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Resolution Foundation

Peaked interest?

What higher interest rates mean for the size and distribution of UK household wealth

Molly Broome, Ian Mulheirn & Simon Pittaway

July 2023

Acknowledgements

The authors are grateful to the abrdn Financial Fairness Trust for supporting this work. Contributions on this report from colleagues at the Resolution Foundation are gratefully acknowledged, particularly Torsten Bell, Mike Brewer, James Smith and David Willetts.

We would also like to thank Arun Advani, Karen Barker, Brian Bell, Sebastian Burnside, Emma Chamberlain, Mubin Haq, Eleni Karagiannaki, Carla Kidd, Sarah Luheshi, David Miles, Ben Moll, Natacha Postel-Vinay, Michael Royce and David Sturrock for their comments. All views and any errors remain those of the authors.

The Resolution Foundation joined the abrdn Financial Fairness Trust to embark on a major investigation into the role of wealth in 21st century Britain. This Wealth in Focus is the first output in a new four-year project. The abrdn Financial Fairness Trust's mission is to contribute towards strategic change which improves financial wellbeing in the UK. Its focus is on tackling financial problems and improving living standards for those on low-to-middle incomes. It is an independent charitable foundation.

Contents

Executive summary

A defining change to Britain and its economy took place over the past four decades: household wealth grew from around three-times GDP in the mid 1980s, a level typical of the second half of the 20th century, to seven-times GDP on the eve of the pandemic. And while the pandemic initially led to a surge in wealth, the cost of living crisis – and the higher interest rates that have followed – have thrown this trend into reverse for the first time in living memory. In this report, we first explore changes in households' active saving behaviour since the start of the pandemic. We go on to put this in the context of the passive changes in wealth brought about by rising interest rates, which have prompted a dramatic reversal in the trend of recent decades. We establish what this means for the composition and distribution of household wealth, analyse the extent to which future family finances hinge on the future level of interest rates and consider how policy makers should respond.

Household saving has whipsawed over the past three years

During the pandemic, there was an unprecedented surge in household saving, accompanied by substantial debt repayments. Between February 2020 and May 2021, total household deposits in banks and building societies rose by £247 billion, while the stock of consumer credit fell by around £28 billion. Overall, household balance sheets improved throughout the pandemic. To a large degree, this reflected government interventions that

protected incomes coupled with the limited opportunities for spending. But the impact varied significantly between different types of households. Among the lowest income quintile, 21 per cent of individuals reported an increase in savings during the pandemic, compared to 42 per cent among the top-income quintile.

As Covid-19 concerns waned, and the economy began to rebound, inflation started to rise. In February 2022, Russia's invasion of Ukraine triggered a significant shock in energy and food prices that pushed inflation to a peak of 11.1 per cent by late 2022, putting a vicious squeeze on living standards. Survey data indicates that some families resorted to reducing their savings in response, with those on lower incomes more likely to say their savings fell compared to those with higher incomes: among the bottom income quintile, 48 per cent of individuals reported a reduction in their savings between December 2022 and March 2023, in contrast to 29 per cent in the top income quintile. This reflects the fact that households in the lowest income quintile allocate a larger portion of their consumption towards the essential items whose prices rose most compared to households in the highest income quintile (59 per cent compared to 43 per cent), leaving them with less flexibility to cut back in the face of price shocks.

Given the anticipated impact that rapidly rising prices would have on real earnings, most forecasters predicted that households would need to deplete their pandemic savings to sustain their consumption through late 2022 and into 2023. The Office for Budget Responsibility (OBR) projected that the adjusted saving ratio would fall to around zero in 2023 and 2024. Notwithstanding most recent data pointing to a record level of withdrawals from banks and building societies, the relative stability of the saving ratio up to Q1 2023 has been surprising. One factor contributing to this discrepancy is the surprising strength in real income growth: real household disposable income is estimated to have fallen by 1.8 per cent in 2022-23 compared with a fall of 3.7 per cent forecast by the OBR, a difference of £28 billion.

To counter the spike in inflation the Bank of England has raised interest rates for a record 13 consecutive meetings of the Monetary Policy Committee since December 2021. The move

to higher rates is boosting the income of richer, typically older families, but is hitting those with significant debts who tend to be younger. On average, in 2018-20, individuals aged 65-74 had more than five times the amount of interest-bearing savings compared to those aged 25-34 (£57,000 and £11,000 respectively). By contrast, younger borrowers, particularly mortgage holders, face higher interest payments. However, the adverse effects of this have yet to be fully felt: by the end of June 2023, only around 56 per cent of households with mortgages will have been affected by the increasing mortgage rates.

But, despite the better-than-feared news on incomes, UK households have not increased consumption in response: real consumption expenditure has remained relatively stable throughout the latter half of 2022 and into 2023, and remains 2.2 per cent below a continuation of its pre-pandemic trend. Instead, UK households have instead continued to save at elevated levels relative to before the pandemic, at least up to Q1 2023. This is in contrast to the US where consumption has seen strong growth since the start of 2021 and has returned to its pre-pandemic trend. As a result, US households are actually saving less than they were pre-pandemic.

Why might UK households be more cautious? There are three main factors that may be at play here. First, with much of the mortgage repayment shock yet to come, indebted homeowners might be adjusting their consumption behaviour in anticipation. Second, as has happened in the past, the highly uncertain economic outlook may be contributing to households' caution. Finally, unlike in the US, UK households remain highly vulnerable to volatile gas prices ahead of next winter and there is significant uncertainty about the long-term impact of the terms-of-trade shock on the country's overall living standards.

Rising interest rates have brought four decades of increasing wealth to an abrupt end

Rather than active saving on the part of households, 'passive' gains from rising asset prices have been the dominant force in determining the level of wealth in recent decades – around three-quarters of the rise in wealth is accounted for by such gains. These rising asset prices have stretched the pre-existing financial gaps between families: in 2020 the average wealth per

adult for a family in the richest tenth was £1.4 million more than for a family in the fifth decile. In 2006, this gap was £1 million on an inflation-adjusted basis.

The onset of the pandemic saw a further acceleration of this long-term trend. As interest rates hit record lows, asset prices boomed. This pushed the value of wealth still higher, dominated by rises in housing and pension wealth, peaking at 840 per cent of GDP in early 2021.

But the cost of living crisis has been markedly different, putting an end to the trend of rising wealth with the biggest fall on record. Asset values have fallen sharply as interest rates have surged , and market pricing now implies interest rates are expected to remain at levels not seen since the financial crisis for the foreseeable future. This in turn has sent the price of government and corporate bonds tumbling: holders of UK government debt have seen around a 30 per cent loss in the value of their investments since the Bank of England started raising interest rates, and holders of sterling corporate bonds have lost 20 per cent. We estimate that this has dramatically reduced households' measured wealth as the value of financial assets falls and the implied value of guaranteed income streams, like defined benefit pensions, is reduced. House prices have also started to weaken, with inflation-adjusted prices already down by seven per cent from their peak in mid-2022.

Our analysis suggests that, from early 2021, these passive changes reduced the household-wealth-to-GDP ratio by 185 percentage points, to around 650 per cent, by early 2023, based on a snapshot of asset prices and interest rates in March. This is by far the biggest fall on record as a proportion of GDP, wiping out £2.1 trillion of household net worth in cash terms. We can expect further falls in wealth as asset prices continue to adjust to higher interest rates, although the scale of those falls is highly uncertain.

We may be looking at the end of the 'wealth era' that drove up intergenerational inequality

This reversal in the decades-long rise in household wealth matters hugely, for society as a whole as well as the individuals holding those assets. Rising asset prices, and the associated

falling returns, have been a key driver of rising intergenerational inequality in recent decades. Increases in the price of bonds and property benefit (typically older) holders of assets looking to sell them at the expense of (often younger) people who need to acquire them. Of course, some assets, such as defined benefit pension entitlements, will be traded only rarely, so a rise in their value today will make little difference to the living standards of their owners. But valuation changes do signal a shift in the nature of wealth and the relative positions of different groups: the income stream promised by a defined benefit pension is worth more in a low-rate world precisely because such an environment makes it harder for those without such a promise to achieve a meaningful income in retirement.

The challenge facing younger people is compounded by the fact that falling returns also slowed the growth of their savings, making it significantly harder to become a homeowner or save for an adequate pension through saving out of income. In particular, average house prices spiralled from a norm of four-times average earnings in the mid-1990s to a record multiple of 8.9 in 2022, which both made home ownership more difficult for young people and required them to devote a larger proportion of their lifetime income to achieving outright ownership. Similarly, for pensions, surging asset prices and falling returns have been reflected in growing concern about the adequacy of retirement saving. These challenges have of course been compounded by the fact that younger workers today typically get less generous and more risky support from their employers, through defined contribution pension schemes, than previous generations had in the form of defined benefit pensions.

The drop in household wealth in a matter of months has put these trends into reverse. This wealth shock underscores the fact that there was nothing inevitable about its increase over the past generation, and raises the question of whether lower wealth is here to stay. The answer depends on whether the rapid and unexpected rise in long-term interest rates persists, as market pricing suggests, or whether the global economic forces that created the low-rate environment of the pre-pandemic world are likely to reassert themselves. The scale and distribution of wealth would look very different in each of these two worlds, with profound consequences for intergenerational inequality.

If we are adjusting to a new 'new normal' of higher interest rates, it's likely that this will come with further falls in wealth

To illustrate the potential implications of these two worlds, we explore two scenarios for the path of future interest rates.

First, we model a 'new normal' for interest rates based on current market expectations. In this scenario, yields on ten-year UK government bonds settle at 3 per cent, lower than rates today, but well above pre-pandemic norms of around 1 per cent. Although the impact of interest rates on the value of some financial assets (most obviously bonds) has been immediate, the impact on the housing market is likely to emerge over time. Economic theory – as well as the experience of the period of falling interest rates – suggests we should expect to see the yield on residential property to adjust to higher rates either through growth in rents, price falls, or a combination of the two. Based on this, the house-price-to-earnings ratio could fall to around 5.6 – the lowest level seen since 2000 – based on current inflation-adjusted interest rates. If so, this would reduce aggregate housing wealth from an estimated 280 of GDP in Q1 2023 to 160 per cent once the full effect of higher interest rates has come through.

With inflation-adjusted house prices already down by seven per cent since mid-2021, this implies substantial real-terms reductions in house prices are still to come, although there is significant uncertainty over how long that adjustment might take. Taking account of inflation, if house prices were to reach their new level over the next five years, this would imply further nominal price falls of some 25 per cent, taking the average house price from £287,000 today to around £215,000.

Overall, our 'new normal' scenario would see wealth settling at around 550 per cent of GDP, a level last seen in 2007. This is above its late-20th-century norm, but well below the post-financial crisis highs.

But if downward pressure on long-term interest rates resumes, the trends of the past 20 years will return

But what if the economic forces behind the decline in long-term interest rates have not gone away and the current burst of inflation has simply masked their effect? In its recent World Economic Outlook, the International Monetary Fund argued this, pointing to continued trends of population aging around the world and weak productivity growth as reasons why we should expect interest rates to eventually fall back to something like their pre-pandemic levels. Recent research from the Bank of England highlights that these long-term drivers will take a long time to play out, and suggested that, based on observed trends, the eventual resting point for long-term real interest rates could be around a percentage point below pre-pandemic levels. Although adjusting to lower rates could take years, if not decades, it is worth considering what household wealth might look like in that kind of world. This is the basis of our alternative scenario in which rates have 'further to fall'.

This scenario sees wealth as a proportion of GDP surging well past its pandemic high and eventually settling at around ten-times GDP. There would be further upward pressure on house prices, with our simple modelling suggesting that they could reach 11 times earnings. Such a shift would push the average house price to more than £350,000 in today's terms. In addition, workers' contributions to their pension would need to be substantially higher to provide them with a standard of living comparable to that enjoyed by today's retirees, with profound implications for living standards of working-age people.

Where wealth goes next will shape our politics

Our two scenarios represent starkly different societies to live in. A higher-rates world is one where middle-income families can aspire to afford their own home and provide for a comfortable retirement in old age, with less pressure on their standard of living during their working lives. But it would mean losses for those with existing wealth, or those hoping to inherit it in future.

On the eve of the pandemic, the typical household at the point of retirement had total net wealth – including pensions, housing,

financial and physical wealth – of around £620,000, or around 22 times average earnings at that time. In a high interest rate world, we estimate that a little over £480,000 (in 2019 prices), or 17 times average earnings, would be sufficient to provide future cohorts with the same standard of retirement given higher annuity rates. But in an ultra-low rates world, a typical household would need to amass far more wealth – some £830,000 in 2019 prices or 30 times average earnings – to achieve the same standard of living. People who already hold assets, or those who receive a large inheritance would be big winners under these conditions. But for those without significant wealth the impact on day-to-day consumption of the required level of saving would mean making large, and possibly unsustainable, sacrifices. Such a world – where inherited wealth hinders social mobility and the role of luck in determining life outcomes is amplified – would put a heavy strain on democratic politics.

Uncertainty about the future of wealth has massive implications for families

The uncertain outlook for the future of interest rates means that households face large financial risks when trying to get on the housing ladder or to provide for themselves in retirement. Is it appropriate for households to bear these risks in full, or should policy seek to lean against the stark distributional implications of large shifts in interest rates? While a detailed policy agenda is beyond the scope of this report, we can begin to identify the areas where policy has scope to act across pensions, housing and taxation.

Higher rates of return make it significantly easier to save for retirement. In the pre-pandemic world of low interest rates, a 40-year-old on median earnings had to save around 16 per cent of their gross income, or just over £5,000 a year, in order to achieve a target replacement rate of two-thirds of gross earnings in retirement. But at today's rates of return, the required contribution rate to achieve that goal is much lower, at 9 per cent, or £3,000 per year, freeing up around £2,000 per year during working age. Although many people are still not saving enough for retirement, the scale of the required increase would be much smaller if rates remain high.

Conversely, prolonged low returns would make it nigh-on

impossible for many people to achieve a decent standard of living in retirement. Periodically reviewing pension contribution rates – especially the default auto-enrolment contribution – in response to changes in the outlook for returns would help people navigate these developments. But uncertainty also underscores the need for intergenerational risk sharing to enable all generations to secure a decent standard of living in retirement. Mechanisms for this include retaining a generous state pension as the backbone of retirement provision and developing market-based provision models like Collective Defined Contribution pensions.

The housing implications of a move to a higher-rate environment depend on the timing of purchase. For those who have yet to buy, or who plan to trade up, any future falls in the price-to-income ratio is good news, easing the deposit constraint that has weighed on home ownership over the past decade. But here too the good news highlights the huge investment and interest rate risk to which families are exposed, with significant implications for their lifetime standard of living. Policy could do more to help people manage these risks. On the consumer side, this could include including reforming the mortgage market to expand the role of mortgage insurance and foster a market in long-term fixed-rate products. Meanwhile, macroprudential policy may help to insulate the housing market from global interest rate volatility. All such policies involve trade-offs – for example, in how these would affect the operation of monetary policy – that would need to be carefully considered.

Getting the taxation of wealth right is a crucial part of any wealth policy agenda that aims to dampen the social consequences of interest rate volatility. When driven by falling interest rates, rising asset prices are accompanied by falling returns, which mean that the holders of assets don't see increases in the incomes they get from their wealth. This creates an asymmetry problem for the politics of wealth: younger people are made worse off, and they know it; while older asset holders become wealthy, but don't feel the benefit of this windfall. Holders of assets are better off, but can only realise those benefits at the point where they sell the assets and consume the proceeds.

Rather than pointing to an annual levy on the value of household wealth as some have called for, these attributes suggest that capital gains should be taxed at the point where assets are transacted and their owners crystallise the gains. This would ensure that wider society benefits from windfall valuation gains of the kind we have seen in the past 40 years. Our recent tax reform proposals accord with these principles, suggesting measures such as addressing issues with Capital Gains Tax by ending the writing-off of capital gains upon death and raising marginal rates to match earnings taxation; reforming inheritance tax by eliminating the Residence Nil-Rate Band; and gradually reducing the tax-free pension lump sum from £270,000 to £100,000.

The future of interest rates will shape our wealth and our politics. They should also shape our policy with reforms that help future proof UK households against further bouts of asset-price volatility and changes in the fortunes that they determine.

Section 1

Introduction

Over the past four decades, the total value of wealth owned by UK households has consistently increased, rising from around three-times GDP in the mid 1980s to around seven-times annual national income on the eve of the pandemic.[1] This rise in wealth has mainly been driven by falling interest rates and the associated increase in asset prices. This trend has exacerbated intergenerational inequality by widening the wealth gap between asset owners (typically older generations) and non-owners (typically younger generations).

The pandemic initially amplified pre-existing trends, as interest rates were pushed down further and social-distancing restrictions prompted a sharp rise in household savings. However, the current cost of living crisis, alongside the monetary policy response, has put the seemingly inexorable rise in wealth into reverse for the first time in living memory.

In this report we document these developments and assess the implications of households' behavioural changes and interest rate shifts on the value and composition of household wealth. In addition, we discuss how policy makers should respond to seismic changes in the level – and volatility – of interest rates.

The report is structured as follows:

- We begin by looking at the impact of the pandemic and cost of living crisis on households' 'active' saving behaviour, both in aggregate and across the income distribution.
- In Section 3 we explore 'passive' changes in wealth that have unfolded since interest rates began to rise and analyse their distributional effects across both household wealth and age.
- Section 4 locates these large recent changes in wealth in the longer historical context and develops two scenarios for how household wealth could evolve in the coming years.

1 M Broome & J Leslie, Arrears fears: The distribution of UK household wealth and the impact on families, Resolution Foundation, July 2022.

- Finally, Section 5 concludes by setting out a framework for how policy makers should respond to uncertainty about the future level of interest rates and wealth.

Section 2

Household saving has been volatile since the start of the pandemic

Savings play a key role in cushioning families from the impact of economic shocks. Since the onset of the pandemic, saving has fluctuated. Initially there was an unprecedented surge in saving, accompanied by significant debt repayments, as Government interventions protected incomes and spending opportunities were limited by measures to reduce the spread of the virus. However, the majority of saving increases during the pandemic were concentrated among those on higher-incomes: among the lowest income quintile, 21 per cent of individuals reported an increase in savings during the pandemic, compared to 42 per cent among the highest income quintile. Russia's invasion of Ukraine in February 2022 lead to a substantial shock in energy and food prices, pushing up inflation to a peak of 11.1 per cent by late 2022. This put significant pressure on living standards and forced some individuals to reduce their savings in response. Lower-income households, who allocate a larger share of their consumption toward essential items, were particularly affected: 48 per cent of those in the bottom income quintile reported that their savings decreased between December 2022 and March 2023, compared to 29 per cent of those in the top income quintile.

But one unexpected feature of the cost of living crisis has been the stability of the aggregate saving ratio. Many had expected that the saving ratio would decrease significantly, possibly even turning negative, to support consumption during the cost of living crisis. Notwithstanding some very recent signs of households drawing down some of the savings built up during the pandemic, data on family finances on the whole point to surprisingly stable saving ratio in the face of rising costs of living. This apparent surprise is accounted for, in large part, by stronger-than-anticipated income growth. While there is significant data uncertainty, it appears that a smaller-than-expected tax drag and higher savings income have been the key drivers of stronger income growth.

Despite some good news on incomes, UK households have not increased their consumption in response. Real consumption expenditure grew by just 0.2 per cent between Q3 2022 and Q1 2023, and it lags behind its pre-pandemic trend. The cautious approach of UK households seems likely to be linked to three possible factors: indebted homeowners adjusting their consumption in anticipation of a mortgage repayment shock; the highly uncertain economic outlook encouraging precautionary behaviour; and the vulnerability of UK households to volatile gas prices and potential long-term effects on living standards.

People benefit from both 'active' wealth accumulation (such putting income aside directly as increased savings, or paying down debt) and 'passive' wealth accumulation (where existing assets become more valuable due to asset price inflation). Together, active saving and passive gains amount to total household wealth. In this Section we focus on active-saving behaviour on the part of households as they have been buffeted by the pandemic, surging inflation and higher interest rates.

Households have continued to save throughout the cost of living crisis

Since April 2020, the economy has experienced fluctuating saving behaviour. The adjusted saving ratio – which measures the percentage of gross disposable income that households have left after consumption – shows that household saving peaked during the pandemic at 24.4 per cent (Figure 1), the highest on record. This surge was the consequence of reduced spending opportunities due to lockdowns, travel restrictions, and social distancing measures. In aggregate, household balance sheets improved throughout the pandemic: total household bank deposits rose by £247 billion between February 2020 and May 2021; meanwhile, the stock of consumer credit decreased by £28 billion.[2] From mid-2021, concerns about the spread of Covid-19 waned and household saving gradually declined as spending patterns returned toward pre-pandemic levels and the economy bounced back.

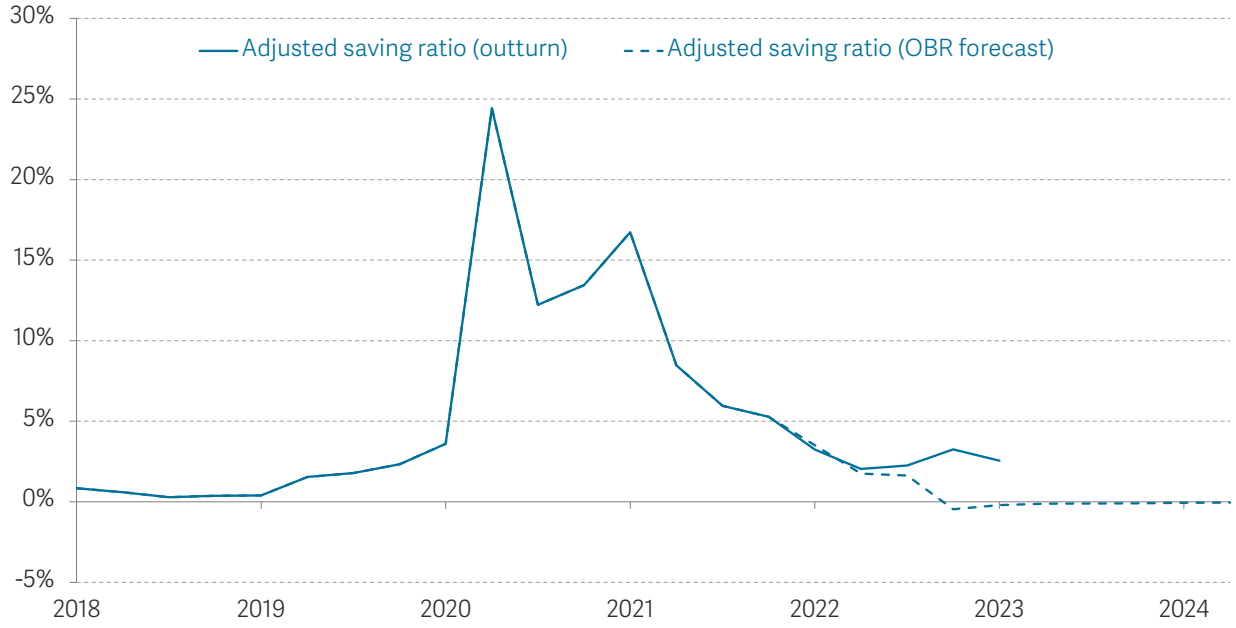
But in the aftermath of the pandemic, a stronger-than-expected recovery coupled with the energy and food price shock that followed Russia's invasion of Ukraine pushed inflation to a peak of 11.1 per cent by late 2022.[3] Despite the squeeze on living standards, and improved aggregate post-pandemic financial position, the saving ratio has remained

2 Bank of England, Bankstats.
3 For more information see: T Bell, J Smith & L Try, Food for thought: The role of food prices in the cost of living crisis, Resolution Foundation, May 2023 and E Fry & J Smith, The only way is down: Assessing the impact of falls in wholesale energy prices on household and public finances, Resolution Foundation, February 2023.

above its pre-pandemic level, standing at 2.6 per cent in the latest data for Q1 2023. This is well up on its average over the 20 years prior to the pandemic (1 per cent).

FIGURE 1: **Household saving spiked during the pandemic**

Household saving ratio outturn and forecast: UK, 2018 Q1 to 2024 Q2



NOTES: Includes non-profit institutions serving households (NPISH). Data is seasonally adjusted. The adjusted saving ratio excludes adjustments to net equity in pension funds.
SOURCE: ONS, Quarterly sector accounts, OBR, Economic and Fiscal Outlook, March 2023.

Despite the positive aggregate saving ratio since the start of the pandemic, there has been significant variation in changes to the stock of savings across the income distribution. Survey evidence suggests that, between February 2020 and May 2021, around a three-in-ten adults (29 per cent) increased their savings while a fifth (20 per cent) reduced them (Figure 2). However, there was a noticeable income gradient in the distribution of savings increases, with the majority occurring among higher-income individuals: 21 per cent of those in the lowest income quintile reported a rise in savings during the pandemic, whereas 27 per cent said savings had fallen. In contrast, among the top income quintile, 43 per cent experienced a rise in savings while only 16 per cent saw a fall, reflecting the propensity of those on higher incomes to spend more on social consumption, and so more likely to save as a result of pandemic restrictions. Furthermore, evidence suggests that lower-income households, particularly those with children, faced higher living costs during the pandemic.[4]

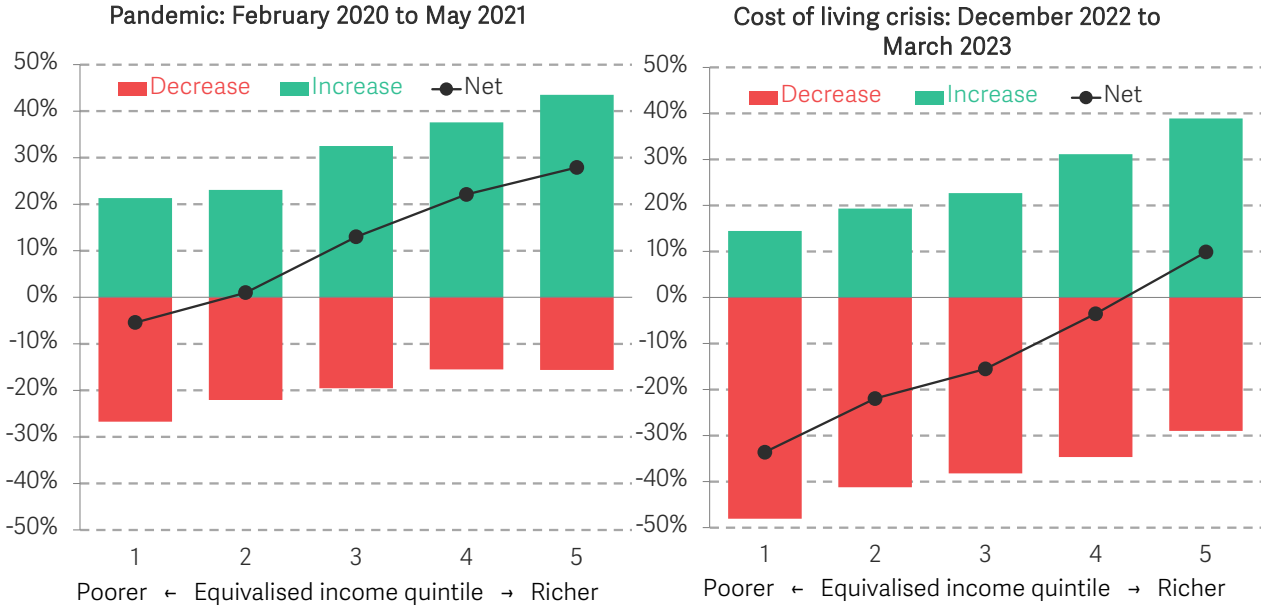
Survey data from the Bank of England mirror our findings: 43 per cent of households in the top-income quintile reported that their savings increased during the pandemic,

4 M Brewer & R Patrick, Pandemic Pressures: Why families on a low income are spending more during Covid-19, Resolution Foundation, January 2021.

while the corresponding figure for the lowest income quintile was 18 per cent. Similarly, only 19 per cent of high-income households reported that their savings had decreased, compared to 30 per cent of low-income households.[5]

FIGURE 2: **The pandemic and the cost of living crisis hit lower-income people's balance sheets harder**

Net of respondents that reported that their stock of savings had increased or decreased, by equivalised income quintile: UK



NOTES: Denominator excludes those that answered 'don't know' and 'prefer not to say'. Equivalised income quintile in the pandemic period is calculated prior to various benefit uplifts. Covid-19 survey: lowest income quintile (n=1121), q2 (n=1522), q3 (n=1085), q4 (n=1237), highest income quintile (n=833). Cost of living survey: lowest income quintile (n=950), q2 (n=1251), q3 (n=1215), q4 (n=1018), highest income quintile (n=1138).
SOURCE: RF analysis of YouGov, adults age 18+ and the Coronavirus (COVID-19) June 2021 wave, Cost of Living Crisis March 2023 wave 1 and Cost of Living Crisis March 2023 wave 2.

As the cost of living crisis struck in 2022-23, many individuals shifted towards dissaving: 39 per cent of respondents reported that their savings levels fell between December 2022 and March 2023. Although the shock of the cost of living crisis was more widespread, there was still a strong income gradient with those on lower incomes more likely to have seen a reduction in their savings compared to those on higher incomes. For example, 48 per cent of those in the bottom income quintile saw their savings decrease between December 2022 and March 2023, compared to 29 per cent of those in the top income quintile. This is because the impact of higher inflation has been larger for lower income households, who dedicate a higher share of spending toward essentials such as

5 Bank of England, NMG household survey data, September 2022.

energy and food which have seen large price rises.[6] In 2019, 59 per cent of households in the lowest income quintile's total non-housing consumption was spent on essentials (i.e. food, fuel, clothing and transport), much higher than the highest income quintile, which spent 43 per cent on essentials.[7]

The stability of the saving ratio during the cost of living crisis has been a surprise

As recently as March 2023, the Office for Budget Responsibility (OBR) was projecting that the adjusted household saving ratio would fall to around zero in 2023 and 2024 as families drew down savings to maintain consumption in the face of weak real income growth. Relative to these forecasts, the stability of the saving ratio in recent months has come as a surprise. This stability is accounted for by stronger-than-expected income growth – real household disposable income growth is estimated to have fallen by 1.8 per cent in 2022-23 compared with a fall of 3.7 per cent forecast by the OBR, a difference a £26.2 billion. Figure 3 shows that, in Q1 2023, aggregate real gross disposable income was £13 billion higher than the OBR had projected (£360 billion in contrast to £347 billion). Meanwhile, real consumption expenditure was broadly flat and, in fact, slightly above what the OBR had projected (by £3 billion).

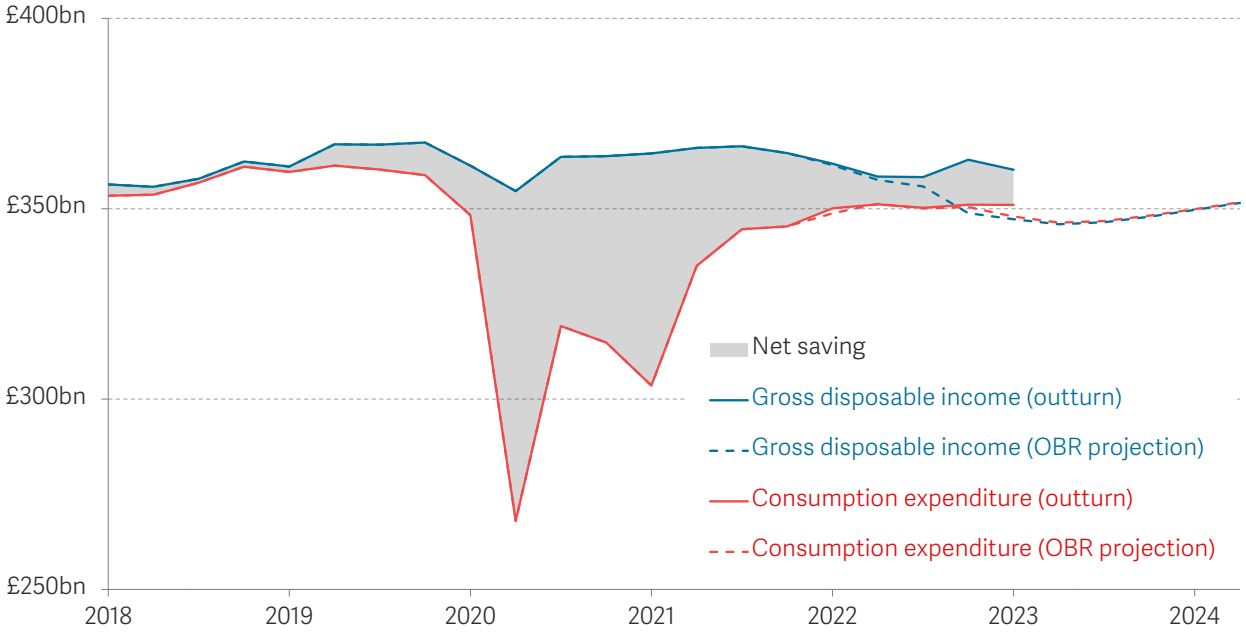
Digging deeper, a key factor accounting for the income strength is a smaller-than-expected tax drag. For example, in Q1 2023, the OBR projected that net taxes and benefits would decrease nominal household disposable income by £6.6 billion, whereas the reality was a decrease of £2.7 billion.

6 In light of differences in consumption baskets, total energy and cost of living support in 2023-24 is generally targeted to low-to-middle-income families. This is because most of the support is being provided through direct payments to benefit claimants. These measures, along with the permanent changes to personal tax and benefits made over the course of this parliament are progressive, meaning that falls in income are greatest at the top of the distribution. For more information see: T Bell et al., We're going on a growth Hunt: Putting the 2023 Spring Budget in context, Resolution Foundation, March 2023.

7 M Brewer et al., A chilling crisis: Policy options to deal with soaring energy prices, Resolution Foundation, August 2022.

FIGURE 3: **The positive saving ratio was driven by stronger-than-expected income growth**

Real gross disposable income and real individual consumption expenditure, outturn and projection: UK, 2018 Q1 to 2024 Q2



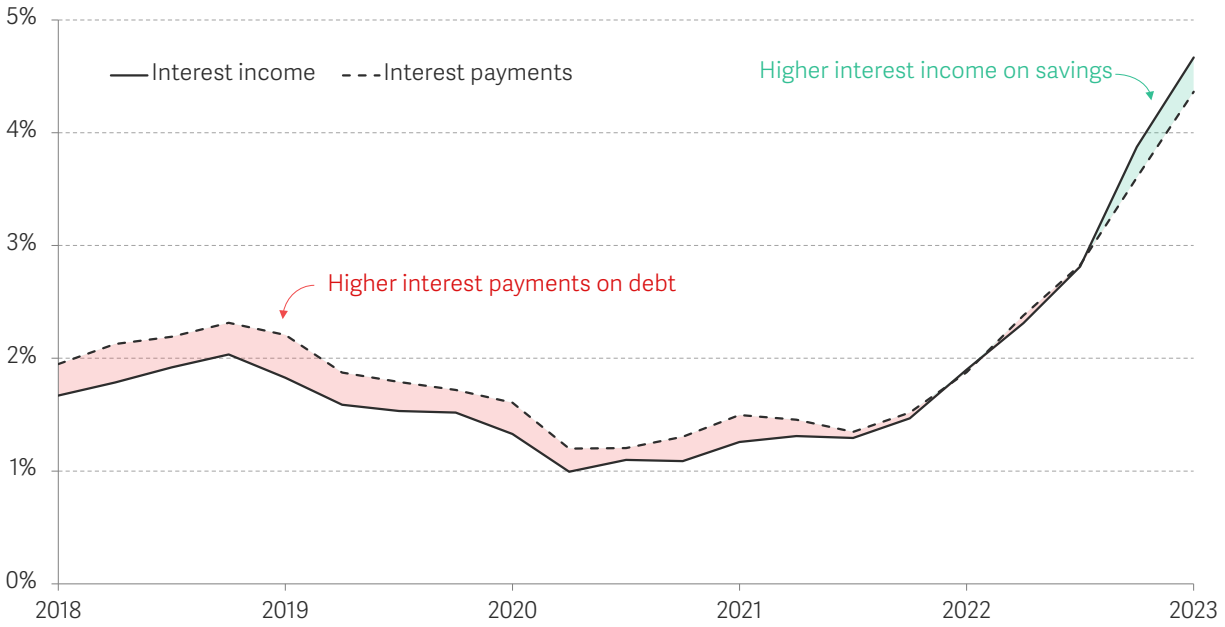
NOTES: Includes non-profit institutions serving households (NPISH). Data is seasonally adjusted. The adjusted saving ratio excludes adjustments to net equity in pension funds. Nominal gross disposable income and consumption expenditure have been deflated using the consumer expenditure deflator.
SOURCE: ONS, Quarterly sector accounts, OBR, Economic and Fiscal Outlook, March 2023.

The other contributing factor behind stronger income growth has been higher than expected income on savings. The Bank of England has been raising interest rates more quickly than expected in an attempt to curb inflation, and this has resulted in savers enjoying an immediate increase in income. Figure 4 shows that, despite UK banks taking a long time to pass higher interest rates onto savers, interest income on savings has risen more quickly than interest payments on debt in Q4 2022 and Q1 2023. [8] This is supported by recent research which found that, at current interest rates, savers are collectively earning £24 billion more a year than in November 2021, while mortgage borrowers are paying £14 billion more in debt interest.[9]

8 Members of the House of Commons Treasury Select committee raised their concerns that banks are not treating their customers fairly when setting savings rates. For more information, see: UK Parliament: Committees, Correspondence to Retail Banks, accessed 12 July 2023.
9 P Aldrick & T Rees, Savings Lift Helps Blunt UK Household Mortgage Pain, Bloomberg, July 2023, accessed: 4 July 2023.

FIGURE 4: **Interest income on savings has risen more quickly than interest payments on debt**

Effective rate on household savings and debt: UK, Q1 2018 to Q1 2023



NOTES: Includes non-profit institutions serving households (NPISH). Data is seasonally adjusted. Effective rate on savings and debt is households' and NPISH interest income and interest payments as a share of disposable income.
SOURCE: ONS, Quarterly sector accounts.

However, it is unlikely that the higher interest income on savings will outweigh higher interest payments on debt for long, as mortgagors gradually move onto higher fixed-rate deals. By the end of June 2023, it is estimated that only around half (56 per cent) of all mortgaged households will have been affected by increasing mortgage rates since the Bank of England started raising rates; the remaining 44 per cent are yet to see their fixed rate deal expire. But, by the end of 2026, almost all British households with a mortgage will have moved onto a higher rate, and are set to end up with annual mortgage bills £2,000 higher, on average, than in December 2021.[10]

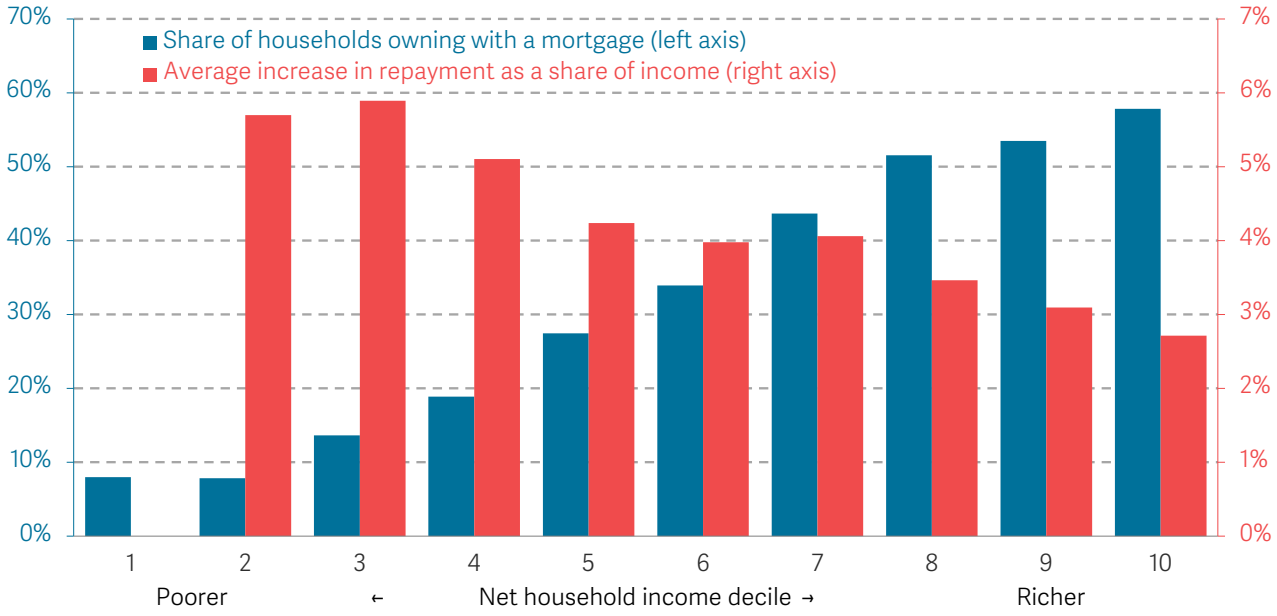
Figure 5 shows how this mortgage pain will be felt across the income distribution by looking at the increase in repayments as a share of disposable income. Although richer households are more likely than poorer households to own their home with a mortgage and face bigger cash increases in repayments, it is low-to-middle income mortgagors that are facing the sharpest hit to living standards. Although relatively few low-to-middle income households own their home with a mortgage, those that do tend to spend a larger share of their income on repayments. As such, between Q4 2021 and Q4

10 S Pittaway, The Mortgage Crunch, Resolution Foundation, June 2023.

2026, annual repayments are expected to increase by around 6 per cent of income for mortgagors in the second-income quintile, compared to 3 per cent for mortgagors in the top-income quintile.[11]

FIGURE 5: **Low-to-middle-income households with a mortgage face the sharpest increase in repayments as a share of income**

Share of households that own their home with a mortgage and estimated average increase in annual mortgage repayments from Q4 2021 to Q4 2026 as a share of income, by net household income decile: GB



NOTES: Interest rate projections are based on market expectations on 12 June 2023. Only includes one owner-occupier mortgage per household, additional mortgages (where applicable) are excluded. Some households with a variable rate in Q4 2021 may have switched to a fixed-rate deal, and vice versa, but this is not captured. Repayments include interest costs and capital repayments, and are calculated assuming that all households have a repayment mortgage. We exclude results for decile 1 due to well-known concerns over the reliability of income data for those on the lowest incomes.
SOURCE: RF analysis of ONS, Wealth and Assets Survey.

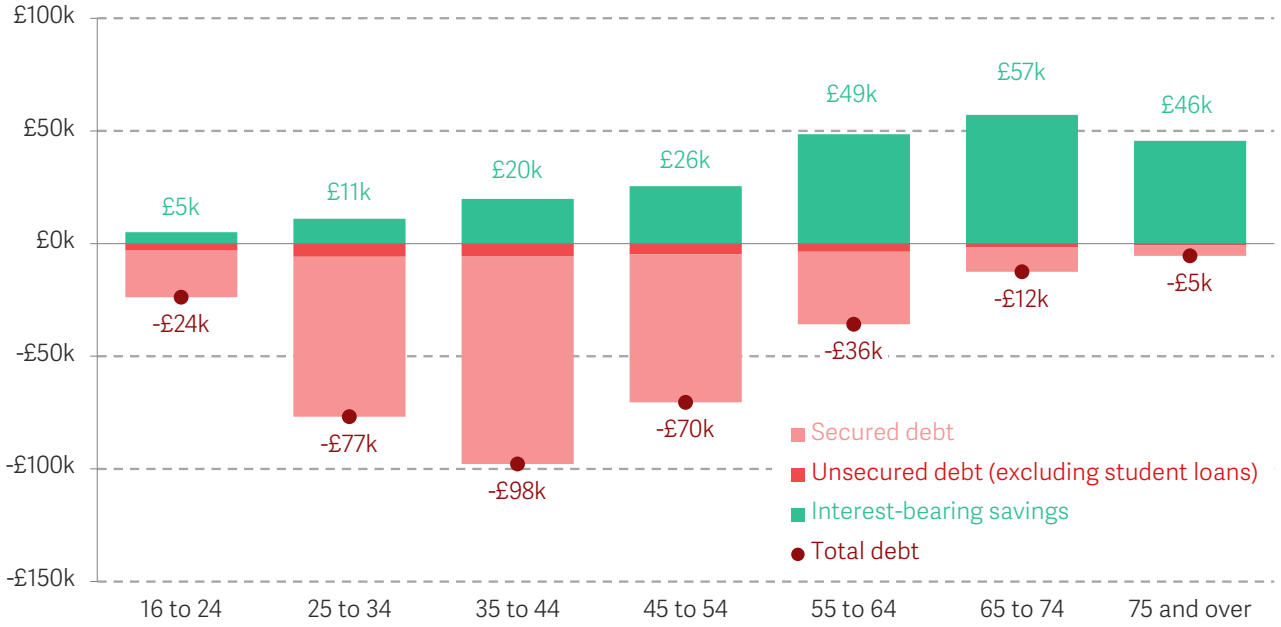
More generally, the impact of higher interest rates depends on household's net wealth position. Figure 6 shows that higher rates will boost the incomes of richer, typically older families, but will hit those with significant debts, who tend to be younger. On average, in 2018-20, individuals aged 65-74 had more than five times the amount of interest-bearing savings than those aged 25-34 (£57,000 and £11,000 respectively). Similarly, households headed by someone aged 75 and above had six times more in interest-bearing saving

11 It is not just mortgagors that will see higher costs, 37 per cent of private renters (2 million) and 67 per cent of social renters (3.3 million) had seen their costs increase between October 2022 and April 2023 as a result of their landlord or housing provider increasing the rent. For more information see: J Evans & S Collard, Financial Fairness Tracker: Housing Edition, University of Bristol, June 2023.

products than they had secured and unsecured debt. In contrast, Figure 6 shows that households headed by young and middle-aged people tend to have the largest amount of unsecured debt and secured mortgage debt.

FIGURE 6: **The young and middle-aged are set to be at the sharp end of rising interest rates**

Mean amount of 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.
SOURCE: RF analysis of ONS, Wealth and Assets Survey.

Despite incomes holding up better than expected, households have not increased consumption

Despite stronger-than-projected income growth, households in the UK have not responded by increasing their consumption. Real-consumption expenditure has remained relatively stable through the latter half of 2022 and into 2023, and remains 2.2 per cent below a continuation of its pre-pandemic trend. This is in contrast to the US where consumption has seen strong growth since the start of 2021 and has returned to its pre-pandemic trend.[12] The data suggests that households are being cautious, but why?

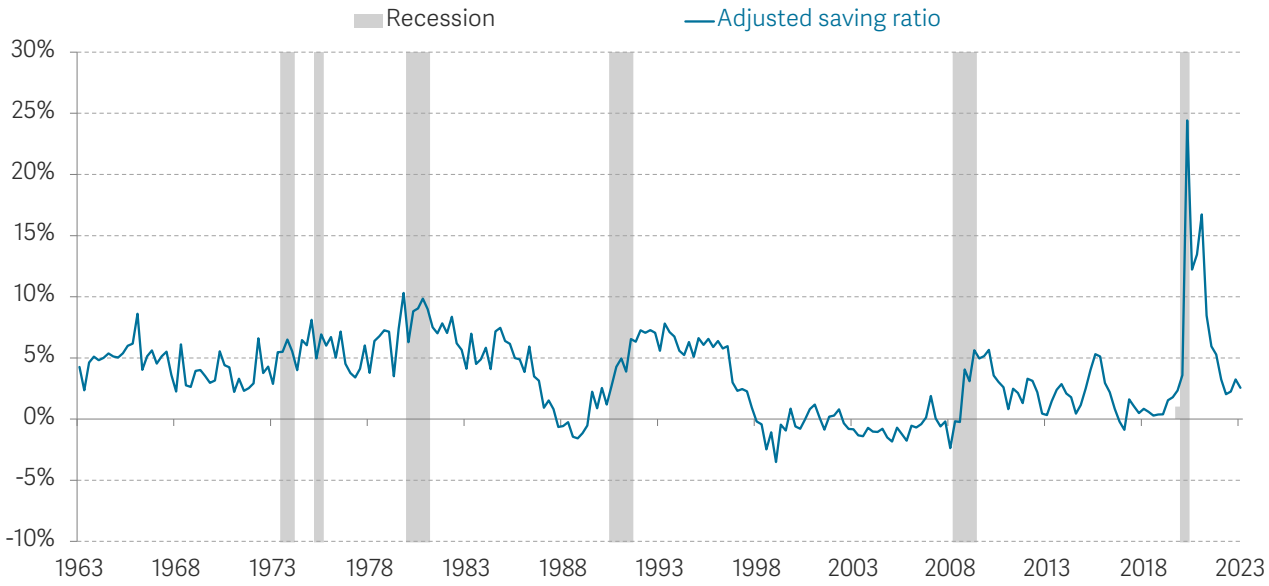
Three factors might explain this. First, as discussed above, higher interest rates will continue to work their way into higher mortgage repayments as fixed-rate deals expire. Households may be adjusting their consumption behaviour in anticipation of the income

12 S Tenreyro, Monetary policy in the face of large shocks – speech, Bank of England, June 2023.

shock associated with these increased mortgage repayments. Second, the highly uncertain economic outlook may have made households reluctant to run down their savings. This trend has been observed during previous periods of economic uncertainty, with the saving ratio tending to increase during recessions. For example, Figure 7 shows that the average saving ratio was -0.8 per cent in year prior to the financial crisis, but it increased to 2.5 per cent during the recession (Q2 2008 to Q2 2009). Similarly, the saving ratio was higher during the 1973 oil crisis – which was a supply shock recession, like the one we are currently experiencing – than in the years before. Third, unlike US households, UK households remain exposed to volatile gas prices, and there is significant uncertainty regarding the long-term impact of the terms-of-trade shock and the country's overall living standards, which could be prompting precautionary saving.

FIGURE 7: **The saving rate tends to rise during recessions**

Household adjusted saving ratio: UK, Q1 1963 to Q1 2023



NOTES: Includes non-profit institutions serving households (NPISH). Data is seasonally adjusted. The adjusted saving ratio excludes adjustments to net equity in pension funds.
SOURCE: ONS, Quarterly sector accounts.

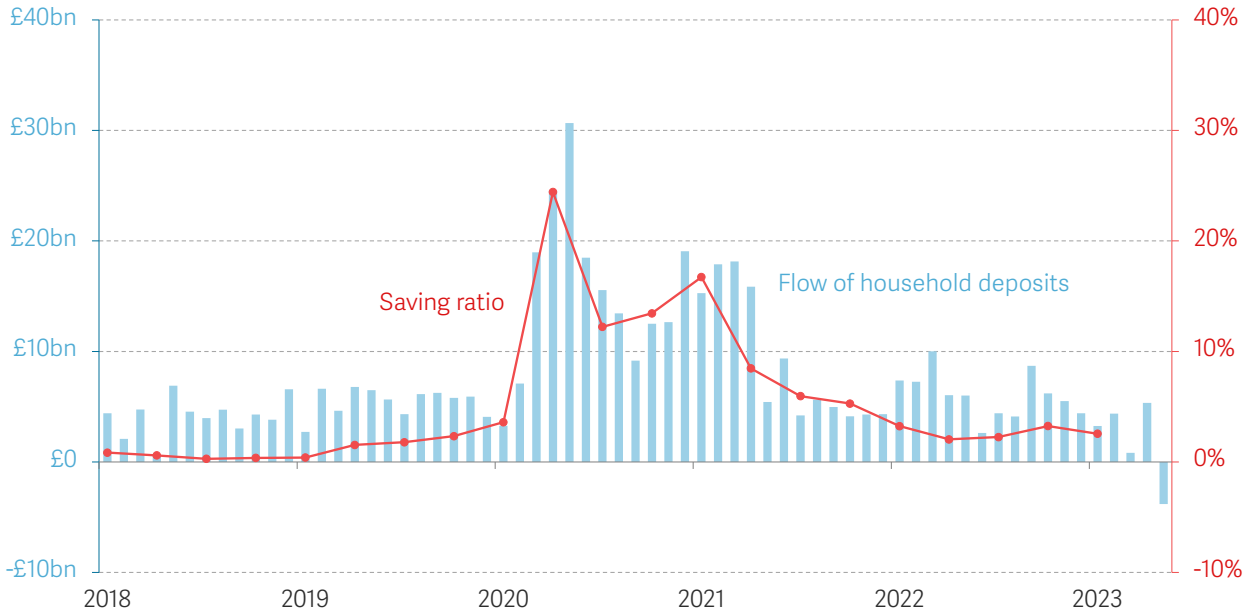
Although there is significant data uncertainty, deposit data show a similar pattern. Initial vintages of the saving ratio are notoriously uncertain, and may well be eventually revised. However, in broad strokes at least, recent movements in the adjusted saving ratio appear consistent with data on household deposits (Figure 8). That said, recent data indicates that UK households made significant deposit drawdowns in May 2023 (of £4.6 billion, the largest withdrawal since monthly records began in 1997).[13] There are some reasons for believing this could prove erratic – it is possible that households are moving money

13 Bank of England, Money and Credit - May 2023, accessed 12 July 2023.

into other savings products outside of the banking sector to capitalise on higher interest rates. But this could signify that households are indeed starting to draw down their pandemic savings. If so, we would expect the adjusted saving ratio to fall in the coming months.

FIGURE 8: **The shape of the adjusted saving ratio broadly follows that of household deposits**

Household adjusted saving ratio and household deposits to banks and building societies: UK, Q1 2018 to Q2 2023



NOTES: Includes non-profit institutions serving households (NPISH). Data is seasonally adjusted. The adjusted saving ratio excludes adjustments to net equity in pension funds.
SOURCE: RF analysis of ONS, Quarterly sector accounts; Bank of England, Bankstats.

It is important to understand how active saving has changed since the start of the pandemic because it has macroeconomic consequences as well as direct implications for a household's wealth holdings and financial resilience. However, although there has been unprecedented volatility in active saving, asset price movements throughout the pandemic followed by sharp rises in interest rates in 2022 and 2023 have had a much greater impact on household wealth though passive changes; this is the focus of the next Section.

Section 3

Higher interest rates have prompted a reversal in the decades-long trend of rising wealth

During the pandemic, household saving reached unprecedented levels, but the fluctuations in interest rates have had a more profound impact on household wealth. Movements in asset prices, such as the recovery in UK and global equities, substantial growth in house prices, and historically low gilt yields during the pandemic caused total household wealth to peak at 840 per cent of GDP in 2021. However, the subsequent rise in interest rates has triggered a reversal in asset values: we estimate that the UK's measured wealth-to-GDP ratio in Q1 2023 was around 650 per cent of GDP, a fall of nearly 200 per cent of GDP compared to its peak in Q1 2021. These fluctuations in wealth can primarily be attributed to changes in property and pension wealth. House prices saw rapid growth during the pandemic and have since fallen slightly as interest rates have risen. Conversely, rising bond yields and annuity rates have resulted in a fall in the measured value of pension holdings, particularly pensions in payment and defined benefit (DB) pensions.

Falling asset prices have led to a partial unwinding of the rise in intergenerational wealth inequality seen in recent decades, and have narrowed the gaps in wealth between households. The impact of price falls has varied across the wealth distribution and across ages, reflecting the different types of wealth held by different groups. Households in the middle of the wealth distribution have been the biggest beneficiaries of asset price changes since the onset of the pandemic. On the other hand, households in the top wealth decile have been disproportionately affected by declines in the value of pensions in payment and DB pensions, leading to a fall in the overall value of their wealth since the onset of the pandemic. Similarly, those who are close to retirement, or have recently retired, have also been disproportionately affected rising annuity rates as they have a greater share of pension wealth. In contrast, younger and middle-aged individuals have been less exposed to the fall in asset prices as a result of their limited wealth holdings and their higher share of housing wealth.

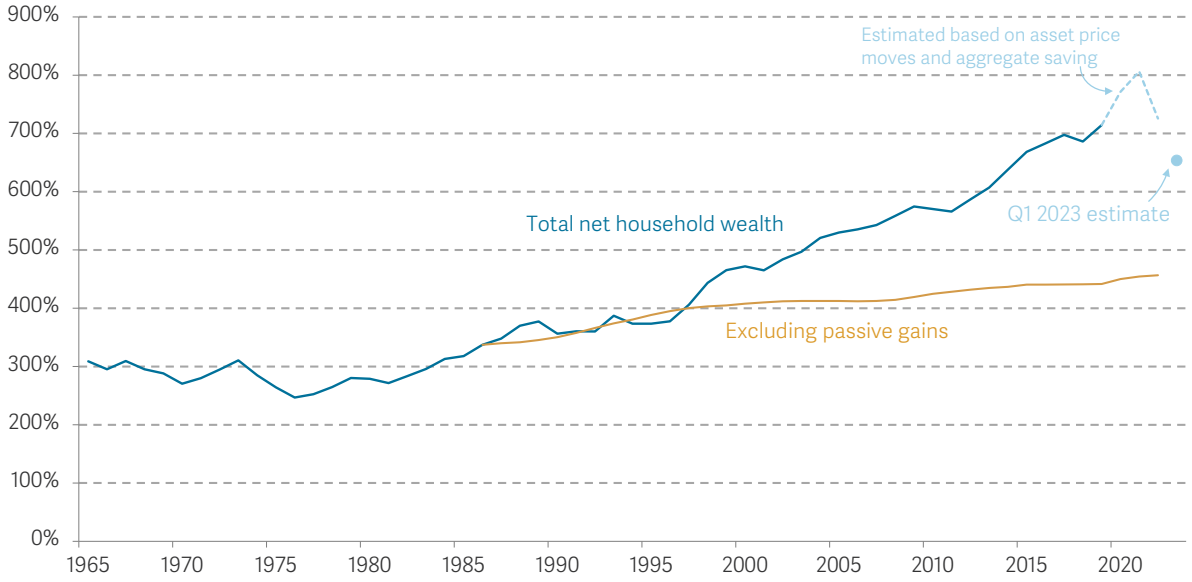
Recent trends in saving and borrowing have been historically remarkable, and are a key part of families' experience of the cost of living crisis. But this is only part of the story of how recent events have impacted family balance sheets. In previous work, we have shown that 'passive' saving has played a decisive role in the increase in household wealth.[14] However, rising interest rates threaten to put a stop to the rising tide of passive gains. In this Section, we analyse the impact of passive changes on household wealth since the start of the pandemic, put these changes into a historical context, and analyse their effect across the wealth and age distributions.

The level of household wealth has boomed over the past 40 years

The recent history of wealth in Britain has been characterised by a seemingly inexorable rise in the value of wealth to GDP. On the basis of calendar years (which obscures some of the sharp movements observed at higher frequencies), wealth grew from around three-times GDP in the 1980s – a level typical of the second half of the 20th century – to seven-times GDP in 2019 (Figure 9). We project that wealth rose still further during the pandemic, reaching a peak of eight-times GDP in 2021 (Box 1 sets out the methodology behind this projection).

FIGURE 9: **Aggregate household wealth grew from 300 per cent of GDP in the 1980s to around 800 per cent in 2021, but has fallen sharply since**

Household wealth as a share of national income: UK



NOTES: Data from 2020 to Q1 2023 are estimated using the methodology set out in Box 1. For Q1 2023, the ratio is the estimated level of household wealth divided by the sum of GDP in four quarters up to and including Q1 2023. Active saving is the household sector's cumulative net lending/net borrowing of the financial account from the ONS National accounts.
SOURCE: RF analysis of OECD; D Blake & J Orszag, 'Annual estimates of personal wealth holdings in the United Kingdom since 1948', Applied Financial Economics 9, 1999; ONS, UK National Accounts; ONS, Wealth in Great Britain; ONS, Gross Domestic Product at market prices.

14 G Bangham & J Leslie, Rainy days: An audit of household wealth and the initial effects of the coronavirus crisis on saving and spending in Great Britain, Resolution Foundation, June 2020.

BOX 1: Methodology for estimating the latest value of household wealth

The Wealth and Assets survey (WAS) provides the most comprehensive and granular details on household wealth holdings in Britain, and forms the basis for much of our analysis of wealth. But the latest data only covers the period 2018-20 and therefore we do not directly know how family balance sheets have evolved since then.

To fill this gap, we estimate the total change in wealth since the most recent survey period by estimating separately: (i) passive changes in wealth; and (ii) the impact of active saving. Our estimates for passive changes are done at the individual level, which allows us to illustrate their distributional impact. However, our estimates for the impact of active saving are only at the aggregate level, due to a lack of comprehensive and timely survey data on individuals' or households' saving behaviour. That said, given the dominant role played by passive changes in the past and present, we are confident that the distributional impact of passive changes should be a reliable guide to the total distributional impact on family balance sheets.

To estimate passive changes, we take observed wealth holdings in 2018-20 and roll forward the value of wealth using broad asset price growth. For example, for a family sampled at the beginning of 2020, we apply changes in house prices, financial assets and interest returns over the period between the sample period and Q1 2023. We recalculate the value of wealth in each quarter, according to the relevant asset prices at the time.

We make a number of assumptions in order to roll forward the value of wealth. First, we assume that all assets change value at the same rate within the asset classes we have returns data for. Second, we assume no changes in the composition of assets households held since the WAS sample period (because we have no data to calibrate asset composition transitions). In practice, we know that some families have shifted asset allocation – for example, by becoming first-time-buyers. Third, the WAS does not provide detailed information of the composition of assets within defined contribution pension pots, so we assume a 70:30 split between equities and bonds, which, 10 years before retirement age, rolls down linearly to 70 per cent bonds and cash.

We also estimate changes to the value of DB pensions and pensions in payment. In the WAS, pensions in payment are valued as the lump sum that would have been needed at the time of interview to purchase the reported annual payment. This calculation is based on annuity rates at

the time of interview. DB pensions are valued similarly, except that their value is discounted to take into account that the income stream is received in future upon retirement, and any future lump sums are also included. This calculation also uses annuity rates from the month in which the individual was surveyed. The WAS uses SCAPE discount rates, which are often used in the valuation of public sector pensions.[15]

We use the same methodology to estimate passive changes in DB pensions. We adjust the annuity rates used to value DB pensions and pensions in payment in line with movements in average market annuity rates, and uprate pension income in line with inflation. We do not account for the fact that individuals will accrue DB income, as we consider this to be active saving (even if it usually doesn't require an active decision on behalf of the pension holder). We also hold constant the discount rates used to value DB pensions, as these would be unduly distorted by high levels of inflation.[16]

Our estimate for the impact of active saving on aggregate wealth used household sector net lending/net borrowing in the UK Economic Accounts, which we add to the aggregated impact of passive changes to arrive at an estimate for the total change in household net wealth since the latest WAS sample period. We assume that the value of past active saving grows in line with GDP.

The main driver of the increased value of wealth since the mid-1980s has been passive capital gains, rather than active saving.[17] To give a sense of the relative importance of these two forms of wealth accumulation, we estimate the contribution to aggregate household wealth from active saving, based on data from the UK national accounts from 1986. On the assumption that, absent interest rate-driven valuation effects, past active saving earns a return in line with GDP growth, we find that nearly four decades of active saving only accounted for one quarter of the increase in the ratio of wealth to GDP from the mid-1980s to 2021, when we estimate that wealth as a share of GDP peaked.[18] The rest has been due to passive gains that have inflated the value of existing asset holdings. Without these gains, total household wealth would have been nearly £8 trillion lower in

15 Full details of the valuation of pension wealth can be found in the Wealth and Assets Survey user guides.
16 SCAPE (superannuation contributions adjusted for past experience) discount rates include both a real component, based on long-run real GDP growth, and a nominal component, based on CPI inflation today. This approach is currently under review and there are good reasons for thinking that it could change in future but in this report, we adopt the ONS's methodology in order to provide a consistent time series for household wealth.
17 J Madsen, Wealth and inequality over eight centuries of British capitalism, Journal of Development Economics, Vol.138, May 2019.
18 Previous Resolution Foundation analysis has similarly found that increases in household wealth have been dominated by passive gains. See, for example, C D'Arcy & L Gardiner, The generation of wealth: asset accumulation across and within cohorts, Resolution Foundation, June 2017.

2021 – or just less than 4.5 times GDP. These passive gains have been associated with the fall in real interest rates over the period, which have boosted asset prices in the UK and abroad.[19]

Higher asset prices, coupled with low rates of return, have made it harder for young people to become homeowners and save for a pension

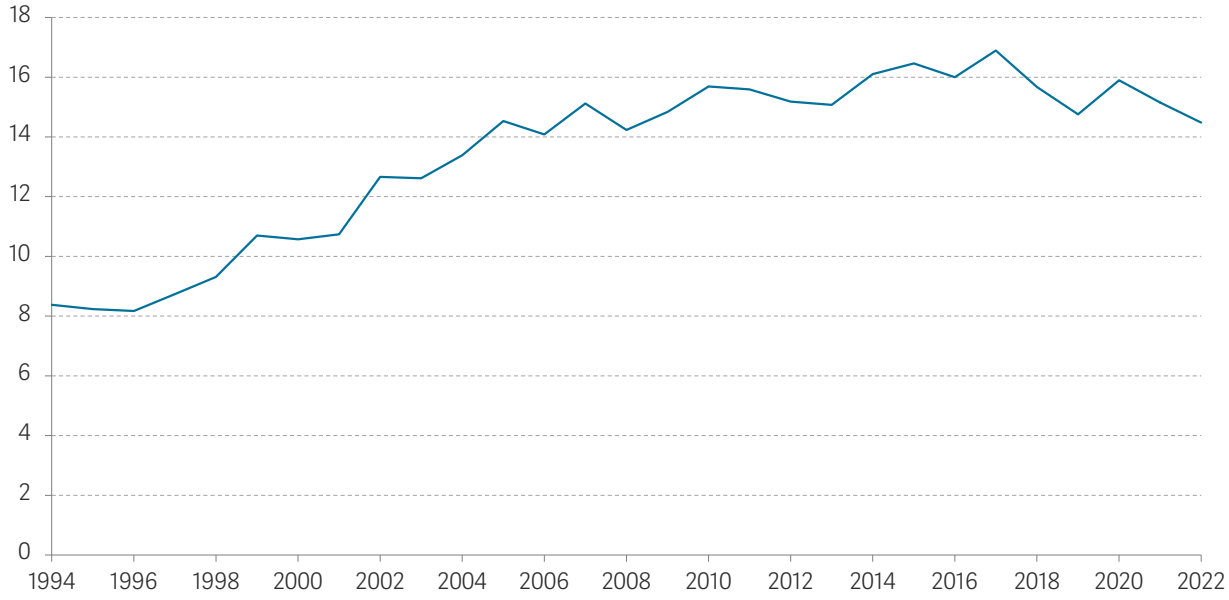
Rising asset prices and falling returns have been a key driver of intergenerational inequality. In general, higher asset prices benefit holders who are looking to sell assets at the expense of those looking to buy. Buyers are typically younger than sellers – think of a family who buys their first home when young, and downsizes in old age – which means that rising asset prices, occurring when they did, have facilitated a transfer of wealth from younger to older generations over the past 40 years.[20]

One particularly obvious part of this transfer of wealth has been in housing. Decades of house-price growth outstripping earnings has boosted the wealth of existing homeowners. At the same time, higher house prices have made home ownership more difficult by raising the proportion of lifetime income that has to be sunk into home ownership for recent generations.[21] Those born between in 1946 and 1950 had housing costs of 11 per cent of their income at the age of 30, compared with 24 per cent for a 30-year-old born between 1981 and 1985.[22] At the same time, saving for a deposit has become much more onerous. The estimated time it would take for a typical young family to save for a deposit now stands at just over 14 years (Figure 10). This is a touch below recent peaks, partly as a result of stamp duty cuts for first-time buyers, but is far higher than the 8 years of saving needed in the mid-1990s.

19 See I Mulheirn, Sources of wealth and their implications for taxation, Wealth Tax Commission, October 2020 and A Fagereng et al, Saving behaviour across the wealth distribution: the importance of capital gains, May 2021.
20 D Sturrock, Wealth and welfare across generations, Institute for Fiscal Studies, April 2023.
21 For a discussion of the barriers to homeownership among young people, see A Corlett & F Odamtten, Hope to buy: The decline of youth home ownership, Resolution Foundation, December 2021.
22 M Broome et al., An intergenerational audit for the UK, Resolution Foundation, November 2022.

FIGURE 10: **Rising house prices have made it harder to save for a deposit**

Estimated number of years required to save for a first-time buyer deposit: UK, 1994-2022



NOTES: Assumes the average non-owning household headed by a 28-32-year-old saves 5 per cent of their annual income, earning a return equal to the five-year average rate on interest-bearing sight deposits, and purchases a home with a 10 per cent deposit at the average UK house price until 2010, and the average UK first-time buyer house price from 2011 onwards. Deposit rates for 2023 and 2024, which are included in the five-year averages for the 2021 and 2022, are projected based on market expectations for Bank Rate as of 30 June 2023. Appropriate stamp duty charges are added to the deposit if required.
SOURCE: RF analysis of HM Land Registry, UK House Price Index; ONS, Family Resources Survey; Bank of England yield curves; Bank of England, Bankstats.

Less well appreciated is the similar scale of challenge that emerged with pensions. Although falling interest rates boosted the price of assets in pension pots for those nearing retirement, they also reduced rates of return for younger people looking to build their pension over time, and meant that any given value of pension savings would provide a lower standard of living in retirement. These strong intergenerational currents were exacerbated by the fact that DB pension schemes have become less common, shifting more of the risks around acquiring an acceptable standard of living in retirement from employers to workers, and particularly for younger generations of workers.

The upshot of these trends since the financial crisis has been growing concern within the pensions industry about the adequacy of most people's retirement savings. Modelling from the Pensions Policy Institute in 2021, for example, suggested that almost half of people were not on course to achieve a 'personally adequate' income in retirement.[23] Last year the Work and Pensions Committee of the House of Commons underlined the need for a substantial increase in the default rate of pensions auto-enrolment from 8 per cent.[24] Previous Resolution Foundation analysis found that, on average, workers today

23 N Hurman et al., What is an adequate retirement income, Pensions Policy Institute, June 2021.
24 House of Commons Work and Pensions Committee, Protecting pension savers – five years on from the pension freedoms: saving for later life, September 2022.

would need to start contributing 16.1 per cent of gross income in order to be on track to secure a good pension.[25] The Living Wage Foundation has subsequently announced a Living Pension benchmark that equates to 12 per cent of full-time earnings.[26]

Recent trends of rising interest rates have prompted the largest annual fall in wealth on record

But since 2021 the picture of ever-increasing wealth levels has been abruptly sent into reverse. As Figure 9 shows, a year-on-year fall in the ratio of measured wealth to GDP is a rare occurrence, happening only three-times between 1995 and 2021. Against that backdrop, the magnitude of the fall in wealth since 2021 has been historically unprecedented.[27] The estimated year-on-year change between 2021 and 2022 is by far the largest on record, and the further fall in the first quarter of 2023 has left household wealth at 650 per cent of GDP – a total hit of nearly 200 percentage points.

Economists sometimes assume that these passive changes in wealth are irrelevant to household welfare. One rationale is that changes in asset prices can reflect underlying economic developments – such as long-lasting changes in productivity – that might affect lifetime real incomes. If that is the case, pure temporary valuation effects will not change the real income flowing from assets to their holders – if that is the case, there would be no effect on aggregate welfare.

But because passive changes have real impacts on the living standards of families, they should not be ignored. Holding more wealth in absolute terms confers a range of benefits. It boosts financial resilience, enabling families to continue spending in bad times and is associated with higher subjective measures of wellbeing.[28] But most importantly passive wealth movements have major intergenerational consequences when driven by valuation effects. They dictate the extent to which people need to save in order to secure housing and income in retirement. In world of high asset prices younger people need to set aside more for a house and pension, reducing their consumption today. When the price of those assets falls, their sustainable consumption today increases.

In the rest of this Section, we dig deeper into the passive changes in wealth over recent years, and examine the impact that they have had on family balance sheets.

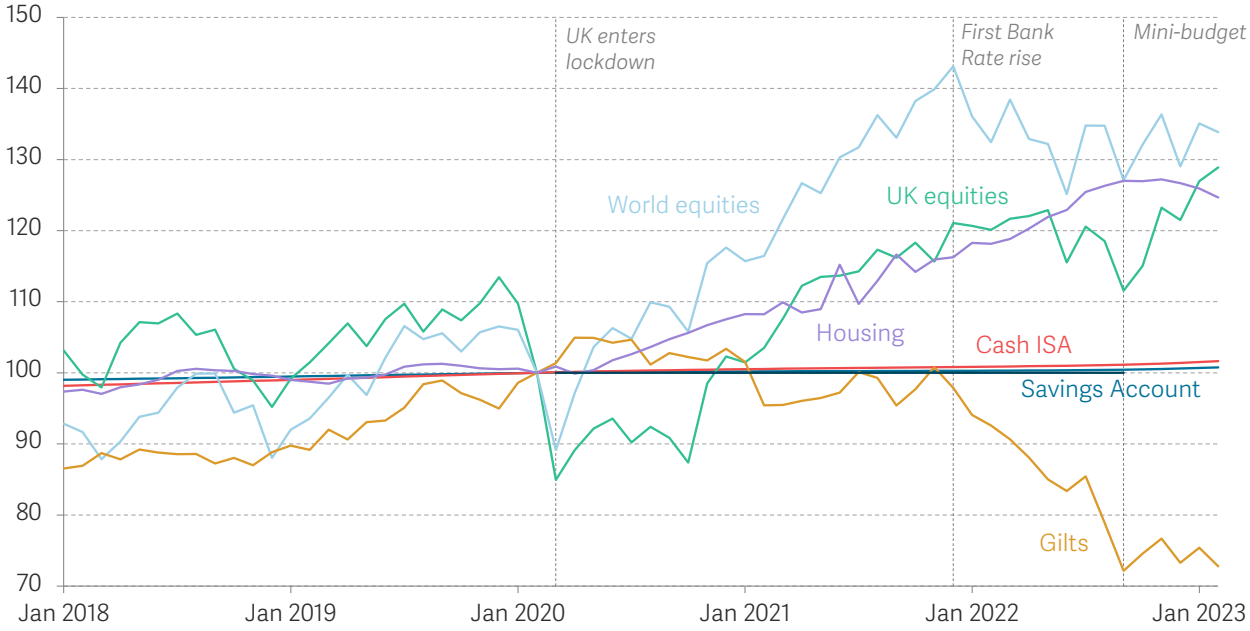
25 N Cominetti & F Odamtten, Living pensions: An assessment of whether workers' pension saving meets a 'living pension' benchmark, Resolution Foundation, July 2022. This report also sets out a 'whole career' benchmark of 11.2 per cent, which would deliver a 'Living pension' if workers started saving for a pension in their 20s.
26 Living Wage Foundation, Living Pension launched to provide security and stability in retirement, accessed 13 July 2023.
27 A Atkinson, Wealth and inheritance in Britain from 1896 to the present, Journal of Economic Inequality, 16 (2), June 2018.
28 For more details on the link between wealth and living standards see: G Bangham & J Leslie, Rainy days: An audit of household wealth and the initial effects of the coronavirus crisis on saving and spending in Great Britain, Resolution Foundation, June 2020.

Asset prices have moved considerably since the start of the pandemic

Despite a sluggish recovery in economic activity, many asset prices surged at the start of the pandemic. Most importantly for UK households, the value of equities and housing have risen substantially. UK and world equities fell sharply in the early months of the pandemic, as lockdowns curtailed economic activity across much of the globe. But their subsequent recovery has been dramatic. In pounds sterling, global equities are now worth around a third more than before the pandemic, with the value of UK equities rising by nearly 30 per cent over the same period (Figure 11). Most of the recovery in equities took place before the end of 2021, as markets were buoyed by unexpected good news on vaccine effectiveness and the pandemic outlook. Momentum stalled in 2022 as economic activity brushed up against global supply-chain bottlenecks, and the economic outlook deteriorated further following the invasion of Ukraine.

FIGURE 11: **Recent years have seen many large and varied price movements across asset classes**

Indexed value of financial assets and housing (Feb 2020 = 100): UK and global



NOTES: Asset classes are UK-based apart from global equities. Equities and gilts indices are for month-ends.
SOURCE: RF analysis of Bank of England, Effective interest rates; FTSE Russell, FTSE All-Share Index TR; MSCI, MSCI World Index TR; S&P Global, S&P UK Gilt Index; and ONS, UK House Price Index.

UK house prices have also been unusually resilient, at least by the standards of previous recessions. In the four UK recessions prior to the pandemic, house prices fell by 22 per cent per year in real terms.[29] By contrast, real house prices were flat when the UK was in technical recession during the first half of 2020, and then increased for more than

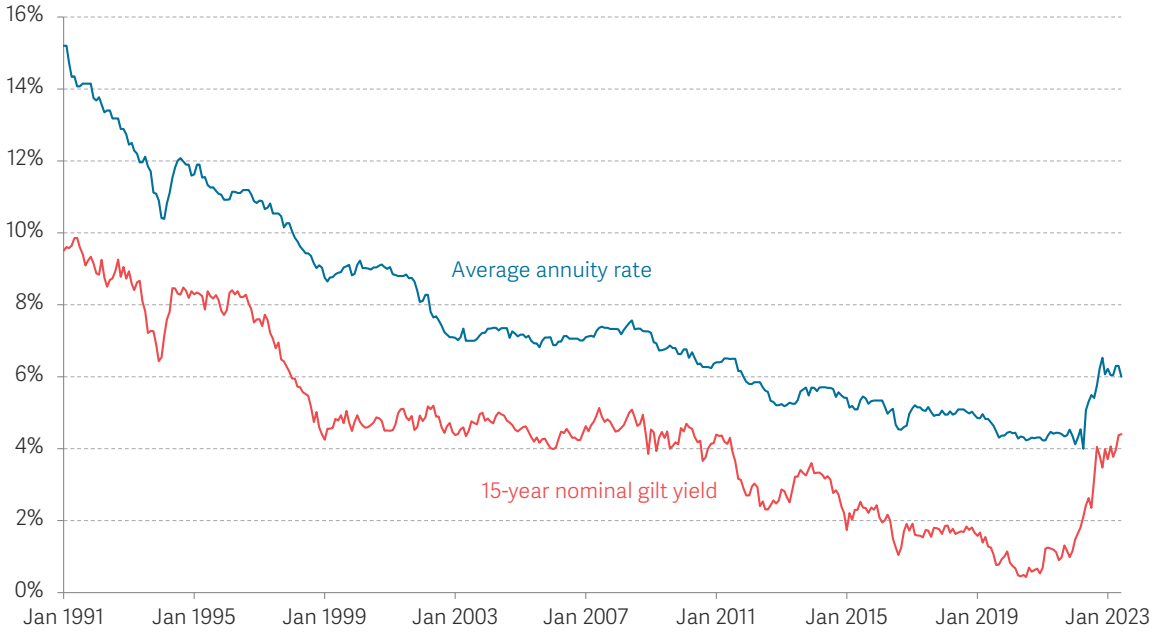
29 J Leslie & K Shah, (Wealth) gap year: The impact of the coronavirus crisis on UK household wealth, Resolution Foundation, July 2021.

two years. UK house prices rose every quarter between July 2020 and December 2022, delivering a cumulative real-terms increase of six per cent. Prices have started to fall since, as higher mortgage rates have started to weigh on demand.

The value of UK government bonds (gilts) was more stable during the pandemic. Unlike equities, the value of gilts rose modestly in the early months of the pandemic, as interest rates were cut to historic lows and this fed through to higher gilt values. After a period of relatively stable value, holders of gilts took significant losses in 2022. Holders of UK Government debt have seen around a 30 per cent loss in the value of their investments since the Bank of England started raising interest rates in December 2021; and holders of sterling corporate bonds have lost 20 per cent.

FIGURE 12: **Annuity rates surged in 2022 after falling to historic lows in the 2010s**

Average annuity rate and 15-year gilt yield: UK, January 1991-June 2023



NOTES: The average annuity rate shown is for a man aged 65, based on a £10,000 purchase of a single life annuity with level payments.
SOURCE: RF analysis of The Annuity Project by William Burrows; Bank of England, Yield curves.

More generally, the fall and rise of interest rates has underpinned movements in asset prices, affecting the value of household wealth directly, but also indirectly reducing the measured value of some sources of pension wealth. A large part (36 per cent) of British households' wealth is in the form of guaranteed future income streams, such as DB pensions and pensions in payment. A common way of valuing these income streams is to ask how much cash would be needed to purchase an annuity that delivers the same flow of payments. Indeed, this is the approach taken by the ONS in the WAS, which we also adopt in this report (see Box 1 for further detail). Annuity rates are influenced by

long-term interest rates and have climbed steeply since the start of 2022, returning them to the level in 2011 (Figure 12). As rates have risen, this has reduced the amount needed to purchase an annuity that pays out a given stream of income, thus reducing the implied value of pension wealth that provides a guaranteed income.

The level of wealth is projected to have fallen dramatically as interest rates have risen, driven mainly by the valuation of pensions

Tracking the evolution of household wealth through the pandemic and the cost of living crisis is challenging, due to a lack of timely and comprehensive data. The latest available detailed snapshot of household balance sheets is from the 2018-20 wave of the WAS. In the absence of more timely data on the distribution of wealth, we combine recent asset price moves and aggregate data on household saving with pre-pandemic WAS data to 'nowcast' the level and distribution of household wealth.[30] Our results are therefore subject to modelling uncertainty, but should act as a guide to emerging trends ahead of the arrival of new survey data.

Figure 13 shows our quarterly estimate for the aggregate level of household net wealth since the start of 2020. The trends in asset prices discussed above – namely the recovery of UK and global equities, substantial growth in house prices, and historically low gilt yields in the latter half of the pandemic – led to wealth as a share of economic activity peaking in Q1 2021 at approximately 840 per cent of GDP (equivalent to around £17.5 trillion). While the pound and pence value of total household wealth was indeed growing over this period, the increase in the wealth-to-GDP ratio was boosted by a fall in nominal GDP during the pandemic.

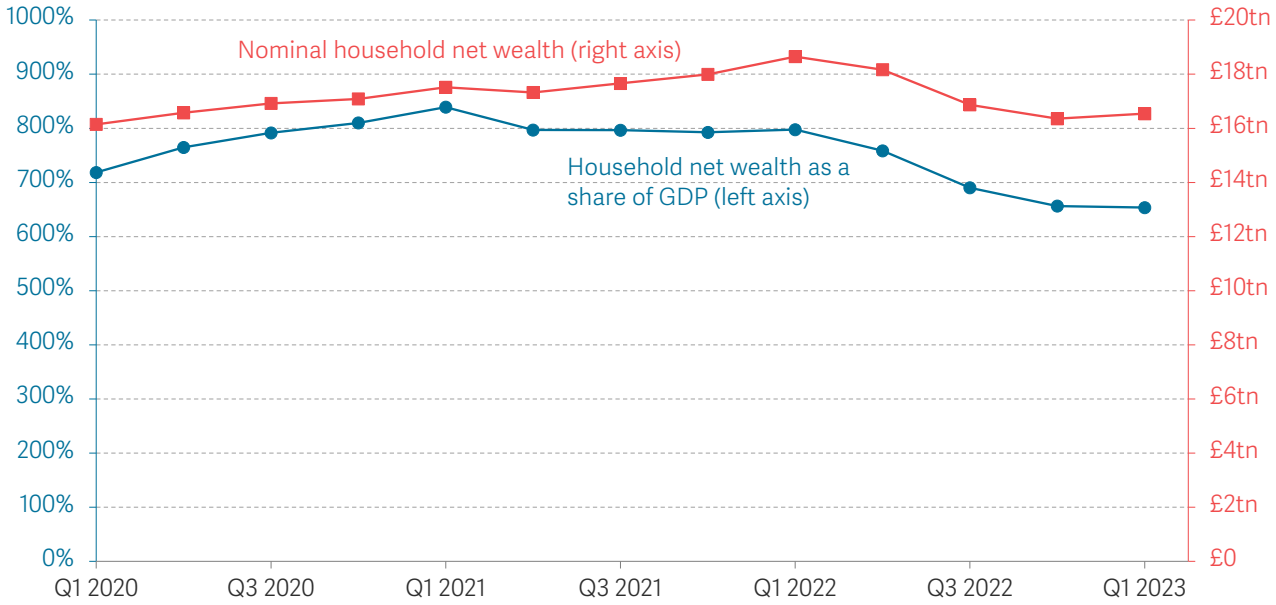
The recent reversal in asset values triggered by rising interest rates in 2022 in response to rapidly increasing inflation has put this process into reverse. Our analysis indicates that the UK's wealth-to-GDP ratio in Q1 2023 was nearly 200 per cent lower compared to its peak in Q1 2021 (Figure 13). If the wealth-to-GDP ratio had remained at its peak level, aggregate household wealth would be £4.7 trillion higher, representing the largest decline in household wealth as a proportion of GDP in the post-war era. In cash terms, the total stock fell by £2.1 trillion in the year to Q1 2023.[31]

30 We are attempting to track a very specific measure of household wealth, namely wealth that is captured by the WAS. The measurement of wealth in the WAS has a few key drawbacks – including that it relies on self-reported valuations and tends to under-sample richer households – but it nevertheless remains the richest source of data on the distribution of household wealth in Britain. For a discussion of the key issues around measuring wealth in the UK, see A Advani, G Bangham and J Leslie, The UK's wealth distribution and characteristics of high-wealth households, Fiscal Studies, October 2021.

31 Although a conceptually different measure of wealth, household sector financial net worth – as measured in the UK Economic Accounts – has also fallen during the period of rising interest rates. In cash terms, household sector financial net worth fell 11 per cent between Q3 2022 and Q4 2021. It rose slightly between Q3 2022 and Q1 2023, but is still 7 per cent down on its Q4 2021 level. As in our results, a large part of this fall is due to a reduction in the value of pensions.

FIGURE 13: **Rising interest rates have caused a sharp drop in wealth to the tune of around 200 per cent of GDP since the peak in early 2021**

Total household wealth as a proportion of GDP: GB



NOTES: The value of household wealth is estimated by modelling changes in the value of individual wealth sources at the household level since the most recent wave (Q2 2018-Q1 2020) of the ONS Wealth and Assets Survey (WAS). The chart shows the ratio of the estimated level of household net wealth as a share of the four-quarter rolling sum of nominal GDP.
SOURCE: RF analysis of ONS, Wealth and Assets Survey; Bank of England, Effective interest rates; FTSE Russell, FTSE All-Share Index TR; MSCI, MSCI World Index TR; S&P Global, S&P UK Gilt Index; The Annuity Project from William Burrows; and ONS, UK House Price Index.

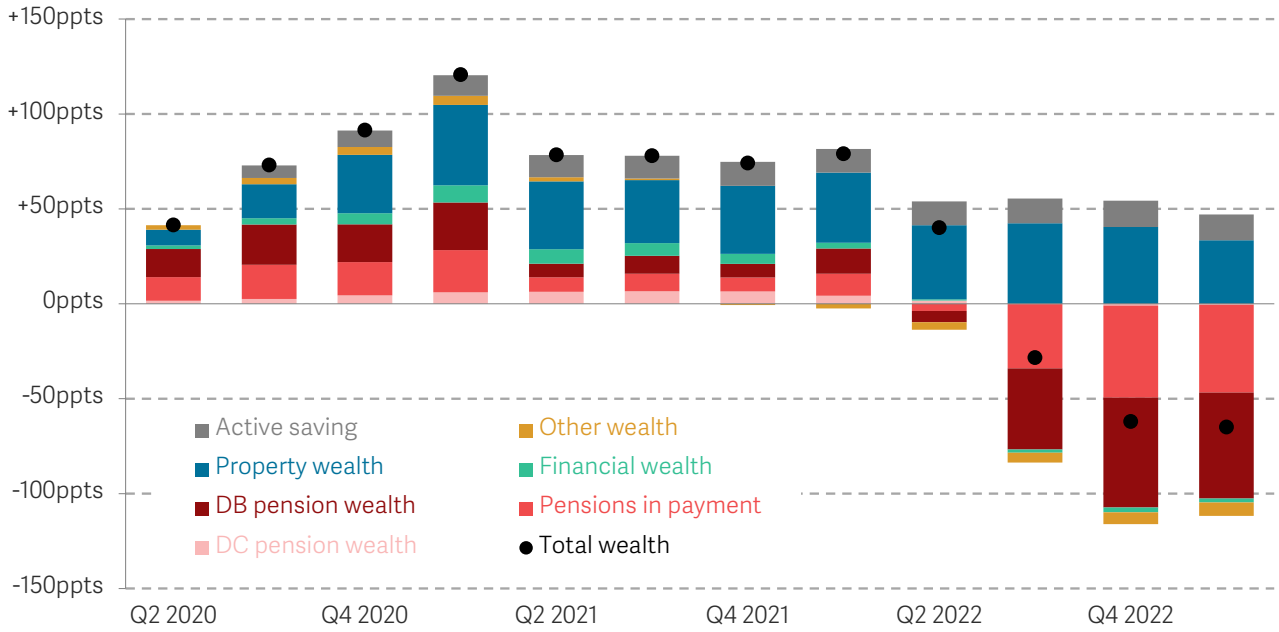
A closer examination of different assets reveals the driving forces behind the fluctuations in total household wealth since the start of the pandemic. Figure 14 shows the contribution of passive changes, plus our estimate for aggregate active saving, to the cumulative change in wealth as a share of GDP since the start of the pandemic. Changes to financial assets have had a relatively modest impact on net household wealth. And, despite historically high levels of saving during the pandemic, the cumulative impact of active saving has pushed up on wealth as a share of GDP by only 14 percentage points. Instead, the fluctuations in household wealth since Q1 2020 can primarily be attributed to changes in property and pension wealth.

Starting with property wealth, house prices increased by 25 per cent between April 2020 and July 2022. Although house prices have started to fall in recent months, and are now 7 per cent below their real-terms peak in mid-2021. they have so far defied projections of substantial falls due to higher mortgage rates. As a result, house price growth has boosted the value of property wealth in all quarters since the start of the pandemic, although its cumulative contribution as prices have fallen in recent quarters as prices have fallen.

The measured value of pensions, on the other hand, has seen more pronounced fluctuations. The rise in pension wealth from Q2 2020 to Q1 2022 can be partly explained by the recovery of UK and global equities during the latter part of the pandemic, which positively impacted the value of defined contribution pensions. However, a more substantial factor was the record low yields on government and corporate bonds which boosted the implied value of guaranteed income streams associated with DB pensions and pensions in payment. However, since Q2 2022, the estimated value of total pension wealth has fallen dramatically as a result of rising interest rates.

FIGURE 14: **Fluctuations in the value of defined benefit pensions have been a key driver of recent changes**

Cumulative change in total net household wealth as a proportion of GDP relative to Q1 2020, and contributions from active saving and passive changes by wealth type: GB, Q2 2020-Q1 2023



NOTES: The value of household wealth is estimated by modelling changes in the value of individual wealth sources at the household level since the most recent wave (Q2 2018-Q1 2020) of the ONS Wealth and Assets Survey (WAS). The impact of active saving is based on household net lending/net borrowing in the UK Economic Accounts. Other wealth includes business and pension wealth. DB pension wealth includes retained rights in defined benefit schemes.
SOURCE: RF analysis of ONS, UK Economic Accounts; ONS, Wealth and Assets Survey; Bank of England, Effective interest rates; FTSE Russell, FTSE All-Share Index TR; MSCI, MSCI World Index TR; S&P Global, S&P UK Gilt Index; The Annuity Project from William Burrows; and ONS, UK House Price Index.

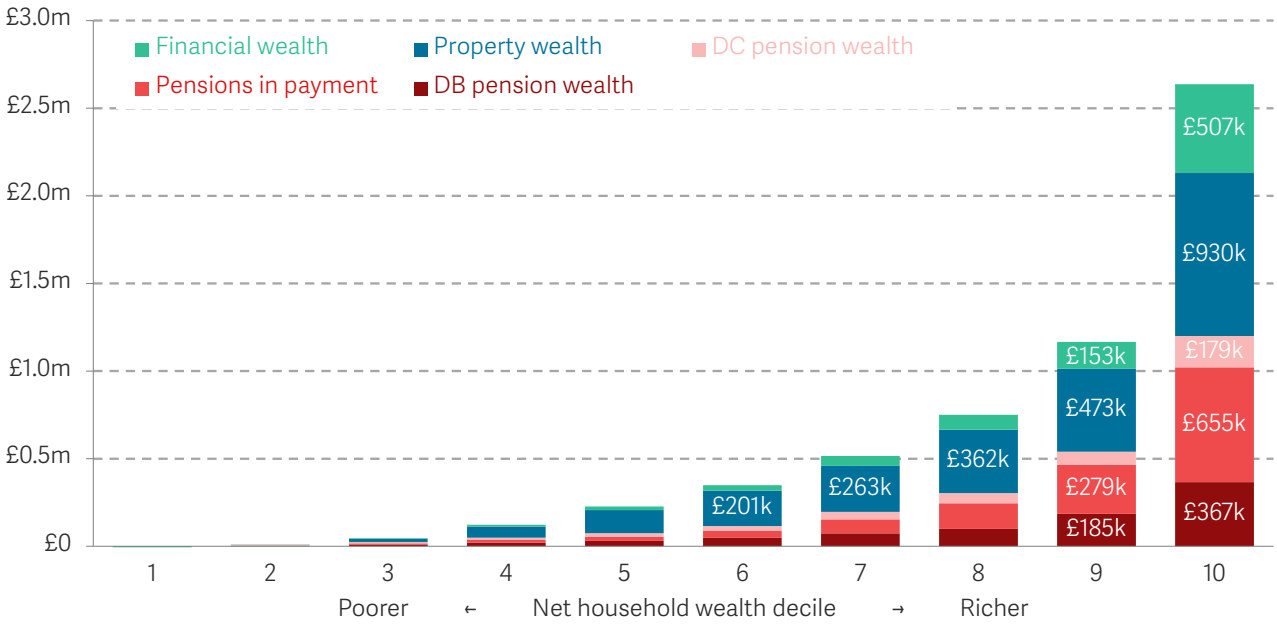
The passive wealth shock has mostly affected older, wealthier households

Recent moves in asset prices and interest rates are projected to have had a significant impact on the aggregate level of wealth. But their impact hasn't been felt equally across families.

Passive impacts have varied across the wealth distribution, depending on the types of assets held by different households. In Figure 15, we show the average household net wealth in each decile of the wealth distribution. There are three features of the distribution that are particularly relevant for the impact of recent passive changes. First, pension wealth is the most important source of wealth at the top of the distribution. Around half of wealth held by households in the richest decile is in the form of pension wealth, with more than four fifths held in the form of DB pensions or pensions in payment. Second, property wealth is more evenly distributed between middle-to-high-wealth households. Property wealth is the largest source of wealth for households in the fifth decile, accounting for 45 per cent of total wealth. Finally, very little wealth is held by households in the bottom two deciles. Indeed, the median household in the poorest fifth has no pension wealth or property wealth.

FIGURE 15: **Pension wealth is the most important source of wealth at the top of the distribution, while property wealth is most important in the middle**

Mean household net wealth, by source of wealth and wealth decile: GB, 2018-20



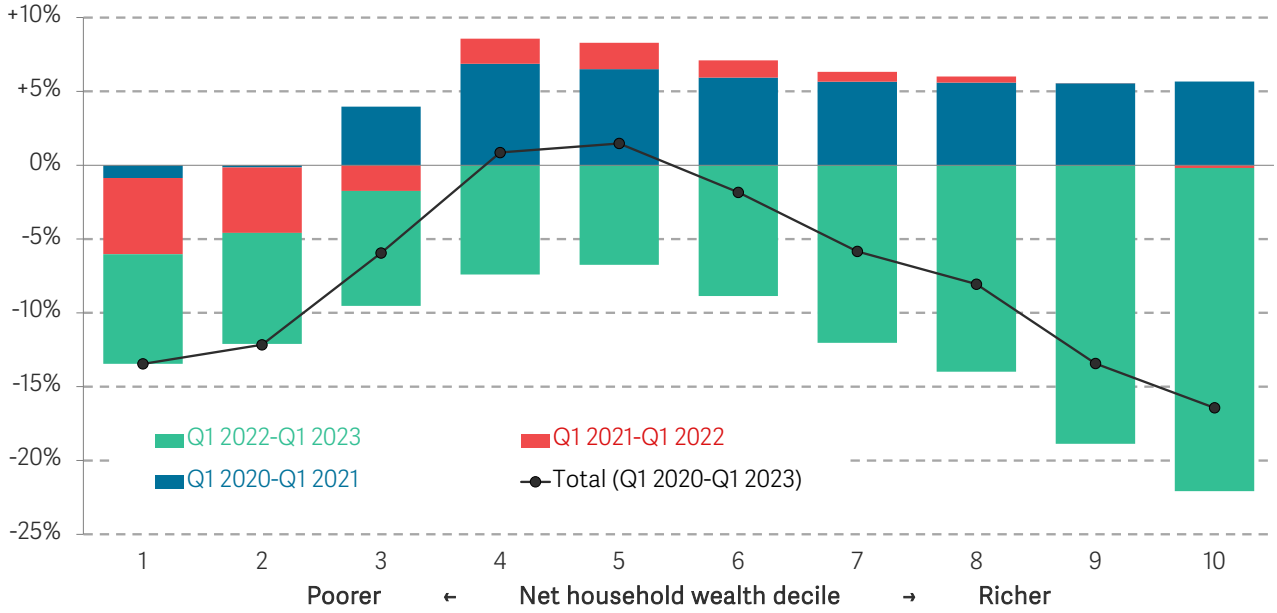
NOTES: Data excludes private business wealth and physical wealth.
SOURCE: RF analysis of ONS, Wealth and Assets Survey.

Figure 16 shows our estimates for the proportional passive changes in household wealth over the three-year period since the start of the pandemic (from Q1 2020 to Q1 2023) across the wealth distribution. Here, we express changes in wealth in real terms, in order to capture changes in the real value of wealth relative to the price of goods and services that households can buy. Given relatively flat levels of real GDP since 2021, and compared to just before the pandemic, trends in real wealth are similar to trends in the level of wealth to GDP.

Almost all households saw passive gains during the pandemic (Q1 2020 and Q1 2021), reflecting the rapid growth in house prices and the strong recovery of equities during this period. However, the picture was more mixed between Q1 2021 and Q1 2022. As inflation started to rise in mid-2021, the real value of assets started to fall. Households in the bottom fifth of the wealth distribution were particularly exposed, as the assets they own tend to attract very little in the way of returns, making it difficult to offset inflation. We estimate that households in the lowest decile saw their wealth fall by 5 per cent between Q1 2021 and Q1 2022. On the other hand, households in the middle of the distribution saw an increase in their wealth between Q1 2021 and Q1 2022: households in the fourth and fifth deciles saw proportional rises of 2 per cent. The relative importance of property wealth in the middle of the distribution has benefitted many middle-income households over this period as growth in house prices continued to outpace inflation.

FIGURE 16: **In proportional terms, passive gains since the start of the pandemic have been largest in the middle of the distribution**

Median estimated change in net household wealth due to passive changes, as a percentage of total wealth in Q1 2020, by net household wealth decile: GB, Q1 2020-Q1 2023



NOTES: Data is adjusted using CPIH into March 2023 prices. The value of household wealth is estimated by modelling changes in the value of individual wealth sources at the household level since the most recent wave (Q2 2018 to Q1 2020) of the ONS Wealth and Assets Survey (WAS).
SOURCE: RF analysis of ONS, UK Economic Accounts; ONS, Wealth and Assets Survey; Bank of England, Effective interest rates; FTSE Russell, FTSE All-Share Index TR; MSCI, MSCI World Index TR; S&P Global, S&P UK Gilt Index; The Annuity Project from William Burrows; and ONS, UK House Price Index.

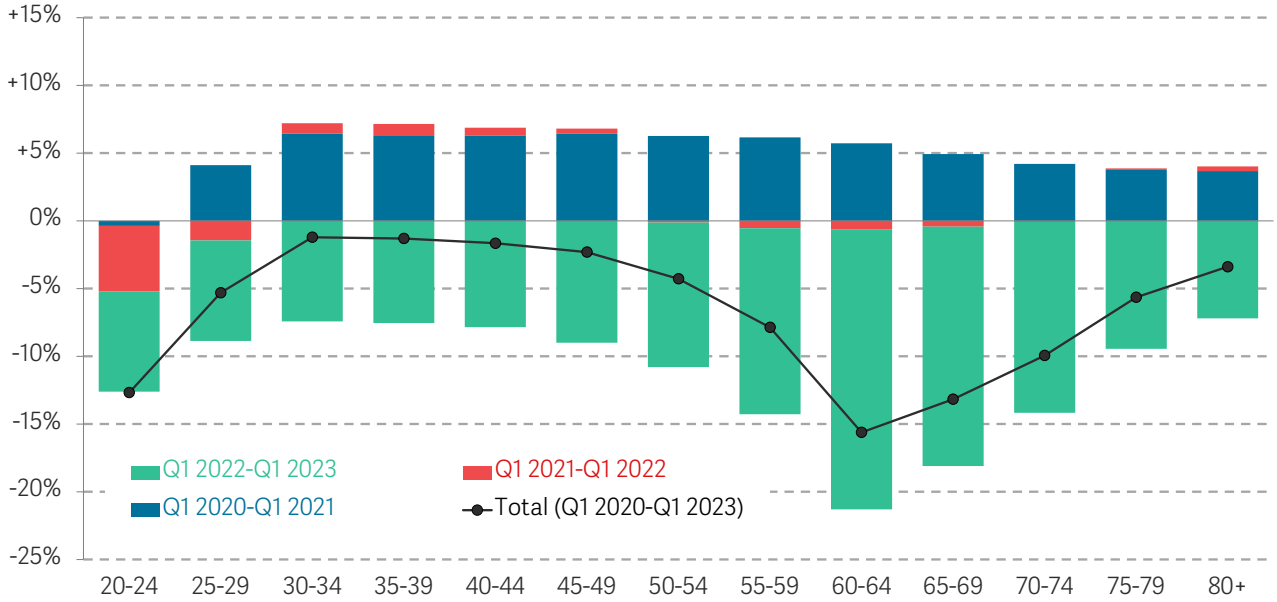
In 2022, inflation peaked and interest rates began to rise, and the impact of these events has been felt across the entire distribution. We estimate that all households saw a fall in wealth between Q1 2022 and Q1 2023. But it is those in the top wealth decile that have

seen the largest proportional falls in wealth: we estimate that households in the top wealth decile will have seen their total wealth fall by over a fifth (22 per cent) between Q1 2022 and Q1 2023. This decline has been primarily driven by rising bond yields and annuity rates, which have had a sharp impact on the value of pensions in payment and DB pensions, as discussed above.

Changes in asset prices since the start of the pandemic also have intergenerational implications. As discussed above, the decline in pension wealth observed in the past year has disproportionately affected those individuals who have a greater share of pension wealth. There is a strong life-cycle pattern to wealth holdings, where individuals start with lower levels of wealth and accumulate it as they age, with wealth peaking around retirement age. As a result, pension wealth makes up a larger proportion of total wealth among those approaching retirement and those who have recently retired. As a result, as shown in Figure 17, individuals aged 44-79 experienced the largest falls in the overall value of their wealth between Q1 2022 and Q1 2023, with 60-64-year-olds seeing real falls of over 20 per cent.

FIGURE 17: **Households around retirement age have seen the biggest proportional fall in wealth over the last year**

Median estimated change in net household wealth due to passive changes, as a percentage of total wealth in Q1 2020, by age of household reference person: GB, Q1 2020-Q1 2023



NOTES: Data is adjusted using CPIH into March 2023 prices. The value of household wealth is estimated by modelling changes in the value of individual wealth sources at the household level since the most recent wave (Q2 2018-Q1 2020) of the ONS Wealth and Assets Survey (WAS).
SOURCE: RF analysis of ONS, UK Economic Accounts; ONS, Wealth and Assets Survey; Bank of England, Effective interest rates; FTSE Russell, FTSE All-Share Index TR; MSCI, MSCI World Index TR; S&P Global, S&P UK Gilt Index; The Annuity Project from William Burrows; and ONS, UK House Price Index.

The specific type of pension product is also relevant in this context. Although DB schemes remain common in the public sector, membership of private-sector DB pension schemes reached its peak in the 1960s and has been declining since.[32] As a result of declining membership and the natural accrual of pensions over people's working lives, DB pension wealth is disproportionately held by those nearing retirement age: 50 per cent of DB pension wealth is held by individuals in their 50s. Of course, wealth from pensions in payment is held by those who have already retired, and is greatest for those who have yet to draw down much of their pension. This further explains why these individuals have witnessed greater proportional decreases in measured wealth.

In contrast, those who are younger and middle-aged have been less exposed to the fall in asset prices. This is due to the shorter period they have had to accumulate pension wealth, and the fact that housing wealth tends to account for a higher proportion of their overall wealth.

Falling total wealth has narrowed some of the financial gaps between families

The recent fall in aggregate wealth has closed some of the gaps across the wealth distribution. Despite the shape of the wealth distribution – as captured by relative measures of inequality – being broadly stable over time, the growing size of the wealth stock over recent decades has increased the pound and pence gaps between households at different ends of the wealth distribution. This has deepened economic inequality by making it harder for families to acquire housing and pension assets through saving out of their own incomes.[33]

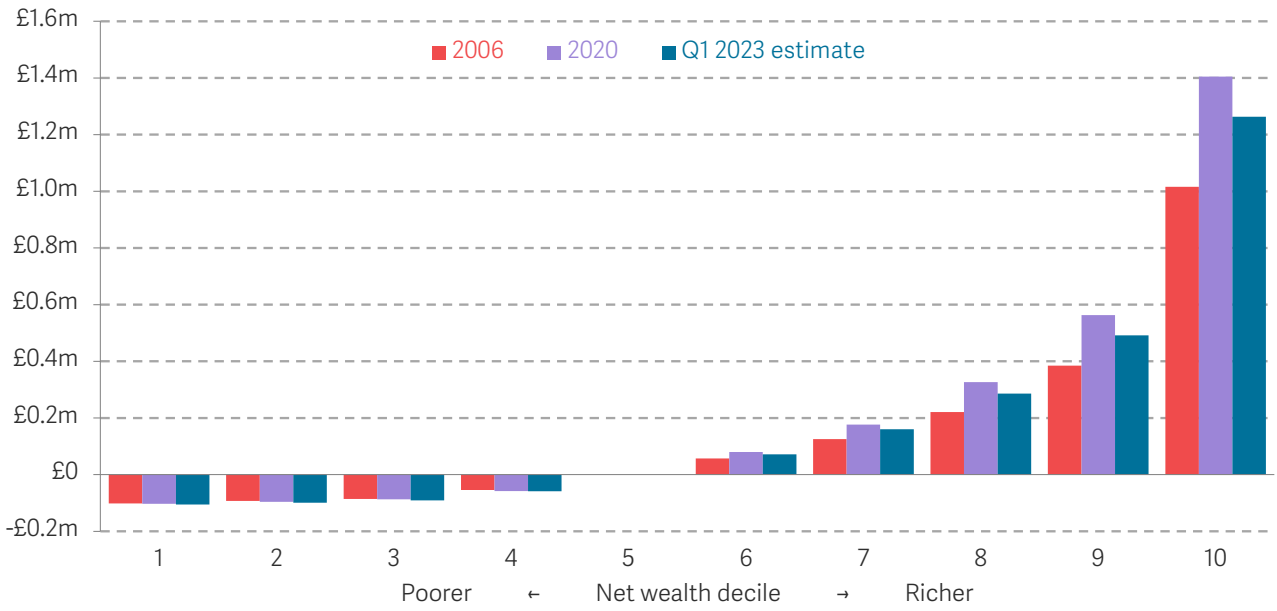
Figure 18 shows the gap between average wealth for a family at the middle of the wealth distribution and average wealth at other wealth deciles. The average inflation-adjusted gap between wealth per adult for families in the fifth decile and the top decile grew from around £1 million in 2006 to £1.4 million in 2020. Recent passive changes in wealth have put this trend into reverse. We estimate that their impact has reduced this gap by £200,000, or around six-times median household disposable income, leaving it at just over £1.2 million.

32 L Carrera, C Curry & N Cleal, The changing landscape of pension schemes in the private sector in the UK, Pensions Policy Institute, 2012.

33 For a fuller discussion of longer-term trends in wealth inequality, see: P Bourquin, M Brewer & T Wernham, Trends in income and wealth inequalities, IFS Deaton Review of Inequalities, November 2022; M Broome & J Leslie, Arrears fears: The distribution of UK household wealth and the impact on families, Resolution Foundation, July 2022.

FIGURE 18: **Passive changes to the value of wealth have narrowed wealth gaps to levels last seen in the late 2000s**

Absolute wealth gap between average family wealth per adult within each net wealth decile and mean wealth per adult for decile 5: GB



NOTES: Data is adjusted using CPIH into March 2023 prices. Wealth is measured at the family unit level - i.e. one or two adults within a household plus any dependent children. Household composition is accounted for by taking wealth per adult within the family. The definition of wealth excludes physical wealth and private business wealth.
SOURCE: RF analysis of ONS, UK Economic Accounts; ONS, Wealth and Assets Survey; Bank of England, Effective interest rates; FTSE Russell, FTSE All-Share Index TR; MSCI, MSCI World Index TR; S&P Global, S&P UK Gilt Index; The Annuity Project from William Burrows; and ONS, UK House Price Index.

Asset price changes since the start of the pandemic have resulted in a large wealth shock over a short period of time, the scale of which has been much bigger even than the unusually large jump in active saving since the start of the pandemic.

How are things likely to evolve from here? Recent interest rate changes have yet to have their full impact on asset prices, and there is an unusual degree of uncertainty about how interest rates may change going forward. The next Section puts the wealth shock into a longer-term context and explores scenarios for the future path of household wealth.

Section 4

Future changes in wealth will depend crucially on whether higher interest rates are here to stay

Rising asset prices, and the associated falling returns, have been the key driver of wealth and intergenerational inequality. But the recent substantial drop in household wealth has begun to put these trends into reverse. However, the future path of long-term interest rates, and household wealth, remains extremely uncertain. To illustrate the implications of this, we construct two scenarios for the path of future interest rates and use them to illustrate how the scale and distribution of wealth would look very different with profound consequences for intergenerational inequality.

First, we model a 'new normal' which adopts the current market outlook, under which interest rates remain elevated well above pre-pandemic levels. In this scenario, we should expect further falls in the value of household wealth. Part of this will be driven by falls in house prices as the market adjusts gradually to a world of higher interest rates. We estimate that the house-price-to-earnings ratio should fall to around 5.6 – a level of affordability not seen since the turn of the century. If interest rates evolve as markets currently expect, wealth as a proportion of GDP would settle at around 550 per cent of GDP, above its late-20th century norm but well below the highs of the past two decades.

We also consider a scenario in which interest rates have 'further to fall' below their pre-pandemic level. This scenario sees wealth as a proportion of GDP surging well past its pandemic high and eventually settling at around ten-times GDP. This would have profound implications for the living standards of young, would-be homeowners as house prices soar, and it would become much more difficult to save an adequate pension.

The precipitous fall in household wealth over the past two years makes it clear that there was nothing inevitable about the increase in wealth since the mid-1980s. It was not the counterpart to thrifty saving, but largely a windfall gain for asset holders driven

by valuation effects. This volatility in measured wealth also illustrates the massive uncertainty about where household wealth will go next. Although many factors will influence the level of wealth, interest rates will play a major role. Below we explore what could happen if today's long-term interest rates are here to stay, or if instead we revert to the global economic forces that created the low-rate environment of the pre-pandemic period.

Although financial markets expect high rates to be with us for the foreseeable future, the outlook is highly uncertain

Current financial-market pricing implies that investors think the Bank of England will keep its policy rate high for some time. The overnight index swap (OIS) instantaneous forward curve, a measure of market participants' expectations for Bank Rate, suggests that it will peak above 6 per cent next year, won't fall below 4 per cent until the end of 2027 and will remain at levels not seen since before the financial crisis for the foreseeable future.[34]

More important for the valuation of household wealth are long-term market interest rates. The ten-year gilt yield, which embodies market expectations for future interest rates, stood at 4.3 per cent at the end of June, a rise of 3.5 percentage points over 2 years (it was just 0.8 per cent at the end of June 2021). This is the biggest rise in yields over a two-year period since 1981, underlining both the magnitude of the change in expectations and the volatility of today's interest-rate environment.

Because of the elevated uncertainty around the outlook for interest rates, it's useful to consider what could happen to household wealth in different scenarios. Our first scenario traces the implications if interest rates stay as high as current market expectations suggest. For this, we define a 'new normal' for interest rates where the ten-year gilt yield falls from its current level and settles at 3 per cent.[35] Ten-year real yields, which account for the expected level of RPI inflation over the duration of the bond, also fall from 0.75 per cent to -0.3 per cent.

If higher long-term interest rates are here to stay, house prices could fall by around 25 per cent

In this scenario, long-term yields fall relative to their value in the most recent quarter of our wealth nowcast (Q1 2023), pushing up the value of financial and pension wealth. We

34 Market expectations are based on data from 30 June 2023 sourced from Bank of England, Yield curves.
35 This is based on the implied forward rate for ten-year yields five years ahead, with an adjustment for term premia based on the historical average for the wedge between the implied forward rate and realised ten-year yields. For another application of this approach, see: M Brooke, N Cooper & C Scholtes, Inferring market interest rate expectations from money market rates, Bank of England Quarterly Bulletin, November 2000.

model a partial recovery in gilts, with falling long-term yields pushing up on prices in a symmetric way to how rising yields have pushed down on prices since the end of 2021. This boosts financial wealth for households' direct investment in gilts, and the value of investments sitting behind pensions. The implied value of DB pensions and pensions in payment also increases from its current level, as we assume the rise in gilt yields feeds through to annuity rates. In line with recent trends, we don't model a fall in equity valuations, which would be consistent with an offsetting change in the equity market risk premium.[36]

Although the impact of rising rates on gilts has come through quickly and clearly on pensions (see Figure 14) the impact on housing wealth has so far been much more muted. House prices have been fairly resilient in the face of sky-high mortgage rates. Inflation-adjusted house prices have fallen just seven per cent from their peak in August 2022, and in nominal terms house prices are seven per cent higher than when the Bank of England started raising rates in December 2021.

If interest rates remain at today's high levels, there will be further downward pressure on real-terms house prices in the years to come. At today's prices and interest rates, average repayments on new mortgages are rapidly approaching levels only previously seen before significant house price falls in the early 1990s and late 2000s.[37] Economic theory tells a similar story. At today's long-term real yields, the economic cost (or user cost) of owning a home is well above its long-run average. This implies that the difference between yields on residential property and safe assets, like government bonds, are unusually low, making them an unattractive investment unless prices fall, rents jump or interest rates drop sharply.

This is not just theoretical navel-gazing. This type of economic logic can account for much of the long-term rise in house prices in the UK. Just as higher rates suggest that prices will have to fall relative to incomes, so too does the trend of falling rates help explain the long-term rise in house prices.[38] Other factors are of course relevant for house prices. Housing supply is an obvious one, and indeed empirical evidence suggests that supply constraints can affect the sensitivity of house prices to interest rate changes.[39] In our scenarios, however, we assume no change in housing supply.[40]

It is important to note that, while such 'user cost' models provide a good long-term guide to house-price changes, many factors affect house prices at shorter-term horizons.

36 The correlation between equity and bond returns has varied substantially over time. See, for example, G Duffee, Macroeconomic News and Stock–Bond Comovement, Review of Finance, September 2022. In deciding not to model a change in equity values despite a recovery in bond prices, we are ultimately taking a pragmatic approach based on recent experience.
37 BuiltPlace, Housing Market Charts, May 2023.
38 D Miles & V Monro, UK house prices and three decades of decline in the risk-free real interest rate, Bank of England working paper No. 837, December 2019.
39 D Walker, How house prices respond to interest rates depends on where they are in the country, Bank Underground, June 2023.
40 More precisely, we assume no change in the ratio of the number of homes to the number of households.

This makes the timing of house-price changes beyond the capacity of such a model to predict. Nevertheless, they can give an indication of the direction of travel, and periods during which such models have suggested significant overvaluation in the past have tended to be followed by a sharp price correction (see Box 2).

BOX 2: **Modelling long-run house-price developments using the 'user cost' of housing**

The most complete measure of the economic cost of owning a house is captured by the so-called 'user cost' of housing, making it a key determinant of long-run house prices. The user cost is the sum of the cost of finance (applied to the full house price to reflect both mortgage interest and foregone interest on equity), depreciation costs, property taxes, minus any expected capital gain.[41] This approach, under which the price multiplied by the user cost is bid up until it equals the rental value of the property, helps us to understand the role that longer-term interest rates play in driving changes in house prices.

In practice, when estimating the user cost, a standard approach is to use longer-dated gilt yields as a measure of risk-free interest rates, acting as the foundation of the cost of finance. And it is this element of the user cost that has declined significantly over the past 40 years.

By contrast, other elements of the user cost have varied by much less over time. Depreciation, taxes and expected capital gains tend to be fairly stable, at least since the demise of tax relief for mortgage interest payments. These elements, therefore, form a fairly stable cost wedge between rental yields and the risk-free real interest rate when the housing market is in equilibrium. Previous research has estimated this wedge to be 6.4 per cent over the 30 years to 2018.[42] Drawing on this estimate, then, allows us to project how shifts in gilt yields are likely to drive the user cost of housing in future.

This approach also allows us to investigate how other factors help determine house prices and rents. Most obviously, the supply of and demand for housing services will play an important role. Population and income growth will also tend to push rents up, while higher housing supply pushes them down. Absent any changes in the user cost then, greater housing scarcity or abundance will drive house prices.

41 J Poterba, Tax subsidies to owner-occupied housing: an asset-market approach, The Quarterly Journal of Economics, vol 99, November 1984.
42 D Miles & V Monro, UK house prices and three decades of decline in the risk-free real interest rate,Bank of England working paper No. 837, Bank of England, 2019.

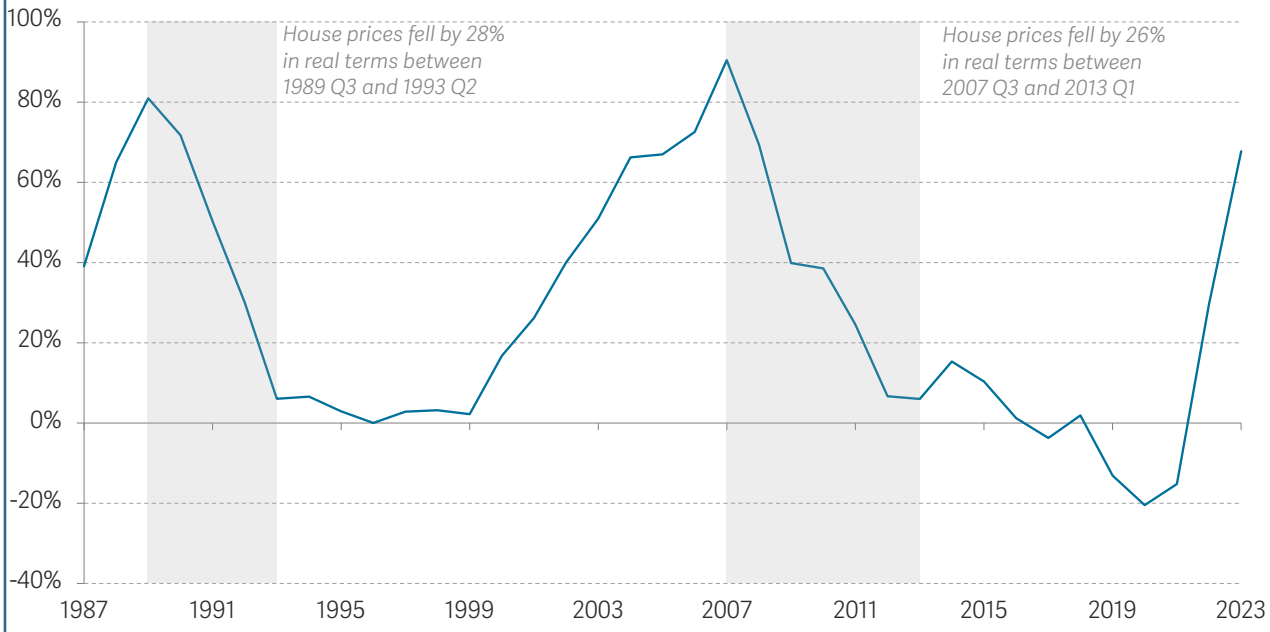
When rents and the user cost are aligned, the housing market is in equilibrium. This allows us to identify whether house prices are above or below their 'fair value' level: when prices are above equilibrium they tend to fall, and when they are lower than the user cost would suggest they tend to rise.

Over long timeframes this kind of asset-price model does a reasonably good job of capturing broad trends in the evolution of house prices for any given level of rents and interest rates.

However, user cost models tend not to be good at predicting short-term fluctuations in house prices due to numerous other short-term factors that affect any asset market. Moreover, house prices can diverge from their implied value for various other reasons.[43] Figure 19 shows the level of modelled overvaluation of house prices over the past 35 years. Periods of extreme overvaluation were unwound through a combination of rising incomes, falling interest rates and a fall in house prices.

FIGURE 19: **The user cost model accurately identifies past periods of overvaluation**

Proportion by which the house-price-to-earnings ratio exceeds the value implied by a user-cost model: UK



Note: Model draws upon D Miles & V Monro, UK house prices and three decades of decline in the risk-free real interest rate,
Bank of England working paper No. 837, Bank of England, 2019. The user-cost model is normalised to the period from 2010 to 2021.
SOURCE: RF analysis of ONS, House price index, Labour Market Statistics; Bank of England, Yield Curves.

43 International Monetary Fund, Global Financial Stability Report, April 2018.

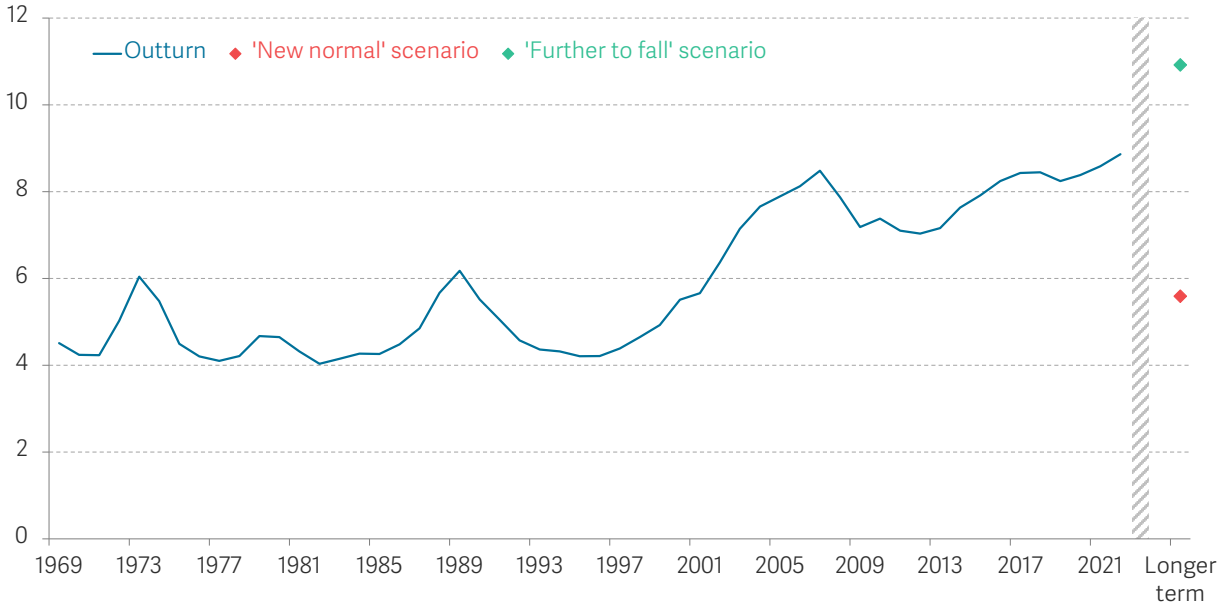
To project how equilibrium house prices develop under different financial conditions, we make the assumption that housing supply is sufficient to keep up with desired household formation at current costs (that is, supply is essentially fixed), such that rents rise in line with earnings. Shifts in interest rates then dictate changes in the equilibrium house price-to-earnings ratios. Of course, in practice higher housing supply would put downward pressure on rents and prices.

A very similar approach to the one described in this box is to determine the over- or undervaluation of housing with reference to house prices, mortgage interest rates and earnings. Such an approach also tends to be reliable at highlighting periods of over- and undervaluation in house prices heralding medium-term adjustments.[44]

Based on a ten-year real gilt yield of -0.3 per cent, we estimate that the ratio of average house prices to earnings would need to fall to around 5.6 in order for the cost of owning a home to come back into line with rents. This down from an all-time high of 8.9 reached in 2022, and would return house prices as a multiple of earnings to their lowest level since 2000 (Figure 20).

FIGURE 20: **The future path of interest rates could have profound implications for the level of house prices relative to incomes**

Ratio of average price for all properties (UK) to average annual whole economy total pay (GB): 1969-2022



NOTES: An annual series for average price is constructed from quarterly and monthly data. From 2005 onwards, when monthly sales volume data becomes available, the annual figure is a weighted mean of each year's monthly data. In previous years a simple mean of each year's quarterly or monthly data is used.
SOURCE: RF analysis of ONS, Average Weekly Earnings; HM Land Registry, UK House Price Index.

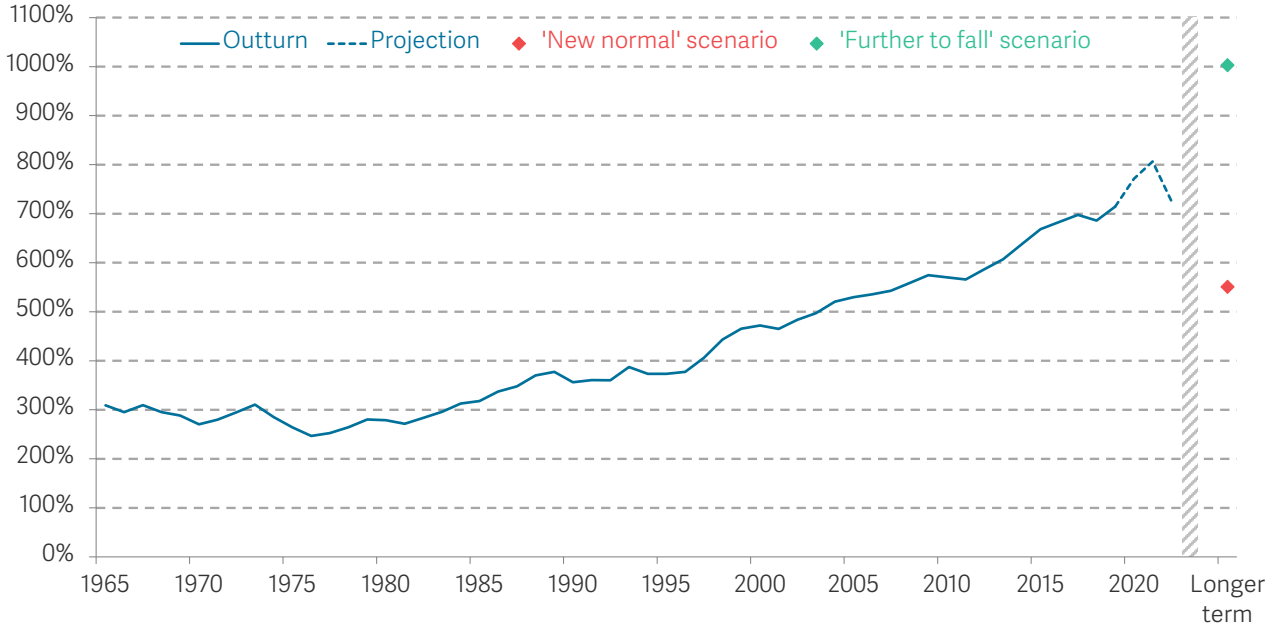
44 See for example N Hudson, Market Commentary, BuiltPlace, January 2023.

With inflation-adjusted house prices 'only' down six per cent since the end of 2021, this implies there could be a much larger real-terms fall to come, although there is significant uncertainty over how long that adjustment might take. And, with a fast-changing economic outlook, it's also uncertain how much of the real-terms adjustment would come from higher household incomes versus lower nominal house prices. If house prices took five years to reach their new equilibrium, and earnings grew roughly in line with the Bank of England's most recent forecast during that time, we could see nominal prices fall by 25 per cent.[45] Over this timeframe, that would amount to the average house price falling to £215,000, down from £287,000.

By extending the projection methodology outlined in Box 2, we can illustrate what these asset-price moves would mean for household wealth. As with the projections in Section 3, this exercise relies on asset holdings from the latest wave of the Wealth and Assets Survey, and thus does not take into account the myriad ways that households might adjust their saving and investment behaviour in a world of higher interest rates. However, it serves as a guide for what the landscape of wealth might look like in such a world.

FIGURE 21: **Aggregate wealth could fall to levels not seen since the mid-2000s once house prices have adjusted to higher interest rates**

Household wealth as a share of national income: UK



NOTES: 2020-2022 data points are estimated using the methodology set out in Box 1.
SOURCE: RF analysis of OECD; D Blake & J Orszag, 'Annual estimates of personal wealth holdings in the United Kingdom since 1948', Applied Financial Economics 9, 1999; ONS, UK National Accounts; ONS, Wealth in Great Britain; ONS, Gross Domestic Product at market prices.

45 This is based on the forecast set out in the Bank of England, Monetary Policy Report – May 2023. In the forecast, average weekly earnings grow 5 per cent in 2023, 3.5 per cent in 2024 and 2.5 per cent in 2025. We assume that earnings continue to grow at 2.5 per cent in subsequent years, which aligns with the OBR's assumption for long-run growth in average earnings.

Falling house prices dominate the aggregate picture, and aggregate housing wealth falls from an estimated 280 per cent of GDP in Q1 2023 to 160 per cent once the full effect of higher interest rates has come through. This is only partially offset by a 30 percentage point increase in the combined value of financial and pension wealth described above, leaving total household wealth at a little more than 550 per cent of GDP (Figure 21). Although this would leave the household-wealth-to-GDP ratio well above typical levels from the late 20th century, it represents a significant fall from the peak in 2021, taking the wealth back to levels last seen at the start of the 21st century.

Or rates could fall further than before the pandemic, sending house prices and household wealth to new heights

Current market expectations are a useful guide, but they are by no means a perfect prediction of future interest rates as their recent volatility shows. It's therefore worth stepping back and considering some of the long-term factors at play. Indeed, the decline in long-term interest rates over recent decades has been found to reflect slow-moving economic forces. Evidence suggests that an ageing population and slowing productivity growth have been two of the main drivers.[46] Longer life expectancies (the counterpart to an ageing population) have increased the amount that people need to save for retirement, while slower productivity growth has reduced returns on investment, resulting in less demand for finance. These forces of higher supply of saving and lower demand for credit have combined to reduce interest rates over time.

These economic forces could reassert themselves once the current policy interest rate cycle comes to an end. Indeed, the International Monetary Fund suggested in its recent World Economic Outlook that their re-emergence could see interest rates falling back to near pre-pandemic levels.[47] And recent Bank of England research has emphasised the length of time it takes for the slow-moving underlying drivers of low interest rates to exert their full effect. This suggests that global, risk-free interest rates could decline by a further percentage point below pre-pandemic levels in the long term as they adjust to forces such as demographics and productivity growth.[48]

Although the timeframes over which such a shift might take place can probably be measured in years if not decades, it is worth considering what household wealth would look like in that kind of world. This is the basis of our alternative scenario in which rates have 'further to fall'.

46 A Cesa-Bianchi, R Harrison & R Sajedi, Decomposing the drivers of Global R*, Bank of England Staff Working Paper No. 990, July 2022.
47 International Monetary Fund, World Economic Outlook: A Rocky Recovery, April 2023.
48 A Bailey et al., Structural change, global R* and the missing-investment puzzle, Bank of England Staff Working Paper No. 997, October 2022.

This scenario sees wealth as a proportion of GDP surging well past its pandemic high and eventually settling at ten-times GDP (Figure 20). This increase reflects the impact of lower rates across asset classes. Based on the approach described in Box 2, house prices could rise sharply to nearly 11 times earnings, supported by a return to ultra-low mortgage rates. In today's terms, that would mean an average house costing more than £350,000 compared to the current average of around £275,000. This compares to five-times earnings at the start of the 21st century, and a multiple of around seven during the 2010s (Figure 20). Pensions wealth too would need to be substantially higher to provide people with a standard of living comparable to that enjoyed by today's retirees, with profound implications for the living standards of working-age people as we explore in more detail below.

Over the past 18 months, we've seen the rising tide of wealth in the UK come to an abrupt stop. It remains to be seen if that's a sign of further falls to come, or if the longer-term trends behind the rise come back with a vengeance. What we do know is that large shifts in wealth can and do occur for reasons largely out of any individual's control. In the next Section, we dig into some of the implications of a world of large and unpredictable swings in wealth, and what policymakers can do to mitigate some of the adverse implications for families.

Section 5

The future path of interest rates will have important implications for society

Our analysis of the difference between remaining in a high-interest-rate world or moving back to one of low rates makes it clear how different those worlds would be. Higher rates mean that middle-income families can realistically expect to be able to afford their own home and provide for a comfortable retirement in old age, with less pressure on their standard of living in between. But if we return to ultra-low interest rates, it becomes much more difficult for families to accumulate wealth from their own resources. Household wealth would become dominated by inheritances, hampering social mobility and amplifying the role of luck in life outcomes with profound implications for our politics and government policy.

The uncertain outlook means big financial risks facing families as they seek to buy a property or plan for retirement. A key issue, then, is how much of this risk we should ask households to bear and how much policy makers should seek to offset. So in this concluding Section we discuss the key areas for government action, focussing on pensions, housing and taxation. While we leave a detailed policy agenda to future work, here we set out a framework for how to approach these areas. An important insight here is that it is not just the level of interest rates that matters for policy but also the uncertainty around them. This implies that policy in these crucial areas must be robust to further changes in the interest rate environment.

We are in a moment of massive uncertainty about the trajectory of household wealth. The path that household wealth takes will have big implications for society. A world of permanently higher interest rates would feel very different from one in which the forces that have, until recently, pushed them down resume. In this Section we discuss how the future of interest rates may shape our politics and government policy.

Where wealth goes next will shape our politics

It is crucial to take the underlying drivers of fluctuations in wealth into account when thinking about their implications. As discussed in earlier Sections, the underlying driver of the sharp reversal in the 40-year-wealth trend is the rise in interest rates.[49] This matters because, if movements in wealth were simply the result of accumulated past income or capital it can be considered the hard-earned fruits of a lifetime of saving or, at worst, the spoils of income inequality. But when understood as largely the product of interest rate fluctuations driven by global macroeconomic forces, the wealth boom of recent decades is revealed as a windfall gain for those merely lucky enough to hold interest-rate-sensitive assets at the right moment.[50]

Recent volatility in long-term interest rates also underlines the substantial uncertainty about how household wealth will evolve in the coming years, as our scenarios show. Will pre-pandemic conditions eventually reassert themselves, unleashing a multi-trillion-pound surge in asset prices? Or will other forces – for example, the fragmentation of the global trade system, surging green investment and governments spending more on rearmament in the face of geopolitical instability – boost investment around the world, leading to further increases in long-term interest rates, creating more downward pressure on wealth?[51]

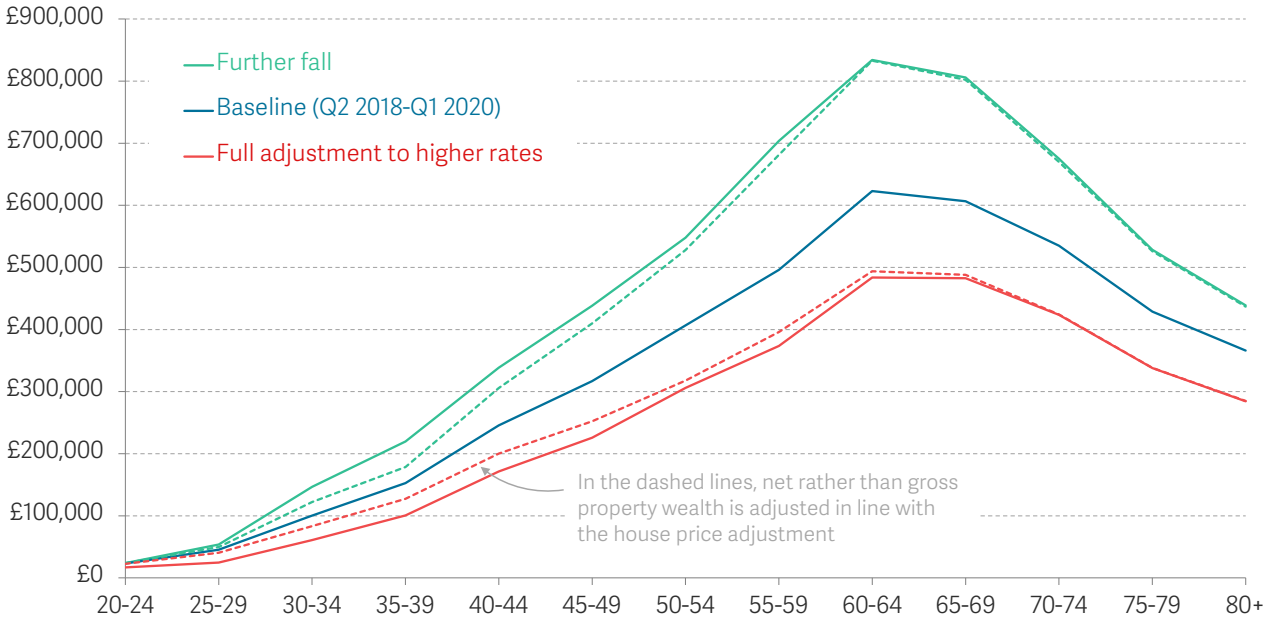
These two scenarios for long-term interest rates represent very different societies. In a higher-rates world, middle-income families can aspire to afford their own home, and put enough money away to achieve a comfortable retirement in old age while enjoying a good standard of living during working age. We can see this by comparing the life-cycle path of wealth for the typical household just before the pandemic to what it would need to be in order to offer the household an equivalent standard of living in retirement under the two scenarios. On the eve of the pandemic, the median household at the point of retirement had net wealth of around £620,000, or around 22 times average earnings at that time, overwhelmingly accounted for by pensions and housing, that promised a given standard of living. Once the full effects of today's higher interest rates have been reflected in asset prices it is likely that future cohorts will be able to achieve the same standard of living in retirement with significantly less wealth at the point of retirement. We estimate that a little over £480,000 (in 2019 prices), or 17 times average earnings, would be sufficient. At the same time, those in line to inherit wealth would typically receive commensurately less.

49 Our analysis illustrates the weakness of some popular explanations for the rise in wealth – either as the result of thrift on the part of older generations, or saving out of capital income on the part of the wealthy. The latter is discussed in T Piketty, Capital in the Twenty-First Century, The Belknap Press of Harvard University Press, 2014.
50 A Fagereng et al., Asset-Price Redistribution, unpublished manuscript, May 2023.
51 A Haldane, The global industrial arms race is just what we need, Financial Times, 26 June 2023.

By contrast, an ultra-low rates world is one in which it is exceptionally difficult for middle-income families to achieve these goals from their own resources. Meanwhile, families benefitting from an inheritance would see its value swell. Our 'further to fall' scenario implies that the typical household in future cohorts would need to amass far more wealth – some £830,000 in 2019 prices – and in an environment of lower returns, just to achieve the same standard of living in retirement. The impact on day-to-day consumption of saving enough to reach this goal of 30 times average earnings would mean making large and possibly unsustainable sacrifices for those who do not receive a significant inheritance.

FIGURE 22: **The typical household needs to amass far less wealth to achieve the same standard of living in a higher-rates environment, but far more if rates drop**

Median value of household wealth by age



NOTES: Chart shows median wealth by age in the 2018-20 Wealth and Assets Survey, and with underlying asset values adjusted in line with our two scenarios for the evolution of interest rates. Dotted lines show the simulation for non-home owners while the solid lines show how capital losses or gains would affect existing home owners in each scenario.
SOURCE: RF analysis of ONS, Wealth and Assets Survey.

Recent years of record wealth have given us a glimpse of what such a society would be like.[52] Ultimately the ultra-low rates world is one in which inherited wealth plays a dominant role in determining where individuals sit within the wealth distribution. This would likely amplify tensions around intergenerational inequality, creating a sense that wealth had not been legitimately acquired and shaping the political discourse for the worse.

52 P Bourquin et al., Inheritances and inequality over the lifecycle: what will they mean for younger generations, Institute for Fiscal Studies, April 2021.

Despite large and arbitrary shifts in wealth in recent decades between households for no justifiable reason, policy towards the distribution of wealth has tended to be agnostic. This contrasts starkly with household income, where the distributional impact of policies is a central consideration at every fiscal event. Given the uncertainty about the outlook, and the stakes involved, government must consider whether it's right or optimal for households to bear such huge financial risks when seeking to make ordinary decisions like how to provide for their retirement and get on the housing ladder? Should policy have a more explicit role in leaning against the distributional effects of such trends and helping households to manage these risks to their living standards over which they have no control? Below we consider some of the available policy levers across pensions, housing and taxation.

Saving for retirement just got easier

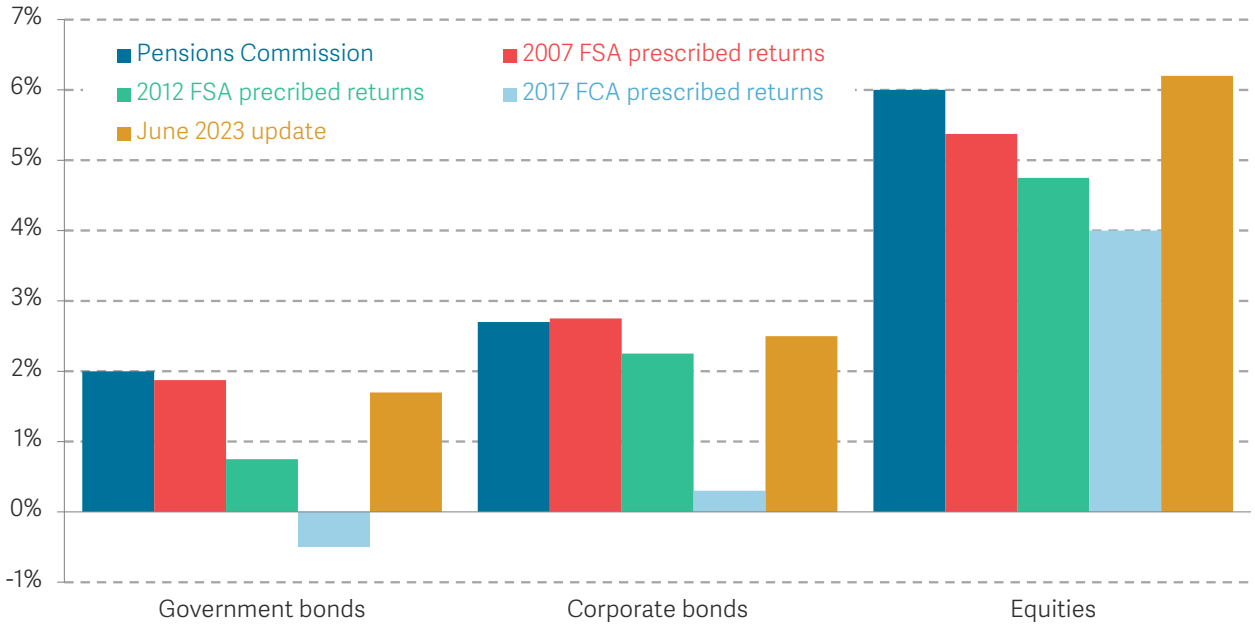
A key implication of our analysis is that saving for retirement has become easier than it was prior to the pandemic for people at the start or in the middle of their working lives. Over recent years there has been mounting concern about the adequacy of household pension saving.[53] In large part, that stems from the sharp decline in rates of return on investments since the Pension Commission made its 2004 assessment, on which the default auto-enrolment contribution rate of 8 per cent was based.[54] The Financial Conduct Authority (FCA) prescribes rates of return that financial services providers must use to illustrate future benefits to retail customers. Reviews of these rates since 2007 have seen them revised down twice, leaving the projected real return on a typical pension investment portfolio around 2 per cent lower by the late 2010s. Its 2017 assessment set out that such a portfolio could expect nominal returns to average around 5 per cent.[55] Further falls in real gilt yields after 2017 made even these projections seem optimistic.

The FCA's prescribed rates of return are grounded in medium-term government bond yields, which have risen to some 2.2 percentage points above their level in the 2017 assessment, and even more relative to immediate pre-pandemic yields. Mechanically updating the implied rates of return based on current gilt yields would increase them significantly, back to around the prevailing rates at the time of the Pension Commission, thereby lowering the contribution rates needed to achieve an adequate income in retirement.[56]

53 The Department for Work and Pensions, Analysis of future pension incomes, March 2023.
54 J Cribb et al., Challenges for the UK pension system: the case for a pensions review, Institute for Fiscal Studies, April 2023.
55 Financial Conduct Authority, Rates of return for FCA prescribed projections, September 2017.
56 These updated projections make no change to other elements that contribute to the overall rate of return, such as the Equity Market Risk Premium.

FIGURE 23: **Projected returns on pension saving have bounced back strongly from their pre-pandemic lows**

Nominal annual projected returns for different asset types



NOTES: June 2023 numbers assume that spreads between corporate bond and gilt yields and the equity market risk premium remain as outlined by the FCA in 2017.
SOURCE: RF analysis of: Pensions Commission, Pensions: Challenges and Choices. The First Report of the Pensions Commission, October 2004; Financial Services Authority, Rates of return for FSA prescribed projections, April 2012; Financial Conduct Authority, Rates of return for FCA prescribed projections, September 2017; Bank of England, Yield curves.

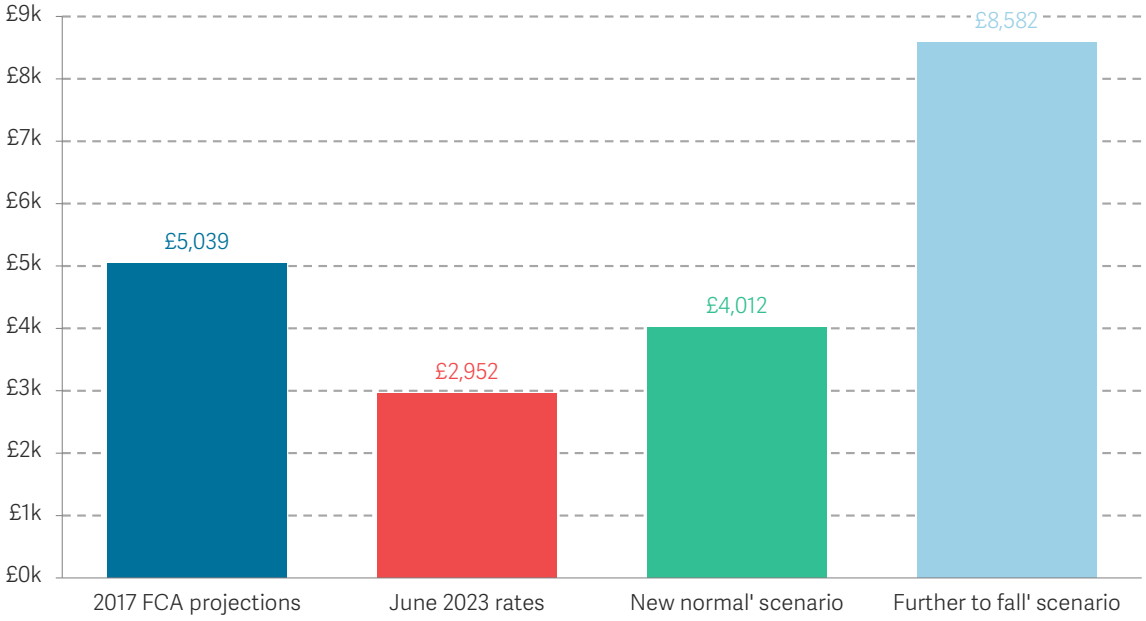
A 2.2 percentage point rise in long-term real interest rates means that not only is it easier for people of working age to save a given sum for retirement, but that pension wealth will buy a higher standard of living as a person's pension pot will continue to see better returns during the drawdown phase. Annuity rates reflect this, having jumped from around 4 per cent in the late 2010s to about 6 per cent in recent months (see Figure 12).

This is not merely a speculative long-term benefit. All else equal, it means people can make lower contributions to their pensions to achieve the same planned retirement income, allowing them to consume more of their income from work today. For example, in a pre-pandemic world of real gilt yields around -0.5 per cent, a 40 year old on today's median full-time earnings of £31,650 with no pension savings would have to save around 16 per cent of their gross income, or just over £5,000 a year in order to achieve a target replacement rate of 67 per cent if retiring at the age of 68 and drawing down their savings over a 20-year retirement.[57] But at today's rates of return, with real gilt yields reaching 1.7 per cent, the required contributions rate to achieve that goal is approximately 9 per cent, or £3,000 per year, freeing up around £2,000 per year during working age.

57 Calculation assumes a flat annual income of £31,650 in constant prices, an equity market risk premium of 4.5 per cent and a portfolio consisting of 70 per cent equities and 30 per cent government bonds, rolling down linearly to 30 percent equities and 70 percent bonds over 10 years to age 68. Drawdown occurs evenly over a 20-year period from the age of 68.

FIGURE 24: **Saving for an adequate retirement in a high-rates environment requires people to save less**

Annual gross saving required to achieve target replacement rates, by scenario



NOTES: Calculations assume a 40-year-old on median full-time earnings and no savings, seeking to achieve a target replacement rate of 67% of gross income in retirement from the age of 68.
SOURCE: RF analysis of: Financial Conduct Authority, Rates of return for FCA prescribed projections, September 2017; Bank of England, Yield curves; ONS, Average Weekly Earnings.

With market pricing implying that yields are expected to fall back slightly later in the decade, the annual contribution rates required under our 'new normal' could rise to 13 per cent or £4,000. Meanwhile under the 'Further to fall' scenario, required contributions would jump to an eyewatering £8,600 per year or 27 per cent.

Prevailing rates of return, then, are clearly good news for young and middle-aged savers in helping to mitigate the scale of and depth of under-saving for retirement across much of the population. Given the outlook, it remains likely that default auto-enrolment rates of 8 per cent are too low for people who did not start saving for a pension in the early years of their working lives.

Moreover, the experience of the past 15 years has underlined the uncertainty that households face in planning for retirement in a world where the returns they can expect can change rapidly over a short period of time.

Two implications flow from this analysis for helping people manage the risks around providing for their own retirement. One is that individuals cannot be expected to be fully abreast of these changes, even though their saving rates must adjust if they are to avoid a nasty retirement shock. One way to address this would be to review default auto-enrolment pension contribution rates in light of the FCA's projected rates of return.

But uncertainty also underscores the importance of intergenerational risk sharing to enable people to secure a decent standard of living in retirement. A key mechanism for this is a decent state pension, which provides the backstop for individual incomes in retirement, protecting low and middle-income households in particular from the effects of interest rate volatility on their living standards in retirement. Should we see rates of return plumb new depths in the years ahead, the appropriate level of the state pension should take account of this. Market-based models of risk sharing like Collective Defined Contribution pensions could also be developed further and the government is exploring options for doing so.[58]

Housing could become more affordable despite mortgage pain growing

The implications of the higher-rate environment for home ownership vary considerably depending on timing of purchase. For those people who bought a house in recent years, with high prices sustained by ultra-low mortgage rates, the sudden surge in interest rates is set to bring mortgage pain, as discussed in Section 2, and potentially capital losses for many.

But for those who have not yet bought, or who plan to trade up, the higher rate environment is good news. As shown in Figure 20, based on current market expectations, it is likely that the house-price-to-earnings ratio will tend towards 5.6, a level not seen since the turn of the century. There is substantial uncertainty over how long this would take, and whether it will involve large nominal falls or mostly a real-terms adjustment with house prices falling slightly as incomes grow. But, absent a return to lower interest rates in the coming years, an adjustment in affordability is likely.

This will help younger cohorts in two ways. First it will ease the deposit constraint on first-time buyers that has been particularly tight during the recent era of high price to income ratios. As shown in Figure 10, the time taken for a typical young family to save for a deposit was 14 years in 2022. All else equal, if house prices were to fall to 5.6 times earnings over the longer term, the time taken to save for a deposit could fall to ten years.

This will not inevitably lead to higher home ownership. Some of the pressures on saving that have weighed on low-to-middle income households in recent months could continue to impact young families looking to build up a deposit. And developments in the mortgage market are just as important as the affordability of houses in determining the rate of home ownership. In the wake of the 2008 house price crash, sharp reductions in the availability of mortgage credit for first-time buyers meant that younger people were

58 Department for Work and Pensions, Extending Opportunities for Collective Defined Contribution Pension Schemes, January 2023.

largely unable to take advantage of substantially cheaper houses.[59] The annual number of first-time buyers halved from its 2007 level and did not fully recover until the second half of the 2010s, by which time prices had largely bounced back.

Second, although new buyers will face higher mortgage interest rates than have been typical over the past decade, lower prices will mean devoting a smaller share of lifetime income to acquiring a house and paying off the mortgage. As with pension saving, a higher interest rate environment makes it easier for people in the early stages of accumulating assets.

But the experience of recent years shows that interest-rate volatility begets house price volatility by changing the house-price-to-income ratio, with extremely uneven distributional effects. Outright owners benefit from surging prices when interest rates fall, but heavily-mortgaged borrowers get hit doubly hard when interest rates rise. Given that households are exposed to huge investment risk and interest rate-risk in the housing market, which can have significant implications for their lifetime standard of living, it is right to ask whether policy should be neutral about this, or whether policy makers should explore ways to help households manage these risks better.

One possible avenue for policy, highlighted by the International Monetary Fund among others, involves seeking to insulate the mortgage market from interest rate volatility using more extensive macroprudential tools.[60] This could help to decouple local housing markets from global forces driving price volatility. On the retail side, reforming the mortgage market to expand the role of mortgage insurance and foster a market in long-term fixed-rate products would help to distribute the risks that home ownership entails for mortgagors more widely.[61]

The taxation of wealth should take interest-rate volatility into account

We have argued that helping households to manage the financial risks associated with interest rate fluctuations and their valuation effects on asset prices should become a more deliberate focus of policy. But to be comprehensive, a new approach to wealth will mean getting its taxation right.

Some authors have suggested that the rising stock of wealth across advanced democracies in the late 20th century was primarily down to active saving on the part

59 J Browne et al., Home ownership and the UK mortgage market: and international review, Tony Blair Institute for Global Change, April 2022.
60 International Monetary Fund, A bumpy road ahead, Global Financial Stability Report, April 2018.
61 J Browne et al., Bringing it home: raising home ownership by reforming mortgage finance, Tony Blair Institute for Global Change, May 2022.

of the rich, where the return on their assets outstripped economic growth.[62] This diagnosis of the wealth boom lends itself to a wealth tax – a broad-based annual tax on a household's stock of wealth.

But changes in wealth in the UK, at least, do not fit this story. Rather, as we have shown, surging household wealth is predominantly a story of windfall valuation changes due to interest rate fluctuations. Under these conditions, rising asset prices are accompanied by falling returns, which mean that the holders of assets don't see increases in the incomes from their higher wealth: people's houses have risen in price but they offer the same accommodation, and pension pots have jumped in value, but they offer the same income in retirement. This creates an asymmetry problem for the politics of wealth: younger people are worse off and they know it, while older asset holders are better off but don't feel it. Holders of assets are better off, but can only realise those benefits when they sell the assets and spend the proceeds. Since many forms of wealth are illiquid – especially DB pension wealth – the scope for doing so is limited.

Moreover, an annual levy on wealth implies higher taxes for those who hold wealth for a long period, but lower taxes for people who hold assets for a short period and benefit from large capital gains, the kind of windfall that should if anything be a higher priority target for taxation. For these reasons, an annual wealth tax may not be the most fair, efficient or practical way to tax wealth.[63] A better approach, in a world of interest rate-driven volatility, is therefore to tax such windfall gains at the point which they are realised – taxing flows of wealth rather than stocks.[64]

A recent Resolution Foundation report proposes an approach to wealth taxation that accords with this principle.[65] Suggested reforms include bringing Capital Gains Tax (CGT) rates for real estate into line with tax rates on earnings, alongside introducing indexation relief and ending CGT forgiveness upon death or when people leave the UK.

There is also a case for expanding CGT to include primary residences.[66] However, as this would primarily affect individuals upon death, it may be more practical to capture capital gains on residences by reforming inheritance tax. Specifically, work suggests abolishing the Residence Nil-Rate Band.

Finally, our pensions tax system could be reformed to be more progressive when falling rates of return inflate the values of pension holdings. In particular, the £270,000 tax-free pension lump sum should be gradually reduced to £100,000.

62 T Piketty, Capital in the Twenty-First Century, The Belknap Press of Harvard University Press, 2014.
63 A Advani et al., A wealth tax for the UK, London School of Economics, November 2020.
64 See A Fagereng et al., Asset-Price Redistribution, May 2023 and I Mulheirn, Sources of wealth and their implications for taxation, Wealth Tax Commission background paper no.122, November 2020.
65 M Broome, A Corlett & G Thwaites, Tax planning: How to match higher taxes with better taxes, Resolution Foundation, June 2023.
66 A Corlett & J Leslie, Home county: Options for taxing main residence capital gains, Resolution Foundation, December 2021.

Fluctuations in wealth are beyond the control of households but policy can do more to confront the risks

In this report we have highlighted the fact that, in aggregate, household wealth is to a large extent driven by fluctuations in interest rates and the return on assets. These fluctuations create volatility in household wealth that can shape the fortunes of different groups and generations to an alarming degree. Such changes can exacerbate intergenerational inequality and create a deep sense of unfairness, putting a heavy strain on our politics.

The forces that drive this volatility are often global in nature and beyond the direct control of households. But policy makers are not powerless in the face of them. As we have begun to outline, there is scope for policy makers to help reduce the risks that families face when seeking to get on the housing ladder or save for their retirement. This moment – when the pressures driving greater wealth inequality have, at least temporarily, abated – is the time to prepare for further volatility ahead.

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For more information on this report, contact:

Molly Broome
Economist
molly.broome@resolutionfoundation.org

Resolution Foundation

2 Queen Anne's Gate
London SW1H 9AA

Charity Number: 1114839

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