

UK: Inflation begins its journey up towards 2%

For various quirky reasons, UK inflation nudged higher in January, a move that is set to continue and take headline CPI to 2% by year-end. But will this last in 2022? We aren't so sure, and this implies higher inflation is unlikely to be a major concern for the Bank of England



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January inflation surprised on the upside

UK inflation has swung around a bit since Covid-19 began, and January was no different. Higher restaurant/hotel prices (despite being closed) and a lower-than-usual post-Christmas drag from transport prices were among the factors that allowed CPI to drift up to 0.7%.

This upward trend is set to continue, given that by April, we'll no longer be comparing current petrol prices to pre-pandemic levels. That, and a 9% rise in the household energy price cap will lift headline CPI to the 1.5% area in the second quarter. Throw in some spillover effect from higher transportation costs (owing to both Brexit and worldwide shipping disruption), then headline inflation is like to be at, or possibly a tad above, the 2% target by the end of the year.

But will it last? Perhaps not...

But the question for the Bank of England (BoE) is whether this lasts - and [as we wrote in much more detail earlier in the week](#), there are reasons to think it won't. We expect headline CPI to dip below target again in 2022.

Partly, this is because the expected rise to 2% is mostly down to energy - core will continue to be pretty stable. Importantly, we also don't expect a massive spillover from the pent-up demand story.

Elevated savings levels are likely to translate into decent consumer spending from the spring (albeit with some caveats), and this is likely to benefit services more than goods.

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But despite the huge fall in consumer service demand during the pandemic, inflation hasn't really slowed in these categories - with the exception of hospitality, which has benefited from a VAT cut. Services inflation is, by and large, much less volatile than for goods - and we expect the same to be broadly true this year. The new 2021 weights, reflecting weaker 2020 services consumption, will also partially limit the effect of any price pressures here.

There will be exceptions (travel accommodation this summer?), just as there were for in-demand goods over the past few months (eg. durable items). But even here, the impact of pandemic-linked demand/supply imbalances among goods categories has provided only a limited boost to overall inflation so far.

Jobs market slack is also a limiting factor

Unemployment is also key, and is set to rise, depending on how the furlough scheme is unwound. Slack in the jobs market means this is not going to be an environment for aggregate wage growth - though again this probably will vary by sector.

The bottom line for the Bank of England is a) inflation doesn't bolster the case for pursuing negative rates in the autumn but b) also probably won't warrant rate hikes/balance sheet reduction until 2023 at the earliest.

Author

James Smith

Developed Markets Economist, UK

james.smith@ing.com

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