

Costs and Prices Monthly: September 2015

STRUCTURAL ECONOMIC ANALYSIS



	Annual CPI inflation				Employment rate (16+)				Unemployment rate				Average Hours (per week)				Whole economy total pay*			
	Sep MPC	Aug MPC	Aug IR	Monthly news	Sep MPC	Aug MPC	Aug IR	Monthly news	Sep MPC	Aug MPC	Aug IR	Monthly news	Sep MPC	Aug MPC	Aug IR	Monthly news (%)	Sep MPC	Aug MPC	Aug IR	Monthly news
Q1	0.10	0.10	0.10	0.00	59.97	59.97	59.97	0.00	5.55	5.55	5.55	0.00	32.11	32.11	32.11	0.00	2.31	2.31	2.31	0.00
Q2	-0.02	-0.02	-0.02	0.00	59.75	59.72	59.72	0.04	5.63	5.64	5.64	-0.01	32.11	32.18	32.18	-0.23	2.83	2.83	2.81	0.00
Q3	0.14	0.07	0.06	0.07	59.81	59.82	59.82	-0.01	5.60	5.63	5.63	-0.03	32.20	32.27	32.27	-0.23	3.29	3.29	3.31	0.00
Q4	0.32	0.36	0.35	-0.03			59.90				5.54				32.33		2.64	2.64	2.91	0.00

* 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 July, 0.1pp higher than expected. The news in the data has been more than offset by further falls in the oil price, leaving the near term outlook for inflation slightly lower than the August IR forecast. **Unemployment** remained unchanged on the month at 5.6% in line with the August IR and we continue to expect it to remain at this rate for the remainder of the year. Total pay was 0.4pp weaker than expected due to downside news in bonus pay, but regular pay was in line with our forecasts.

Chart 1: Changes in the forecast since Aug IR

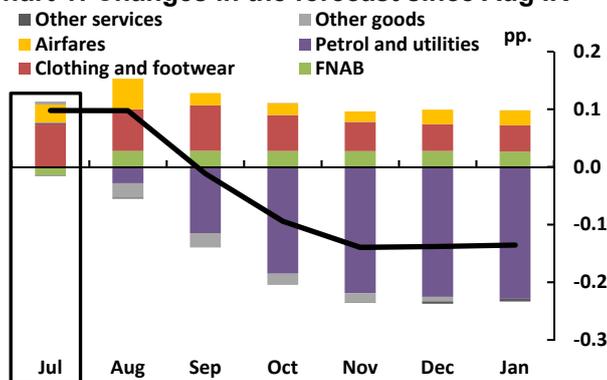


Chart 2: The short-term inflation forecast

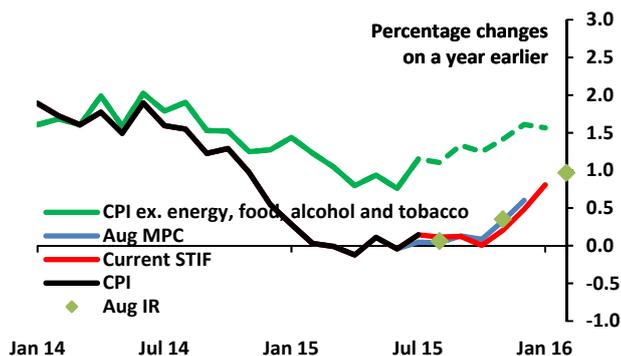
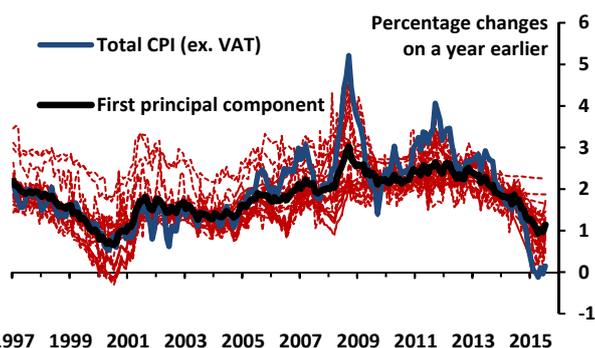


Chart 3: Core inflation measures



Inflation

The July outturn was 0.1pp higher than we were expecting.

This reflected higher than expected contributions from clothing, recreational goods, coach fares and airfares, partly offset by lower contributions from food and alcohol (**Chart 1**). Inflation is forecast to rise in the near term due to an increase in core inflation along with base effects in energy, which are still large enough to offset the downward pressure from recent falls in the oil price (**Chart 2**).

An unusual sales pattern last year accounted for some of clothing's upward contribution to inflation in July, but prices this year were also higher than expected. We had anticipated smaller sales this year thanks to intelligence from the Agents. However, clothing prices fell even less than we expected on the month, contributing 0.07pp of upside news. Discounts were less prevalent in July's price collection than in previous years, and retailers reported to the Agents that tighter stock control and the good weather this year has enabled them to sell this season's stock without the need for heavy discounting. Taking the months affected by summer sales together, prices fell by less overall in 2015 than in any year since 2010, before which comparable data are not available.

Part of the rise in core inflation in July seems likely to be sustained. The ONS measure of core inflation, CPI excluding energy, food, alcohol and tobacco, rose from 0.8% in June to 1.2% in July, higher than the 0.9% we were expecting. Alongside clothing, some of the other components within this measure are prone to volatility. However, core inflation also rose in July on measures which explicitly exclude or downweight the most volatile components. The CPI excluding energy, food, alcohol and tobacco is forecast to rise to 1.6% by January 2016 on the basis of the disaggregated forecasts for the remainder of the CPI (**Chart 2**).

The principal component of 26 different core measures rose in July to 1.1% from 1.0% in June (**Chart 3**). The 26 measures receive a relatively even weight in the principal component,

Chart 4: Oil futures and retail fuel forecasts

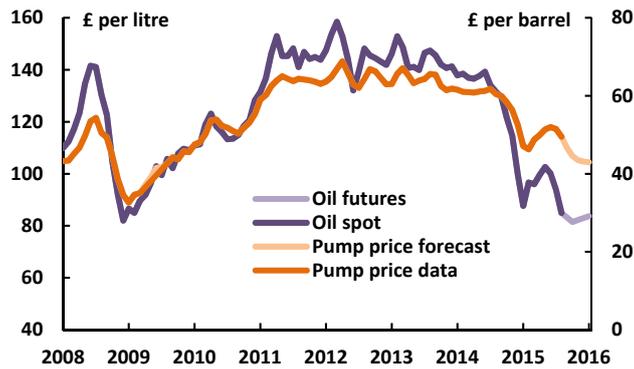


Chart 5: Net contributions to CPI inflation from fuel base effects and this year effects

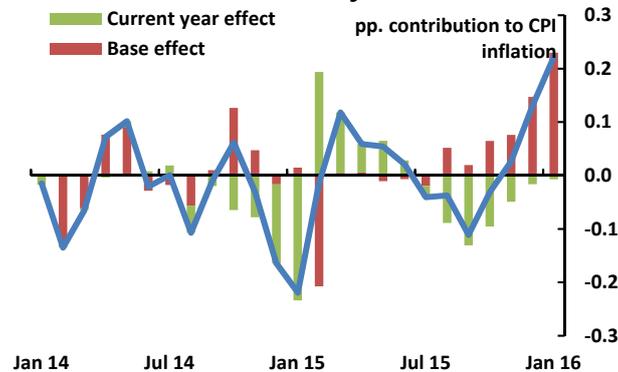


Chart 6: Short term unemployment forecasts

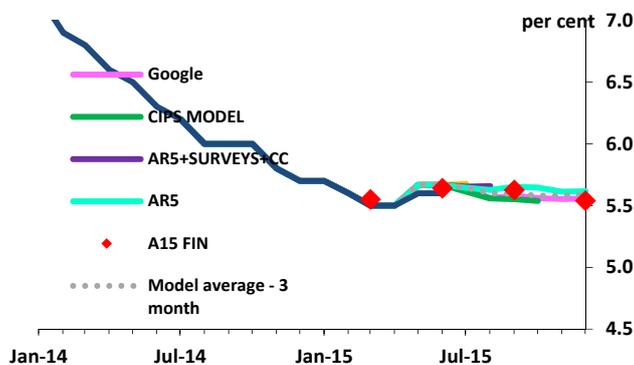
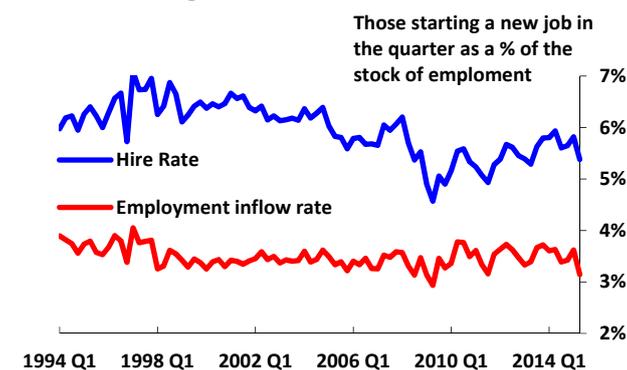


Chart 7: Hiring Rate



and 11 of the 26 measures were higher than 1.1% in July.

Combined with the upside news in July's data, the news in oil prices leaves the near term outlook slightly lower than the August IR. The sterling spot oil price has fallen to its lowest level since December 2008 (Chart 4). The 20% fall in the oil price between the August IR and August 26th produces an estimated drag of up to around 0.2pp over the six month STIF horizon, associated with lower prices of petrol, diesel and household liquid fuels.

Large positive base effects in fuel prices are expected to provide some offsetting upward pressure over the forecast, following from the sharp falls in successive months over the same period last year (Chart 5).

The forecast is based on an assumption that other energy providers will follow British Gas in cutting gas bills in September. So far, no further cuts have been announced, and it's increasingly likely that any further cuts would be implemented later than we assume in the forecast. However, the impact of this assumption on the STIF is small. (If no further cuts are implemented before September's price collection this would contribute 0.02pp upside news to the forecast).

Food prices remain in deflation over the forecast. Our internet collection of food prices has increased the FNAB forecast for next month relative to what we were expecting at the time of the IR (see the green bars in Chart 1), but food price inflation averages -1.7% over the forecast, consistent with lower import prices and competitive pressures.

Labour market

Employment and Unemployment

The unemployment rate in the three months to June remained unchanged on the month at 5.6%, in line with our expectations. The recent slowdown in the decline in the unemployment rate, coupled with the claimant count data, which has been unchanged since March at 2.3%, has our short term unemployment forecast models projecting the unemployment rate to remain unchanged for the next six months at 5.6% (Chart 6). The long term unemployment rate fell to 1.7% from 1.8% in the previous quarter, indicating a continued gradual fall in the medium term equilibrium unemployment rate. The short-term unemployment rate increased from 2.9% to 3% in the same period.

The recent increase in unemployment has been driven by a decline in the rate of hiring, whereas the rate of job destruction has remained relatively flat. These data though are very volatile, Chart 7 shows how the hiring rate has been trending up since 2010 and has only sharply dropped in Q2. To a degree we suspect this is data volatility. Other flows are still showing relative strength in labour markets; the job losers rate (those who involuntarily separated from their job) continued to decline in Q2.

Employment surveys are still broadly consistent with continued employment growth (Chart 8). Agents' contacts

Chart 8: Swathe of Employment Expectation Surveys

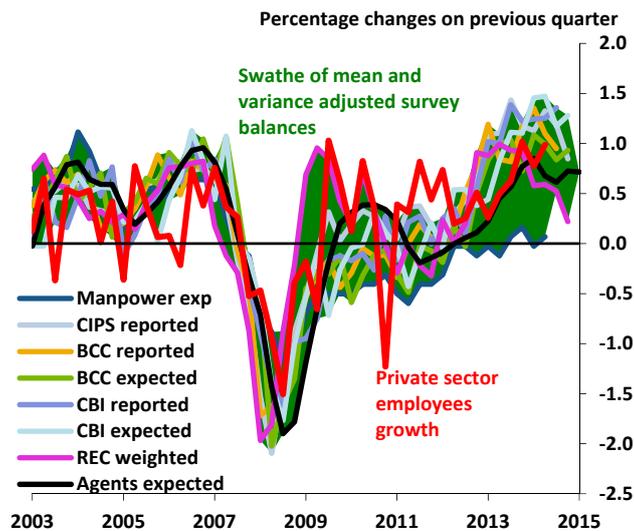


Chart 9: Participation rates of cohorts sampled in next month's data

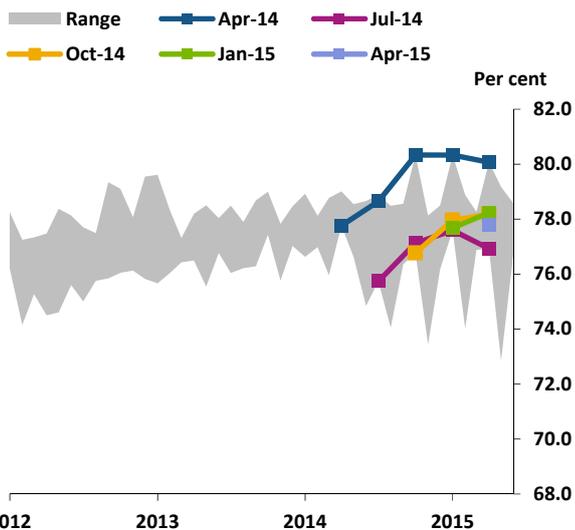


Chart 10: Bell and Blanchflower measure of desired hours

suggest that there has been a softening in employment intentions in some areas, but all Agents report that employment intentions are still positive in their areas.

New migration data were released on August 27th. Net long-term inward migration was 330,000 in the four quarters to 2015 Q1, around 0.6% of the population and was the highest net migration on record. This is about 30,000 higher than we had in our latest forecast.

Participation and hours

Participation was down on the quarter from 63.5% to 63.3% as expected. This decline is partially explained by an increase in the long term sick as a share of those inactive as well as an unwind of the Q1 increase in the activity rate of those over 65.

We expect participation to tick down next month due to upcoming cohort effects. Each month of labour market data from the LFS consists of five waves of participants who are sampled every three months, meaning that there are 15 waves involved in the survey at any one point. Each month one wave falls out and a new wave is introduced. The wave which is falling out of the LFS next month had an exceptionally high participation rate of 80.1% (16-64) (**Chart 9**). While it is hard to predict the characteristics of the new cohort we expect the aggregate estimate of the participation rate to fall back slightly.

Average hours were again below our forecast, staying flat at 32.1 hours in Q2, 0.2% below our forecast of 32.2 hours. **Chart 10** shows average hours, our current trend for average hours in the August IR and our updated Bell and Blanchflower measure of desired hours. Our current forecast for trend is based upon the expectation that the gap between desired and actual hours will be eliminated by a roughly equal increase in average hours and decline desired hours. In the latest micro data desired hours have declined due to both an increase in those who wish to work fewer hours and a decrease in those who wish to work longer hours. This implicitly puts more weight on the desired hour measure in our estimate of average hours slack than we did before.

Other cross checks of our estimate of trend average hours remain unchanged in the latest data. The decreased wedge between actual and usual hours driven by a decline in holiday taken by workers remains and the elevated share of part time workers who would like a full time job is at 15.8%, well above pre-crisis levels of around 8%.

The June data for average hours has resulted in downside news to total hours in Q2 relative to the August IR of -0.2%. We do not expect the news from average hours to unwind in Q3 given we already expect an increase in average hours.

Earnings

Regular pay growth, both whole economy and private sector, came in according to our expectations at 2.8% and

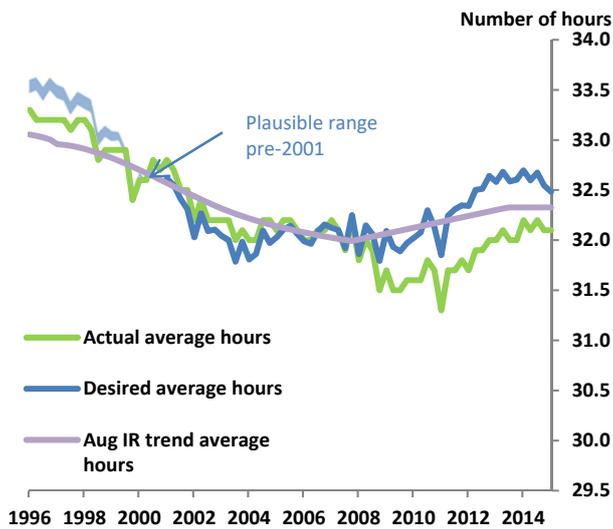


Chart 11: Pay growth

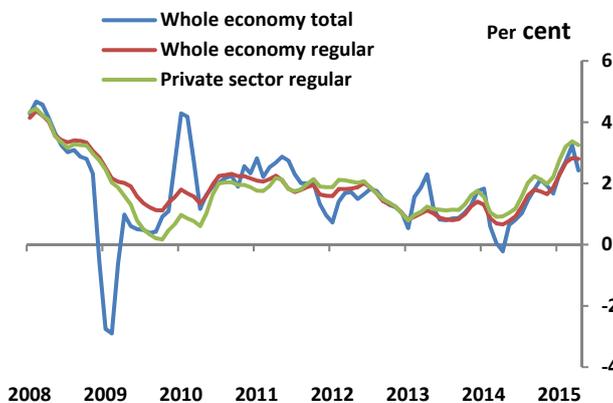


Chart 12: Voluntary Job to Job Flows

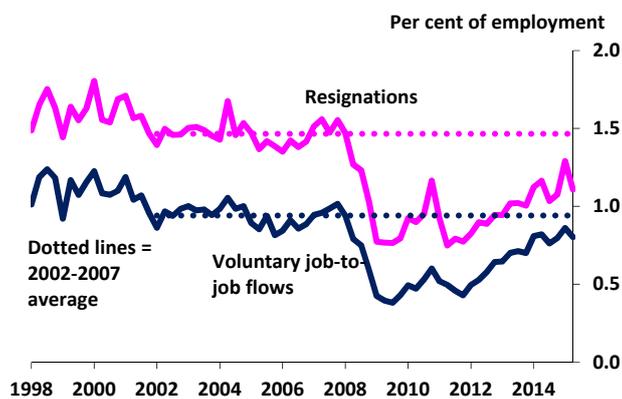


Chart 13: Compositional effects

3.3% respectively (Chart 11). However bonuses were weaker than expected, with whole economy total pay being 0.4pp lower than expected at 2.4% and private sector total pay 0.2pp below our forecast at 2.8%.

There is currently a large residual between public sector total wages and public sector regular pay, with total pay being less than regular. The ONS are reviewing their seasonal adjustment methodology, hoping to address this.

Despite this statistical oddity, there is reason to believe the weakness in whole economy bonuses is genuine. There are no similar residuals in the whole economy and private sector wage data, which are seasonally adjusted independently of public sector pay.

We don't think this news in bonuses gives a strong steer on labour market slack. Evidence from Agents' contacts suggests that employers tend to pay bonuses in a backward looking manner to reflect past performance, as opposed to as a method of staff retention. We have yet to try to investigate this relationship empirically though.

The resignation rate and voluntary job to job flows, which we can update with the latest micro-data, are two measures we can look at which might suggest whether employers are having difficulties retaining staff. Both of these measures though remain below their pre-crisis levels and declined slightly in Q2 (**Chart 12**). Perhaps consistent with this our current forecast of pay growth remains around current levels.

The latest micro-data have also allowed us to update the compositional effects for Q2. The compositional drag on whole economy wages has reduced from around -1% to -½% from Q1 to Q2 (**Chart 13**), this potentially helps to explain a degree of the upside news we have seen in pay and productivity in recent months. The unwind in compositional effects was driven by a slowdown in the number of low skilled jobs created.

Unit Wage Costs and Labour Costs

Due to whole economy total pay coming in below our expectations, AWE-based estimates of unit wage costs for Q2 grew at 0.9% on the year lower than the 1.2% expected (Chart 13). We will update on Unit Labour Costs in the briefing meeting, after we receive the update to the National Accounts on Friday.

[Data Annex](#)

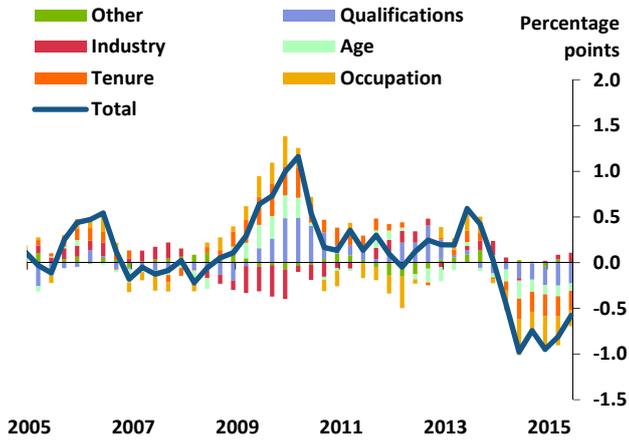


Chart 13: Unit Wage Cost Growth

