

UK

BoE Inflation Report – First Impressions

- The MPC's growth forecasts are marginally lower than in the August Inflation Report, but remain above consensus, with central forecasts for GDP growth of 3.5% in 2014 (unchanged from the August IR), 2.9% in 2015 (3.1% previously) and 2.6% in 2016 (2.8% previously). The MPC have slightly downgraded their forecasts for exports and business investment, but cite offsetting stimulus from lower food and energy prices as well as the recent drop in market rates.
- With soft recent CPI data, plus powerful nearterm disinflationary effects from food, energy and the previous appreciation of sterling, the MPC have sharply cut their nearterm inflation forecasts, and now expect that CPI inflation will be about 1.0% YoY on average in H1-2015 (versus 1.9% YoY in the August IR). Given some usual volatility of the monthly data around that forecast, the Governor noted in the press conference that *"it is more likely than not that I will have to write an open letter to the Chancellor in the next six months on account of the inflation rate falling below 1%"*. However, the MPC's forecast of very weak nearterm inflation is very much focused on a reflection of declines in imported costs: the MPC continues to expect average earnings growth of 3¼% YoY in 2015 (unchanged from the August IR) and actually lifted their forecast for unit labour cost growth in 2015 to 2% from 1½% in the August IR, and forecast ULC growth at 2¼% YoY in both 2016 and 2017. Such a pace is very close to the average of the last 20 years (2.1% YoY), a period in which CPI inflation has averaged 2.2% YoY – ie very close to the 2% inflation target. In other words, the MPC's forecast implies that unit labour cost growth in 2015 and beyond will be roughly consistent with hitting the inflation target over time rather than producing a medium-term undershoot.
- We broadly share the MPC's view that the UK is set for solid economic growth with low inflation in 2015. Our inflation forecasts are not quite as low as the MPC's in the next couple of quarters (although the difference is quite small). The key difference probably is that we expect that solid economic growth will ensure that the jobless rate continues to fall rapidly – consistent with the high level of job vacancies and the strength in survey readings on firms' hiring intentions. The MPC expect the jobless rate to level off at 5.2% over the next 2-3 years, a fraction above their estimate of the long-term equilibrium jobless rate (5.1%). By contrast, we expect that job growth (currently 2.3% YoY) will remain far above workforce growth (0.5% YoY), so that the jobless rate falls below 5% during 2015. Hence, even while low nearterm inflation makes the timing of the first MPC hike highly uncertain (we go for Q2-2015), over time we suspect that the continued tightening in the labour market means that the MPC will need to hike more than markets price in.

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