Guernsey Quarterly Inflation Outlook Bulletin

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POLICY COUNCIL
THE STATES OF GUERNSEY

1.1 Introduction

This is the first quarter edition of 'Inflation Outlook': a Policy Council report providing forecasts for inflation. The forecasts are based on econometric models and provide composite forecasts of RPIX and RPI. These forecasts are revised and published on a quarterly basis in the month following the Policy Council's publication of official Guernsey quarterly inflation rates and are timed to follow the Bank of England's quarterly inflation outlook.

NB - Forecasts are presented with statistical confidence (or error) bands (the shaded area). These represent the range of possible outcomes with (in this case) a 95% statistical certainty.

1.2 Headlines

- The official headline measure of inflation, RPIX has remained at the target of 3% for the last two reported quarters. It was 3.0% for the fourth quarter of 2012.
- On the whole, the outlook for local inflation remains remarkably similar to the last quarter.
- There is a likelihood that in the short term we could experience a mild increase in inflation, driven by administrative and regulatory factors, but thereafter the projection is that inflation should subside back to around three percent as it has been for much of the last three years.

Figure 1.2.1: Forecast Guernsey RPIX

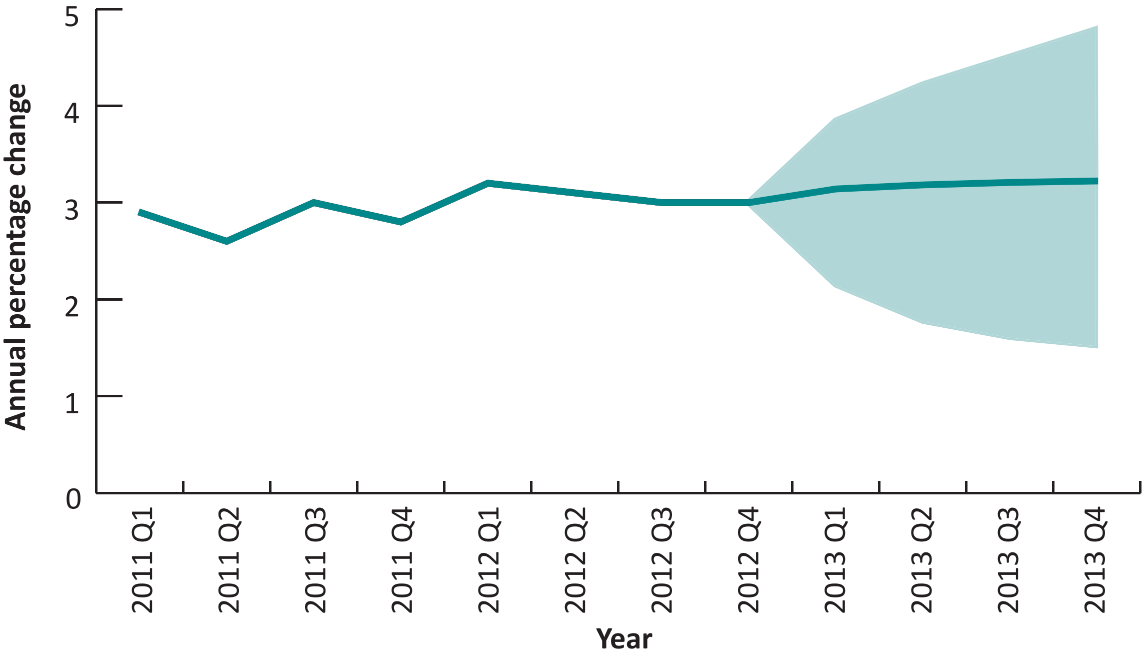
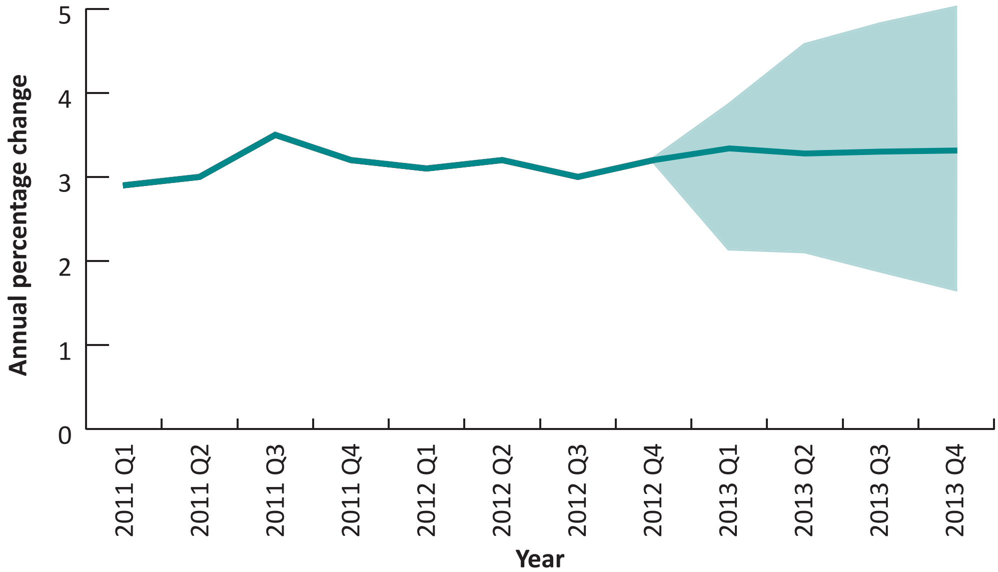


Figure 2.1.1: Forecast Guernsey RPI

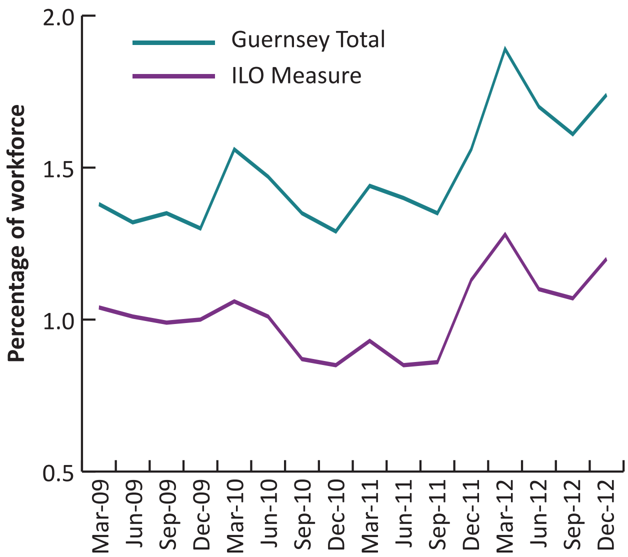


The outlook for local inflation remains remarkably similar to the last quarter.

There is a likelihood that in the short term we could experience a mild increase in inflation, driven by administrative and regulatory factors, but thereafter the projection is that inflation should subside back to around the three percent or so mark that it has stayed for much of the last three years. General conditions are such that there are few factors to push inflation higher, but those that there are should be offset by continuing downward forces.

A short term increase in inflation is possible through the continuing feed through of electricity price rises that began to be felt in the final quarter of 2012. As reported inflation is an annual phenomena, the rises announced in Autumn last year should continue to be felt early this year - the regulatory factors. Other duties announced in the budget, particularly tobacco, which did not fully feed into the final quarter figures (as retailers in general did not immediately pass on all these rises) should also 'show up' in the first quarter reported inflation rates. These are the administrative factors. However, even if these do feed through into a slight increase in early 2013 this should be temporary and in actual fact neither reflect underlying economic conditions.

Figure 2.1.2: Percentage of workforce registered as unemployed



Those underlying conditions remain as they were at the end of last year. General economic conditions are weak. Unemployment continued to gradually increase towards the end of last year and the beginning of this year and total employment fell back slightly at the end of 2012. This picture of the labour market for us was generally consistent with expectations as the forecasts, last estimated in the middle of 2012, projected a flat economy overall for 2012.

Whilst the lay person may equate a worsening of the labour market with contraction or recession, this is not necessarily so; the natural working of the economy means that different sections of the economy send different signals at different stages. Economic growth itself is a means to an end. One end is increasing living standards in the long run. Another end is the creation of new employment. As firms strive to become more efficient and technology and processes improve, less labour is required to provide the same output. Without a general increase in demand this naturally results in less required labour input and hence higher unemployment as there is insufficient alternative demand to take up the slack of surplus labour created. After four years of below par growth therefore it is unsurprising to see these effects taking place in our labour market.

We do expect economic fortunes to improve as the year progresses. We expect this to be led by the finance sector as general global financial conditions improve. In the early stages this might not immediately feed through into more employment so the paradox is that whilst the economy might be recovering it may not immediately feel that way. What this means is that consumer demand might be weaker than otherwise for a while and thus exert little upwards pressure on prices.

Similarly in the housing market we have recently experienced a slow down in volumes and price increases. This itself is a natural consequence of a weaker labour market and slack real earnings growth leading to little support for rapid price rises. However, that is in part offset by the recent availability of easier credit terms so whilst the market is slower the central expectation is that this is a softening of the market rather than anything more concerning and as the economy improves later in 2013, again, the expectation is that conditions will pick up.

But these two areas of weakness should themselves ensure there is as an absence of significant upwards pressure on inflation during the course of 2013 and they should also be sufficient to offset any pressures in the other direction. These do still exist; Sterling weakened towards the end of 2012, exhibiting upwards pressure on import prices; oil prices, whilst stable in dollar terms, becomes costlier after exchange rate effects; and due to adverse weather conditions, commodity pressures continue to feed through into food prices. However, on the other hand (in the inimitable words of economists) price pressures on retailers are severe from competition from the internet and many of our high street retailers that are part of UK chains are not immune to the terrible conditions on the UK high street.

In summary, a combination of present weaker conditions is expected to offset upward pressures in the short term. Over the course of the year, whilst we expect the economy to improve, this is unlikely to feed into inflationary pressures. Thus the outlook for inflation remains benign.

Figure 2.1.3: Comparison of RPIX

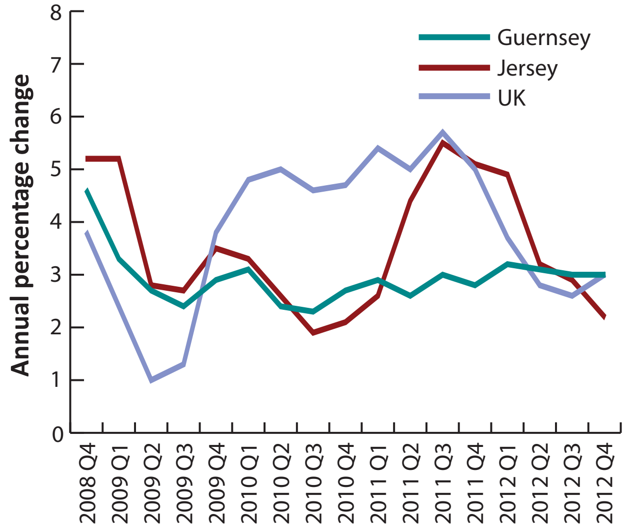
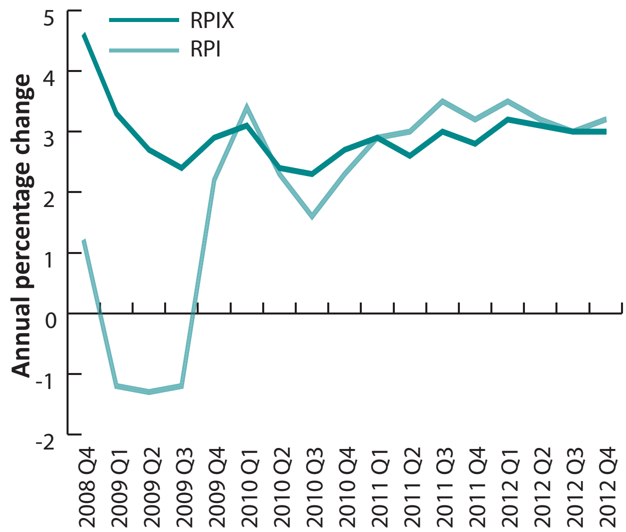


Figure 2.1.4: Guernsey RPI and RPIX



3.1 Contact details and further information

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The next inflation outlook (for Q2 2013) will be published in May 2013.