

Market Commentary

The Bank of England increased official bank rate by 0.25% to 5% in early November. This had been widely expected. Financial markets expect a further 0.25% increase by next spring.

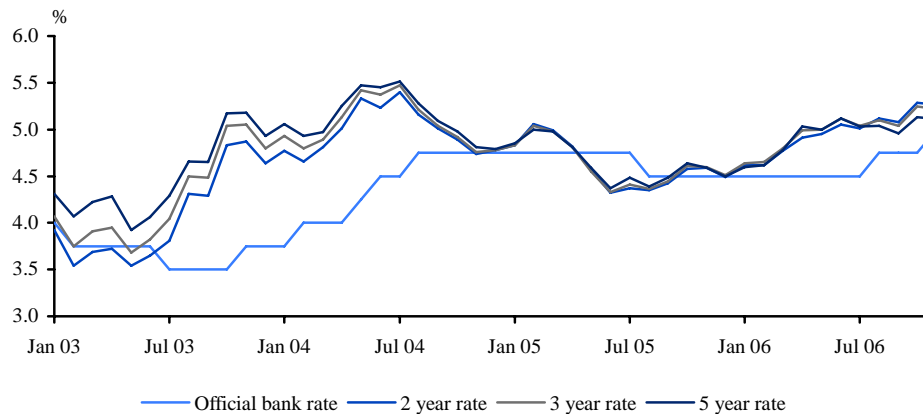
The housing market remains strong. House prices have risen by about 8% over the past year, with price growth in London and the South East particularly strong. Northern Ireland and Scotland also continue to experience significant price growth.

Higher interest rates may result in a cooling in the market next year.

Economic background

The MPC's decision to increase official bank rate by 0.25% to 5% in November was not a surprise. Financial markets expect a further 0.25% rise by next spring. Two, three and five year market rates have increased by around 0.2% over the past month, ending the period of broad stability seen since the spring.

Chart 1: Bank of England official bank rate and market interest rates



Source: Bank of England

A more in-depth analysis of the Bank of England's thinking will be published in the Inflation Report on 15 November.

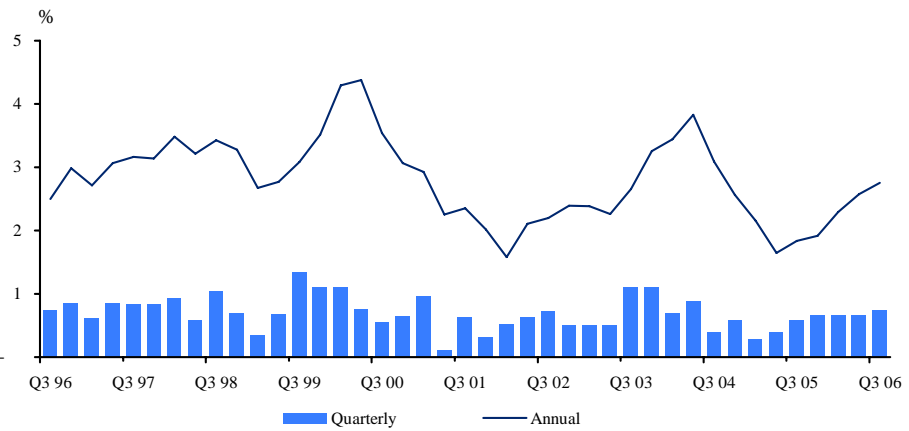
Economic growth has been remarkably steady over the past year, at 0.7% a quarter. As a result, the annual growth rate has picked up to 2.8% from 1.8% a year ago. This is a little above the long-term trend rate of around 2.5%. Growth in the third quarter was broadly balanced across the service sector, which grew by 0.8%, and manufacturing sector, which grew by 0.7%.

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Chart 2: GDP growth



Source: National Statistics

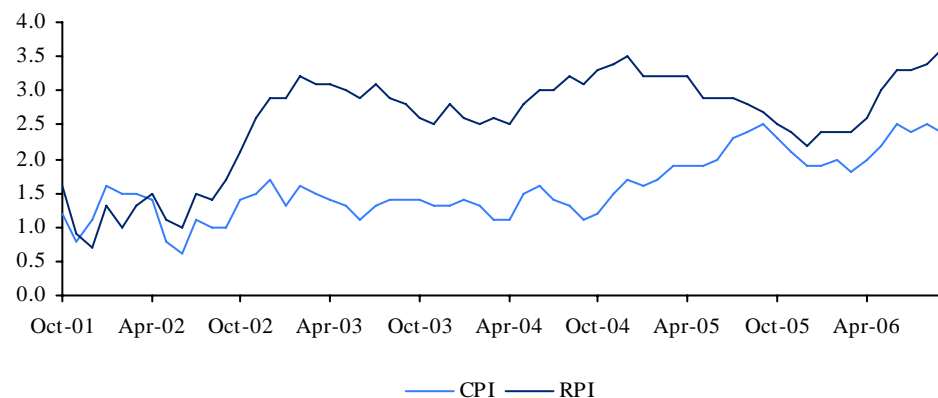
Over the summer there were signs that growth in the service sector was slowing, but service sector activity appears to have been very strong in October. Consumer spending also appears to have been more hesitant over the summer. There was little change in the level of sales between June and September following growth of 1.9% in the second quarter. And sales were affected by warm weather in October.

The size of the workforce has increased sharply over the past couple of years, reflecting high net inward migration and rising participation among older age groups. This helps to explain why employment and unemployment have risen at the same time. The unemployment rate has risen to 5.5%, its highest level for six years even though the economy has been growing at an above-trend rate.

Consumer price inflation eased to 2.4% in September from 2.5% in August. It has been above the government's 2% target since May. Excluding energy, consumer price inflation has risen to 1.7% from a low of 1.1% in May.

Looking ahead, there are mixed pressures on inflation. Higher retail gas prices and university tuition fees will put upward pressure on consumer price inflation over the next couple of months. Thereafter, much depends on what happens to wages. These have been remarkably well behaved in recent years and may remain so if the increase in the labour force means that the economy can expand more quickly than in the past without generating upward pressure.

Chart 3: Inflation



Source: National Statistics

But retail price inflation, which is widely used as a benchmark in wage negotiations has risen to an eight year high of 3.6%. The Bank of England is likely to remain cautious until the impact of this on the coming wage round can be assessed.

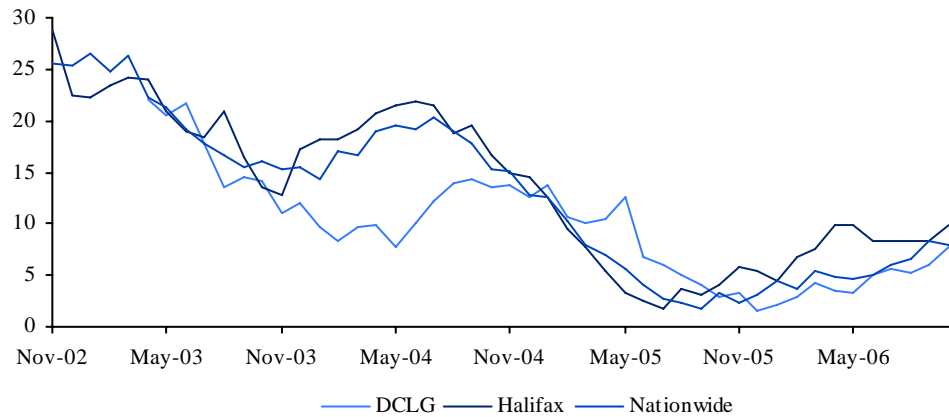
Housing market developments

Housing market activity remains strong, with little indication that the earlier August rise in interest rates has had a significant impact. While there is the usual monthly volatility between the various house price indices, there is a reasonably broad consensus that annual UK house price growth is now around 8% or stronger.

Annual growth in prices on the Halifax measure strengthened to close to 10% in October. The monthly rates of increase have been very strong over the past three months. The Nationwide index has risen from around 5% at mid-year to 8% and the DCLG measure shows a similar acceleration.

Annual price growth continues to remain especially strong in Northern Ireland. Both Halifax and Nationwide report that prices rose by over 30% in the year to the third quarter and the DCLG reports a rise in excess of 25%. Price growth in Scotland has also been strong while it has slowed in Wales. In England, the South East and London have seen rising rates of house price growth over the past year.

Chart 4: House price growth, annual % change



Source: DCLG, Halifax and Nationwide

October also saw the launch of a new house price index, produced by HM Land Registry (HMLR). HMLR had published simple quarterly average prices in the past but the new index is monthly. It covers England and Wales only (unlike the Halifax, Nationwide and DCLG measures which cover the UK), but includes cash sales, whereas the other measures are based on property purchases with a mortgage. The HMLR measure uses an innovative repeat sales methodology, comparing the sale price of a property against the value the last time it was sold. But this means that sales of new properties are excluded. On the HMLR measures, annual house price growth in England and Wales is currently a little above 6%.

HMLR third quarter figures based on its old methodology show average prices in England and Wales up 8.7% from a year earlier, and a 17% increase in the number of homes sold.

Surveyors and estate agents continue to report upward pressure on prices. There was a continued rise in buyer interest in September as sales volumes edged up. The number of new instructions to sell continued to decline, indicating that supply is failing to keep up with demand. This points to continuing upward pressure on prices.

The number of reservations for new properties continued to rise, despite a small fall in site visitors. The levelling-off in the use of sales incentives, along with rising prices, points to strength in the new homes market.

HMRC property transactions data show that, on a seasonally adjusted basis, market volumes have remained stable throughout most of 2006 at a considerably higher level than a year ago. The transactions figures include some commercial transactions so do not relate solely to housing.

Mortgage market developments

The seasonally adjusted number of mortgage approvals edged up to 295,000 in September from 293,000 in August. This is higher than the monthly average for the first half of the year of 291,000, and is almost unchanged from the 297,000 in September 2005. The seasonally adjusted value of loans approved in September was £30.3 billion, 3% higher than in August and the highest figure on record.

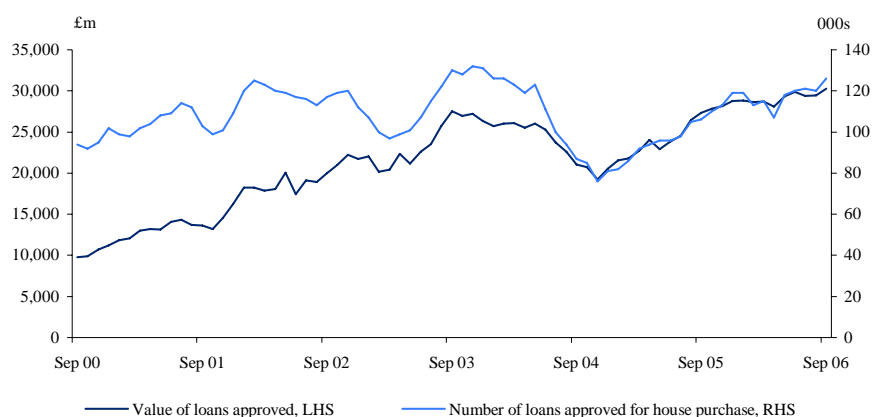
The volume of approvals for house purchase rose, while approvals for remortgages fell. Approvals for other loans, which are mainly further advances, remained unchanged.

There were 126,000 loans approved for house purchase in September, an increase from 120,000 in August and the highest monthly total since February 2004. This compares with an average of 91,000 approvals a month in 2005 and 115,000 a month in the first half of 2006. In the past, approvals have only exceeded 126,000 a month in a brief period from September 2003 to February 2004. The seasonally adjusted value of loans approved for house purchase was a record £16.9 billion.

There were 93,000 loans approved for remortgages in September, a fall from 97,000 in August. Remortgaging volumes averaged 95,000 a month in the third quarter, which compares with 100,000 in the first half of the year and 103,000 in 2005. The value of loans approved for remortgages was £11.2 billion, unchanged from August but a little below that seen in the first half of the year.

The number of approvals for other loans remained unchanged at 76,000, in line with the monthly average seen in the first half but lower than the 2005 average of 79,000.

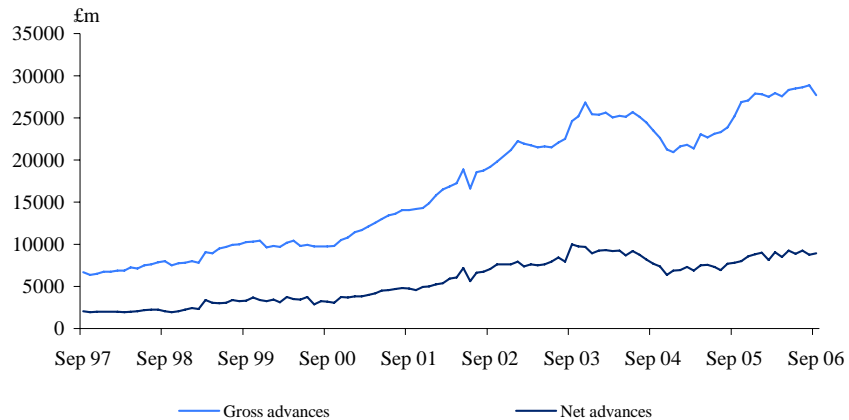
Chart 5: Mortgage approvals, seasonally adjusted



Source: Bank of England

Gross mortgage lending fell by 13% in September to £29.2 billion. Seasonally adjusted, gross mortgage lending fell by 4% to £27.7 billion, but it was 10% higher than a year earlier. Early indications are that lending rose again in October. Seasonally adjusted, net lending rose by 2% in September to £8.9 billion. This was a 15% rise from September 2005.

Chart 6: Gross and net advances, seasonally adjusted



Source: Bank of England

The gap between gross and net lending has widened since the spring. Bank of England figures show that this is the result of a substantial rise in repayments on redemption not related to remortgaging. It is not clear what has caused this.

Recent press coverage has picked up on an apparent easing in mortgage lending criteria, with some lenders willing to consider lending up to a multiple of five times joint income, up to 125% of the value of the property and extending mortgage terms beyond the standard 25 years to 40 years or more. These innovations are designed to help borrowers to enter the market, but they will only be available to those who pass strict affordability criteria. And the interest payments for a borrower borrowing an amount equivalent to five times their income today would be less than those borrowing three and a half times their income in the early 1990s.

The Department for Constitutional Affairs (DCA) reported a 4% rise in mortgage possession actions entered in the third quarter and an 8% rise in court orders made. Actions have risen by 15% over the past year and orders made by 22%. It should be noted that lenders only use possession actions as a last resort, and that the vast majority of actions entered into do not result in actual possession. Looking ahead, lower levels of mortgage arrears point to an improving outlook for possessions next year.

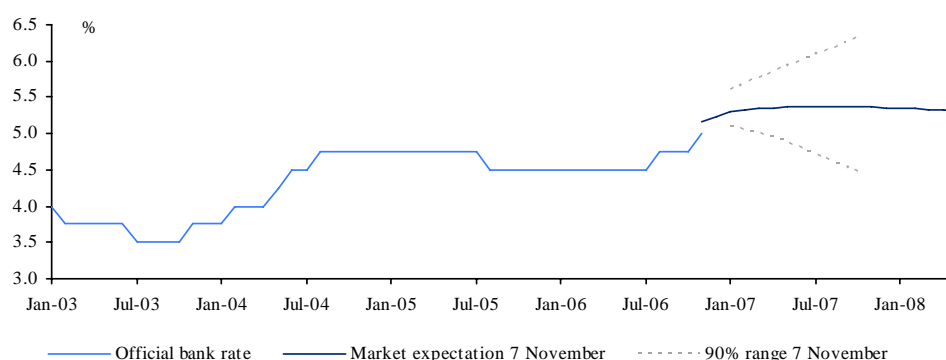
A recently published report by Elaine Kempson at the University of Bristol looked into the risk of financial difficulties facing households in the event of interest rate increases, fuel price increases and job loss. The research found that although 23% of borrowers said that they would begin to have real financial difficulties if their mortgage repayments went up by a tenth, only 1% would actually have difficulties.

Outlook

The UK economy looks set to continue to grow a little above the long-term trend rate over the coming year. The major risk to the outlook comes from the international environment, in particular the possible impact of the downturn in the US housing market. But to date there is no clear evidence that this has had a significant impact on the US demand.

The financial markets expect official bank rate to rise to 5.25% by the spring. The markets put a 30% chance on rates being 5% or less by November 2007 and a 35% chance on them being above 5.5%.

Chart 7: Bank of England official bank rate and market expectations



Source: Bank of England

Notes: The market expectation curves relate to commercial bank liabilities which will typically be 10-15 basis points higher than the Bank of England's official bank rate. The market expectation ranges are derived from short sterling option and futures contracts traded on LIFFE.

Recent indicators point to continued strength in the housing and mortgage markets. As yet it is unclear to what extent the recent and prospective increase in rates will weigh on activity given the strength of underlying demand, the shortage of housing supply and mortgage product innovation.