UK inflation set to rise this year despite lower-than-expected March data

UK headline inflation was lower than expected in March, but higher contributions from household energy and water bills will help take it to 3.5% or above in the second half of the year. At the same time, services inflation should come lower imminently, helping cement quarterly rate cuts from the Bank of England

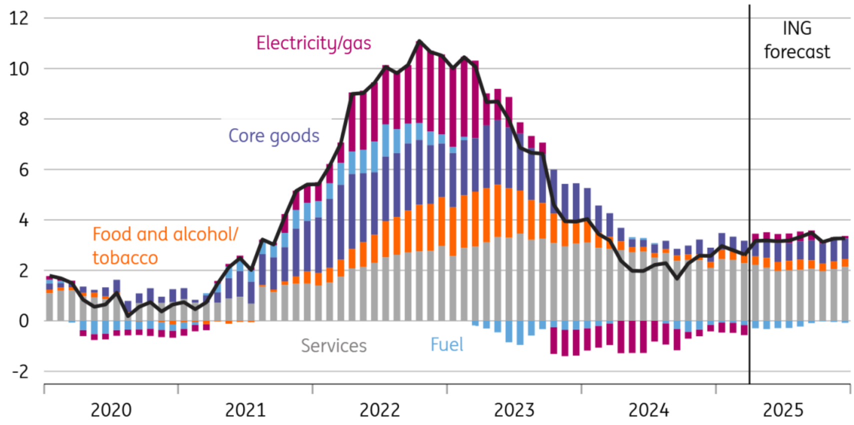
More benign services inflation could help cement one rate cut per quarter from the Bank of England for the rest of 2025 and into 2026

At 2.6%, March's headline UK inflation reading is likely to be the lowest we'll see for some time.

Household energy bills have generally been a net drag on overall inflation, a legacy of the steep falls in natural gas prices we saw after the 2022 spike. But as of April, that will no longer be the case. Those energy bills will be contributing 0.8ppt more towards April's annual CPI figure than they did in March. Water bills have risen sharply this month, too.

Fortunately, petrol prices will offset some of that, having fallen on the back of lower oil prices. Indeed, that's the main reason March headline inflation was lower than February (2.8%). Still, wrap all of that together, and we see April's CPI figure at 3.2%, rising to 3.5% or maybe even a tad higher towards the end of the third quarter.

Contributions to UK headline inflation (YoY%)



Source: Macrobond, ING

On paper, none of this should be of much concern to the Bank of England. But after several years of elevated inflation, policymakers are more attentive than usual to pressure from energy prices. Officials learned the hard way during the 2022 gas price shock that this can spill into more domestically-focused areas of the inflation basket, like services.

We suspect those concerns are overblown this time around, but it's also true that services inflation is still uncomfortably high, at 4.7%, even if that's a little lower than the Bank of England had forecasted it back in its February update.

The story should, however, start to look better through the spring. April is typically when annual price resets kick in, affecting large parts of the service-sector basket. Remember that certain elements, like phone and internet bills, are explicitly tied to past rates of headline inflation, which have been a little lower this winter than in the last. We expect services CPI to dip to 4.6% in April and drop lower still in May. If we're right, that would pitch it half-a-percentage point lower than the BoE had previously forecast.

More benign services inflation, if it materialises, is unlikely to be a catalyst for the Bank to speed up the pace of cuts – but it would help cement one rate cut per quarter for the rest of 2025 and into 2026.

Author

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Disclaimer