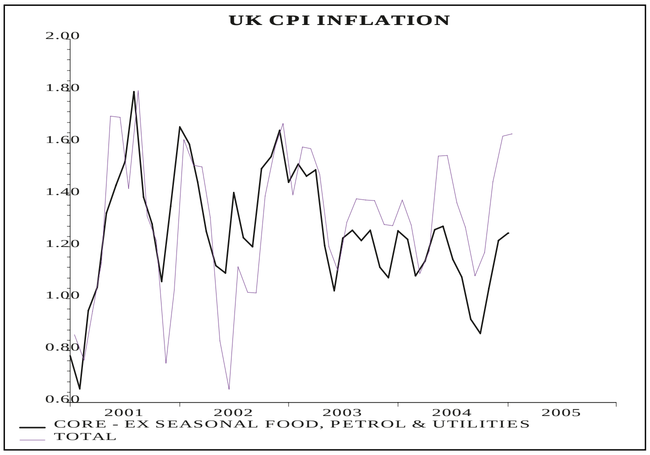
February 21st 2005

GFC ECONOMICS

DAILY COMMENTARY

BOE TOO PESSIMISTIC ON INFLATION

The Bank of England raised both its growth and inflation forecasts in last week's inflation report. It is now projecting inflation to be slightly above 2% in two years time, but is more than probably too pessimistic. Seasonal food, petrol and utility prices have contributed to the 0.5% rise in inflation since September. Core inflation has done no more than reverse its decline in Q3 last year, and the underlying trend remains flat. Upward pressure from labour costs is likely to remain minimal. The labour market is not as tight as headline measures suggest, and the gradual rise in wage increases has been offset by strong productivity gains. Import prices should also continue to depress the CPI, as will intense competition on the high street, which is likely to minimise any pass-through from the pick up in producer prices. An undershoot of both its inflation and growth forecasts could still pave the way for the MPC to start cutting rates later in the year.



Core Inflation Remains Subdued

Inflation has increased from a low of 1.1% in September to 1.6% in January. This rise has caught the MPC by surprise - it had expected inflation to average 1.2% in Q1 - and was almost certainly the major factor behind last week's upward revision to the Bank's forecast. The increase in inflation in recent months has sparked fears that upward pressure on prices has begun to build in response to the tight labour market and the sharp rise in input costs. However, it is far from clear that this is the case. Non-core items, namely seasonal food, fuel and utility prices have exacerbated the recent rise in inflation. While headline inflation is up 0.5% from its low in September, core inflation has risen only 0.3% since then.

This is not to say that non-core items do not matter. It is just that these components are subject to the vagaries of the oil price and the weather. They are, therefore, intrinsically more volatile and unlikely to be representative of the underlying trend in inflation. Seasonal food prices have added 0.14% to the overall inflation rate since September. Utility prices have contributed a further 0.17% though petrol prices have actually reduced inflation by 0.07%. Over the next few months, recent price rises announced by various utility suppliers will continue to boost the m/m numbers, but the bulk of the boost to the annual rate has now been seen. Assuming the oil price remains around current levels, petrol should also have little further impact on inflation until May, when base effects should knock some 0.1% off the headline rate.

Core inflation is currently running at 1.25%, compared to 1.6% for the headline measure. This in itself is of some comfort, as the current boost from non-core items may not be sustained. But more importantly, whereas the headline rate of inflation has arguably been trending higher over the last eighteen months, the core rate has basically been flat over this period. Rather than the rise in the underlying measure in recent months being the start of a new uptrend, it is most likely just a correction to the fall from 1.3% y/y to 0.9% y/y between June and September last year. Certainly, inflation pressures have taken time to build up in the past, and sharp moves in the core inflation rate over the last few years have proven to be short-lived. All the same, there is more reason now to believe that inflation pressures might be building, than there has been in the last few years. As Mervyn King said last week, "the principal upside risk to inflation is uncertainty about earnings growth in such a tight labour market". The upward pressure on wages so far, however, has been limited, and the Bank's central forecast is that

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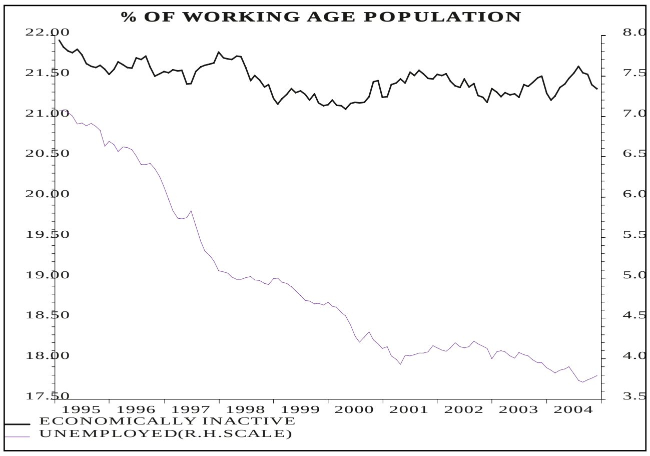
there is only a modest further pick up in wage inflation. Private sector average earnings growth excluding bonuses edged up to 4.4% y/y in December, and the IDS have reported that the average pay settlement in the three months to January was 3.2%, up from 3% during most of 2004.

Various factors have been keeping wage inflation in check and look set to do so. Most notably, the labour market is not as buoyant as the headline data makes out. Whereas the claimant count showed the unemployment rate slipping to a new low of 2.6% in January, the more reliable ILO measure of unemployment edged up to 4.7% in the three months to December. And even this measure seems to understate substantially the slack in the labour market. Currently, only 15% of the working age population without a job is classified as unemployed. The remainder are 'economically inactive' - either not looking for a job, unavailable to start work, or both. Even though the unemployment rate has fallen sharply over the last decade, the inactivity rate has hardly changed and has actually risen slightly over the last two years. If the inactive are weighted according to their likelihood of getting a job, the inactivity rate does show a marked fall during the 1990s, but little change since then. The relevance of all this is that, in the year to spring/summer 2004, more jobs were filled by the economically inactive than by the unemployed. Other developments, such as labour market reform, increased immigration and the threat of jobs being moved offshore have also certainly helped keep a lid on wage growth - and they should continue to keep it in check.



Even if wage increases do keep on drifting higher, it is questionable how much upward pressure this will put on inflation. Private sector productivity growth has picked up strongly over the last two years and is currently running at over 4% y/y. Growth in whole economy unit wage costs, as a result, actually hit an eight year low in Q3. However, in the Bank's eyes, the labour market is not the only source of potential upward pressure on inflation. Import prices are another concern but, on balance, this threat also looks unlikely to materialise. Prices of imported goods have been falling for most of the last decade and, with consumer goods imports now accounting for some 23% of total consumer spending, this has not been an unimportant source of downward pressure on the CPI. Increased sourcing of products from low cost countries such as China has depressed prices and should carry on doing so, particularly following the recent end to global textile quotas. As for the exchange rate, with sterling trading at 13 year highs against the US$, this looks unlikely to boost import prices.

Producer prices are another worry for the MPC. Core input inflation surged in December to 7.2%, a 10 year high and underlying producer output inflation is also running at its highest level since 1995. However, the link between producer and consumer prices has become much weaker over the last decade, and this divergence looks set to continue. As well as increased import penetration, there is also much greater competition on the high street than before. And, now that the retail boom is drawing to a close, the downward pressure on prices from this source looks set to become more, not less, intense. Indeed, the retail sales deflator was down 1.5% y/y in January, the same as in September. If consumer spending does slow further, as we expect, this can only make it all the more difficult to pass on any cost increases. Rather than continuing to edge up over coming months, as the Bank is assuming, inflation looks more likely to unwind some of its recent rise.