UK inflation: The only way is down...

Higher contributions from clothing and footwear, as well as a rise in petrol prices, unexpectedly lifted UK inflation in July. But the combination of VAT changes and the 'Eat Out to Help Out' scheme mean we're set for a big downward move in August, while the rise in unemployment means domestically-generated inflation is set to remain muted

UK inflation data has been volatile

UK inflation came in quite a bit higher than expected in July, and means that core inflation is now a touch below target at 1.8%, up from 1.2% in May. A much less pronounced fall in clothing prices than we'd normally see at this time of year seemed to be the main culprit, but there were a series of small contributors to July's outperformance.

This latest volatility emphasises that the inflation data is pretty difficult to read cleanly at the moment. We know for instance that in the midst of the lockdown back in April and May, around 40% of the stuff consumers usually buy was unavailable, according to Bank of England estimates. That meant that it was difficult to measure various prices, although the ONS notes this issue has now pretty much gone away.

But a potentially longer-lasting consequence of the pandemic is that the weights attached to the

CPI basket are probably no longer a great indication of what people are spending their money on. Habits have shifted dramatically as a result of Covid-19 - the rapid switch from in-store to online retailing is one good example.

Policy changes set to drag inflation lower

The inflation picture is likely to get muddier still when we get the August figures. We're likely to see a heavy drag from the VAT cut from 20% to 5% on things like restaurants, hotels and various recreational activities, but also the 'Eat Out to Help Out' scheme. This latter policy has enabled restaurants to offer half-price food and non-alcoholic drinks on Monday-Wednesday through August.

Although it's pretty much guesswork as to how noticeable these policy changes will be, it is possible that August's CPI rate will fall below zero. The Bank of England has estimated that the VAT change and the Eat Out scheme will each knock around 0.4% off headline CPI, the latter effect obviously evaporating in September once the policy has ended. For what it's worth we think we could see a deeper slide in August, but in the end it's a bit of an academic question.

Wider Covid-19 pandemic unlikely to end up being inflationary

More importantly, we'd reiterate that the wider Covid-19 crisis is unlikely to be inflationary. While ongoing supply-chain disruption will inevitably cause price spikes in certain areas, the more dominant factor will be the widely-predicted rise in unemployment.

With the Job Retention scheme currently being unwound, we unfortunately think the unemployment rate will probably rise further than 7.5% later this year, as the BoE is currently forecasting. That in turn means the overall recovery is likely to be slower than the central bank is expecting, and in this environment, domestic price pressures (i.e. wage growth) are set to be muted.

We therefore think policymakers - both from the Treasury and Bank of England - will be under growing pressure to add additional stimulus in the autumn/winter.

Author

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