

## UK inflation shock piles pressure on the Bank of England

The bar is set pretty high for the Bank of England to accelerate the pace of rate hikes to 50 basis points this week. But another inflation shocker all but guarantees a 25bp hike tomorrow and another in August

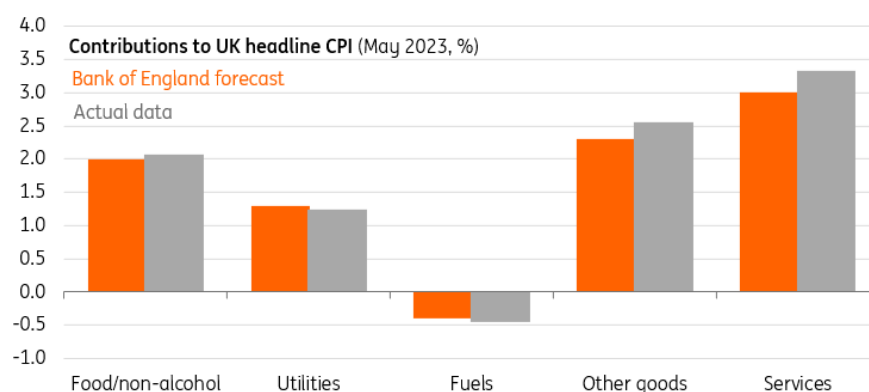


Headline inflation remained unchanged at 8.7% in May

It's another month where UK inflation has come in dramatically higher than expected, and that all but guarantees another rate hike from the Bank of England tomorrow. Headline inflation remained unchanged at 8.7% in May, and because the contribution from energy and food reduced, that means core inflation actually rose to 7.1% from 6.8% previously.

Unfortunately, things look just as concerning when you look into the figures in more detail. The Bank of England is most focused on services inflation because it tends to exhibit more persistent and less volatile trends. And here we saw a further increase in the annual rate of inflation, and that means the contribution from services to overall headline CPI is about 0.3pp higher than the BoE had previously been forecasting. Crucially, this upside surprise doesn't appear to be concentrated in any single category.

## How May's inflation data compare to the BoE's forecast



Source: Macrobond, ING calculations, Bank of England

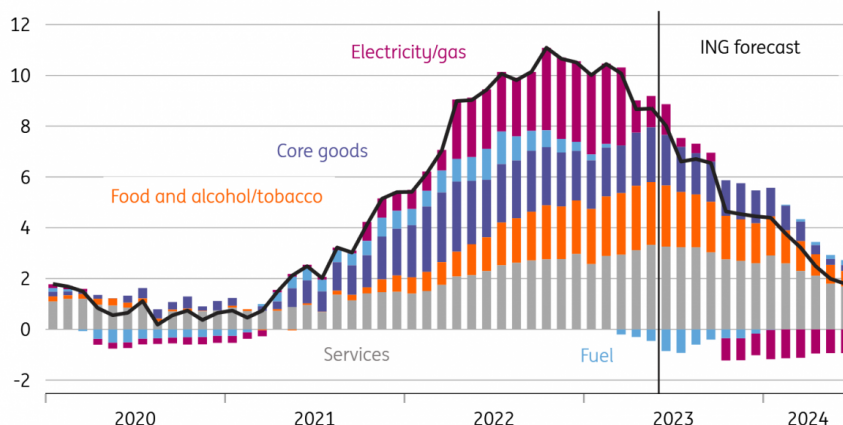
Headline inflation should come down more noticeably over the next couple of months, owing to some pretty hefty base effects. Last June saw a near 10% spike in petrol prices, whereas prices are currently falling, and of course in July we'll see a material fall in household electricity/gas bills. Core inflation we think should come lower too, though to a much lesser degree and mainly because of further renewed downward pressure from certain goods categories.

Headline CPI, we think, will be just below 7% by July and around 4.5% by year-end. Core inflation will probably end the year above 5%.

All of this makes life even harder for the Bank of England. We think the bar for another 50bp hike is set pretty high, but a 25bp hike is basically guaranteed, as is another in August. But markets are now fully pricing a 6% peak for the Bank rate, which implies six more rate hikes from current levels. That seems excessive, and we suspect the Bank of England would privately agree.

When rates got this high last November, the BoE offered some rare pushback against market expectations and signalled a lower peak for rates. But this time, with inflation consistently coming in hotter than expected, we suspect officials will be more reluctant to offer any firm guidance on what comes next. Policymakers won't want to steer market rate expectations lower, only to find that further inflation surprises force it to go further than it would like over the coming months.

## UK inflation should come in lower in June/July on energy base effects



Source: Macrobond, ING forecasts

Ultimately though, 6% rates would be extremely restrictive. The current structure of the mortgage market – whereby the vast majority of households are fixed for either two or five years – means rate hikes filter through to the economy fairly gradually. That means that the length of time rates stay restrictive is arguably more important these days than the absolute level interest rates reach over the shorter term. As the BoE itself has made clear, the impact of all those past hikes is still largely to hit the economy – and just taking rates to 5% and keeping them there would exert a large drag on the economy.

We also expect the news on inflation to get a little better through the summer. The BoE's survey measures of inflation have been improving, and forward-looking indicators like producer prices point to more noticeable declines in headline CPI later this year. Crucially, we think the fall in gas prices is good news for service sector inflation, and suggests we could get more noticeable disinflation in this sector, even if wage growth takes longer to ease.

### Author

**James Smith**

Developed Markets Economist, UK

[james.smith@ing.com](mailto:james.smith@ing.com)

### Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose

possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit [www.ing.com](http://www.ing.com).