Costs and Prices Monthly: October 2015

STRUCTURAL ECONOMIC ANALYSIS

	Annual CPI inflation				Employment rate (16+)				Unemployment rate				Average Hours (per week)				Whole economy total pay*			
	Oct MPC	Sep MPC	Aug IR	*Monthly news*	Oct MPC	Sep MPC	Aug IR	*Monthly news*	Oct MPC	Sep MPC	Aug IR	*Monthly news*	Oct MPC	Sep MPC	Aug IR	*Monthly news (%)*	Oct MPC	Sep 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	59.75	59.72	*0.00*	5.63	5.63	5.64	*0.00*	32.11	32.11	32.18	*0.00*	2.58	2.42	2.81	*0.15*
Q3	0.04	0.14	0.06	*-0.09*	59.87	59.81	59.82	*0.05*	5.51	5.60	5.63	*-0.08*	32.04	32.20	32.27	*-0.48*	3.43	2.97	3.31	*0.46*
Q4	0.21	0.31	0.35	*-0.11*	60.00		59.90		5.43		5.54		32.09		32.33		2.82	2.64	2.91	*0.18*

* 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 0.0% in August, 0.1pp below our forecast. The downside news was concentrated in clothing and food prices, and core inflation ticked down on the month. Employment and unemployment remain broadly in line with the August IR. The main news in the latest data is in average hours which unexpectedly fell and were 0.7% lower than the August IR. Following volatility in bonuses during the past two months, we expect earnings growth to be broadly similar to the August IR projections.

Chart 1: STIF changes since the August IR

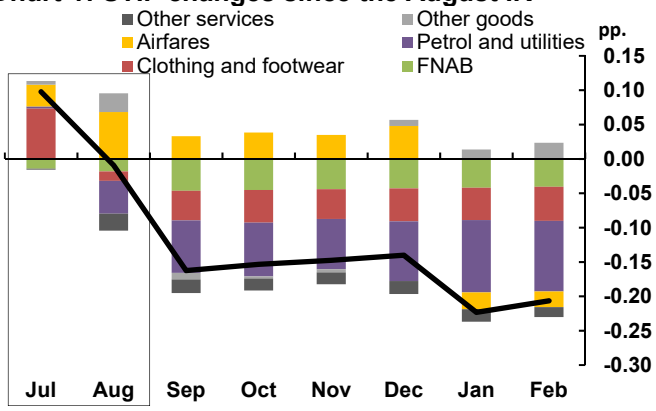


Chart 2: The short term inflation forecast

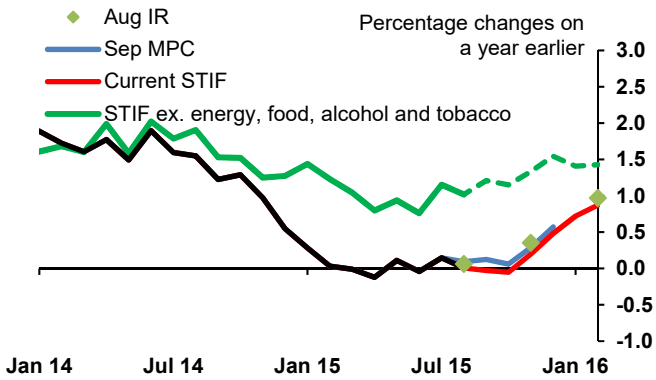


Chart 3: 2015 FNAB forecasts forQ4 and Q1 2016

Inflation

The August outturn was 0.1pp lower than we were expecting. This reflected lower than expected contributions from clothing and food, partly offset by small news in other goods. Combined with the news in oil prices, the **forecast is around 0.2pp lower than at the time of the August IR**.

Following upside news last month, clothing surprised on the downside, leaving the level of clothing prices in line with past averages after the recovery from the summer sales. The pattern of clothing sales appears to have changed in recent years, making it more difficult to interpret the news in these months. Taking the news in the July and August data together, clothing inflation has been marginally weaker than we expected at the time of the August IR (**Chart 1**). The forecast has been revised down slightly, reflecting the limited evidence so far of currency-related effects.

Annual food inflation fell 0.1pp to -2.8% in August. UK harvests have been an important determinant of food inflation in recent years, particularly in Q4 and Q1. Following good harvests last year, there may be some upward pressure on food if yields this year disappoint.

The competition between supermarkets could continue to provide offsetting weakness in measured inflation, depending on the types of discounts implemented by the supermarkets.

The balance of external and domestic pressures acting on food hasn't changed materially over the course of the year, reflected in the similarity of the current forecast to our expectations at the end of Q1 (Chart 3).

News in other components of the forecast was small. Overall, other goods contributed 0.05pp of upside news, mainly in household goods. Other services contributed -0.02pp of downside news. We still assume in the forecast that other

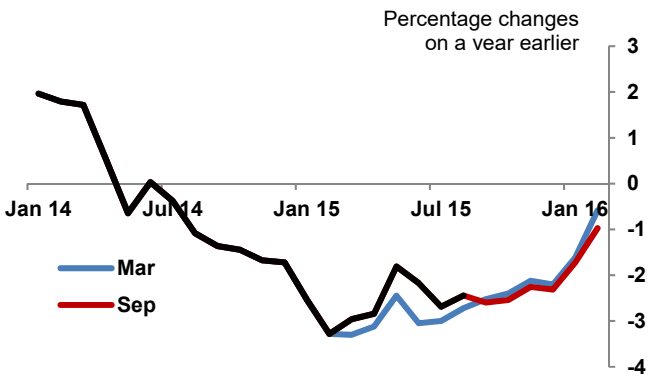


Chart 4: Measures of core inflation

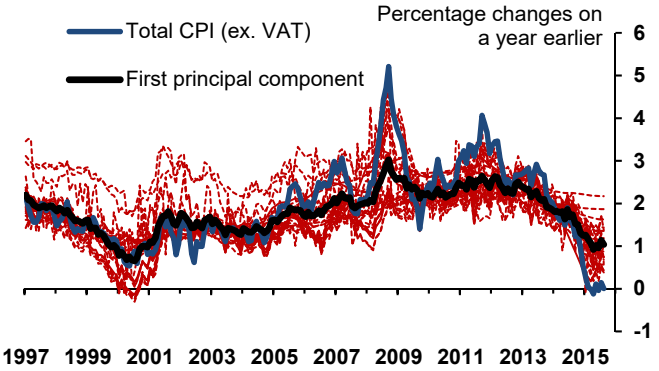


Chart 5: Drivers of the absolute change in CPI inflation over the STIF

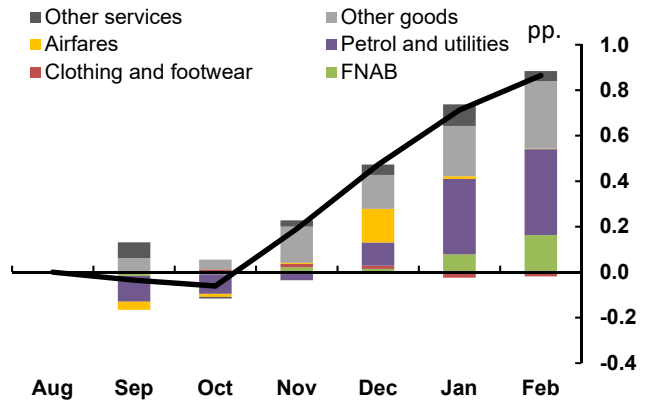


Chart 6: Workforce Jobs v LFS

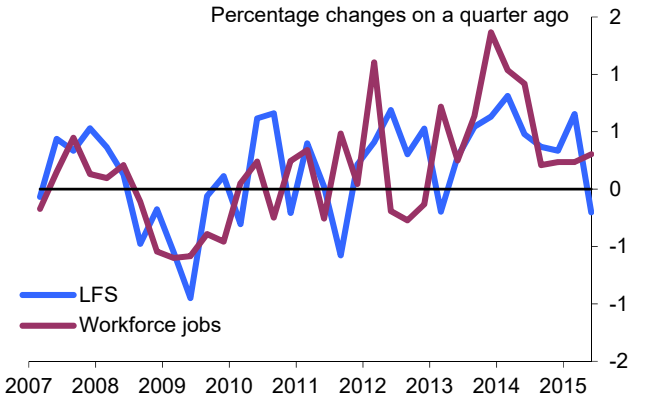


Chart 7: Employment intentions survey swathe

major energy providers will follow British Gas in cutting gas bills, but have shifted the timing of this change later in the forecast (spreading the further cuts between November and January). No further cuts have been announced, but the upside risk to the forecast is small. (If no further cuts are announced, this would contribute 0.06pp upside news to the forecast by January).

Core inflation fell back in August, from 1.2% to 1.0% on the ONS measure of CPI excluding energy, food, alcohol and tobacco. The principal component of a set of 26 core measures ticked down to 1.0% in August, from 1.1% in July (**Chart 4**). The proportion of CPI components, excluding food and energy, with positive annual inflation rates was 58%, down from 61% in July. Food, energy and other goods continued to account for around ¾ of the deviation of CPI inflation from the 2% target.

The absolute profile for CPI inflation falls into negative territory in October (just, on the rounding). A sixth Open Letter is more likely to be triggered by the March data given the downwards revision to the STIF. CPI inflation is still expected to rise around 0.9pp from its current level by February 2016, largely reflecting positive base effects in food and energy prices (**Chart 5**).

Labour market

Employment

Employment grew in the three months to July, stronger than we expected last month, but was **broadly in line with the August IR.** The employment rate was 59.8% which represented an increase of 42,000 on three months earlier. This was all composed of part-time self-employed workers. The number of employees was broadly flat.

While employment continues to rise, it is growing at a slower rate than in 2014. Quarterly Workforce Jobs (WFJ) data released this month broadly corroborate this (Chart 6). Employment growth continues to be driven by the private sector as public sector employment data, also published this month, suggested continuing falls (-16,000 in Q2).

In the near-term, we expect employment to bounce back in Q3 and grow by 0.4% on the quarter in Q4, in line with the August IR projection. The data support this outlook. Surveys of employment intentions are positive although some such at the Agents, CBI and the REC have softened in recent months (Chart 7). Vacancies, a measure of firms' labour demand, have increased slightly in the three months to August, following slight falls earlier this year. They remain near their record high and are consistent with further growth in employment. We don't expect cohort effects to cause volatility in the near-term.

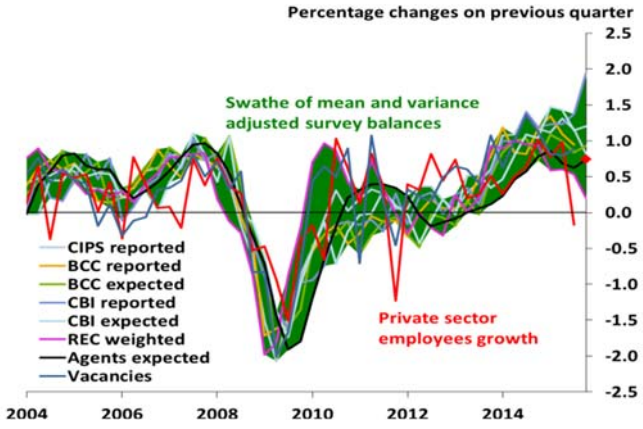


Chart 8: LFS unemployment rate

Chart 9: Unemployment rate by duration

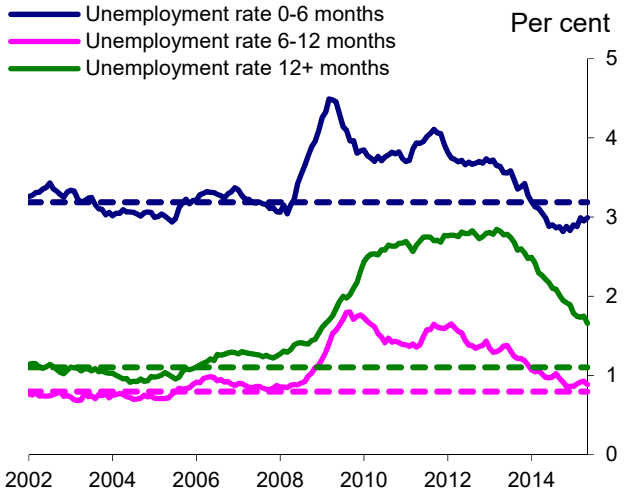


Chart 10: Short-term unemployment forecast

Participation and unemployment

The participation rate was broadly flat at 63.3% in the three months to July, in line with the August IR. We expect it to continue gently rising in the near-term to around its estimated trend level (63.5%).

Unemployment data has broadly followed the August IR forecast in the latest data (Chart 8). Given a flat particiation rate and growing employment, the unemployment rate fell on the month. It was relatively flat at 5.5% in the three months to July when compared to the previous non-overlapping three months. The reduction in unemployment continued to come from the long-term rate (12+ months) while the short-term rate (0-6) has picked up since the start of the year (Chart 9).

The unemployment rate has fallen steadily since mid-2013 but the pace of decline has recently slowed. This could be due to a weaker demand for labour. Employment growth has been slowing but vacancies are close to their record high. We would also expect the unemployment rate to decline more slowly as it approaches its natural rate. Recent analysis of the equilibrium unemployment rate suggests that it is more likely that the rate is slightly above its pre-crisis levels.

We expect the unemployment rate to decline only very gradually in the near-term, broadly in line with the August IR (Chart 10). It is projected to reach 5.4% by Q4. This view is consistent with timelier indicators of unemployment, such as the Claimant Count rate, which at 2.3% in August was flat for the past six months.

Average and total hours

Average hours continued suprising us on the downside as they fell by 0.5% to 32.0 in the three months to July. They are now 0.7% below what we expected at the time of the August IR. The latest fall occurred among full-time as well as part-time workers, whose share in the workforce increased in the latest data. But the number of part-time employees wanting to work full-time had also decreased.

We expect average hours to rise in the near-term but at a slower pace than before (Chart 11). There are opposing pressures on average hours. On one hand, as firms expand output, they might increase the hours of existing staff if struggle to hire additional and appropriately skilled staff. On the other hand, as real incomes rise, some workers might choose to reduce their hours.

Our outlook implies that there will remain a significant gap between average hours and their trend in the near-term. We have been expecting this gap to close for more than a year and the persistent run of downside surprises might signal a lower average hours trend. Our current approach, outlined in the May stocktake, assumes half of the additional hours people said they wanted would feed into actual hours (Chart 11). We are now implicitly assuming three quarters of those desired hours will lead through feed through which looks optimistic. Returning to a 50% assumption would suggest a

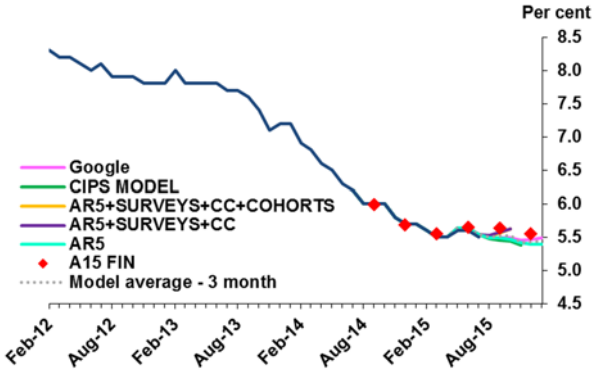


Chart 11: Desired average hours

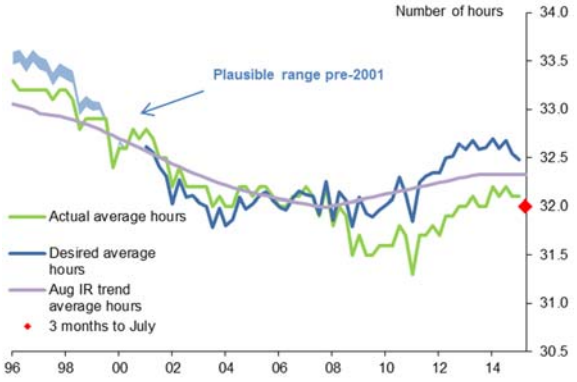


Chart 12: News in total hours relative to the August IR

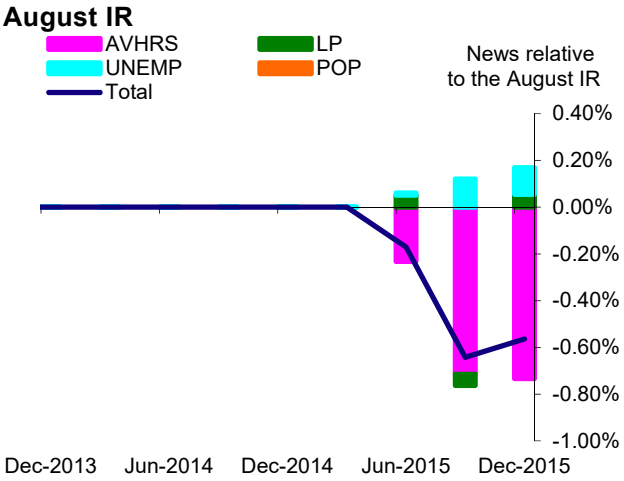
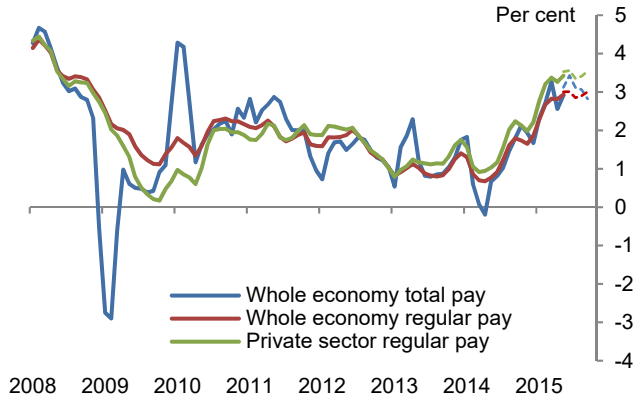


Chart 13: Whole economy and private sector pay



trend that might be around 0.5% lower.

Overall, total hours decreased to 994.2 million in the three months to July, a fall of 0.4% compared to three months earlier. Total hours were 0.3% lower than expected last month and 0.6% lower than expected at the time of the August IR. and this is entirely due to the weakness in average hours (Chart 12).

Earnings

Whole economy total pay growth was 2.9% in the three months to July, 0.3pp above our forecast. Private sector total pay growth was 3.4%, 0.5pp higher than expected (Chart 13). Bonuses surprised to the upside in the latest data but did not push up on total pay growth. The news can be accounted for partly by a stronger July bonus pay outturn and partly by upward revisions to earlier months. **This reversed the downside news we had last month leaving total pay growth close to the August IR forecast.**

Whole economy and private sector regular pay growth were 2.9% and 3.4%, respectively, in the three months to July, and broadly as expected. Shorter-term measures suggest regular pay is growing at annualised rates of 2.5% for the whole economy and 3.0% for the private sector (Chart 14).

We expect earnings to continue to grow in the near-term. Headline whole economy annual total pay growth is forecast to be 3.4% in Q3. It is expected to fall to 2.8% in Q4 because of strong bonuses last year which acts as a negative base effect. But whole economy regular pay growth, which excludes bonuses, is expected to remain around 3.4% in Q4. In the private sector, we expect annual pay growth to be around 3 ½ %, on average, during the second half of the year.

Pay growth in smaller firms has been weaker than in larger firms as measured by the Annual Survey of Hours and Earnings. This will be incorporated into next month's AWE figures as part of the regular yearly revisions process. We expect a small downward revisions to headline AWE growth in the order of 0.1-0.2pp.

Unit Wage Costs

Unit wage costs were lower in Q2 but we expect them to grow in line with the August IR projections in the near-term (Chart 15). The downside news in pay and employment mean that unit wage cost growth was weaker than expected in Q2. But this had reversed this month leaving the outlook for unit wage cost growth in the near-term broadly in line with the August IR.

That might change with the Blue Book next week. The revisions will result in changes to output but also wages, self-employment income and non-wage labour costs. For more information on our expectations, see

Chart 14: Short-term measures of pay growth

Data Annex

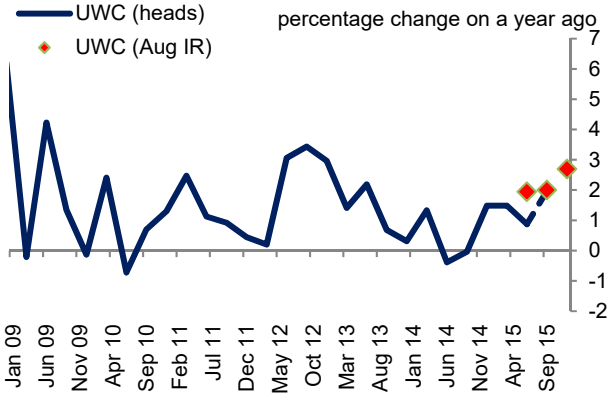



Chart 15: Unit wage cost growth