Essential reading – MPC

Costs and Prices Monthly: March 2015

STRUCTURAL ECONOMIC ANALYSIS

	Annual CPI inflation				Employment rate (16+)				Unemployment rate				Average Hours (per week)				Whole economy total pay*			
	Mar MPC	Feb MPC	Feb IR	*Monthly news*	Mar MPC	Feb MPC	Feb IR	*Monthly news*	Mar MPC	Feb MPC	Feb IR	*Monthly news*	Mar MPC	Feb MPC	Feb IR	*Monthly news (%)*	Mar MPC	Feb MPC	Feb IR	*Monthly news*
Q3	**1.46**	**1.46**	**1.46**	*0.00*	**59.57**	**59.57**	59.57	*0.00*	**5.98**	**5.98**	5.98	*0.00*	**32.08**	**32.08**	32.08	*0.00*	**0.98**	**0.98**	0.98	*0.00*
Q4	0.94	0.94	0.94	*0.00*	59.67	59.62	59.62	*0.05*	5.68	5.75	5.75	*-0.06*	32.24	32.24	32.24	*0.01*	2.17	1.69	1.69	*0.48*
Q1	0.11	0.12	0.12	*-0.01*	59.86	59.76	59.76	*0.10*	5.43	5.60	5.60	*-0.17*	32.32	32.32	32.32	*0.00*	2.40	2.30	2.30	*0.10*
Q2	0.04	0.04	0.03	*0.00*	60.06		59.91		5.27		5.51		32.36		32.33		2.57	2.57	2.60	

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

Main message: This month's inflation forecast is similar to that in the February *Inflation Report*, with a trough of zero from March. Downside news in unemployment and upside news in employment leaves the labour force participation profile as in the February *IR*. The surprising strength in pay this month was due to bonuses, which are erratic, and so the outlook for pay is also largely unchanged with a gradual pickup over 2015.

Chart 1: Short-term inflation forecast

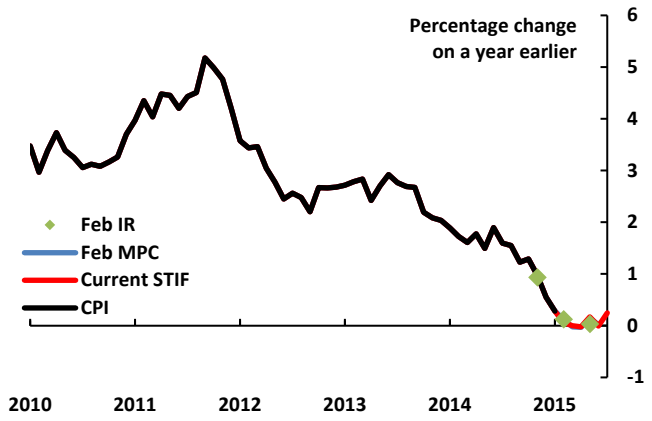


Chart 2: Changes on month/since February *IR*

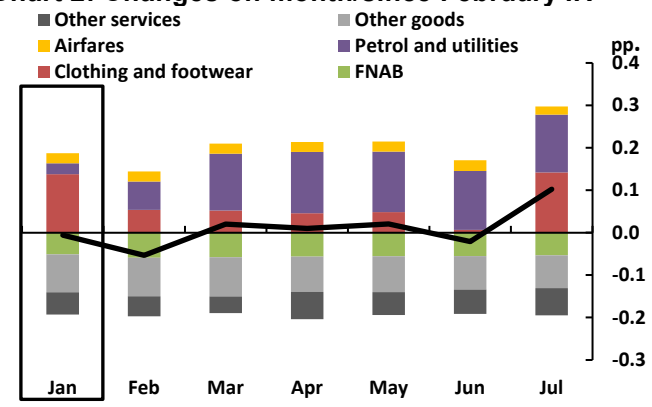
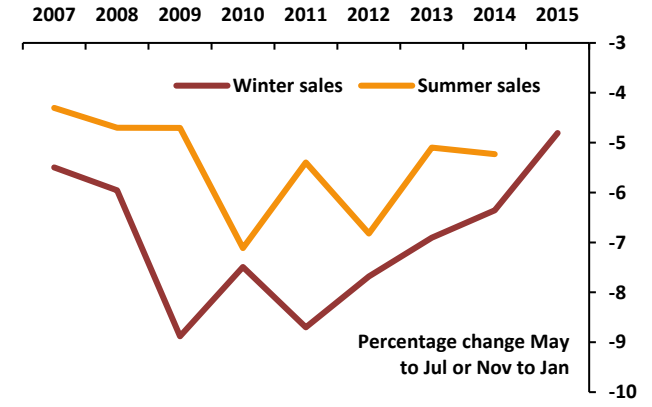


Chart 3: Depths of clothing and footwear sales



Inflation

CPI inflation fell to 0.3% in January, down from 0.5% in December and in line with our forecast. Food and energy were responsible for the fall and now contribute -1.0pp to inflation. The STIF profile is little changed in aggregate this month, but that disguises a higher forecast for petrol prices that is offset by slightly weaker forecasts for several other components. Inflation is therefore forecast to remain close to zero for most of Q1 and Q2 before beginning to pick up in Q3 (Chart 1).

1. **January's outturn contained little aggregate news but there were notable offsetting errors.** In particular, there was 0.14pp upside news from clothing and footwear, matched by downside news in food and non-alcoholic beverages (FNAB) and recreational goods and services **(Chart 2)**.

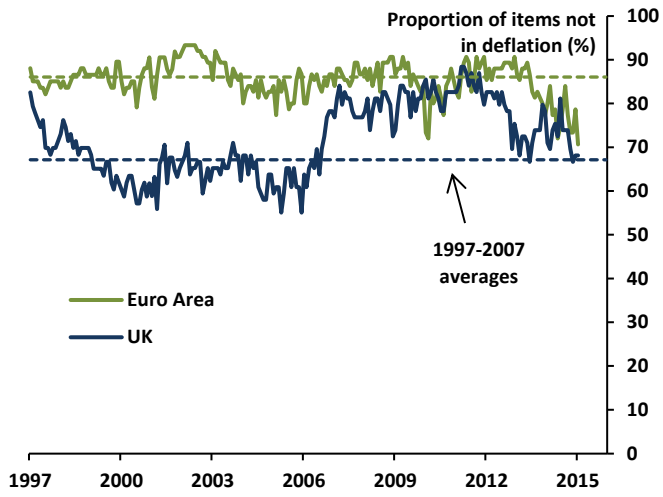
2. **We have unwound most of the news in clothing and footwear by February.** That reflects evidence that retailers needed to discount less in this year's January sales due to a combination of growing sales and Agents' reports of tighter stock management. Indeed, the depth of sales has generally been falling in recent years **(Chart 3).** ONS data also suggest that the increase in the breadth of sales between December and January this year was smaller than last year. Therefore, we view most of the news in January's data as due to sales and have mostly unwound it, which leaves the clothing and footwear profile only a little higher than last month.

3. **Higher oil prices have pushed up on the forecast by 0.1pp from March.** Petrol prices will continue to exert downward pressure, but are forecast to reverse recent falls following an 18% increase in the average sterling price of oil between January and February to date.

4. Offsetting this are downside changes from taking on news from non-clothing components in the January outturn and a couple of component level adjustments.

5. Inflation excluding FNAB and energy is expected to fall over the coming months, partly reflecting our assumption of continued exchange rate pass-through.

Chart 4: Proportion of UK and euro area CPI items excluding FNAB and energy not in deflation



How generalised is negative inflation?

6. As inflation has fallen towards zero, attention has turned to how widespread falling prices are becoming. A simple way is to look at the proportion of the 69 CPI items excluding FNAB and energy that aren't experiencing deflation (as discussed in this month's open letter). That proportion was unchanged on the month in January, at 68%. But the proportion may not be very informative, given how dispersed inflation rates are across the basket and the somewhat arbitrary nature of drawing a line at zero.

7. Changes in the proportion may be more helpful and it may also be instructive to compare it with countries that are arguably at more risk of generalised deflation, like the euro area. **Chart 4** shows this comparison, excluding food and energy for both the UK and euro area. While both proportions have fallen recently, the UK's remains close to its pre-crisis average, whereas it is lower in the euro area.

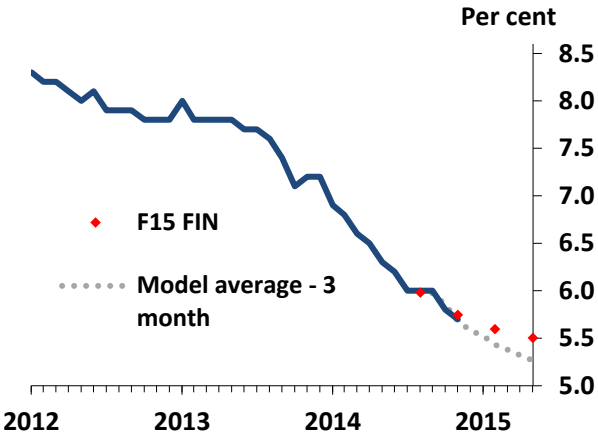
8. But note that even if a decrease in the proportion of non-negative inflation rates indicates that deflation may be becoming more generalised, it doesn't tell us how long it may last. For example, sterling's appreciation is a plausible explanation for the recent dip in the UK's proportion, which has been evident in higher frequency data too. This should have only temporary effects and would tell us little about how entrenched low inflation might become.

9. Finally, core measures of inflation have become more narrowly clustered around 1½ per cent in the January data (see data annex).

Labour market

Unemployment

Chart 5: Short-term unemployment forecast



1. **The unemployment rate in Q4 fell to 5.7% from 6% in the previous quarter, representing a fall of 1.5pp on a year ago.** This was slightly steeper than we had expected (to two decimal places), despite the pace of decline in unemployment slowing somewhat as the labour market tightens. A mechanical update of our short-term statistical unemployment suite points to a Q2 unemployment rate of 5.3%, 0.2pp below the February *IR* (Chart 5). This implies a faster erosion of slack going into Q2, but we will have another data point to inform our judgement prior to preparing the May benchmark forecast.

2. **Long-term unemployment remains elevated, but accounted for half of the decline in aggregate unemployment in Q4.** This in itself does not necessarily imply that the long-term unemployed are finding jobs, as they could simply be exiting the labour force. However, Chart 6 shows that long-term unemployment has not been falling due to labour force exit. Rather, job finding rates of the long-term unemployed have held up well during the recession, even after adjusting for government training schemes (GSTs).

Chart 6: Exits from long-term unemployment

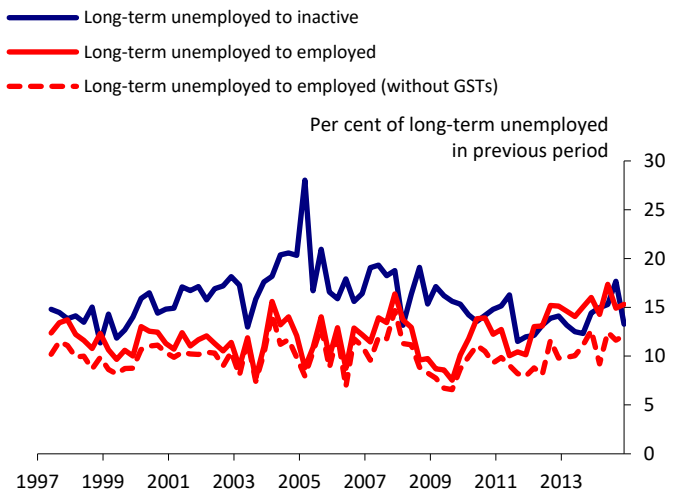


Chart 7: Selected labour market transitions[1]

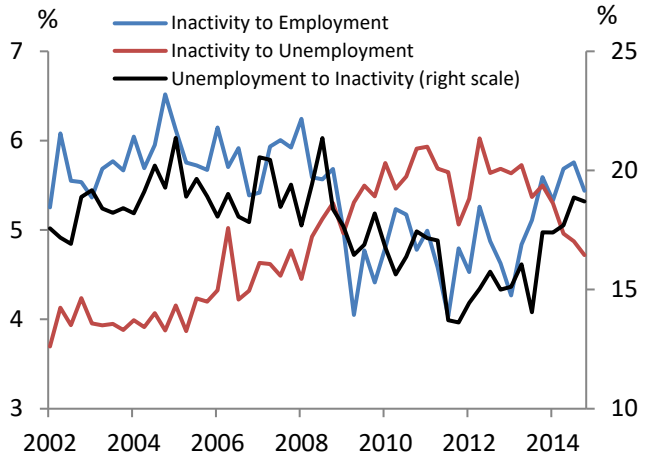
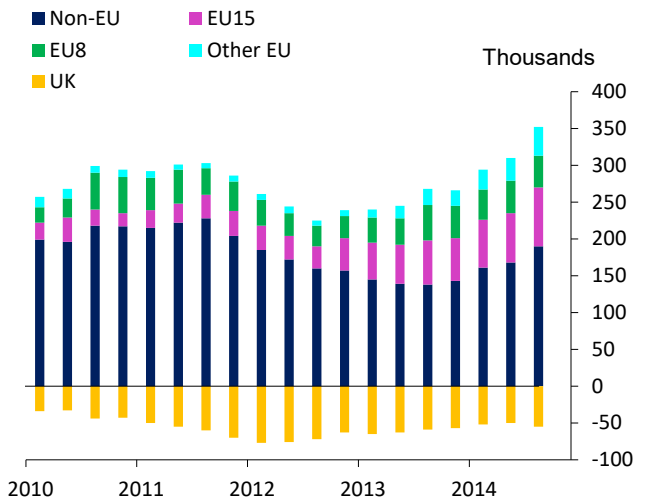


Chart 8: Migration



Labour force participation and employment

3. There were 30.9 million people aged 16 and over in work, resulting in a Q4 employment rate of 59.7% (up 0.1pp on the quarter). With 1.9 million remaining unemployed, the aggregate labour force participation rate was 63.3%. The downside news in unemployment was reflected in upside employment news, which has fed through to our outlook for the next two quarters (Q2 employment rate now at 60.1%), with little news in the participation rate (which ticked up slightly on the month). The path for participation is the same as in the Feb *IR*, climbing a notch to 63.4 in Q2.

4. The ONS have published revised estimates of the LFS longitudinal (flows) data that have been re-weighted based on the 2011 Census population estimates. Chart 7 plots a few key flow probabilities which display relatively pronounced movements and are instructive in understanding movements in the stocks. The chart shows that previously inactive individuals who enter the labour force are now more likely to do so by moving directly into employment as opposed to unemployment.

5. Also, the rate at which unemployed individuals exit the labour force has increased. This is likely to be due to a compositional effect in which many employees with strong labour force attachment lost their jobs at the onset of the recession and have by now re-entered employment and so are no longer in the unemployment pool. This combination of (i) lower inflows from inactivity to unemployment and (ii) higher outflows from unemployment to inactivity is likely to contribute to further falls in unemployment.

6. Net long-term migration to the UK was 298k in the year ending September 2014, an increase from 260k for the year ending June 2014. The pickup was broadly based across EU and non-EU immigration (Chart 8).

Hours

7. Average weekly hours in the three months to December were as expected at 32.2. With the employment outturn slightly higher (0.05pp) than expected, total hours worked were about 0.1% higher than expected. We will return to the judgements on trend average hours and trend participation as part of the May forecast.

8. Productivity fell in Q4 following the sharp increase in Q3. Hourly productivity in Q4 was only 0.3% higher than a year earlier.

Pay

9. Whole economy total pay growth was stronger than expectations in the three months to December at

[1] Transition rates are calculated as the gross flow between two labour market states as a percentage of the stock in the previous period.

Chart 9: Contributions to annual growth in bonuses

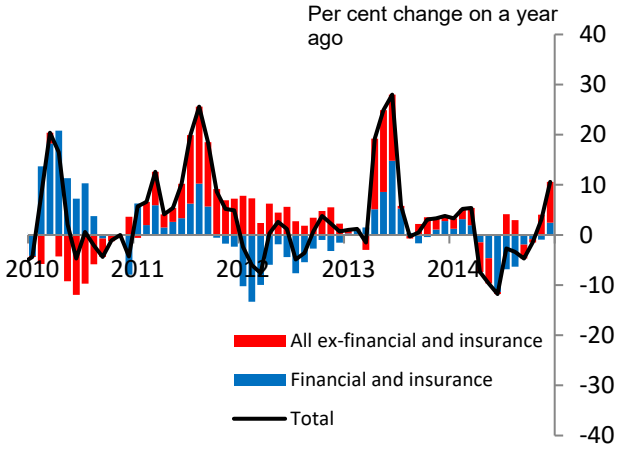
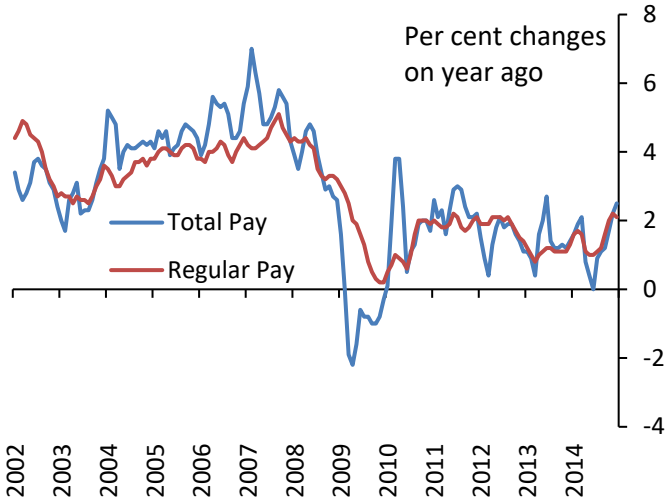


Chart 10: Private sector pay growth



2.1%. This is accounted for by bonuses—and not just in the financial sector (Chart 9). Private sector pay growth rose to 2.5%. As expected, 3 month on 3 month annualised regular pay growth fell back in December to 3% for the whole economy and 3.3% for the private sector.

10. However, Chart 10 puts the recent strength in pay growth into perspective. Despite the rebound in the latest data, underlying pay growth in the private sector is still roughly at levels seen during 2011/12.

11. Overall, we have not taken a substantial steer from the latest strength in bonuses, given the volatility of the series, keeping the outlook for pay growth in line with the February Report, but we will need to see how bonuses evolve over the coming months.

12. Continuing to look forward, the Low Pay Commission has recommended a 3% increase in the national minimum wage to £6.70 from October 2015, the same rate of increase as the year before. The proposal has yet to be accepted by the Government.

13. We don't have a full set of ULC data for Q4 yet, but the GDP second release does get us most of the way there, and assuming mixed incomes grow in line with employee compensation, it would point to unit labour costs rising by around 1.3% in the year to Q4. That is higher than the 0.5% we had projected in the February Report, but we don't yet know whether the news is in the wages and salaries component of compensation or the more volatile pensions bit. We'll find that out next month. Nevertheless, it remains subdued relative to pre-crisis growth rates.

Data annex