

Costs and Prices Monthly: May 2015

STRUCTURAL ECONOMIC ANALYSIS



	Annual CPI inflation				Employment rate (16+)				Unemployment rate				Average Hours (per week)				Whole economy total pay*			
	May MPC	Apr MPC	Feb IR	Monthly news	May MPC	Apr MPC	Feb IR	Monthly news	May MPC	Apr MPC	Feb IR	Monthly news	May MPC	Apr MPC	Feb IR	Monthly news (%)	May MPC	Apr MPC	Feb IR	Monthly news
Q4	0.94	0.94	0.94	0.00	59.67	59.67	59.62	0.00	5.68	5.68	5.75	0.00	32.24	32.24	32.24	0.00	2.10	2.13	1.69	-0.03
Q1	0.10	0.11	0.12	-0.01	59.95	59.83	59.76	0.12	5.51	5.55	5.60	-0.04	32.17	32.32	32.32	-0.46	1.81	1.95	2.30	-0.14
Q2	0.01	-0.09	0.03	0.10	60.05	59.96	59.91	0.09	5.35	5.43	5.51	-0.07	32.27	32.34	32.33	-0.22	2.11	2.32	2.60	-0.21
Q3	0.25	0.06	0.08	0.20			60.08				5.46				32.38		2.65	2.84	3.43	-0.19

* 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 again 0.0% in March. Our forecast is higher on the month by 0.1p.p. in Q2 and 0.2p.p. in Q3. We expect inflation to remain around 0% in the near term, before beginning to pick up quite sharply towards the end of the year. Unemployment continued to fall relatively rapidly; we project it to reach 5.4 per cent in Q2. Most of the output gap is now concentrated in below-trend average hours. Following discussion at Key Issues, we have revised down our near-term projection for the level of pay (and productivity) by 0.5pp over the next year or so.

Table 1: Difference in contributions from average

Percentage points	1997-2007 average	March 2015	Difference from average
Energy, food and other goods ^(a)	0.4	-1.1	-1.5
Services	1.6	1.1	-0.5
Total^(a)	2.0	0.0	-2.0

(a) Adjusted for the close to 0.4 percentage point downward bias from clothing that existed until 2010

Chart 1: Core goods and services diffusion indices

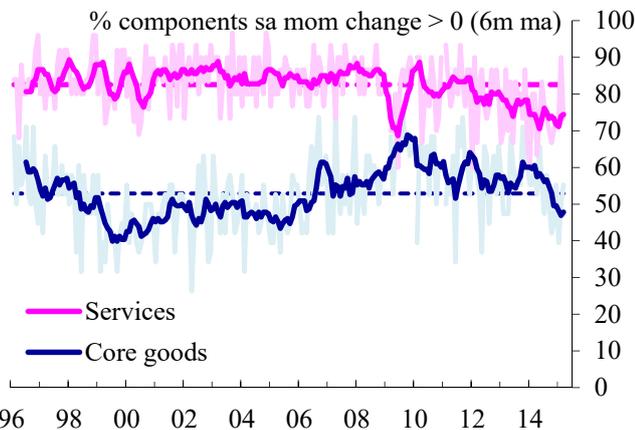
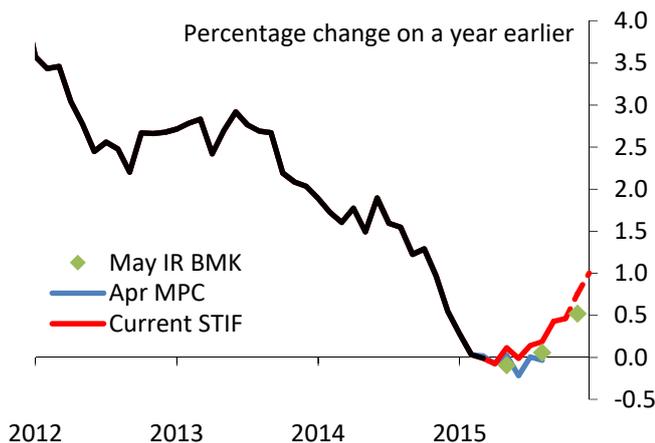


Chart 2: Short-term inflation forecast



Inflation

- CPI remained at 0.0% in March, as expected.** The [CPI indicator](#) provides more information about that outturn.
- The 2 p.p. shortfall from target is accounted for ¾ by food, energy and other goods and ¼ by services.** We judge the food, energy and other goods contribution to be driven mostly by external factors, while the services contribution to be driven mostly by domestic factors, principally the weakness of wage growth. Table 1 updates the table presented in the previous Open Letter.
- The proportion of CPI Services components with increasing prices remains low.** The Open Letter for the December outturn reported the proportion of the low-level components (excluding food and energy) with positive annual inflation rates. Since that letter, this proportion has fallen slightly from 67% to 62%, a little below its pre-crisis average. That movement reflects import price effects pulling down on a wider range of goods. But as Chart 1 shows, while developments in the (higher frequency) diffusion index for core goods are consistent with that observed after the late 90s appreciation, the proportion of services components with increasing prices remains unusually low.
- We expect inflation to remain around zero in the near term (Chart 2)....** Our forecast for April is -0.076%, the only monthly outturn for which we think the published 1d.p. number will be negative. That further fall is driven in large part by an airfares base effect. The timing of Easter last year meant that April's airfares were collected during the school holiday price spike, but this year Easter fell between the mid-month CPI price collections.
- Movements in sterling oil prices on the month mean that we no longer expect any negative quarterly inflation outturns (this is a change since the Benchmark Forecast). Indeed, together, energy and food can account for the revision to the forecast on the month. And at 0.3p.p., our forecast for Q3 represents 0.2p.p. upside news relative to the February IR.

Chart 3: Contributions to the expected increase in inflation

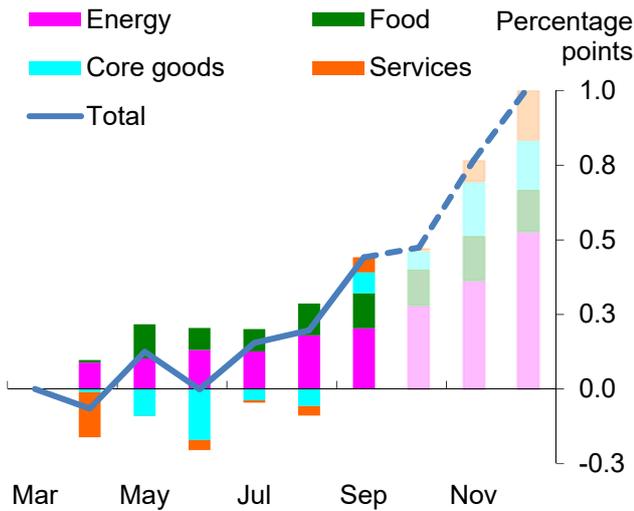


Chart 4: CPI Core Goods and Services inflation

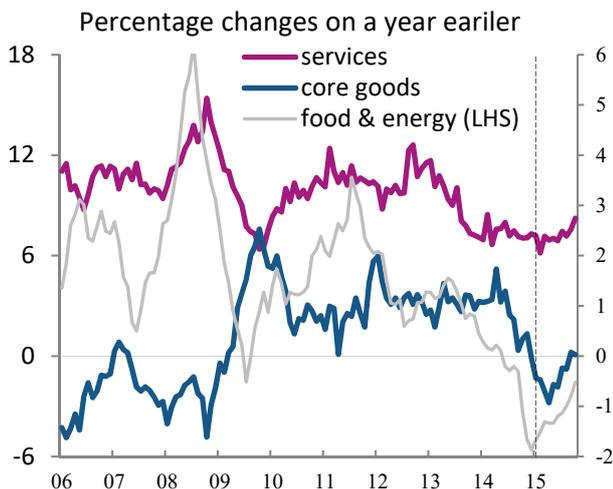
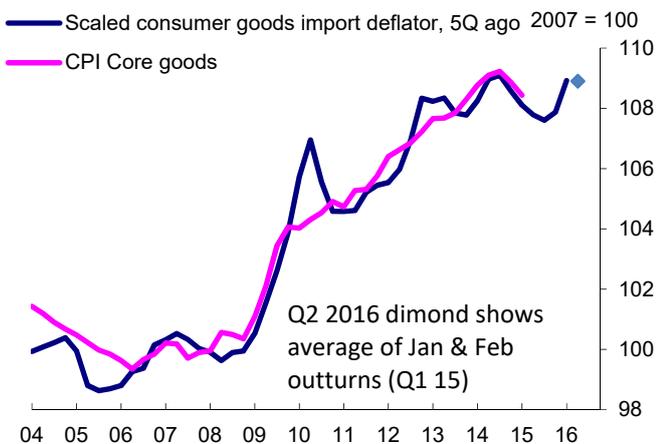


Chart 5: Core goods and consumer price deflator



6. ... then pick up quite sharply towards the end of the year as earlier price level effects, specifically from food and energy, drop out of the annual comparison (Chart 2).

7. Our indicative projection for Q4 is very close to the latest draft forecast.

8. **Food prices are expected to keep falling to Q3, but at a slower pace than last year.** The euro area is our main source of food imports, so we would expect sterling's appreciation versus the euro to put continued downward pressure on consumer prices. However, the food import price deflator has been surprisingly strong (it has actually been increasing since September), and food producer output prices have been stable for some time. But after further discussion with the Agents, we judge that food prices will continue to fall, as the current environment of heightened competition means that any cost saving is likely to be passed through. But we no longer think that there will be a marked increase in the rate of price falls. Even though we expect prices to fall further, it is at a slower pace than this time last year and therefore makes a positive contribution to inflation in Chart 2.

9. **We would also expect core goods and services inflation to pick up by the end of the year (Chart 4).** Changes in core goods prices typically follow changes in the consumer goods import price deflator with about a five-quarter lag (Chart 5). That relationship suggests more weakness in the near term, but, absent any further falls in the deflator, the downward drag from import prices should wane and the subsequent increase in import prices become more important.

10. Services inflation is expected to remain around its current rate for the six months; our indicative projection has it picking up a little thereafter.

Labour market

Unemployment

1. **Unemployment fell to 5.6 per cent in the three months to February, in line with our expectations (Chart 6).** This was a fall of 0.2pp on the previous non-overlapping three months. The timelier claimant count measure continued to fall to 2.3 per cent in March, a fall of 0.1pp on the previous month.

2. We are projecting unemployment to fall to 5.5 per cent in Q1 and 5.4 per cent in Q2, in line with the steer from our suite of short-term statistical models. Further out, the unemployment rate is assumed to converge to 5 per cent over the three years of the forecast. The fact that unemployment falls so gently over the forecast may on the face of it appear unlikely given its recent pace of decline. But such a slowdown is consistent with labour market flow

Chart 6: Unemployment forecast

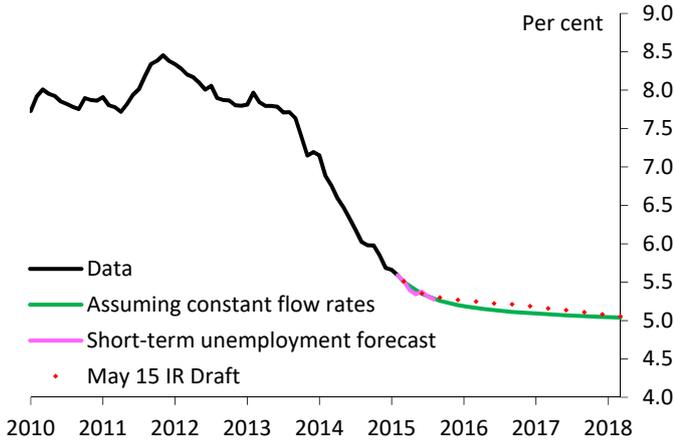


Chart 7: Unemployment by duration

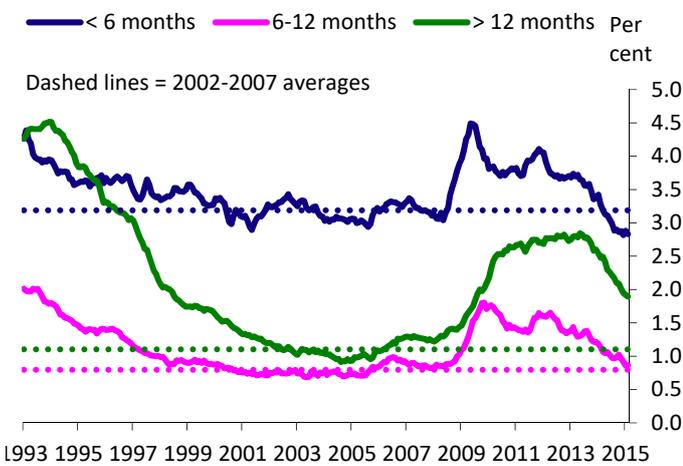
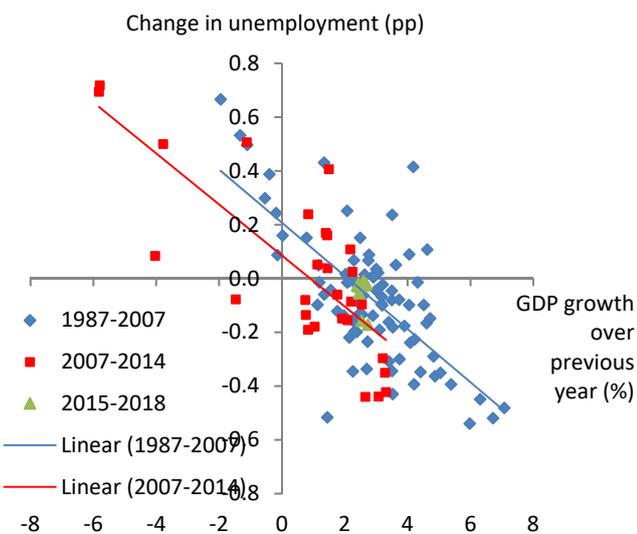


Chart 8: Okun's law



rates remaining at their current levels (a scenario shown by the green line in Chart 6). As the unemployment pool shrinks, fewer matches are generated holding outflow rates constant. If flow rates continue to evolve, of course, this could change the picture. For example, if job finding rates increase further (due to increased labour market tightness), this could generate downside risks to the forecast.

3. Most of the fall in headline unemployment on the quarter was accounted for by the medium- and long-term unemployed. The short-term unemployment rate remains below its 2002-2007 average (Chart 7). It has flattened over the last 7 months of data at around 2.8 per cent, a level below its previous series minimum. The longer this rate remains below its 2002-2007 average, the more possible it is to motivate a downside risk to our estimate of the natural rate.

4. A plot of (the growth-rate form of) Okun's law suggests that the average rate of GDP growth consistent with no change in unemployment has fallen, consistent with the weakness in productivity growth (Chart 8). The Draft forecast (the green triangles in the chart) assumes the economy reverts to the pre-crisis relationship.

Employment

5. There were few signs of slowing labour demand in the latest data. Employment grew by 248,000 on the previous non-overlapping three months, and the employment rate rose 0.4pp to 59.9 per cent. Full-time employees accounted for the majority of the increase (191,000). Vacancies rose by 4.5 per cent on the quarter, and are at a record high. Labour market tightness rose, with the number of unemployed persons per vacancy falling to 2.5 from 2.7 three months previously. And private sector surveys point to fairly flat (but high) employment growth expectations (Chart 9), with the Agents' expectations score ticking up slightly.

Labour force participation and average hours

6. The 16+ participation rate rose by 0.3pp on the previous non-overlapping three months to 63.5 per cent. This was 0.1pp higher than expected. The 16+ participation rate is 0.05pp below our estimate of trend. There is now little contribution to the output gap from the participation gap (Table 2).

7. In contrast, average hours were 0.4 per cent weaker than expected, and were 0.9 per cent below our revised estimate of trend in the three months to February. The average hours gap is the main source of slack in the

Draft forecast.

Chart 9: Employment surveys

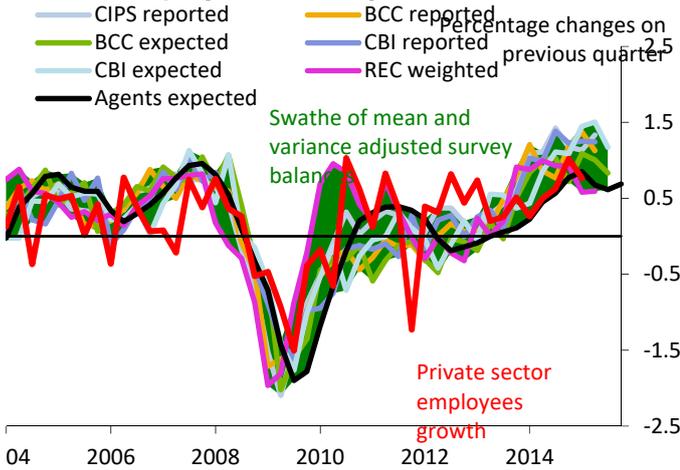


Chart 10: Loops around a convex wage Phillips Curve

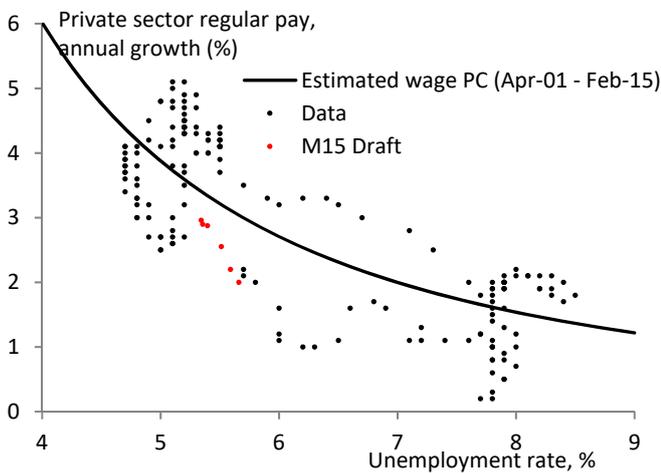


Table 2: Contributions to the output gap

	Feb IR		May BMK		May draft	
	Q1	Q2	Q1	Q2	Q1	Q2
U gap	-0.2	-0.2	-0.2	-0.1	-0.2	-0.1
AVH gap	0.0	0.0	-0.3	-0.2	-0.7	-0.4
LP gap	-0.6	-0.5	-0.2	-0.1	-0.1	-0.1
CAPU	0.3	0.2	0.2	0.2	0.0	0.0
Total	-0.6	-0.5	-0.4	-0.3	-0.9	-0.5

8. The projected level of total hours is 0.2 per cent stronger in Q1 and 0.4 per cent stronger in Q2 than assumed in the February IR. Although average hours are now assumed to be weaker, this is more than offset by upward revisions to our population assumption (adding 0.3 per cent to total hours relative to February) and to participation, and downward revision to the unemployment rate.

Pay

9. Whole economy regular pay growth rose to 1.8 per cent on a year ago, in line with our expectations and up from 1.6 per cent in the three months to January. Private sector regular pay growth picked up to 2.2 per cent. But due to weaker than expected bonuses, whole economy total pay growth was slightly weaker than expected at 1.7 per cent.

10. Following February’s data, and Committee discussion at Key Issues, we have revised down our projection for quarterly wage growth by 0.1pp in each quarter over 2015 Q1 – 2016 Q1. We have also made similar downward revisions to productivity growth. We calibrated this adjustment by assuming that the compositional drag on wage growth due to a larger than normal share of employment in low wage occupations persists for a year.

11. As discussed at Key Issues, there are other potential explanations for the weakness of wages – weak wage expectations may weigh on actual wage growth in a way not likely to be captured by any of our models. One could also appeal to convexity in the wage Phillips Curve. A.W. Phillips’ original paper noted that the curve itself was likely to be convex, and furthermore that the economy appeared to loop around this curve. **Chart 10** shows that one can reasonably characterise the recent behaviour of private sector pay growth as looping around a convex curve, as discussed in a recent post. The revised earnings forecast is consistent with a return towards this curve (the red dots).

12. This leaves projected annual pay growth in 2015 Q4 much lower than in the February IR (2 ¼ vs. 3 ½ per cent). This number will be published in the Stockton tables. The 3½ per cent projection generated press interest in February. Around ½ pp of the revision is due to upside news to pay growth in 2014 Q4 (related to unusually strong bonuses) and the consequent base effect a year later. The remainder of the revision reflects the news in the recent data, and the judgement requested at Key Issues.

13. Following revisions to the GDP backcast, unit labour cost growth in the year to 2014 Q4 has been revised up from 0.8 to 0.9 per cent.



[Data annex](#)