

Guernsey Quarterly Inflation Outlook Bulletin

Quarter 3 2013 - Issue date 16th August 2013



POLICY COUNCIL
THE STATES OF GUERNSEY

1.1 Introduction

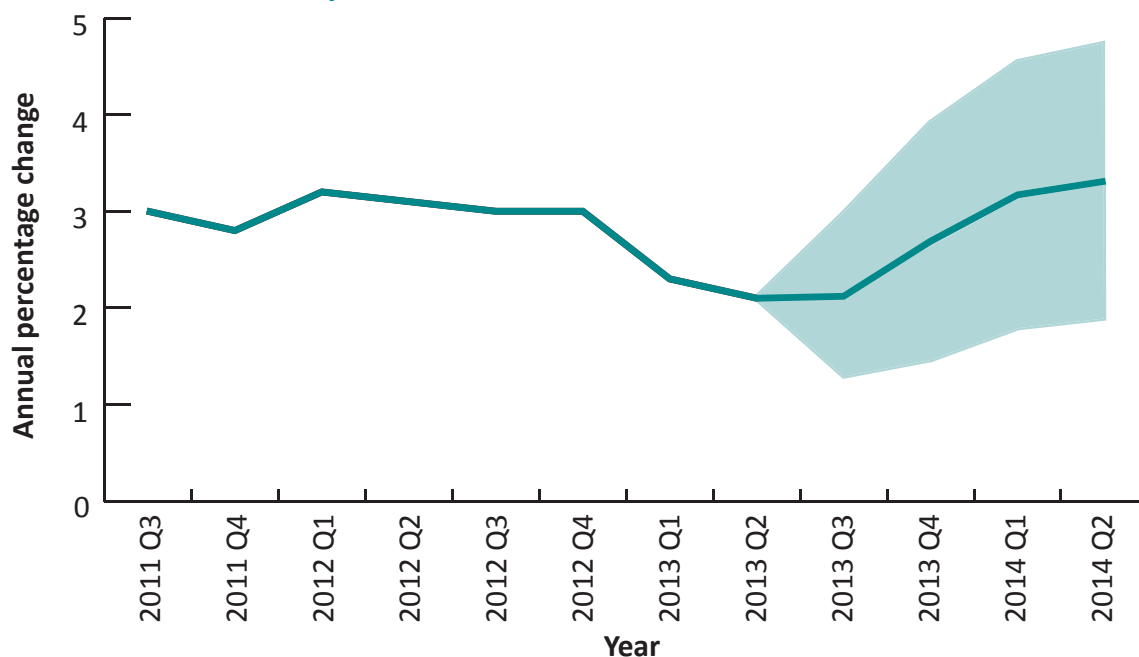
'Inflation Outlook' is a Policy Council report providing forecasts for inflation. The forecasts are based on econometric models and provide composite forecasts of RPIX and RPI. These forecasts are revised and published on a quarterly basis in the month following the Policy Council's publication of official 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

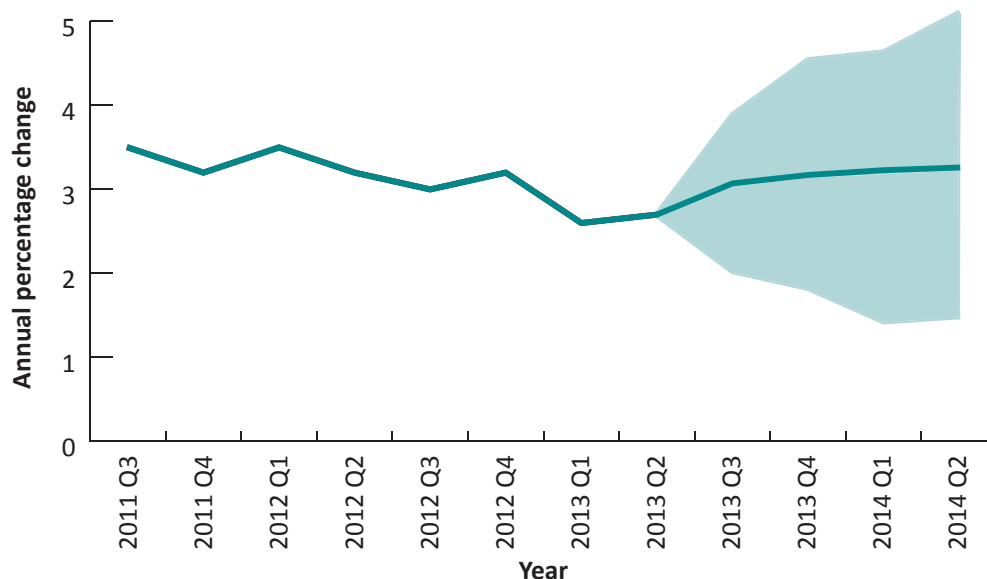
- Inflation has been unusually low for the last two quarters, in essence reflecting a subdued local economy and pressures on retailers. We expect inflation to rise going forwards and to be back at more 'normal' levels in around a year's time – a little over three per cent.
- Our expectations of higher inflation a year out are driven primarily by two factors:
 - *Global:* 'Forward guidance', the new Bank of England policy, has had an immediate opposite effect to that intended, moving market expectations of interest rises forward rather than back. This, combined with early signs of a UK housing bubble driven by the UK Government mortgage subsidy policy, could put upward pressure on inflation.
 - *Local:* Our expectations are of improved economic conditions a year hence. The Chamber of Commerce's Annual Business survey has proven to be a reliable forward indicator in the past and underpins our view that this year will see positive (if marginal) growth.

Figure 1.2.1: Forecast Guernsey RPIX



2.1 Inflation Outlook

Figure 2.1.1: Forecast Guernsey RPI



Forecasting inflation is a notoriously difficult task. The Bank of England (BoE) attempts to do it within a two year time horizon and the States of Guernsey attempts to do it within a year's horizon. The BoE withstood varying degrees of criticism over its track record in recent years. Here in Guernsey, for the most part, our forecasting record hasn't been that bad, that is, within a reasonable margin of error. However, the last two quarters have been the exception to prove the rule, with inflation falling to levels not anticipated. That said, we are reasonably confident that inflation in a year's time is likely to be higher than it is today. This is no particular cause for alarm as the expectation is for the annual change in RPIX to increase to just above the current 3% target, against nearly a full percentage point lower than target at the end of June 2013.

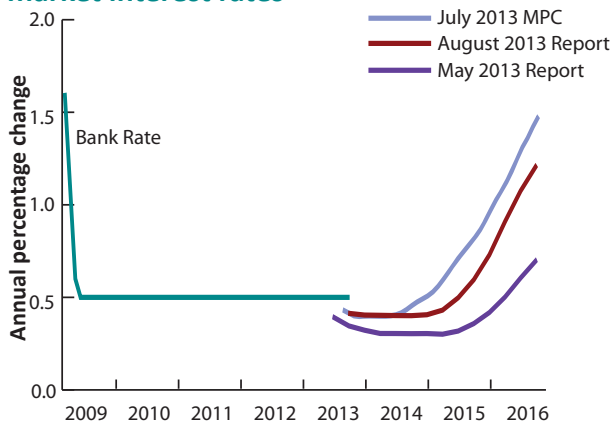
The last two quarters have seen inflation at historical lows in Guernsey (and Jersey) with headline rates (RPIX) just over 2%. It is expected that by the middle of next year, inflation will be just above the 3% target, in part due to expected improvements in the local economy and in part reflecting factors that will similarly affect prices both locally and in the UK.

Taking the latter issue first: the key words on monetary policy makers' lips in recent days have been 'forward guidance' - a new policy introduced by the new Governor of the Bank of England, Mark Carney. In recent decades a strict inflation target has been set, the BoE stating it will do whatever is necessary to maintain the target. It has then been left to the markets to judge what the BoE is likely to do to achieve this in setting their expectations for policy and future market prices. Forward guidance, in layman's terms, basically outlines what the BoE intend to do subject to certain conditions. In specific terms, the BoE have stated that interest rates are on hold until unemployment falls below 7% and that it does not expect this to happen before 2016. The Governor stated that he hoped this would move back market expectations of interest rate rises, which had been moving ever closer (see [Figure 2.1.2](#)), further into the future. Perversely, this has had the opposite effect. Commentators have judged that the BoE has misjudged the level of 'slack' or 'spare capacity' in the economy and that unemployment will fall faster than projected. Some also believe that the BoE may have to move on interest rates to quell the early signs of a housing bubble created by the UK Government's various mortgage subsidy schemes. The combined impact would put upwards pressure on inflation in the UK which, by the Bank's admission, is in any event likely to remain above target for the next twelve months, rising in the very short term (see [Figure 2.1.3](#)).

Another factor is energy and other commodity prices. Oil prices have risen in the last six months and indeed we have seen this effect at our local pumps in recent months. Growing demand, irrespective of improvements in extraction of other energy sources (such as gas fracking) and political instability, is likely

2.1 Inflation Outlook (continued)

Figure 2.1.2: Bank of England Rate and forward market interest rates



Source: Bank of England and Bloomberg.

Figure 2.1.3: UK CPI* inflation projection based on constant nominal interest rates at 0.5% and £375 billion asset purchases

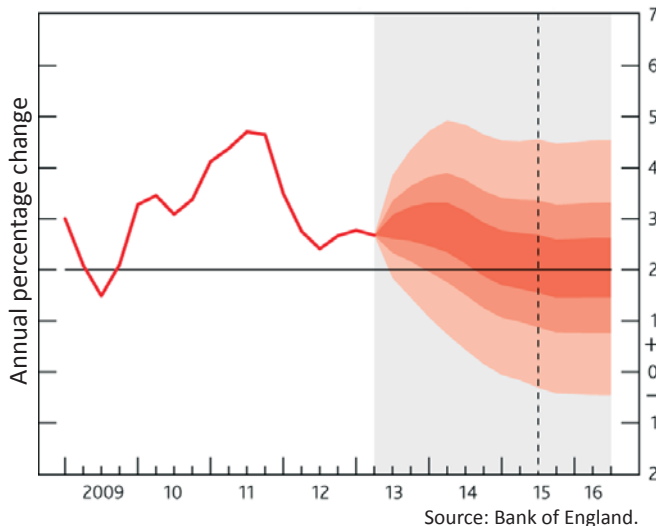
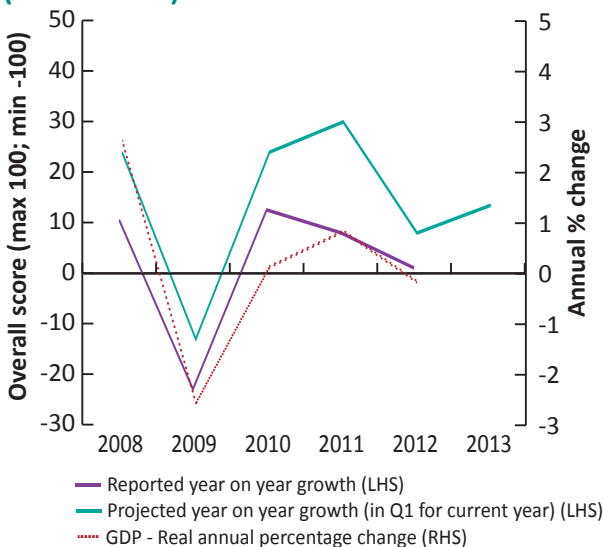


Figure 2.1.4: Overall survey scores for reported and projected year on year growth in profits (March 2013)



Source: Policy Council and Chamber of Commerce Young Business Group Annual Business Survey.

to exert upwards pressure on commodities, an unwelcome factor for inflation as the economy picks up. Locally, potential energy investment requirements, together with recently announced price rises, are likely to provide additional pressures on energy costs.

In the last decade, inflation in Guernsey generally tracked around 1% above the UK rate. This trend has reversed in recent months. This exceptionally low inflation in Guernsey (and Jersey) reflects continuing local economic weakness. Robust growth has now been lacking for four years and its absence has caught up in terms of general confidence, consumer spending and business recruitment. This isn't to portray prospects as bleak, merely a sober assessment that a difficult first six months of 2013 have followed a poor 2012, which itself followed a weak 2011. Inevitably this has fed into spending patterns and put downward pressure on inflation.

Ironically, the Channel Islands continue to experience stagnant conditions just as developed world growth is confirming its setting on an upwards trajectory - the US leading the way followed by the UK and now the Eurozone. Indeed experience and events of recent days imply that Guernsey is still experiencing fallout as a result of four consecutive years of sub-par or negative growth. Our finance firms also have to adapt to the pressure of increased compliance costs in the face of numerous global regulatory initiatives and information exchange requirements. This probably explains, in part, why activity has yet to pick up in response to improved financial market conditions. However, the central expectation is that conditions will be improved in 12 months' time and hence supportive of the central projection that domestic inflation will be around a percentage point higher a year from now. Indeed, the Annual Chamber of Commerce, Business Trend Survey presented a picture of a better 2013 than 2012 (see [Figure 2.1.4](#)). The survey has proven a remarkably good forward indicator and underpins our belief that 2013 will still experience some (albeit minor) economic growth.

* CPI (Consumer Prices Index) is the UK's official measure of inflation.

3.1 Contact details and further information

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