UK inflation surprise lifts chances of February rate rise

Inflation has surprised higher (again) and that's only likely to increase the temptation for Bank of England policymakers to hike rates for a second consecutive meeting this February. But with inflation rates set to plunge in 2023, and the prospects of a severe wage-price spiral looking less likely, subsequent moves are likely to be more gradual

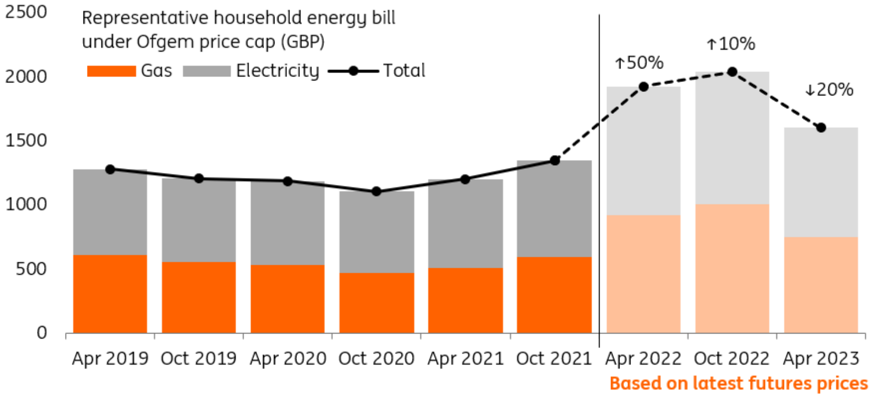
Source: Shutterstock

UK inflation has once again come in above expectations, and we suspect this will add to the temptation at the Bank of England to hike rates again in February.

Headline CPI accelerated to 5.4% in December, and the underlying details reveal no single specific reason for that outperformance. Food prices jumped for a second consecutive month, which appears linked to higher import and producer cost inflation. Furniture prices rose more than usual for the time of year, likely a further by-product of supply chain disruptions.

Of course we're now getting closer to the inflation peak, which we expect to be roughly 6.5% in April. That's when the next increase in the household energy cap is due, and the latest futures prices suggest we're looking at a 50% increase, followed perhaps by another (much smaller) increase in October. That means the electricity costs alone will be adding over 2 percentage points to the headline inflation rate for most of 2022.

Energy costs set to increase by 50% this April



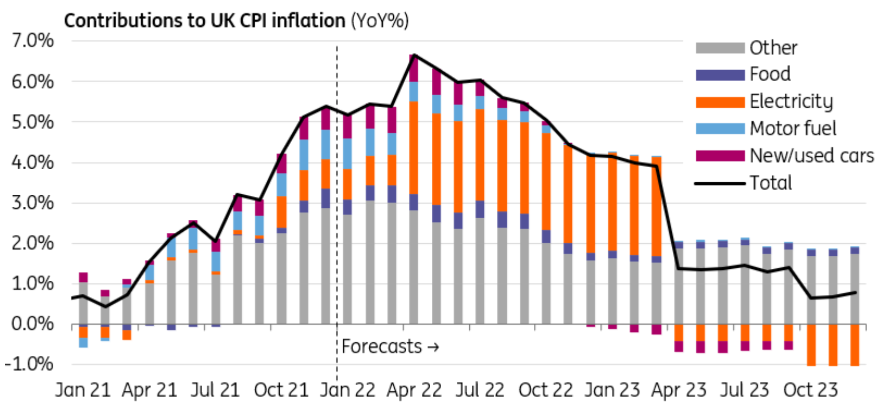
Source: Ofgem, ING calculations

Estimates based on direct fuel component of Ofgem's calculation model, using recent gas and electricity futures. Other non-fuel costs largely assumed to stay unchanged

But part of the reason why the peak is set to come in April and not later, is that many of the items affected by supply chain issues will see inflation rates slow. While the disruption appears far from over, many of the goods affected – including furniture and used cars – started experiencing sharp prices from last spring. It's unlikely that pace will be replicated at the same time this year, reducing pressure on the annual comparison.

Still, headline inflation is likely to still be around 4% at year-end. And given the Bank of England has shown itself to be especially worried about elevated rates of CPI, these latest figures will increase the chances of a rate hike in February. Inflation is already comfortably above the rates forecasted by the Bank last November.

Inflation set to peak around 6.5% in April



Source: Macrobond, ING

However, given that headline CPI is likely to plunge in 2023, pretty much regardless of what happens to energy and used car prices over coming months, there are questions as to how worried the Bank should really be about the current levels of inflation. That's why we think wage growth will assume higher priority in deciding how far to increase Bank rate this year.

We discussed yesterday why we think a wage-price spiral is unlikely in the UK, and that suggests policymakers will tighten policy more gradually than markets are currently pricing. Remember, it's highly unlikely that wages will keep pace with inflation through the majority (if not all of) 2022, weighing on consumer activity.

We expect two rate hikes this year.

Author

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

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