



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

13 July 2006

Dear Pay Review Body Chair,

## **INFLATION EVIDENCE FOR PAY REVIEW BODY RECOMMENDATIONS**

Each year the treasury submits evidence to Pay Review Bodies on the Government's general approach to pay and includes information on various economic indicators. The attached paper provides an interim update on the inflation part of this evidence.

Since the Government established its monetary policy framework in 1997, the UK has benefited from its longest period of sustained low and stable inflation since the 1960s. As a consequence, interest rates have been at record lows, benefiting millions of public sector workers as well as households on the rest of the economy.

Against this background of historically low inflation and interest rates, CPI inflation increase last year to reach a peak of 2.5 per cent in September 2005. Since then it has dropped back, and stood at 2.2 per cent in May 2006. Recent increases in inflation rates have in large part been due to the temporary impact of higher oil prices. Once the impact of oil (and other goods with volatile prices) is stripped out, underlying or 'core' inflation has remained consistently below 2 per cent and has been falling since August 2005.

However, in recent months goods price inflation has picked up as a result of these temporary price increases. This means it is important to remain vigilant to the risk of higher pay settlements feeding through into higher inflation going forwards.



It will be important to ensure that public sector pay increases do not contribute to inflationary pressures in the economy going forwards. To do so would risk converting a temporary increase in inflation into a permanent increase. The Pay Review Bodies should therefore continue to base their pay settlements on the achievement of the inflation target of 2 per cent.

Yours sincerely,

A stylized, handwritten signature in black ink, appearing to be "Gordon Brown".

**GORDON BROWN**

## **EVIDENCE ON INFLATION FOR THE PAY REVIEW BODIES**

1. Each year the Treasury provides the Pay Review Bodies (PRBs) with evidence on the economic situation to inform the assessment of pay settlements for public sector workers. This paper provides advance analysis of the inflation part of this evidence, a key issue in assessing pay awards, especially in the context of rising goods price inflation, high service sector inflation, significant rises in oil prices seen over the past two years and the importance of ensuring no second round effects on wage inflation. The paper updates the analysis on inflation provided by the Treasury to the PRBs in November 2005.

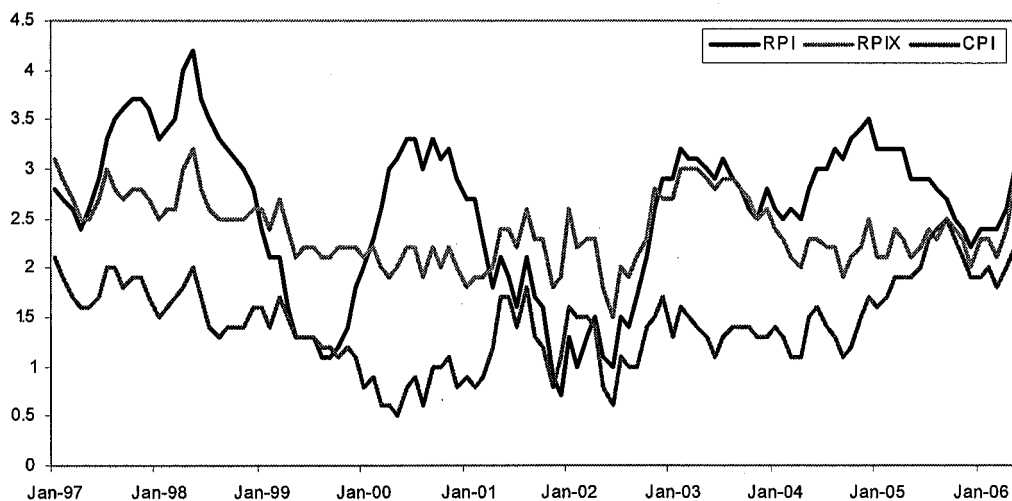
2. The paper begins by examining recent movements in inflation as shown by the different measures of inflation. It then considers the causes of these changes, the extent to which they are temporary, and the implications for wage-setting in the public sector.

3. Since the Government established its monetary policy framework in 1997, the UK has benefited from its longest period of sustained low and stable inflation since the 1960s. For example, whereas inflation as measured by the Retail Prices Index (RPI) averaged 6.5 per cent between 1979 and 1997, it has averaged 2.6 per cent since 1997. As a consequence of this low inflation environment, interest rates have also been at record lows. Having averaged 12 per cent between 1979 and 1997, mortgage interest rates have been 7 per cent on average since 1997 and currently stand at under 6.5 per cent. These low interest rates have benefited millions of public sector workers as well as households in the rest of the economy.

4. Against this background of historically low inflation and interest rates, Consumer Price Index (CPI) inflation increased last year to reach a peak of 2.5 per cent in September 2005. Since then it has dropped back slightly, and stood at 2.2 per cent in May 2006. Other measures of inflation, such as RPIX, have risen less quickly over the same period. Headline RPI inflation actually fell throughout 2005, as house prices eased and mortgage interest payments (excluded from CPI and RPIX) were reduced as a result of the Bank of England's base rate cut in August 2005.

5. All three measures of inflation have picked up slightly in recent months. This can largely be attributed to a temporary increase in the rate of inflation for goods with volatile prices, such as oil and seasonal foods.

Chart 1: UK inflation



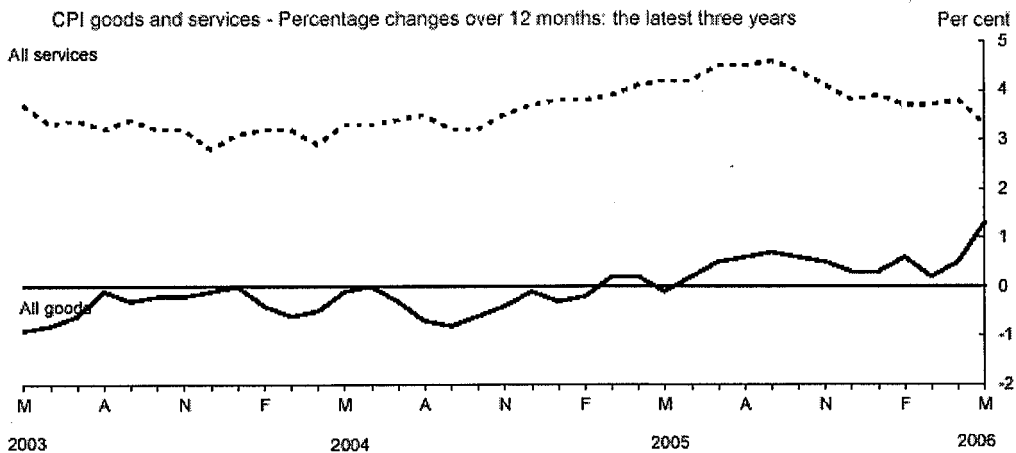
6. Increases in the prices of petrol, energy and food have resulted in a pick up in goods price inflation. Over the past 15 years services inflation in the UK has consistently outpaced goods inflation. For much of the past 7 years goods inflation has in fact been negative or around zero, whilst services inflation has hovered around a 4 per cent annual growth rate. But with goods and services inflation each accounting for roughly half of the total CPI

basket (goods: 55%; services 45%) this scenario has proved consistent with the maintenance of the headline CPI inflation rate around its 2 per cent target.

7. As Chart 2 shows, goods price inflation picked up to 1.3 per cent in May as a result of these temporary price increases. Although this has been accompanied by a slight decline in inflation in the service sector (in which wages represent a higher proportion of total costs), service sector inflation remains significantly higher than goods prices inflation. Overall CPI inflation has remained broadly stable around the Government's 2 per cent inflation target.

8. Rising good price inflation coupled with service sector inflation of around 4 per cent means it is important to remain vigilant to the risk of higher pay settlements feeding through into higher inflation. In order to avoid a permanent increase in inflation going forwards, discipline in pay settlements will need to be maintained and where necessary strengthened, through pay awards that are consistent with the achievement of the Government's CPI inflation target of 2 per cent.

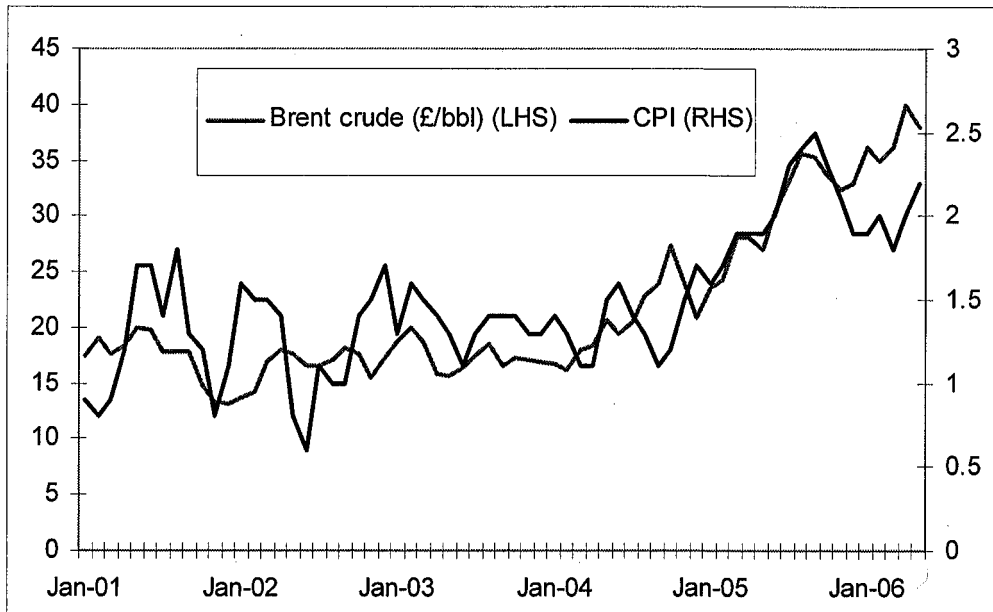
Chart 2: CPI goods and services inflation



## The price of oil

9. One of the main reasons for the increase in the rate of CPI inflation since the start of 2005 is the sharp increase in crude oil prices. Oil prices have increased by more than 75 per cent since the beginning of 2005, and recently reached a new record high in May 2006.

Chart 3: Sterling oil price and UK headline inflation



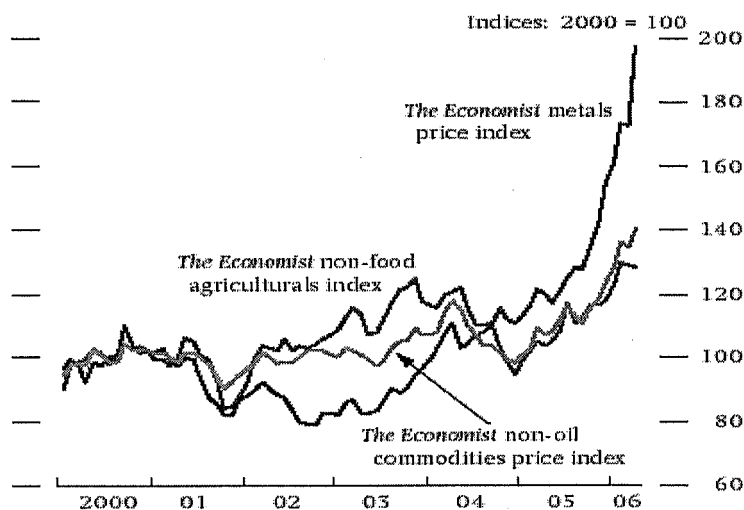
10. Chart 3 shows the oil price against CPI inflation. The increase in oil prices in 2005 had a direct impact on CPI inflation, as a result of increases in the price of petrol and other fuels. These increases have added around 0.4 percentage points to the current annual rate of CPI inflation, accounting for nearly 20 per cent of current inflation by this measure.
11. Increasing energy prices as a whole have had an even greater impact on inflation, accounting for half of the current rate of CPI inflation, or 1.1 percentage points.

12. Throughout 2005, the impact of higher oil prices on the RPI and RPIX measures of inflation was offset by easing house price inflation, and additionally by a reduction in mortgage interest payments for the RPI. However, in recent months RPIX and RPI inflation have picked up alongside the CPI measure, as these 'offsetting' factors have declined and higher energy prices have consequently fed through into higher headline inflation.

### Other commodity prices

13. The increase in global commodity prices has not been limited to crude oil. In recent years a number of other commodity prices have been subject to considerable price rises. Chart 4 shows that *The Economist* non-oil commodities price index has risen by around 45 per cent in sterling terms over the past 18 months; whilst the increase in metals prices has been of the order of 80 per cent over the same period.

Chart 4: Global commodity price inflation



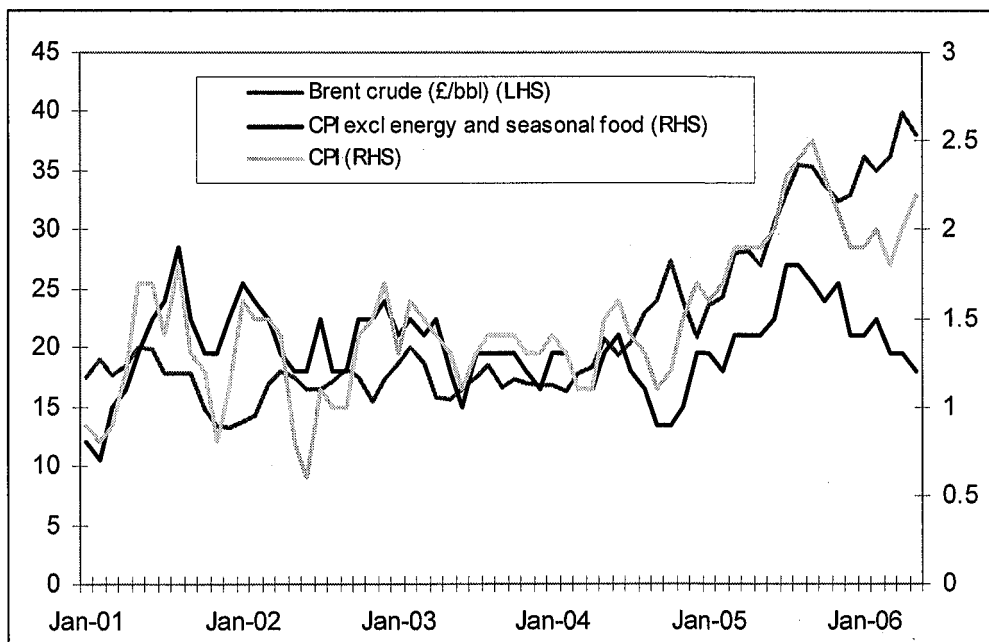
Source: Thomson Financial Datastream.

(a) Monthly averages, in sterling terms. Indices exclude iron and steel.

## 'Core' inflation

14. It is possible to abstract from the effects of volatile price changes by looking at measures of 'core' inflation. These measures exclude certain items from the CPI basket whose price effects might be considered to be temporary and/or volatile: examples include energy prices and seasonal food prices. As such these measures, which are intended to give a measure of 'underlying' inflation in the economy, are more likely to reflect the balance of the pressures of demand on supply and thus should be taken into account when pay settlements are determined.

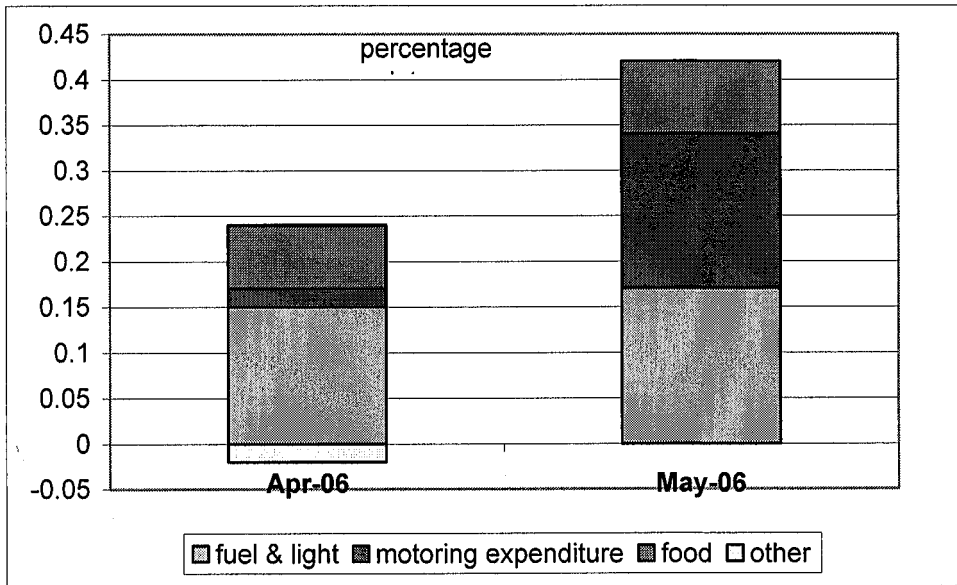
Chart 5: Oil price and UK 'core' inflation



15. Chart 5 shows that while 'core inflation' has been close to the average rate seen in recent years the sharp rise in oil prices over 2005 has driven up headline CPI inflation.
16. As Chart 6 shows, the temporary increase in the rate of inflation for energy, oil (increases in the price of petrol are

reflected in an increased contribution from the motoring expenditure category) and seasonal foods has also resulted in a temporary pick up in RPI inflation in April and May 2006.

Chart 6: Main contributions to the month's change in the annual RPI rate



## **Conclusion**

17. In conclusion, this paper has shown that against a background of high service price inflation, goods price inflation has been increasing and there has been a temporary increase in consumer price inflation due to higher oil prices. It will be important to remain vigilant to the risk of higher pay settlements feeding into higher service sector inflation and that public sector pay increases do not contribute to inflationary pressure in the economy going forwards. To do so would risk converting a temporary increase in inflation into a permanent increase through second round effects on wage inflation with subsequent implications for interest rates. The Pay Review Bodies should therefore base their pay settlements on the achievement of the inflation target of 2 per cent.