Essential reading – MPC

# Costs and Prices Monthly: July 2015

STRUCTURAL ECONOMIC ANALYSIS

and

| | Annual CPI inflation | | | | Employment rate (16+) | | | | Unemployment rate | | | | Average Hours (per week) | | | | Whole economy total pay* | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Jul MPC | Jun MPC | May IR | *Monthly news* | Jul MPC | Jun MPC | May IR | *Monthly news* | Jul MPC | Jun MPC | May IR | *Monthly news* | Jul MPC | Jun MPC | May IR | *Monthly news (%)* | Jul MPC | Jun MPC | May IR | *Monthly news* |
| Q1 | **0.10** | **0.10** | **0.10** | *0.00* | **59.97** | **59.97** | 59.95 | *0.00* | **5.55** | **5.55** | 5.51 | *0.00* | **32.11** | **32.11** | 32.17 | *0.00* | **2.31** | **2.31** | 1.79 | *0.00* |
| Q2 | -0.02 | -0.02 | 0.01 | *0.01* | 59.90 | 60.07 | 60.05 | *-0.17* | 5.50 | 5.38 | 5.35 | *0.11* | 32.24 | 32.24 | 32.27 | *0.00* | 2.94 | 2.17 | 2.12 | *0.76* |
| Q3 | 0.18 | 0.18 | 0.26 | *0.01* | 60.01 | | 60.11 | | 5.42 | 5.29 | 5.29 | *0.13* | 32.30 | | 32.33 | | 3.38 | 2.82 | 2.78 | *0.56* |
| Q4 | 0.62 | 0.61 | 0.72 | *0.00* | | | 60.14 | | | | 5.24 | | | | 32.37 | | | | 2.42 | |

* Growth rates calculated from published rounded levels, so may not match 3 month average annual growth as published by the ONS.

**Main message: CPI inflation was 0.1% in May, up from -0.1% in April. The outlook is little changed in comparison to the M15 forecast for 2015 Q3 and Q4. Unemployment remained at 5.5%, above expectations. Both participation and employment surprised to the downside. Whole economy total pay surprised significantly on the upside, mainly in bonuses, and we have largely locked that news in implying a stronger near-term profile.**

**Chart 1: Short term inflation forecast**

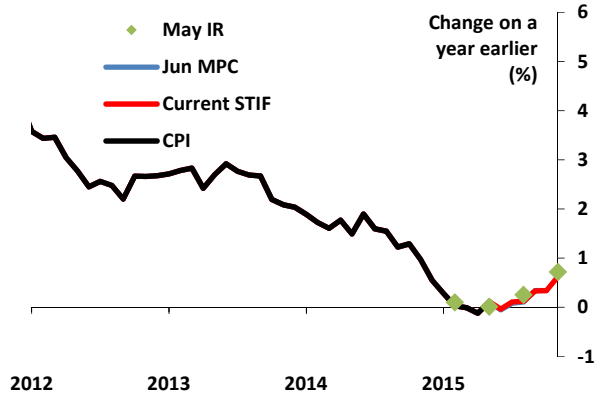



**Chart 2: Distribution of core CPI component inflation rates**

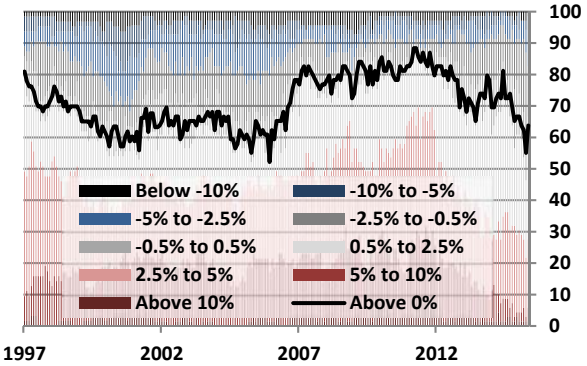
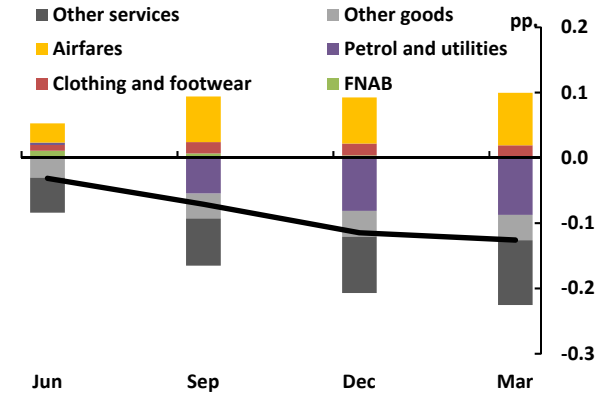



**Chart 3: Change since the M15 forecast**




## Inflation

1. **CPI inflation was 0.1% in May, up from -0.1% in April. The outturn was in line with our forecast and the market median forecast, leaving the near term outlook little changed in comparison to the M15 forecast for 2015 Q3 and Q4 (Chart 1).** The major effects acting on the absolute profile for inflation over the next few months include a relatively shallow seasonal sales period for clothing prices; pass-through of lower import prices of food, partly offset by higher import prices of other consumer goods; and the positive net effect of energy base effects and the ongoing pass-through of recent movements in the oil price.

2. Headline CPI inflation is expected to dip back down to zero in June, due to summer sales effects on clothing and footwear. Given the changing pattern of sales in recent years, there is considerable uncertainty around the outturn. Another negative outturn is possible in June, and a new low may be reached of -0.2%, but this is not our central case.

3. As expected, the May data unwound temporary Easter-related effects that had pulled down on inflation for airfares and other transport components in April. In turn, the proportion of CPI components (excluding energy and food) with positive inflation rates bounced back to 64% in May from 55% in April (**Chart 2**). As discussed in the CPI indicator, measures of core inflation rose in May and range between 0.8% and 1.5%.

4. The latest forecast is around 0.1pp lower than the M15 forecast for Q3 and Q4, mainly owing to movements in sterling oil prices since the *Inflation Report* was published, with internet airfares data pushing in the opposite direction (**Chart 3**). Food prices surprised slightly on the upside in the May data, with non-seasonal food prices remaining flat on the month against our expectation of a fall. Food price inflation overall was -1.8% in May and is -1.9% on average over the forecast, reflecting the effects of supermarket price wars and sterling's appreciation over recent months, particularly against the Euro. There have been sustained

**Chart 4: Home-produced, imported and retail food**

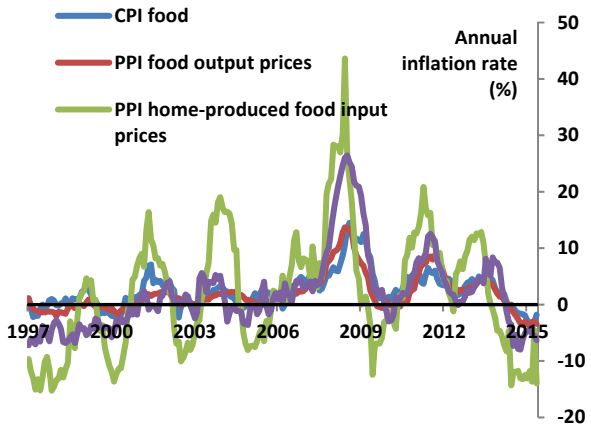



**Chart 5: Non-A&R components implied forecast**

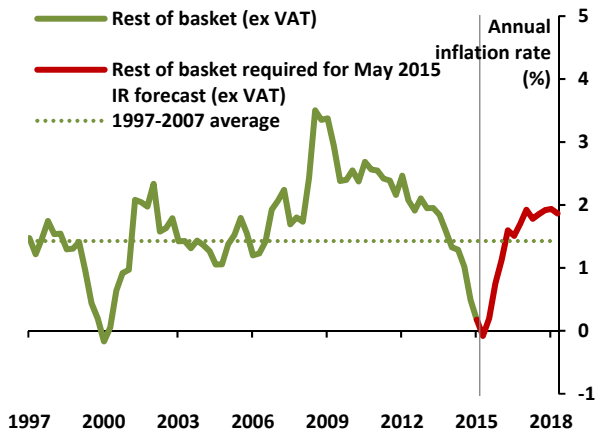
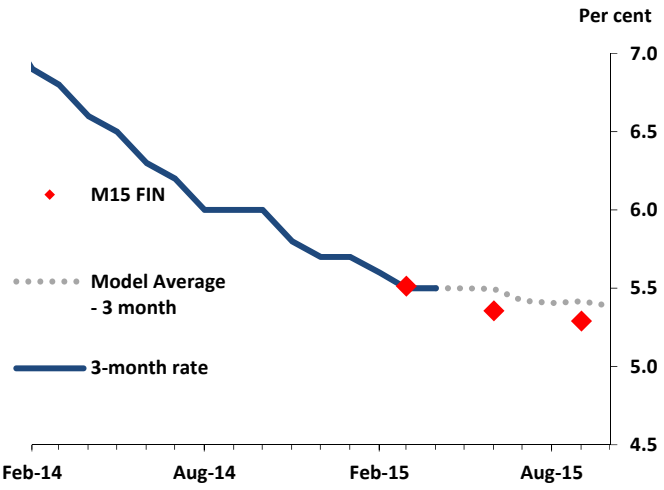



**Chart 6: Short term unemployment forecast**




effects on prices of home-produced, imported and retail food, but the deflation now appears to be easing gradually (**Chart 4**).

5. There are risks on either side of the profile for food prices. Last year the UK had good harvests, which could put upward pressure on food inflation if they are not repeated this year (though good harvests are expected at the moment). On the downside, there is a risk that the ongoing price war between the supermarkets could escalate. However, intelligence from the Agents suggests that the impact on measured inflation may lessen in the coming months, as some prices are being increased to offset cuts elsewhere.

6. Administered and regulated (A&R) prices seem likely to drag on inflation by growing less quickly than in the past, representing a potential downside risk to the forecast that extends beyond the horizon of the STIF. These prices make up nearly a quarter of the CPI basket and growth rates are often linked to past rates of CPI or RPI inflation. We can form a best guess for how A&R prices will evolve over the forecast using stated government policy (including the commitment not to increase VAT). This best guess shows us that, to achieve the M15 forecast of 2.0% by mid-2017, prices of the non-A&R components of the CPI basket would need to grow at around 2%. That is above the pre- crisis average for these components (**Chart 5**).

## Labour market

### Unemployment

7. **The unemployment rate in the three months to April remained at 5.5%, slightly above the 5.4% anticipated.** The level of unemployment was still down by 44,000 on three months earlier.

8. Based on our short term forecast models, we now expect unemployment to fall at a slightly slower pace over the next 6 months compared to the May IR, with unemployment staying at 5.5% in Q2 and then declining to 5.4% in Q3, 0.1 pp higher than previously expected (Chart 6).

### Labour force participation

9. **The employment and participation rates both surprised to the downside in the three months to April with outturns of 59.9% and 63.4% respectively.** These were 0.2pp and 0.1pp lower than expected respectively.

10. Participation remains close to the 63.45% we estimate for trend participation. As such we view the news in the last two months to be a degree of noise around this and we have participation coming back close to trend over the next six months.

**Chart 7: Decomposition of news in total hours**

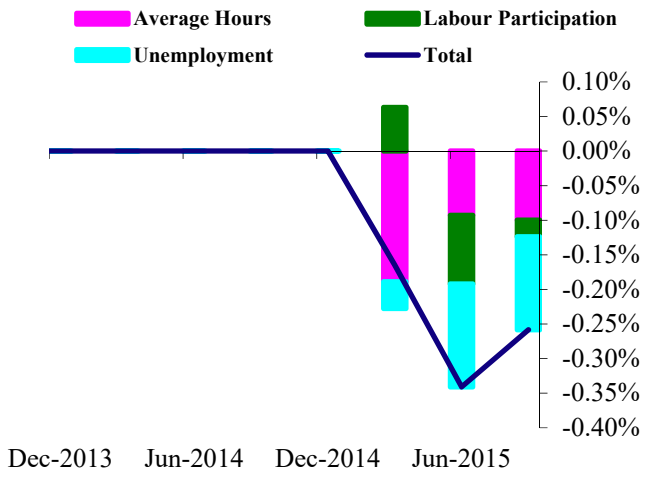
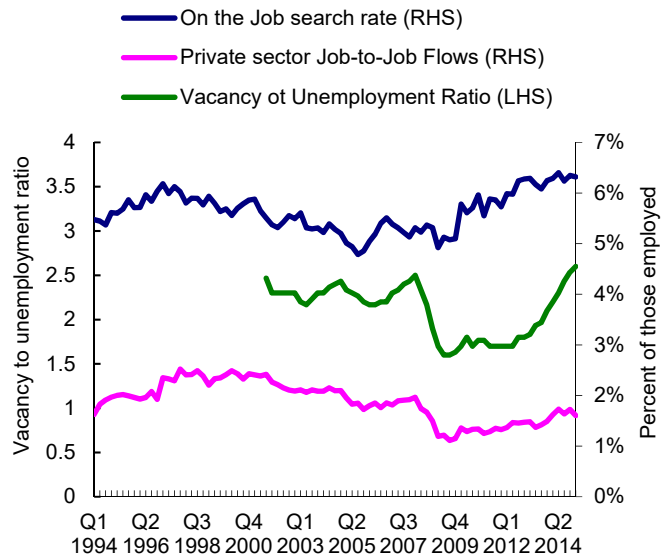



**Table 1: Mechanical changes in the 'bottom up' output gap**

*Note The: CAPU gap is not shown as it remains unchanged at 0*

| | Unemployment gap | | Average Hours gap | |
|---|---|---|---|---|
| | May IR | Update | May IR | Update |
| Q1 | -0.2 | -0.2 | -0.7 | -0.8 |
| Q2 | -0.1 | -0.2 | -0.4 | -0.5 |
| Q3 | 0.0 | -0.1 | -0.2 | -0.3 |
| | **Labour Participation gap** | | **Total** | |
| | May IR | Update | May IR | Update |
| Q1 | -0.1 | 0.0 | -0.9 | -1.0 |
| Q2 | -0.1 | -0.2 | -0.5 | -0.8 |
| Q3 | 0.0 | -0.1 | -0.3 | -0.5 |

**Chart 8: Measures of labour market tightness**




## Hours

11. **After a significant downside surprise last month, average hours came in as expected at 32.1.** Our forecast has average hours continuing to rise over the next 6 months, reaching 32.3 hours in Q3, as it slowly converges on our estimated trend of 32.4.

12. Chart 7 summarises the cumulative news to our forecast in total hours space since the May IR. The April outturn was 0.5% below the May profile, but we assume that around half of that news unwinds over the next few months. By Q3 we project total hours to be about ¼% lower than previously expected, this is primarily accounted for by the slower fall in unemployment (~50%) and lower average hours (~40%).

13. Table 1 shows how the news in chart 7 feeds through into a mechanical update of our 'bottom up' approach to the output gap. It would leave the output gap slightly larger in Q3 at -0.5pp compared to a gap of -0.3pp in the May IR.

## Labour market tightness

14. Chart 8 looks at three measures of labour market tightness, all of which reached post crisis highs in the last year and remain elevated. 6.3% of those currently employed are actively searching for another job, with roughly a quarter of these saying that they are dissatisfied with pay (a share which peaked in Q4 2014, but still remains higher than any other time in the past ten years). For the first time since 2005 there are now more people searching for a job from within employment than from unemployment.

15. Private sector job-to-job flows reached a post crisis high of 1.7% in Q2 2014, but have levelled off since then and were 1.6% in Q1 2015. The vacancy to unemployment ratio peaked in December at 2.6 vacancies per individual in unemployment and has been level since then.

## Pay

16. **Whole economy total pay surprised significantly on the upside, mainly in bonuses, coming in at 2.7% compared to our expectations of 2.0%. Regular pay was 0.1 pp higher than expected at 2.7%.** There were also upward revisions to the March data with both total and regular whole economy pay being revised up to 2.3% from 1.9% and 2.1% respectively.

17. While most of the news since the May IR has been in bonuses, regular pay growth was 0.2pp stronger as well.

18. **The combined impact of both of these surprises**

**Chart 9: Short term earnings forecasts**

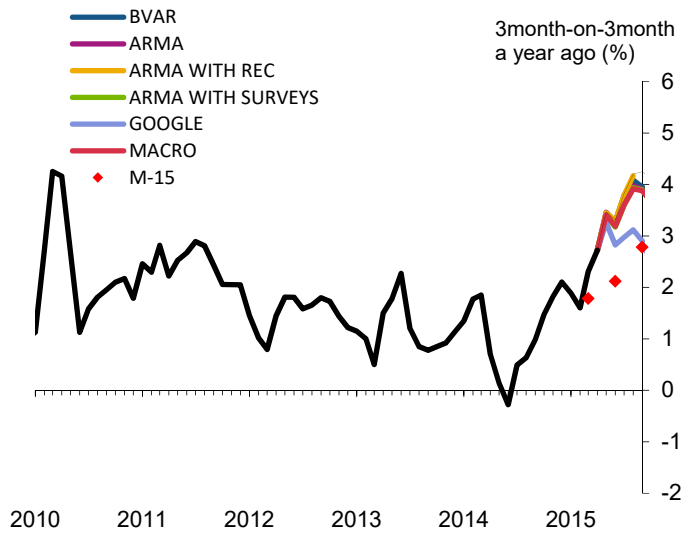



**Chart 10: Private sector bonuses**

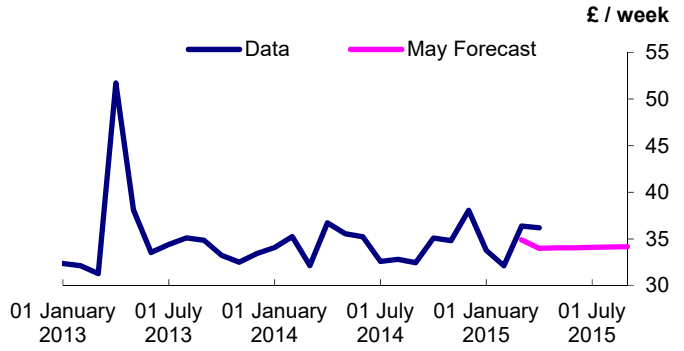
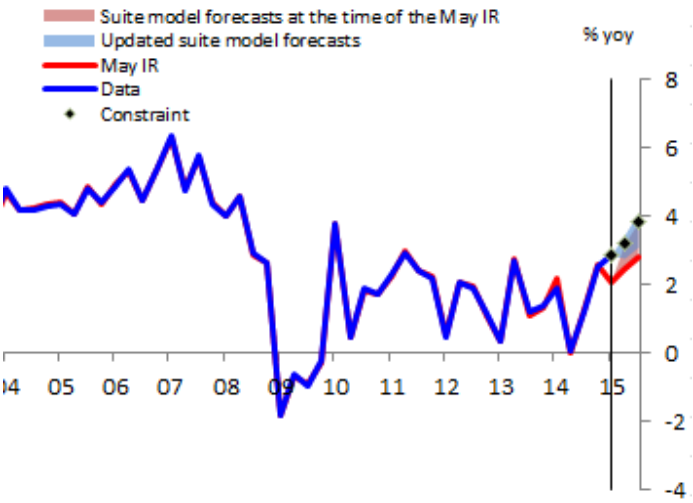



**Chart 11: Medium term private sector total pay**




**has been to shift the projections from our short term earnings forecasting models for whole economy total pay up significantly compared to the May forecast (Chart 9).** The median STEF projects growth of 3.1% and 3.9% for Q2 and Q3 respectively. This compares with forecasts of 2.1% and 2.8% from the May IR.

19. **We have revised up our constraints significantly, but not as far as the models would suggest. We would be cautious about placing too much weight on these models as they are heavily influenced by recent outturns and the strength of bonuses.** Private sector bonus growth has been difficult to forecast over recent years, in part due to timing effects from tax changes in 2013. Chart 10 shows the latest news in private sector bonuses, relative to our previous constraint. As there are no obvious timing effects, we have locked this news into our latest forecast.

20. While bonuses are partly driving the high total pay forecasts from our models, regular pay growth is also contributing significantly. **Our private sector regular pay forecast is for 3.4% in Q2 and 3.5% in Q3.**

**Our current forecasts for total whole economy and private sector pay up to Q3:**

| | 3M average on a year ago | | | |
|---|---|---|---|---|
| | WE Total Pay | May IR (WE) | Private Total Pay | May IR (Private) |
| Q1 | 2.3 | 1.8 | 2.8 | 2.1 |
| Q2 | 2.9 | 2.1 | 3.2 | 2.5 |
| Q3 | 3.4 | 2.8 | 3.8 | 2.8 |

21. In May, we pushed down on near-term pay growth relative to what our models would've suggested. However we had strong pay growth in the medium-term with private unit labour costs at above their pre-crisis average at a little over 3%. As such it is unclear if this recent news should impact our medium term expectations of wage growth. Chart 11 compares our updated suite models with the forecasts they were producing at the time of the May IR and shows that their profiles in the medium term are roughly consistent. This is an issue to which we will need to return to in the forecast round.

22. In absolute terms pay growth has picked up sharply. Annual regular pay growth has increased by over a percentage point in the past six months. That reflects rises across a range of diverse sectors such as accommodation, IT and construction, so it is unlikely to be driven by idiosyncratic factors. It also brings pay growth back into line with other indicators of pay.

23. Combined with the upward revisions to GDP in the QNA, the downside news on labour market quantities leaves productivity growth (in hours) 0.5pp stronger in the year to Q1 than projected in the May IR at 0.8%. Unit labour cost growth remained subdued, at 0.6% in the year to Q1, unchanged from the (downwardly-revised) growth in Q4.

Data annex