Lower UK core inflation unlikely to dampen BoE's hawkish mood

The latest slip in core inflation was mainly down to volatile airfares, and policymakers remain more heavily focused on stronger wage growth figures. We expect further hints that markets are underestimating the Bank of England's tightening ambitions, although ultimately we don't expect a rate hike in 2019

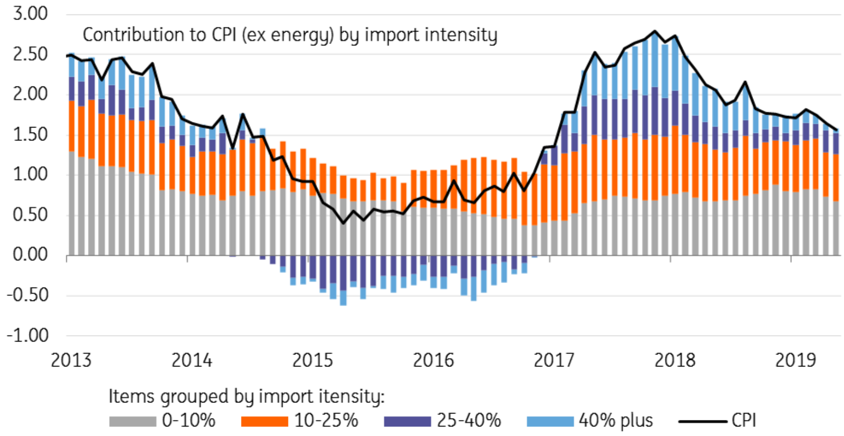
Source: Shutterstock

At face value at least, the fact that UK core inflation has now been below the Bank of England's 2% target since last September appears to offer little reason to tighten policy further. However, there are a few key reasons why we suspect policymakers will remain a little more hawkish on the outlook for inflation over the coming months.

Firstly, the latest dip in core CPI to 1.7% in May was largely down to airfares - a volatile component of the inflation basket, which fell back after Easter by around 5%.

Secondly, and more broadly, the modest downtrend in core inflation over recent months also reflects the lagged impact of sterling's post-Brexit plunge filtering out of the numbers. Stripping the inflation basket down by import intensity – the proportion of the good/service that is effectively imported – suggests that the contribution from items with a lower sensitivity to currency moves has been more stable over the past couple of years.

UK inflation broken down by import-intensity (excl energy)



Source: Macrobond

Even so, it's fair to say that underlying consumer inflation has still been fairly unexciting. Another measure of so-called domestically-generated inflation, the core services index, has slipped back since 2017. That said, as MPC member Michael Saunders recently highlighted, much of this has been driven by lower contributions from rent and insurance.

Most importantly though, policymakers continue to put greater emphasis on wage growth, which is still performing fairly solidly. The BoE expects wage pressures to continue building as skill shortages bite.

Read MPC member, Michael Saunder's full speech here

In other words, we expect the Bank to stick to its reasonably hawkish mantra at tomorrow's meeting. Policymakers have been keen to highlight that they believe market expectations of interest rates are too low, and it's possible we see more explicit references to this in either tomorrow's statement or accompanying minutes.

Ultimately though, we think it's unlikely the Bank will get an opportunity to tighten further this year. For more, see our latest Bank of England dashboard

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