If the UK's new mortgage guarantee is conditional on longer duration interest rate fixes, the result is likely to be reduced upward pressure on housing prices & a reduction in the UK economy's structural vulnerability to higher interest rates

The UK is in the process of introducing a 5% deposit mortgage guarantee to the already hot UK housing market. This risks being just another well-intentioned effort to improve the ability of younger flat sharing Britons to get on the housing ladder, but that ultimately raises prices and benefits existing homeowners. Chancellor Sunak's goal should not just be to facilitate access to mortgages for those that are years away from a traditional down-payment, but to avoid further stoking housing inflation.

A simple tweak will not only help deliver this objective, it will also counter a sizeable structural vulnerability in the mortgage market that UK policy makers have yet to acknowledge. That vulnerability is the overwhelming reliance on variable and 2-year fixed rate mortgages. In the UK, over two thirds of mortgages equating to half of GDP are variable or fixed mortgages where interest rates reset within two years. This has been an absolute cashflow boon for UK mortgage holders as rates have tumbled, while rising house prices and have dramatically reduced affordability for those not on the housing ladder (UK mortgage holders average payments are under a fifth of household income vs half for renters). However, in a world where the many including the Bank of England chief economist are credibly discussing scope for inflation, that mortgage driven gravy train needs to be prudently managed to avoid becoming a future economic train wreck.

Were mortgage rates predominantly fixed, interest rate rises would not impact existing consumer cashflows and would be restricted only to reducing the propensity for new borrowing. However, because of the variable nature of UK mortgages, rising interest rate not only slow future borrowing, they also directly hit the cashflow of existing mortgage holders. Based on the average mortgage size and duration, I calculate that every 100bp rise in rates would equate to a contraction in consumer purchasing power equivalent 0.5% of GDP. While required stress tests mean rate rises are unlikely to lead to mortgage defaults, the simple reality is that UK rate rises automatically lead to short term contractions in consumer purchasing power. In an environment when the Bank of

England is actively trying to cool the economy, that is not bad thing. However, in an environment of weak demand and rising inflation (which is not an impossibility in a country that tends to import inflation post currency weakness), the Bank of England would have to choose between continued currency weakness and higher inflation, or highly recessionary rate hikes. That day has yet to come, but if and when it does, the UK will regret will having missed an easy opportunity to eliminate this unnecessary structural vulnerability to rising rates. It should be the job of fiscal policy makers to impact incomes, while a Central Bank's job should just be to impact the propensity to borrow. The UK's reliance on variable mortgages means the Central Bank has a large and direct impact on household cashflows. That is great when they are trying to stimulate, but a disaster if the UK ever faces imported inflation pressures with a weak economic backdrop.

The solution to both minimising the negative consequences of excessive housing inflation and eliminating this potentially catastrophic structural vulnerability is simple. Do not allow the new mortgage guarantee to be used for variable or 2-year fixed mortgages. Instead require that fixed rate durations be a minimum of 5 years, preferably 7-10 years, and ideally the duration of the mortgage.

This transfer of interest rate risks from consumers to lenders will mean interest payments are slightly higher (today 5-year fixed rates can be had for about 1.5% vs 1.2% for 2-year mortgages). However, the government should not be worried about requiring slightly higher repayment terms as the problem for young Britons trying to buy houses is not cashflow, it is savings. Importantly, those slightly more costly borrowing terms will equate to a bit more price sensitivity, meaning equilibrium housing clearing prices for those reliant on the guarantee will be less likely to spur further house price inflation. The objective of the mortgage guarantee to stimulate housing demand, but not prices, will be made easier.

Importantly, with a major government initiative creating demand for longer term fixed borrowing, the cultural and legal bias of the UK mortgage market to focus on short duration rate fixes should begin to evolve towards longer duration rate fixes for mortgages. At a time of a strong currency, low inflation and low rates, that transition will seem very benign. But if the Chancellor misses this opportunity, when the time of higher rates eventually materialises, the costs may feel anything but benign.

Mike Harris is the founder of Cribstone Strategic Macro. He spent 24 years as a market facing analyst, strategist and research manager where he covered scores of companies, dozens of industries and 20 economies. With 22 number 1 rankings, he was among the highest ranked sell-side research specialists in the history of the Institutional Investor Survey. He currently advises selling shareholders and companies on IPO feasibility and optimising equity stories. He consults with large investment funds on macro issues in Emerging Markets, and he developed and teaches a course on EU Economic Policy Failures as an Adjunct Professor of Economics at Syracuse University in London.