Lower UK inflation unlikely to faze Bank of England

UK inflation is set to fall over the next few months on lower household energy costs. Barring a more significant decline in economic activity, we think the Bank of England will 'look through' lower CPI and keep rates on hold this year

Source: Shutterstock

Higher petrol prices lifted UK inflation in January, but this is unlikely to last. We expect headline CPI to fall from the latest figure of 1.8% to around 1.1/1.2% by June, as falls in household energy costs trickle through. Sharp cuts to water bills, as well as a lower regulated energy cap, should become a fairly noticeable drag on inflation.

Of course, none of this will come as much of a surprise to the Bank of England, which is more concerned about the fairly muted level of core services inflation. This is one of the better measures of what policymakers call “domestically-generated inflation”, and with wage growth having risen over the past couple of years, core services CPI would have been expected to rise in tandem.

We think a rate cut looks fairly unlikely for the time being

But this hasn't really happened, which suggests margins have become compressed. Will this change now that optimism is rising again after the election? Part of the answer depends on whether firms feel they have greater pricing power to pass on these higher wage costs to shoppers. Despite some early signs that consumer confidence recovered a little after the election in December, we suspect competitive pressures and ongoing lack of demand in some retail segments will still make it challenging for retailers to lift prices more quickly.

At the same time, skill shortages in various industries (notably construction and hospitality) are unlikely to fade, and this will continue to maintain structural upward pressure on wage growth in some sectors.

> This is one story the Bank of England is likely to keep a close eye on at its next few meetings, but even so, we think a rate cut looks fairly unlikely for the time being. Policymakers will be looking for signs that rising business sentiment is translating into faster economic growth, although we think it would take a material deterioration in the economic backdrop for them to ease policy in the near-term.

Author

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