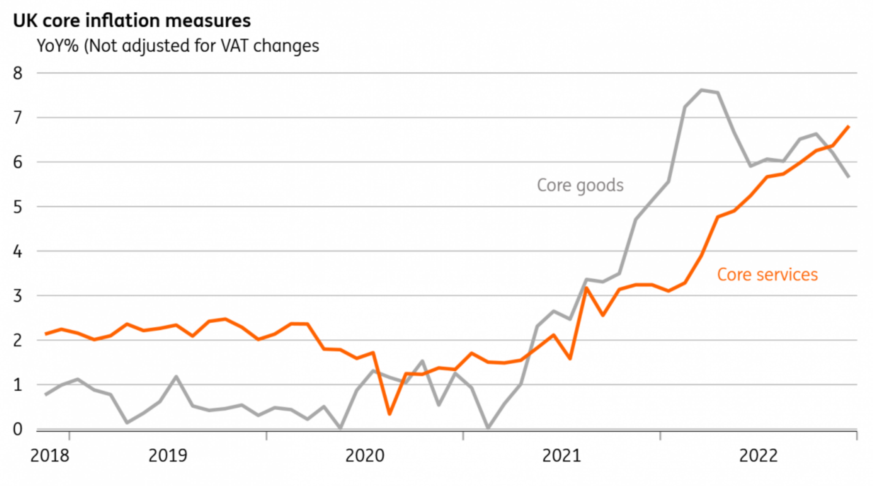
Jump in UK services inflation provides ammunition to BoE hawks

Headline inflation has peaked but pressure from the service sector continues to build. That's likely to tip the balance for Bank of England hawks in favour of one final 50 basis point hike at the February meeting

The good news, at least, is that it seems like UK headline inflation is slowing. At 10.5% in December, the latest CPI figure is below October's 11.1% peak. We expect this headline measure to stay roughly where it is for the next couple of months before showing more dramatic signs of easing as we approach Easter, which is when electricity/gas base effects begin to become more favourable.

Last year's near-50% increase in bills won't be matched, and if anything it looks like the Treasury will either need to lower unit prices for consumers later this year, or scrap April's planned increase altogether, given the recent fall in wholesale gas prices. On current policy, we expect headline inflation to fall back towards 6% by summer and to 3.5-4% by year-end.

UK services inflation has risen further



Source: Macrobond, ING calculations

'Core goods' excludes food, energy and tobacco. 'Core services' excludes air fares, package holidays and education

The bad news, at least as far as the Bank of England is concerned, is that its favoured 'core services' measure of inflation has jumped, even as goods inflation slows dramatically. At 6.8%, core services CPI (which excludes volatile components like airfares and package holidays) is materially higher than the Bank had been forecasting back in November, and reflects ongoing pressure from both wages and energy bills on service sector costs.

While we suspect this is nearing a peak, it provides further ammunition for the BoE's hawks to push for one final 50 basis point rate hike at the February meeting, putting the peak at 4% for Bank Rate (or perhaps 4.25% if the Bank adds one further 25bp hike in March). The UK's somewhat unique combination of structural worker shortages, and therefore potential for persistently higher wage growth, as well as its exposure to Europe's energy crisis, suggests the Bank of England will be less quick to cut rates than in the US, where we expect cuts later this year.

Author

James Smith
Developed Markets Economist, UK
james.smith@ing.com