

Data alert: Inflation

Back on trend - upwards

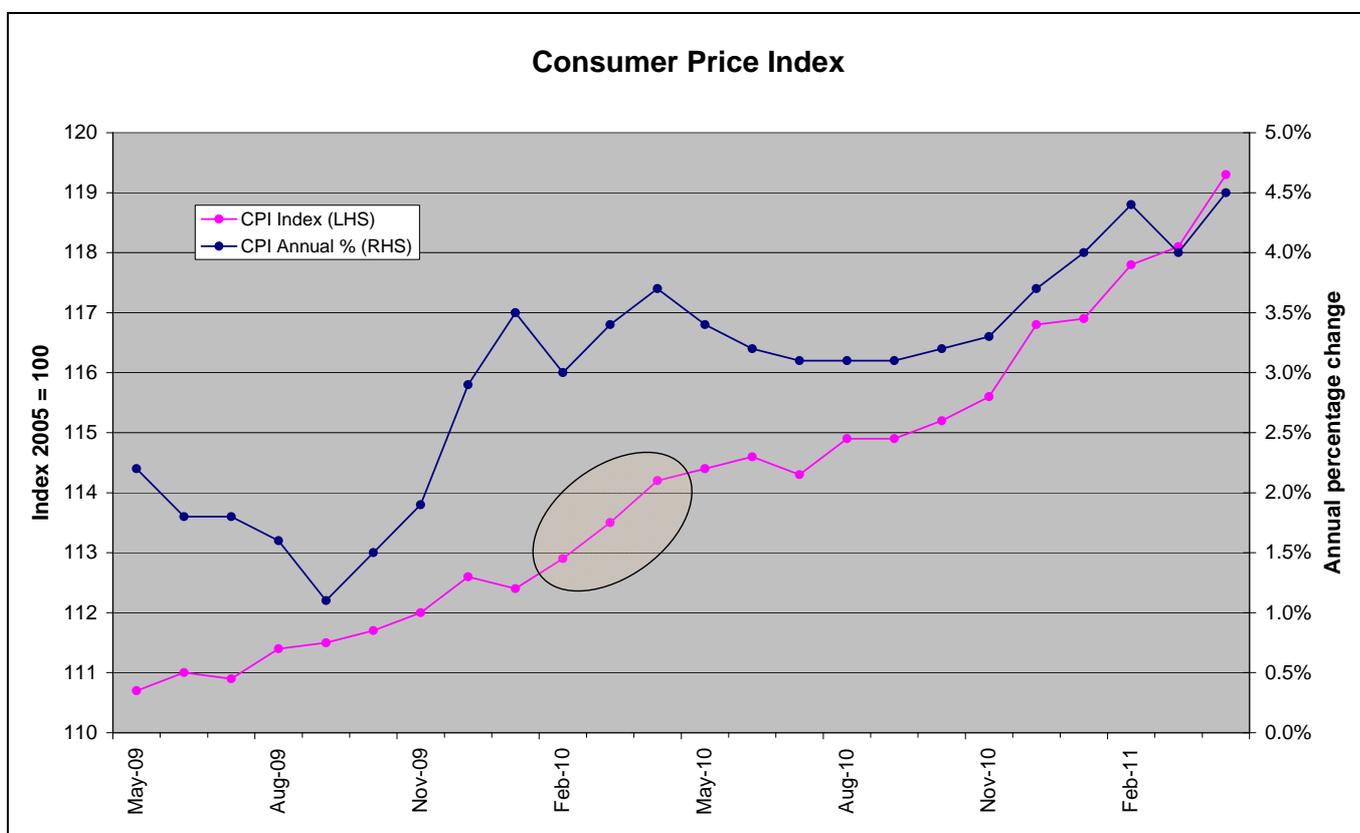
May 2011

Inflation

This week’s publication of the consumer and retail price indices for April completes the cycle of inflation data releases. This data alert gives an update on the emerging picture.

The consumer perspective

After the briefest of pauses, the preferred¹ headline measure of inflation, the Consumer Price Index, resumed its upward trend in April, reaching a new recent high of 4.5%. This level was seen very briefly in 2008 during the commodity price spike but otherwise we have not been in this territory since 1992.



In the spring of last year, circled on the chart above, the index was rising at a particularly rapid rate as the increase in VAT fed into prices after the normal post Christmas season dip². In order for the current annual inflation rate to keep rising, the current month-on-month changes need to be at least as fast they were a year ago. In March, prices did rise but a slower rate so the headline indicator fell back. By contrast prices surged in April at an alarming annualised rate of 13% with nearly half of the change coming from air transport prices.

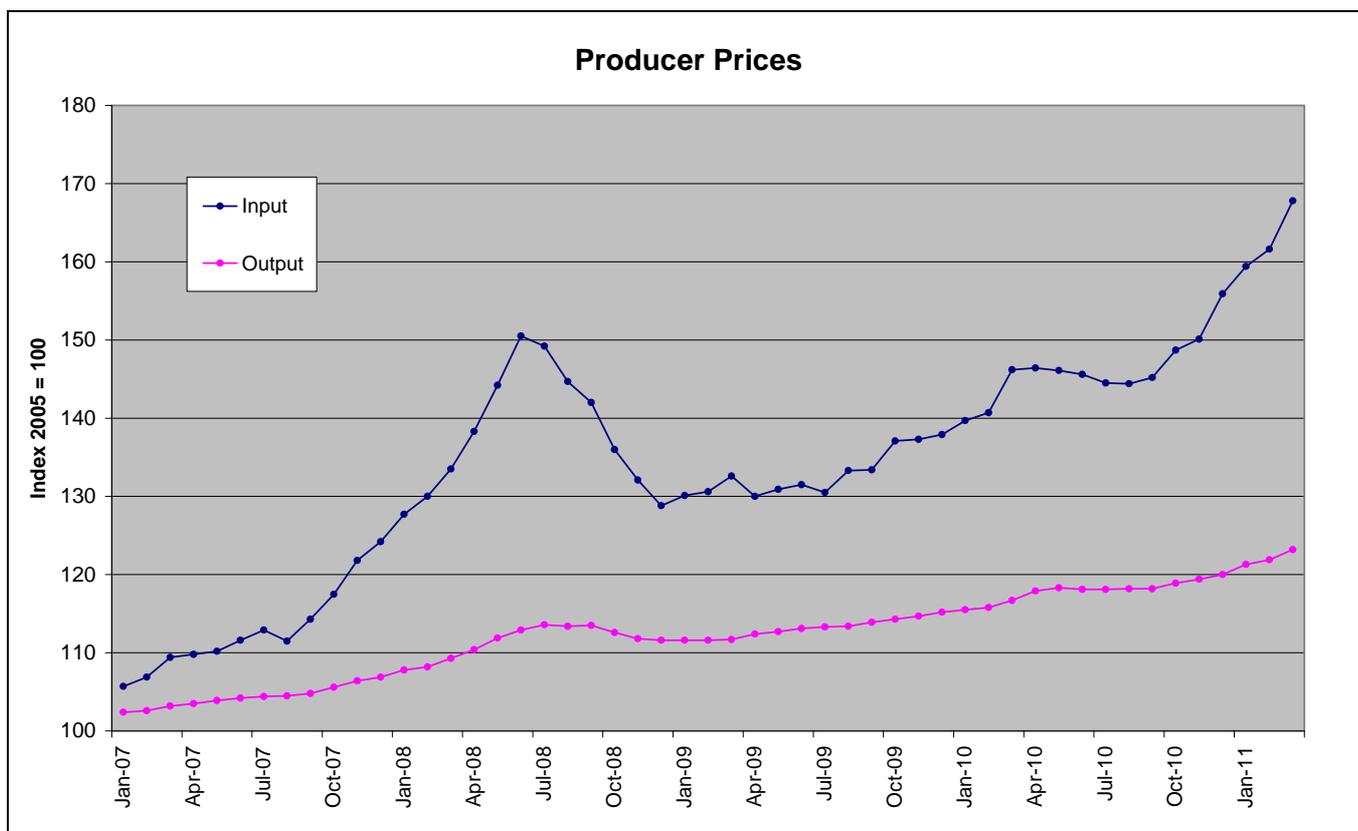
¹ The alternative Retail Price Index (RPI) fell back slightly to 5.3% whilst the RPIX, which excludes mortgage payments, was also down slightly at 5.2%

² These price indices are not seasonally adjusted.

As has been widely reported the combination of these rising price indices with very little wage or employment growth means that there is a very real squeeze on consumer spending in the economy.

The producer perspective

The manufacturing sector experienced an eye-watering 17.6% annual increase in its input costs in the year to April. Of this increase over 9 percentage points are accounted for by crude oil, which increased by 37.7% in the year. By contrast output prices for domestic sales are rising at 5.3% and for the sectors other than food and fuel by only 3.4%. This wide difference continues a trend of marked divergence between input and (domestic) output prices, see chart.

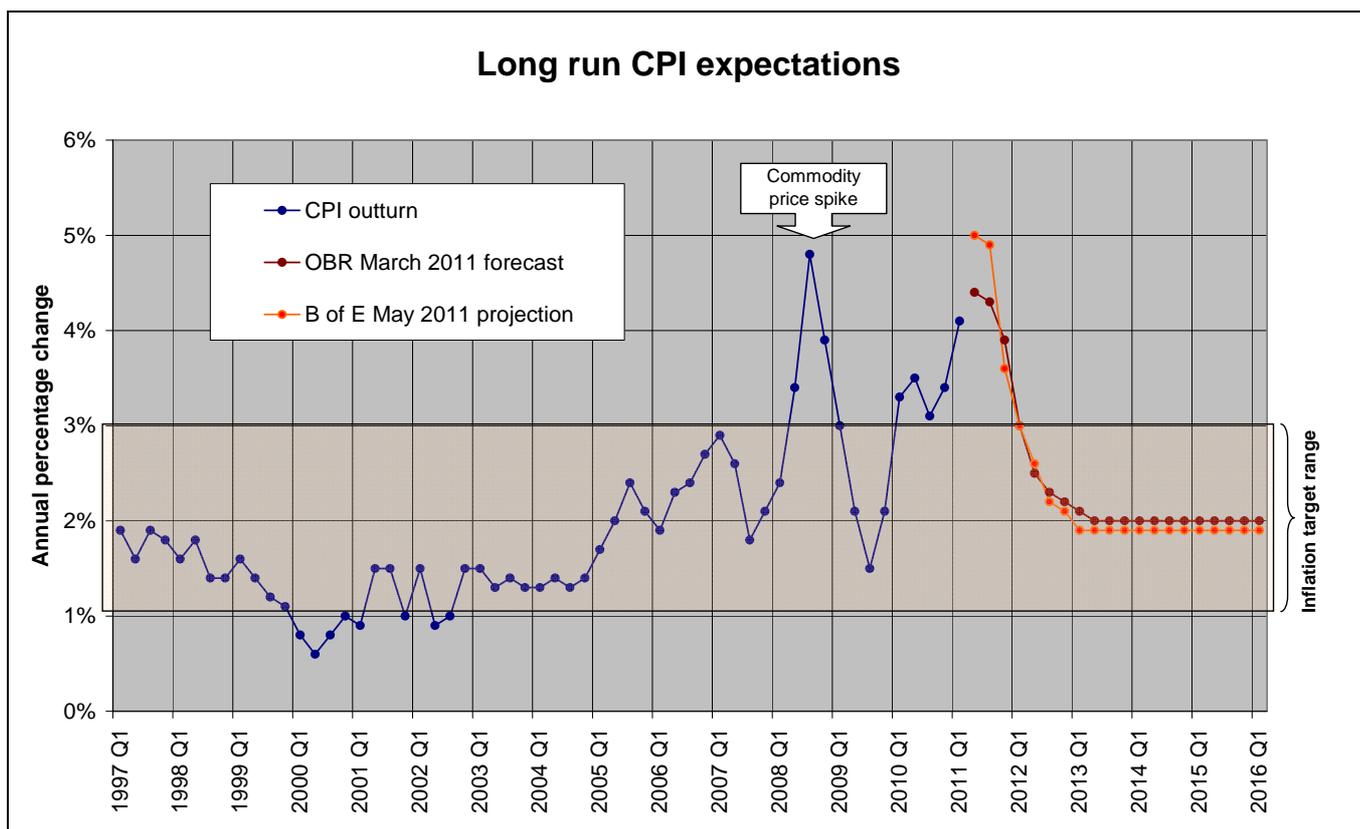


This sustained gap between input and output prices is unprecedented and indeed historically the gap has tended to be the other way. One key element of the explanation for this is that the cost of the value added is largely wages, which have seen very subdued growth. At the same time investment has also been very weak so that overall manufacturing company profitability is only slightly lower than the recent average.

Inflation outlook

In its May Inflation Report the Bank of England again revised upwards its projection of CPI inflation, saying that there was now an even chance of a peak of over 5% being reached before the measure fell back. The Bank has a mandate to keep inflation within a one percentage point band around 2% which it largely achieved up until 2008, see final chart. Although the present

inflation overshoot may seem somewhat challenging, the Bank remains sanguine about the inflation outlook. Key to this is the distinction made between ‘core’ inflation coming from price and wage expectations within the economy and pressure arising from elsewhere. It is estimated that together the VAT rise, energy prices and import prices account for between 3.1 and 5.0 percentage points of the headline number, i.e. underlying inflation was actually running at between *minus* 0.9% and plus 1.0% in the first quarter of 2011. These factors are expected to be played out over the coming twelve months to bring inflation back within the target range.



(Bank of England series shows the midpoint of their projected range)

Although this underlying theory is generally accepted, the actual rate of inflation has gone significantly higher than previous Bank of England projections and indeed these latest numbers show a further deterioration in outlook when compared with the Office for Budget Responsibility’s figures which were the basis for the March budget.

Of the external factors it is energy prices which have been least easy to predict, rising much faster than expected. Oil and other commodity prices have been particularly turbulent, even by their volatile standards, in the last few weeks but there is a sense that some speculative pressure has been unwound. If the price reductions are at least maintained, if not extended, then there is good reason to think that the latest projections may actually be borne out.

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