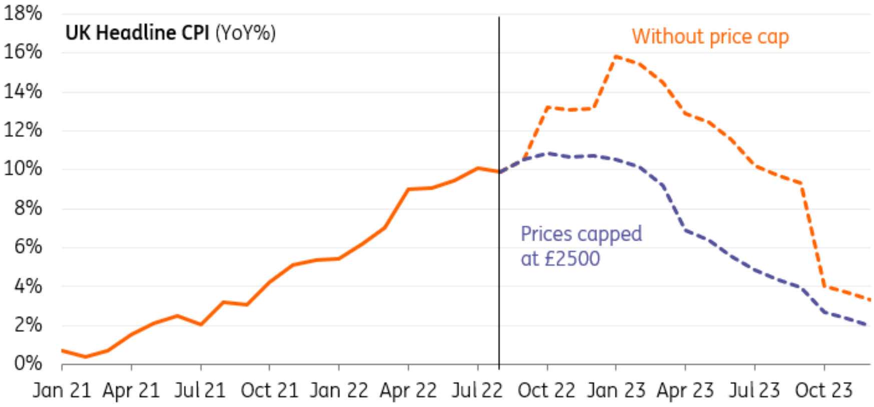
UK inflation set to peak around 11% after energy price support

Headline inflation will rise a little further having eased back below 10% in August, and it's likely to stay around 11% into early next year before falling back more dramatically. However, the Bank of England is watching wage growth more closely, as the hawks worry that worker shortages could lead to core inflation staying more persistently above target

The absence of another upside surprise to UK inflation this month takes a bit of pressure off the Bank of England to move even more aggressively when it meets next week. Headline CPI came in a touch lower than both consensus and last month's level, at 9.9%, and that's largely because of a near-7% fall in petrol/diesel prices during August. We expect another 2% decline in next month's figures.

The introduction of a government cap on household energy prices means that we should now be fairly close to the peak in these headline figures. The fact that electricity/gas bills won't be rising by around 80% in October and a further 30-40% in January means that the peak in CPI should be around 5 percentage points lower. With the government due to cap the average household energy bill at £2500, up from around £2000 now, we expect a peak in the region of 11% in October. That's compared to 16% in January which is what we'd forecasted before the support was announced.

UK inflation now set to peak at around 11% after energy price support

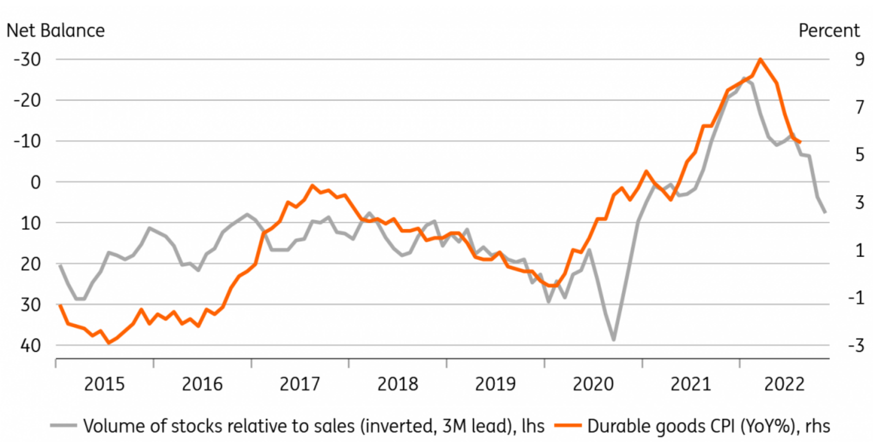


Source: Macrobond, ING forecasts

We'd expect inflation to stay around there until early next year, before cooling more quickly as energy base effects kick-in. We think it could be more-or-less back to the Bank of England's 2% target by the end of next year, crazy as that currently seems.

But what policymakers are more interested in is core inflation – or to put it more accurately, the more persistent parts of the inflation basket. Here the news is mixed. On a month-on-month price basis, the increases we saw in August do seem fairly broad-based. However, there are signs that 'core goods' inflation is easing off, linked perhaps to the rise in retailer inventory levels relative to sales. That's a function of supply chains beginning to improve, and in some cases commodity prices having fallen, which is coinciding with reduced demand for goods.

Higher inventories and lower sales reducing pressure on goods prices



Source: Macrobond, ING

However, the Bank is more focused on wage growth, and as we noted yesterday, the worker shortages that have plagued the jobs market for several months now don't appear to be resolving themselves very quickly. The BoE's hawks are concerned that this will translate into persistent pressure on wage growth.

We aren't totally convinced this will be enough to swing the pendulum in favour of a 75 basis-point rate hike next week, despite both the ECB and Federal Reserve going down this path. It's a pretty close call, not least because the hawks will be worried about the recent slide in sterling, and markets are closer to pricing a 75bp move than a 50. But for now, we think another 50bp move next week is the most likely outcome, followed by another such move in November.

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