Essential reading – MPC

Costs and Prices Monthly: April 2015

STRUCTURAL ECONOMIC ANALYSIS

	Annual CPI inflation				Employment rate (16+)				Unemployment rate				Average Hours (per week)				Whole economy total pay*			
	Apr MPC	Mar MPC	Feb IR	*Monthly news*	Apr MPC	Mar MPC	Feb IR	*Monthly news*	Apr MPC	Mar MPC	Feb IR	*Monthly news*	Apr MPC	Mar MPC	Feb IR	*Monthly news (%)*	Apr MPC	Mar 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*	**2.17**	**2.17**	1.69	*0.00*
Q1	0.11	0.11	0.12	*0.00*	59.83	59.86	59.76	*-0.03*	5.55	5.43	5.60	*0.12*	32.32	32.32	32.32	*0.00*	1.95	2.40	2.30	*-0.45*
Q2	-0.09	0.06	0.03	*-0.15*	59.96	60.06	59.91	*-0.10*	5.43	5.27	5.51	*0.16*	32.34	32.36	32.33	*-0.06*	2.32	2.57	2.60	*-0.25*
Q3		0.33	0.08	*-0.33*			60.08				5.46				32.38		2.84	2.92	3.43	*-0.08*

* 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 fell to 0.0% in February, estimated by the ONS to be a 55-year low (Chart 1). We forecast inflation to turn negative in April. Sterling's divergent performance against the dollar and euro implies differing outlooks for certain CPI components, and is a key source of uncertainty. Unemployment did not fall as anticipated on the month, remaining at 5.7%, and participation and employment were broadly as expected. Regular pay was a little weaker than expected, and so we have slightly marked down our wage forecast for Q1 and Q2.

Chart 1: Unofficial ONS estimates indicate that CPI inflation, at 0.0%, is at its lowest since 1960

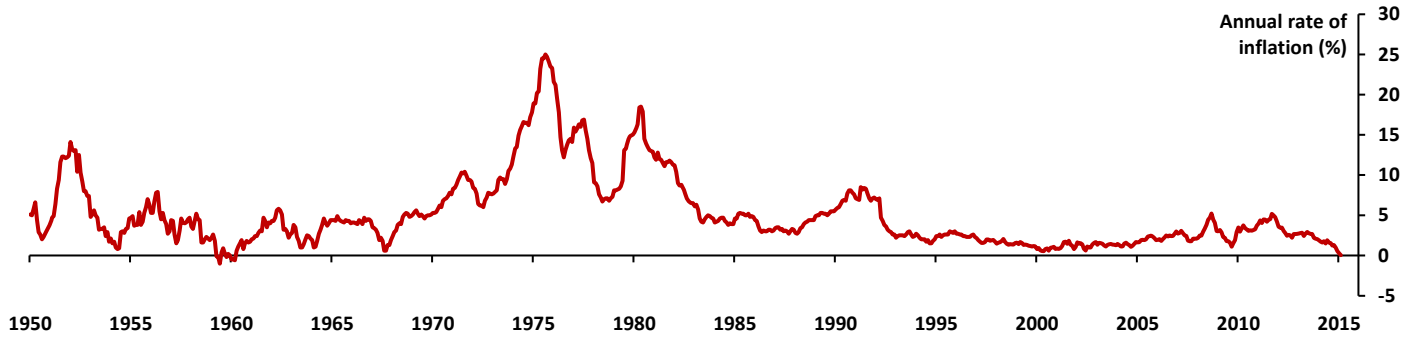


Chart 2: Short-term inflation forecast

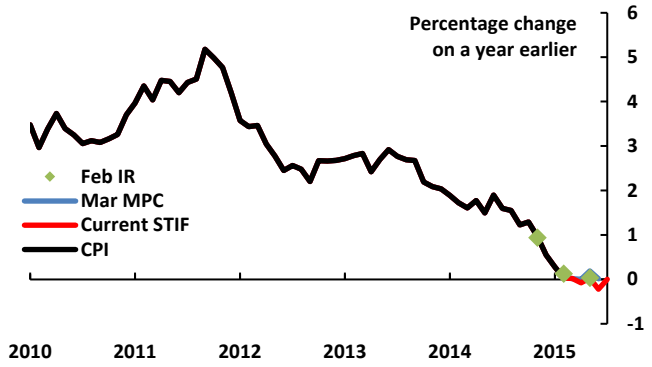
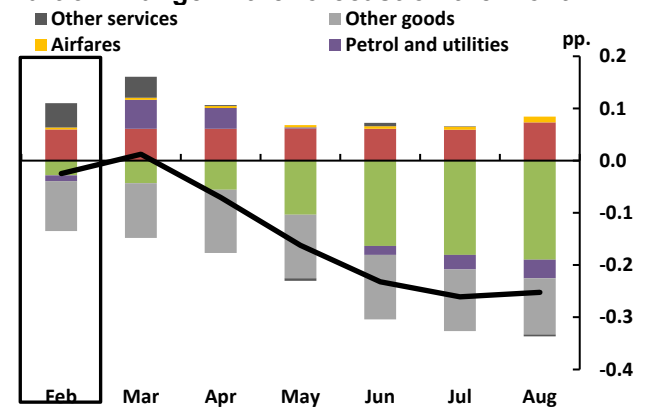


Chart 3: Change in the forecast on the month



Inflation

1. **CPI inflation fell to 0.0% in February, down from 0.3% in January to its lowest since official records began in 1997. To two decimal places there was -0.03pp news to our forecast, but there were some notable errors within the components. Our forecast remains close to zero for the next six months, reaching a low of -0.2% in June before returning to zero in July (Chart 2).**

2. The forecast is lower this month, reflecting a lower outlook for food and non-alcoholic beverage prices (FNAB) and catering services, and a fall in the sterling oil curve (**Chart 3**).

3. **We have imposed judgements on a number of components this month to reflect three key developments:** sterling's continued appreciation against the euro; sterling's depreciation against the dollar; and revised duty changes in the March 2015 Budget.

4. **Import prices are likely to be pulling down on inflation currently, following sterling's appreciation last year.** In particular, the appreciation against the dollar until the summer is likely to explain the recent falls in household, audio-visual and recreational goods inflation.

5. **We expect that effect to continue, but it is likely to diminish as sterling's more recent depreciation**

Chart 4: Sterling has fallen against the dollar, but is up against the euro

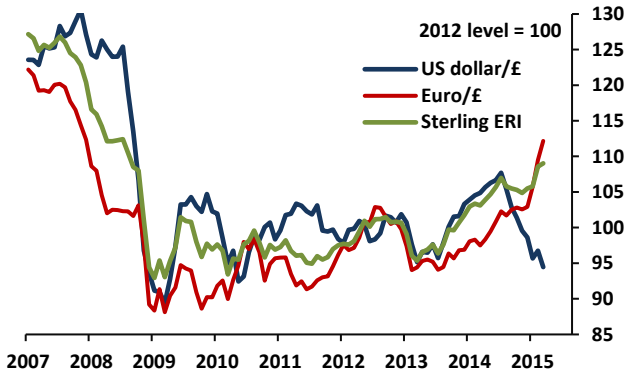


Chart 5: The euro's depreciation is expected to add further downward pressure on food prices

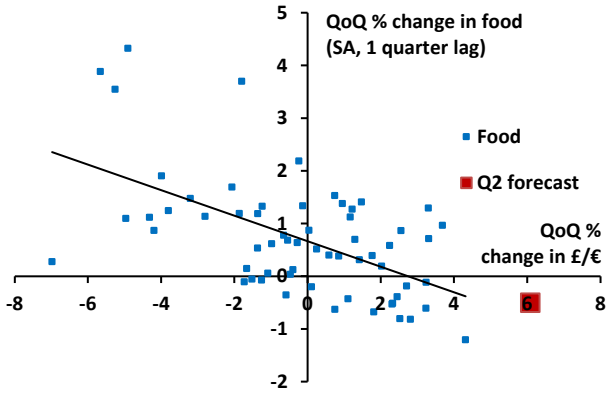


Table 1: Judgements made to reflect movements in sterling's exchange rates

Components	Appreciation vs dollar up to mid-2014	Appreciation vs euro up to mid-2014	Depreciation vs dollar since mid-2014	Appreciation vs euro since mid-2014
Household, audio-visual, recreational goods	Signs already in data; expect a bit more		Likely to come from late-summer	
Clothing and footwear	Signs already in data		Possibly now, more likely after summer	
FNAB		Mostly in the data		Likely in next few months
Package holidays		Likely in next few months		Likely in 2016

Chart 6: Core goods and services diffusion indices diverged in February

against the dollar feeds through. Since mid-2014 the pound has fallen to a five-year low (**Chart 4**). We have therefore pushed up on the forecasts for household, audio-visual, recreational and clothing & footwear goods from the end of this summer. Indeed, clothing and footwear prices may have already started to respond to the dollar's strength. We had judged that January's relative strength was sales related, but in light of February's data we believe that the higher cost of imported clothing may be starting to play a significant role.

6. Chart 4 also highlights the difference between sterling's performance against the dollar and its exchange rate index. It is likely that the weight attached to the dollar (and dollar-pegged currencies) in the ERI is lower than its relative importance for CPI inflation, since EU currencies have a weight of 70% in the ERI, whereas it is unlikely that 70% of the the CPI basket is influenced more by EU currencies than dollar-based currencies.

7. **But sterling was 6% higher against the euro in Q1 than in Q4, and we have pushed down on our FNAB and package holidays forecasts.** That appreciation is the largest quarterly increase on record and took sterling to a seven-year high against the euro. Given the relatively quick pass-through to FNAB prices, we have lowered our FNAB forecast for Q2 and Q3 (**Chart 5**).

8. We have also reduced our forecast for package holidays, as these are predominantly to Europe. However, that judgement reflects only the appreciation until mid-2014 due to the lag on its impact. Agents' reports inidcate that the more recent appreciation is likely to continue affecting these prices into 2016.

9. **Sterling's divergent performance against the euro and dollar therefore implies differing outlooks for different CPI components. Table 1** summarises the judgements we have made on these outlooks this month, which we will continue to keep under review.

10. The proportion of non-FNAB and energy items with positive annual inflation rates (adjusted for measurement changes) dropped to 65% in February, from 68% in the two previous months. That was driven by a fall in the proportion of core goods items with positive seasonally adjusted monthly inflation rates (**Chart 6**), likely reflecting the impact of sterling's appreciation on the CPI basket. The equivalent proportion for services ticked up.

11. **Following announcements in the Budget, we have also pushed down on our alcohol, tobacco, fuel and catering forecasts.** Cuts to beer, cider and spirit duty, a freeze on wine duty and the removal of September's increase in fuel duty were announced in the Budget. Combined with lower RPI inflation, affecting the indexation of tobacco duty, we estimate that the Budget will reduce CPI inflation by around 0.1pp by September, with around half of that effect from April.

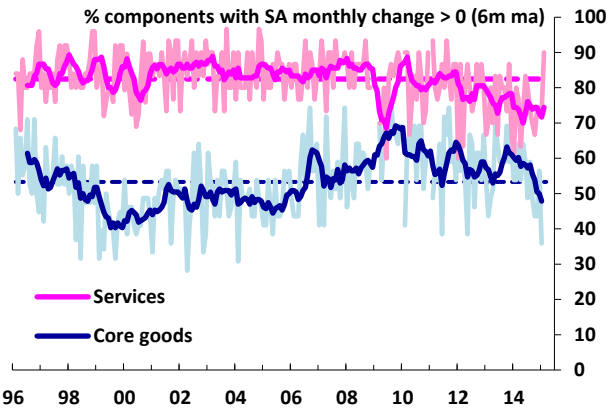


Chart 7: Short-term unemployment forecast

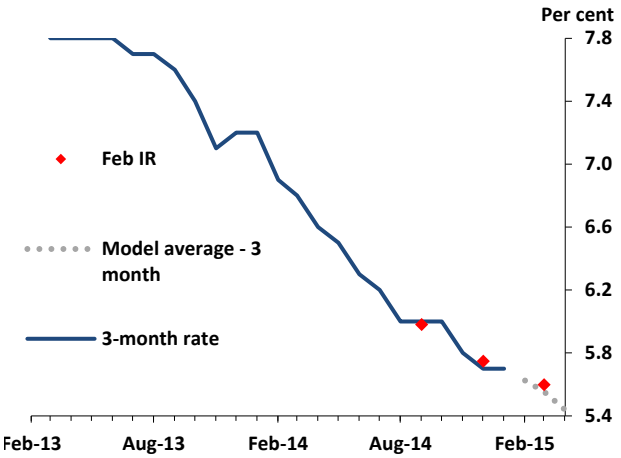


Chart 8: Non-participants who would like a job

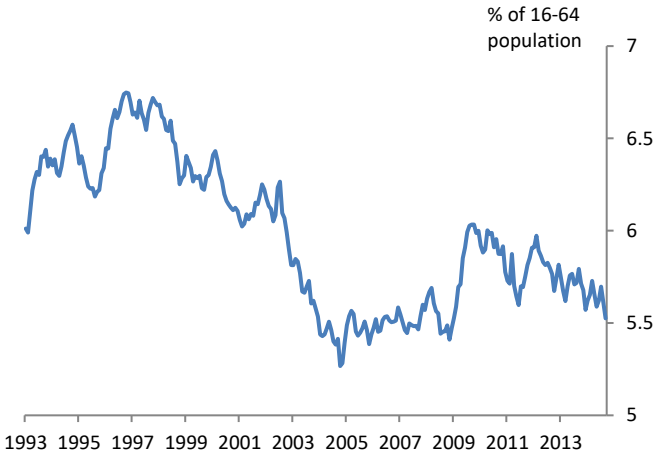


Chart 9: Revision to trend participation

Labour market

Unemployment

1. The unemployment rate fell to 5.7% in the three months to January whereas we had expected an outturn of 5.6% (Chart 7). Unemployment was flat on the month, but we think it will continue to fall slightly to 5.4% by Q2 as the job finding rate ticks up a bit further in line with pre-recession levels.

2. Our current view is still that unemployment will settle around 5% in the longer run. The unemployment gap is projected to be the same as in the February *IR* in Q1, but to unwind a little faster going into the second quarter. Table 2 below decomposes the changes to the output gap components in the May Benchmark forecast compared to the February *IR*.

Labour force participation

3. Aggregate labour force participation was flat on the quarter, with an outturn of 63.3% in the three months to January, broadly as expected. The employment rate was also close to our expectation at 59.7%. More detail on the employment data, including the latest Workforce Jobs release, can be found in this month's indicator

4. Current cyclical indicators seem to be more consistent with somewhat weaker trend labour supply than we had assumed in the February *IR*—for example, the measure of non-participants who would like a job has fallen back to pre-recession levels (Chart 8).

5. Following a stocktake of labour supply, which is summarised in we have made some revisions to the labour market trend variables. More detail on the participation judgement in particular can be found in

6. Although any estimate of trend is uncertain, our current view is that the more recent labour market data seem to point to a smaller participation gap of about 0.2pp in 2015q1, as depicted by the new trend line in Chart 9. This results in a participation gap which is 0.3pp smaller than what we had in the February *IR*.

7. We have kept the revised profile flat over the recession and forecast horizon, removing the previous mild upward slope, bringing the trend more in line with the recent data. We have also removed the small dip in 2014 that was intended to capture sampling variability in the headline participation rate caused by an unusually high number of students in Wales in June last year. This effect seems to have disappeared in subsequent waves for that cohort, suggesting no distortions to the headline data.

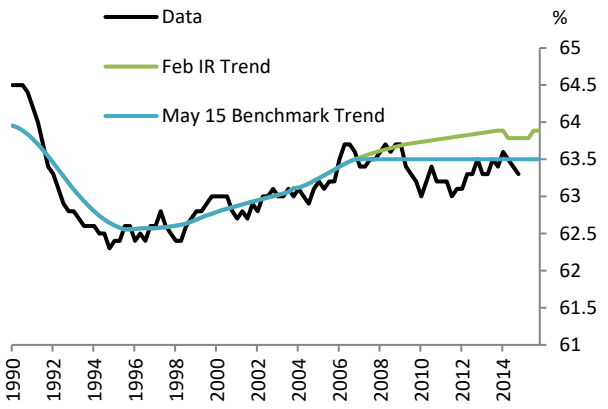


Chart 10: News to total hours since February *IR*

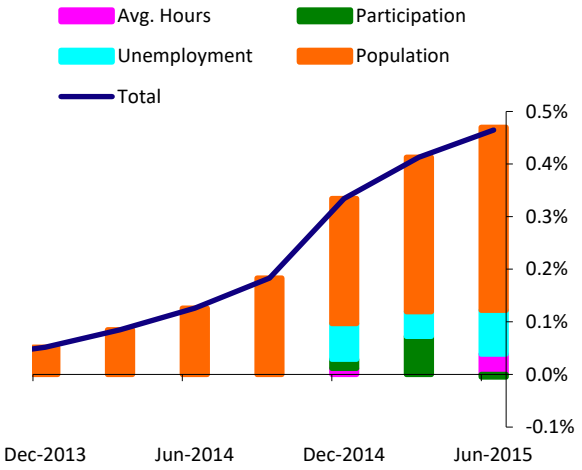
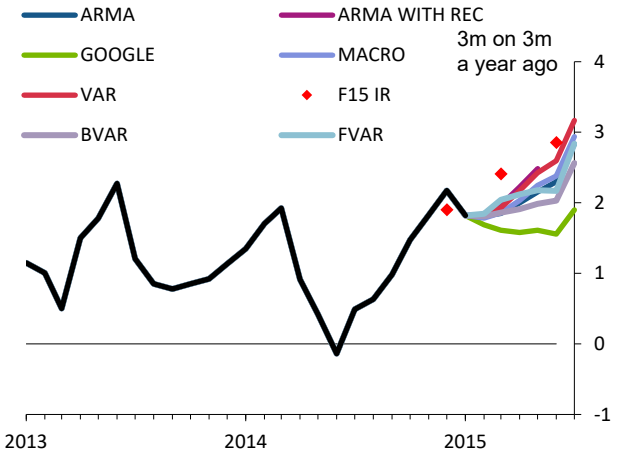


Chart 11: Short-term earnings forecasts



Hours

8. Average weekly hours in the three months to January were broadly as expected at 32.2, unchanged on the previous non-overlapping three months. We had -0.04% news on the level of employment and -0.07% news on average hours, so news in total hours was -0.11% this month.

9. More importantly, we have revised up estimates of population by 0.3% in 2015q1 (and 0.7% by the end of the forecast) in order to better capture the strength in migration over the past couple of years, which has been stronger than incorporated in the LFS estimates by the ONS. This does not affect employment or unemployment rates, but the news to total hours is substantial, as shown in Chart 10. Further details on this adjustment will be provided in a forthcoming note.

10. Average hours have already recovered strongly from their post-crisis trough, but there are still signs of potential underemployment, mainly from part-time workers. We do not see a case for large changes to the trend for average hours, although we have proposed some small tweaks to the profile, closing the forecast at the same level as in the February *IR* at the end of the horizon. Going into the first two quarters of 2015, however, we now anticipate a slightly larger contribution from average hours to the output gap (Table 2).

11. This is outlined in more detail in . The key judgement for the outlook of average hours is the manner in which the currently elevated share of part-time workers who want full-time work will normalise.

12. Alongside some small downside news from the capacity utilisation surveys, this leaves the output gap in Q2 (the quarter that we would be referencing in the May *IR*) slightly smaller at 0.3% (Table 2).

Pay

13. Whole economy total pay growth was lower than expected in the three months to January at 1.8% (-0.4pp news). There was also some downside news (-0.2pp) on regular pay. Bonus pay, which tends to be volatile, was particularly weak in January, following positive news in the previous month. We have not taken a strong steer from either of these movements.

14. Looking ahead, we have taken a steer from the weakness in the most recent outturn for regular pay, with our current Benchmark forecast for whole economy total pay growth now at 2% and 2.3% in Q1 and Q2, respectively. The numbers for both of these quarters are about 0.3pp below the path in the February *IR*. But the broad profile is nonetheless one of a strengthening in pay in the first two quarters of 2014. That is in line with most of our near-term forecasting models (Chart 11).

Table 2: Contributions to the output gap

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

15. Unit labour costs rose by 0.8% in the year to Q4, slightly stronger than the 0.5% projected in the February IR. There was upside news from wages and salaries partly offset by stronger GDP growth and weak non-wage labour costs.

16. A key challenge to our view that there is relatively little slack left in the labour market is that wages remain weak relative to their determinants. Indeed, this was a reason behind the MPC's judgement to increase labour supply in the August 2014 round. But there are a range of potential explanations for weak wages that do not rely on there being more slack. We will be exploring these in more detail as part of the forecast round.

Data annex