

Data Alert: UK inflation

Latest ONS release

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Introduction

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

This particular alert considers the UK inflation series. The main message for SW business is that the supply chain continues to put upward pressure on costs and prices across many sectors. Imported costs remain high and the costs of non-discretionary items, such as foods, fuels and other resource-based components and services continue to outpace the pricing power of most companies selling to consumers.

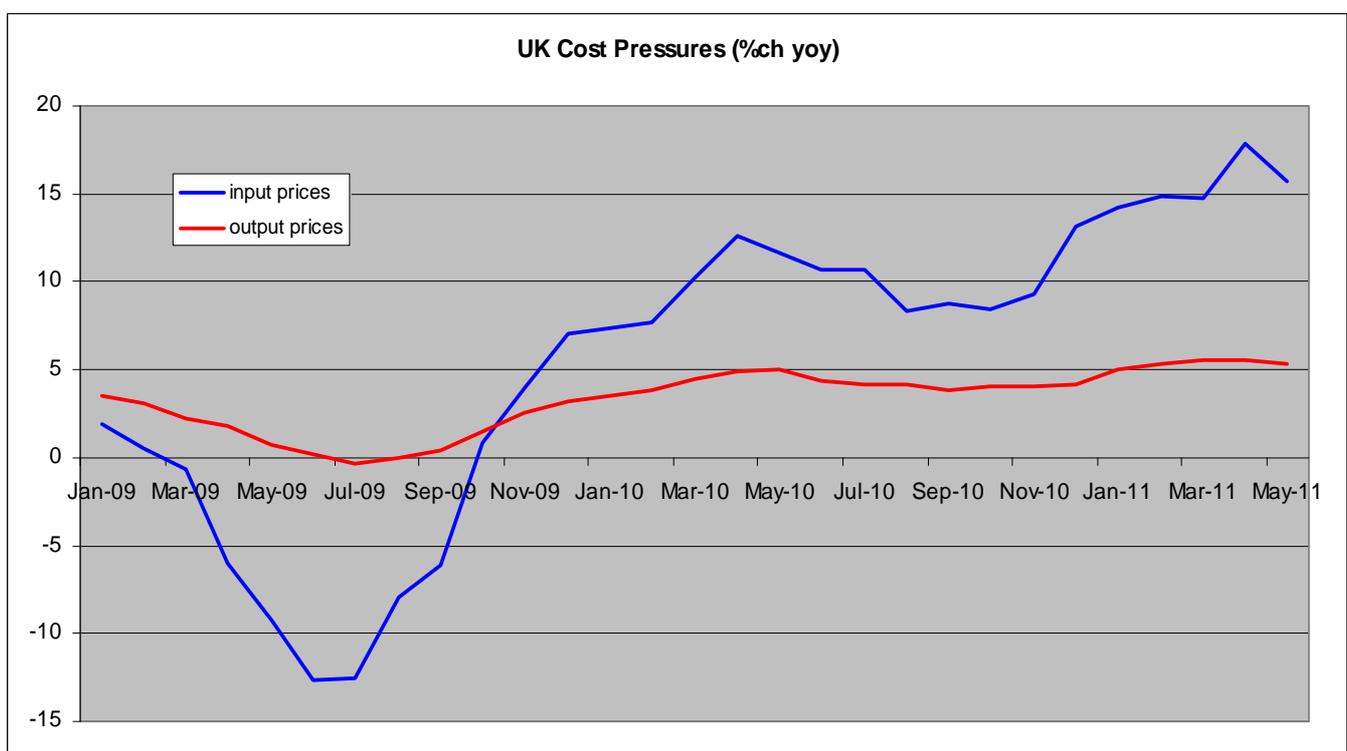
Despite negative real interest rates at the official level, real spending power is under pressure, with inflation exceeding earnings growth. The monetary authorities continue to ignore these inflation signals, despite the distortions it causes to a range of consumer and investor incentives and behaviours. Nevertheless, we should plan for a slow rise in official interest rates, to at least 2%, from 0.5% currently, over the next 18 months.

Data Headlines

UK consumer (CPI) and retail (RPI) inflation rates were 4.5% and 5.2% respectively in the year to May 2011. The former remains at a peak whilst the latter is only a little lower than the high reached in February. Inflation is putting downward pressure on real incomes and living standards for most households and businesses.

Moreover, the chain of price rises coming through the system remains taut. Output prices were 5.3% higher than a year ago in May and input prices were 15.7% higher on the same basis (see Figure 1 below).

Figure 1: UK inflation pressures: January 2009 – May 2011 (% change, year-on-year)

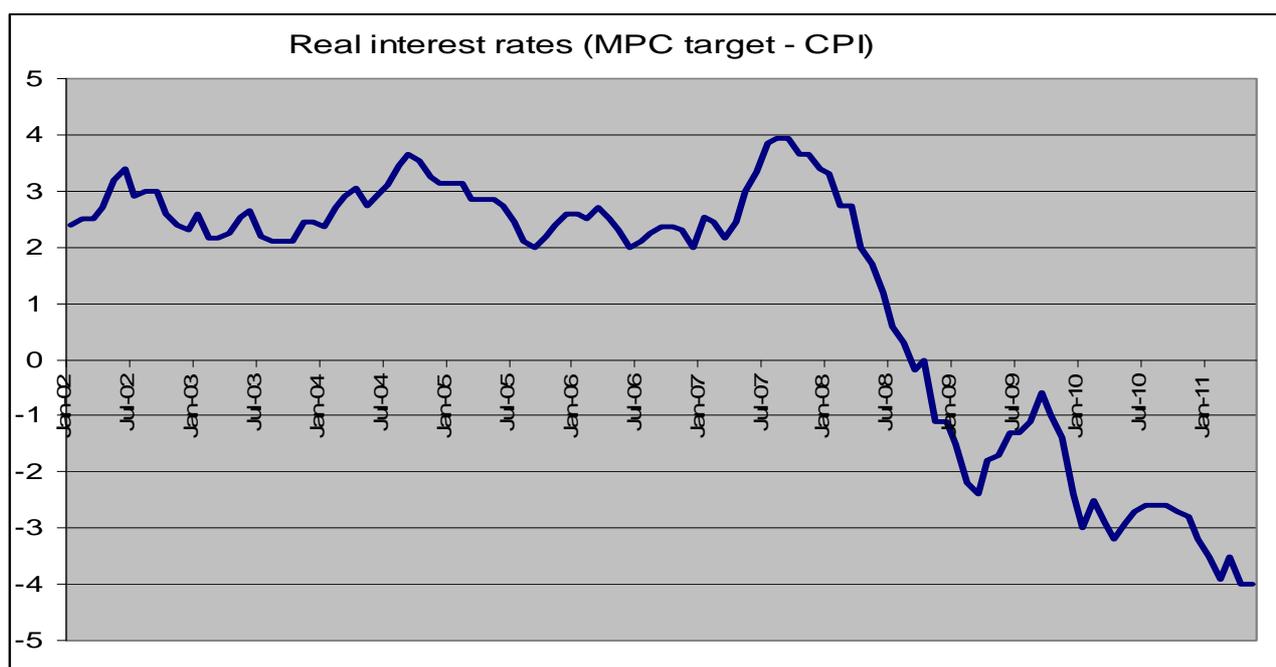


With inflation still well above target, the Bank of England's Monetary Policy Committee needs to take action to get it back down within the 2% +/- 1% range. From a monetary policy perspective, the "base" rate of 0.5% is no longer tenable. Real interest rates are worryingly negative and well below 'normal' (see Figure 2 below).

The MPC majority continues to fear that higher interest rates will dampen the already weak level of real economic activity (and hurt the 'rebalancing project' by firming the pound sterling). It must be remembered, however, that easy monetary policy cannot substitute for tight fiscal policy in terms of overall macroeconomic stabilisation. Given the liquidity trap we are in, monetary policy should focus on inflation, not aggregate demand, otherwise it merely distorts asset markets and savings behaviour.

Inflation has been above target for most of the last three years, apart from a brief period in mid-2009 at the height of the "Great Recession". This is a cause for concern, especially as UK inflation has generally been higher than amongst its competitors. The UK's control of inflation has been relatively lax and the MPC's forecasting record poor.

Figure 2: MPC real Interest rates: January 2002 – May 2011 (% rate)



Prospects

Headline inflation is expected to start to tail off later this year. But with further fuel hikes announced for the summer, there must be some doubt over this. It may not be back to target until well into 2012. Moreover, if inflation expectations start to anticipate 3% or more through continued policy inaction, even this cannot be guaranteed. With many people's incomes not rising, prolonged high inflation puts pressure on firms and households to seek compensation through profit margins and wage demands. A perfect storm of stagflation is brewing.

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