UK inflation unlikely to return quickly after coronavirus

Headline UK inflation is set to head down towards zero over the summer, and with unemployment rising, we doubt we'll see price pressures rapidly return any time soon

What does coronavirus mean for UK inflation? Well in the short-term, the clear direction is down. A combination of a plunge in oil prices, and a fall in regulated water and household energy costs, saw headline inflation drop noticeably in April to 0.8% from 1.5%. Energy price weakness will drag headline CPI closer to zero through the summer.

0.8% UK April inflation

(YoY%)

Medium-term price pressures set to remain muted

On the medium-term outlook for inflation, there has been more of a debate. However with a 'V-shape' recovery looking unlikely now, and the rebound from Covid-19 set to be gradual, we doubt inflationary pressures will meaningfully build for some time.

The most obvious reason for that is the slack in the jobs market. While the government's Job Retention Scheme has been successful in slowing the speed of unemployment so far, there are growing fears that we could see a wave of redundancies later in the year depending on how the furlough scheme evolves. This would imply that wage pressures are set to remain largely muted.

And while it is true that both the government and the Bank of England are pumping large amounts of money into the economy at the moment, neither are likely to generate any immediate inflation. Most of the fiscal support has been aimed at keeping firms and consumers afloat, rather than to stimulate spending (which by definition, is constrained by the lockdown).

The obvious counterpoint to all of this is that supply constraints could push some prices higher as demand begins to return. And there are probably some areas where that is true. Restarting supply chains will be no easy task, and some firms will need to rework theirs if some of their suppliers have not been able to recover, inevitably putting upward pressure on costs.

Equally in the jobs market, those structural skill shortages that were evident long before this crisis, could become magnified. One example might be those industries - for example agriculture and construction - which rely heavily on overseas workers, and could continue to experience disruption while international travel is constrained.

> Still, the broader economic picture of consumer and business caution suggests that demand will take a long time to recover - and that implies inflation is going to stay generally muted.
>
> We don't expect the UK economy to return to its pre-virus size until 2022 at the earliest, and we see the Bank of England adding further support over coming months in the form of extra QE.

Author

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