Essential reading – MPC

Costs and Prices Monthly: August 2015

STRUCTURAL ECONOMIC ANALYSIS

and

	Annual CPI inflation				Employment rate (16+)				Unemployment rate				Average Hours (per week)				Whole economy total pay*			
	Aug MPC	Jul MPC	May IR	*Monthly news*	Aug MPC	Jul MPC	May IR	*Monthly news*	Aug MPC	Jul MPC	May IR	*Monthly news*	Aug MPC	Jul MPC	May IR	*Monthly news (%)*	Aug MPC	Jul 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	-0.01	0.01	*-0.01*	59.72	59.90	60.05	*-0.19*	5.64	5.50	5.35	*0.14*	32.18	32.24	32.27	*-0.19*	2.83	2.94	2.12	*-0.11*
Q3	0.07	0.20	0.26	*-0.13*	59.82	60.01	60.11	*-0.19*	5.63	5.42	5.29	*0.21*	32.27	32.30	32.33	*-0.09*	3.29	3.38	2.78	*-0.09*
Q4	0.34	0.63	0.72	*-0.29*			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 0.0% in June and Q2 as a whole. That was in line with the May IR Forecast, but there has subsequently been 0.4p.p. of downside news, mostly from energy. Significant downside news to labour market quantities on the month left the total hours forecast for Q2 0.9% lower than expected in the May IR. Unemployment rose to 5.6%, higher than expected, with both average hours and participation lower than forecast. Wage growth was slightly below expectations on the month, but much stronger than expected in the May report.

Chart 1: Changes in the forecast since May IR

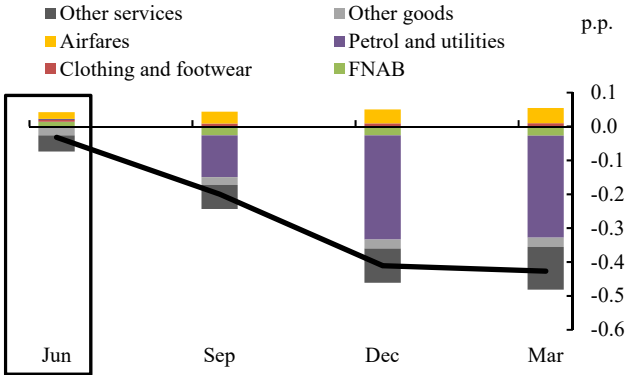


Chart 2: The short-term inflation forecast

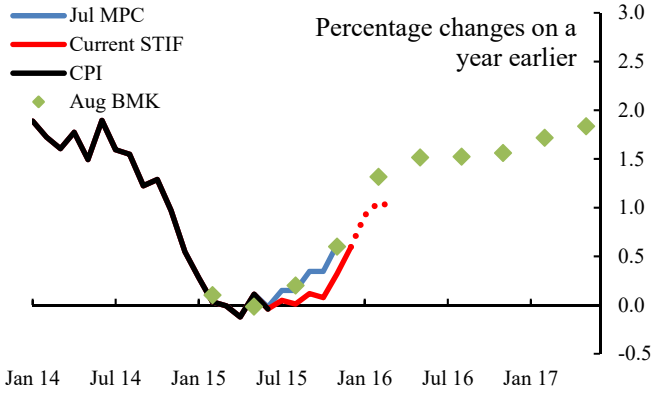
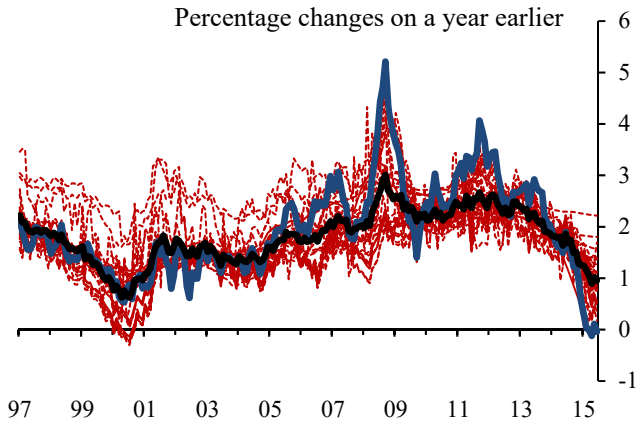


Chart 3: Measures of core inflation



Inflation

1. **Despite little news in recent forecast outturns, developments in energy prices leave our forecast for Q4 0.4p.p. lower than in the May Forecast (Chart 1).** Since the May Inflation Report, the £oil spot price has fallen by 9% and the futures curve over H2 by 19%. Retail petrol prices, however, still remain above those from the time of the May IR, but we expect these recent oil price falls to pass through to CPI inflation by September, lowering the forecast by 0.18 p.p. British Gas announced a 5% cut in their gas price, which will enter September's CPI. We now assume that the other utilities suppliers will also cut gas prices by 5% over the CPI months Sep – Nov. That leads to an additional 0.12 p.p. reduction in the forecast energy contribution.

2. The expected inflation contribution from other services is also lower than in May, by 0.1p.p. in Q4. But we do not interpret this as a weakening in domestically generated inflationary pressures. This is accounted for by package holidays and catering services, two of the services sub-components more sensitive to the exchange rate and world (food) prices.

3. **So a fifth Open Letter is now in prospect.** Our forecast for CPI inflation in December is now 0.6%. That would trigger a letter to be released alongside the February IR. Our indicative STIF model forecast for March CPI is now 1.0%, so the probability of a sixth letter has materially increased.

4. **How confident can we be that inflation will return to 2% within two years?** A key feature of the August Benchmark forecast is that inflation picks up to 1.2% after one year and is close to target at two years. Evidence from the price data is broadly supportive of that, but there are risks in both directions.

5. *Measures of core inflation remain low…* Our usual set of core annual inflation measures lies mostly between 0.5% and 1.0%. A recent note considered the properties of a much larger set, and concluded that the optimal measure is a principal component summary of 26 individual measures. That was 1.0% in the June data, compared with its series average of

Chart 4: STIF-consistent forecasts of core inflation

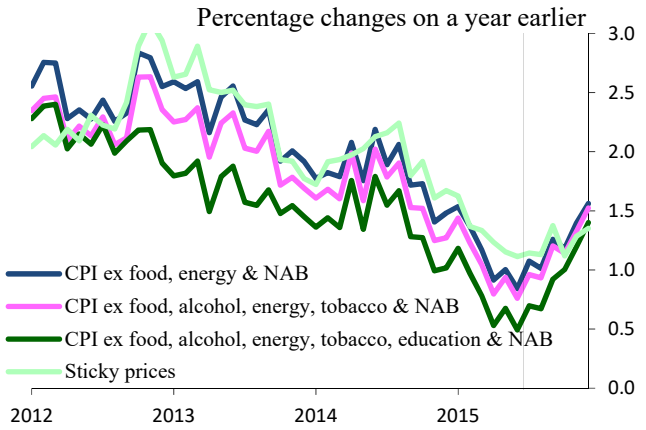


Chart 6: Core goods prices and the consumer goods imports deflator

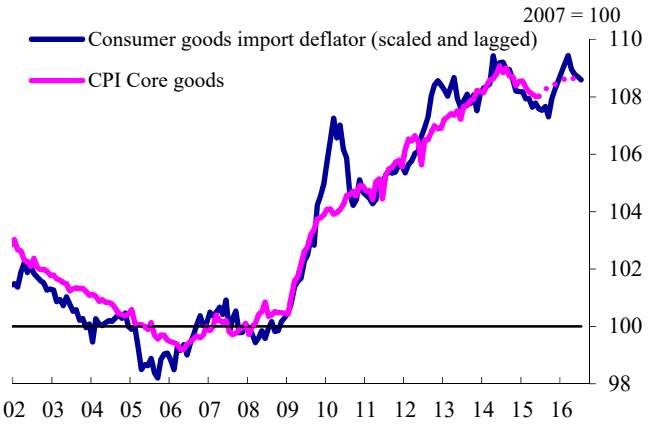


Chart 7: Wage growth and services inflation

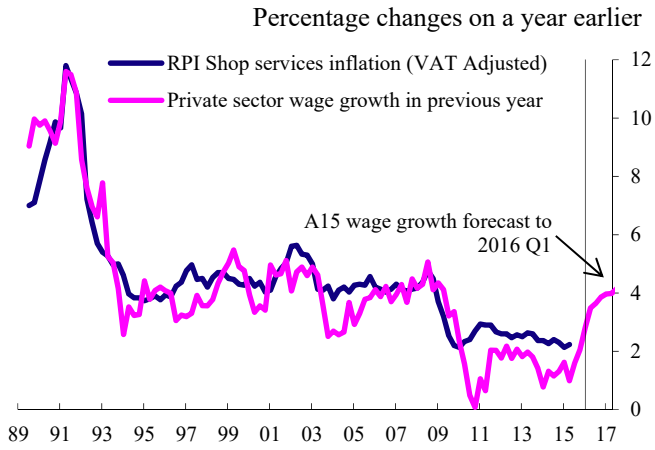
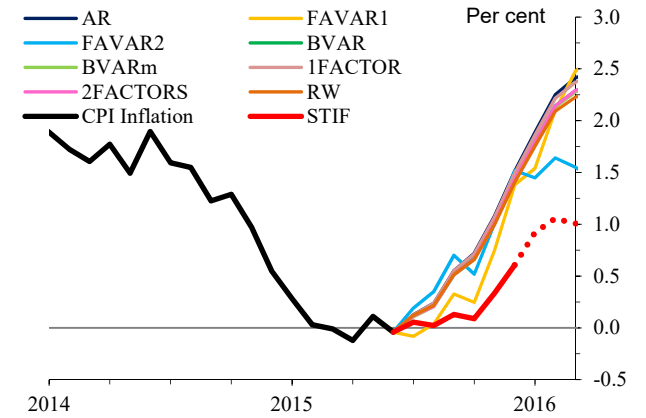


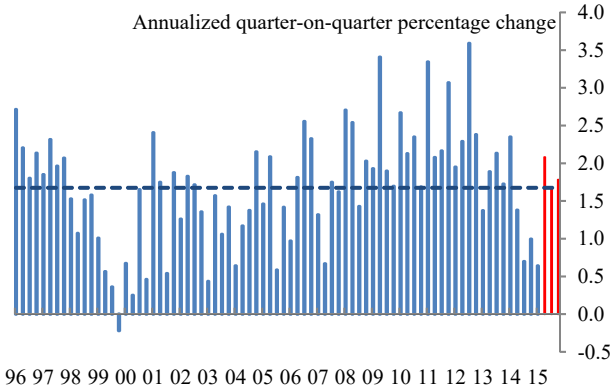
Chart 8: The suite of statistical inflation models



1.8%.

6. *…but in the STIF we expect these to rebound sharply* Most of the expanded core measure set are constructed using low-level disaggregate data, which we are not able to project forward. But for the simple exclusions-based measures, we do have projections consistent with the STIF. Chart 4 shows that we expect these measures to reach 1½% by December, materially higher than the 0.6% expected for total CPI inflation, reflecting the ongoing large drag from direct energy and food inflation. This pick-up is particularly visible in instantaneous space. Chart 5 shows that from Q3, we expect seasonally-adjusted quarter-on-quarter inflation rates to be around their historical average.

Chart 5 Seasonally adjusted qoq CPI inflation excluding food and energy



7. *We expect seasonally-adjusted core goods prices to start increasing, supported by the past increase in consumer goods import prices.* Core goods inflation tends to track the lagged consumer goods import deflator, and our forecast is consistent with that relationship continuing to hold (Chart 6). While a smoother CPI Core Goods profile does not look unusual, it might imply the balance of risks changes with horizon: to the downside over the remainder of this year, but to the upside from 2016.

8. *And there is no sign of inflationary pressures building within producer prices.* PPI output price inflation was 0.1% in Q2 while PPI input price inflation was -3.9%.

9. *Further ahead, the forecast increase in wage growth is consistent with a boost to services inflation.* Weakness in services inflation currently accounts for a quarter of the deviation in total CPI inflation from target. A longer run measure of services inflation (excluding insurance and travel costs) has followed lagged wage inflation quite closely (Chart 7). Empirically, this is a much closer relationship than that obtained with ULCs. So the recent pick-up in wage growth, and that expected over the next year could be considered consistent with an increase in services inflation.

10. *Our suite of statistic inflation models suggest upside risks.* The forecasts from the suite of statistical models are for a sharper increase in inflation than the STIF (Chart 8). But the usual caveat applies: these models are driven purely by data outturns, without any conditioning paths, so

Chart 10: Hours and GDP news in annual productivity growth in a given constraint quarter, compared to what was expected in the previous round

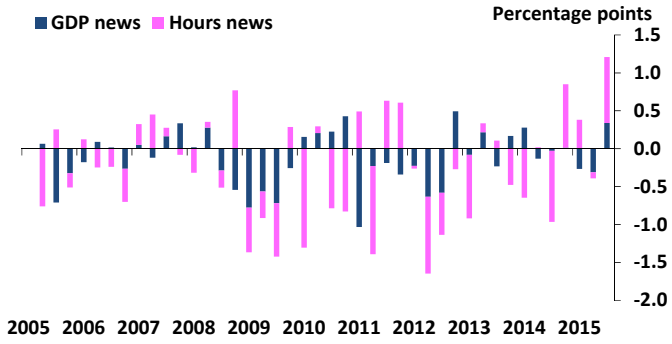
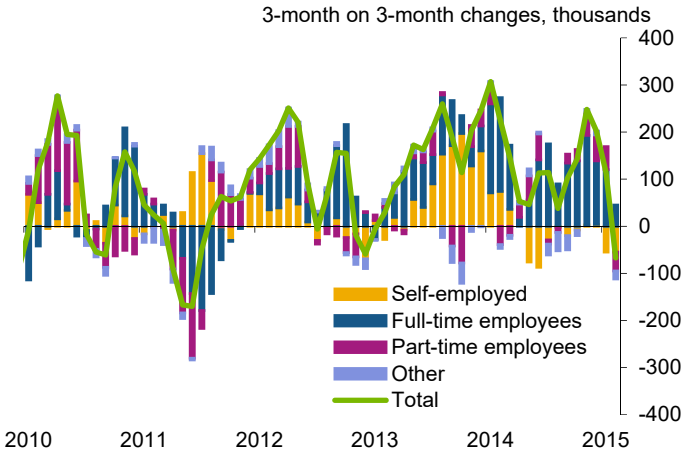


Table 1: News in total hours worked in 2015 Q2

	May IR	Aug bmk	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%

Chart 11: Employment decomposition



do not take account of factors such as expected utility price cuts.

Labour market

Quantities

11. **Downside news on the month added to the earlier downside news since the May IR**, with total hours worked being 0.9% lower than expected in May. The latest data were already incorporated into the benchmark forecast. The news while large is not exceptional compared to news shocks we've experienced in recent years. Chart 10 decomposes news in annual productivity growth for a given constraint quarter between GDP and hours news, relative to what we had forecast in the previous round. From this we can see that hours news of the size we have seen since the May IR have occurred several times since the onset of the crisis, with the notable difference that they have primarily been in the opposite direction. An examination of ONS revisions to GDP suggest that news in total hours has very little informational content about how GDP numbers are likely to be revised. Furthermore a simple test found no evidence of statistically significant autocorrelation in hourly productivity rates, either positive or negative.

12. **Table 1 decomposes the hours news since the May IR, showing that the news has been evenly split between unemployment, participation and average hours.** Since the May IR there have been three releases of labour market data from the ONS; in all three unemployment was higher and average hours lower than expected. There is a reasonable case though that at least some of this recent weakness is due to data volatility. The sampling errors provided by the ONS on the LFS data are large, with the Q2 news for both the participation rate and average hours lying within the 95% confidence interval provided. The 0.3pp downside news for unemployment was only a little below the +/- 0.2pp bounds for the outturn in May.

Employment and unemployment

13. **The three month on three month employment level fell in May for the first time since April 2013.** This was driven by a decline in part time employees by 40,000 and the self-employed by 55,000 (Chart 11). The number of full time employees increased by 45,000, although this is significantly slower than the average quarterly growth of 134,000 we had seen over the previous year.

14. Self-employment has fallen from its peak in June last year; however self-employment as a share of employment is still significantly above its pre-crisis average of 12.4%, currently at 14.4%. Even accounting for a pre-crisis trend in self-employment the self-employment rate is still elevated (Chart 12).

15. **The three month unemployment rate increased in May to 5.6%, the first increase since December 2013.** The claimant count rate, a more timely measure, has been flat at 2.3% for the four months up to june. We have subsequently revised up our forecasts and now have unemployment

Chart 12: Self-employment as a share of employment

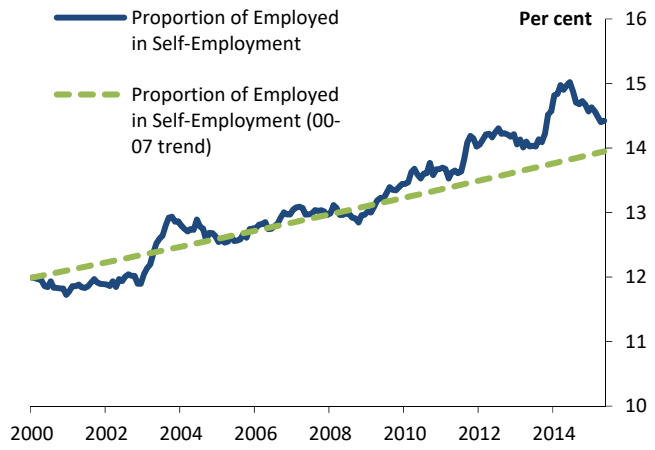


Chart 13: Short term unemployment forecast

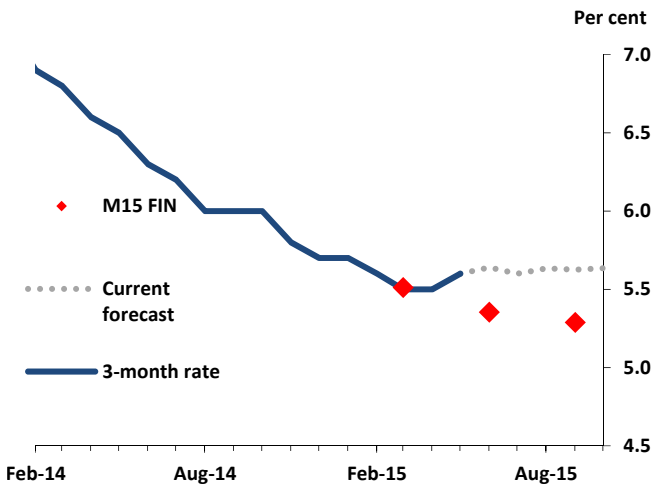
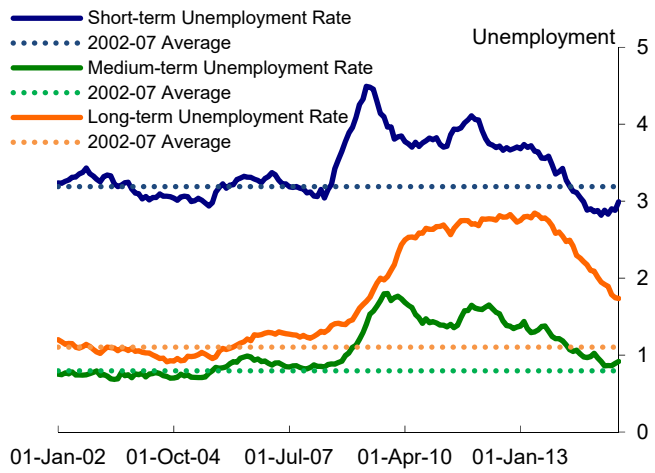


Chart 14: Short, medium and long term unemployment rates



remaining flat at 5.6% out to September (Chart 13). This represents 0.3% and 0.4% of news to total hours in Q2 and Q3 respectively relative to the May IR.

16. **The increase in unemployment came primarily from an increase in the short term (0-6 months) unemployment rate from 2.9% to 3% (Chart 14)**. This may suggest that we have reached the current limit for reducing such frictional unemployment. Medium term (6-12 months) unemployment also increased slightly. In contrast the long term unemployment rate continued to decline, providing some reassurance against the risk of hysteresis effects being large.

17. Evidence from employment surveys continues to remain strong, consistent with robust growth in employment in Q2 (Chart 15). Even the REC, which has seen some weakening since last September, is still at levels consistent with quarterly growth in employees of around half a percent. Alongside the continued strength of output indicators, this would suggest that the fall in hours is less likely to reflect a slowing in labour demand.

Participation and average hours

18. **Participation was slightly lower than expected in May and 0.2pp below the May Report projection. It is not clear from the data that the weakness of participation will be persistent and we have assumed that it will gradually unwind. This has led to a downward revision of our near term forecasts resulting in news to total hours of 0.3% and 0.1% for Q2 and Q3 respectively relative to the May IR.**

19. At the time of the May IR the participation rate was around our estimate of trend, 63.5%. Since this time there has been a slight unwind in the participation rate of those aged 65+, although this group is still pushing up on participation relative to the beginning of 2014 (Chart 17). The participation rate of those aged 35-49 has also declined in recent months. When giving reasons for inactivity, there has been a slight increase in the long-term sick in recent months.

20. Balanced against this decline in activity rates, there are still reasons to think that participation will pick up again. The proportion of people who are inactive but would like a job has ticked up slightly over the past three months as participation has declined and is slightly elevated relative to its pre-crisis average (Chart 18). Furthermore there are likely cohort specific effects from the latest wave of participants in the LFS sample pushing down on participation (Chart 19). The most recent wave's participation rate (16-64) is at 75.5%, compared to the average of the other four waves at 77.9%. Although this does not capture the recent decline in the participation rate of those aged 65+, it is indicative that some of the remaining decline in participation could reflect statistical noise.

Chart 15: Employment surveys

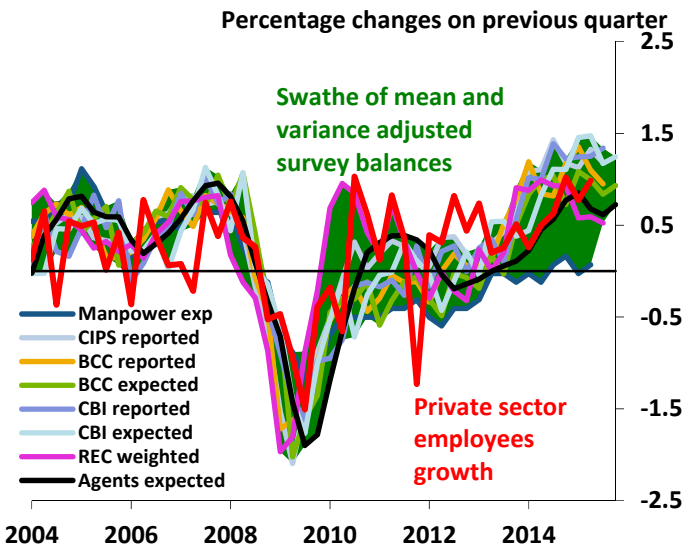


Chart 18: Measures of desired work

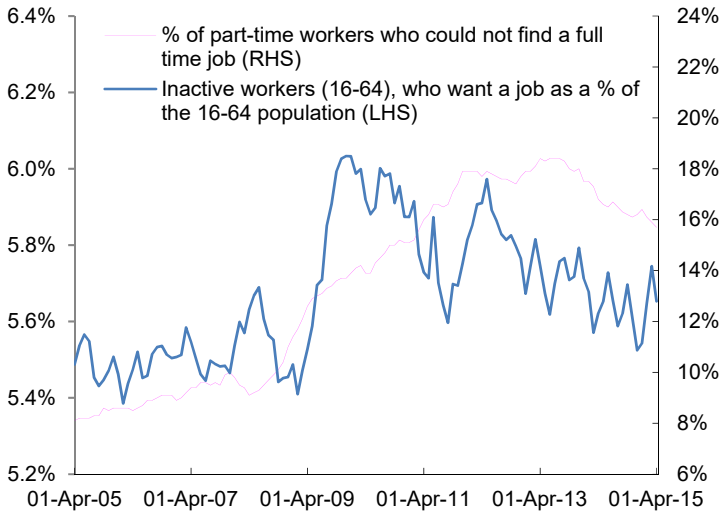


Chart 16: Labour participation trend and forecasts

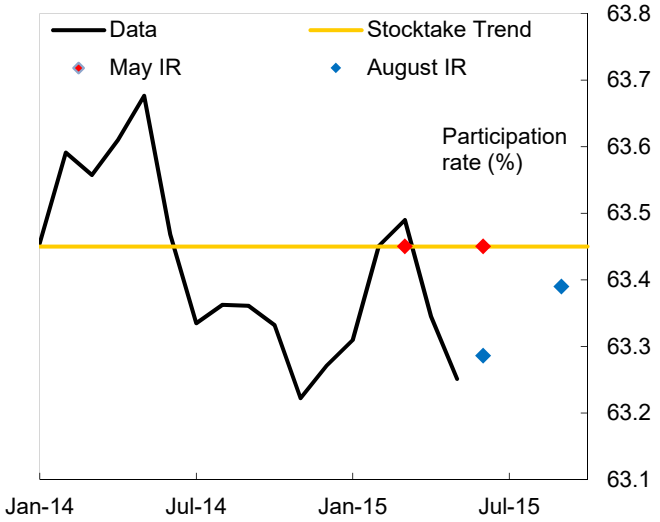


Chart 19: Participation rate swathe of the different cohorts making up the LFS

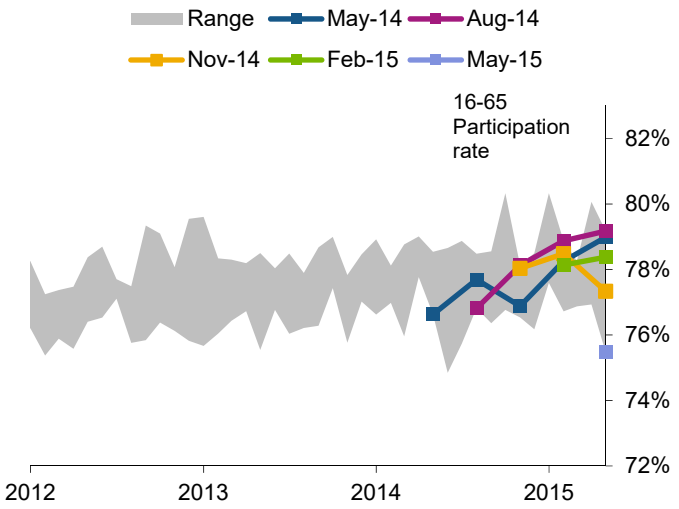


Chart 17: Labour participation decomposition by age group since 2014

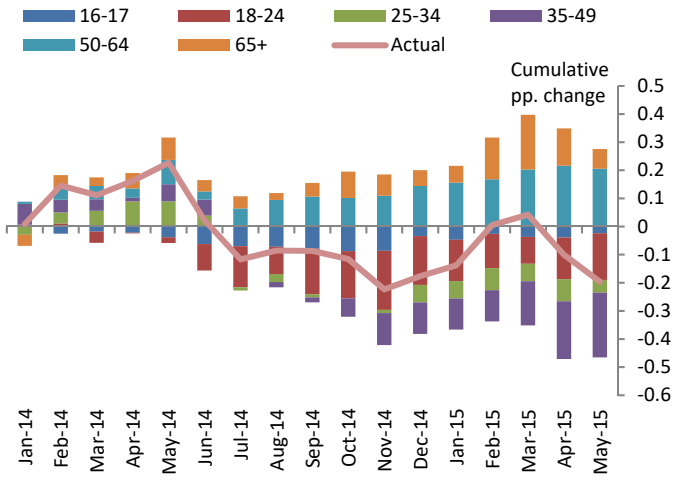


Chart 20: Recruitment difficulties

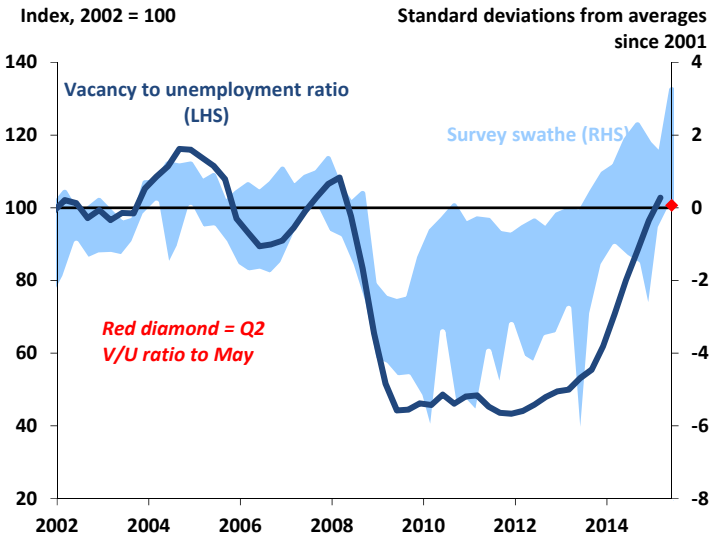


Chart 21: Aug BMK pay constraints

Chart 22: Pay vs settlements

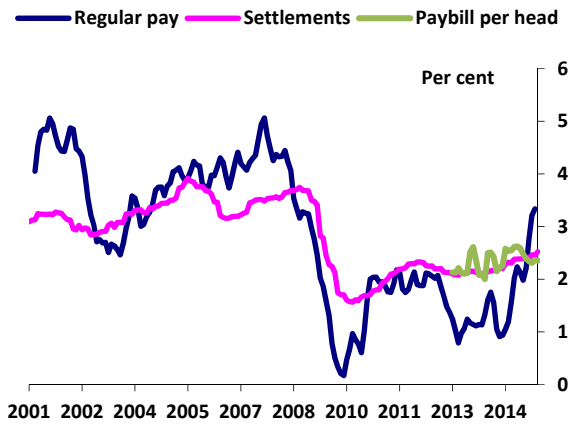


Table 2: News in Whole Economy total pay growth since May IR

	May IR		Current		News	
(percent)	Q2	Q3	Q2	Q3	Q2	Q3
WE Total Pay	2.1	2.7	2.8	3.3	0.7	0.5
WE Regular Pay	2.7	2.7	2.8	3.0	0.1	0.3
PS Total Pay	2.5	2.8	3.0	3.7	0.5	0.9
PS Regular Pay	2.9	2.9	3.3	3.4	0.4	0.5

21. **Average hours have remained relatively flat since the May IR at around 32.1 hours. However, due to our forecast for rising average hours, this represented downside news. Again we are assuming this will gradually unwind, with our current forecast resulting in total hours news of 0.3% and 0.1% for Q2 and Q3 respectively relative to the May IR.**

22. Our expectations of increases in average hours are based upon our decision to set trend average hours at 32.4 due to measures of underemployment. These measures still remain elevated, for example the percentage of those in part time employment because they could not find a full time job is at 15.7% compared to a pre-crisis average of around 8.9% (Chart 18). We have seen little movement in other indicators which led us to our original assessment of trend average hours at the time of the May IR, although many of these rely on quarterly micro data which we only have up to Q1 2015.

23. While recent news has been to the downside, there are still many signs of a tight labour market. **The vacancy to unemployment ratio, a measure of labour market tightness, remains elevated and at its highest level in over a decade. Similarly surveys of recruitment difficulties continue to remain high (Chart 20).**

24. It is worth bearing in mind that much of the downside news is due to slack in the labour market not being eroded as we expected, rather than slack increasing substantially. We expected the hours gap to narrow by 0.6pp between 2014Q4 and 2015Q2 but in the August draft it now widens by 0.2pp.

Pay

25. After strong upside news to wage growth in the April labour market data, the May data came in slightly weaker than expected, 0.1pp lower for both whole economy total pay (3.2%) and regular pay (2.8%). Our revised constraints for Q2 and Q3 for whole economy total pay are now 2.8% and 3.3%

(Chart 21). This represents 0.7pp and 0.5pp of news relative to the May IR for Q2 and Q3 respectively.

26. The news in earnings has been almost exclusively driven by the strong news in the April data, with the slight upside news from the March data and the downside news in the May data roughly offsetting. It should be noted that the April data involved a significant upward revision to the Q1 pay data as well. Most of the news has been in bonuses, which we have largely locked in.

27. While regular pay growth has picked up in recent months, we have yet to see a corresponding increase in other indicators of pay growth, such as settlements and pay bill per head. While these have increased slightly over the past year, they are below the recent high levels of regular pay growth (Chart 22).

Data Annex