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.

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