Costs and Prices Monthly: November 2015

STRUCTURAL ECONOMIC ANALYSIS

	Annual CPI inflation				Employment rate (16+)				Unemployment rate				Average Hours (per week)				Whole economy total pay*			
	Nov MPC	Oct MPC	Aug IR	*Monthly news*	Nov MPC	Oct MPC	Aug IR	*Monthly news*	Nov MPC	Oct MPC	Aug IR	*Monthly news*	Nov MPC	Oct MPC	Aug IR	*Monthly news (%)*	Nov MPC	Oct MPC	Aug IR	*Monthly news*
Q2	**-0.02**	**-0.02**	**-0.02**	*0.00*	**59.75**	**59.75**	59.72	*0.00*	**5.63**	**5.63**	5.64	*0.00*	**32.11**	**32.11**	32.18	*0.00*	**2.58**	**2.56**	2.81	*0.02*
Q3	0.01	0.04	0.06	*-0.03*	0.60	59.87	59.82	*-59.27*	5.37	5.51	5.63	*-0.14*	32.04	32.04	32.27	*0.00*	3.24	3.43	3.31	*-0.19*
Q4	0.11	0.19	0.35	*-0.08*	0.60	60.00	59.90	*-59.40*	5.34	5.43	5.54	*-0.09*	32.09	32.09	32.33	*0.00*	2.59	2.82	2.91	*-0.23*
Q1	0.67	0.78	0.97	*-0.11*																

Main message: CPI inflation was -0.1% in September, its joint lowest since official records began in 1997. We forecast another negative month, at -0.1%, in October. The forecast is 0.3pp lower than the August IR by Q1, reflecting lower petrol and clothing and footwear prices. Core inflation is forecast to pick up only gradually, but higher frequency movements indicate some recent strength. In the labour market, wage growth was weaker than expected and has also stalled a bit recently, at least at the aggregate level. But the labour market has tightened pointing to a pickup in inflation in the medium-term.

Chart 1: STIF changes since the August IR

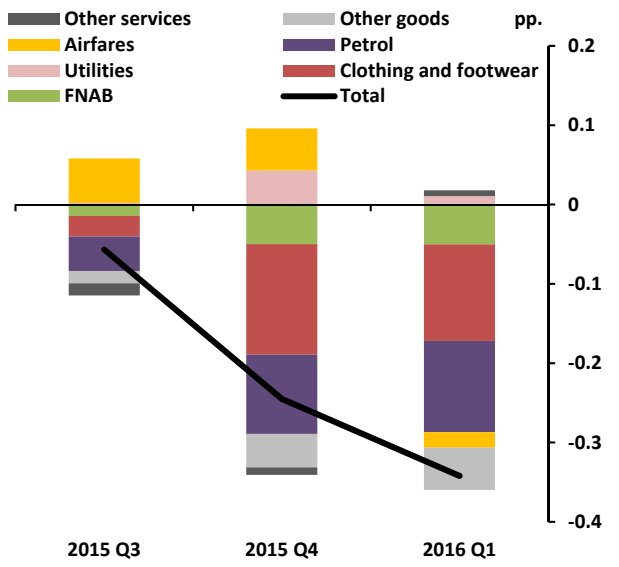
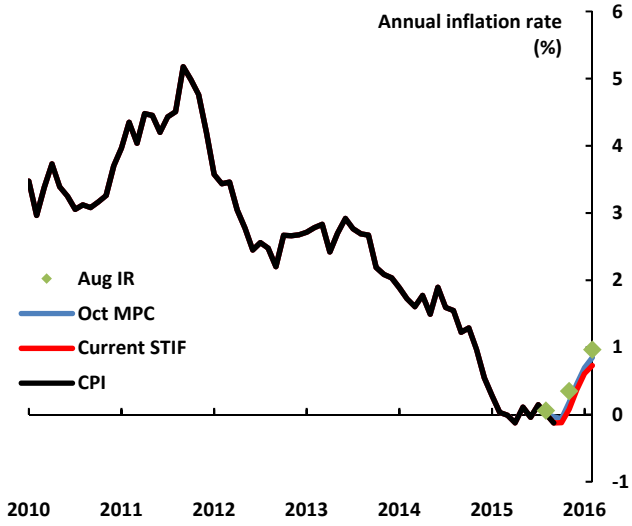


Chart 2: The short term inflation forecast



Inflation

Annual CPI inflation fell to -0.1% in September, 0.1pp below our forecast and the market median and its joint lowest since official records began in 1997. Based on ONS modelled estimates of CPI, this is also the joint lowest since March 1960.

For Q3, inflation was 0.0%, 0.1pp below the August *Inflation Report* forecast. The news has mostly been focussed in goods, with lower petrol prices following the fall in sterling oil prices since August accounting for much of that (Chart 1).

The forecast is 0.1% for Q4, a quarter of a percentage point lower than in the August IR. We forecast another negative outturn in October, at -0.1%. The August IR forecast for Q1 was slightly lower than the STIF at the time, but the latest forecast for Q1, at 0.7%, is 0.3pp lower for both (Chart 2).

Clothing and footwear prices have reduced the forecast by around 0.1pp. This is the net of upside news in July's outturn and downside news in August's and September's. The sales and recovery periods have been difficult to forecast over the past year or so. Upward pressure has come from stronger demand and tighter stock management, which has reduced the need for extensive sales, but downward pressure has come from previous weakness in imported costs. We think the weak recovery from this year's sales may in part be related to cheaper input costs and have therefore locked in the news, but there is a risk that some of it may unwind.

Sterling oil prices are now forecast to be 13% lower in Q4 than in the August IR, reducing the contribution from petrol prices by 0.1pp.

We have pushed back our forecast cuts to gas prices to January-March, from November-January. British Gas' 5%

Chart 3: Deviation of CPI relative to pre-crisis

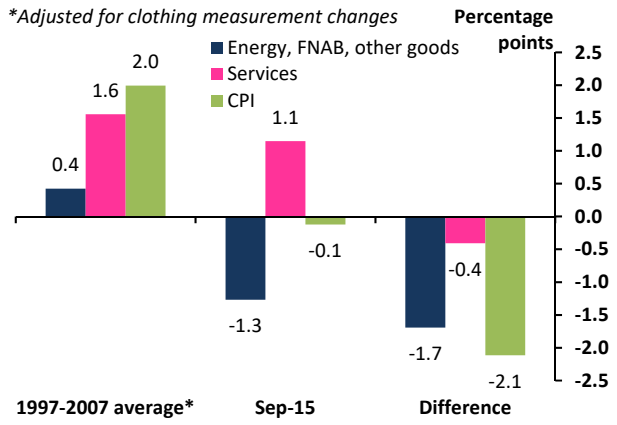


Chart 4: Waning impact of energy and FNAB weakness on CPI inflation

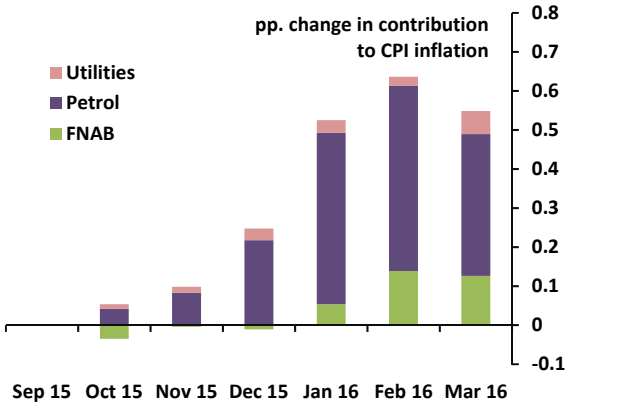
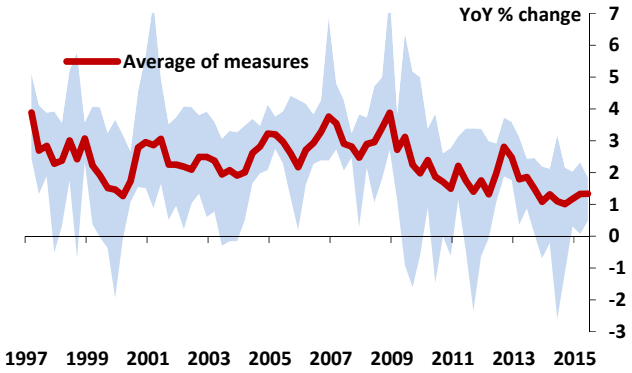
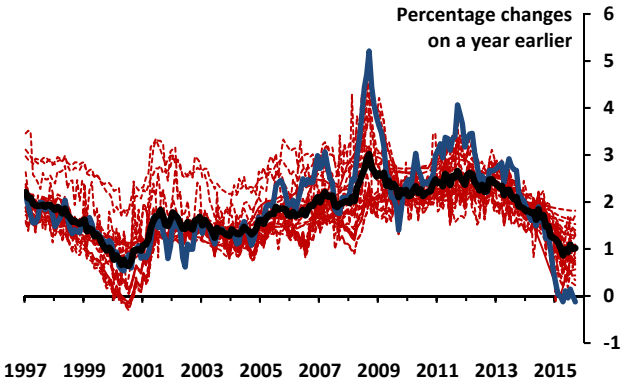


Chart 5: DGI measures are stable



Swathe includes whole economy ULCs, private sector AWE-based UWCs, services PPI, GDP deflator, GDP deflator excluding government, CPI services ex. air fares and education, and inverse import intensity weighted ONS core inflation ex. education

Chart 6: Measures of core inflation



gas price cut entered the CPI in September and we continue to forecast a further 5% cut by the other five major suppliers, following cuts by all six earlier in the year.

Four-fifths of the deviation of inflation from target is now estimated to be due to food and non-alcoholic beverages (FNAB), energy and other goods, up slightly from three-quarters at the time of the August IR (Chart 3). That reflects the lower contributions from clothing and footwear and petrol prices.

Services inflation picked up to 2.5% in September, but we expect that to ease slightly in October. Education price inflation is expected to fall, reducing CPI inflation by 0.1pp, as last year's increase in tuition fees for third-year students falls out of the annual comparison.

The waning effects of past falls in energy and food prices are expected to boost inflation over the coming months. Chart 4 shows that the drag from FNAB and energy is likely to ease by around a half of a percentage point over the next six months, driven by previous weakness dropping out of the annual comparison.

Measures of domestically generated inflation (DGI) are fairly stable. The average of a slightly broader range of measures than those discussed in a box in the August IR have picked up slightly over the last year (Chart 5), but the broad picture is of subdued but stable DGI.

ONS core inflation was 1.0% in September, 0.2pp lower than forecast at the time of the August IR. We forecast that to pick up to 1.3% by December and remain near there until March.

The principal component of 26 core measures of inflation remained at 1.0% (Chart 6).

Nonetheless, timelier measures of core inflation have edged up. Annualised three-month on three-month seasonally adjusted ONS core (CPI excluding FNAB, energy, alcohol and tobacco) reached 1.8% in September, from 0.7% three months earlier (Chart 7). A measure of services excluding air fares and education (one of our domestically generated inflation measures) was also higher. These are volatile, but we forecast them to remain flat to slightly lower over the next few months, at higher levels than seen earlier in the year. That seems consistent with the gradual unwinding of weakness associated with weak import prices and labour costs.

Chart 7: Timelier measures of inflation

Chart 8: Whole economy pay growth

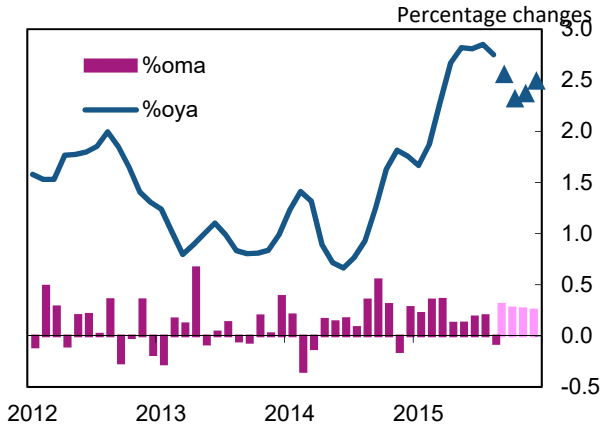


Chart 9: Distribution of regular pay growth across industries

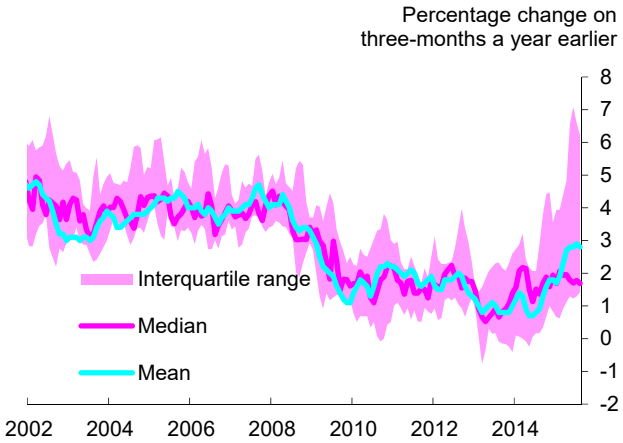
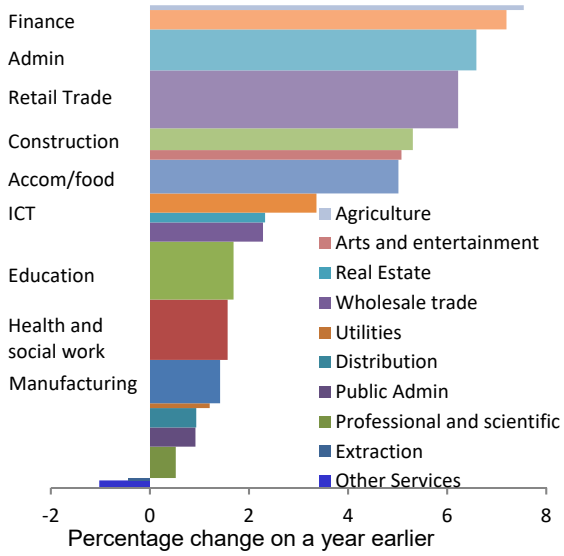
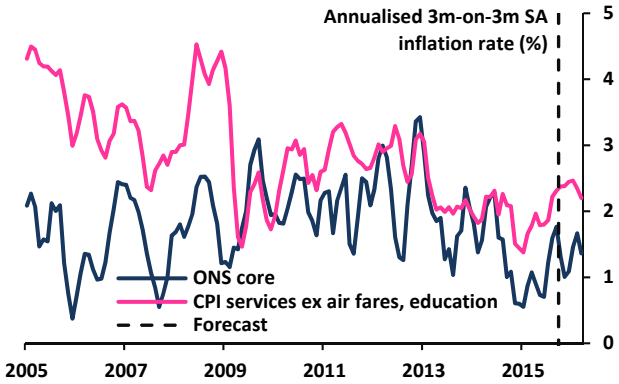


Chart 10: Regular pay growth by sector[(a)]



(a) Width of bars indicates share of employment.



Labour market

Earnings and unit labour costs

Pay growth in August was weaker than expected. Pay fell slightly on the month in August, leaving annual whole economy total pay growth at 3.0% in the three months to August, 0.1pp below our forecast. Private sector total pay growth was 3.4%, 0.1pp lower than expected. The news was concentrated in regular pay growth, which was 0.2pp lower than expected, thanks to the weak August outturn and downward revisions to the July data.

There were also revisions to the AWE levels data this month due to the data on average pay in firms of less than 20 employees being incorporated from the 2014 Annual Survey of Hours and Earnings (ASHE). Overall, the changes were small with the level of whole economy regular pay 0.15% lower over the past few years (and consequently little impact on annual growth rates).

The weaker outturn pulls down on our forecast and we expect annual pay growth to ease back over the rest of the year. The fall in August was the first fall in regular pay for nine months, but these data can be volatile and we have seen monthly falls in pay growth in previous periods of rapid growth in pay, such as late 2014 (Chart 8). We have not taken a strong signal from this data and are projecting solid increases in pay over the next few months. But we are unlikely to see a further pickup in annual pay growth over the rest of this year. Some pretty large increases in pay in late 2014 will be dropping out of the annual rate, and so annual growth in regular pay is expected to ease back a little to 2½% by the end of the year (blue diamonds in Chart 8). Whole economy total pay growth is now expected to be 0.3pp lower in Q4 than in the August Report.

There is more evidence of strong pay growth in the some sectors of the economy. Chart 9 shows the distribution of regular pay growth across sectors (weighted by the size of each sector). While regular pay growth in the median sector remains around 2%, the top end of the distribution has picked up very sharply over the past year – with industries accounting for a quarter of the workforce reporting increases in pay in excess of 6%.

There is no clear story for why some sectors are reporting strong regular pay growth. The sectors that are up at the top

Table A
Annual growth in selected measures of unit labour costs

	Pre-crisis average	2015 Q2	2015 Q3	2015 Q4
Whole economy				
ONS ULC (excl backcast)	3.0	2.2	2.3	2.0
ULC incl backcast	3.0	1.8	2.1	1.8
UWC incl backcast	2.5	1.5	2.0	1.8
AWE / productivity	2.5	1.2	2.0	1.4
Private sector				
ULC incl backcast	2.7	1.7	2.3	2.1

Chart 11: Contributions to employment changes

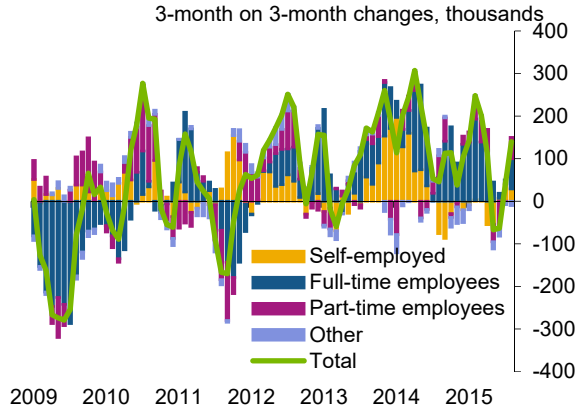


Chart 12: Short-term unemployment forecast

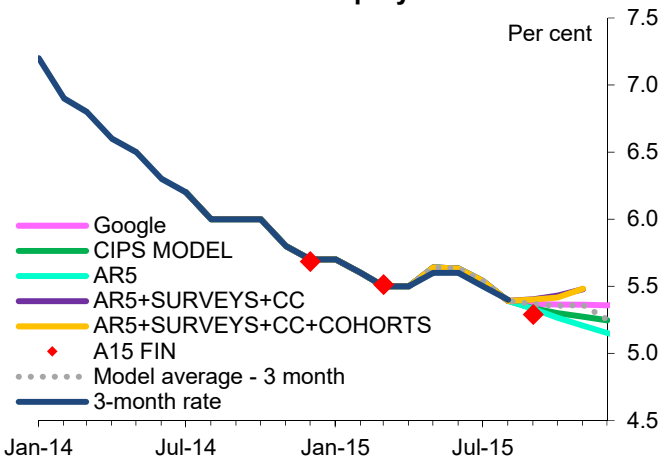


Chart 13: Unemployment rate and U*

of the distribution are mixed and cover low-paid sectors such as retail and accommodation and food services, but also high-paid sectors such as finance (Chart 10). Sectoral growth rates can be quite volatile, and some of the sectors now reporting high growth saw low growth a year ago. Like whole economy measures of AWE, industry pay levels can be affected by changes in the mix of the workforce, so some of the pick-up in these sectors may reflect the general waning of the drag from compositional effects: we would therefore be cautious about drawing strong conclusions about pay pressures.

There are a range of measures of unit labour costs (ULCs) that can be used to assess domestic cost pressures. The most comprehensive measure uses National Accounts data on wages, non-wage labour costs and an estimate of the labour component of self-employment income. Typically, we also take into account the backcast for GDP. A narrower measure is unit wage costs. This strips out the non-wage pension and NICs components, which can be volatile and are partly imputed. An even simpler measure, which also excludes mixed income and uses the timelier AWE data, is to look at the ratio of AWE to productivity.

With pay growth still weak, measures of unit labour costs remain below their pre-crisis averages despite weak productivity growth. Table A sets out the annual growth rates for various measures over the near term. By the end of the year the annual growth rate for the whole economy measures range from 1.4% on the AWE-based measure to 2.0% if we exclude the backcast from the most comprehensive measure. Stripping out the drag of public sector pay restraint, private sector ULC growth reaches 2.1% by 2016 Q1 also below its pre-crisis average of 2.7%.

Looking further ahead, the outlook for wages and unit labour costs will depend on the balance between supply and demand in the labour market and the outlook for productivity.

Employment

The employment rate was 59.9% in the three months to August, increasing by 0.2pp relative to three months earlier. This was broadly in line with our updated forecast ahead of the October MPC meeting. Full-time employees increased by 70,000 in this period and part-time employees increased by 50,000, contributing to an overall increase of 140,000 (Chart 11). The proportion of part-time workers that could not find a full-time job continued to fall, but remained well above its pre-crisis average.

In the near-term, we expect employment to grow by 0.4% on the quarter in both Q3 and Q4, similar to the August IR projection. Although most surveys of employment intentions have softened in recent months they remain positive. Vacancies, a measure of firms' labour demand, fell slightly on the month, but remained at near record high levels, also suggesting continued strength in labour demand.

Inactivity and unemployment

The inactivity rate was 36.7% in the three months to August, slightly higher than expected. The number of those

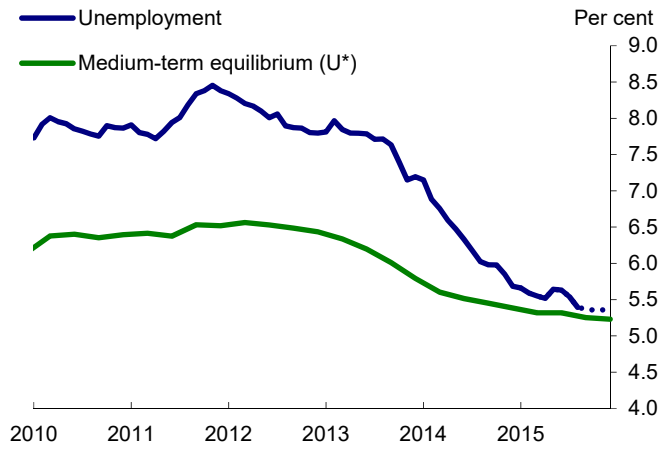


Chart 14: Beveridge curve

Chart 15: Recruitment difficulties

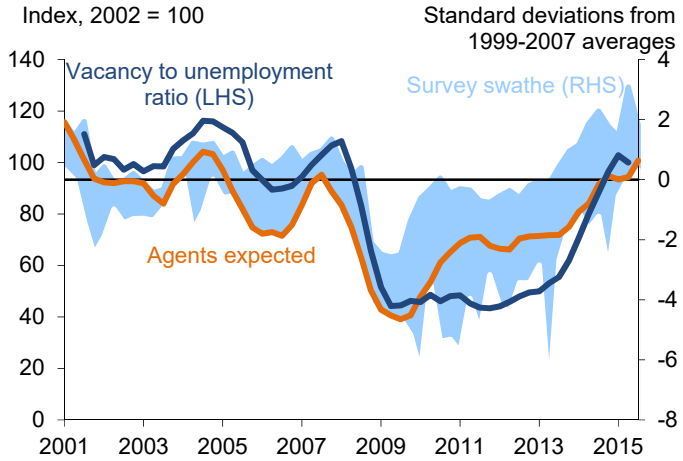


Chart 16: News in total hours relative to the August IR

inactive rose by 21,000 driven by increases in students and the long-term sick. We expect inactivity to fall back as participation returns to our estimate of trend.

The headline unemployment rate fell to 5.4% in the three months to August, which was 0.1pp lower than our forecast. The level of unemployment fell by 79,000 on three months earlier and is the lowest unemployment rate since June 2008.

We expect the unemployment rate to decline slightly in the near-term. The lower than expected outturn leaves our Benchmark forecast for unemployment at 5.4% in Q3 and 5.3% in Q4, down from 5.6% and 5.5% in the August IR. The slight fall is consistent with our suite of near-term unemployment forecast (Chart 12). The timelier Claimant Count rate remained flat at 2.3% in September, as it has for the past seven months.

The resumption in the fall in unemployment leaves unemployment close to estimates of its medium-term equilibrium. The short-term unemployment rate (0-6 months) and the long-term unemployment rate (12+ months) both fell on the month to 2.9% and 1.6% respectively. The medium-term unemployment rate (6-12 months) remained unchanged on the month at 0.9%. The falls in longer-term unemployment mean our estimate of U* continues to drift down: we expect it to reach 5.2% in Q4 (Chart 13).

The slight fall in both unemployment and vacancies means the labour market continues to edge closer to its pre-crisis state. This could be consistent with a gradual looping back of the Beveridge curve (Chart 14). But, with vacancies still above pre-crisis levels and unemployment still slightly elevated, even the recent data could still imply an upside risk to our assumption about the natural rate of unemployment.

The fall in unemployment is consistent with surveys of recruitment difficulties, which continue to remain elevated (Chart 15), although it is unclear how quickly this will feed into pay growth. This is consistent with our forecast for pay growth to continue to pick up in the medium term, but the elevated level of recruitment difficulties is not yet feeding into widespread pay pressures. The 12-month average of settlements in September was 2.2%, and a survey by HR consultants XpertHR shows employers expect settlements to remain around 2% in the first half of next year.

Hours and productivity

Average hours worked in the economy fell by 0.1% to 32.0 in the three months to August, and were as expected. The fall in average hours was driven mainly by the fall in average hours worked by full-time workers, which fell by 0.4% on the previous three months. Following the downside news in previous months, average hours remain 0.7% below the August IR profile.

Overall, total hours worked in August were up 0.1% compared with three months earlier: in line with our revised forecast ahead of October's MPC meeting. But cumulative news since the August IR leaves the level of our Q4 total hours forecast ½% lower than the August IR (Chart 16). We

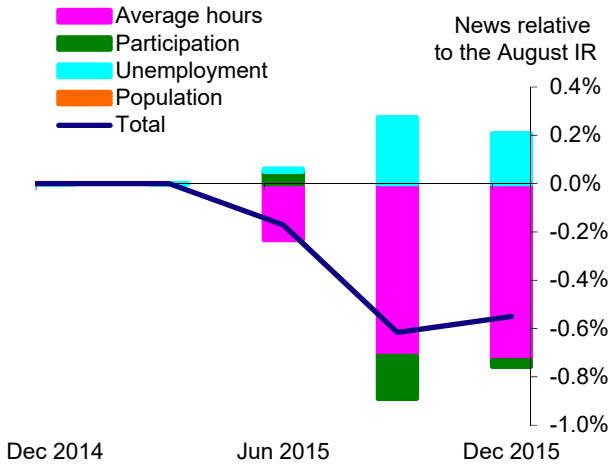
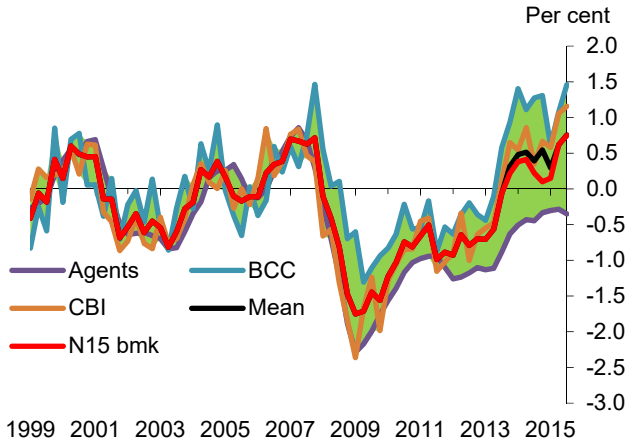


Chart 17: Surveys of spare capacity in firms



expect total hours to grow 0.2% in Q3 and 0.6% in Q4.

The forecast assumes that some of the recent strength in productivity growth is cyclical and will unwind over the forecast. Quarterly growth in productivity per hour averaged 0.6% in 2015 H1. But surveys of spare capacity within firms point to a pickup in capacity utilisation this year (broadly consistent with the November Benchmark judgements on the output gap – Chart 17). Our near-term projections for productivity are driven by the steer from surveys and recent labour market data, but are consistent with an expectation that some of the over-utilisation of labour within firms will unwind. Over the second half of this year we expect hourly productivity growth to average 0.2%.

Data Annex