MPC MEMBERS

**COPIES OF THE AUGUST 2015 PRE-MPC MEETING PRESENTATIONS**

In advance of the MPC meeting, please find attached copies of all presentations given at the August 2015 Pre-MPC meeting.

Monetary Policy COO Division (TS-G)
29 July 2015

# 1: Financial Markets

# Financial Markets

## August 2015 Pre-MPC
## FED, MFAD & SMD

# Plan

- International backdrop
- Short rates and policy
- Exchange rates

# Summary table of moves since May IR and July MPC

| | Meeting-to-meeting | | |
|---|---|---|---|
| | July MPC (07 July) | Latest (27 July) | **Change** |
| UK 1-year instantaneous OIS rate | 0.70 | 0.84 | **14 bps** |
| UK 3-year instantaneous OIS rate | 1.52 | 1.67 | **15 bps** |
| UK 10-year gilt yield | 1.95 | 2.05 | **10 bps** |
| £ ERI | 92.8 | 93.1 | **0.4%** |
| FTSE All Share | 3520 | 3554 | **1%** |

# Summary table of moves since May IR and July MPC

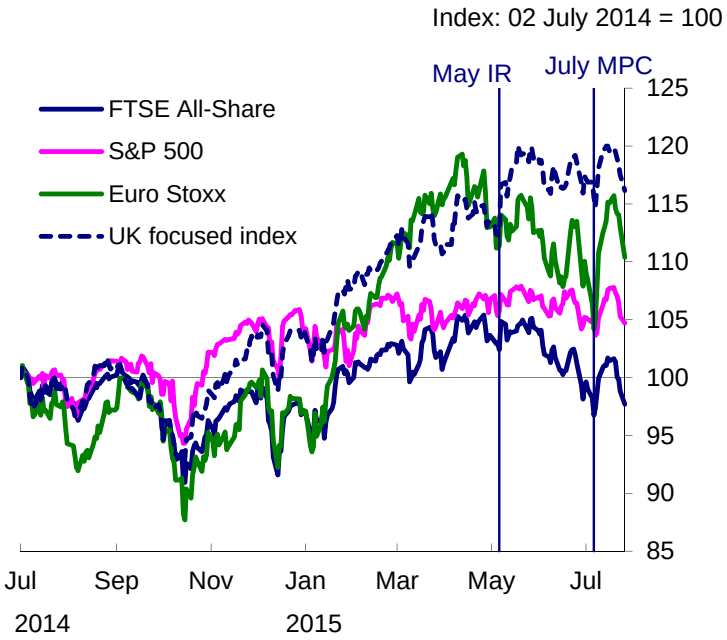
| | Meeting-to-meeting | | | *Inflation Report* averages | | |
|---|---|---|---|---|---|---|
| | July MPC (07 July) | Latest (27 July) | **Change** | May (15 day average) | August (13 days' data) | **Change** |
| UK 1-year instantaneous OIS rate | 0.70 | 0.84 | **14 bps** | 0.65 | 0.84 | **18 bps** |
| UK 3-year instantaneous OIS rate | 1.52 | 1.67 | **15 bps** | 1.38 | 1.73 | **36 bps** |
| UK 10-year gilt yield | 1.95 | 2.05 | **10 bps** | 1.84 | 2.18 | **33 bps** |
| £ ERI | 92.8 | 93.1 | **0.4%** | 90.4 | 93.4 | **3.4%** |
| FTSE All Share | 3520 | 3554 | **1%** | 3784 | 3650 | **-3.6%** |

- Short rates higher on the month, but only a little higher still since the May *Inflation Report*
- Sterling ERI up a touch on the month, but has risen by over 3% since May

# Change in equity prices over past year

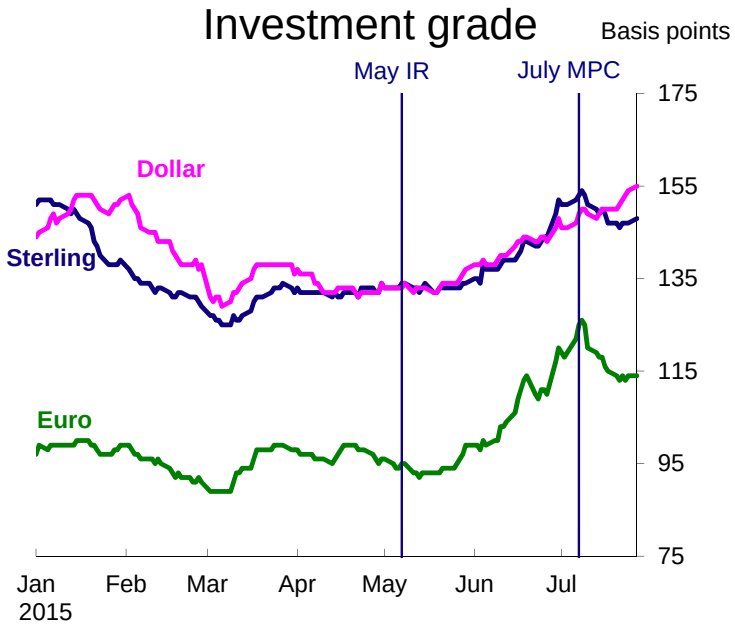
- International equity indices rallied initially following developments in China and Greece

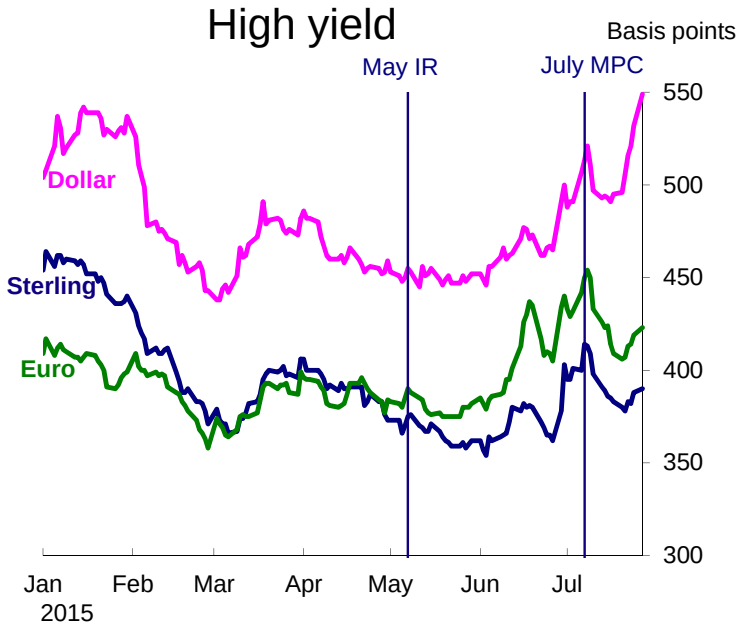
# Change in equity prices over past year




- International equity indices rallied initially following developments in China and Greece
- Some of that initial increase has since unwound
- UK focused equities still up compared with May

# Corporate bond spreads

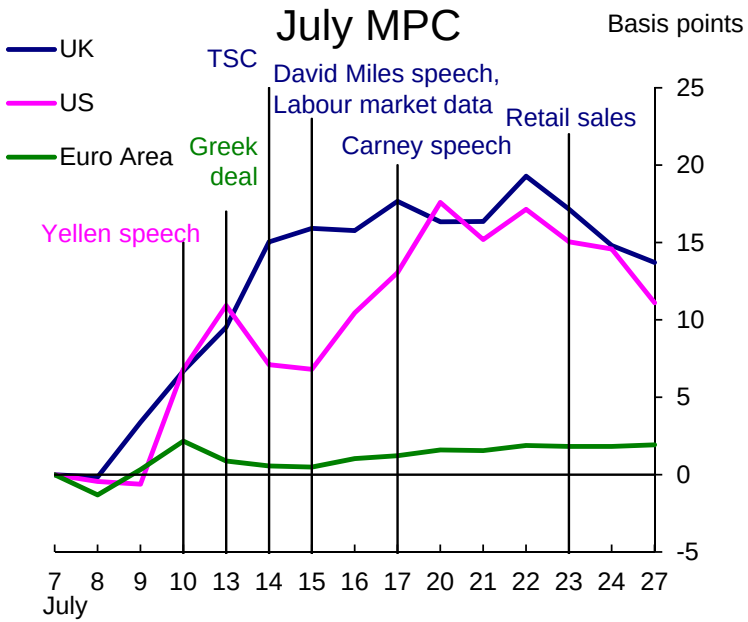



- Narrowing in sterling- and euro-denominated corporate bond spreads
- Euro-denominated bond issuance picked up following news of the Greek bailout deal

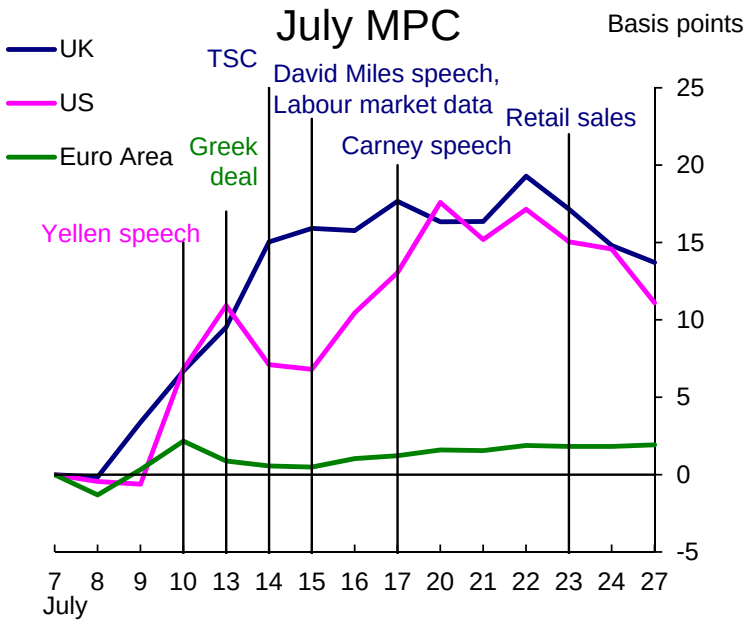
# Interest rates and policy expectations

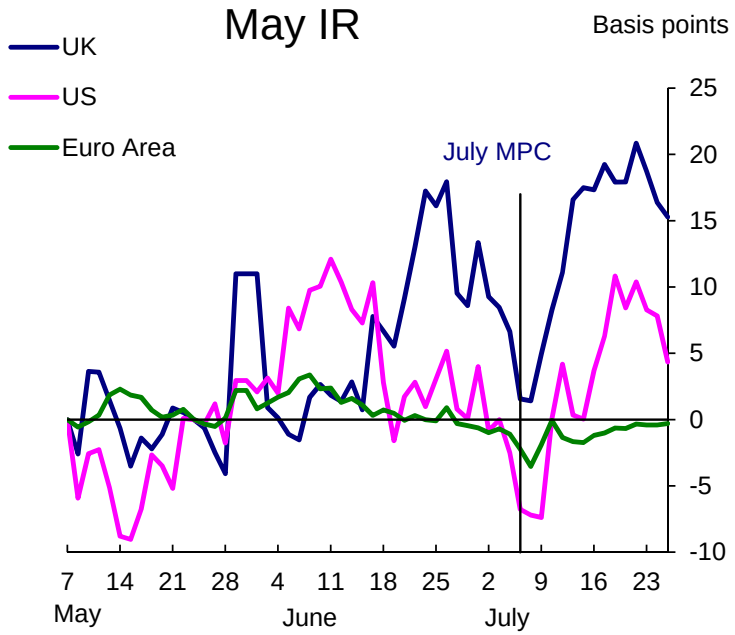
# Cumulative changes in 1-year instantaneous forward OIS rates




- UK short rates have risen this month due to central bank communications and improved sentiment following the Greek deal

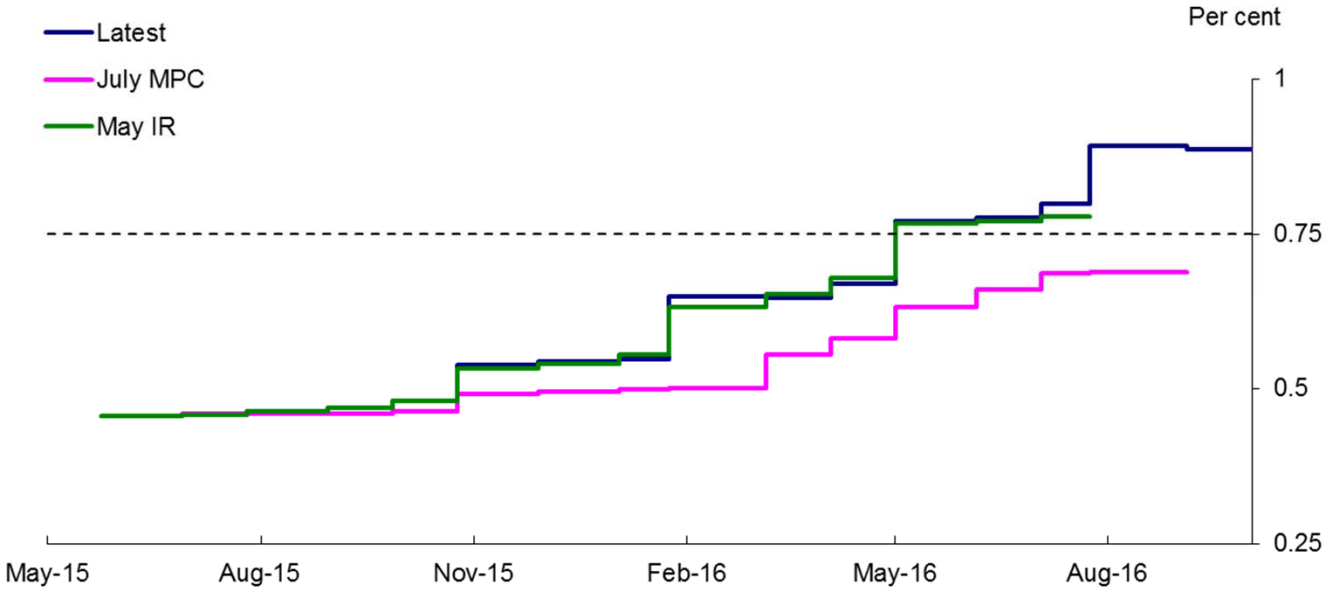
# Cumulative changes in 1-year instantaneous forward OIS rates



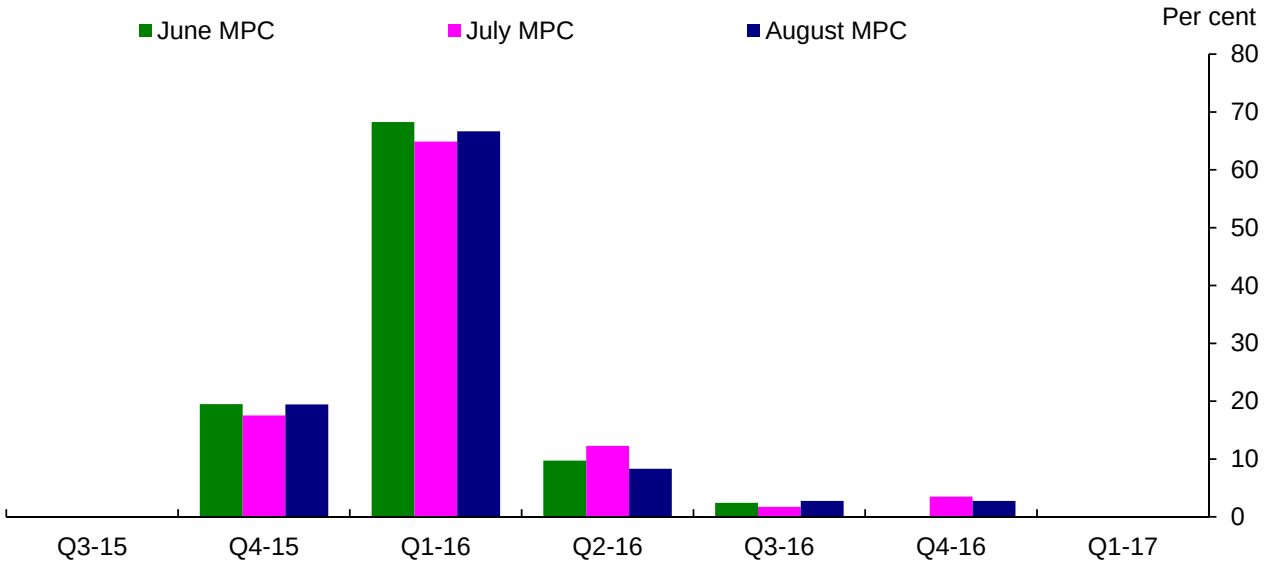

- UK short rates have risen this month due to central bank communications and improved sentiment following the Greek deal
- Considerable volatility in UK short rates over the past couple of months

# MPC “meeting-to-meeting” OIS swaps



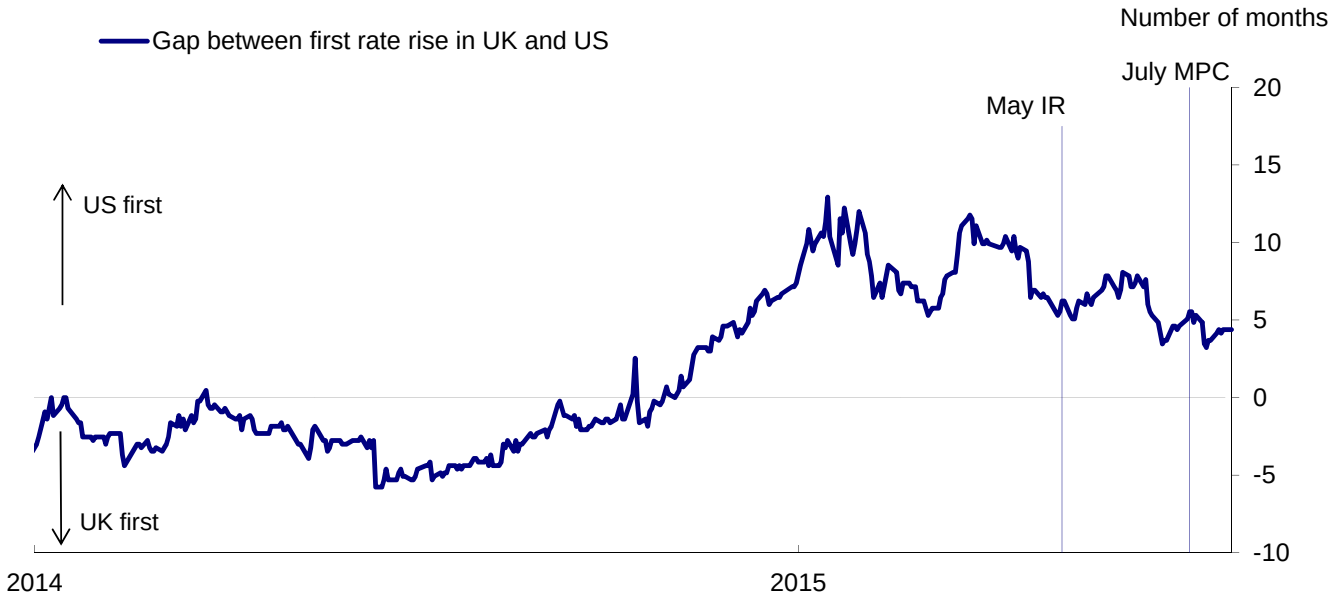

- Meeting-to-meeting swaps put lift-off in May, broadly in line with the OIS curve
- Little change compared with the time of the May *IR*

# Reuters poll: timing of the first rise in Bank Rate




- Economists expect lift-off in Q1 next year

# Gap between timing of first rate rise in UK and US




- Further small decline in gap between timing of lift-off in the US versus the UK

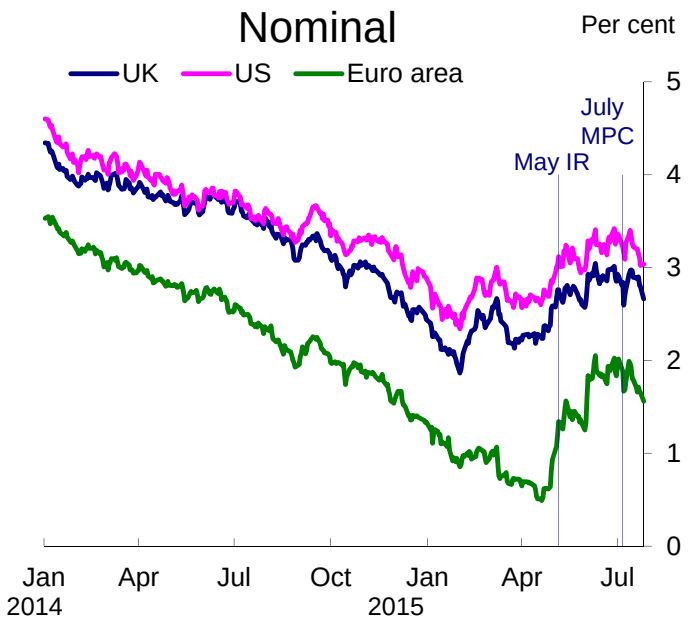
# Pace of tightening summary table

| | UK | | | US * |
|---|---|---|---|---|
| **Bps per quarter after lift-off for OIS to rise a further:** | May IR (15 day average) | July MPC (7 July) | Aug IR (13 day average) | Latest (27 July) |
| **50bps** | 10 | 12 | 14 | 17 |
| **100bps** | 6 | 9 | 11 | 17 |

**Calculations consider Fed Funds effective rate to be around 35bps after lift-off.*

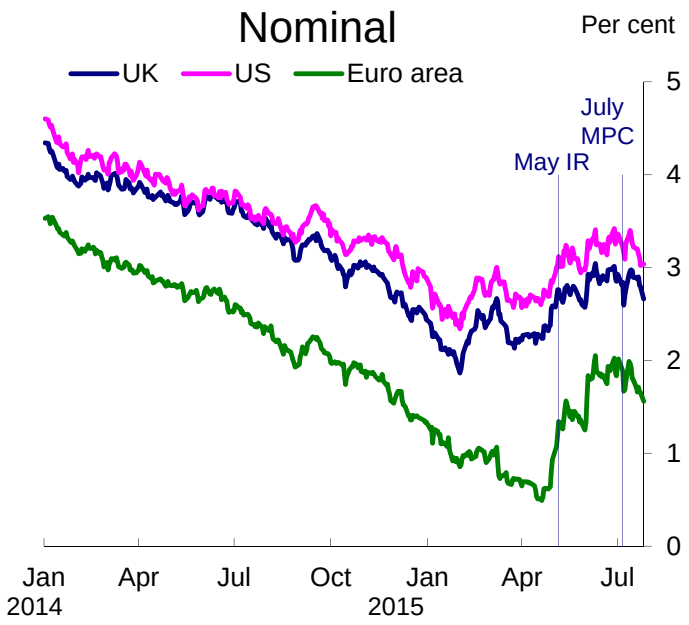
- Slight increase in pace of tightening in the UK compared with July MPC and May *IR*
- Pace of tightening remains gradual

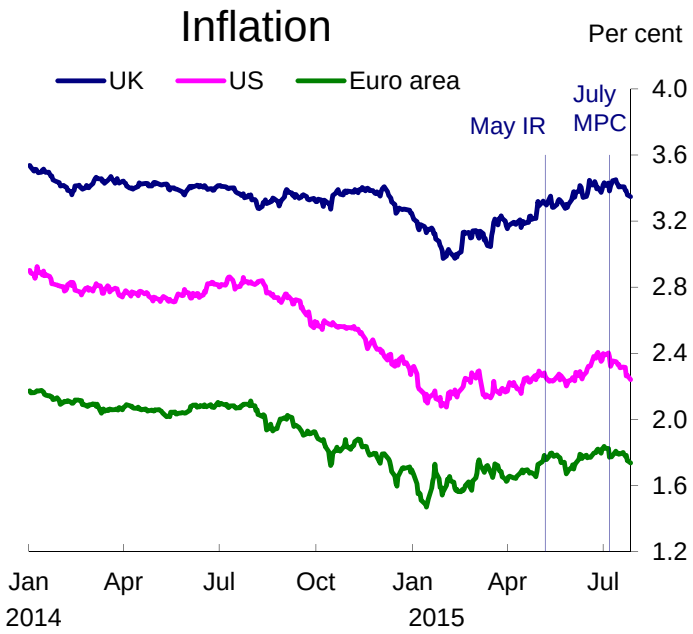
# 5-year, 5-year forward rates




- UK nominal 5-year, 5-year forward rates broadly unchanged on the month overall
- US long rate has declined a touch, reflecting slight fall in inflation expectations

# 5-year, 5-year forward rates

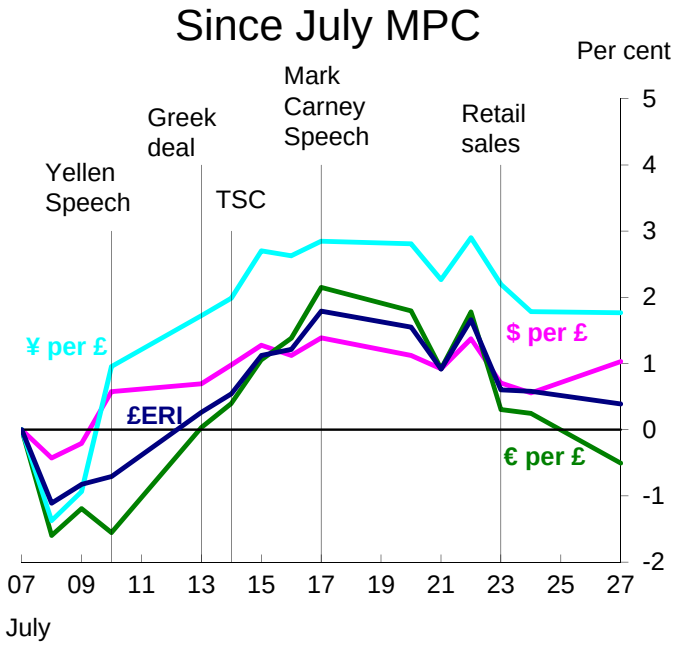



- UK nominal 5-year, 5-year forward rates broadly unchanged on the month overall
- US long rate has declined a touch, reflecting dip in inflation expectations
- Likely to be due to lower oil prices

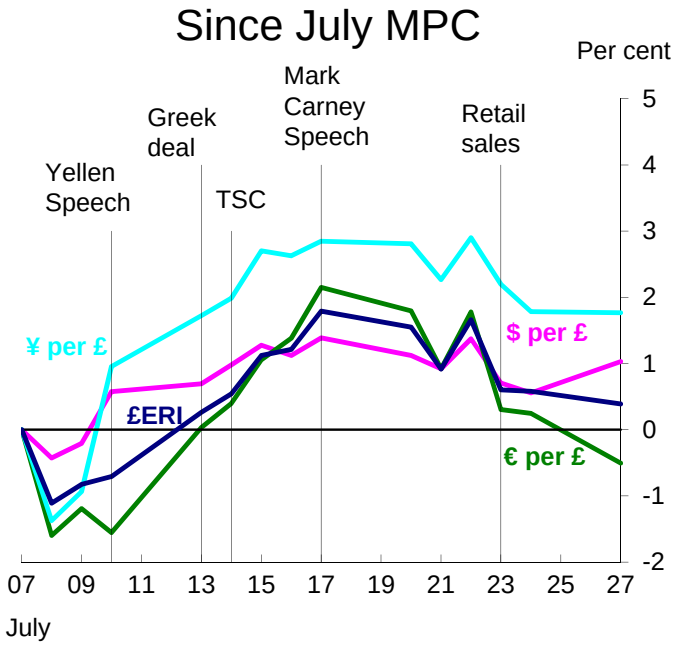
# Exchange rates

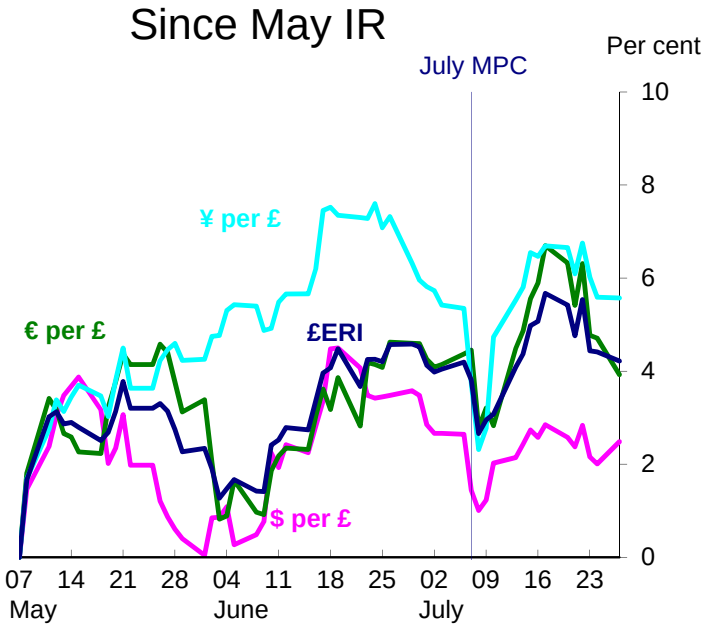
# Cumulative changes in sterling




- Further modest appreciation of sterling over the month
- Over 4% rise since May IR cut off (3.4% compared with 15-day average in forecast)

# Cumulative changes in sterling




- Further modest appreciation of sterling over the month
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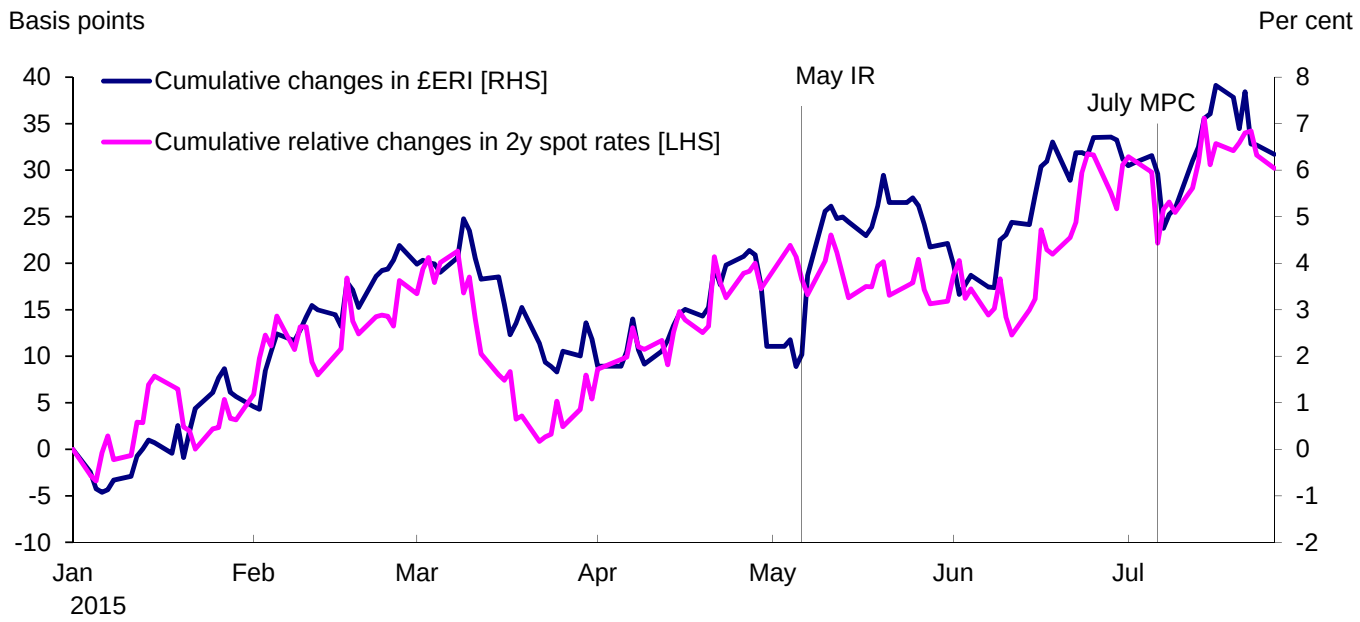
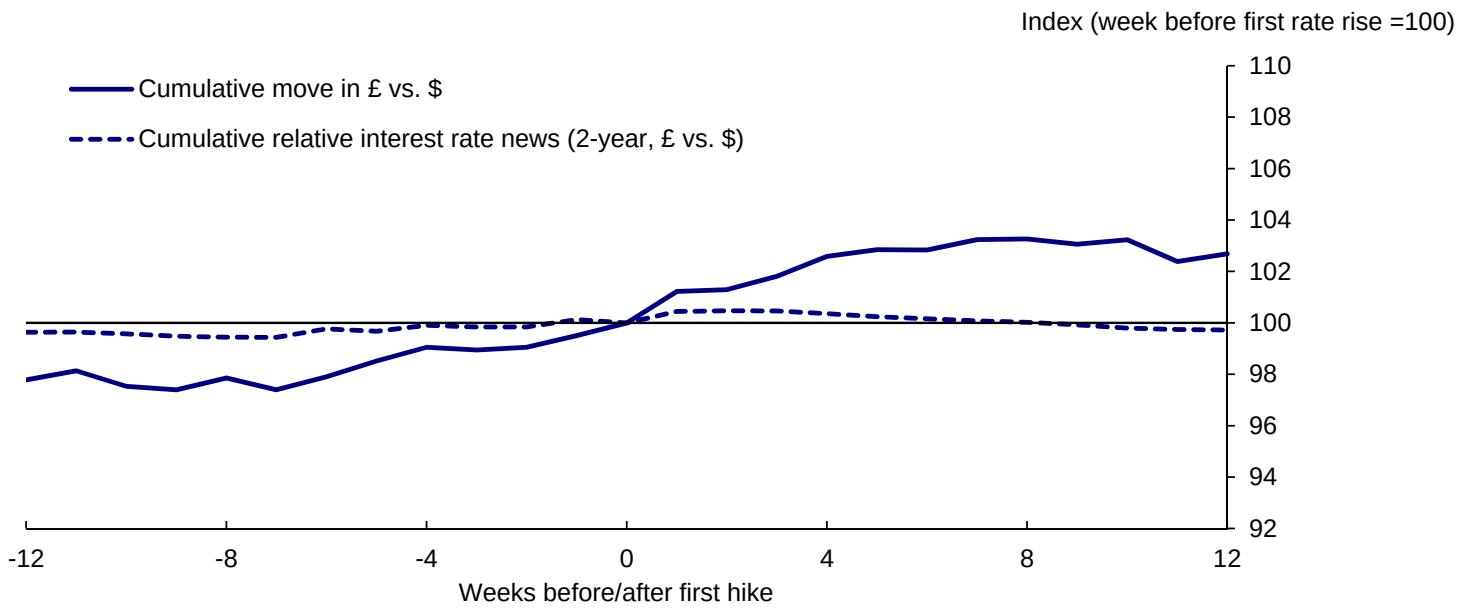
# Sterling ERI and interest rate differentials



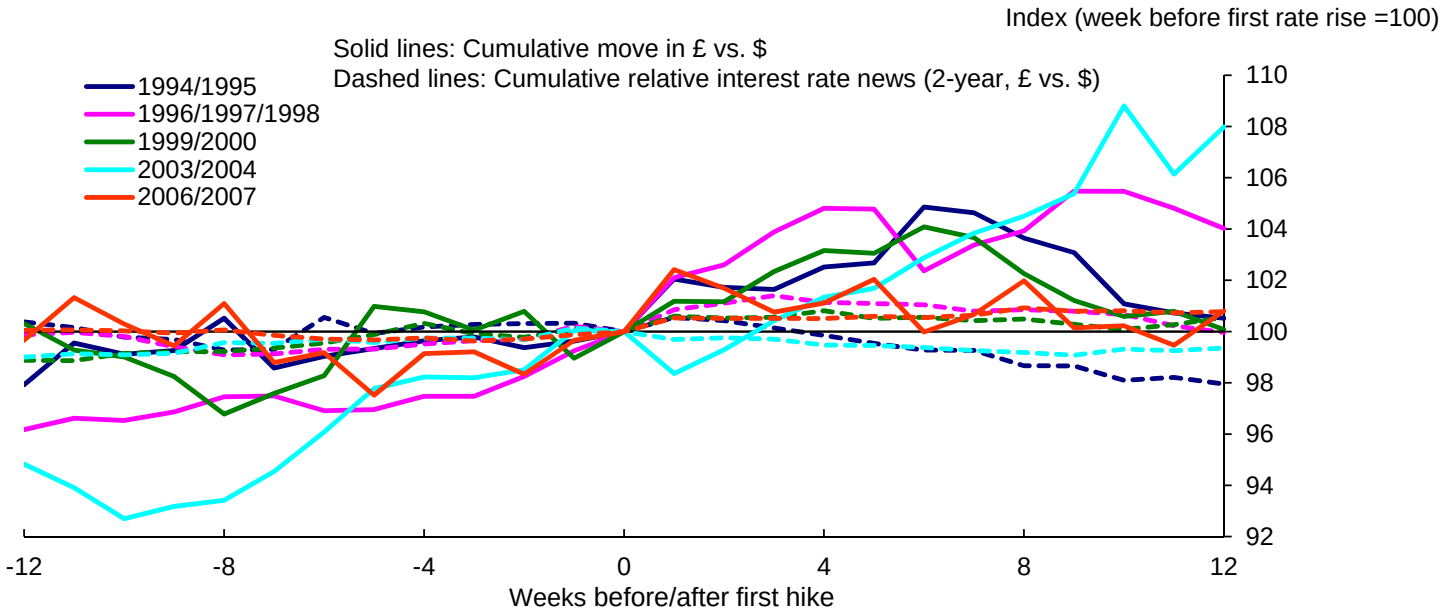

- Fairly close co-movement of sterling ERI and changes in UK rate differentials with US and Germany

# Average sterling moves around previous UK hiking cycles




- Sterling has tended to rise, on average, in the run-up to, and after, the start of past cycles
- Sterling has risen by more than implied by news in relative interest rates

# Sterling moves around previous UK hiking cycles




- Broadly similar experience can be observed across most of the recent historical examples
- Could point to upside risk to the exchange rate during the current cycle

For more details see by staff in MFAD and SMD

# FX strategy round

- Broadly, little upside risk to sterling versus the dollar, given closeness of business cycles
- Material risk of appreciation versus the euro
  - growing use as a funding currency
  - impact of crowding out due to ECB assets purchases
- For those looking for a ‘policy divergence’ trade, there aren’t many alternatives to sterling, especially if the dollar rally runs out of steam

July FX srategy round summary to be circulated later today

## Key points

- UK short term interest rates have risen a little over the period since the May *Inflation Report*
- Pace of tightening in the UK is a touch faster than in May, but still very gradual
- Sterling has appreciated materially since the May *IR*
- Some upside risk to the exchange rate as we approach lift off, and perhaps beyond

# 2: Global Environment

# Bank of England
# International Directorate

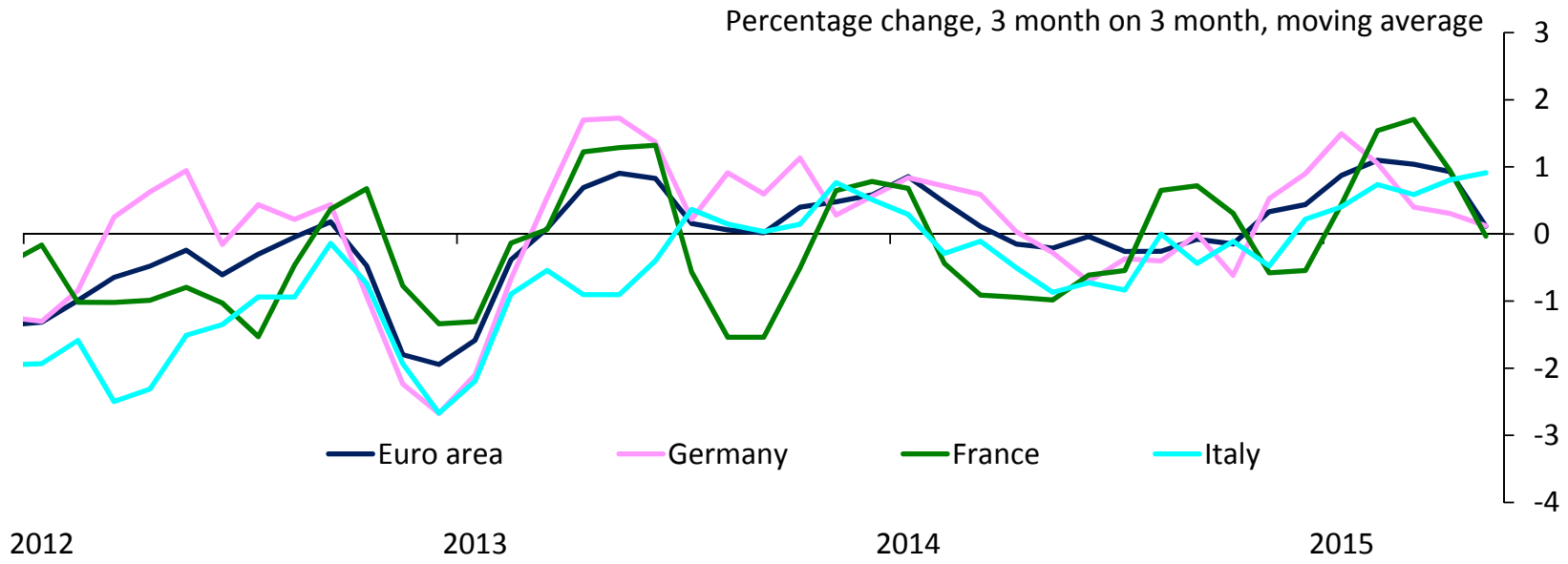
## Global Environment
## Pre-MPC August 2015

# Outline

- Euro area
- US
- China
- World activity
- Commodities

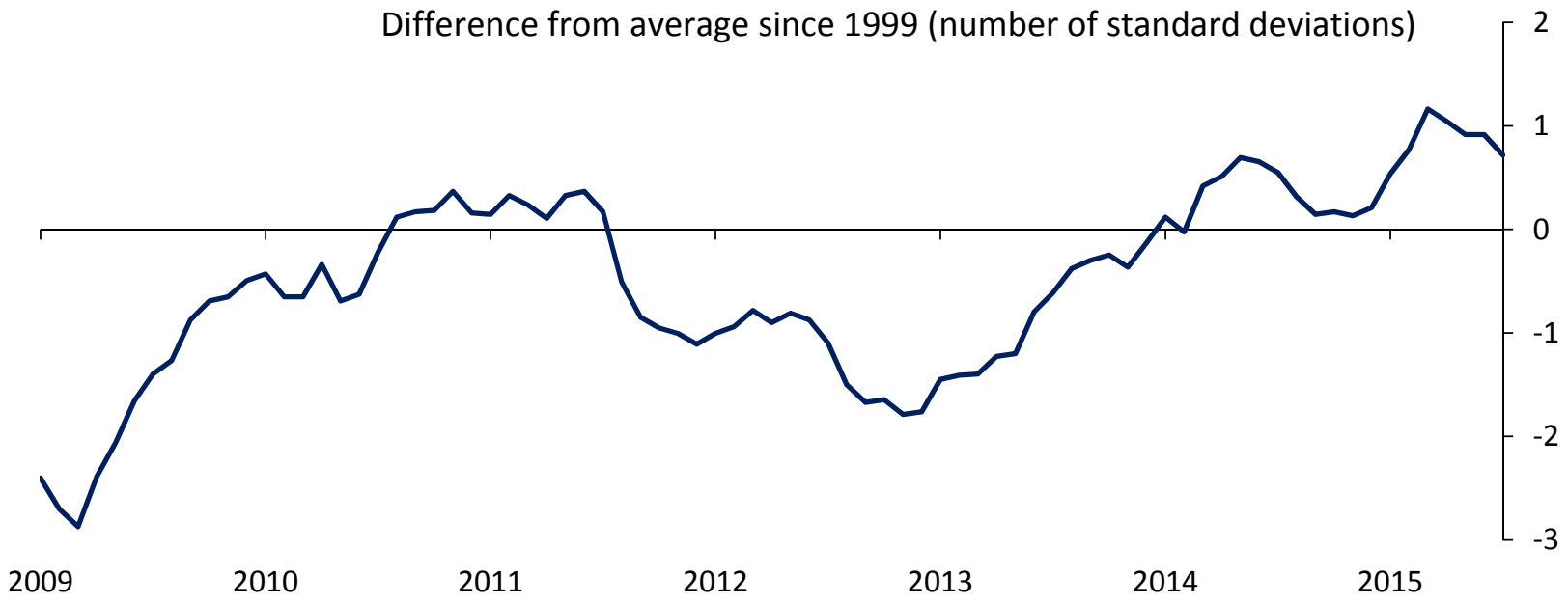
# Euro area

# Industrial production: selected €A countries



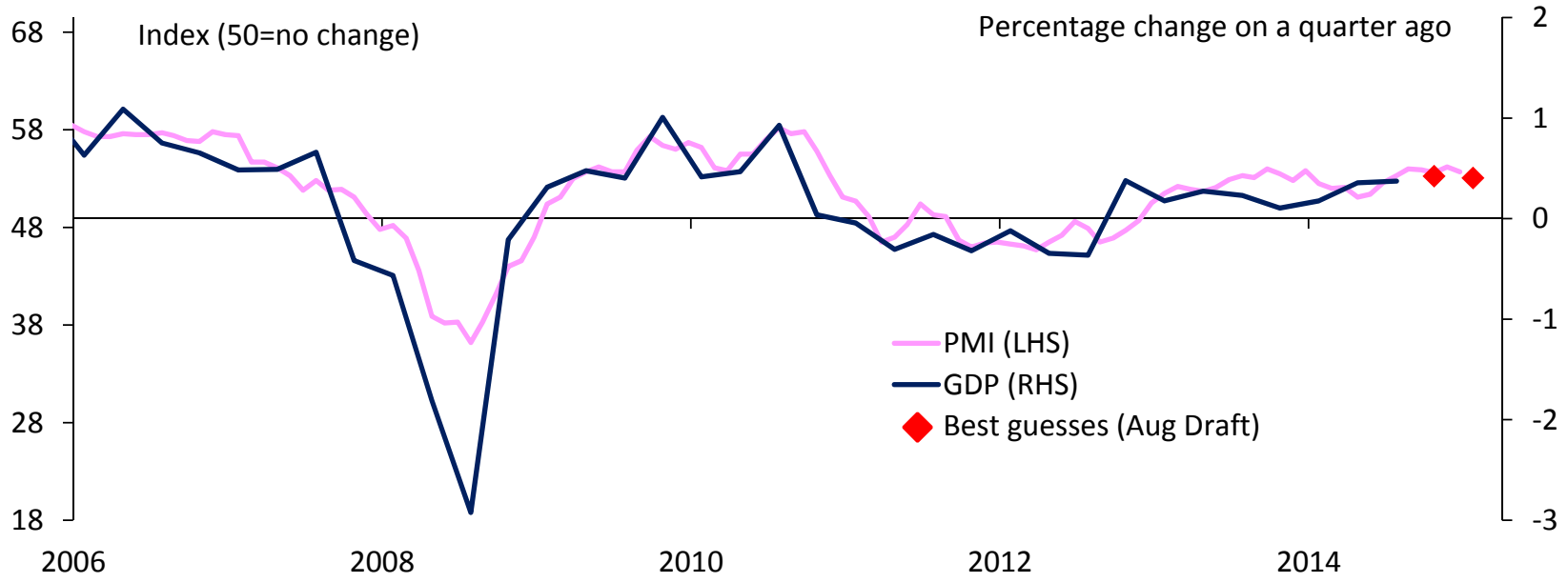

- Weak IP in May led us to revise down our best guess for Q2 GDP to 0.4% (from 0.5%).

# European Commission €A consumer confidence



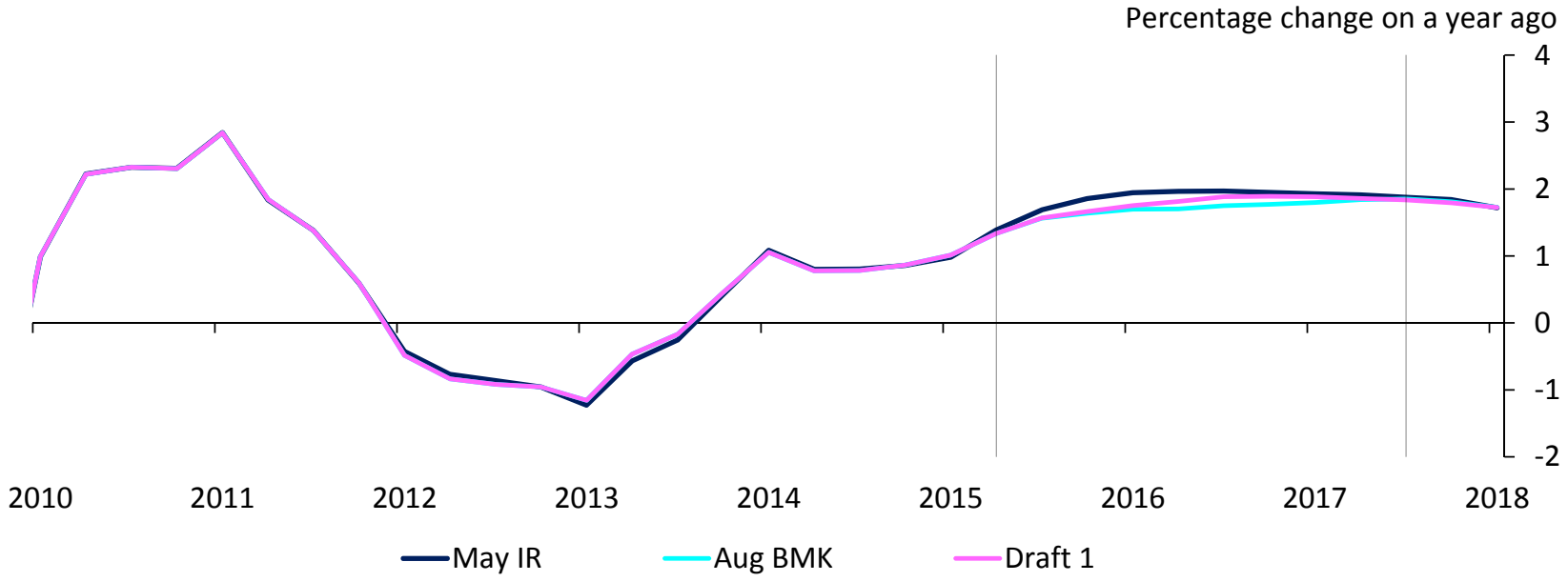

- Flash €A consumer confidence indicator fell by 1.5 points in July but remains fairly high.

# Euro-area PMIs and GDP growth



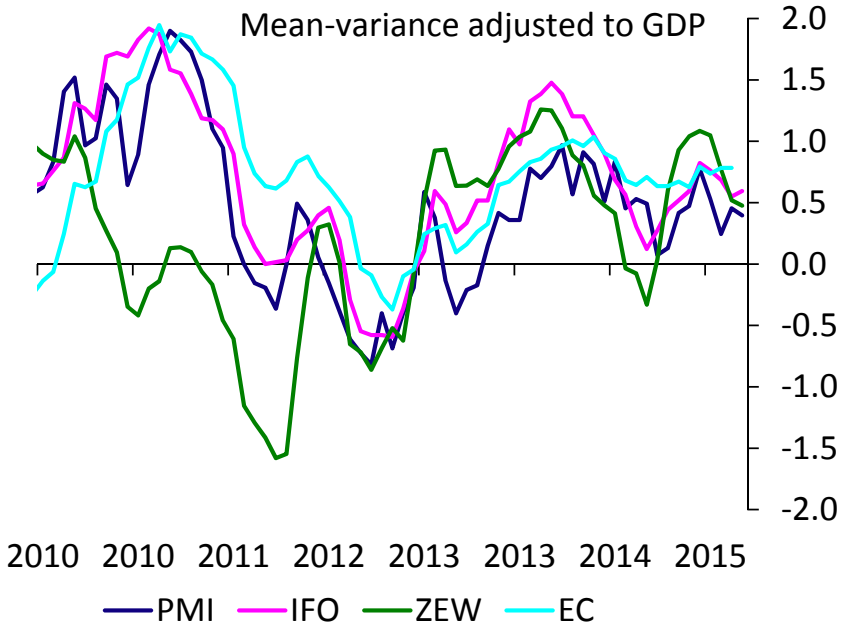

- Modest fall in PMIs did not change our best guess of Q3 GDP of 0.4%.

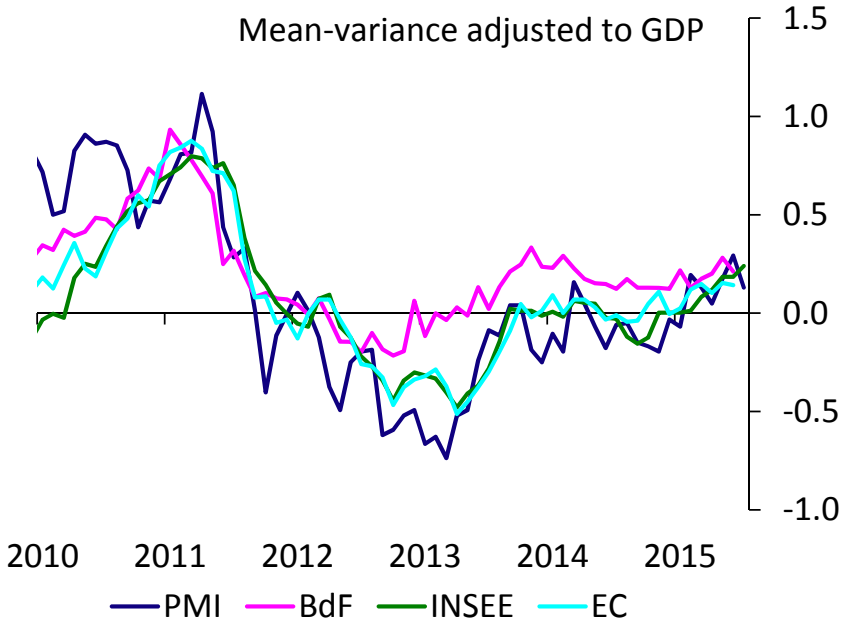
# Euro-area GDP forecast




- Level of €A GDP in Draft 1 is now 0.2% lower than in May IR.

# Near-term outlook for France and Germany



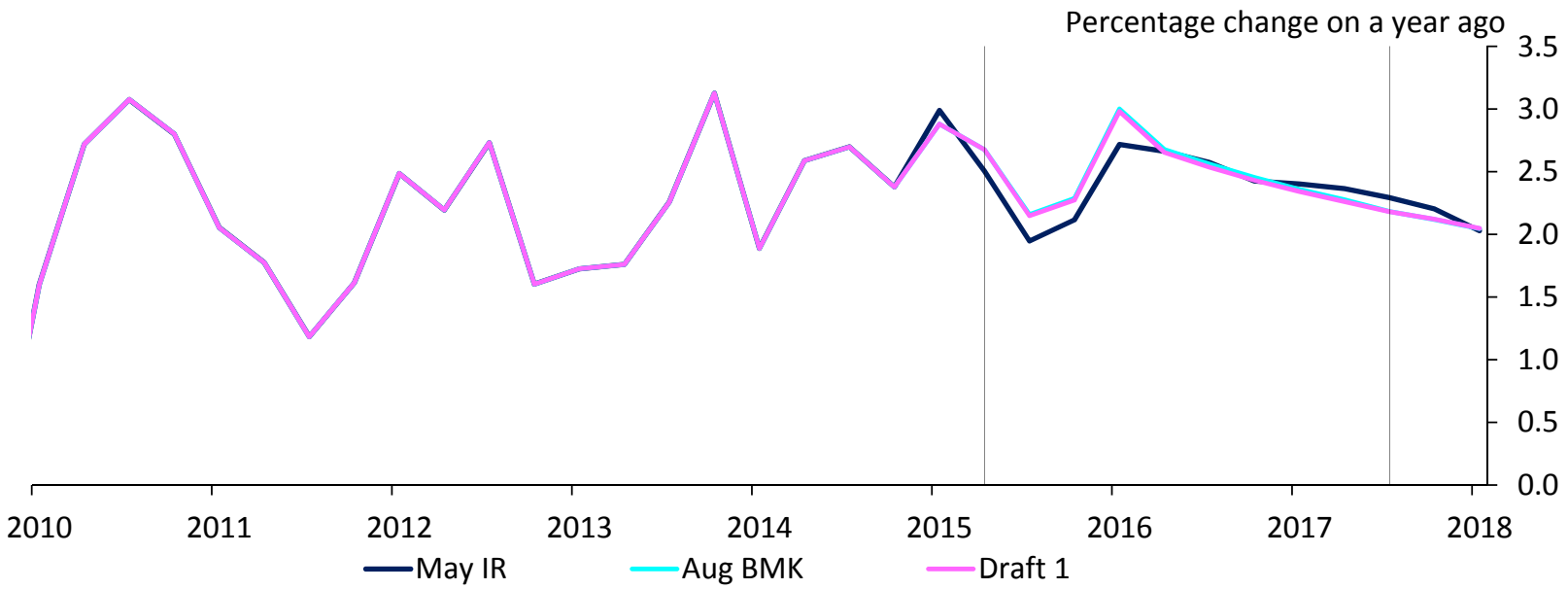

- July survey data for France and Germany looked mixed.

## Greece: recent developments

- Next flash point: 20 August ECB bond repayment…
- …but there's still sufficient funds left in the EFSM
- Longer-term problems remain:
  - implementation and political risks
  - recapitalisation of the banks
  - longer-term debt sustainability

# US

# US GDP forecast




- US GDP projected to grow by 2.5% in 2015 and 2.6% in 2016.

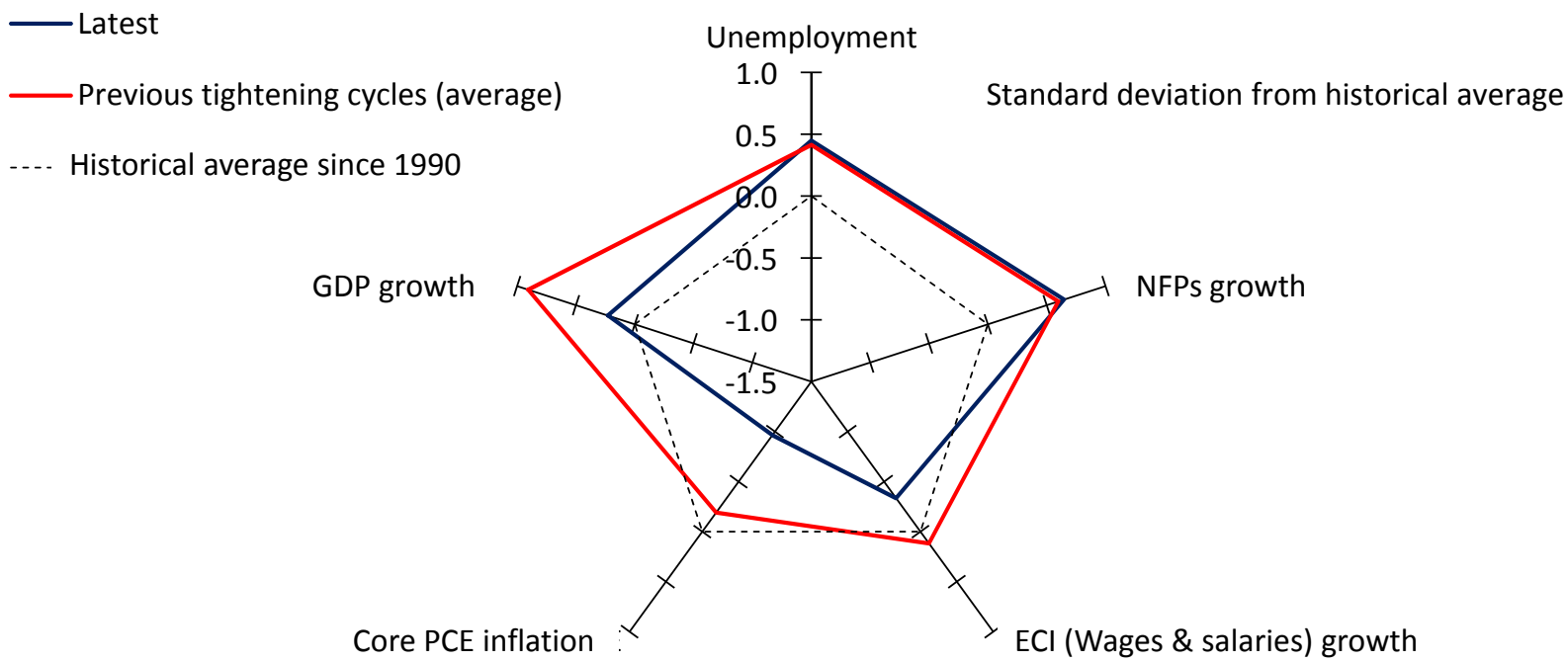
## FOMC policy decision

In June, the FOMC said….

- "labor market indicators continue to move toward levels [FOMC] judges consistent with its dual mandate"
- "Inflation is anticipated to remain near its recent low level in the near term"

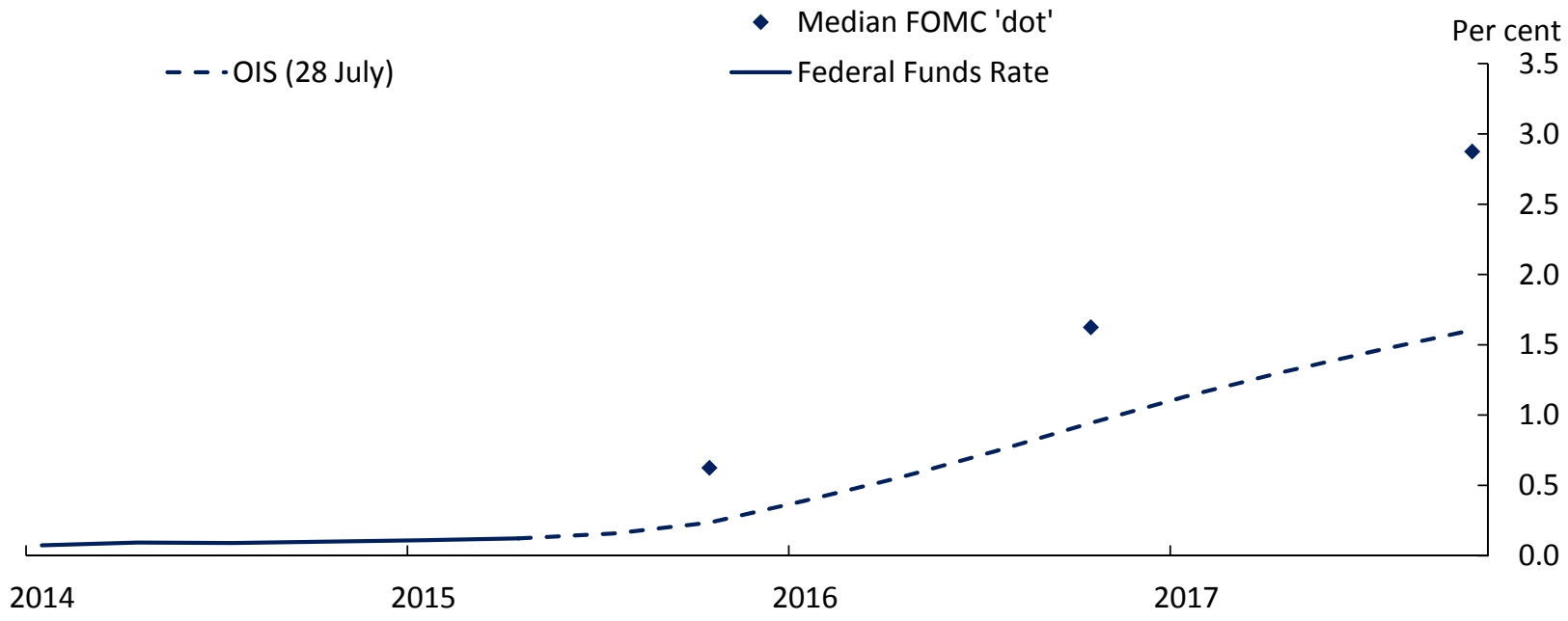
See:

# Macro variables in previous US tightening cycles

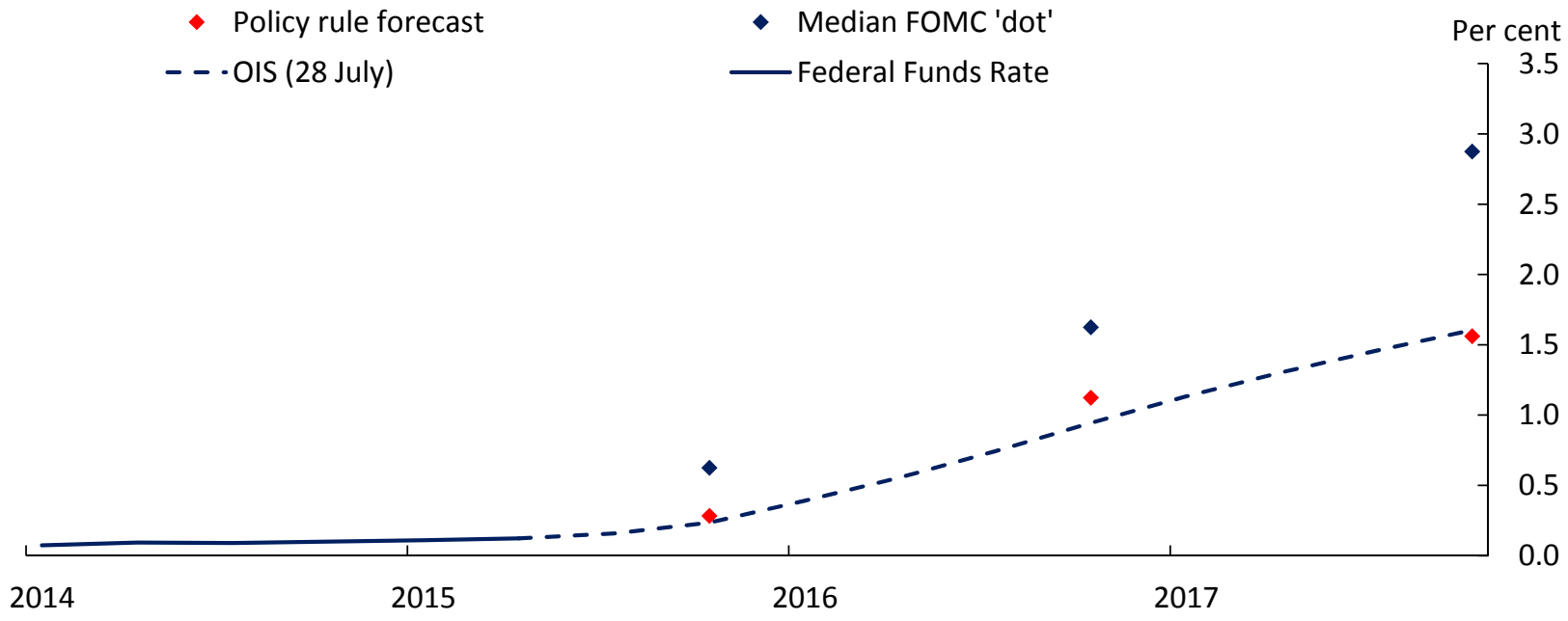



- Current weakness of nominal variables is unusual for run-up to tightening cycle.

# Policy rules for Fed funds rate

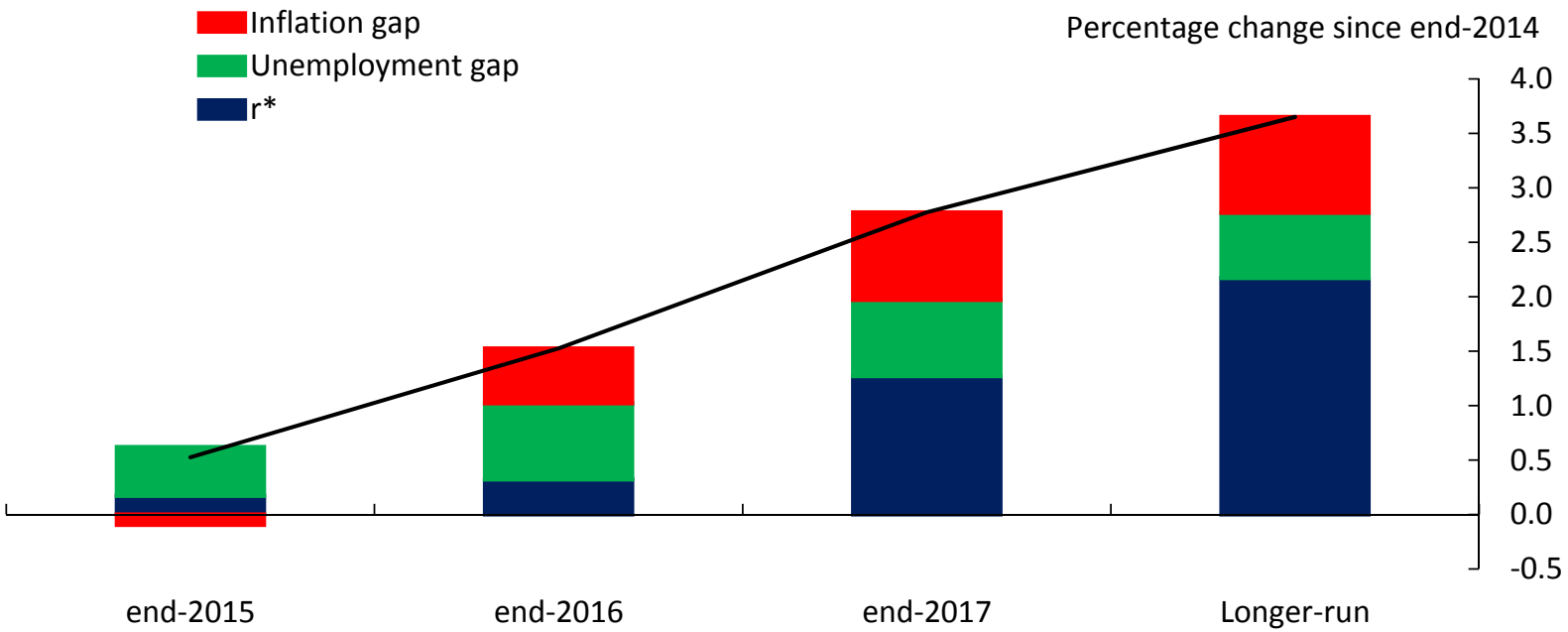


# Policy rules for Fed funds rate




- Janet Yellen's preferred policy rule with no pick-up in r* gives similar profile to OIS curve

# Decomposition of pick-up in median FOMC 'dots'

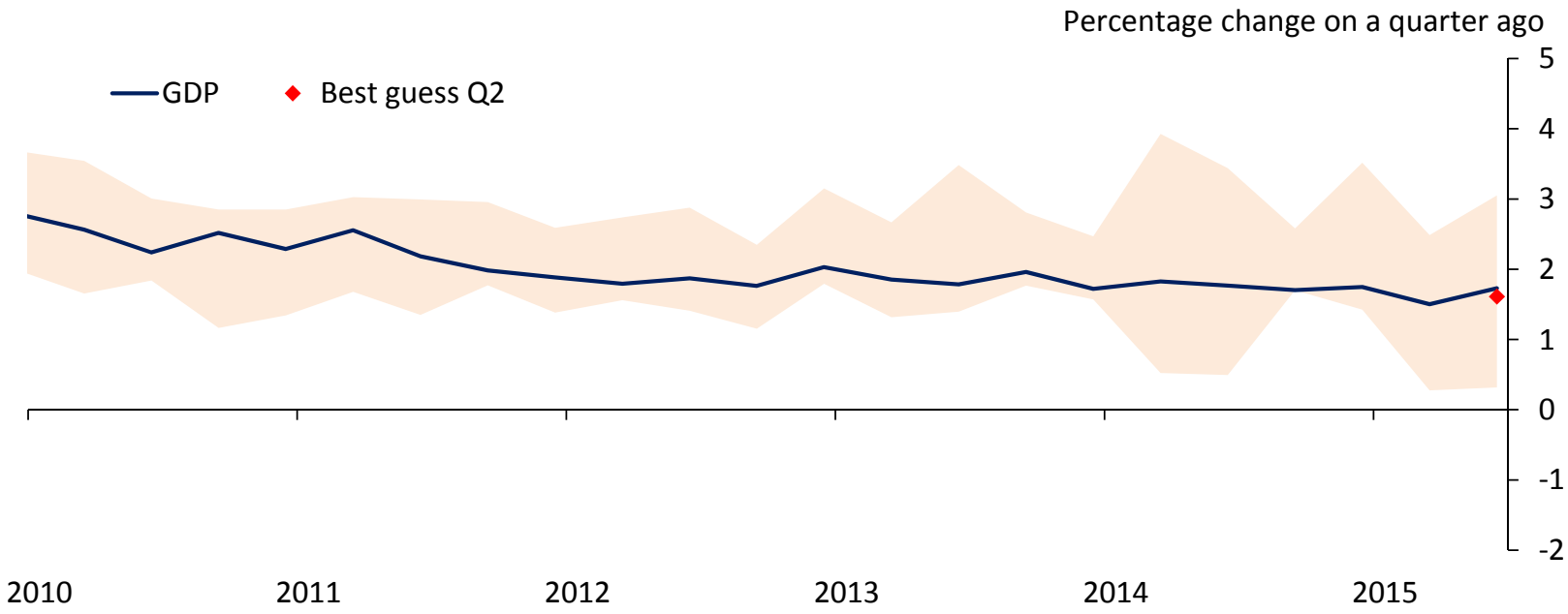



- Backward induction using policy rule suggests higher r* explains majority of pick-up

# China

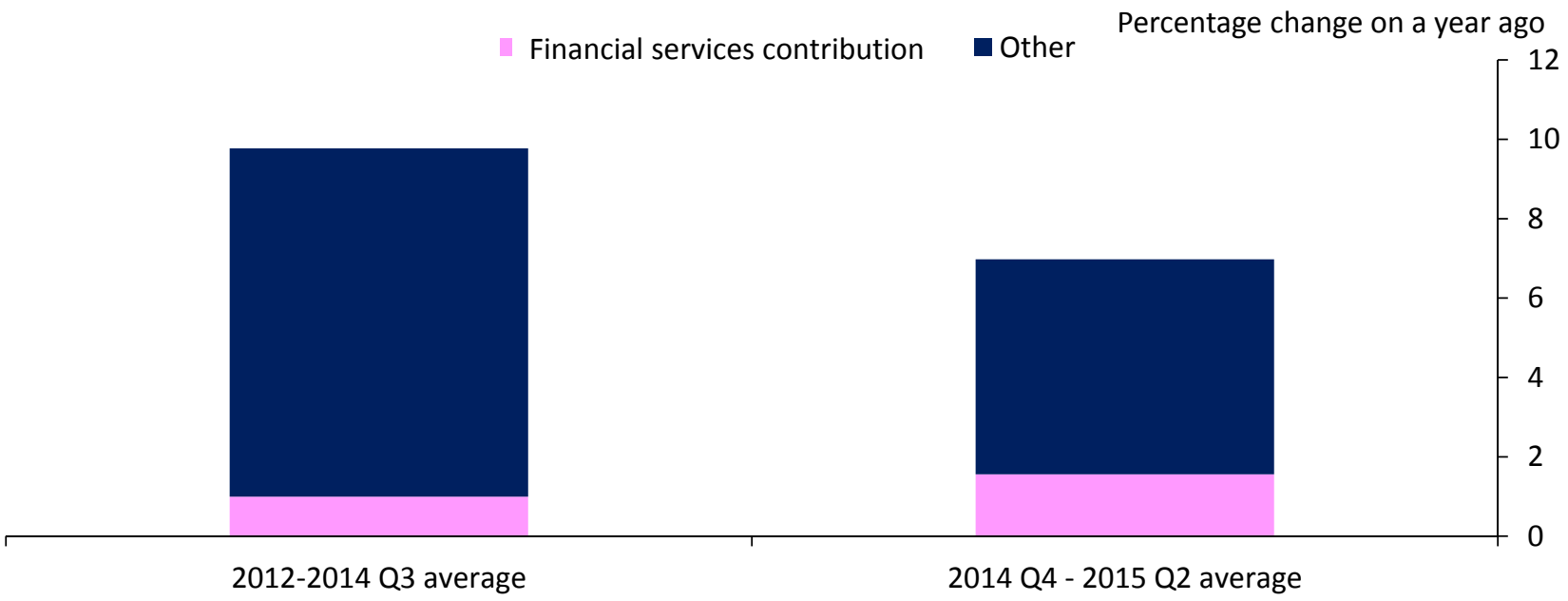
See:

# Chinese GDP and swathe of indicators



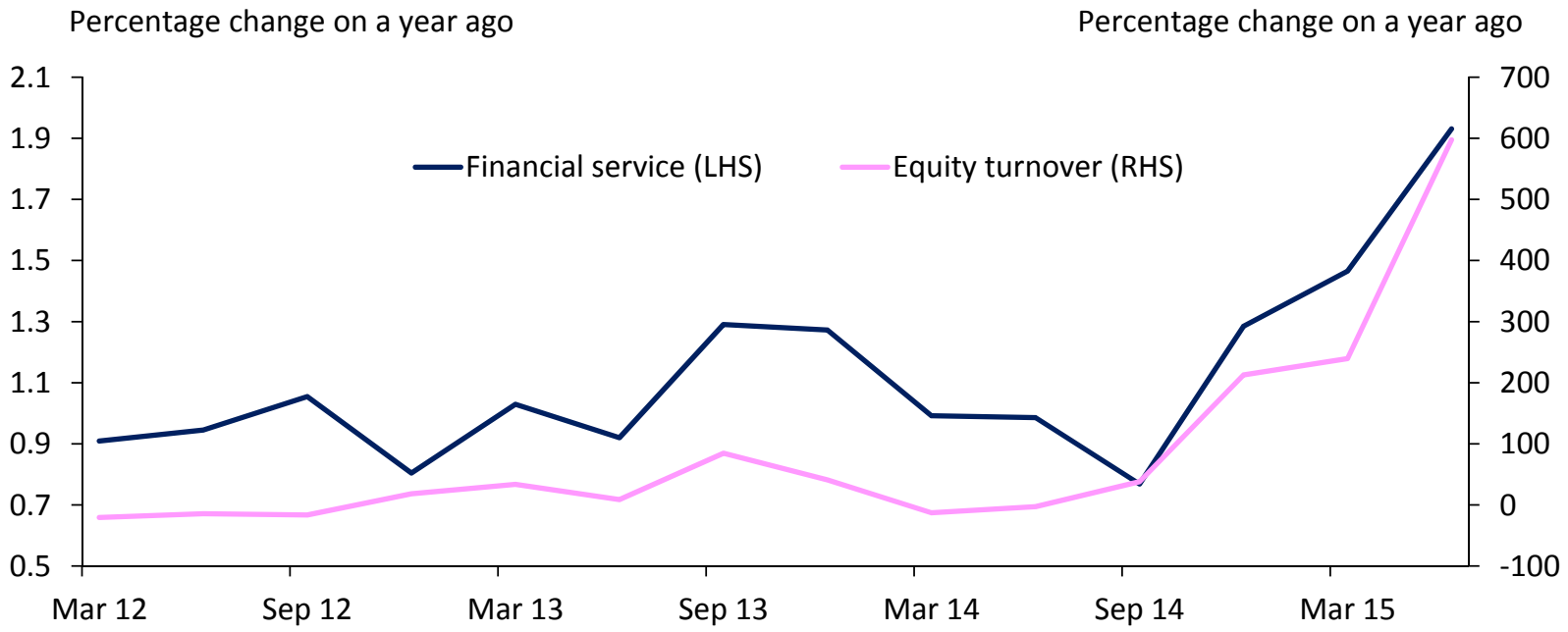

- Q2 GDP grew at 1.7% oqa by OECD measure, 0.1 pp above our best guess.

# Contributions to nominal GDP growth




- Since late 2014, financial services contributed 1.6pp to GDP growth (cf 1.0pp in 2012-14)

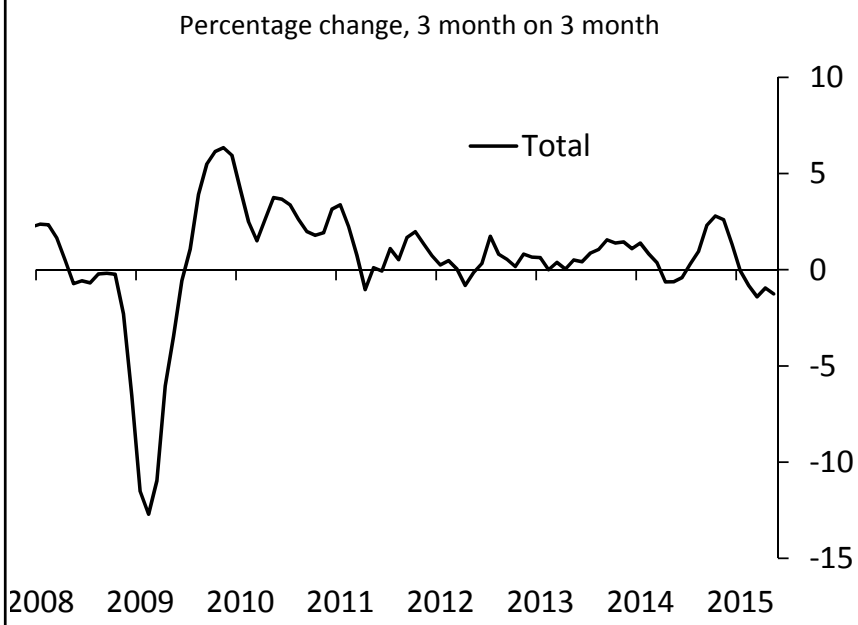
# Chinese equities turnover and financial output

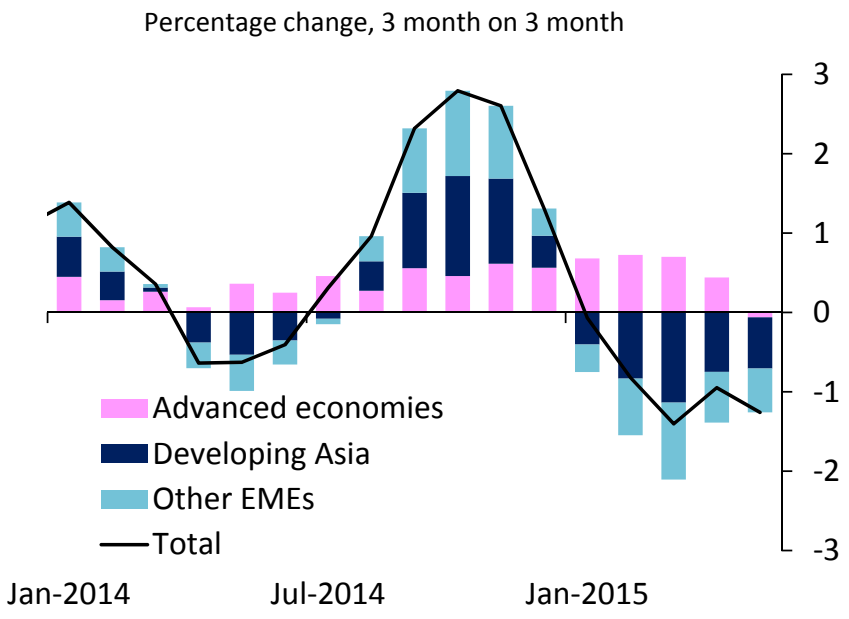



- Turnover in equities market closely correlated with measured financial sector output.

# World activity

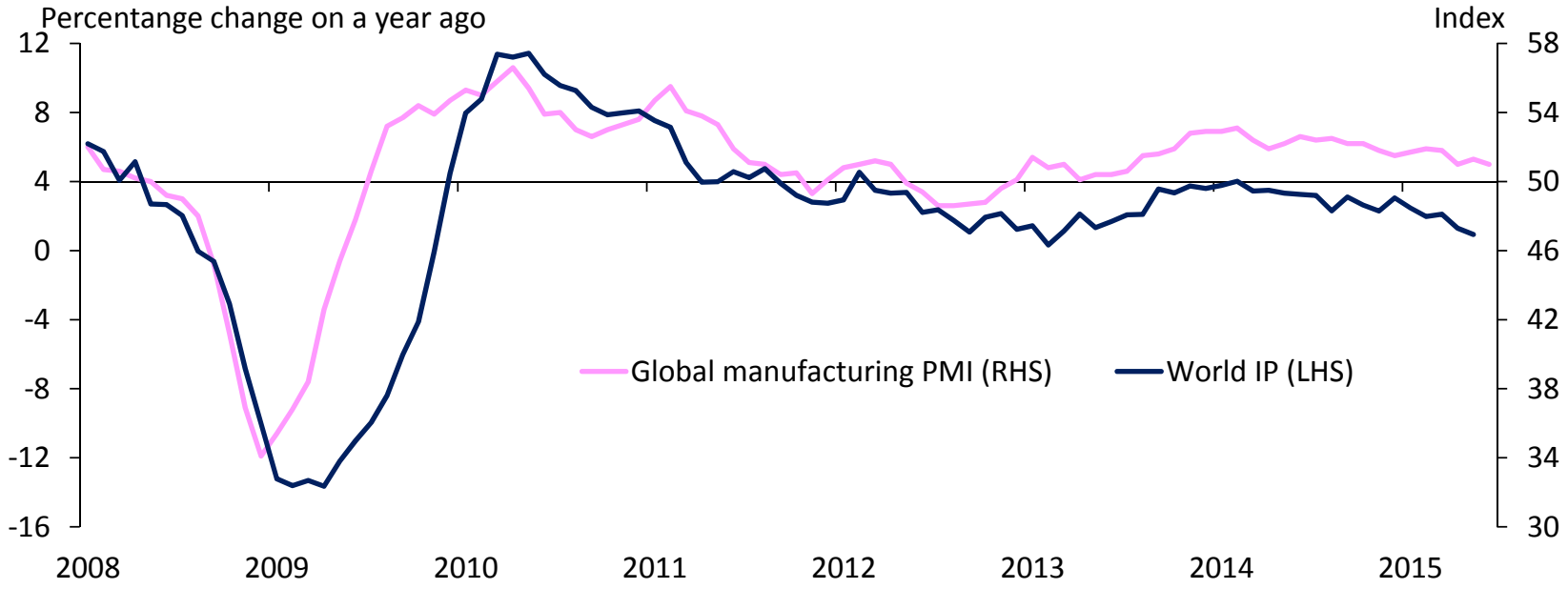
# Contributions to world goods trade growth



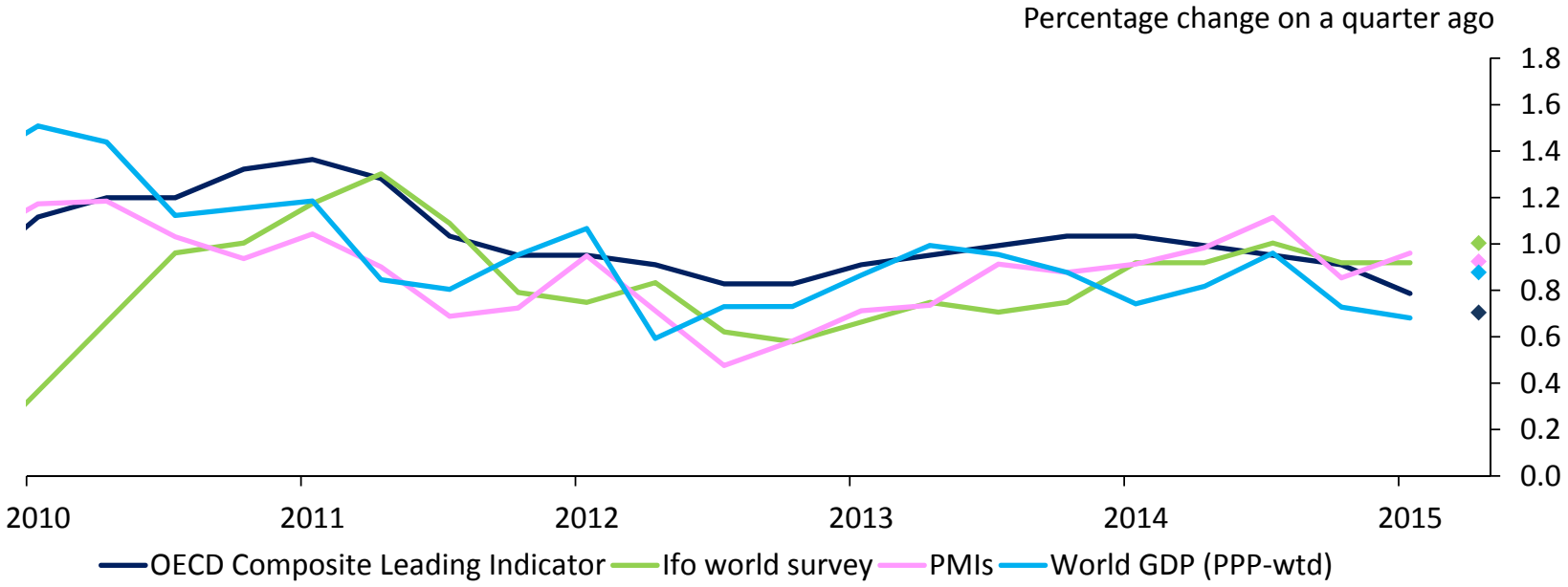

- CPB world goods trade fell in May to -1.3% , mainly reflecting weakness in emerging Asia.

# Global IP and manufacturing PMIs (PPP-wtd)



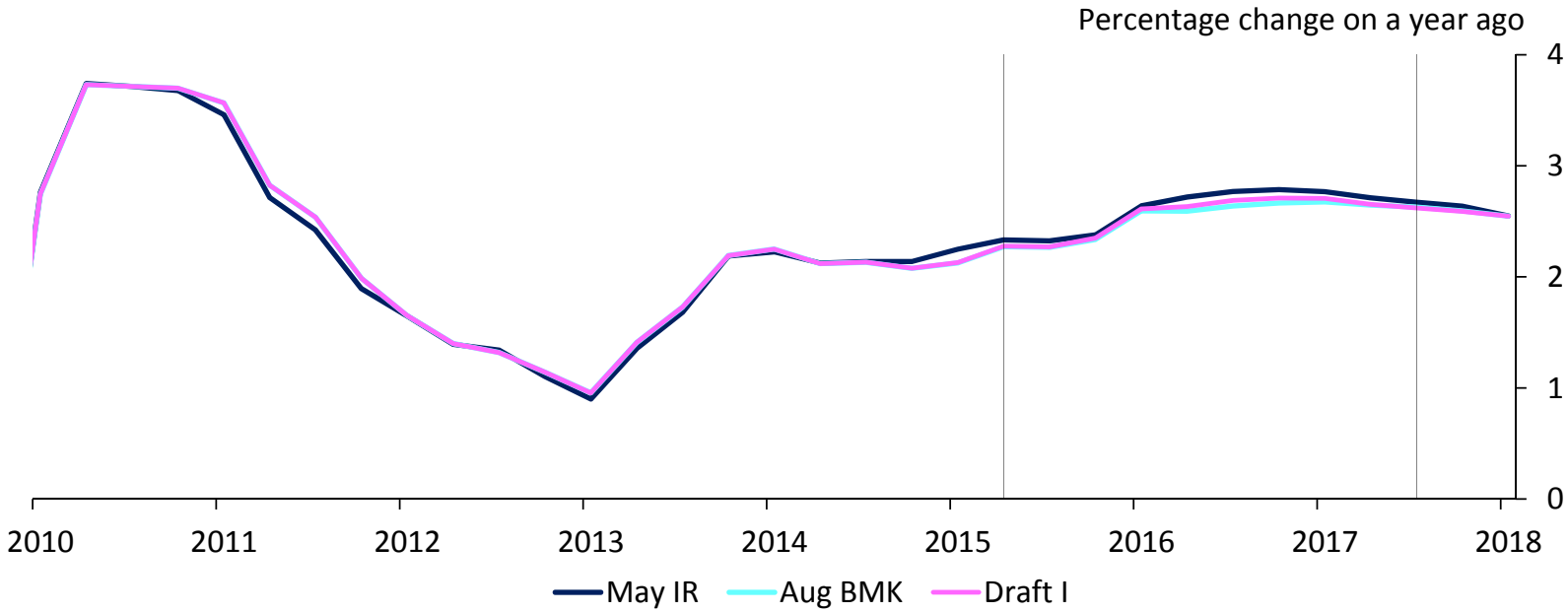

- World IP growth fell by 0.3pp to 0.9% in May; manufacturing PMIs fell 0.3 pts to 51 in June.

# Global indicators: mapping to world GDP




- We expect PPP-w global growth to pick up to 0.9% in Q2, in line with indicators.

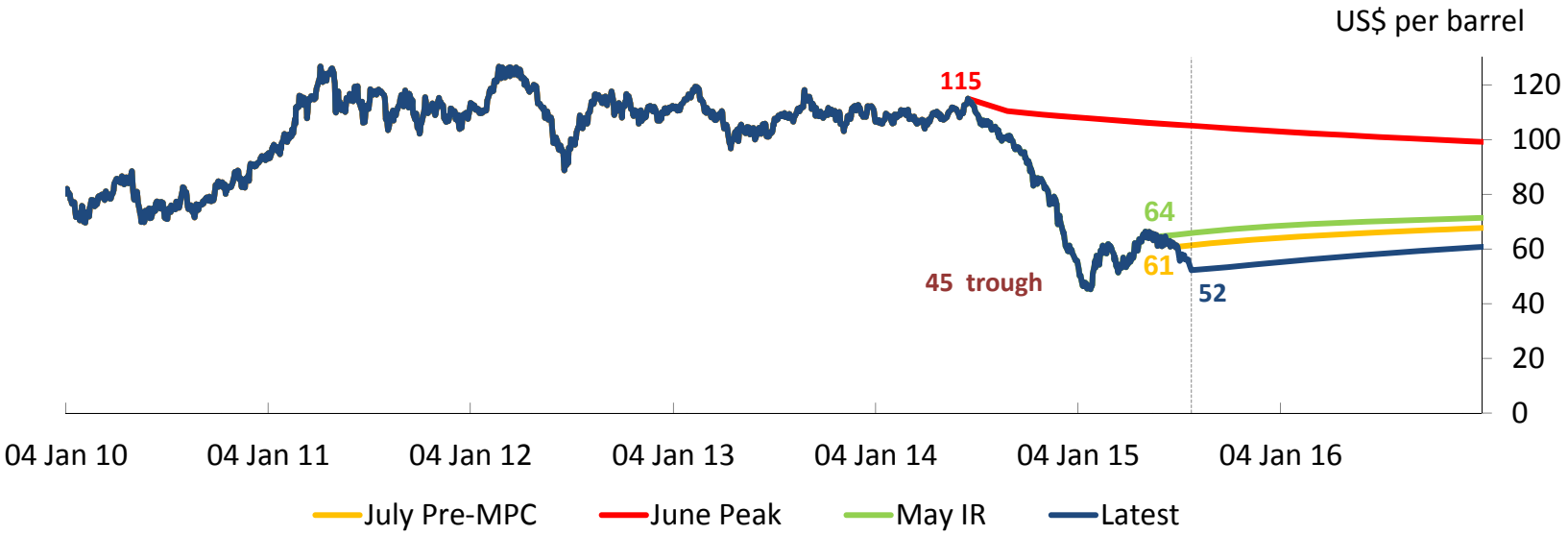
# UK-weighted world GDP forecast




- UK-weighted world GDP growth forecast now 2.3% in 2015 and 2.7% in 2016.

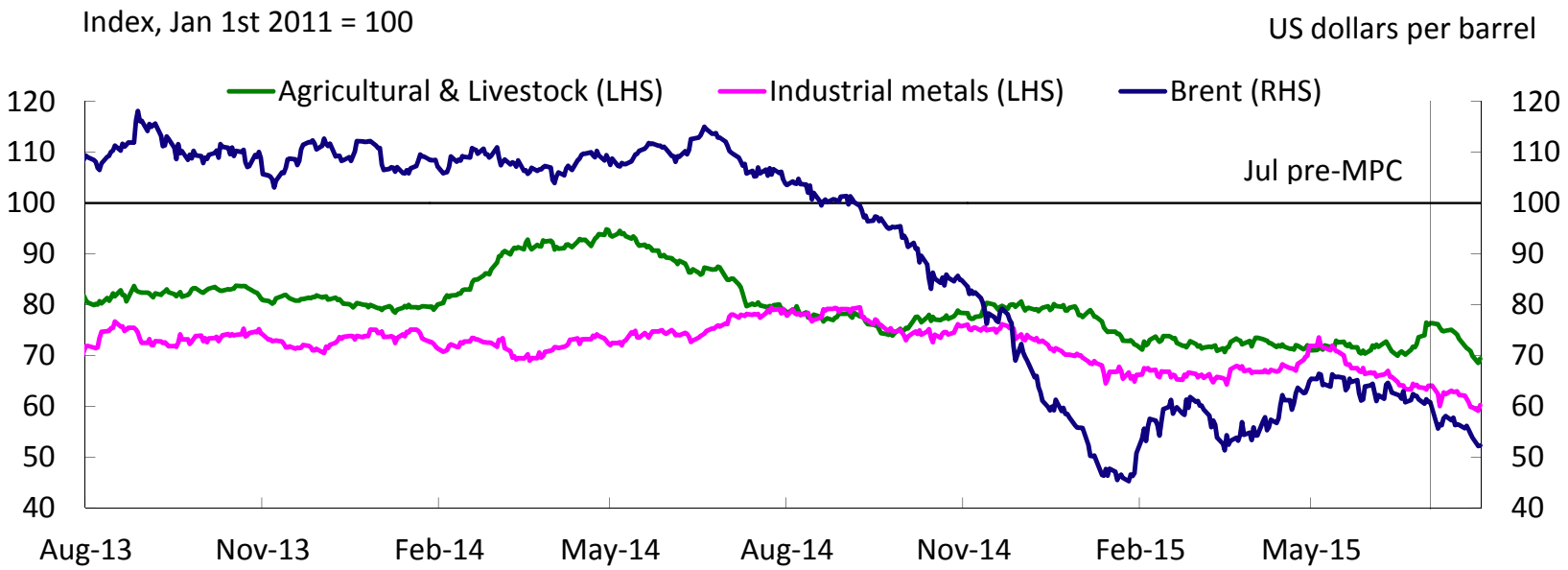
# Commodities

# Oil futures curve




- Oil prices have fallen by 14% since July pre-MPC to US$52.26pb (10% across futures curve).

# Non-oil commodities prices




- Industrial metals (by 6%) and agricultural prices (by 9%) have fallen since July Pre-MPC.

# Key messages

- In €A, some softness related to Greece in Q3 but forecast revised up slightly vs Benchmark.
- In US, FOMC policy decision still finely balanced.
- Chinese GDP surprised on upside in Q2 but partly reflects financial services; equity price turmoil will weigh on Q3.
- Global trade still weak, particularly in emerging Asia.
- Commodity prices fell materially, largely reflecting supply.
- Draft 1 forecast little changed from Benchmark.

# End

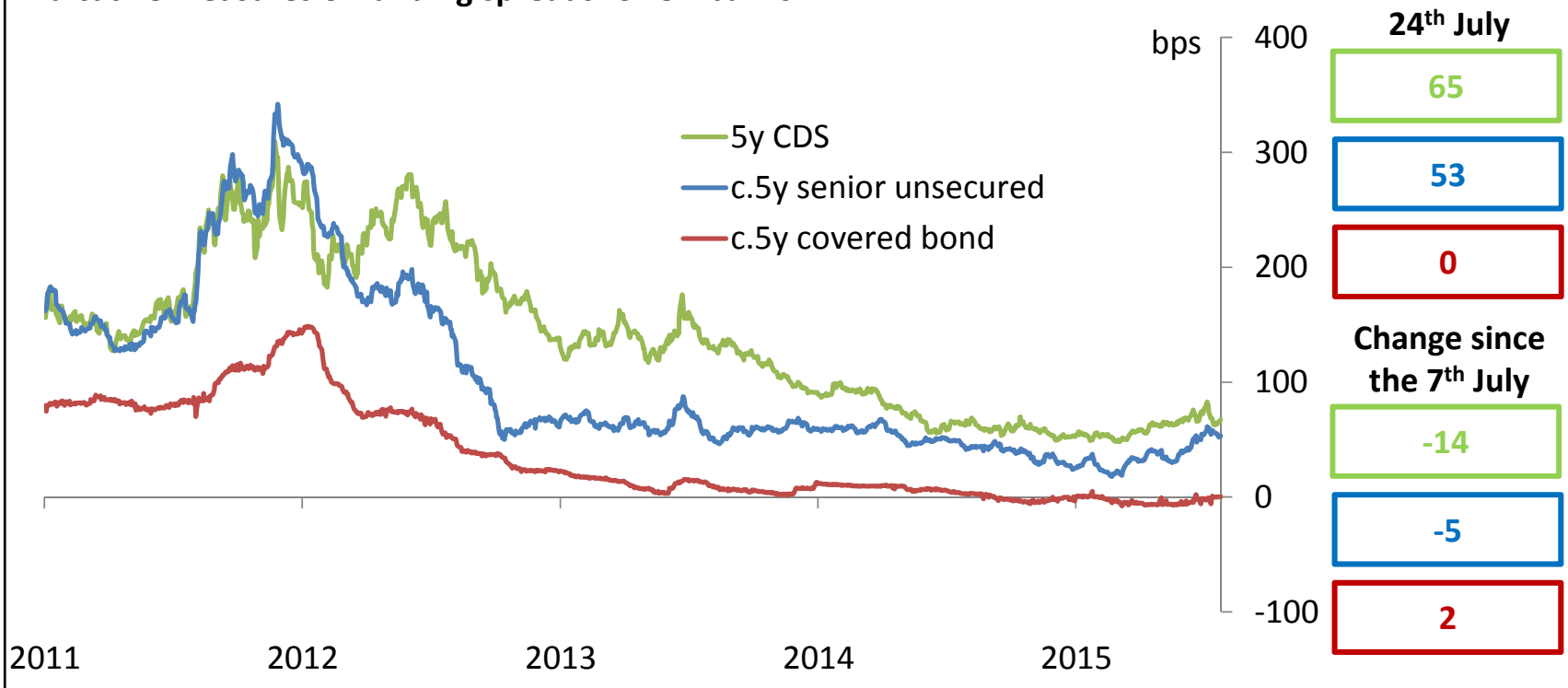
# 3: Money, Credit and Nominal Trends

# MONEY, CREDIT AND NOMINAL TRENDS August 2015

- **How have financial conditions changed?**
- Has the downside risk from inflation expectations dissipated?

[redacted]

**Indicative measures of funding spreads for UK banks**

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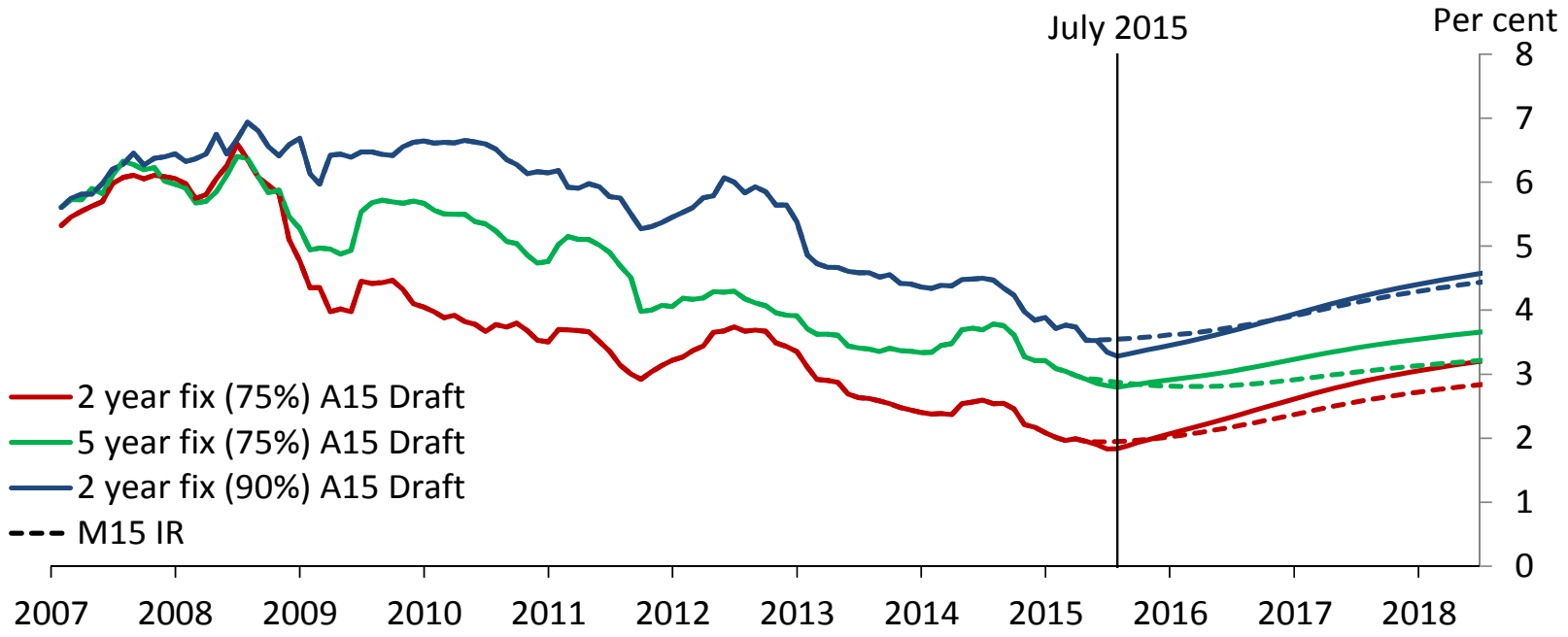
**Quoted mortgage rates**

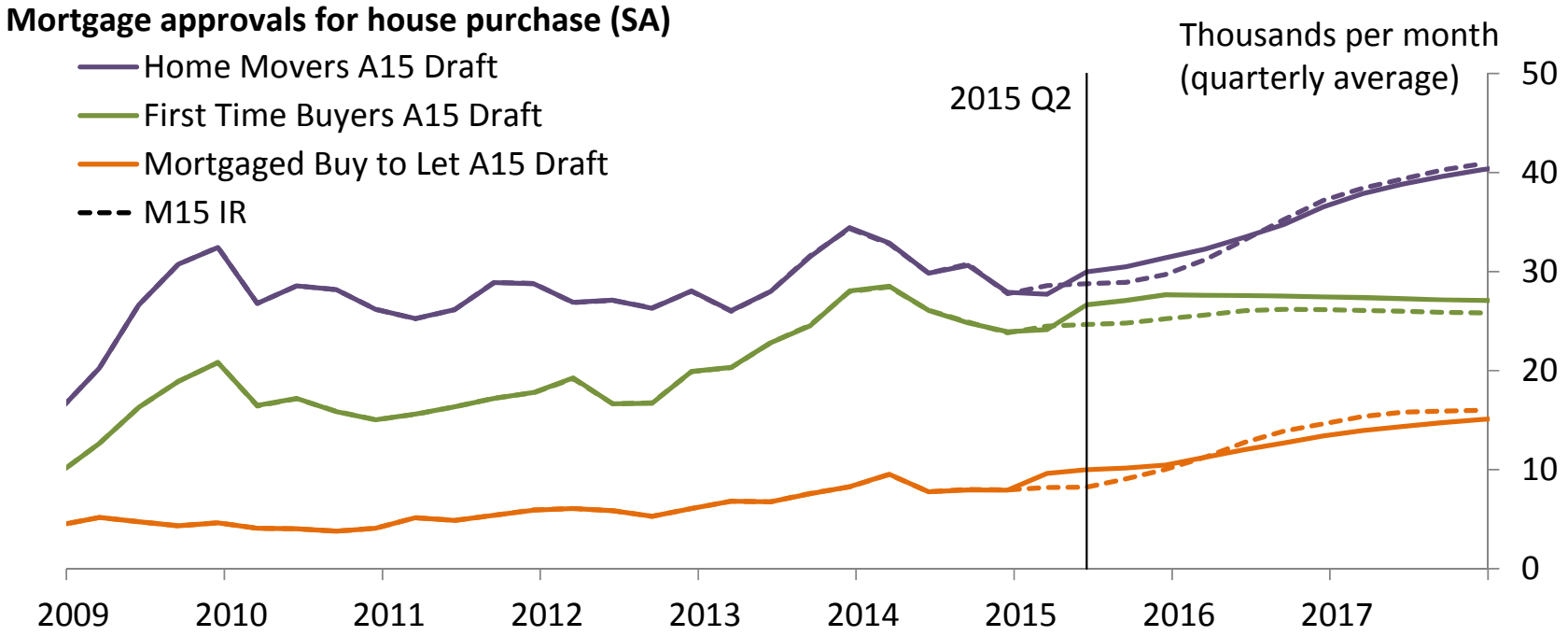



**Early estimates of provisional July 2015 quoted rates that will be published 11th August**

[redacted]

[redacted]

**Mortgage approvals for house purchase (SA)**

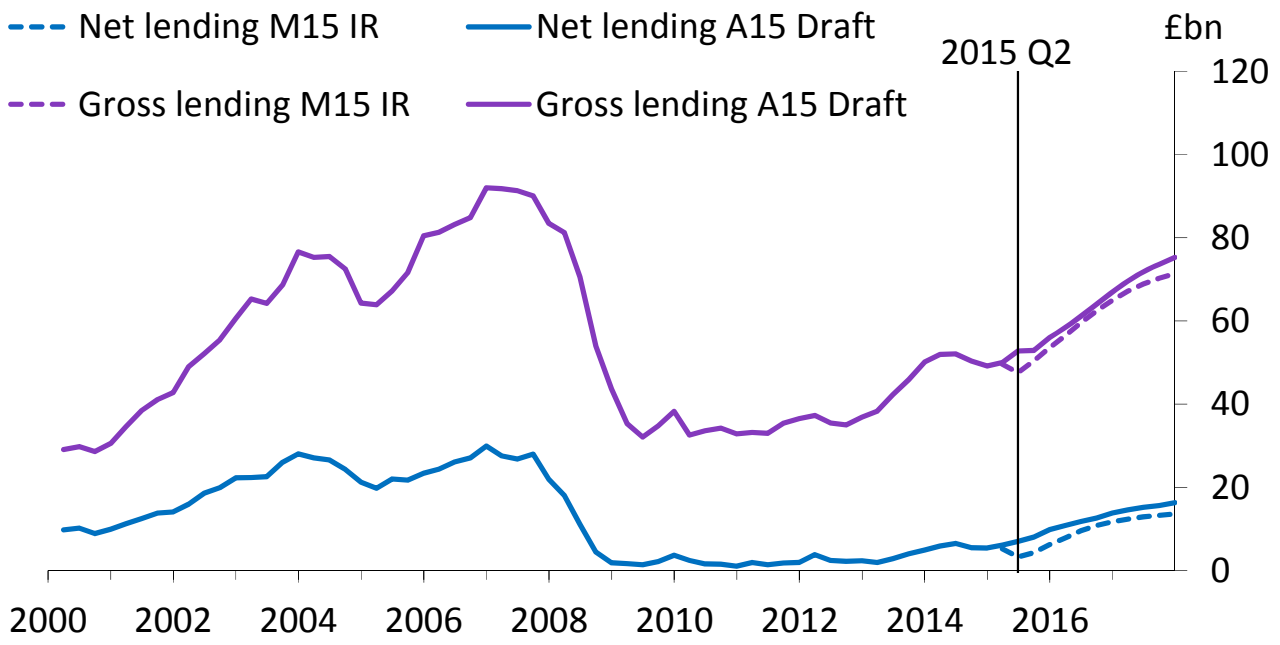



- Aug *IR* monitoring judgement: A rise in mortgage approvals for house purchase to around 70,000 a month, on average, in 2015 Q4.

[redacted]

[redacted]

**Gross and net secured lending to individuals**

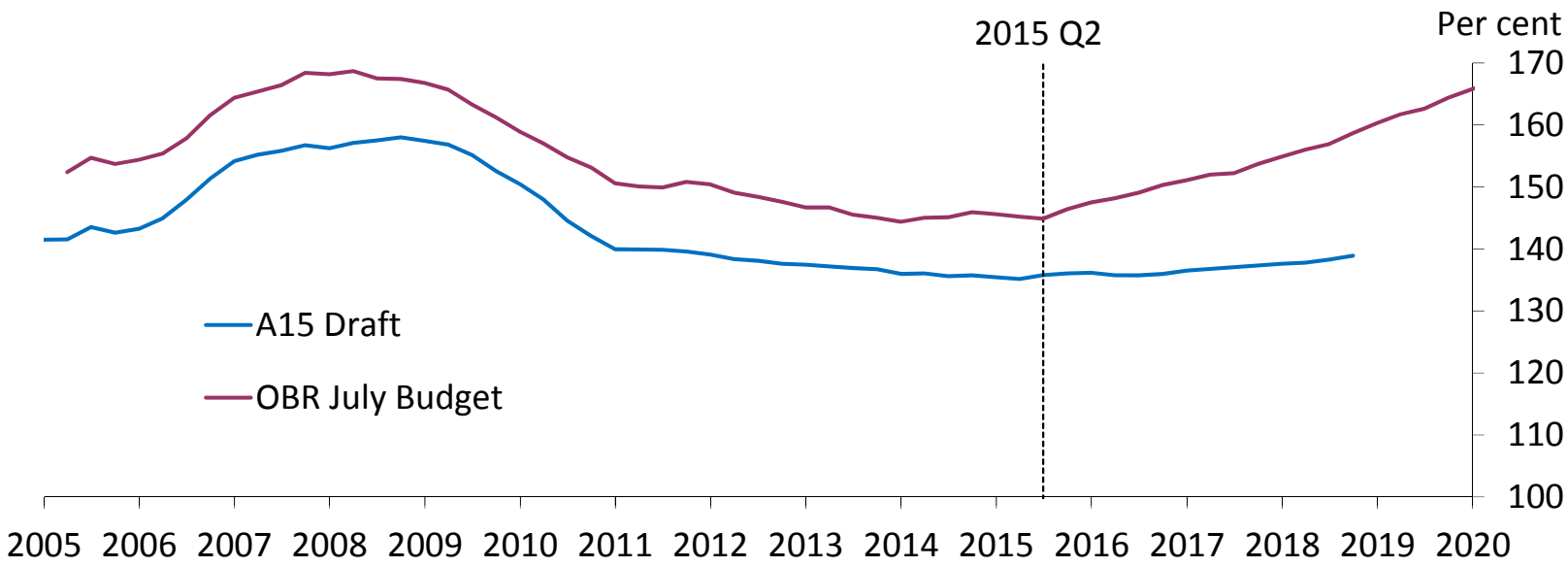



| £bn | 2015 | 2016 |
|---|---|---|
| Gross secured lending | | |
| MASD | 212 | 251 |
| CML | 209 | 230 |
| Net secured lending | | |
| MASD | 31 | 49 |
| CML | 32 | 38 |

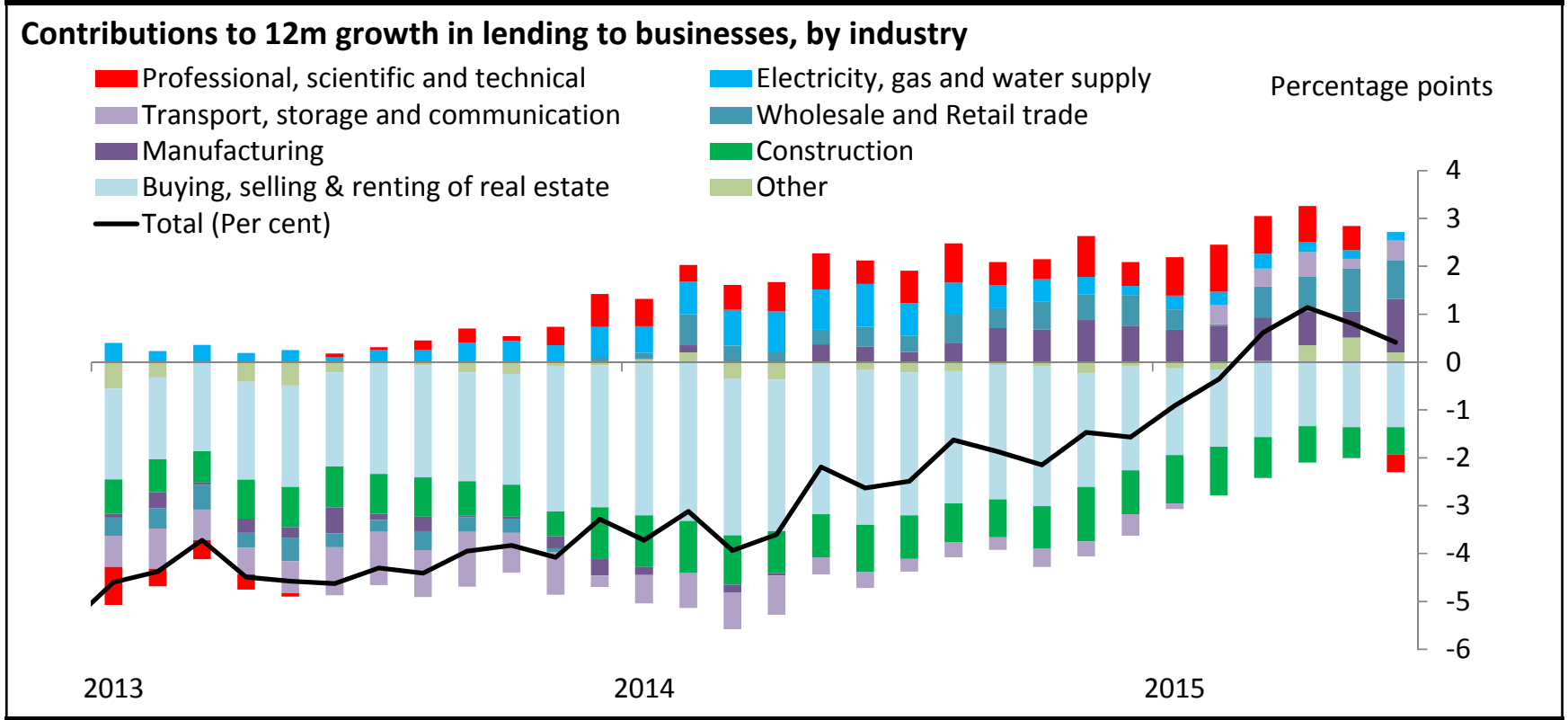
- CML more pessimistic than us on secured lending.

[redacted]

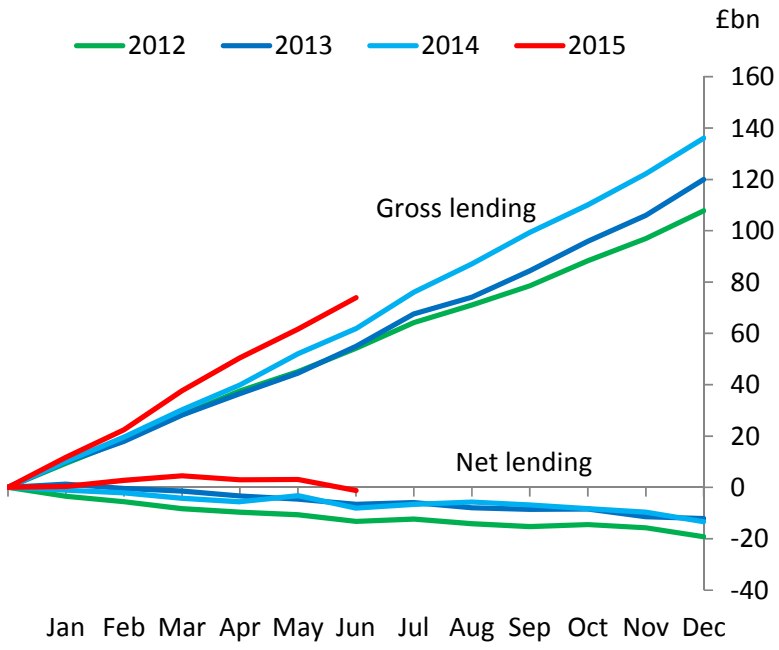
**Household debt to income – OBR vs MASD forecast**



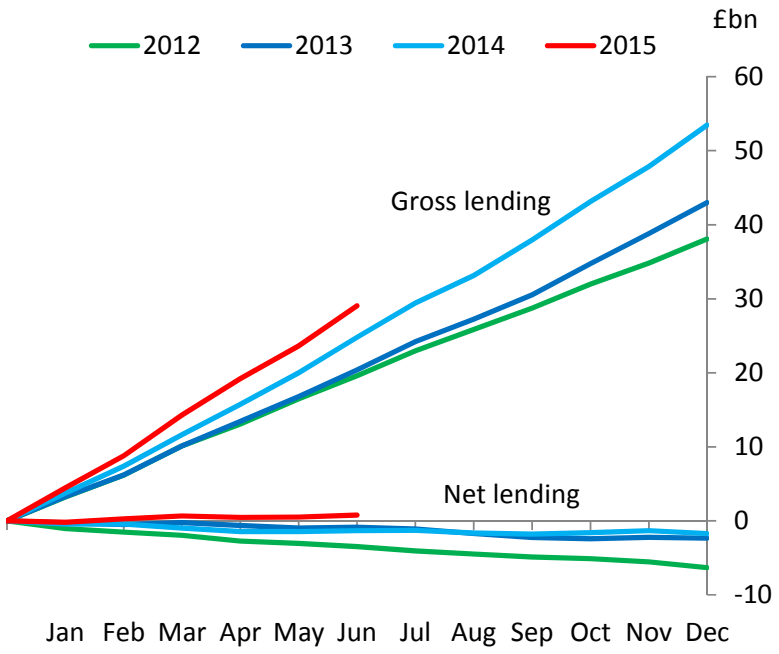

- NPISH liabilities and household derivatives are excluded from Bank definition of household debt.
- MASD projection of household secured debt is based on projections for approvals, house prices and LTVs. The OBR use a top-down approach.


Contributions to 12m growth in lending to businesses, by industry
Professional, scientific and technical
Electricity, gas and water supply
Transport, storage and communication
Wholesale and Retail trade
Manufacturing
Construction
Buying, selling & renting of real estate
Other
Total (Per cent)
Percentage points
4
3
2
1
0
-1
-2
-3
-4
-5
-6
2013
2014
2015

## Cumulative lending to large businesses

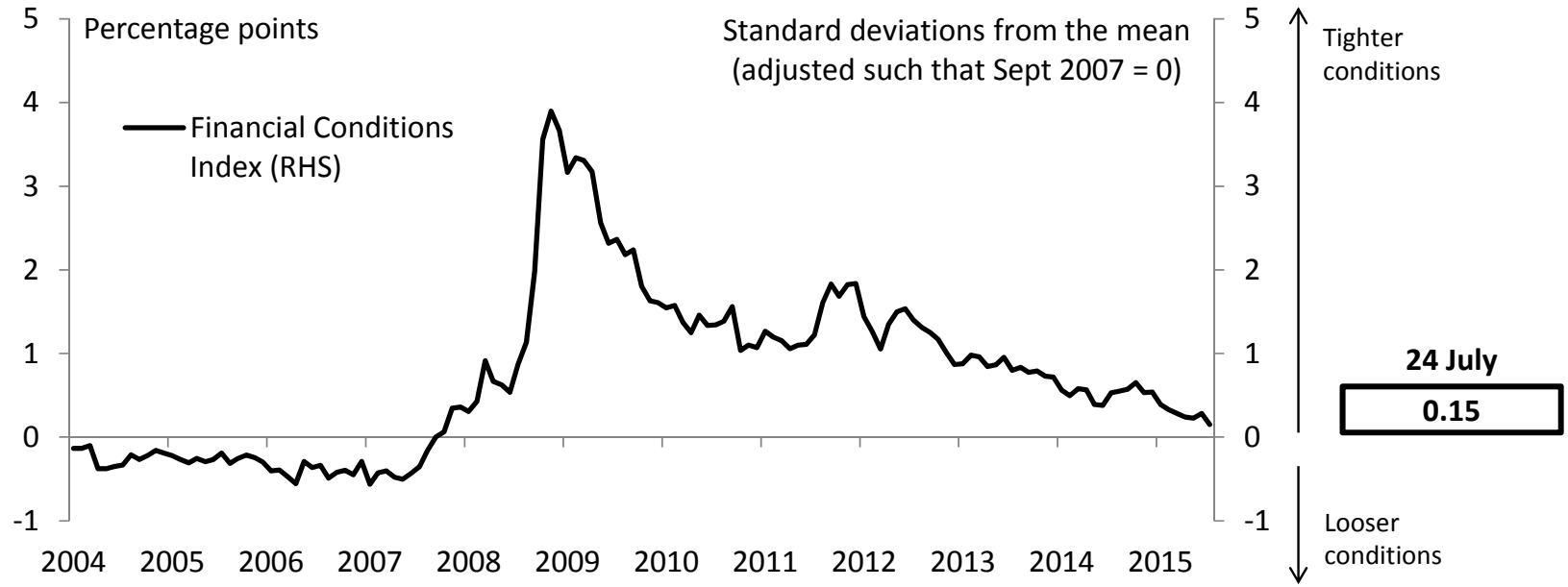



## Cumulative lending to SMEs



[redacted]

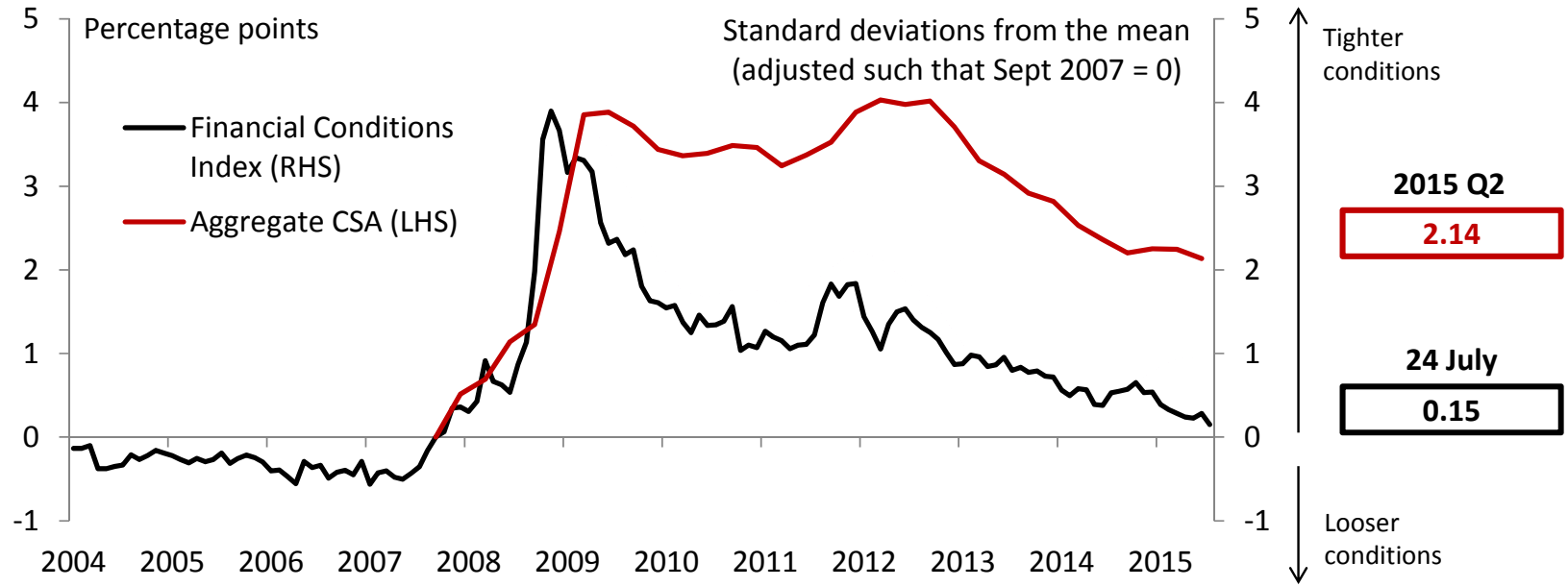
**UK Financial Conditions Index***




* See [redacted]

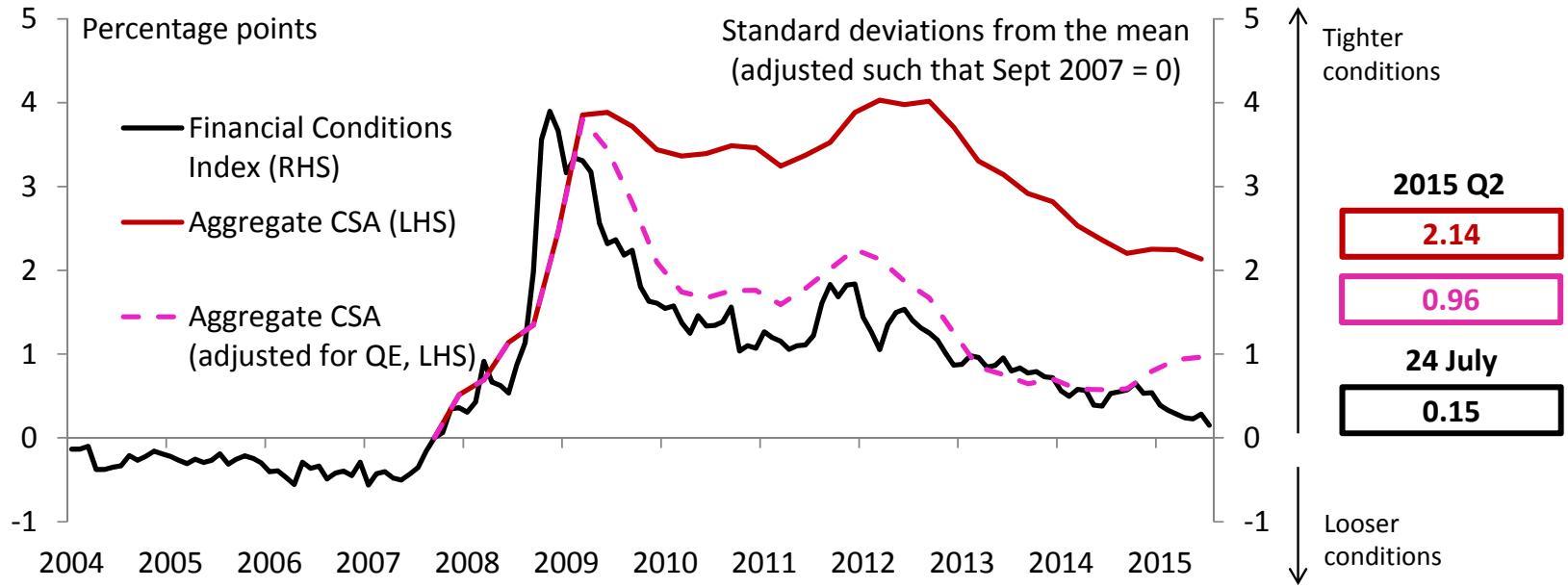
[redacted]

## UK Financial Conditions Index* and the Aggregate CSA




* See

## UK Financial Conditions Index* and the Aggregate CSA (adjusted** for QE effect)



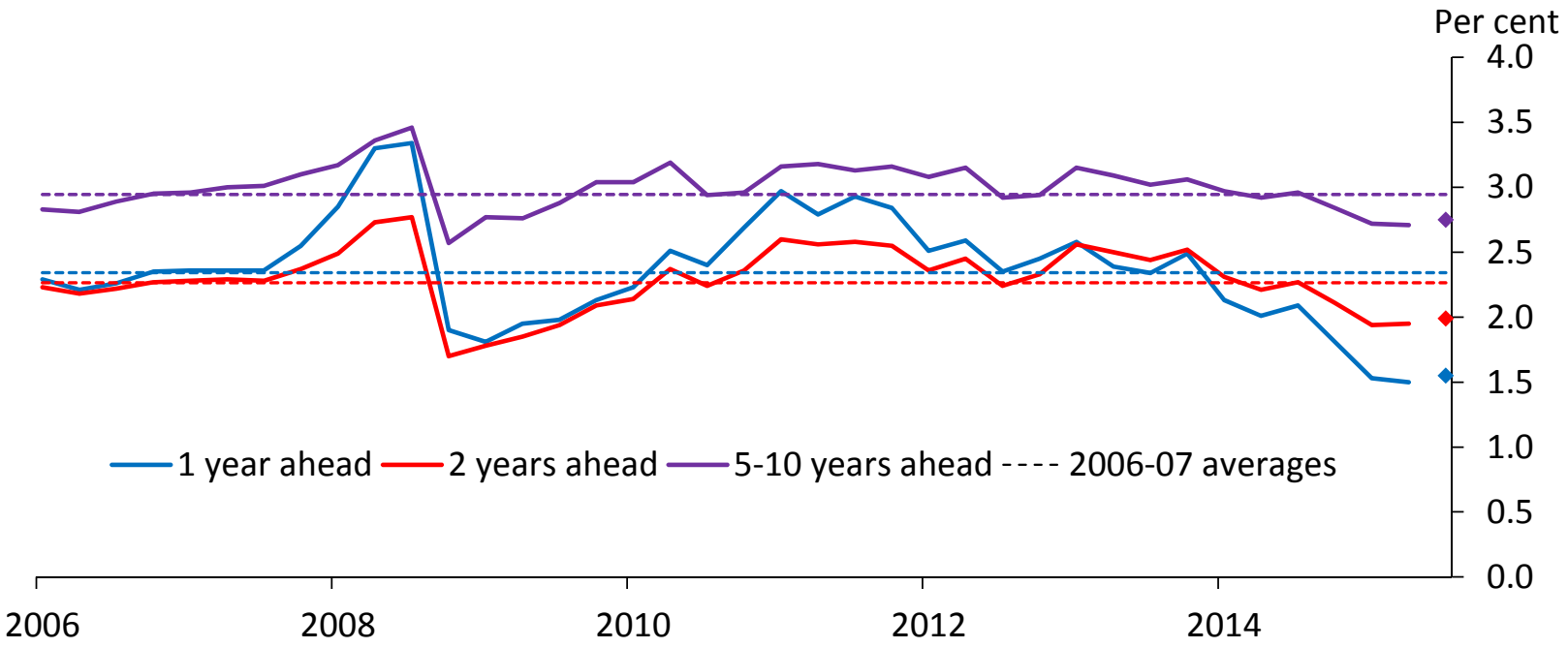

* See

** Adjusted by subtracting the estimated impact of QE in terms of Bank Rate from the Aggregate CSA

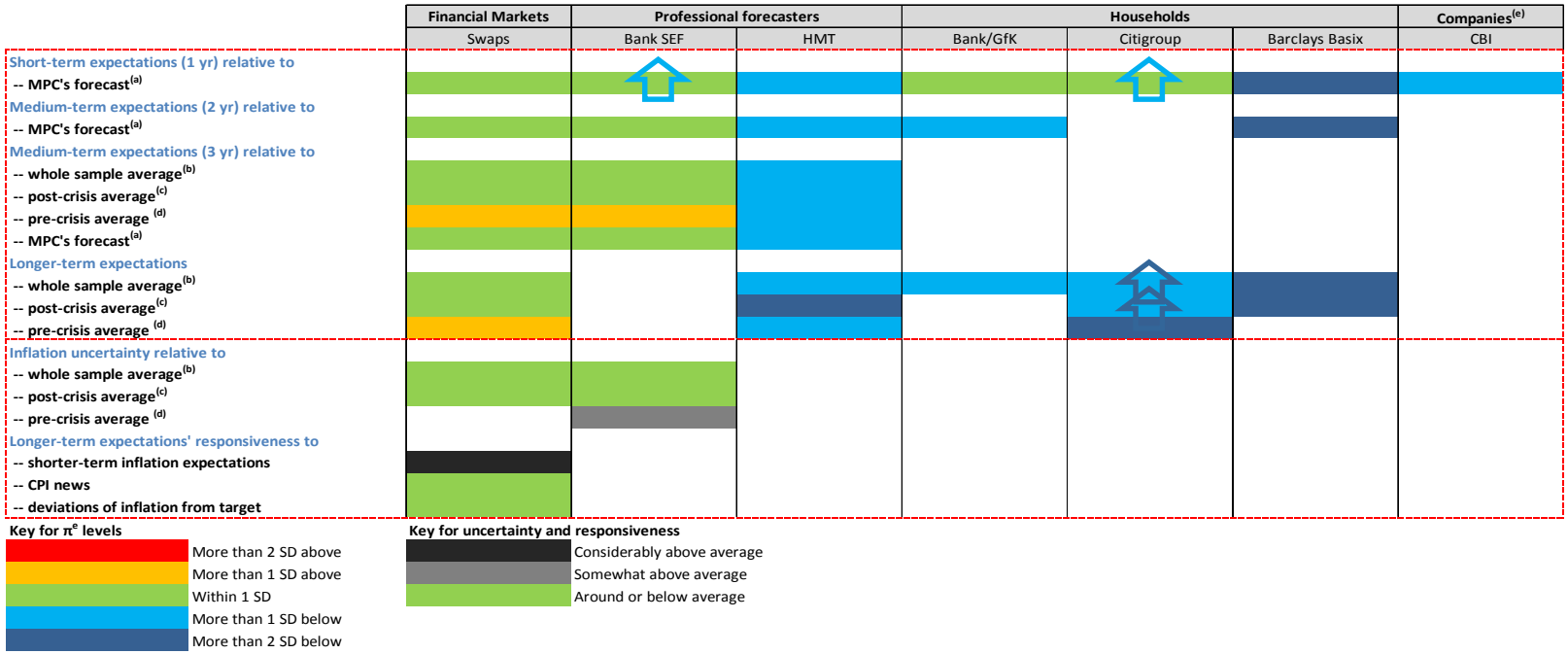
- Domestic financial conditions are as stimulatory as they have been since the crisis.

- How have financial conditions changed?
- **Has the downside risk from inflation expectations dissipated?**

**Inflation expectations summary measure***

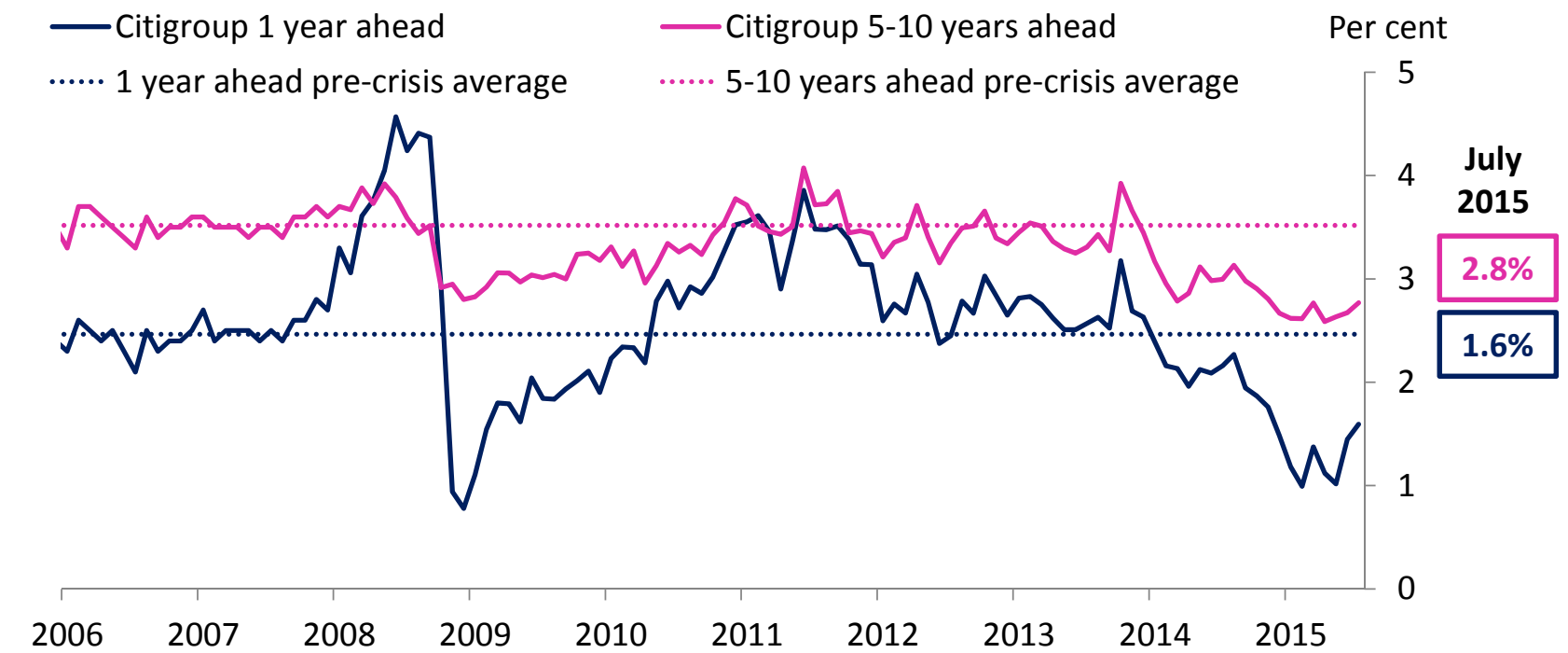



* Diamonds show Q3 estimate generated using available data



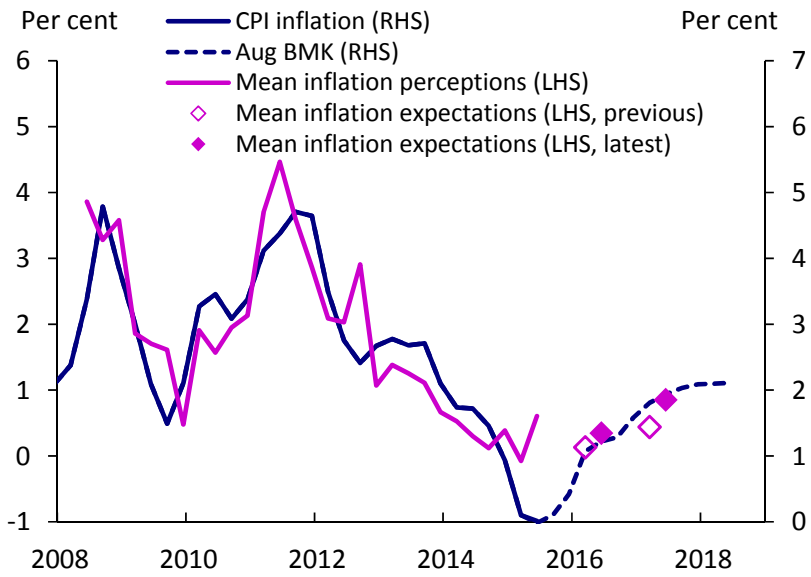

- Aug *IR* monitoring judgement: Indicators of inflation expectations continue to be broadly consistent with the 2% target

**Citigroup survey of household inflation expectations***



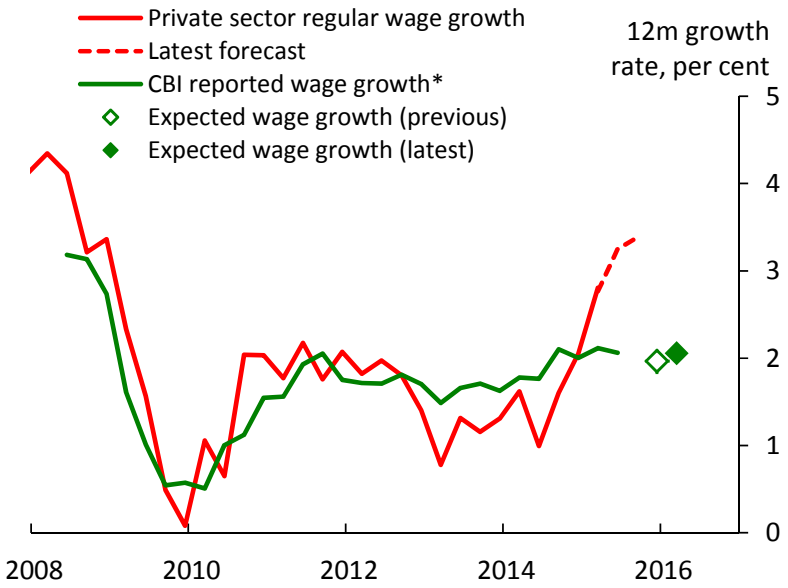

* Survey question: *"How do you expect consumer prices of goods and services will develop over the next one and five to ten years respectively?"*

## Inflation perceptions and one-year ahead expectations in CBI distributive trades survey




Survey question: *"What has been the percentage change over the past 12 months in the general level of selling prices in the UK markets that your firm competes in and what is expected to occur over the next 12 months?"*

## Wage growth and expectations in CBI surveys*

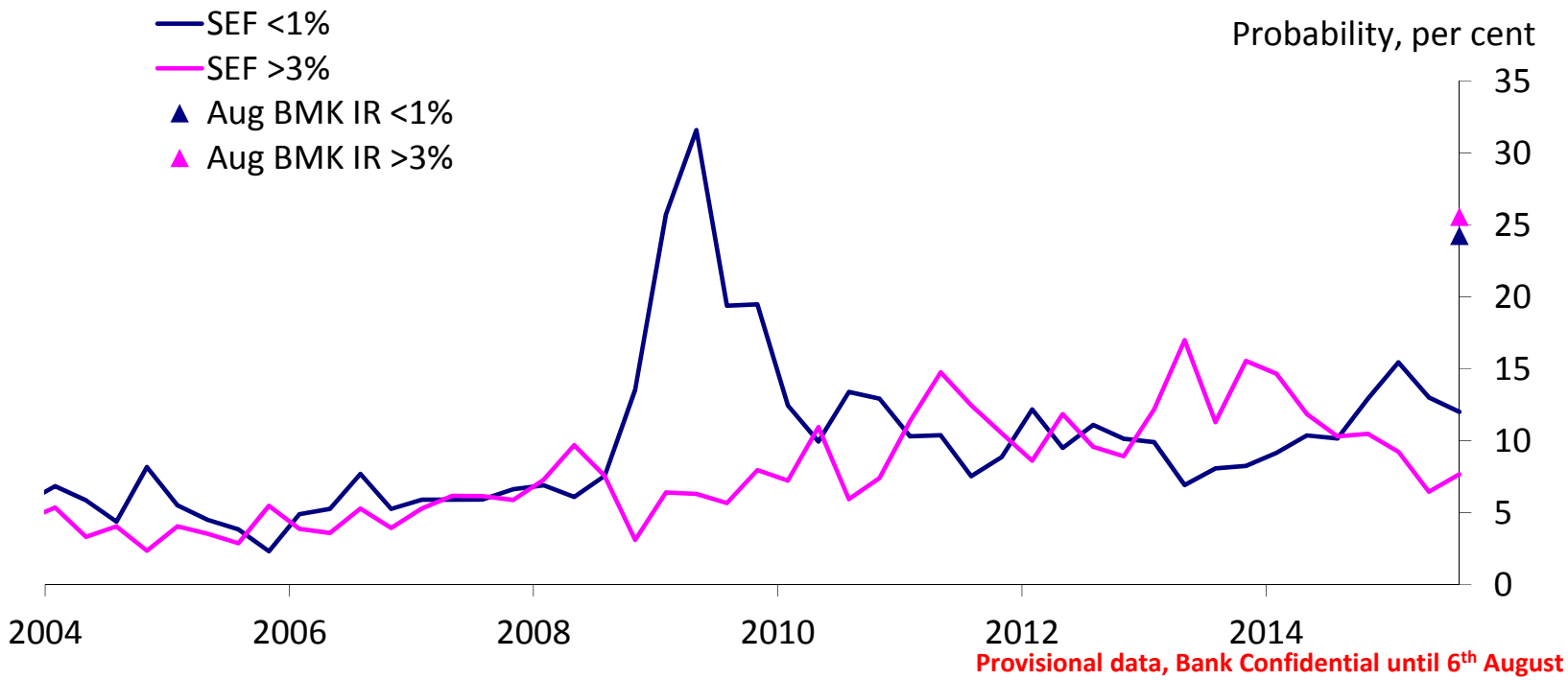



* Distribution, manufacturing & service sectors, weighted by employment shares

Survey question: *"Over the next 12 months, what percentage change is expected in your firm's wage/salary cost per person employed (including overtime and bonuses) and what is expected to occur over the next 12 months?"*

[redacted]

**Inflation expectations 2 years ahead, average probabilities in Survey of External Forecasters (SEF)**




Provisional data, Bank Confidential until 6th August

[redacted]

- Domestic financial conditions are as stimulatory as they have been since the crisis.

- Downside risk of self-fulfilling low inflation expectations has lessened, but not gone away yet.

# 4: Demand and Output

# Demand and Output

## August 2015

DSI, UK and UK forecast teams

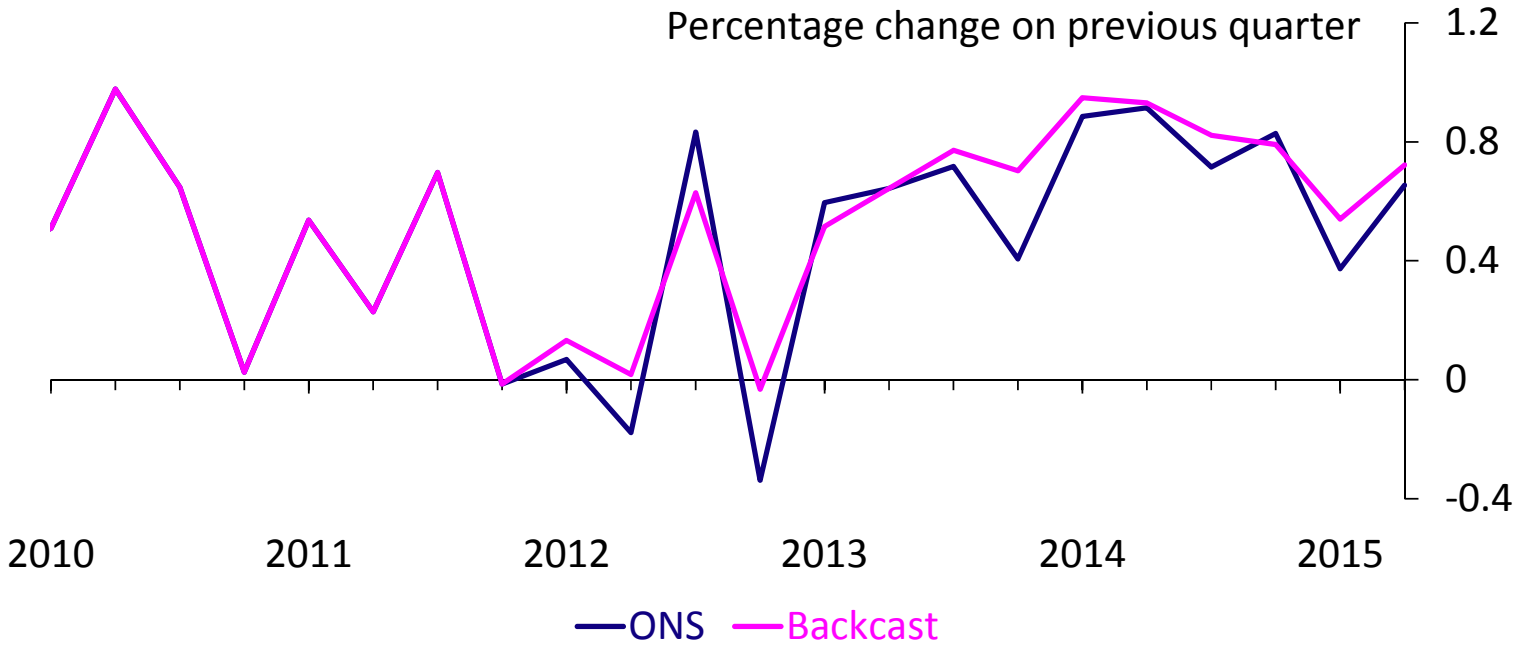
# Outline

**Are we right to expect steady growth for the rest of this year?**

**i. Updated near-term outlook**

**ii. Impact of sterling's appreciation**

# Real GDP growth

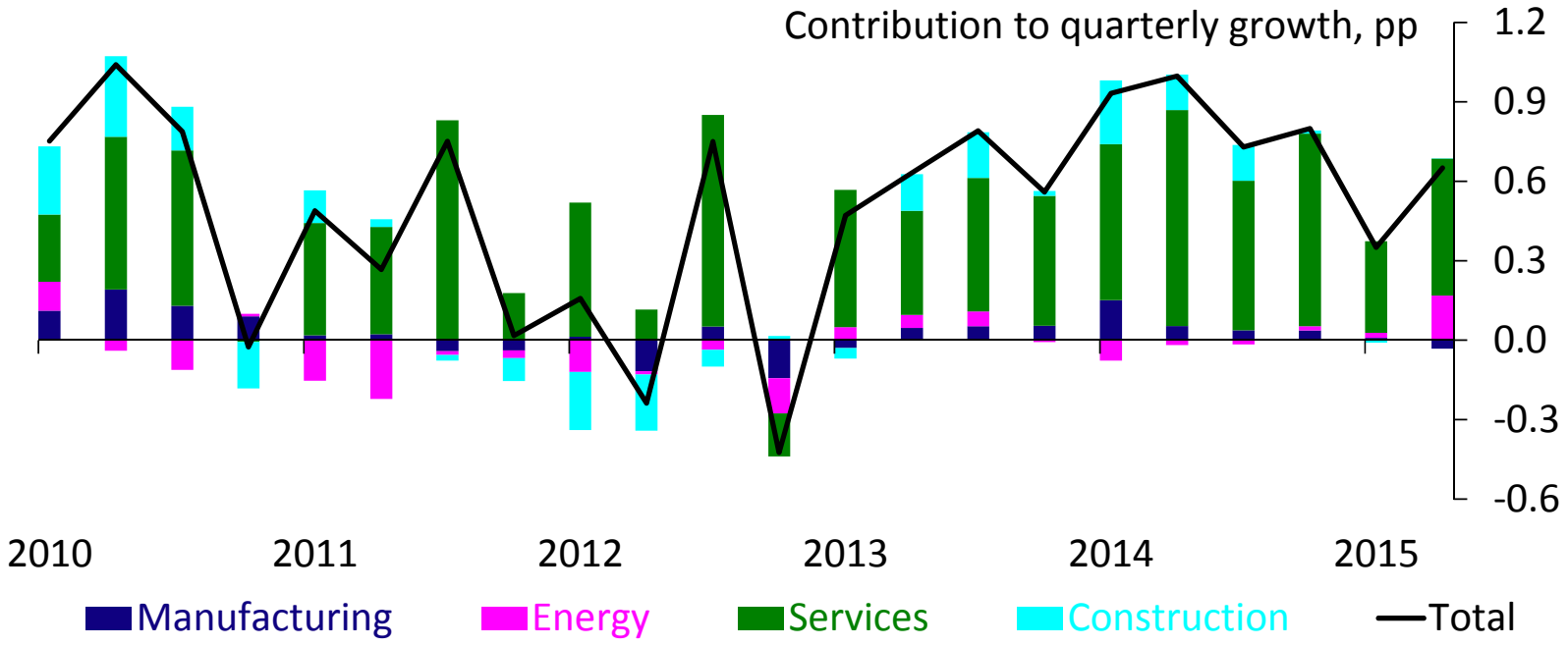



- Q2 GDP growth was 0.7%, 0.1pp higher than we had expected

# Explanations for Q1 weakness

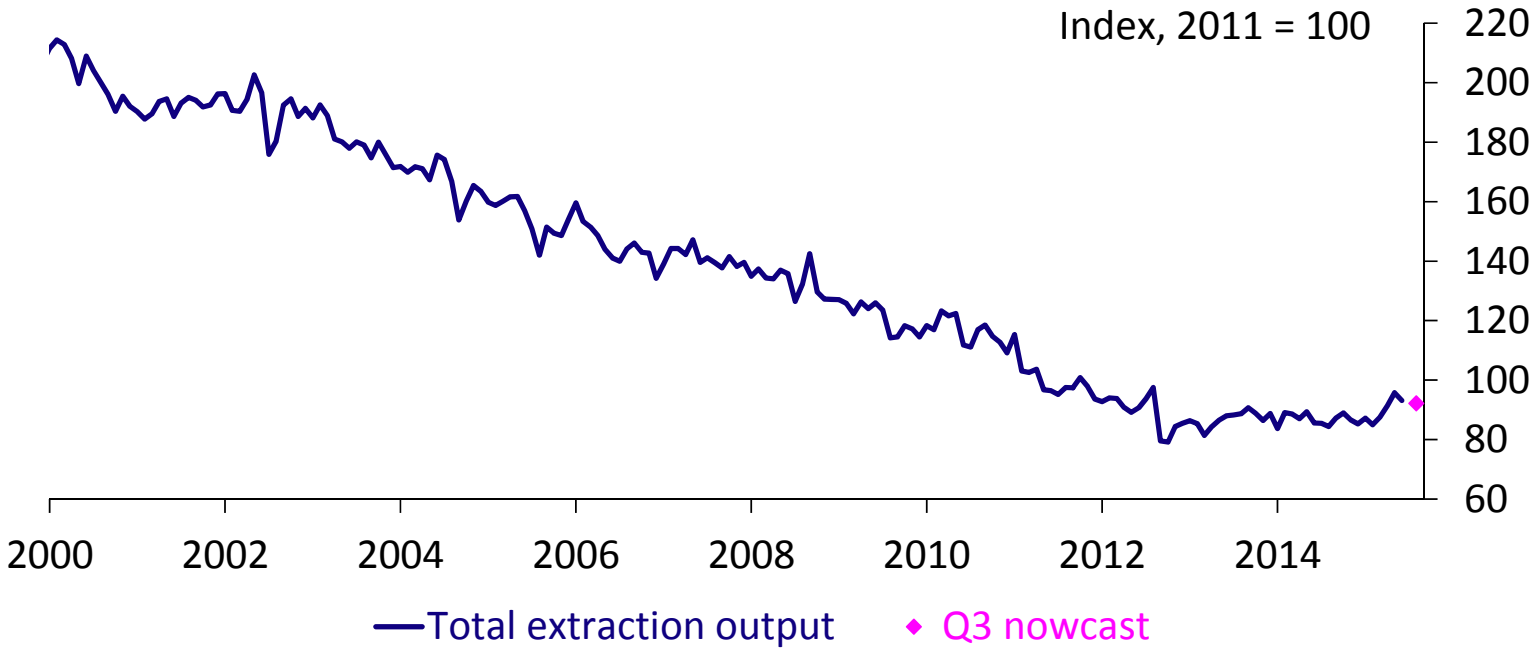
| Explanation | Assessment last quarter | Latest assessment |
|---|---|---|
| 1. It will be revised away | Q1 likely to be revised up to 0.5% | Already been revised up 0.1pp, further 0.1pp still expected |
| 2. Data volatility | Could easily account for 0.1pp | Assessment unchanged |
| 3. Temporary weakness | Little evidence (unlike in US) | Assessment unchanged |
| 4. Persistent weakness | Little evidence, but an important risk | Still a possibility |

# Contributions to quarterly GDP growth



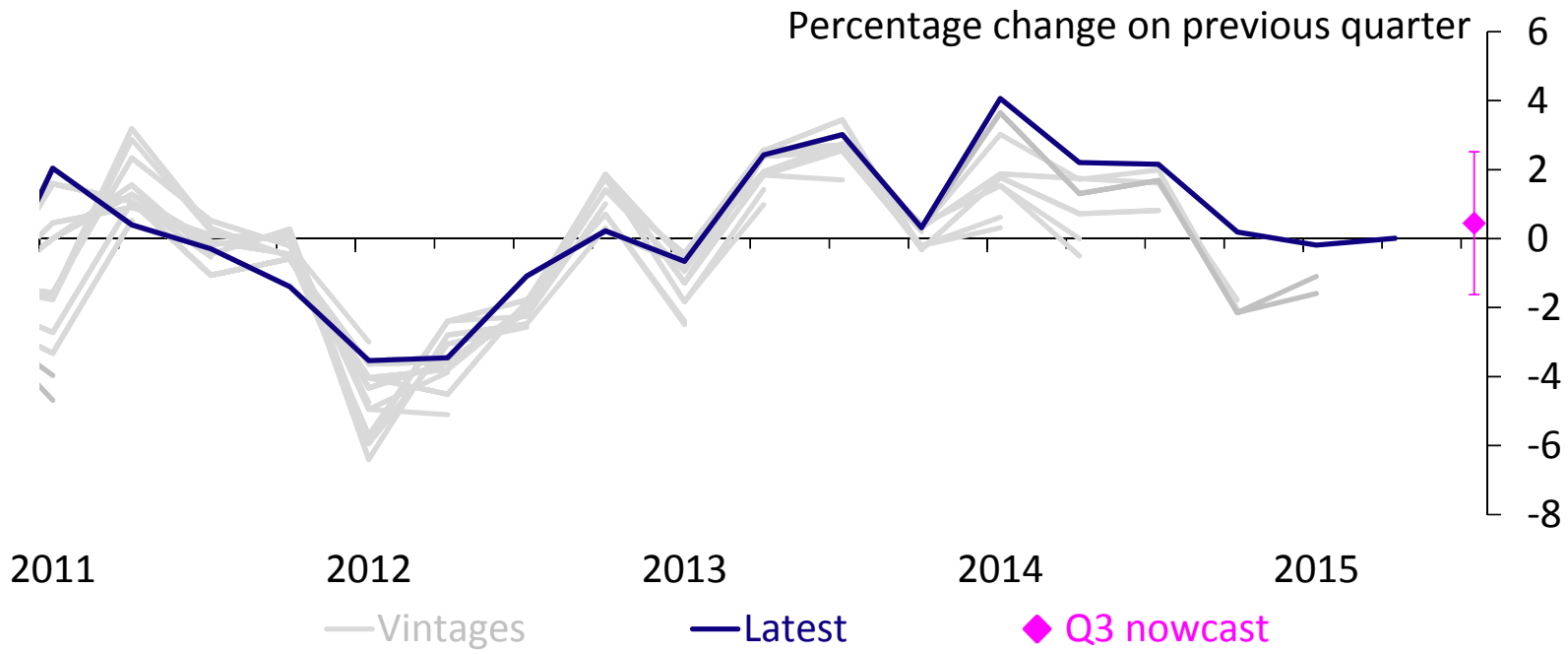

- Energy accounted for +0.2pp of quarterly growth, much stronger than usual

# Extraction output




- Intelligence from DECC suggests a small fall in extraction output in Q3

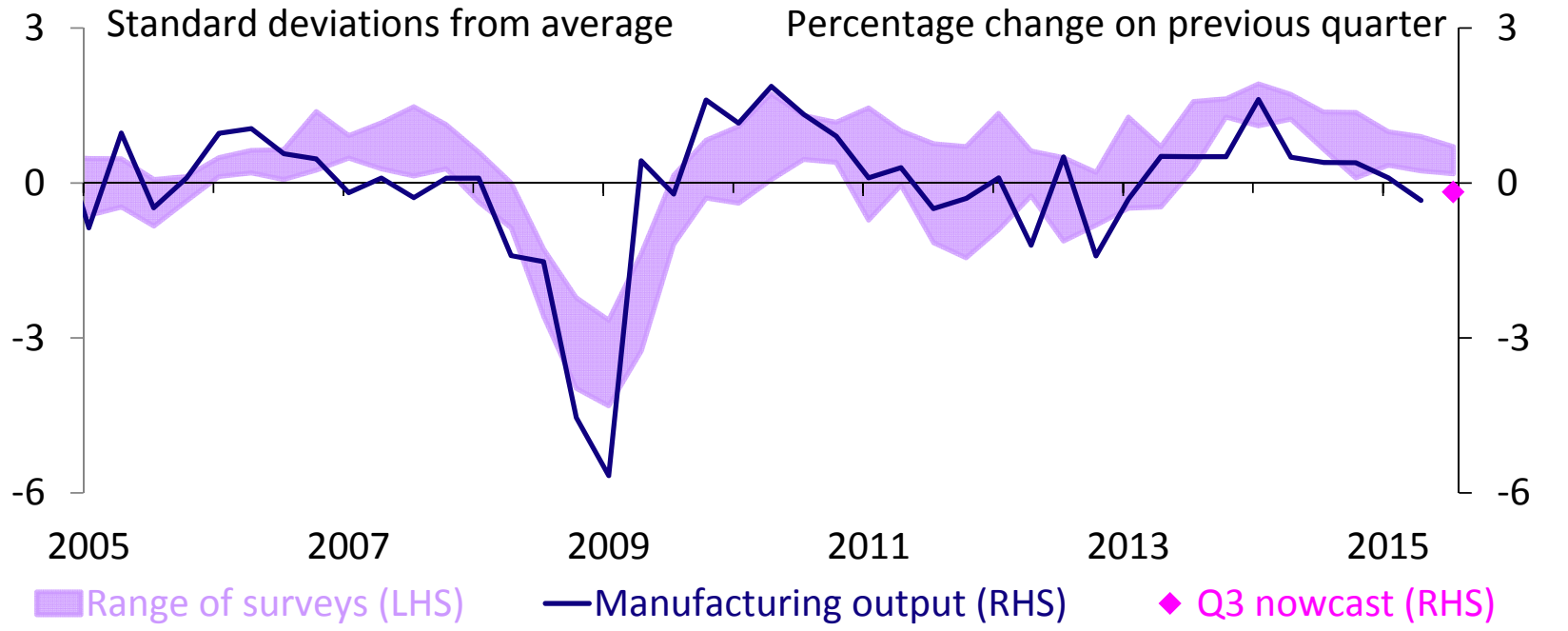
# Construction output




NB error band represents RMSE for out of sample pseudo real-time nowcasts on latest data

- Construction growth has fallen back; we expect 0.4% growth in Q3

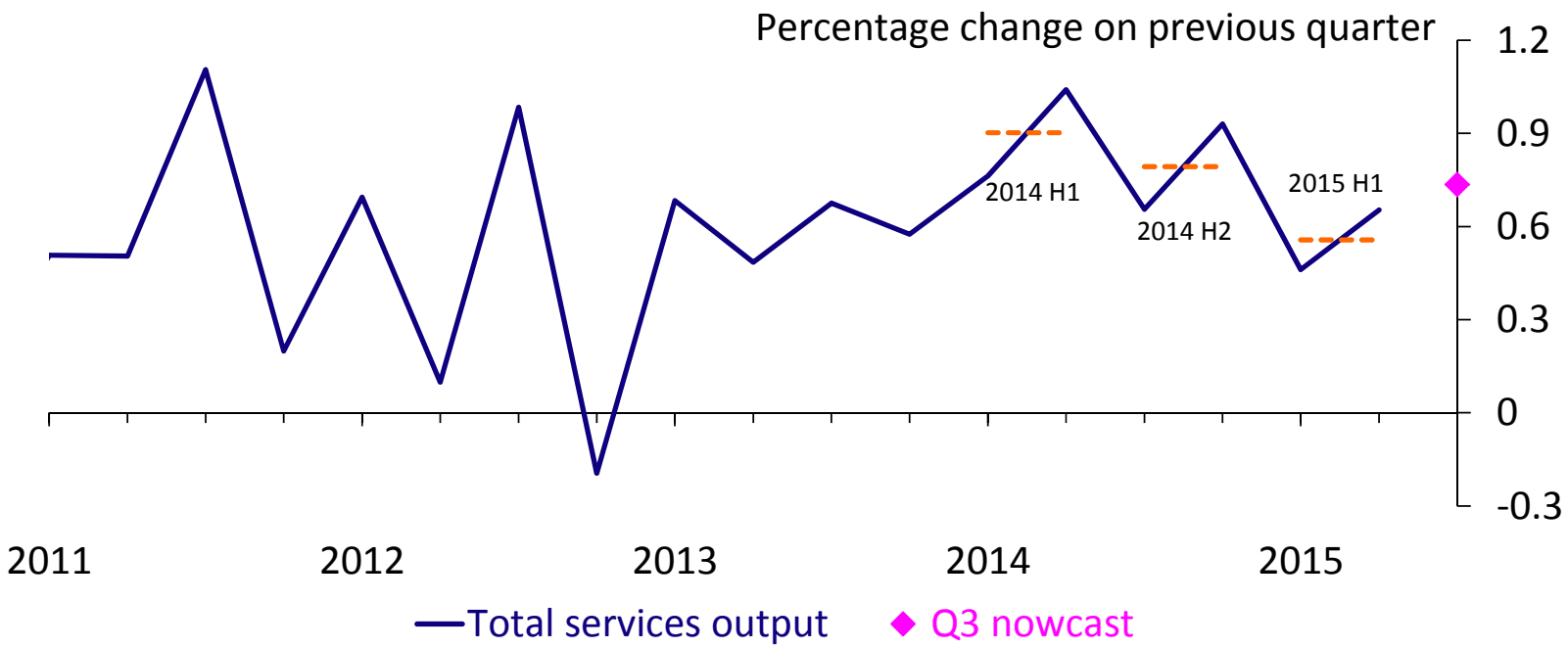
# Manufacturing output




NB swathe contains manufacturing output and expectations series from Markit/CIPS, CBI and BCC surveys

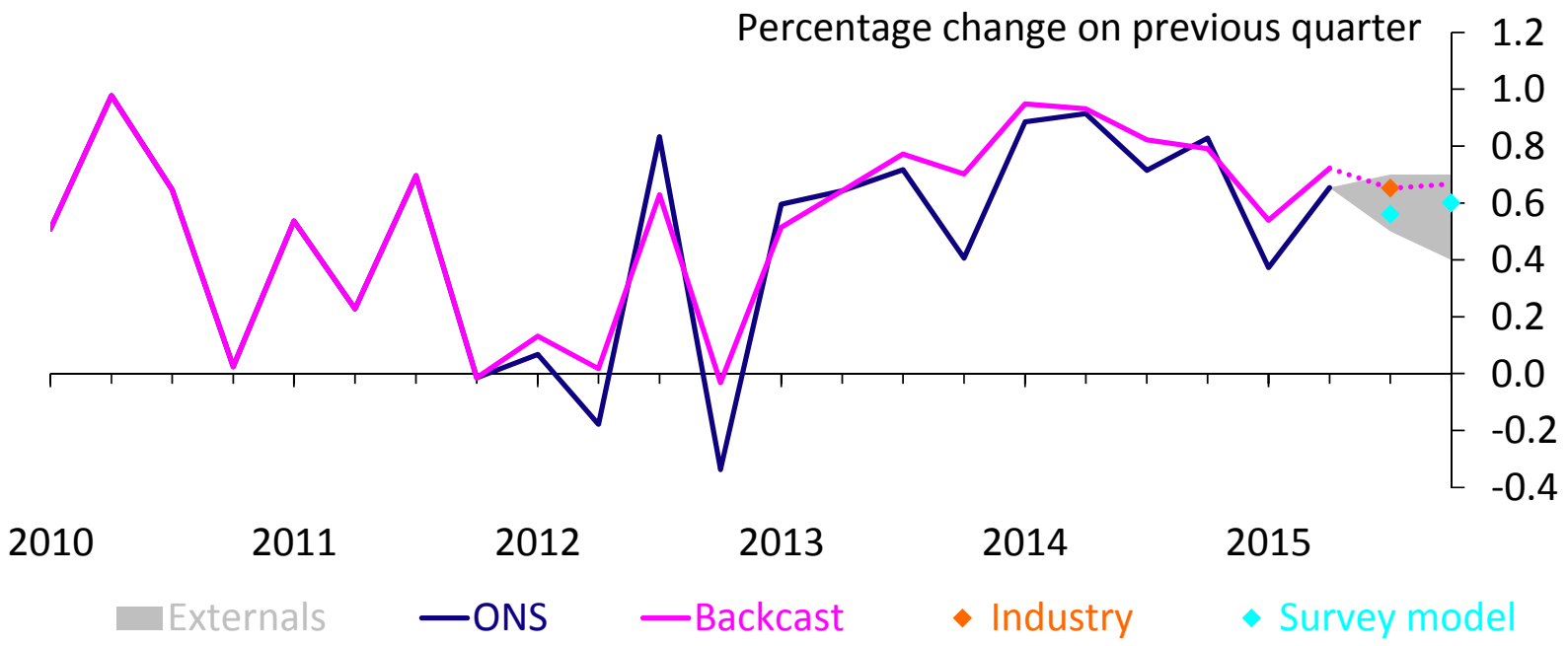
- Manufacturing was weak, broadly in line with the surveys

# Services output




- Industry model suggests a pickup in services growth in Q3

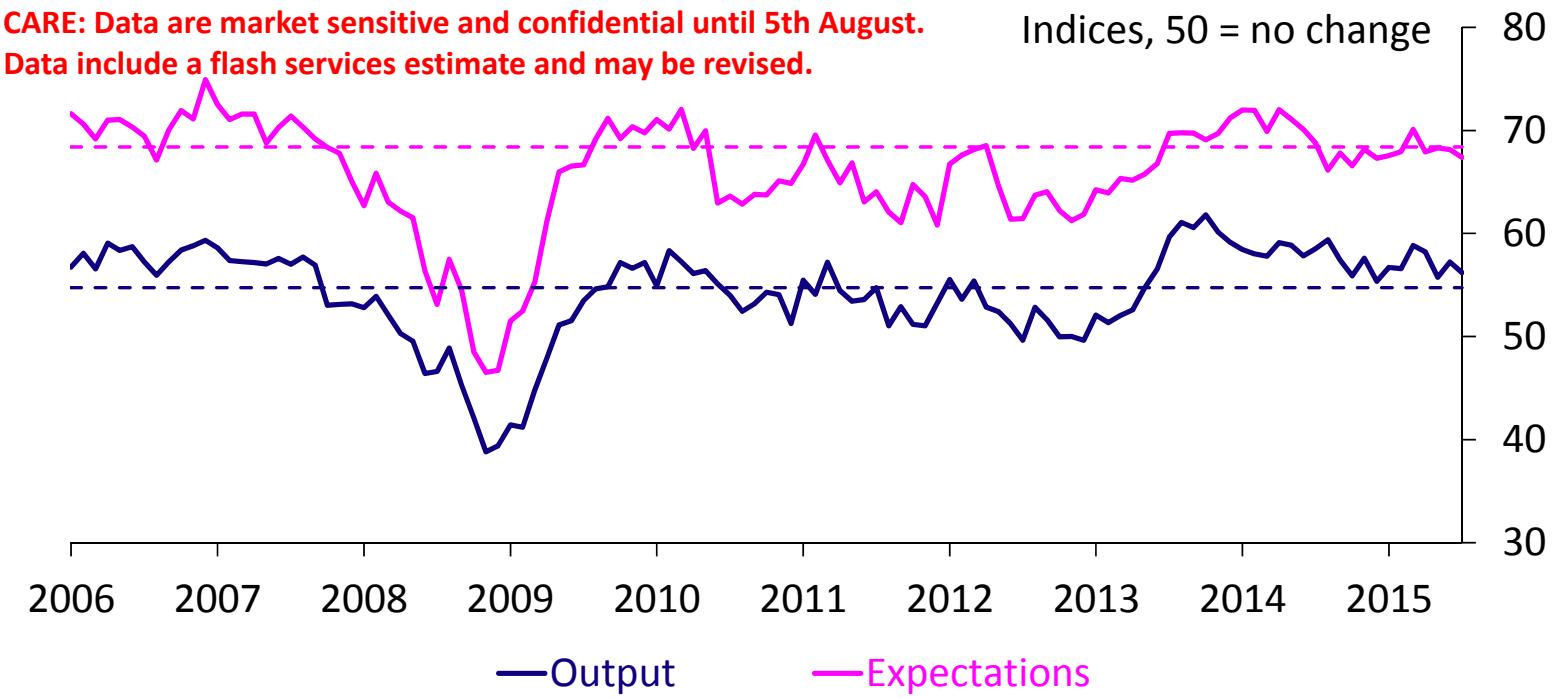
# A15 *Draft* forecast




- Industry model suggests 0.7% in Q3, Survey model 0.6%, externals range from 0.5-0.7%

# Markit/CIPS output and expectations composite

**CARE: Data are market sensitive and confidential until 5th August.**
**Data include a flash services estimate and may be revised.**

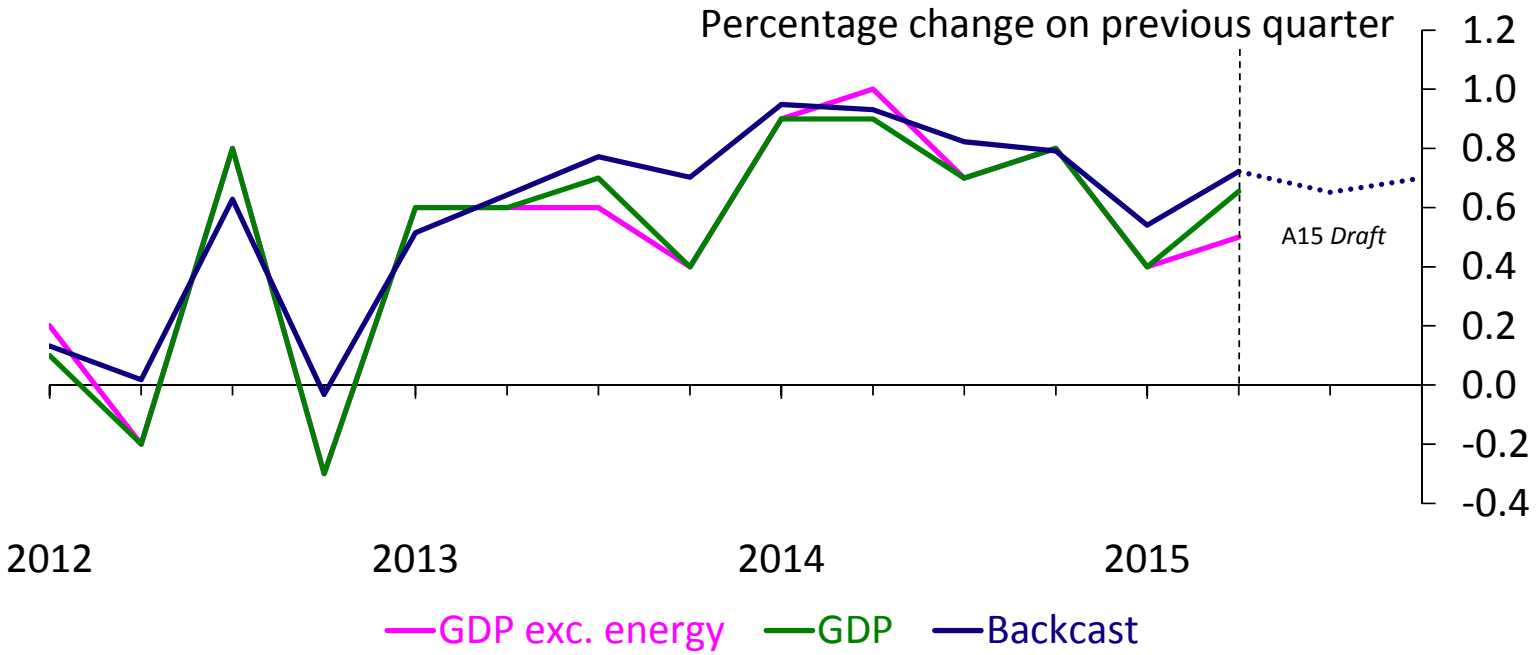



- Both the flash output and expectations composites fell a little in July

## Message from contacts on confidence effects from Greece/China

- The Agents, CBI & BCC report no direct impact so far on businesses from confidence/uncertainty:
  - Little impact noticed on consumer demand
  - Little evidence of adjusted investment plans
- Concerns remain about impact via trade channels

# GDP and GDP exc. energy




- We expect growth of 0.7% in Q3 and Q4, although weakness of GDP ex energy in Q2 is worrying

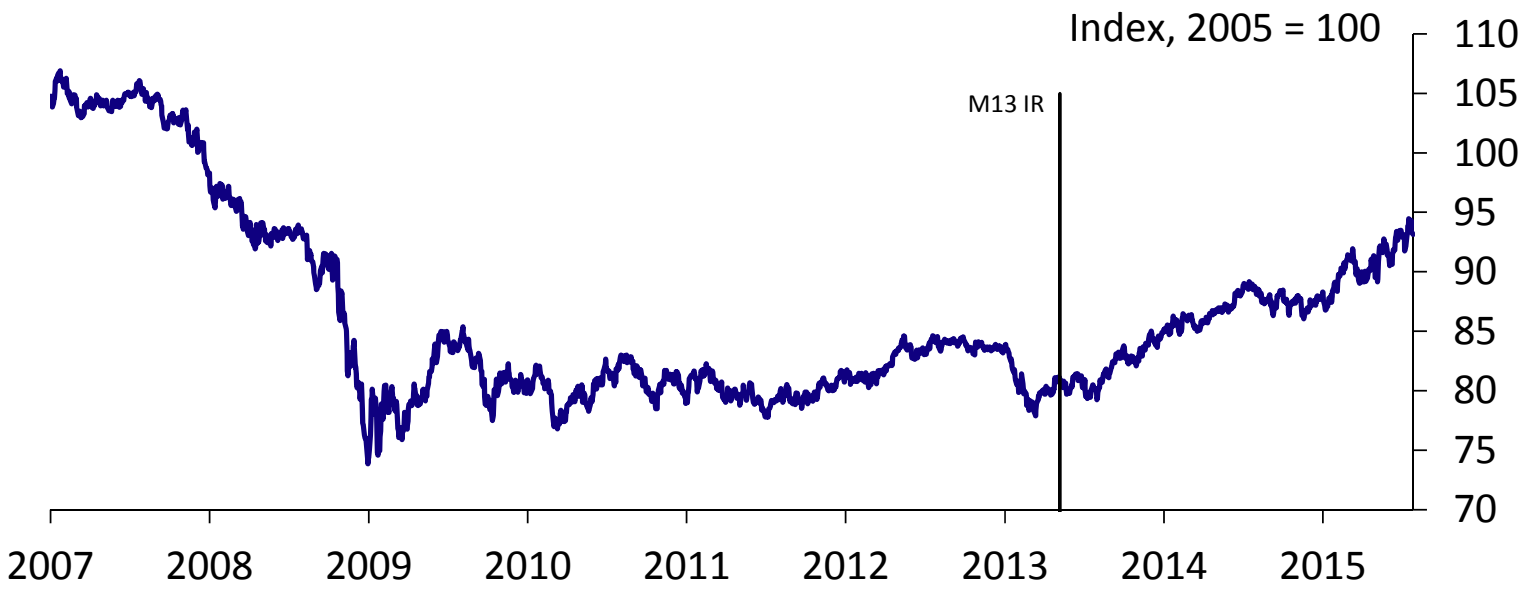
# Outline

Are we right to expect steady growth for the rest of this year?

i. Updated near-term outlook

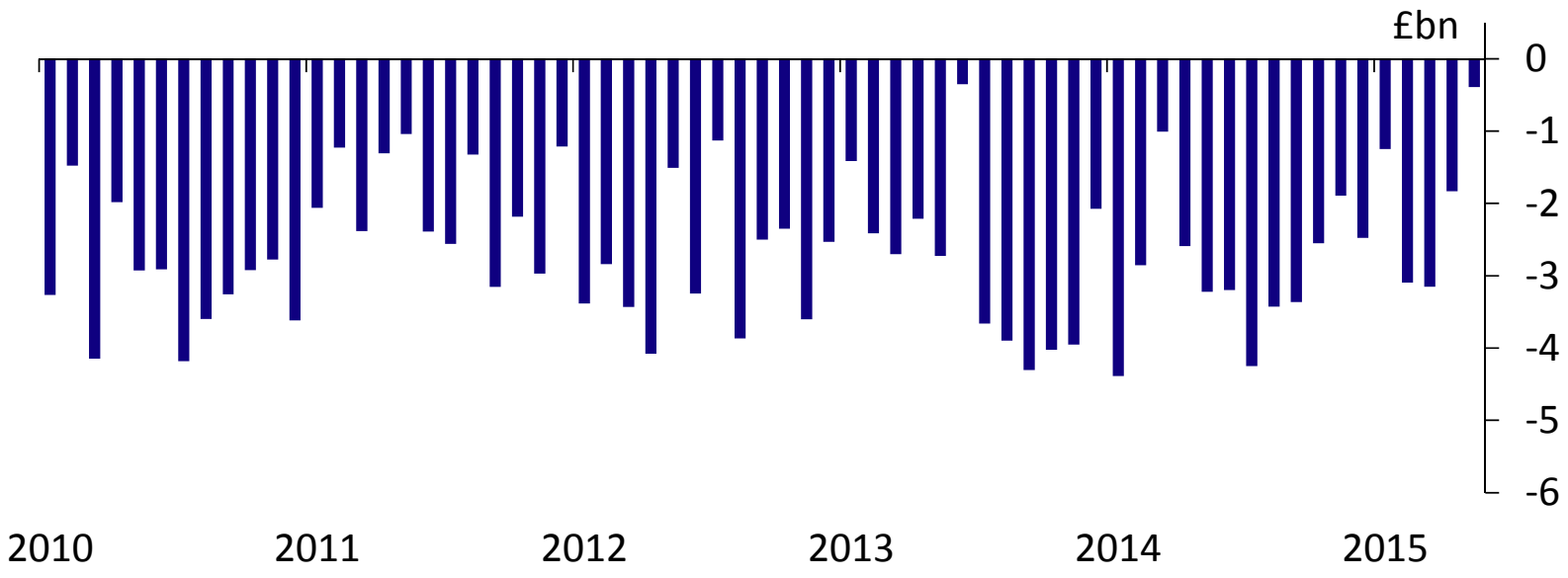
ii. **Impact of sterling's appreciation**

# Sterling ERI



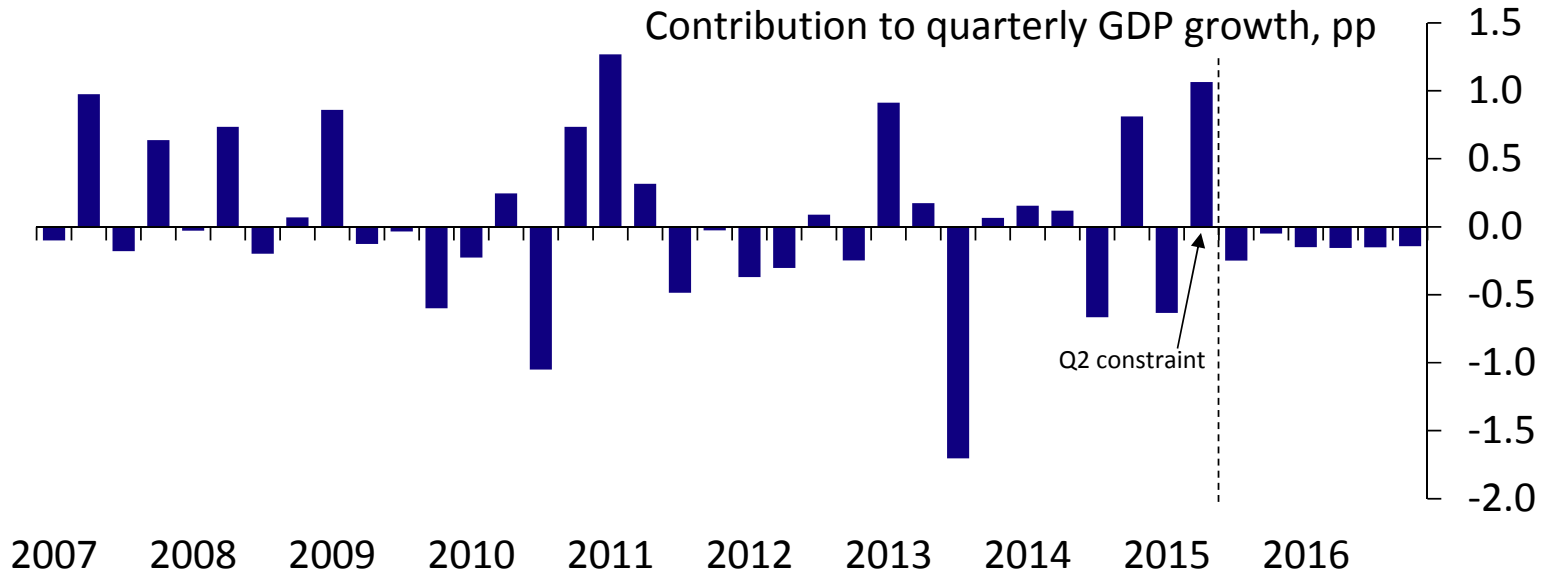

- Sterling has appreciated by 5% since August 2014 and by 16% since May 2013

# Monthly nominal trade balance



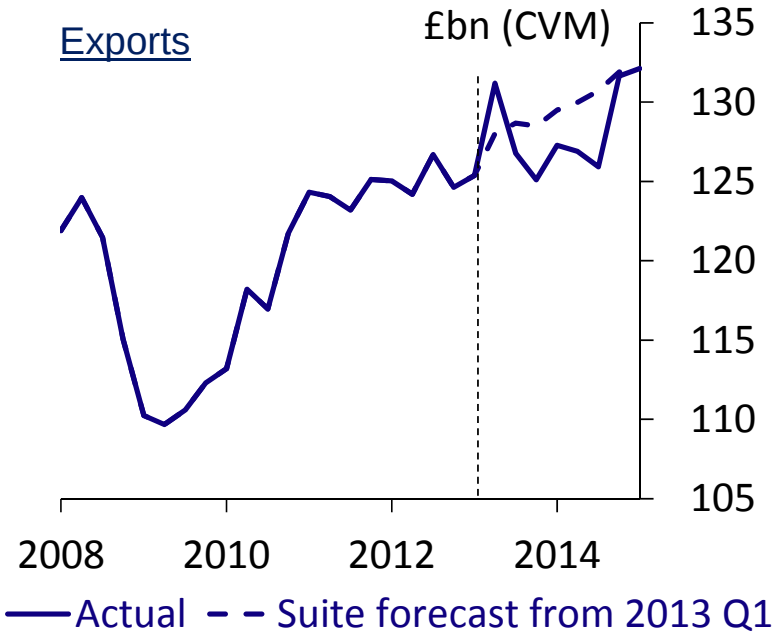

- The monthly deficit in May was £0.4bn. But monthly trade data are volatile and prone to revision

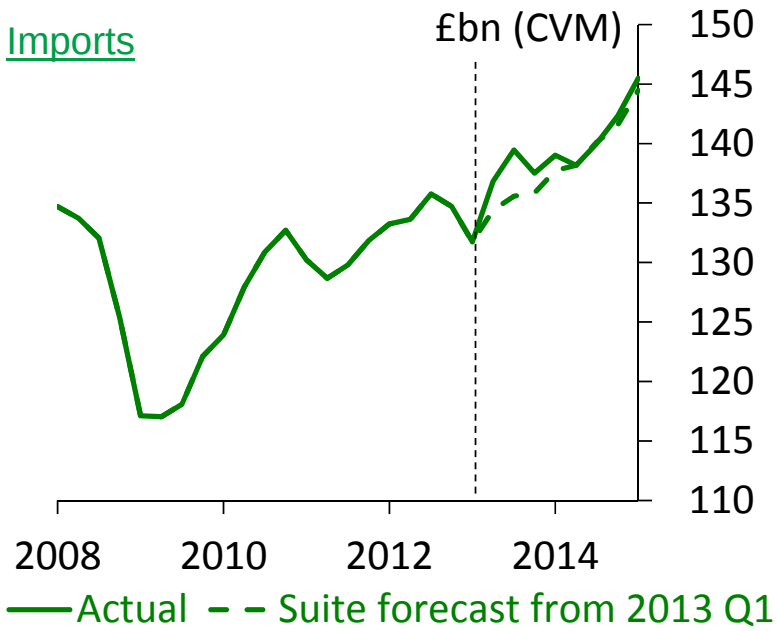
# Contribution of net trade to quarterly GDP growth




- The average net trade contribution to quarterly real GDP growth since 2013 Q1 has been -0.1pp

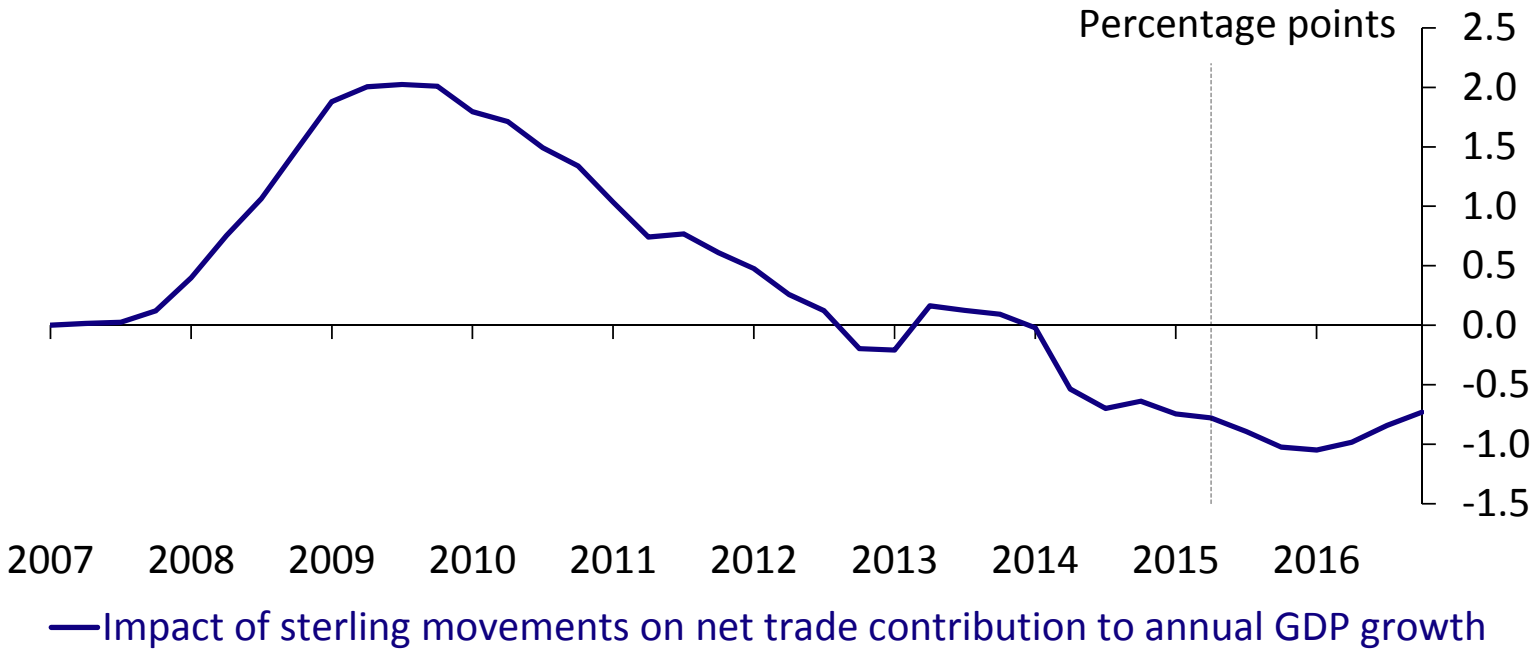
# Suite forecasts of exports and imports



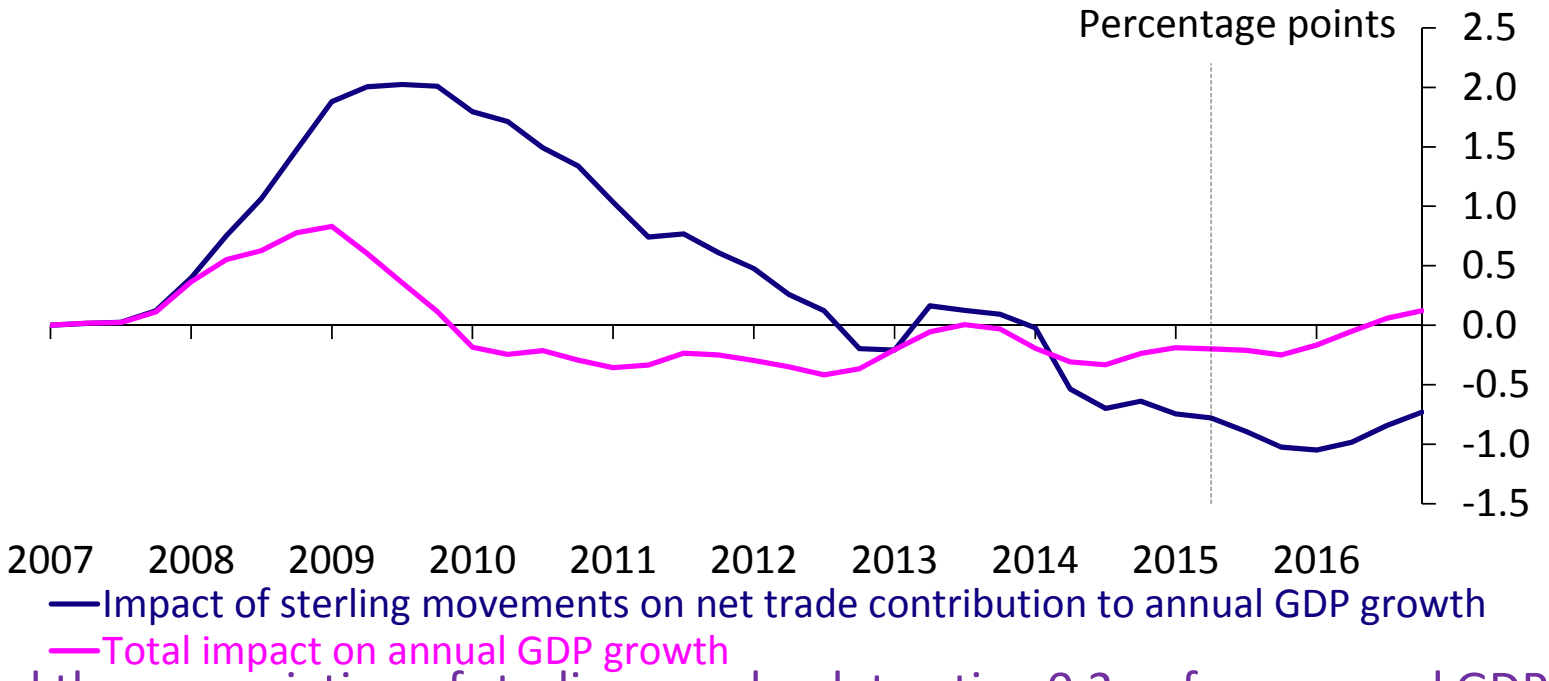

- The levels of exports and imports are in line with the forecasts from our suite equations run from 2013 Q1

# Estimated impact of exchange rate on net trade




- The appreciation of sterling could be pulling down the net trade contribution to annual GDP growth by 0.8pp

# Estimated impact of exchange rate on GDP




- And the appreciation of sterling may be detracting 0.2pp from annual GDP growth, which was 2.6% in Q2

## Key messages

- The *Draft* forecast incorporates steady growth of 0.7% in 2015 H2
- Risks slightly to the downside
- Past appreciation of the exchange rate likely to drag on annual growth in 2015 by around 0.2pp

# END

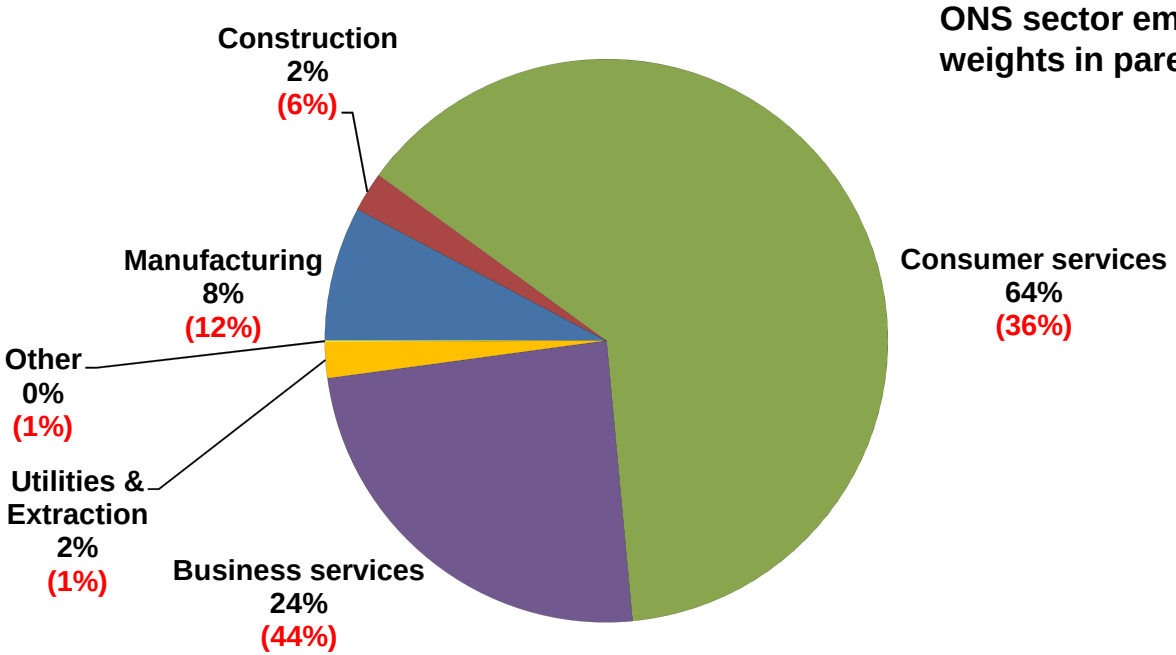
# 5: Agents' Special Topic

# Agents' Investment Survey

**29 July 2015**

Agency for the South East & East Anglia
**Inflation Report & Agency Intelligence Division**

# Responses weighted by employment



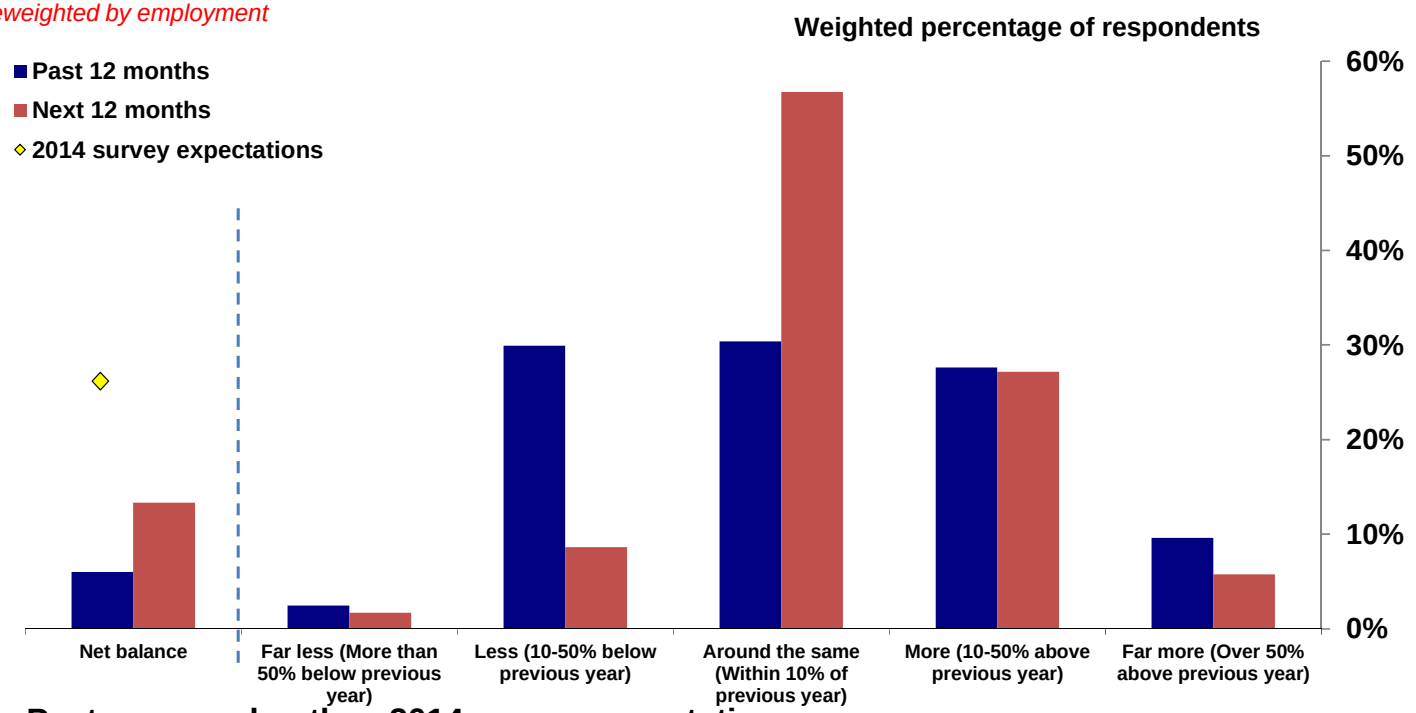

See also background note by

# Survey questions

- **Q1: Annual change in UK capital expenditure over the past 12 months, and expectations over the next 12 months.**
- **Q2: Expected change in UK investment spend over next 12 months.**
- **Q3: Factors affecting UK investment plans over next 12 months.**
- **Q4: Expected change in spending on M&A activity.**
- **Q5: Primary source of investment finance over next 12 months.**

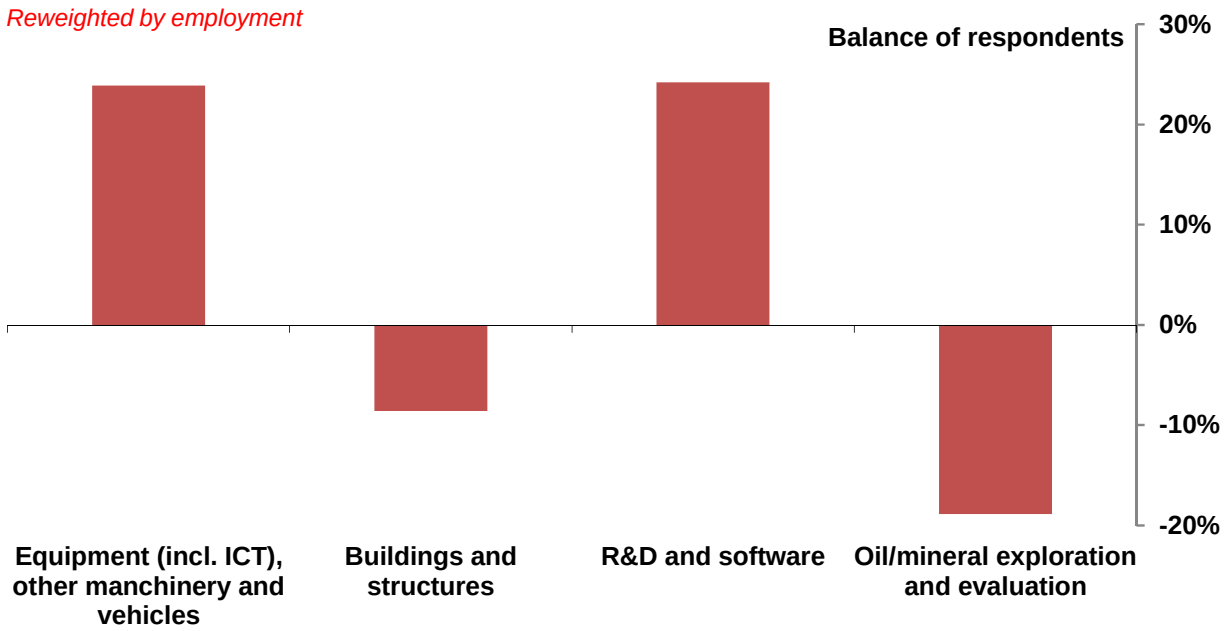
# UK Investment history and intentions

*Reweighted by employment*




- **Past year weaker than 2014 survey expectations**
- **Net balance increases for the next 12 months**

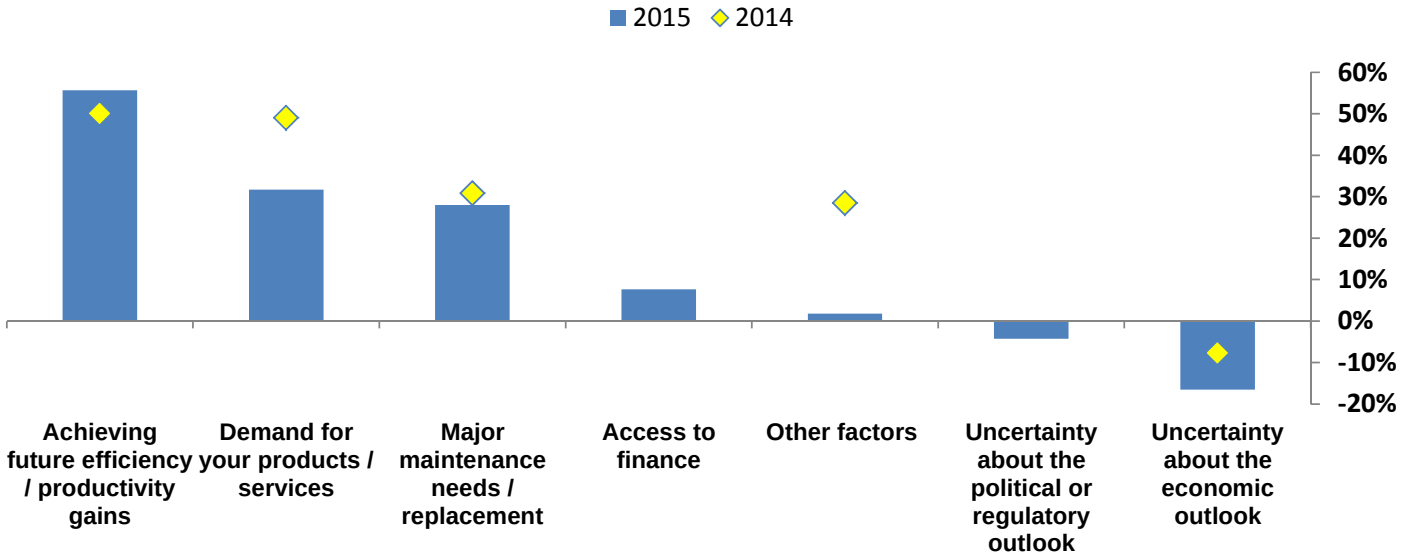
# Investment spending: next 12 months




- **Low oil prices impacting investment in O&G and mineral extraction;**
- **Building and structures investment dragged down by consumer services.**

# Investment drivers: next 12 months

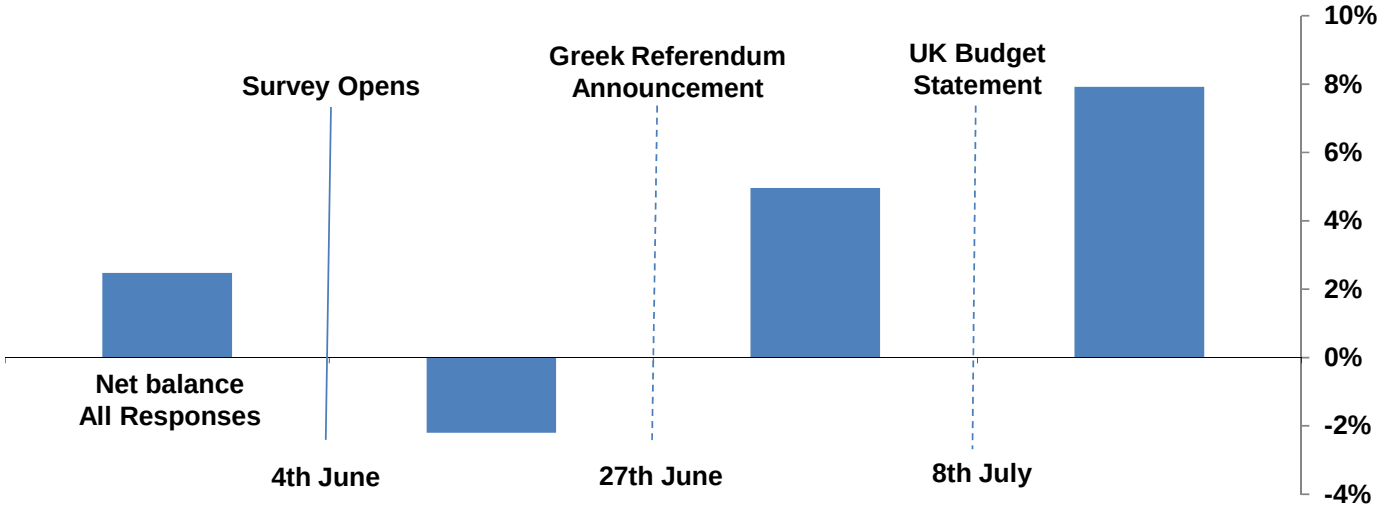
*Reweighted by employment*




**The main three positive factors are broadly similar to last year's survey; Uncertainty about the economic and political outlook act as a drag.**

# Investment driver: economic uncertainty

*Unweighted*

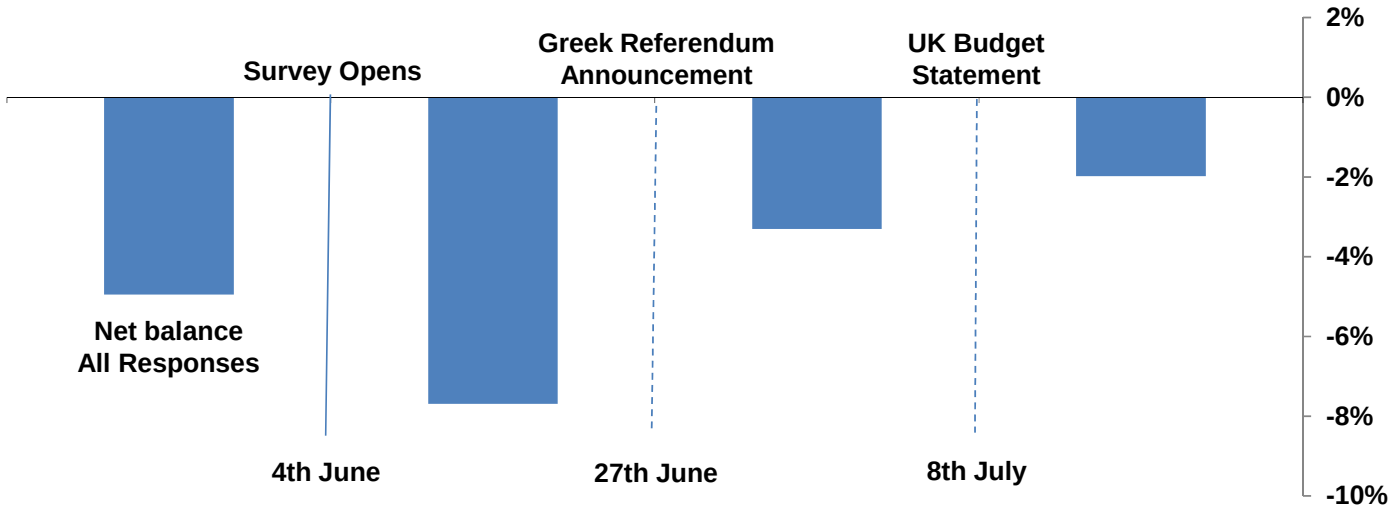



**Less economic uncertainty is evident through the survey period.**

**NB A negative balance acts as a drag on investment intentions**

# Investment driver: political outlook

*Unweighted*

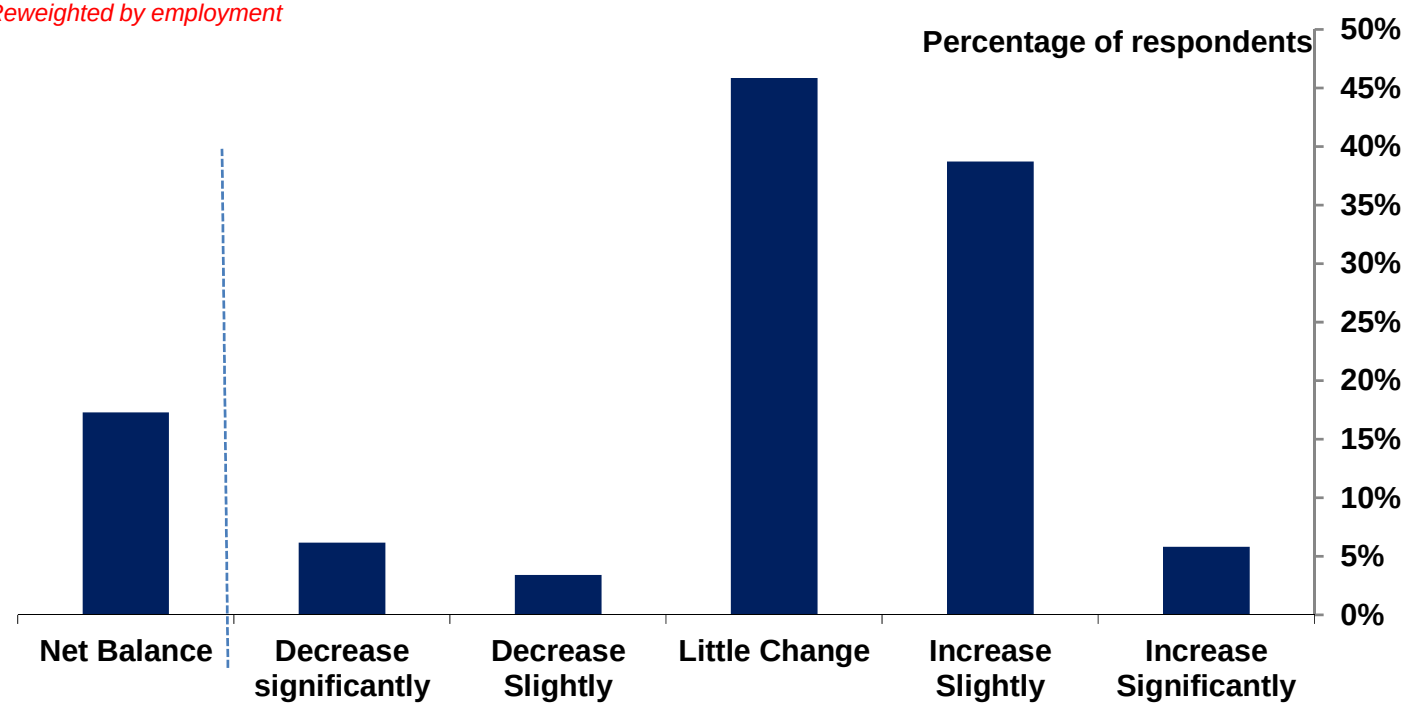



**Uncertainty acts as a continuous drag, but less so through the survey period.**

**NB A negative balance acts as a drag on investment intentions**

# Expected change in M&A spending

*Reweighted by employment*

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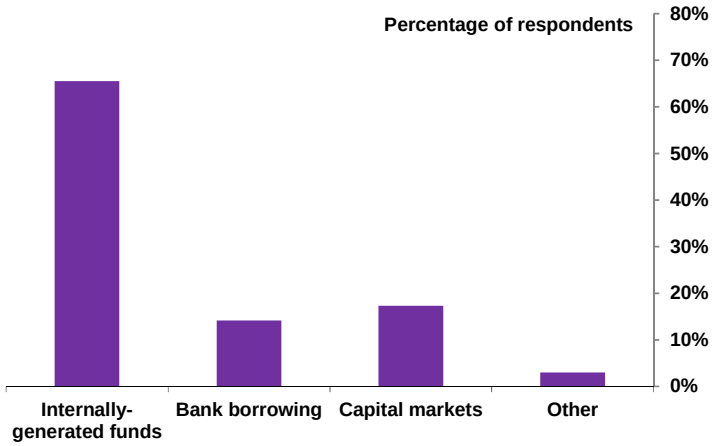
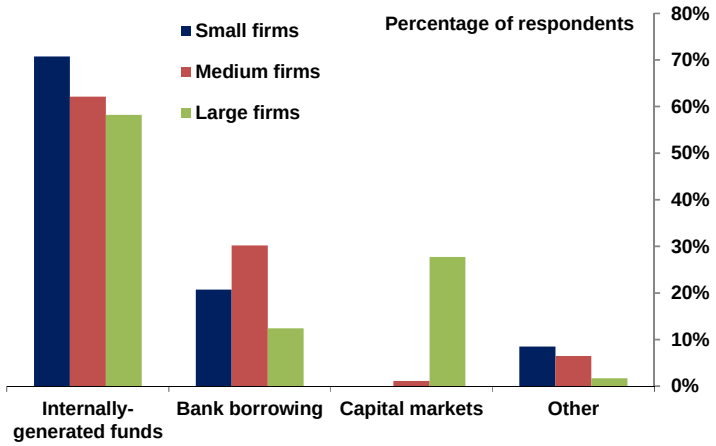
# Primary source of investment finance

*Reweighted by employment*




**Internally generated funds are the primary source of funding across all sizes of business.**

# Summary

- Contacts expect to increase their investment spending;
- Primary drivers are similar to last year;
- Economic climate is cited as a possible drag, but…
- Timing of the responses may have conditioned outturns;
- Firms expect to increase M&A activity in the next year;
- Firms show a preference to use internal finance to fund investment.

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# END

# 6: Costs and Prices

# Costs & Prices

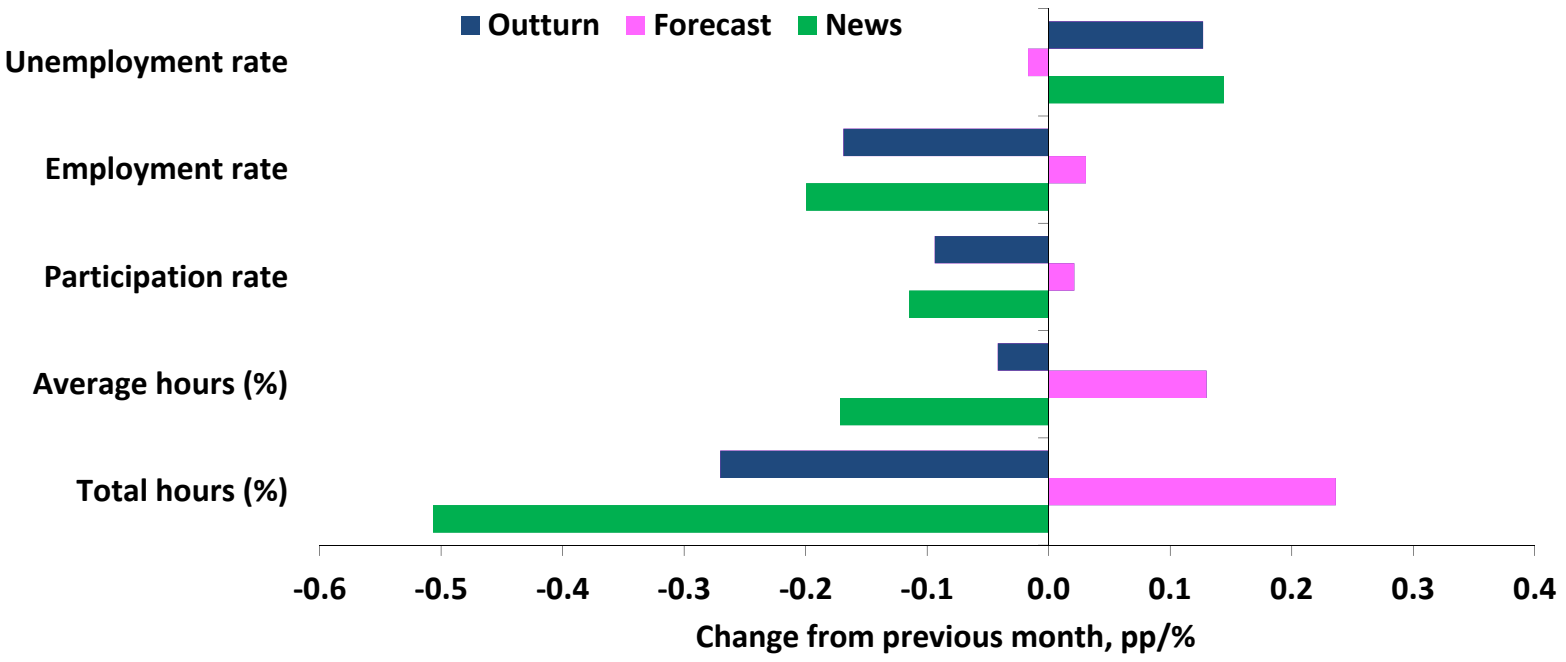
29 July 2015

Structural Economic Analysis Division

# Key questions

- **How confident should we be that inflation will pick up to 2% in a couple of years' time?**
  - **Interpreting the weak employment data**
  - **Signal from core inflation**

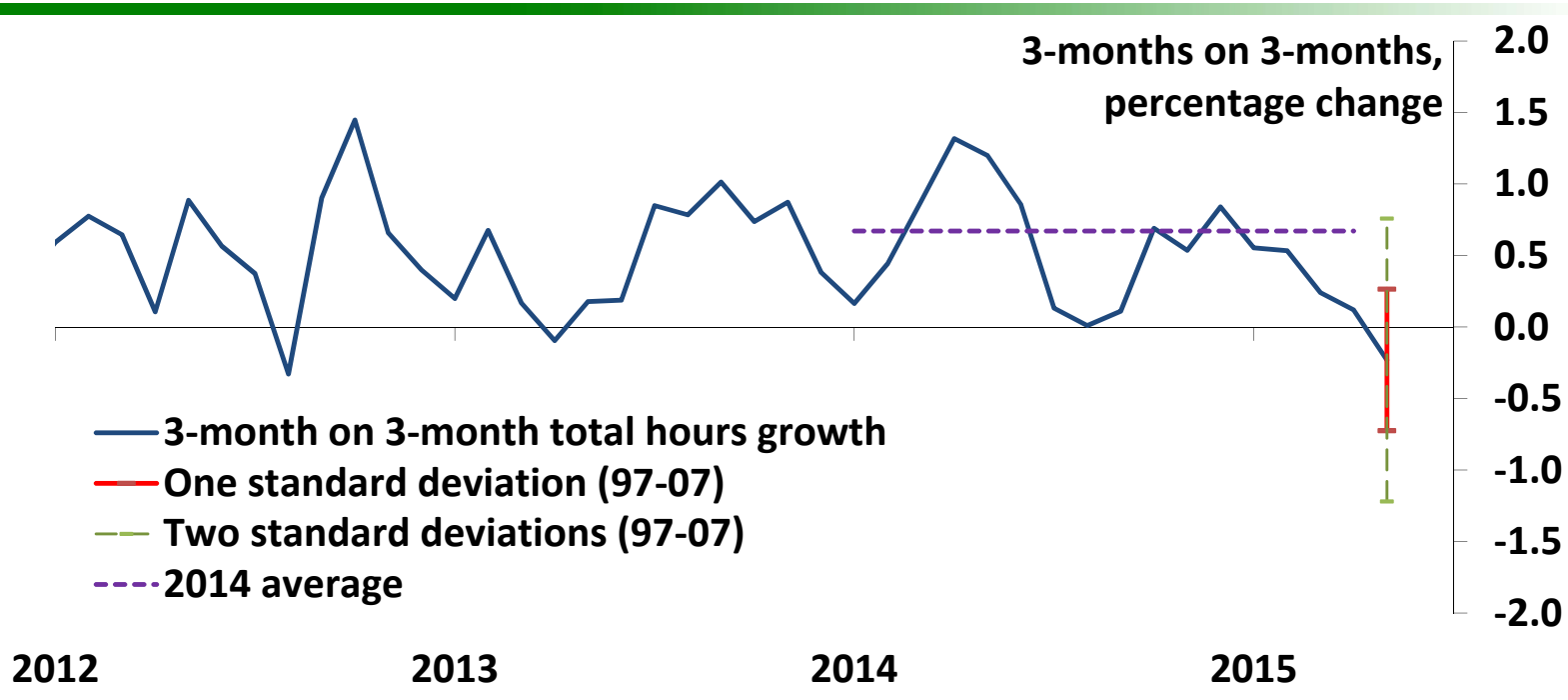
# News in labour market quantities



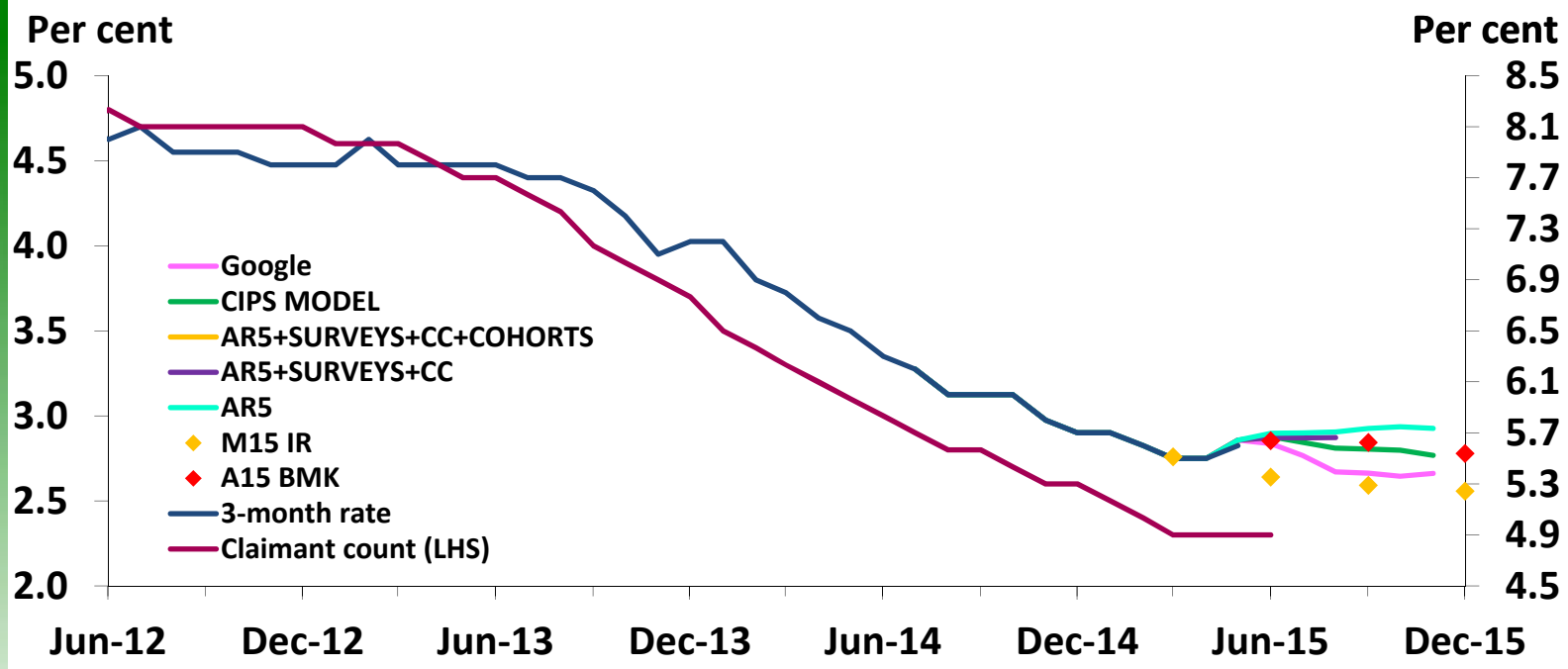
# News in total hours worked in 2015Q2

| | May IR | Aug Benchmark | Difference | Impact on total hours |
|---|---|---|---|---|
| **Unemployment rate** | 5.4% | 5.6% | +0.2pp | -0.3% |
| **Participation rate** | 63.5% | 63.3% | -0.2pp | -0.3% |
| **Average hours** | 32.3 | 32.2 | -0.1 | -0.3% |
| **Total hours** | 1010mn | 1002mn | -0.9% | -0.9% |

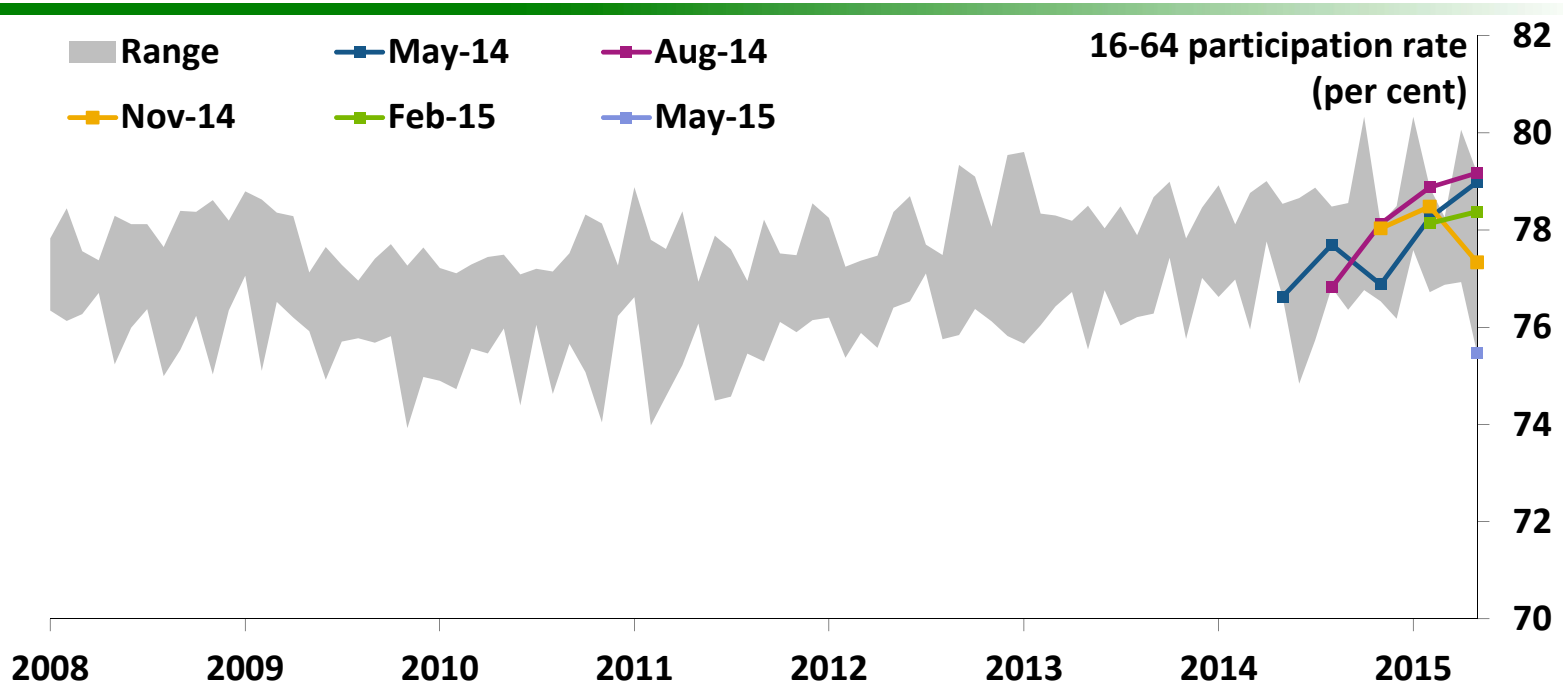
# Total hours growth



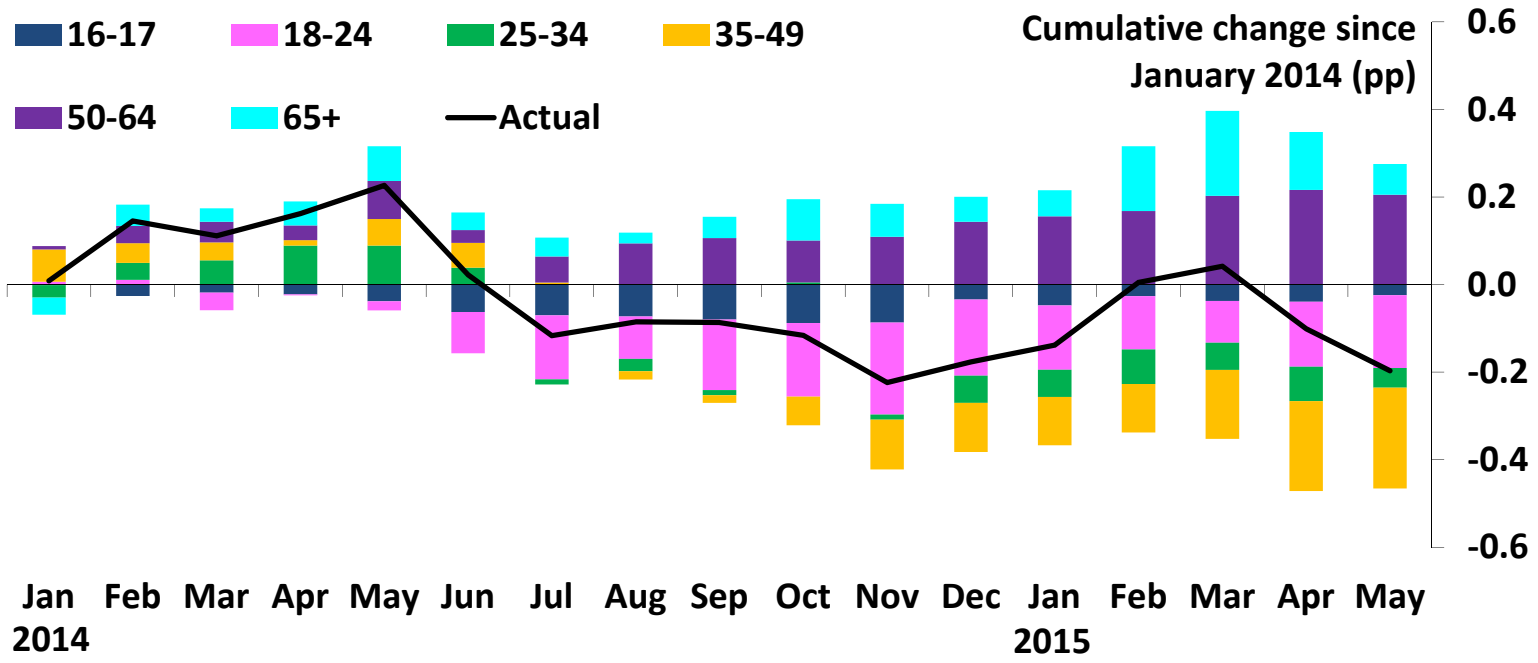
# Short-term unemployment forecast



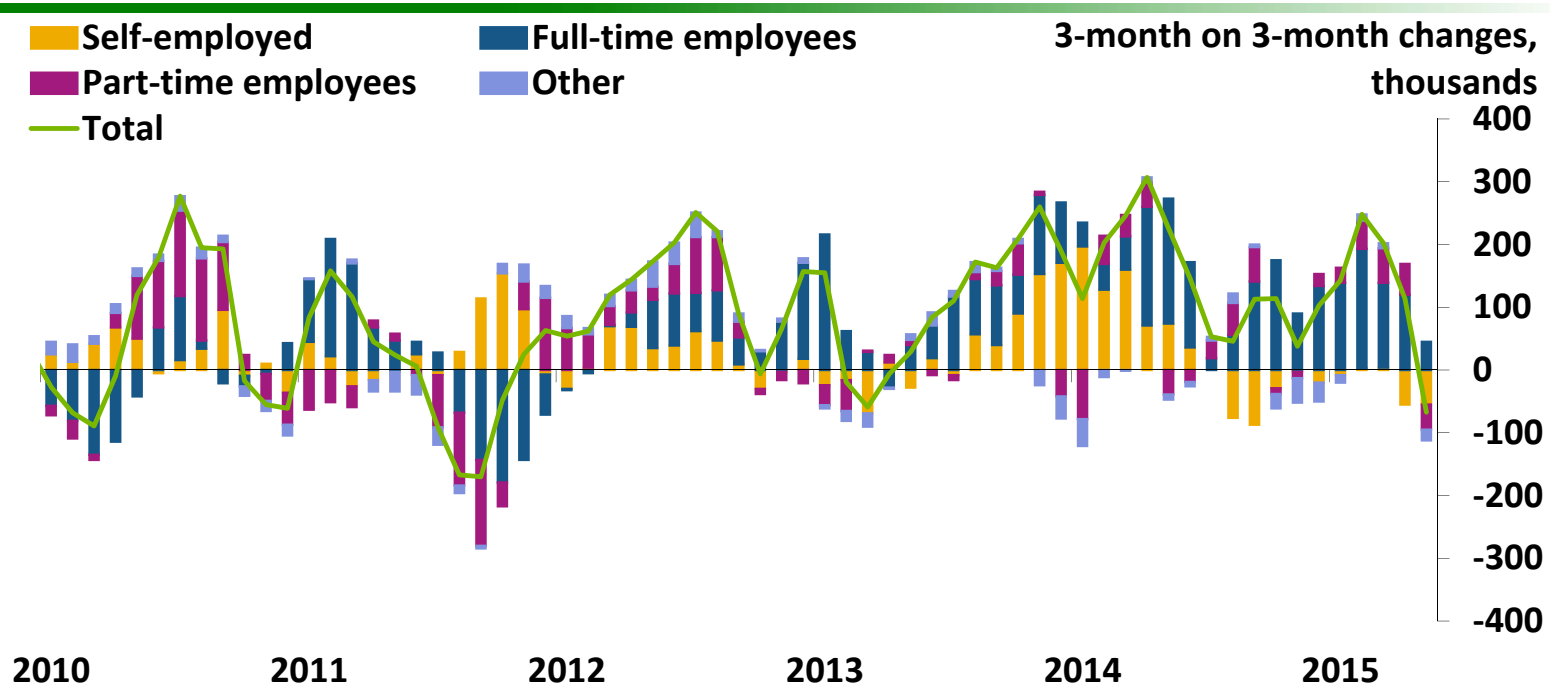
# Cohort participation rates (16-64)



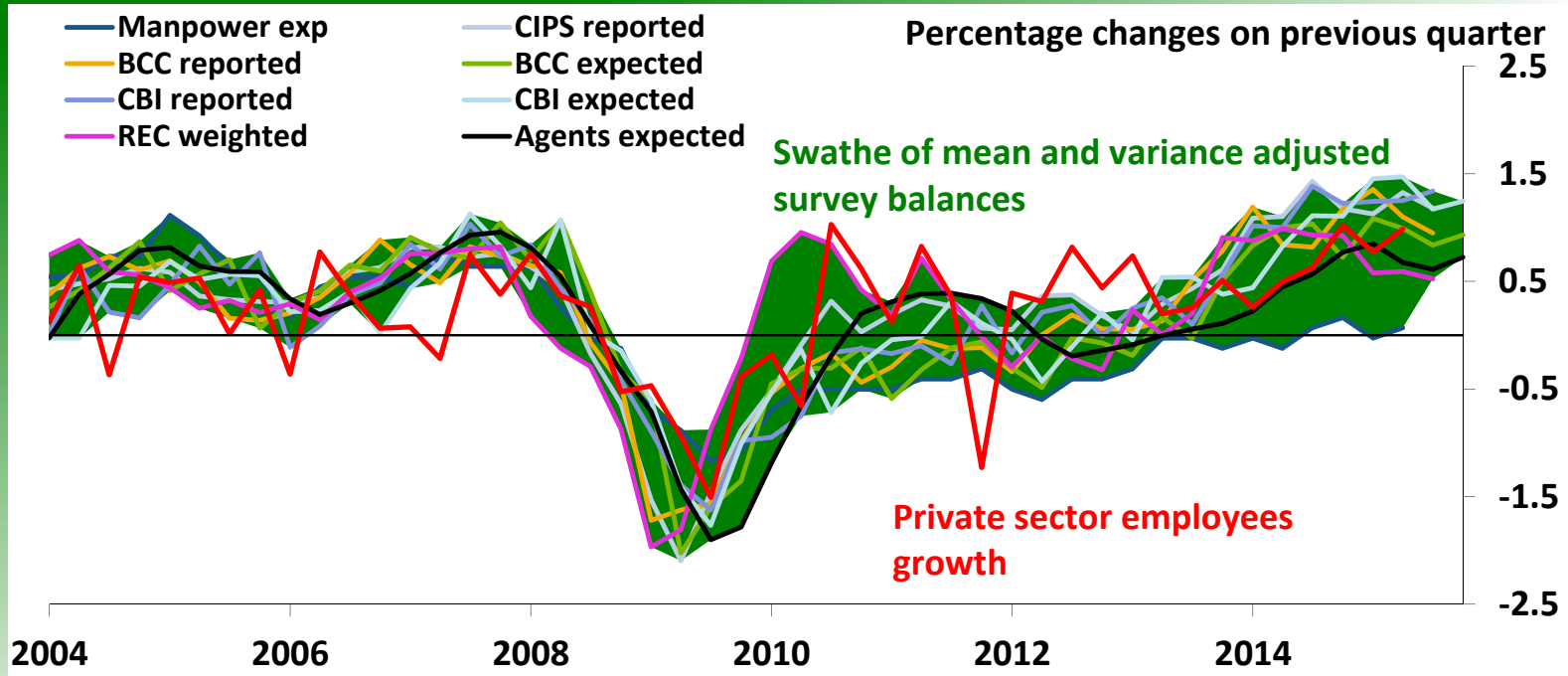
# Participation rate decomposed by age



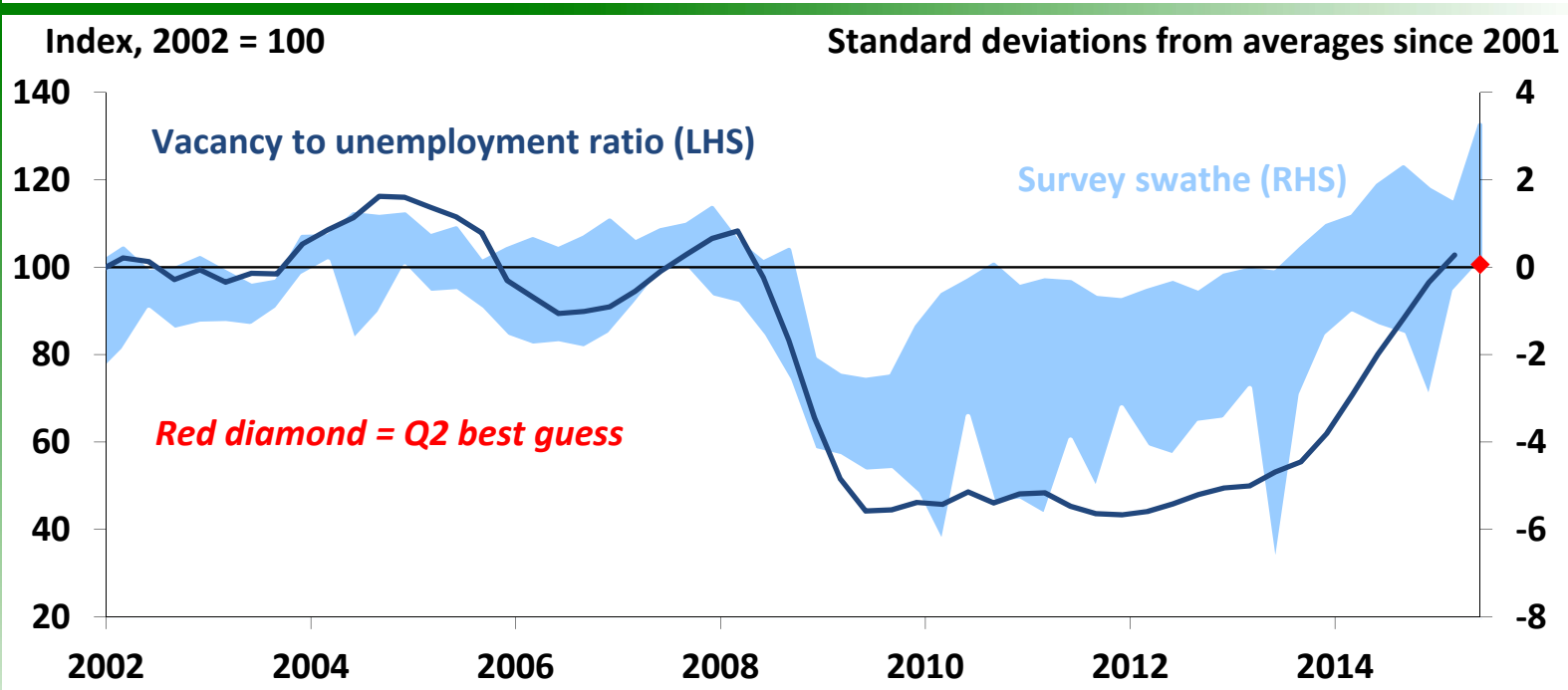
# Employment decomposition



# Employment swathe



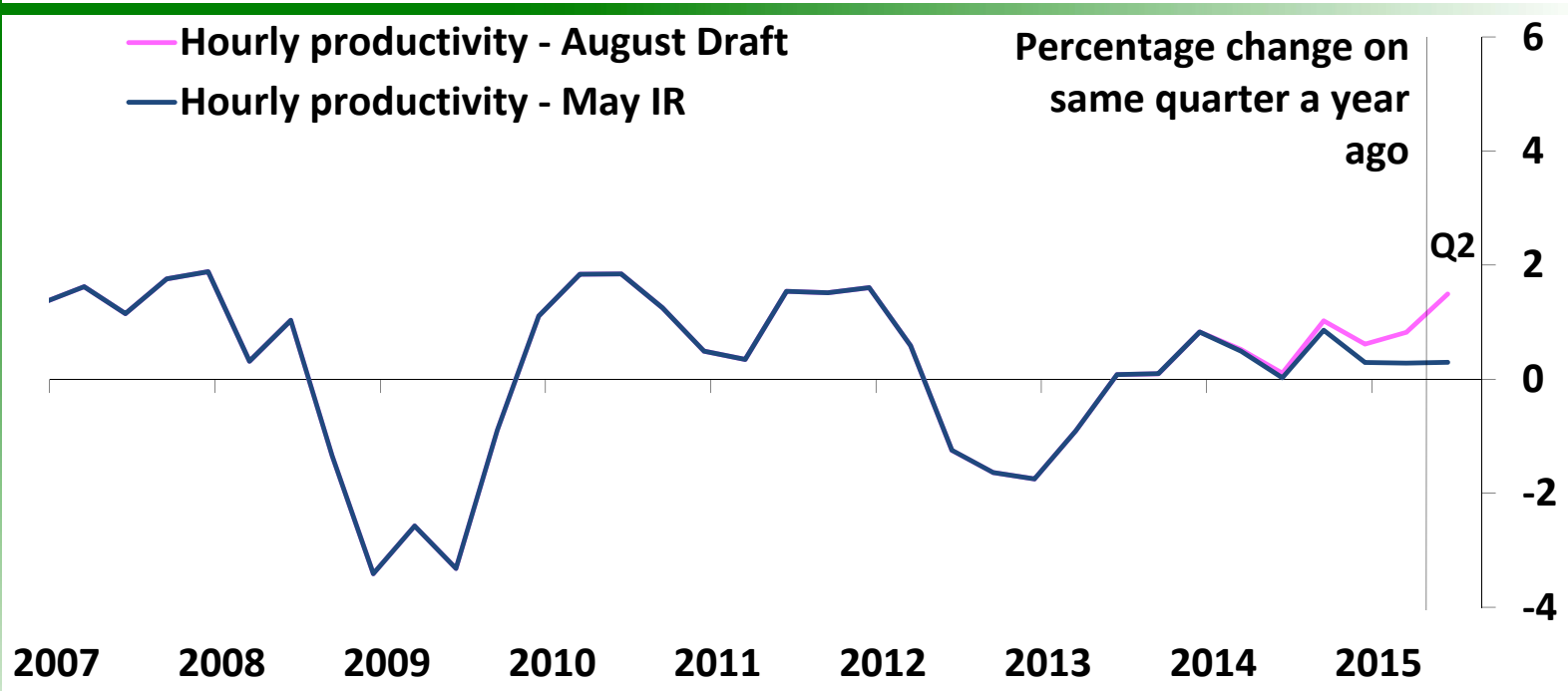
# Recruitment difficulties swathe



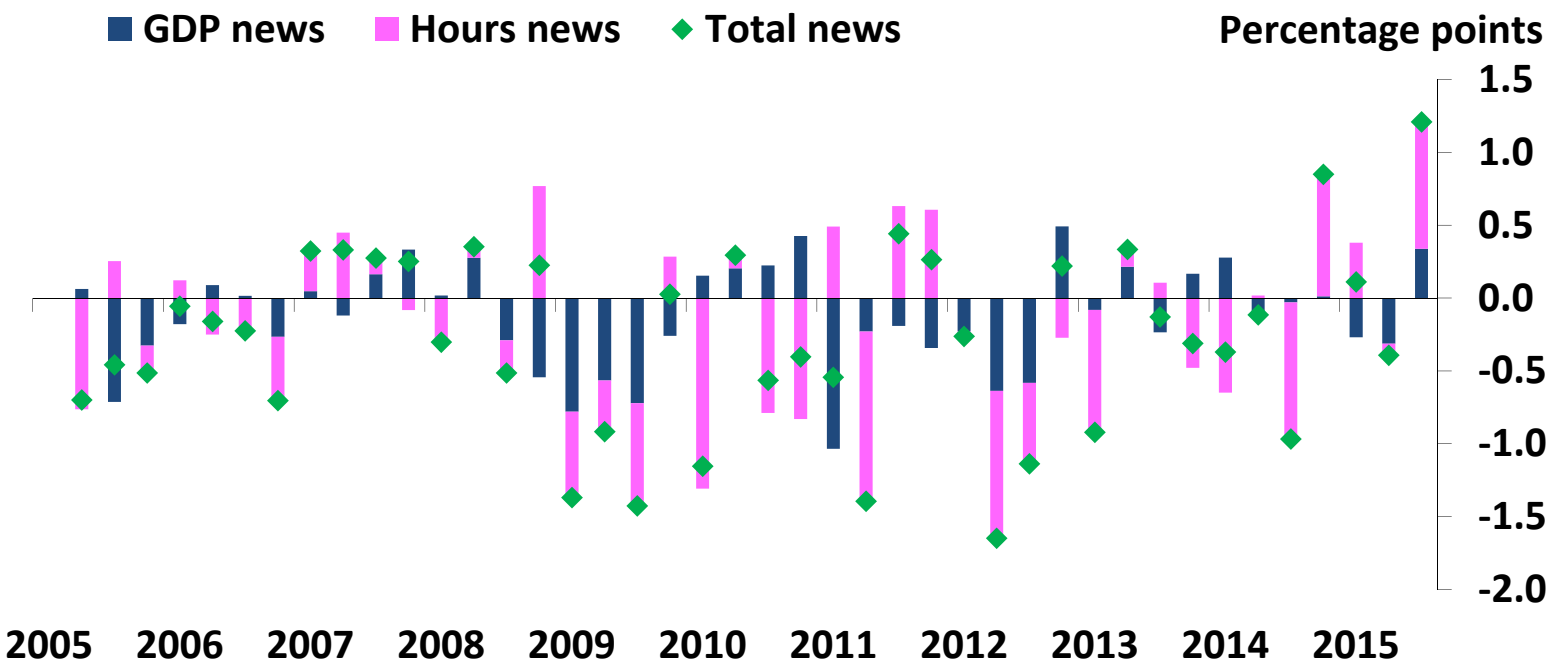
# Labour quantities summary

- Probably some data sampling volatility. But the recent decline in employment growth and flattening of the unemployment rate appear significant.
- Might imply less rapid absorption of spare labour than supposed – i.e., more slack in the labour market.
- But surveys of labour demand and pre-crisis levels of market tightness suggest the employment slowdown could also be consistent with congestion effects as slack is exhausted.
- The flip side of weaker employment growth (all else equal) is higher productivity and greater capacity pressures within firms.

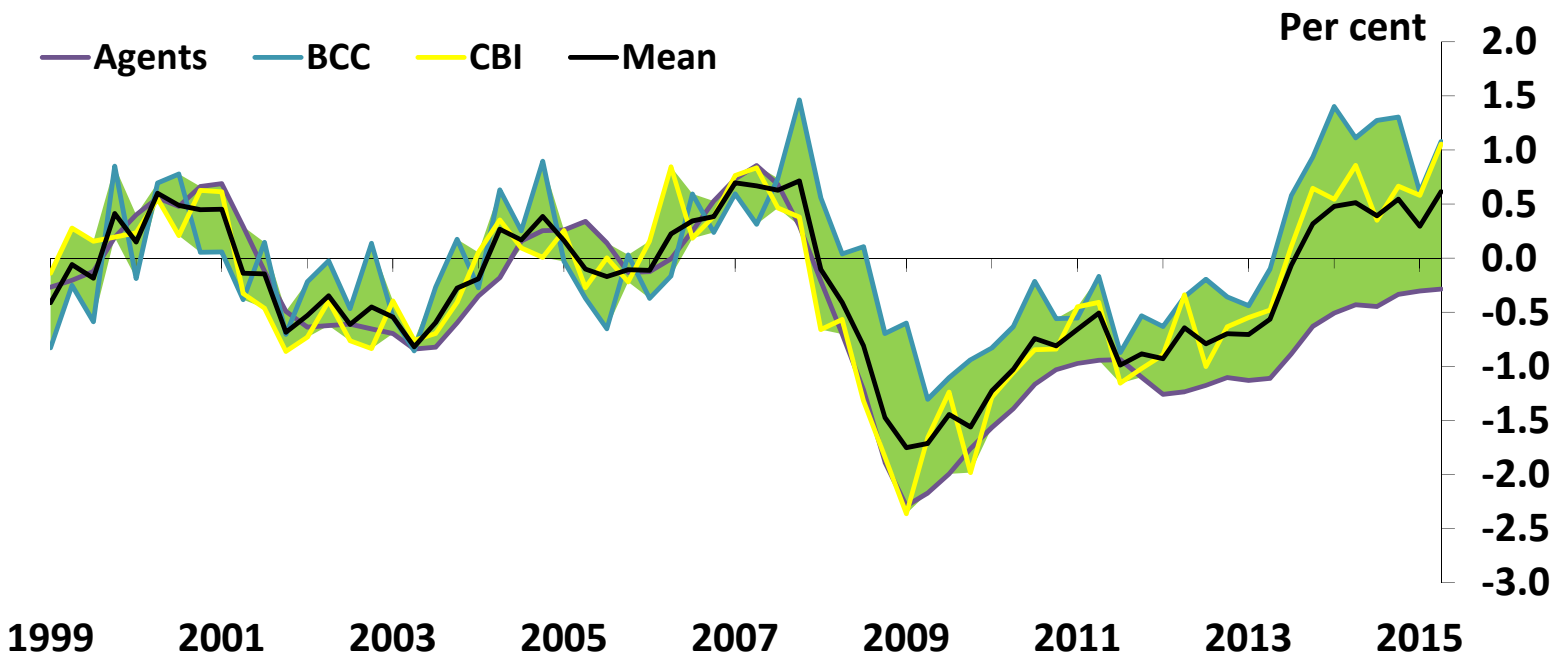
# Productivity news since May IR



# Productivity news (on annual growth rate)



# CAPU survey swathe

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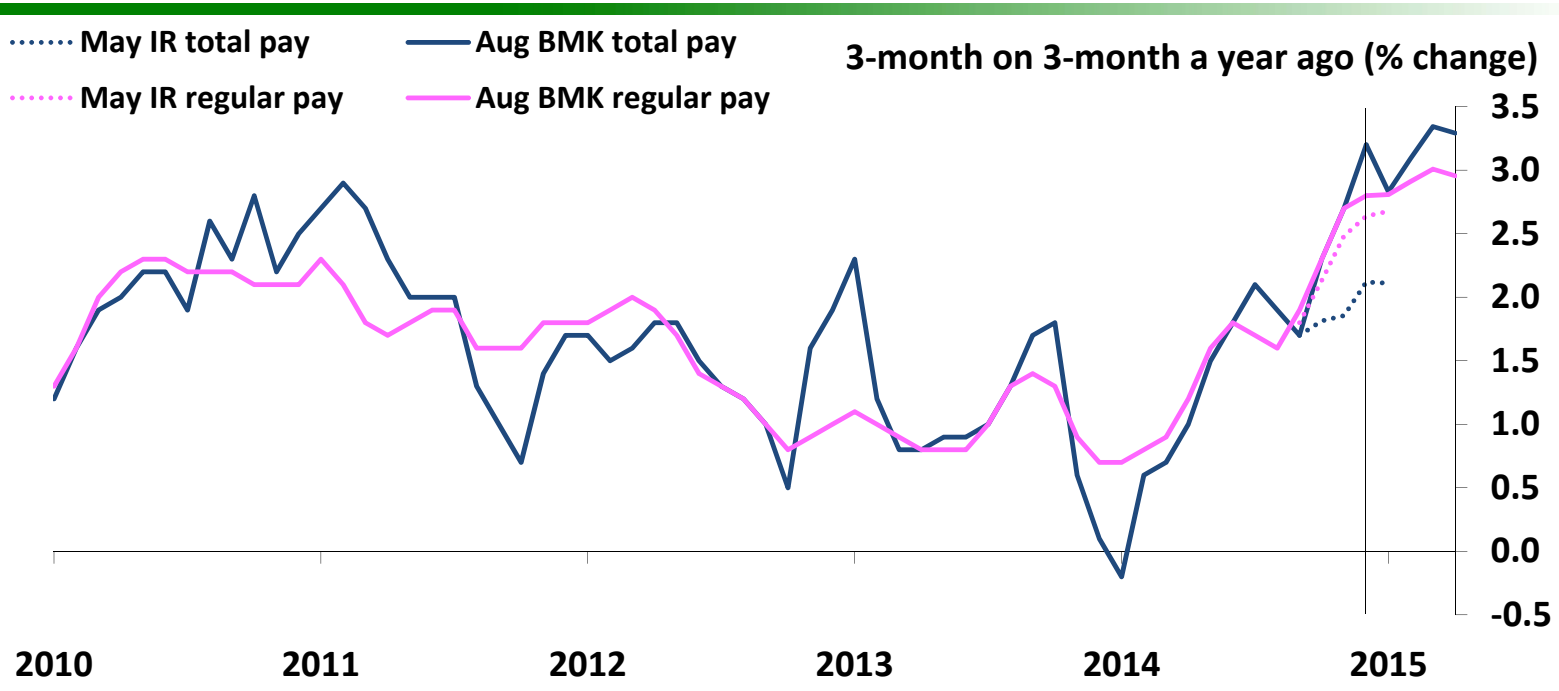
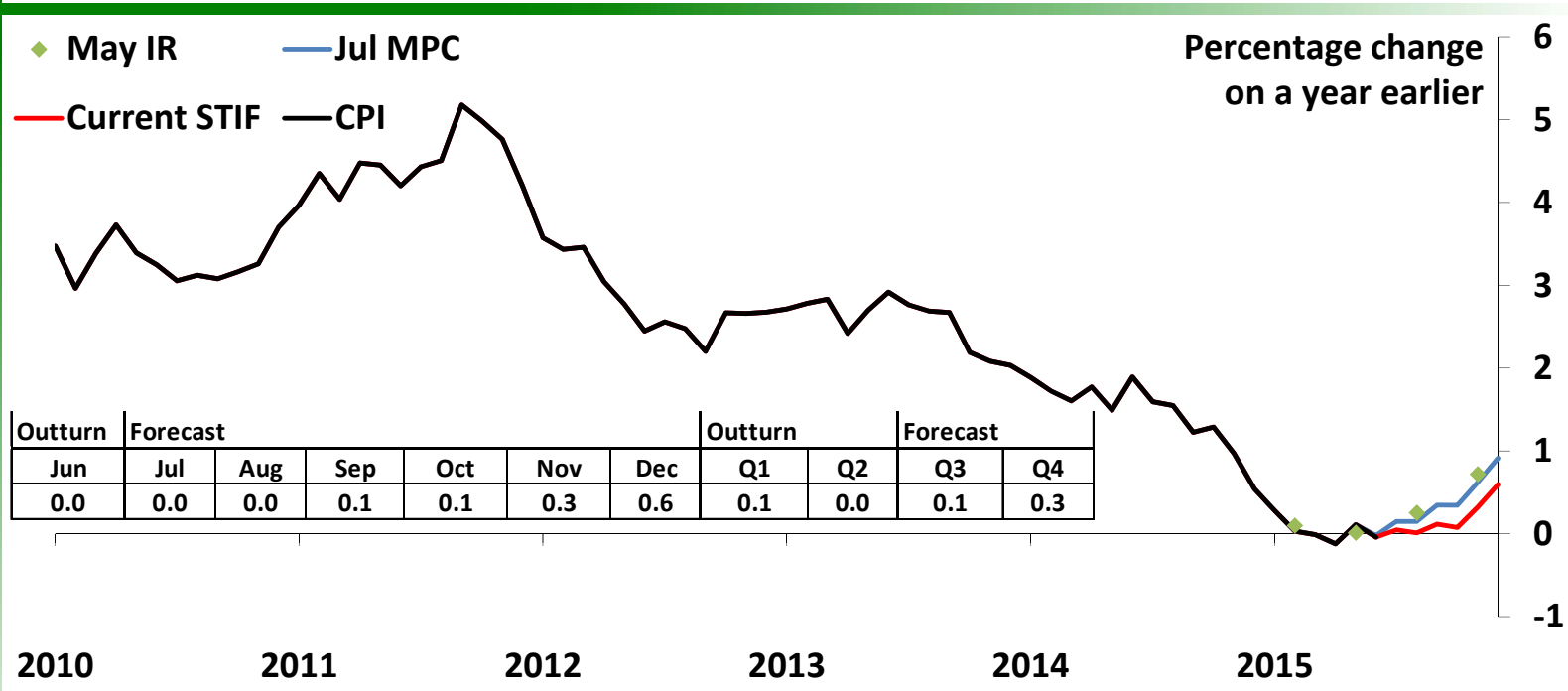
# Pay news since May IR



# News in key labour costs variables

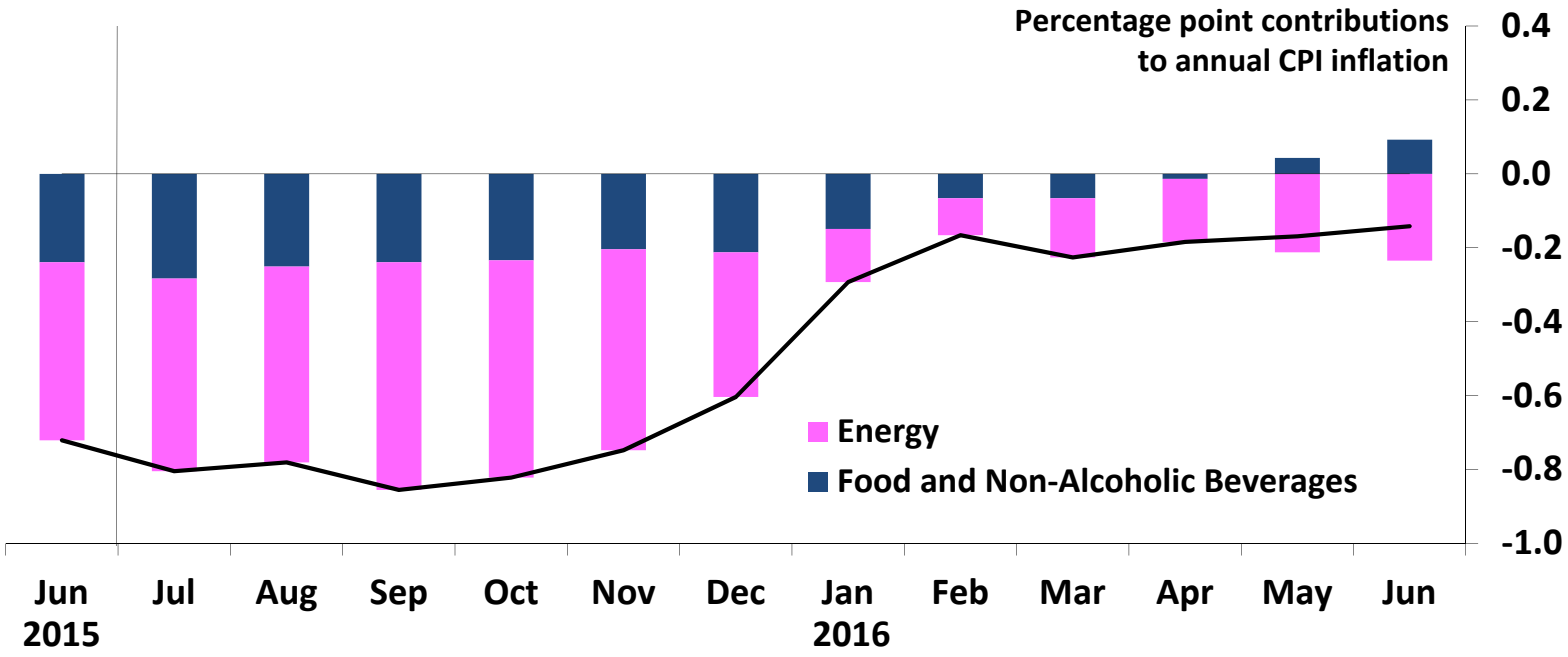
| *Percentage change on a year earlier* | May IR | | Aug BMK | | News | |
|---|---|---|---|---|---|---|
| | Q2 | Q3 | Q2 | Q3 | Q2 | Q3 |
| **Whole economy** | | | | | | |
| **AWE** | 2.1 | 2.8 | 2.8 | 3.3 | +0.7 | +0.5 |
| **Productivity (heads)** | 0.6 | 0.7 | 1.5 | 1.4 | +0.9 | +0.7 |
| **AWE / productivity** | 1.5 | 2.1 | 1.3 | 1.9 | -0.1 | -0.2 |
| **ULC (Nat Accounts)** | 1.4 | 1.4 | 1.3 | 1.7 | -0.1 | +0.3 |
| **Private sector** | | | | | | |
| **AWE** | 2.5 | 2.8 | 3.1 | 3.7 | +0.6 | +0.9 |
| **Productivity (heads)** | 0.9 | 0.8 | 1.9 | 1.7 | +1.0 | +0.9 |
| **AWE / productivity** | 1.5 | 2.0 | 1.2 | 2.0 | -0.3 | 0.0 |
| **ULC (Nat Accounts)** | 1.1 | 1.5 | 0.5 | 1.4 | -0.6 | -0.1 |

# Short-Term Inflation Forecast

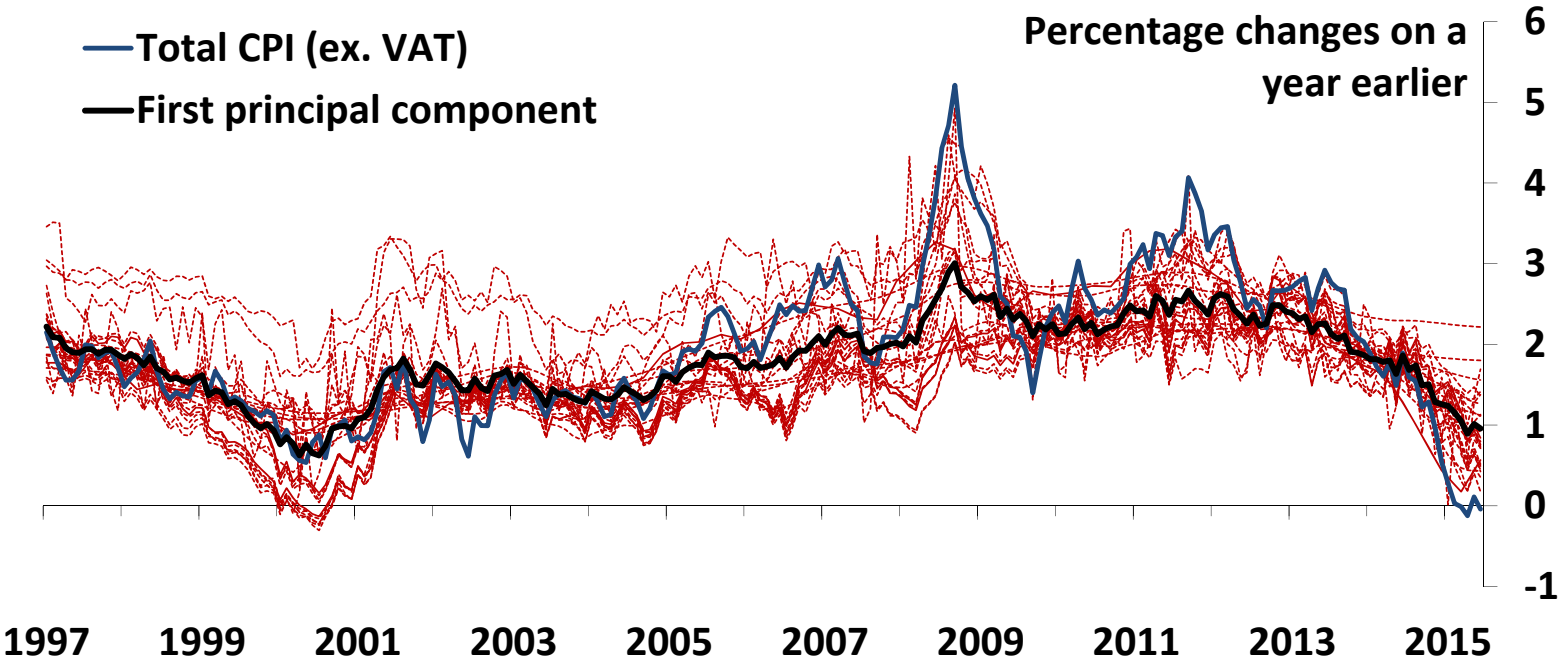



| Outturn | Forecast | | | | | | Outturn | | Forecast | |
|---|---|---|---|---|---|---|---|---|---|---|
| Jun | Jul | Aug | Sep | Oct | Nov | Dec | Q1 | Q2 | Q3 | Q4 |
| 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.3 | 0.6 | 0.1 | 0.0 | 0.1 | 0.3 |

# Food and energy contributions



# Core inflation measures




- See on core inflation.

# Core inflation

- **Summary core CPI measure better at forecasting headline CPI than headline CPI itself around one year ahead – but not a very strong statistical result (p-value=0.13)**

- **Core CPI is a better forecast of headline inflation than a naïve forecast of 2% up to 19 months ahead. Little to choose between them by the two-year point.**

- **Initial BVAR estimates suggest core inflation depressed by imports and, to a surprising extent, commodity prices. (Sort of) surprising lack of role for unit labour costs, however. More work to be done.**

# Summary

- Slowdown in employment growth and flattening of unemployment rate seem significant.
- Skills shortages and v/u ratio have now risen to pre-crisis levels, implying little abnormal labour market slack.
- Capacity pressures within firms have probably increased (at least a bit).
- Big upside news on productivity (for a change).
- Unit labour cost news neutral or to the downside.
- STIF down by 0.4pp in Q4, implying more open letters and a less pronounced increase in inflation around the turn of the year.
- Core inflation low, needs to rise, but not alarming yet.

# END

# 7: Agents’ Update

# Agents' Update

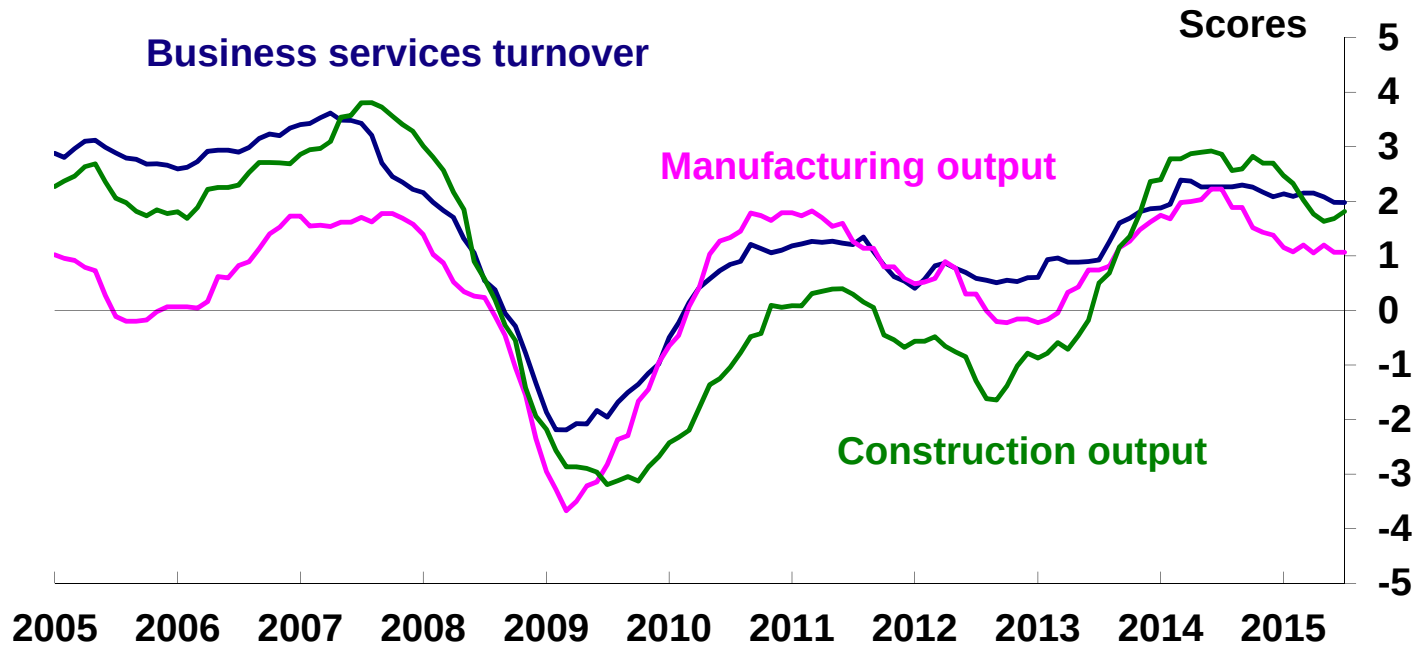
**29th July 2015**

, Agency for the North West
**Inflation Report & Agency Intelligence Division**

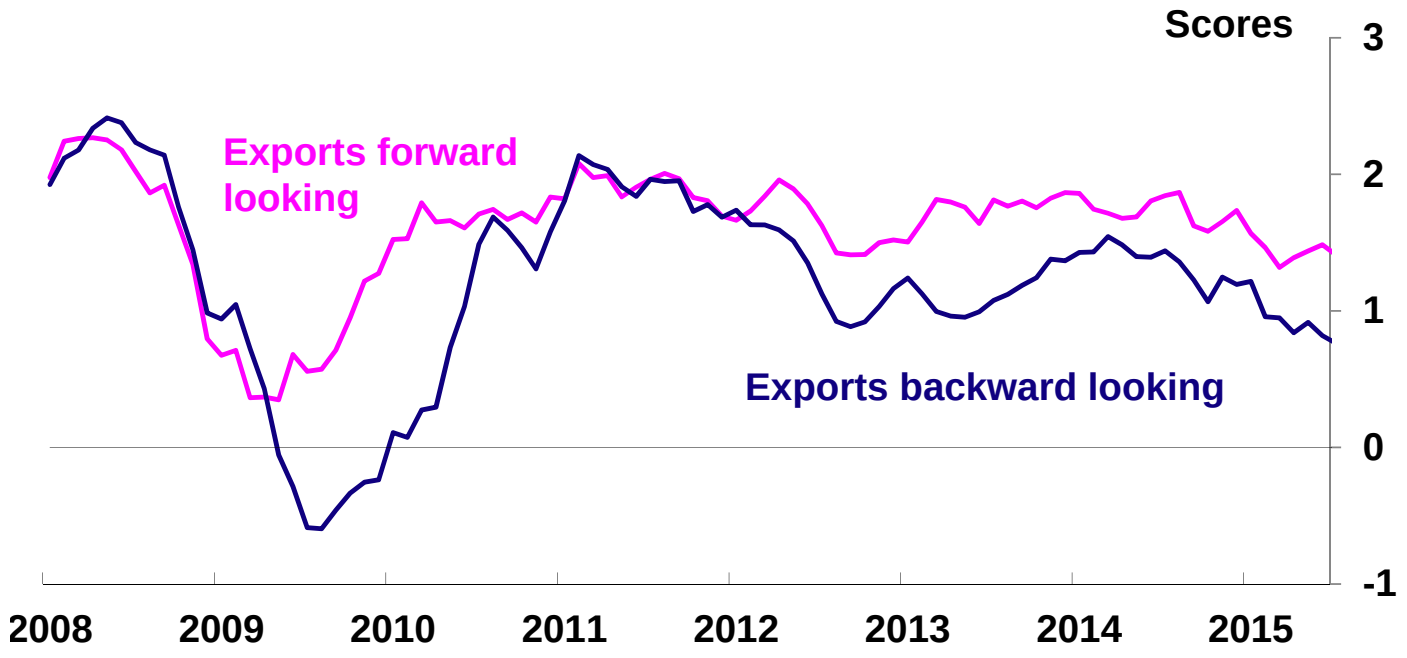
# Topics

- **Impact of exchange rate appreciation on output and prices**
- **Recruitment difficulties**

# Output growth: Agents' scores



# Exports: Company visit scores

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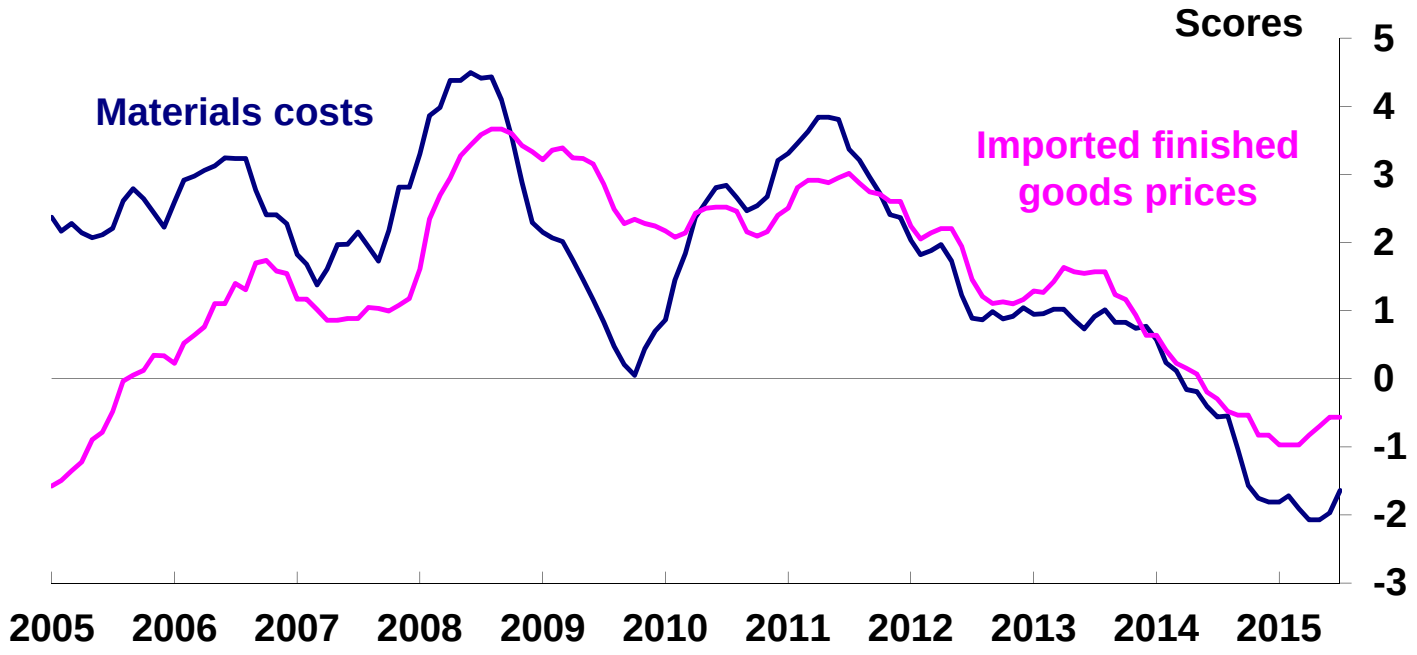
# Trade

- Some Euro area market recovery (Spain, Ireland)
- Demand still growing in the US, Middle East and most of Asia - but China has slowed
- £ appreciation is creating a greater headwind for exports
- Export volumes now being affected – both goods and services
- Import penetration has increased

# Costs: Agents' scores

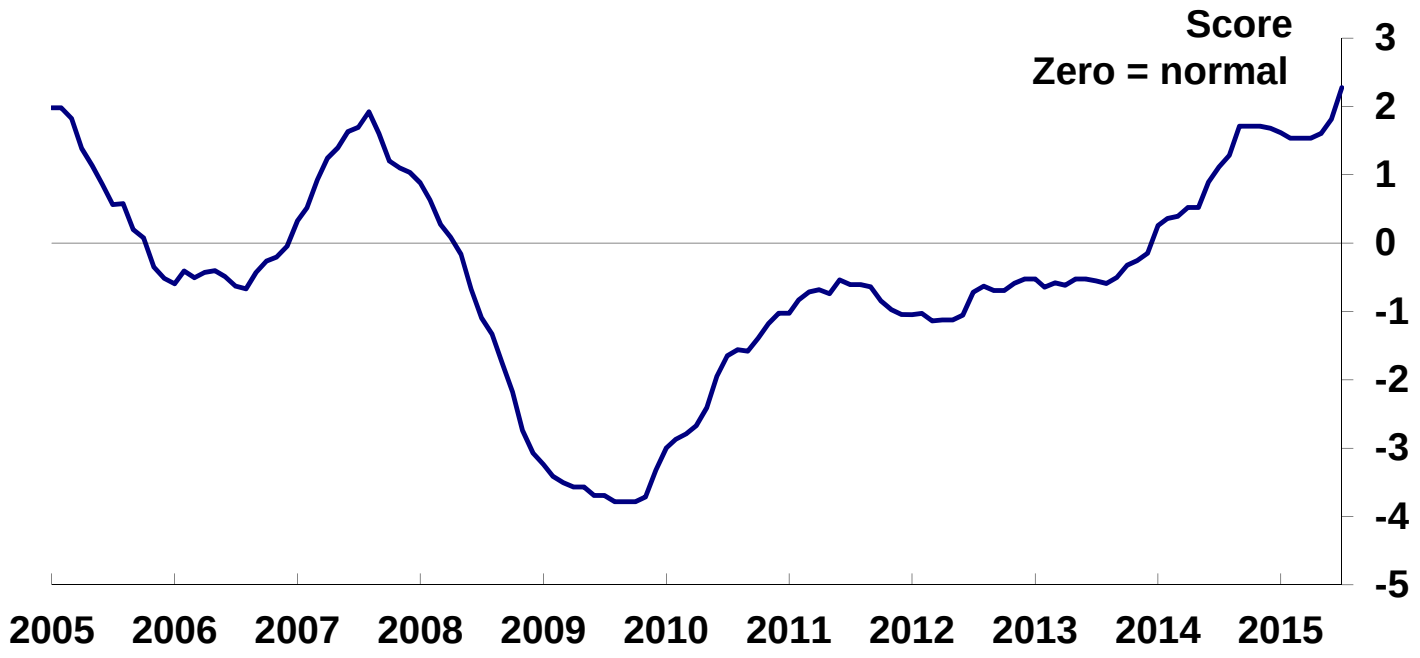



- Agents' scores suggest annual input cost deflation has eased

# Prices

- € impact particularly on basic chemicals, food ingredients, manufactured components and capital goods
- Expected to keep downward pressure on retail food price inflation
- Non-food prices stickier
- Firms currently rebuilding margin and pass-through to non-food consumer price inflation more limited

# Recruitment difficulties: Agents' score




- **Recruitment difficulties have increased sharply**

# Recruitment difficulties

- Range of skill shortages has broadened further
- IT, engineering, construction trades and property-related skills, professional services, HGV drivers etc
- Staff turnover is increasing and vacancies are taking longer to fill
- Key workers are costing more to replace
- Individual pay awards to pre-empt potential leavers have increased

# Summary

- **The stronger exchange rate is now affecting export volumes and reducing some components of inflation**
- **Increasing recruitment difficulties are putting upward pressure on individual pay awards**