

UK inflation bounces back, charting a course to 2%

UK inflation is set to rise above 2% this year, predominantly on energy-related tailwinds. But will this last into 2022? We suspect CPI is more likely to drift lower, suggesting the pressure on the Bank of England to tighten policy again will be fairly modest



Source: iStock

UK inflation bounced back to 0.7% in March, after a series of quirks caused an outsized slowdown in headline CPI to 0.4% in February.

Clothing prices were one such drag, recording a more than 6% fall in prices between December and February. Unsurprisingly the effect of the latest lockdown meant many clothing retailers were forced to prolong their usual sales period, though with schools having returned in March and more activities reopening, fortunes are likely to be improving gradually. Indeed the price of garments rebounded by 1.6% in March.

More importantly, though, this is really the last reading where we are comparing current prices to pre-pandemic levels. From next month, we'll likely see the rate of CPI more-or-less double. Partly this reflects the slump in energy prices this time last year, but more recently we've also had a sharp 9% rise in the household energy cap. These factors, combined with the ongoing cost rises associated with global shipping and Brexit, are likely to push headline inflation above 2% later in the year.

What matters for policymakers, however, is whether this above-target stint lasts into 2022. And unlike the US, where we expect inflation to be relatively sticky above 2%, we think the UK story is likely to be less exciting. Partly this is because we think the pent-up demand story may be less pronounced than in the States, linked to the fact that the rise in savings has been more heavily concentrated among high-income earners who tend to have a lower propensity to spend.

We'd also expect any demand-supply imbalances to be more reflected in services prices over coming months, given that this is where consumer resources are likely to be more heavily targeted. Will these sectors take the opportunity to lever up prices? There will undoubtedly be some examples of this, though in general the price of services tends to be much stickier than goods. Indeed, despite the damaging effect of the pandemic on the likes of consumer services, the rate of inflation hasn't really noticeably slowed (if you strip out the effect of the VAT cut in hospitality).

For the Bank of England, all of this has two implications. The fact that inflation is likely to rise this year while the economic outlook is improving suggests little imminent need to look at negative interest rates. However, the less exciting inflation story for 2022 suggests policymakers will be in little rush to tighten policy, which we don't expect to happen before 2023.

Author

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.