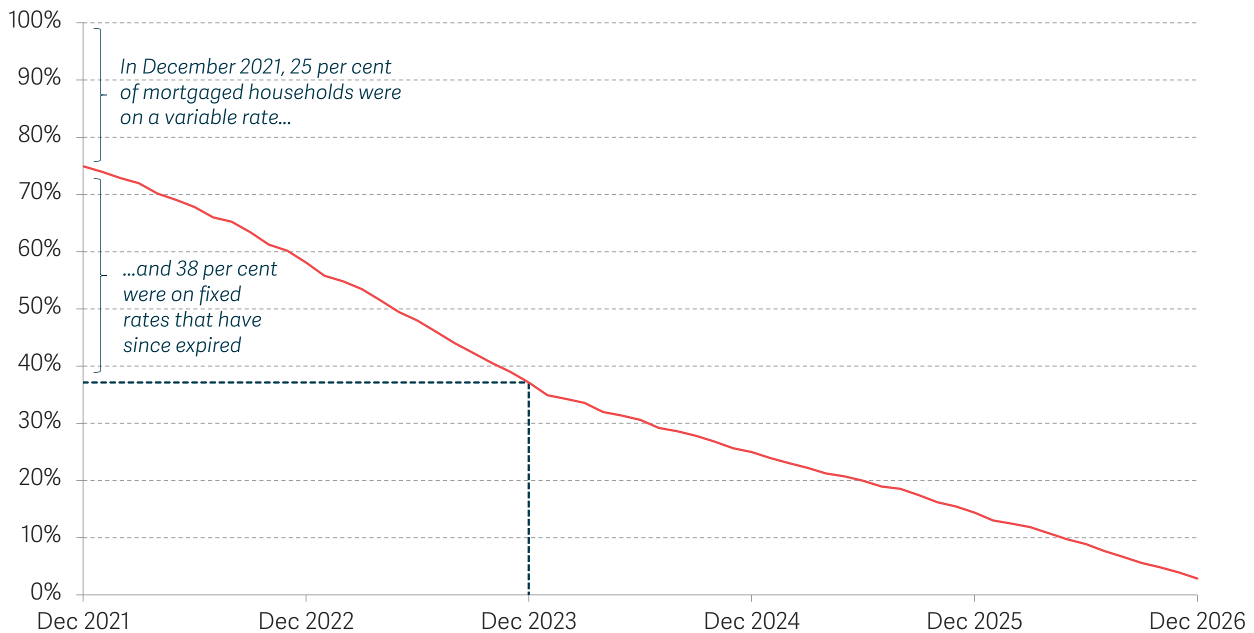
Rising net interest income is the result of slow pass-through to mortgage rates...

A defining feature of this most recent rate-rising cycle has been the slow and gradual pass-through of increases in the Bank of England's base rate to higher mortgage rates for families. In the year before the Bank began to raise rates, more than £9 in every £10 (95 per cent) of new mortgage lending was issued at a fixed rate, compared to around £4 in every £10 (41 per cent) between 2004 and 2006. And, since 2016, there has also been an increase in the average length of fix, with the five-year fix overtaking the two-year fix as the most popular mortgage product. As a result, many families have been shielded from rate rises for some time until their fixed-rate deal has expired. Indeed, as shown in Figure 3, nearly

two-in-five households that had a mortgage when the Bank started raising rates (37 per cent) have yet to see their fixed-rate deal come to an end.

FIGURE 3: **Nearly two-fifths of households that had a mortgage when the Bank started raising rates have yet to reach the end of their fixed-rate deal**

Proportion of outstanding owner-occupier mortgages in December 2021 that have not reached the end of their fixed-rate deal: UK



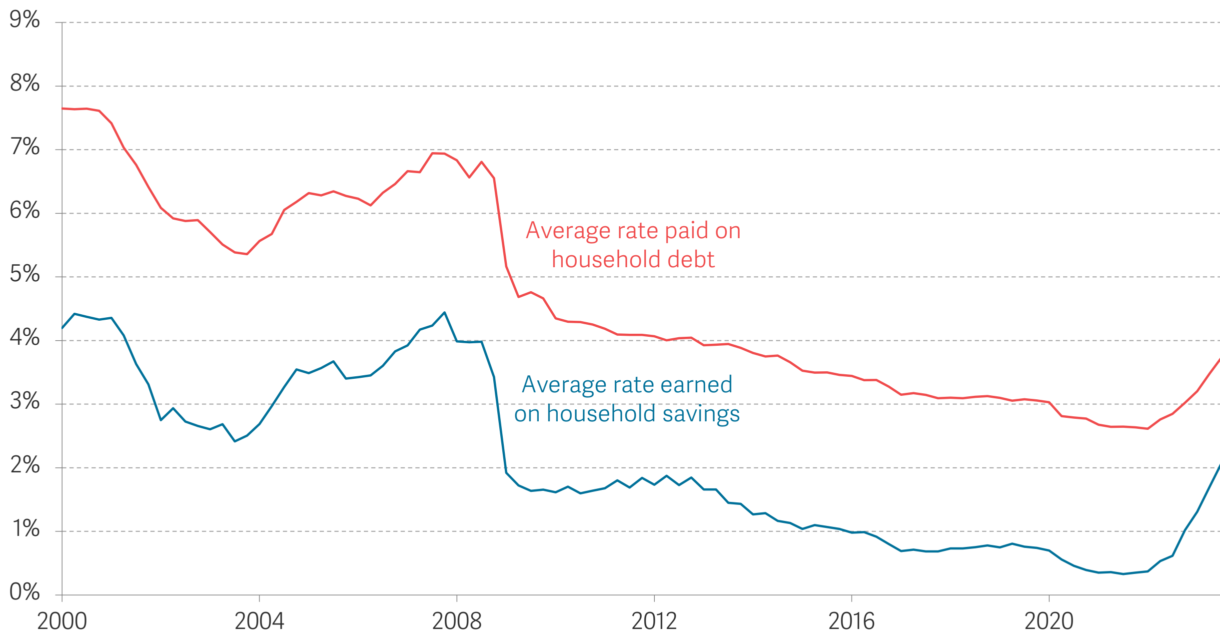
SOURCE: RF analysis of FCA, Product Sales Data.

The wide prevalence of fixed-rate mortgages has meant that increases in the average rate across all mortgages have lagged well behind increases in the Bank of England's base rate. And, because mortgage debt makes up around £9 out of every £10 owed by UK households, this feeds through to a sluggish increase in households' overall interest payments. As shown in Figure 4, the average effective interest rate on household sector debt increased by only 1.1 percentage points between Q4 2021 and Q3 2023, despite more than 5 percentage points of rate hikes by the Bank of England in that time.

Although savings rates haven't kept pace with rises in the Bank of England's base rate, they have more rapidly than rates on household debt. The average effective rate on household savings increased by 1.7 percentage points between Q4 2021 and Q3 2023, as seen in Figure 4. It is this difference between the increase in savings rates and the increase in rates household debt that has resulted in higher net interest income for households.

FIGURE 4: **On average, interest rates paid by households have increased by less than the interest received on savings**

Average effective interest rate on household sector interest-bearing assets and liabilities: UK



NOTES: Quarterly effective interest rates received/paid by households are calculated by dividing interest resources/uses before FISIM by the stock of interest-bearing assets/liabilities. The chart shows annualised equivalents of these quarterly rates. Interest-bearing assets are the sum of: deposits with UK Monetary Financial Institutions, deposits with rest of world Monetary Financial Institutions, other deposits, debt securities, and loans. Interest-bearing liabilities are loans.
SOURCE: RF analysis of ONS, Economic Accounts.

...but the size of the income boost has been magnified by improved household balance sheets

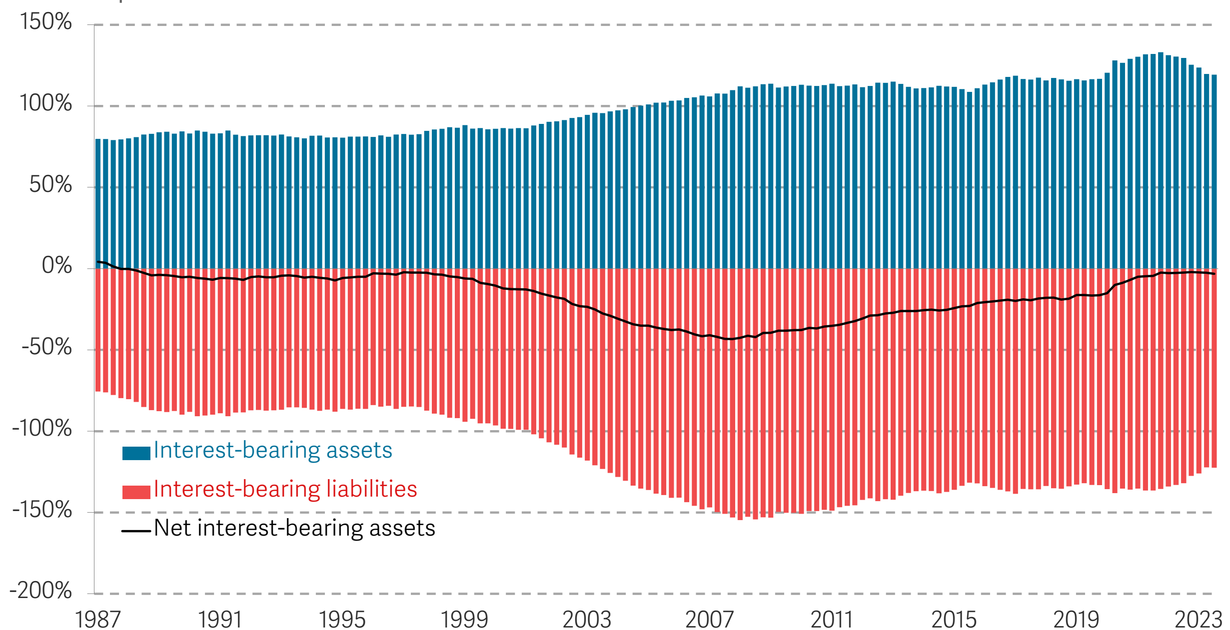
The *size* of the boost to net interest income as a result of differential changes in rates depends crucially on the health of household balances sheets. The extent to which households are able to benefit from lopsided increases in savings rates depends on their net balance of interest-bearing assets (mainly savings accounts) and interest-bearing liabilities (mainly mortgage debt). If interest-bearing liabilities are significantly larger than interest-bearing assets then, even if mortgage rates rise more slowly than savings rates, the cash increase in interest payments can still outweigh the cash increase in interest income. If assets and liabilities are more evenly-matched, then households are in a better position to benefit.

As shown in Figure 5, households' net balance of interest-bearing assets to interest-bearing liabilities has improved markedly since the financial crisis. In 2007, interest-bearing liabilities stood at 150 per cent of disposable income, and interest-bearing assets were much lower, at only 108 per cent of disposable income. The net balance of assets and liabilities improved gradually following the financial crisis, as tight credit conditions and subdued housing market activity caused household debt to fall. It then improved more rapidly during the pandemic, as households saved at record levels during

lockdowns (although passive changes in the value of non-interest bearing assets had a much larger impact on *overall* household balance sheets at this time). By the time the Bank of England started raising rates, interest-bearing liabilities (136 per cent of household disposable income in Q4 2021) were only slightly larger than interest-bearing assets (132 per cent). Not since the 1980s had the gap between interest-bearing liabilities and assets been so small, leaving households in a historically advantageous position to benefit from recent trends in interest rates.

FIGURE 5: **In aggregate, households' balance of interest-bearing assets and liabilities is the strongest since the 1980s**

Household sector interest-bearing assets and liabilities as a proportion of annualised gross household disposable income: UK

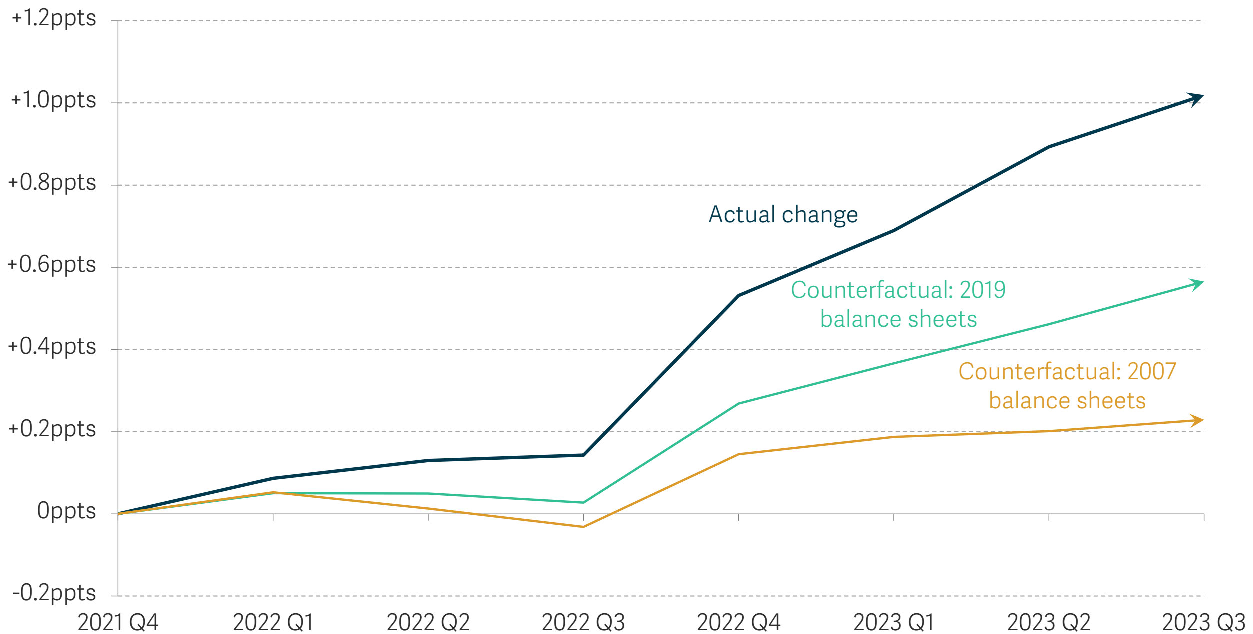


NOTES: Interest-bearing assets are the sum of: deposits with UK Monetary Financial Institutions, deposits with rest of world Monetary Financial Institutions, other deposits, debt securities, and loans. Interest-bearing liabilities are loans. Gross disposable household income is annualised seasonally adjusted quarterly income.
SOURCE: RF analysis of ONS, Economic Accounts.

These changes in household balance sheets have amplified the boost to household income from higher interest rates. Figure 6 quantifies their impact by comparing the actual change in household net interest income (as shown in Figure 1) to two counterfactuals. The first, shown by the gold line, estimates the change in net interest income based on actual changes in interest rates between Q4 2021 and Q3 2023, but assuming that households had 2007 (i.e. pre-financial crisis) levels of interest-bearing assets and liabilities. The second, shown by the green line, repeats this exercise with 2019 (i.e. pre-pandemic) balance sheets. The actual increase in net interest income (1.0 per cent of disposable income) is more than four times larger than it would have been if households went into this rate-rising cycle with pre-financial crisis balance sheets (0.2 per cent). Balance sheet improvements during the pandemic were also significant, almost doubling the boost to income from higher interest rates (from 0.6 percent).

FIGURE 6: **Improvements in households' net asset position has put them in position to benefit from recent trends in savings and loan rates**

Actual and counterfactual change in household sector net interest income as a proportion of gross household disposable income relative to Q4 2021: UK, 1987-2023



NOTES: Interest-bearing assets are the sum of: deposits with UK Monetary Financial Institutions, deposits with rest of world Monetary Financial Institutions, other deposits, debt securities, and loans. Interest-bearing liabilities are loans. Gross disposable household income is seasonally adjusted.
SOURCE: RF analysis of ONS, Economic Accounts.

Net interest income is likely to fall in 2024 as more households roll on to higher mortgage rates

Sadly for British households, the increase in net interest income over the past two years seems unlikely to last: the best guess is that it will unwind as the Bank of England pivots to cutting rates in 2024 (financial markets currently expect around 1.5 percentage points of cuts this year). Savings rates, which are mostly variable, are expected to fall relatively quickly. Whereas mortgage bills will take longer to come down. The 1.5 million households due to reach the end of their fixed-rate deal in 2024 will see their annual bill rise by £1,800 on average, and many others will remain locked in to expensive fixed-rate deals secured over the past year.

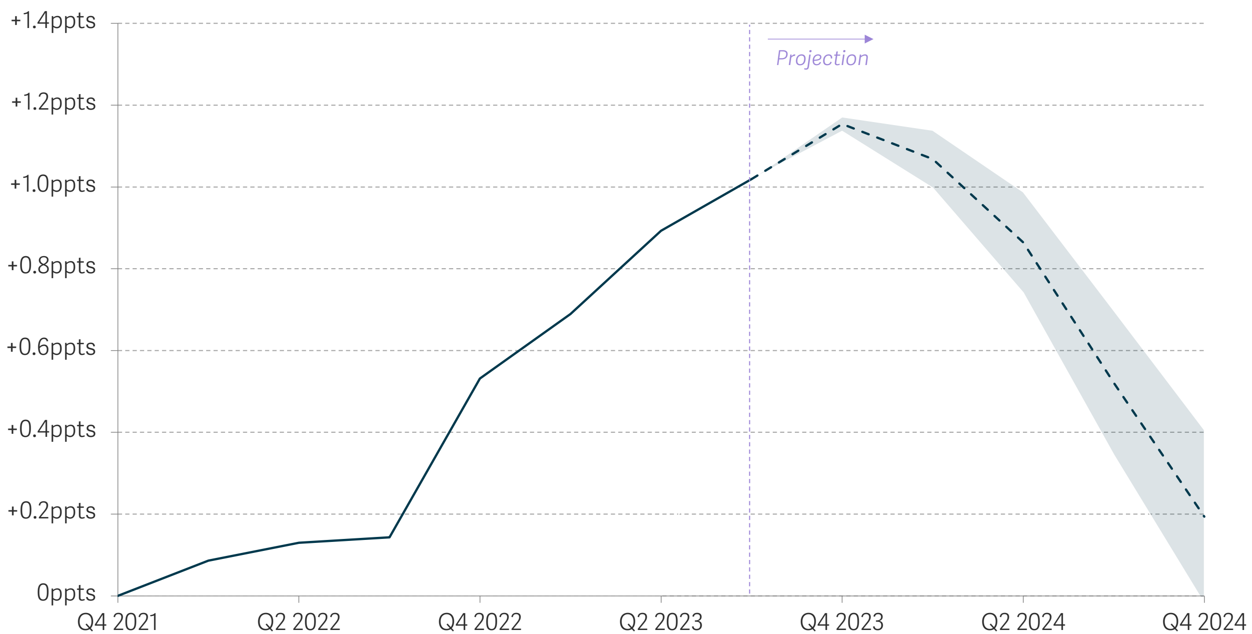
Figure 7 shows an estimate for the evolution of household net interest income up to the end of 2024. This estimate combines projections for the average rate on household savings and debt, taking into account when savers and borrowers are due to come to the end of any existing fixed-rate deals.[3]

[3] The methodology for this estimate builds on previous RF work for projecting mortgage rates, with Bank Rate expectations taken from overnight index swap (OIS) rates on 27th December 2023. In addition to mortgage rates, we project the average rate on consumer credit and household deposits up to the end of 2024. The average rate on the stock of consumer credit declines in line with the expected future path for Bank Rate. The extent of pass-through from future Bank Rate cuts is assumed to be equal to the observed pass-through to average stock rates between November 2021 and October 2023. Rates on instant access deposits – including National Savings &

Net interest income as a share of disposable income is projected to peak in the final quarter of 2023 before falling by around 0.9 percentage points throughout 2024. As a result, we estimate that by the end of 2024 almost all of the recent boost to net interest income could have unwound.

FIGURE 7: **Net interest income is due to fall in 2024**

Change in household sector net interest income as a proportion of gross household disposable income relative to Q4 2021, outturns and projection: UK



Notes: Based on market expectations for Bank Rate on 27th December 2023. The grey swathe reflects significantly uncertainty around the outlook for instant-access savings rates; the dotted line is the average of the top and bottom of the swathe. See endnotes for further detail on the projection methodology.
SOURCE: RF analysis of ONS, Economic Accounts; Bank of England, Bankstats and Yield curves.

The gains from higher savings income and the burden of higher debt interest have not been shared equally across families

The distribution of gains and losses from rising rates matters in addition to aggregate trends. In Britain, wealth and interest income are both very unequally distributed. For example, according to the ONS's Wealth and Assets Survey, the top 5 per cent of households hold nearly half (44 per cent) of all interest-bearing savings, while the bottom 50 per cent hold just 3 per cent. For many families, rising rates will have no perceptible impact on their incomes. And, even for those with substantial savings, the net impact will also depend on their level of outstanding debt.

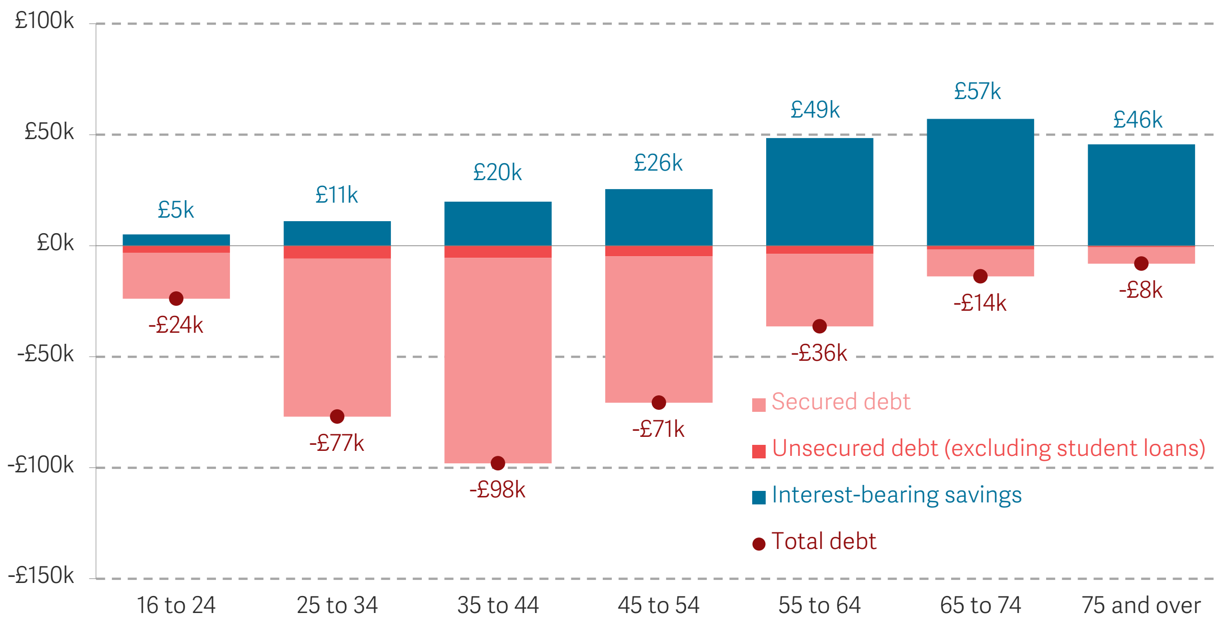
Age is an important determinant of the extent to which someone is likely to gain or lose from rising rates. As shown in Figure 8, older households – who tend to have accumulated savings throughout

Investments (NS&I) and the majority of cash ISA balances – are also assumed to move in line with Bank Rate. For NS&I and cash ISAs, the spread below Bank Rate is based on quoted rates in November 2023. For other sight deposits, we model two scenarios for the future spread, as a notably wide gap has emerged between quoted rates and effective rates over the past year. In one scenario, we assume that the current spread between Bank Rate and the average effective rate on sight deposits persists indefinitely; in the other, we assume that over the next 12 months the spread narrows to reach the latest spread between Bank Rate and the average quoted rate on instant access deposits. For time deposits – including a minority of cash ISAs – we use aggregate Bank of England data on the stock of outstanding fixed-term bonds, and the average quoted rates on new fixed-term bonds in recent years, to estimate the evolution of the average rate on the stock of fixed-term bonds over the coming year.

their working lives and often own their homes outright – are more likely to have benefitted from rising rates than younger households. Compared to the average household headed by a 35-to-44-year-old, the average household headed by a 65-to-74-year-old has nearly three times as much in interest-bearing savings (£57,000 versus £20,000) and around seven times less outstanding debt (£14,000 versus £98,000).

FIGURE 8: **The young and middle-aged are set to be at the sharp end of rising interest rates, while older households stand to benefit**

Mean interest-bearing household savings, secured debt, and unsecured debt, by age group of household reference person: GB, 2018-20



Notes: Interest-bearing savings are defined as: current accounts in credit, savings accounts, cash ISAs and NS&I products. Secured debt refers to mortgage debt and unsecured debt includes loans, credit/store/charge cards, hire purchases, outstanding mail-order accounts and arrears. Debt excludes student loans.
SOURCE: RF analysis of ONS, Wealth and Assets Survey.

The uneven impact of rising rates across households is an important part of monetary policy transmission. Spending from households with outstanding debts tends to be more sensitive to rising rates than households with savings. Between 2014 and 2020, the Bank of England's NMG survey asked households how they would respond to a sustained increase in their mortgage repayments and, separately, interest income from savings. Half of households (47 per cent) said they would cut back on spending after a rise in mortgage repayments. But less than one-in-ten (8 per cent) said they would spend more after an increase in savings income.

This distributional impact of higher rates – plus their wider effects on the exchange rate, businesses, asset values and households' incentives to save – was crucial in putting the brakes on spending and economic activity in 2023. But, in stark contrast to Britain's previous rate-rising cycles, the direct impact of higher rates on aggregate household income acted in the opposite direction, boosting incomes and helping the UK economy avoid an outright recession. 2024 will be messy, as expected cuts in Bank rate will boost spending, but be offset by rising mortgage payments for many as more fixed-rate deals expire, and falling savings rates remove a rare source of income growth for many households. All of this suggests the Bank of England's job of steering the economy won't get easier any time soon.

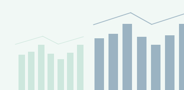
Resolution Foundation

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged.

We do this by undertaking research and analysis to understand the challenges facing people on a low to middle income, developing practical and effective policy proposals; and engaging with policy makers and stakeholders to influence decision-making and bring about change.

For more information on this report, contact:

Simon Pittaway, Senior Economist
simon.pittaway@resolutionfoundation.org



Resolution Foundation

2 Queen Anne's Gate

London SW1H 9AA

Charity Number: 1114839