Costs and Prices Monthly: December 2015

STRUCTURAL ECONOMIC ANALYSIS

	Annual CPI inflation				Employment rate (16+)				Unemployment rate				Average Hours (per week)				Whole economy total pay*			
	Dec MPC	Nov MPC	Nov IR	*Monthly news*	Dec MPC	Nov MPC	Nov IR	*Monthly news*	Dec MPC	Nov MPC	Nov IR	*Monthly news*	Dec MPC	Nov MPC	Nov IR	*Monthly news (%)*	Dec MPC	Nov MPC	Nov IR	*Monthly news*
Q2	-0.02	-0.02	**-0.02**	*0.00*	**59.75**	**59.75**	59.75	*0.00*	**5.63**	**5.63**	5.63	*0.00*	**32.11**	**32.11**	32.11	*0.00*	**2.58**	**2.57**	2.58	*0.01*
Q3	0.01	0.01	0.01	*0.00*	**60.00**	59.88	59.88	*0.11*	**5.31**	5.37	5.37	*-0.06*	**31.89**	32.04	32.04	*-0.48*	**2.99**	3.24	3.24	*-0.25*
Q4	0.14	0.10	0.10	*0.04*	**60.01**	60.01	60.01	*0.00*	**5.34**	5.34	5.34	*0.00*	**32.09**	32.09	32.09	*0.00*	**2.22**	2.62	2.59	*-0.40*
Q1	0.66	0.67	0.67	*-0.01*																

* 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 October as expected. The drag from energy and food is still expected to diminish in the near term, and core inflation is expected to rise, supporting a rise in headline inflation to 0.8% in six months' time. In the labour market, wage growth was weaker than expected with the level of private sector regular pay falling for the past two months. That may reflect falling average hours depressing weekly pay and the drag from compositional effects increasing, but could also signal other downside risks to pay growth. We had further downside news on labour quantities with average hours particularly weak.

Inflation

Annual CPI inflation remained at -0.1% in October, in line with our forecast and the market median forecast. The updated forecast profile shows inflation beginning to rise again from next month, to 0.1% in November, 0.4% in December and 0.7% in March 2016 (**Chart 1**). The 0.3pp rise between November and December relates to base effects in energy, as well as a temporary holiday-timing-related boost from airfares. Food and energy base effects drive another 0.2pp increase between December and January.

Sterling oil prices fell below £30, but our internet price collection for seasonal food and tobacco showed a strong rise between October and November. As a result, the beginning of the forecast is slightly higher than in the November IR, but this difference is eroded by the small fall in the oil price since the IR forecast passing through into fuel prices (**Chart 2**).

The drag from energy and food on CPI inflation is still expected to diminish over the next six months, contributing around ½ a percentage point of the forecast rise in inflation (**Chart 3**). In October's data, energy, food and other goods explained three-quarters of the deviation of CPI inflation from the 2 per cent target, down from four-fifths in the September data, which formed the basis of the most recent open letter. By March, the STIF implies that energy, food and other goods will explain less than two-thirds of the deviation from target.

The pattern of clothing sales in October's data continued to deviate from the strong seasonal patterns that we have observed in the past, resulting in large upside news to the forecast. There are risks on either side of the forecast for November's data, as the mild weather conditions may have left retailers with leftover stock, making an increase in discounting more likely. The producer price indices indicate that inflation in the supply chain is subdued, with the factory gate prices of clothing falling slightly between September and October. On the other hand, the timing of any discounting, and the

Chart 1: The short term inflation forecast

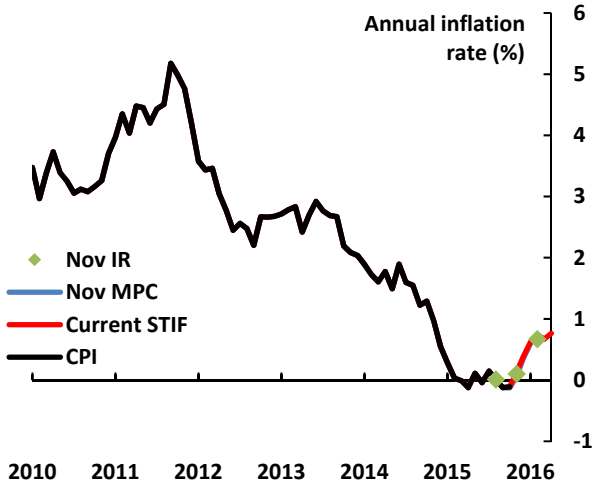


Chart 2: Change since the Nov IR forecast

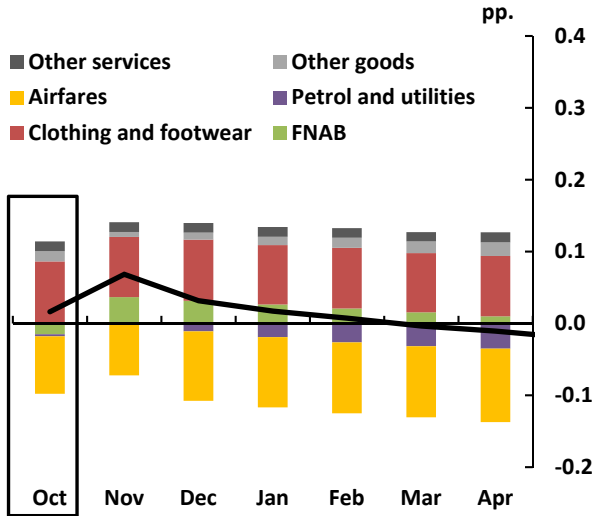


Chart 3: Contributions to the rise in inflation

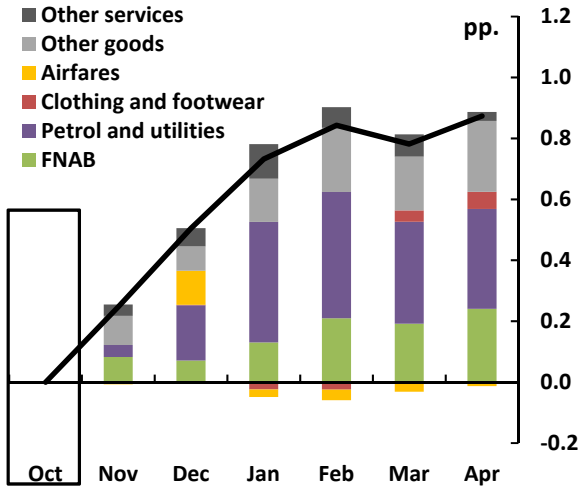


Chart 4: November IR and OBR inflation forecasts

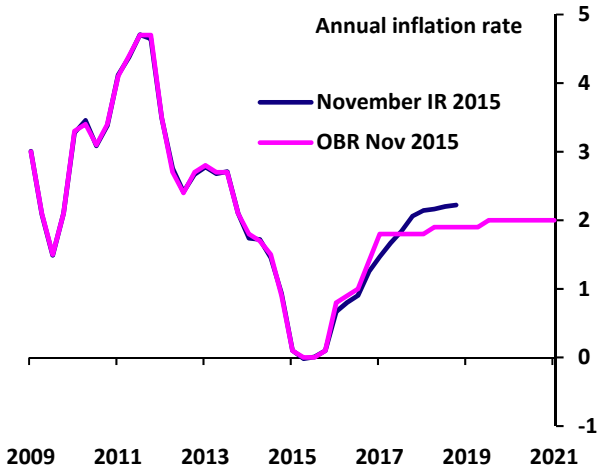
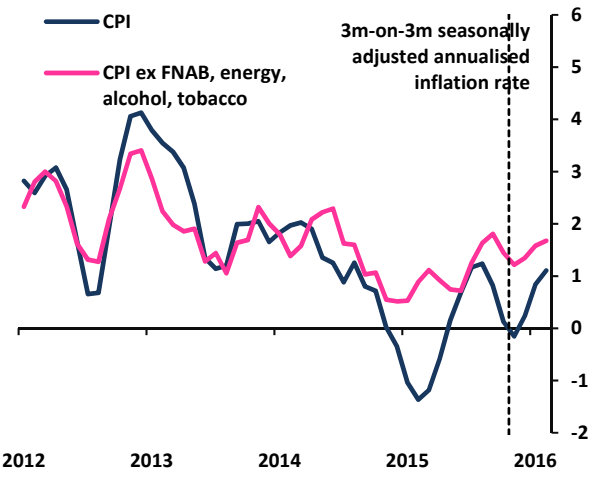


Chart 5: Seasonally adjusted 3m on 3m inflation



influence of competitive pressures on the prices of a wide range of goods, may have been masked in November, by retailers maintaining higher prices until Black Friday.

The OBR's newly published forecast for inflation is higher than the November IR in the near term, but remains lower from the second half of 2017 onwards. The forecast profile is around 0.1pp higher throughout 2016 to mid-2017 (**Chart 4**). The OBR noted that the upward revision was due to a change in their assumption about the inflation impact of unit labour costs. The Autumn Statement announced policies aimed at reducing utility bills, for which the OBR adjusted their inflation forecast by -0.1pp in 2017.

Core inflation rose 0.1pp to 1.1% in October on the ONS measure excluding energy, FNAB, alcohol and tobacco. On a 3m-on-3m basis, this measure eased in October, reflecting the final round of the effect from changes in undergraduate tuition fees. Momentum is expected to return from next month (**Chart 5**). The principal component of 26 core measures of inflation was 1.1% in October, up from 1.0% in September.

Labour market

Earnings

Whole economy pay growth was 3.0% in Q3, compared to 2.6% in Q2. Pay growth came in 0.2pp below the 3.2% expected for Q3 in the November IR. The downside news in September means our current Q4 forecast for whole economy pay growth now stands at 2.2%, 0.4pp lower than in the November IR for Q4 and even further below our forecast at the time of the August IR (chart 6).

Annual regular pay growth has eased a little, due to weak outturns in recent months. Shorter term measures of pay growth have fallen sharply, with three-month on three-month annualised private sector regular pay growth standing at 1.4%, down from 3.1% in Q2, and the level of private sector regular pay has fallen for the past two months (chart 7).

What can explain the recent flattening in annual pay growth? One factor is likely to be the recent falls in average weekly hours (see below). AWE is a measure of *weekly* hours and so can be affected by changes in average hours. Average pay *per hour* has been more robust, picking up to 3.6% in Q3 for the whole economy (chart 8).

The drag from compositional effects due to changes in the mix of employment also appears to have increased in Q3, from 0.4pp in Q2 to 0.8pp (chart 9). A number of factors contribute to the increasing compositional drag, including age, occupation and tenure. We would still expect the drag on pay growth from compositional effects to unwind over time, but it may take longer than we anticipated.

Changes in average hours and compositional effects are also likely to affect productivity, with the effects netting out for unit wage costs. Annual productivity growth in hours was 0.3pp stronger than expected in Q3 at 1.6%, whereas productivity growth in heads was 0.2pp weaker at 1.0%. A simple measure

Chart 6: Pay growth forecasts

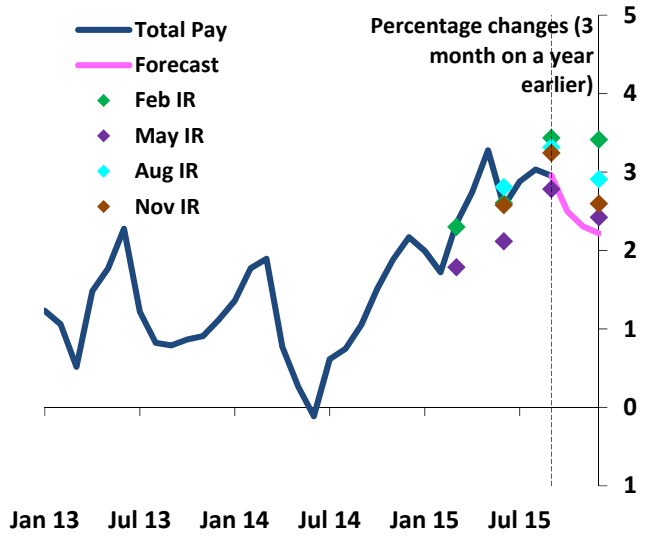


Chart 7: Private sector regular pay growth

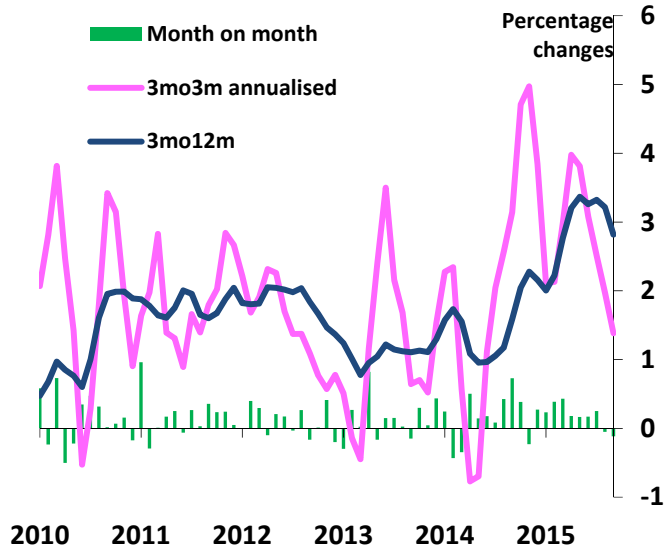
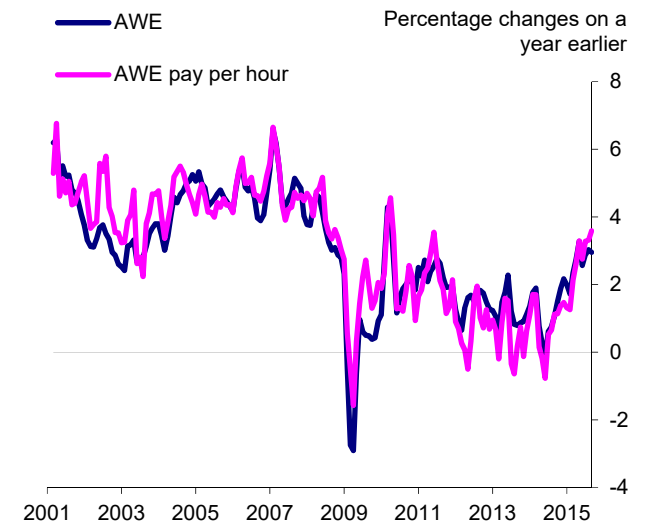


Chart 8: Hourly wage growth



of unit wage costs based on AWE relative to productivity per head rose by 2.0% in the year to Q3, broadly as expected, although it is expected to fall to 1.3% in Q4. An estimate of the broader measure of unit labour costs from the National Accounts, based on partial data from the GDP 2nd release, rose by 1.8% in the year to Q3.

The latest flows data from the micro-data indicates that both resignations and voluntary job-to-job flows in Q3 resume their gradual trend back to pre-crisis levels after small reversals in Q2 (chart 10). This suggests that employers are not facing the same level of difficulty in retaining their staff as they did pre-crisis, and so may be able to limit pay rises to particular groups where recruitment difficulties are acute rather than increasing pay across the board.

A further possibility is that the persistent low level of inflation is restraining pay growth. There is some evidence of that from the Bank's Agents, and survey measures of pay have been fairly flat for some time. That could mean more persistence in low wage growth than we had assumed. Another potential explanation is that labour market slack has increased over the past couple of quarters. Total hours growth has been weak since the start of the year, and a mechanical update would imply an increase in labour market slack over the past two quarters, although we will need to reassess our trends for labour supply for the February round (see below).

One factor that does not appear to have pulled down on private sector pay growth in recent years is the reduction in public sector employment and public sector pay restraint. In recent empirical work private sector pay growth was not found to be lower in areas with a high concentration of public sector workers over the period 2011-2014. There was some sign of a drag in 2015 but it was not statistically significant. Overall, it is likely that changes in average hours and the composition of the workforce explain at least part of the flattening off in pay growth, but it also highlights the downside risks if low inflation or labour market slack are exerting more of a drag than we anticipated.

Employment

The employment rate rose by 0.2pp to 60.0% in Q3. This was 0.1pp higher than the 59.9% forecast in the November IR. Our current Q4 forecast rises to 60.1%, locking in this upside news.

Employment reached another record high – with 31.2 million now in employment. Employment increased by 177,000 in the three months to September. There were increases in the number of self-employed workers (+38,000), part-time employees (+113,000) and full-time employees (+33,000). Vacancies fell slightly on the month but remained robust.

Inactivity

The inactivity rate fell by 0.1pp to 36.6% in Q3. This was 0.1pp lower than the 36.7% forecast in the November IR. The participation rate is now very close to the equilibrium

Chart 9: Compositional effects

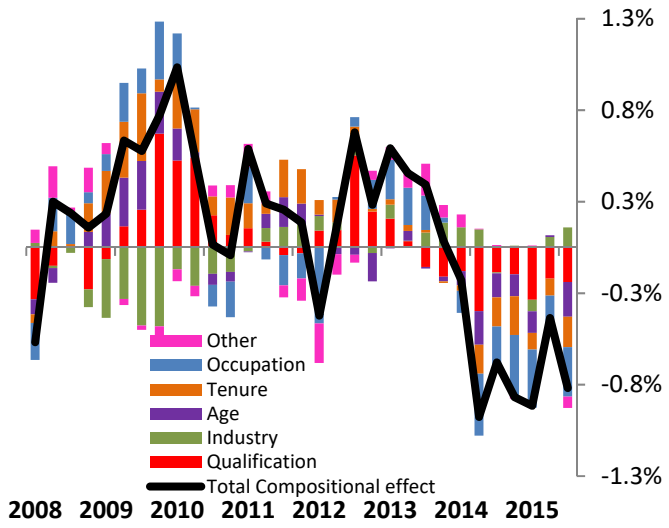


Chart 10: Voluntary job-to-job flows

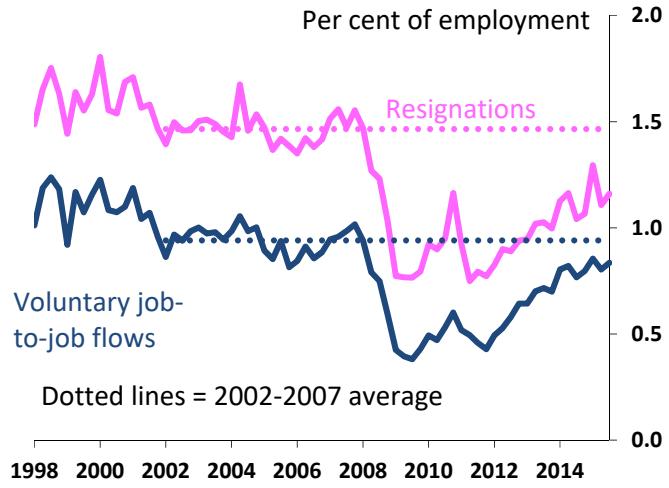
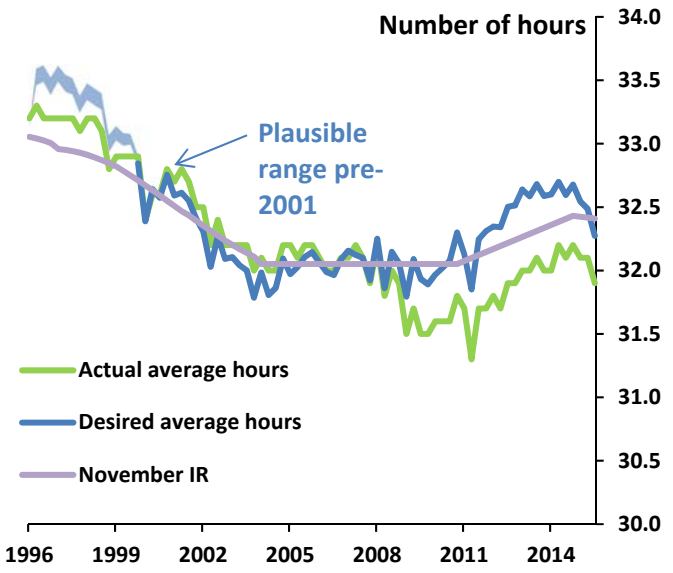


Chart 11: Desired average hours



estimate of 63.5%. The current Q4 forecast is flat at 36.6% - unchanged from the November IR.

Some of the increase in the participation rate is due to cohort effects. Each month a new wave of participants enter the LFS. The incoming September wave had a particularly high participation rate. They will remain in the sample for five quarters, but may not signal further increases to come.

Unemployment

The unemployment rate fell by 0.1pp to 5.3% on the month, 0.1pp lower than expected in the November IR. Our current Q4 forecast stays flat at 5.3% - slightly lower than the November IR but unchanged on the rounding.

The number of unemployed workers now stands at 1.75 million, 103,000 fewer than the previous quarter. The reduction in the number of long-term unemployed contributed the most to the reduction in the number of unemployed workers (-62,000), with the numbers of medium-term and short-term unemployed also falling (by -27,000 and -14,000 respectively). The proportion of short term unemployed (0-6 months) as a proportion of the active labour market is below the 2002-2007 average, the proportion of medium term unemployed (6-12 months) is at the pre-crisis average and the proportion of long term unemployed (12+ months) continues to move back to the pre-crisis average.

Another month of falling unemployment and vacancies means the labour market continues to move closer to its pre-crisis state, with the Beveridge curve continuing to loop back towards its pre-crisis locus.

Hours

Total weekly hours fell by 0.1% in Q3. Total hours came in 0.3% lower than expected in the November IR, driven by lower than expected average hours. Our current forecast for Q4 total weekly hours also comes in 0.3% lower than the November IR, with weakness in average hours expected to continue exerting a drag.

Average weekly hours fell from 32.1 to 31.9 between Q2 and Q3, a fall of 0.7%. That was 0.5% lower than expected. The November IR anticipated average hours in Q3 of 32.0.

Despite the large increase in the number of part-time workers in Q3, the number of workers who worked part-time because they could not find a full-time job fell by 30,000 (although the proportion is still well above the pre-crisis average, with 4.0% of all workers being part-time workers who want a full time job compared to an average of 2.1% between 2002-2007). This is reflected in a 0.7% fall in desired hours, from 32.5 to 32.3 hours per week (chart 11). That leaves desired hours below the assumed trend for average hours in the November IR. We will be revisiting this assumption as part of the supply stocktake for the February round.

Data Annex,