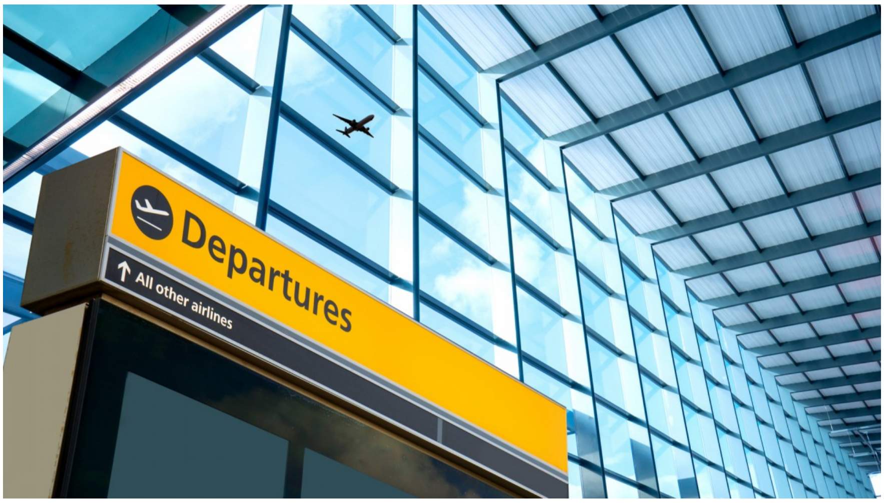
UK inflation dips on Christmas airfares

Core inflation has dipped more sharply than expected, and will continue to fall towards the Bank of England's target over the course of the year



Source: Shutterstock

2.5% UK core inflation (YoY%)

Worse than expected

With headline UK inflation now back at 3%, Governor Carney has narrowly avoided writing a second letter to the Chancellor explaining why CPI is above target. The reason for December's dip is a fairly familiar tale: airfares. Whilst only making up a small proportion of the overall CPI basket, plane fares are prone to pretty wild price swings between months. Last year, plane ticket prices rose by almost 50%, while this year's seasonal increase was more modest.

This was offset to some degree by higher petrol prices, which once stripped out meant that core inflation (which excludes energy) fell more than expected. That's partly because the cost of many recreational goods, many of which are sensitive to sterling fluctuations, have begun to rise more slowly. For example, the inflation rate for audio-visual items has begun to slow now that prices have largely adjusted to the new level of sterling.

Core CPI may be in for one last hurrah when we get January's data, with a possible spike back up to 2.7/2.8%. But after that, we anticipate core inflation falling more or less back to target by the middle of this year as the FX pass-through continues to fade.

> This will take some of the heat off the Bank of England to hike later this year, although of course a lot still depends on Brexit. The likely agreement-in-principle of a transition deal by the end of the first quarter means a rate hike in May is possible, although not yet guaranteed. Whatever the Bank decides, the window to squeeze in another rate hike is likely to close over the summer, as Brexit starts to heat up ahead of October's artificial deadline for a deal.

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