

# Data Alert: UK headline inflation

**Latest ONS release**

February 2011

## Introduction

These data alerts highlight key economic statistics as they are released and relate the messages they convey to the SW economy.

This particular alert considers the UK inflation series as just released. The main message for SW business is that imported costs and tax effects continue to feed upwards through the price chain to headline consumer and retail prices. There is a limit to how long the monetary authorities can ignore this signal and economic actors should be planning on the basis of higher interest rates over the next 18 months.

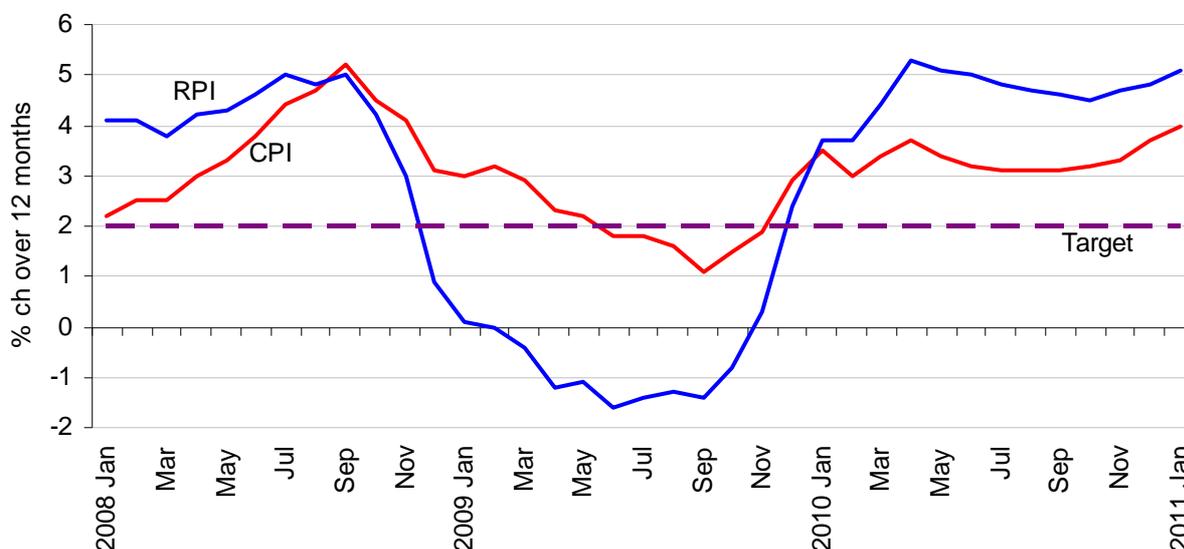
## Data Headlines

Consumer prices (CPI) were 4% higher in January 2011 than a year earlier. This was the highest rate since the end of the boom and the last oil price spike. The current high reflects the surge in imported commodities and domestic foodstuff costs, indirect tax increases and companies' desire to protect profit margins. The CPI has stayed above the 2% policy target for 15 months whilst bank rate has been held at 0.5%. The retail index (RPI) was 5.1% higher than a year earlier in January, largely responding to the same upward pressures as the CPI.

The figure below shows the trend in consumer prices and retail prices since just before the recession. It shows that inflation has been above target for most of the last three years, apart from a brief period in mid-2009. This must be a cause for concern, especially as UK inflation has generally been higher than equivalent rates amongst our competitors. The fall in the pound sterling has played a role and some inflation has been "allowed" as part of the surety that the banking crisis and housing bust was not too severe. Nevertheless, there is still a worry that the UK's control of inflation has been relatively lax, particularly in the last six months when the authorities might have been expected to signal more direct action to reverse the adverse trend.

Underneath the headlines, the latest release indicates oil and VAT as the main sources of upward pressure on inflation. Compared with a year ago, the VAT hike particularly affected 'big ticket' items, such as cars, and leisure services, such as eating out. At the other end of the spectrum, inflation was low for some banking and business services and for clothing and footwear.

Figure: UK headline inflation: January 2008 – January 2011 (% change, year-on-year)



### Prospects

Headline inflation is expected to start to tail off later this year, but not over the next few months when it may even go higher. It may not be back to target until 2012. Moreover, if inflation expectations are allowed to solidify at 3% or more through continued policy inaction, even this cannot be guaranteed. With many people’s incomes not rising, high inflation puts pressure on firms’ and households to rebuild margins and increase wage demands respectively.

The Bank of England probably needs to signal higher interest rates soon, perhaps with a first move of 25 basis points by mid-year. It would be surprising if rates rising slowly from 0.5% to 1.5% over the next year to 18 months would seriously dampen economic activity. Indeed, a greater risk is that rates have to go up faster than that because recovery proves stronger than currently expected. As always in monetary policy, keeping inflation under control is best done pre-emptively rather than reactively. The former tends to mean interest rates do not have to climb so far or so quickly. This would help businesses, savers and borrowers plan for a return to “normal” interest rates as the recovery progresses. In turn, this should help to restore the lifeblood of sensible credit flow around the UK economy.

Nigel Jump, February 2011

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