UK: Inflation dives, but it's unlikely to last

Steep discounting on clothing helped drive inflation quite a bit lower in February, but this is arguably only a blip on the road to 2% later this year

Oxford Street, on the post Christmas Bank Holiday and in tier 4, London, UK

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A surprise dip in inflation

UK inflation unexpectedly dipped back in February, with headline CPI registering only a 0.4% rise year-on-year, compared to expectations of 0.8%. But while that's undoubtedly quite a big miss, we can chalk most of it down to either temporary or quirky factors.

The major driver was an unexpectedly sharp fall in clothing/footwear prices. Having already fallen by over 4% month-on-month in January, retailers slashed prices by a further 1.5% in February, a month when in 'normal times' the sales periods are usually done-and-dusted. The ONS also notes there were some unusual falls in things like games and toys, which helped skew inflation lower.

None of that, unsurprisingly, is likely to last. While clothing retailers have arguably been one of the worst-hit parts of the high street through the pandemic, their prospects may begin to improve as the reopening phase begins and people start thinking about refreshing their wardrobe, helping to relieve some of the downward pressure on prices.

From April we'll also see the headline rate of inflation leap on energy prices, partly because we'll no longer be comparing petrol prices to pre-pandemic levels, but also because the household energy price cap will rise to 9%. 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.

Will the rise in inflation last? Possibly not

But the key question from a monetary policy perspective is whether this lasts into 2022? We think it's more likely that headline CPI will dip back after this year as some of those energy boosts fade.

A key question of course is whether service-sector firms take the opportunity to ramp up prices to make up for lost time. This is inevitable for some services, but it's also worth noting that inflation hasn't really slowed much in these hard-hit sectors during the pandemic so far - with the exception of hospitality, which has benefited from a VAT cut. Services inflation is, by and large, historically much less volatile than for goods - and we think the same will be broadly true this year. We looked into this in more detail a few weeks ago.

> For the Bank of England, all of this has two implications. The latest dip, based on temporary factors, matters very little for policymakers, and the prospect of a rise in CPI through this year is another argument against adding further stimulus later this year. But equally, the more moderate medium-term outlook suggests little pressure to begin looking at tightening, and indeed this is unlikely to come before 2023.

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