Essential reading – MPC

Costs and Prices Monthly: June 2015

STRUCTURAL ECONOMIC ANALYSIS

	Annual CPI inflation				Employment rate (16+)				Unemployment rate				Average Hours (per week)				Whole economy total pay*			
	Jun MPC	May MPC	May IR	*Monthly news*	Jun MPC	May MPC	May IR	*Monthly news*	Jun MPC	May MPC	May IR	*Monthly news*	Jun MPC	May MPC	May IR	*Monthly news (%)*	Jun MPC	May MPC	May IR	*Monthly news*
Q1	**0.10**	**0.10**	**0.10**	*0.00*	**59.97**	**59.95**	59.95	*0.02*	**5.55**	**5.51**	5.51	*0.04*	**32.11**	**32.17**	32.17	*-0.19*	**2.03**	**1.81**	1.79	*0.22*
Q2	-0.02	0.01	0.01	*-0.03*	60.07	60.05	60.05	*0.02*	5.38	5.35	5.35	*0.03*	32.24	32.27	32.27	*-0.09*	2.17	2.11	2.12	*0.06*
Q3	0.21	0.26	0.26	*-0.05*			60.11				5.29				32.33				2.78	

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

Main message: Annual CPI inflation was -0.1% in April as expected. Measures of core inflation edged down further, on average by 0.2% due to temporary Easter timing effects. The outlook is little changed on the month with inflation expected to remain close to zero for the next few months. Unemployment fell to 5.5% as anticipated, and participation and employment were broadly as expected. Average hours surprised on the downside, while pay was slightly stronger than expected, but the outlook for both pay and quantities is little changed.

Chart 1: Unofficial ONS estimates indicate that CPI inflation, at -0.1%, is at its lowest since 1960

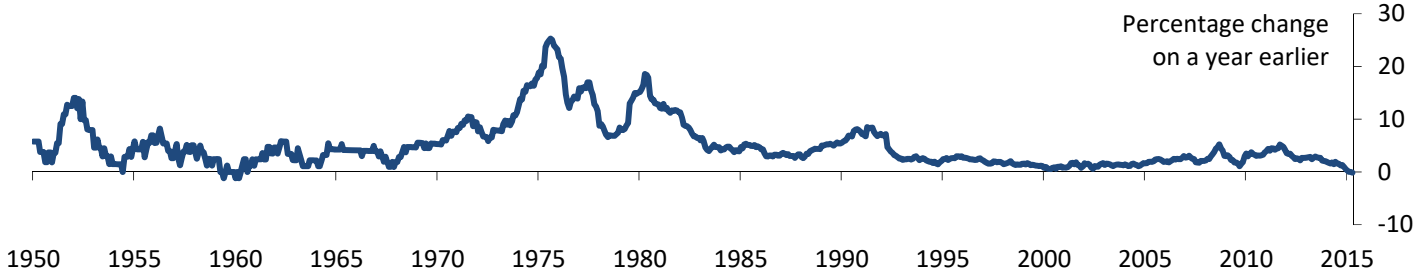


Chart 2: Core goods and services diffusion indices

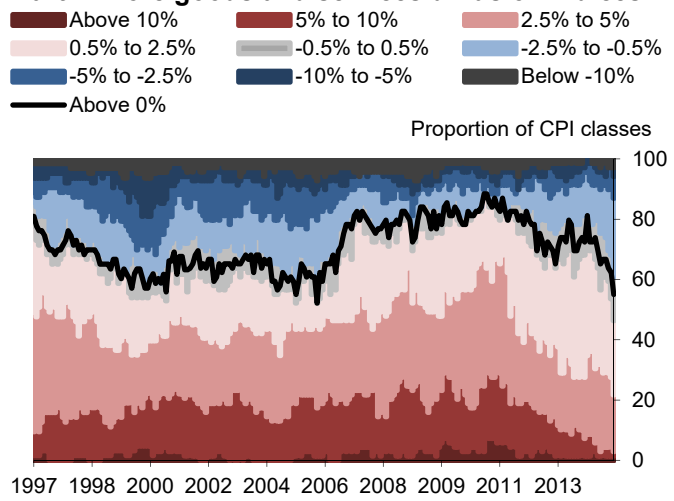
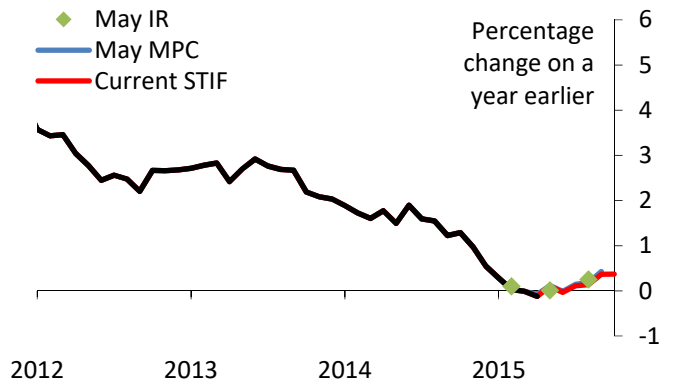


Chart 3: Short-term inflation forecast



Inflation

1. Annual CPI inflation was -0.1% in April, down from 0.0% in March. To two decimal places it was -0.12%. This is the first time since 1960 that CPI inflation has been negative to one decimal place (Chart 1).

2. In the CPI indicator we noted that the latest outturn was strongly affected by temporary factors. In particular, the largest downward effect came from Transport services (exerting a temporary -0.18pp drag to the CPI annual inflation) and is accounted by the timing of Easter. Therefore it will largely unwind from next month.

3. The May open letter reported the proportion of the CPI components (excluding food and energy) with positive annual inflation rates. Since that letter, this proportion has fallen slightly from 62% to 55%, a value that is close to the lowest level since 1997, although that partially reflects the Easter timing effect. Chart 2 provides more details about this statistic. The largest proportion of the components in deflation falls in the mild deflation class (-0.5 to -2.5%). The share of goods with severe deflation remains very contained in comparison with previous historical episodes.

Chart 4: CPI goods and services inflation

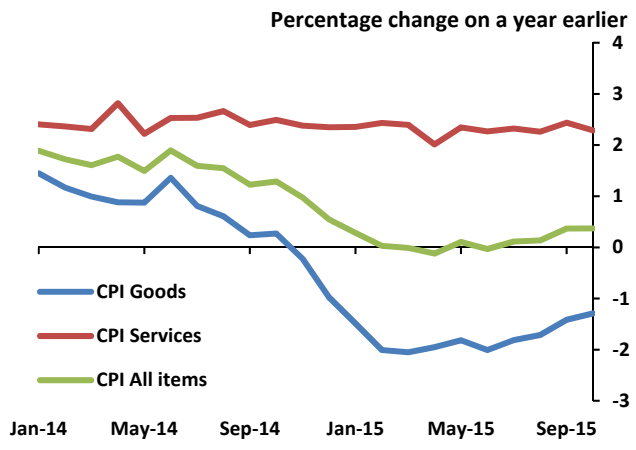


Chart 5: CPI Core inflation and import prices

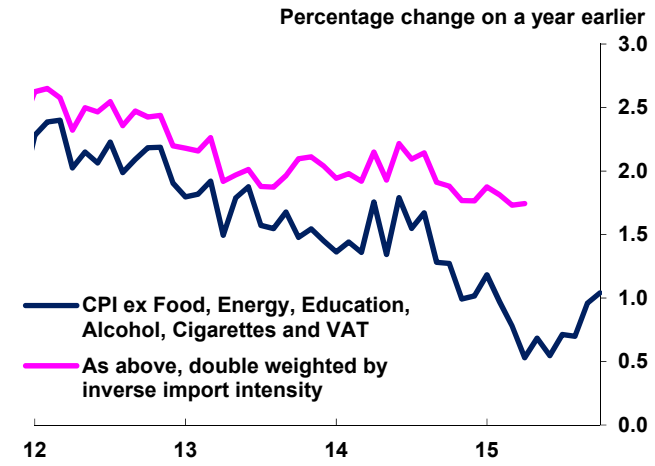
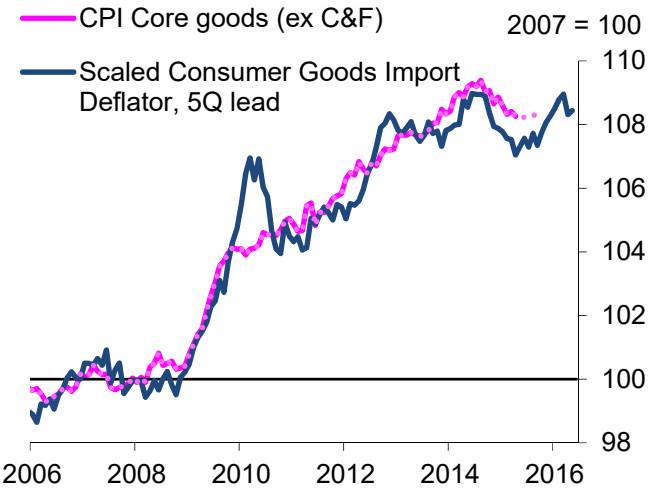


Chart 6: Core goods and consumer price deflator



4. **Inflation in April was consistent with our forecast,** and there was little news in the components. As a result our forecast for near term inflation remains little changed compared with our previous one.

5. **We expect inflation to move back to positive territory from next month, but to remain around zero in the near term (Chart 3).** Our forecast for May is 0.1%, it slows back to 0.0% in June and rises to 0.4% towards the end of the forecast horizon. This is consistent with the forecast in the May *IR*.

6. The profile for inflation reflects the reversion of the temporary drag on transport services from next month as well as easing negative pressures in CPI goods toward the second half of the forecast horizon (Chart 4). The easing downward pressure on goods prices reflects, to some extent, our judgment on the likely boost to inflation due to the depreciation of sterling against the dollar. The main food and energy base effects kick in around the turn of the year.

7. Core measures of inflation continued to slow down. Their weakness reflects weak import prices in the last few quarters (Chart 5). **We continue to expect core goods and services inflation to pick up by the end of the year.** As the pressure from import prices eases core inflation comes to reflect domestic inflation pressures.

8. Changes in core goods prices in the recent past have followed the changes in the consumer goods import price deflator with about a five-quarter lag (Chart 6). That relationship suggests more weakness in the near term, but, absent any further falls in the deflator, the downward drag from import prices should wane and the subsequent increase in import prices become more important.

Chart 7: Short-term unemployment forecast

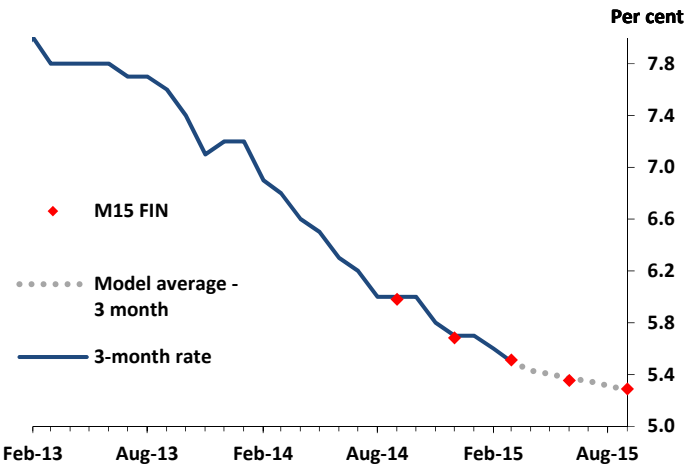


Chart 8: Unemployment to Employment flows

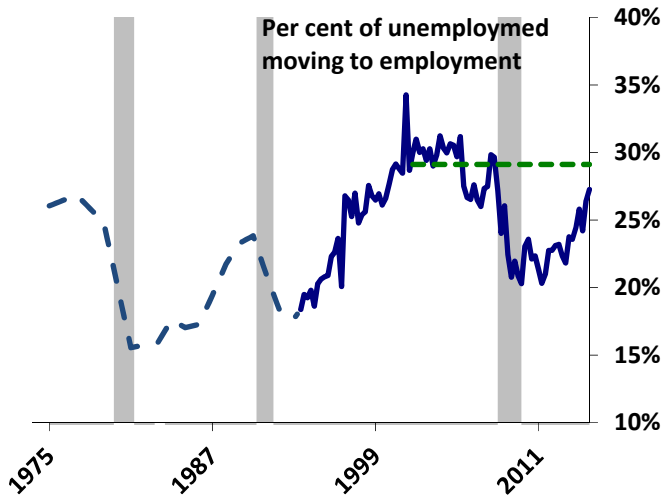
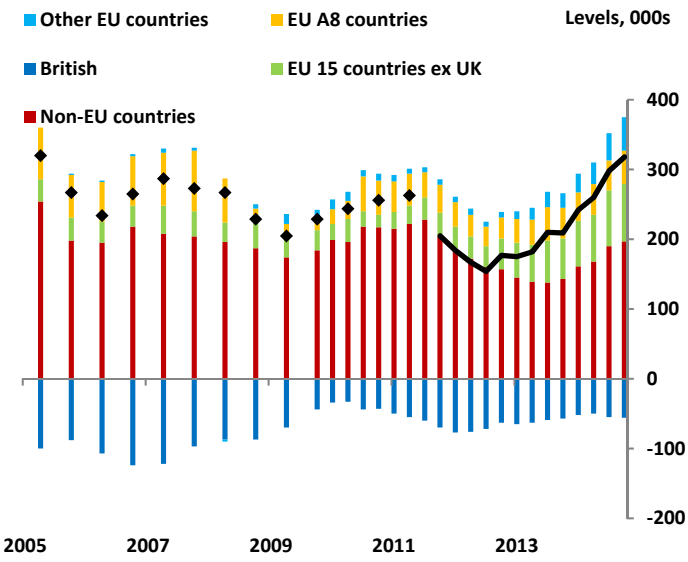


Chart 9: Long term Migration



Labour market

Unemployment

1. The unemployment rate fell to 5.5% in the three months to March in line with our expectations (Chart 7). Unemployment continued to decline and remains in line with the May forecast, with our expectation being that unemployment falls to 5.4% in Q2 and 5.3% in Q3.

2. In order for this path for unemployment to be achieved though, this relies on flows from unemployment to employment returning to their pre-crisis average of 29%. The rate currently stands at 27%, but has been rising in recent years (Chart 8). Were this and other labour flows to remain at their current level however, the implications would be a slower decline in the rate of unemployment with unemployment only declining to 5.4% by Q3.

Labour force participation

3. The 16+ labour force participation rate rose strongly to 63.5 per cent, a rise of 0.2pp on the previous quarter as expected. The employment rate was also in line with our expectation rising 0.3pp to 60.0 per cent. More detail on the employment and participation data can be found in this month's indicator .

4. Participation is now in line with our estimate of trend and we do not forecast any change over the next quarter.

5. Employment grew by 202,000 on the quarter, with the majority (96%) of this being accounted for by flows in from unemployment and inactivity and the remaining from population growth. Some of the population growth will be attributable to migration, which in the latest Q4 data has been particularly strong, with net long term (over one year) migration for 2014 being 318,000, or roughly 0.5% of the population.

6. Chart 9 shows the upward trend in long term migration, with the latest figure for the year of 2014 being near the record high of 320,000 in mid-2005. This figure represents an increase in net migration of 109,000 over the level in 2013, of this increase 51% of the increase came from EU migration and 49% from non-EU migrants.

7. While migration has been broadly balanced between EU and non EU migrants, employment growth of non-EU migrants has been weak in the latest data, with only a 1% increase on the year to Q1 2015, in comparison to EU migrant employment which grew by 17% over the same period. (Further analysis of the latest migration statistics can be found in

Chart 10: Shift in short term average hours forecast

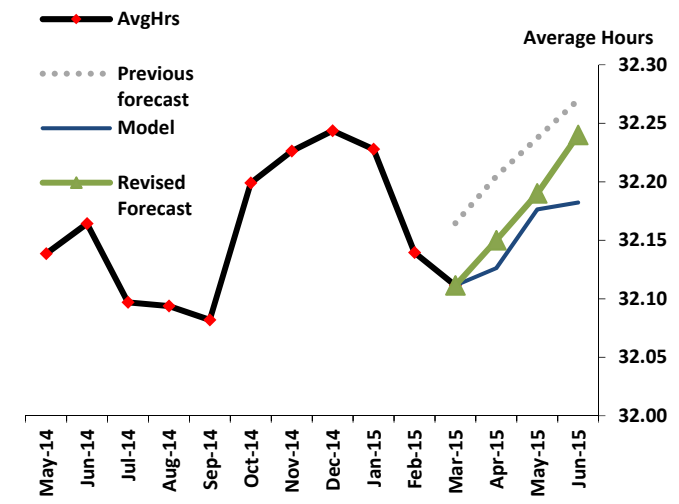


Chart 11: Short-term earnings forecasts

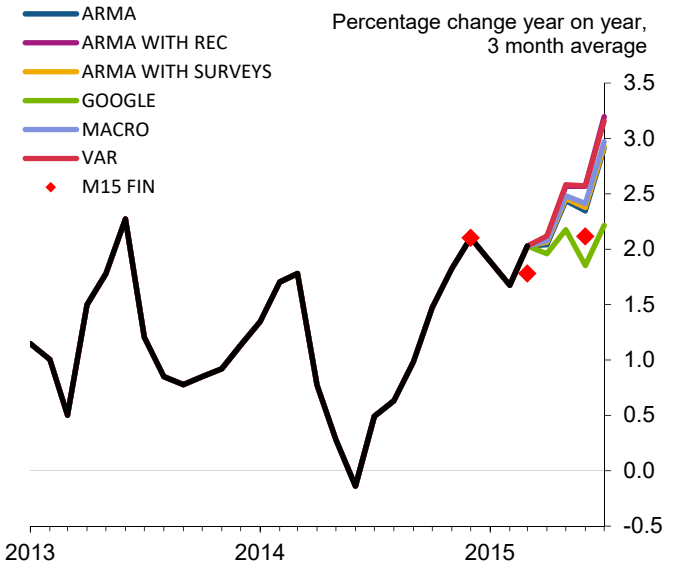
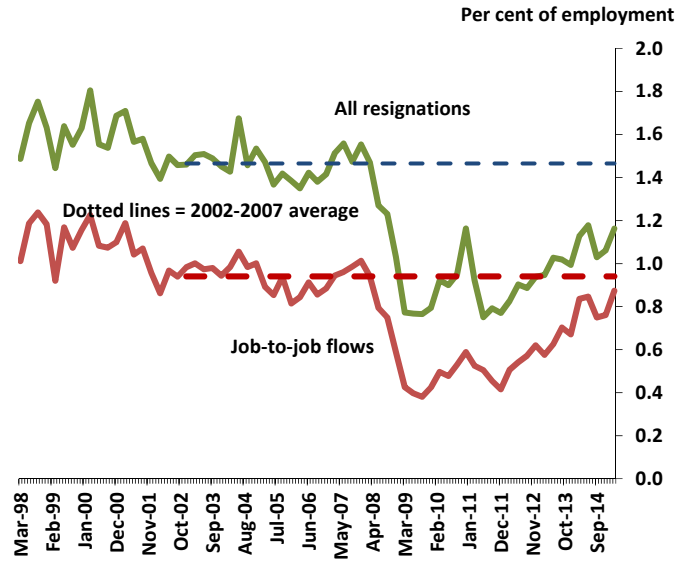


Chart 12: Job to Job flows



Hours

8. Average weekly hours surprised to the downside coming in at 32.1 below the 32.2 expected. However due to the rise in employment net change in total hours was still positive at 0.2%, although weaker than the 0.5% expected. This left productivity (in hours) rising by 0.2% in Q1, slightly stronger than expected.

9. The decline in average hours in Q1 was most prominent amongst full time workers whose hours fell from 37.6 to 37.4, compared to hours for part time workers which continued to rise. This is important as our longer term view of increasing average hours is based upon the trend decline in holidays taken by full time employees in recent years proving to be persistent. If this transpires to be cyclical and we see an unwinding of this, with employees feeling freer to take holiday as the labour market tightens, we may have to revise this position.

10. Chart 10 shows how we have adjusted our short term average hours forecast given the news this month. We now do not expect to reach the 32.3 average hours in Q2 previously forecast, instead revising this down to 32.2 hours. This revision still has slightly faster growth than our statistical model is currently predicting; we have imposed this slight upwards judgement due to the significant gap between current average hours and our view that average hours star is 32.4.

11. The latest estimate of desired hours (the Bell and Blanchflower measure) for Q1 suggested little change to the number of additional hours people want to work.

Pay

12. Whole economy total pay growth was slightly stronger than expected on a year ago at 1.9% in Q1 (+0.1pp news). There was also some upside news on regular pay. This was primarily driven by strong private sector pay growth (2.4% total pay growth and 2.7% regular pay growth). This result is even stronger once we adjust for compositional effects, which we currently estimate are dragging down by around 1pp on headline wage growth. We have taken a slight steer from this result for our Q2 forecast pushing up on wage growth.

13. Chart 11 shows the forecasts for whole economy total earnings from our suite of statistical models. Most of these models forecast a slightly stronger pick up than in the May IR. We have consequently revised up our forecast of Q2 total earnings growth to 2.2%.

14. Job to job flows continued to pick up and are now close to their pre-crisis average (Chart 12). This is consistent with our forecast of wages continuing to pick up, although such flows are small relative to the stock, so that pickup is driven more by the effects on recruitment and retention rather than direct churn in the labour market.

15. The surveys of companies' expectations of pay growth are broadly stable and pointing to pay growth around 3%. The REC – which we think is the one that most closely captures the pay of new workers – picked up again on the month, although the wedge between the REC and AWE growth is closing.

Data annex