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The UK's persistent inflation problem

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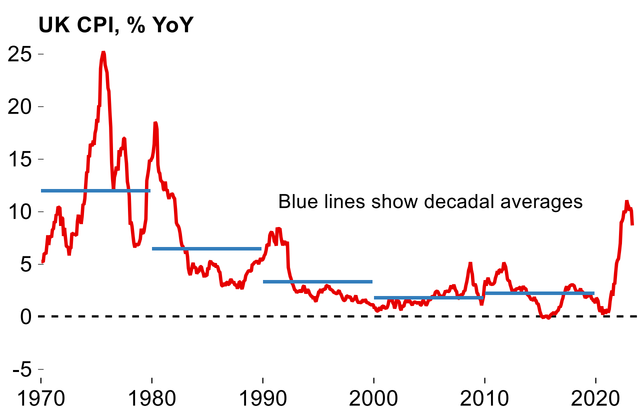
- Falling energy costs mean that headline UK inflation has now clearly passed the peak. However, food price inflation remains high and underlying inflationary pressures are proving stubbornly persistent.
- We expect relatively muted GDP growth in 2024 as lagged effects of monetary policy tightening weigh on the economy.
- Despite this, core inflation may still remain above the BoE's target through most of 2024. The UK's labour market remains tight and supply-side issues around labour supply and Brexit mean that UK inflation may be stickier than elsewhere in Europe.
- The higher-than-expected inflation in April has shaken up the outlook for the Bank of England. It's clear that the BoE has more work to do on rates.

Core inflation is showing no sign of fading

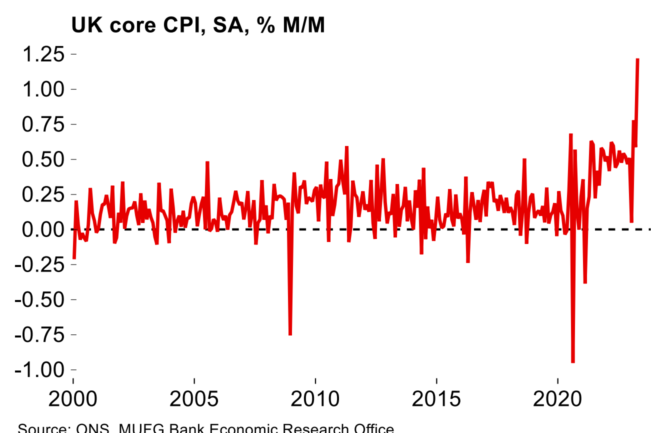
After seven months of double-digit rates, headline UK inflation fell sharply in April – from 10.1% to 8.7% Y/Y (Chart 1). That's more or less where the good news ends. The lower rate was mostly driven by base effects as last year's household energy price rise fell out of the calculation. There were no signs at all of any broader easing of price pressures – food and beverage inflation remained around 19%, and core CPI inflation jumped from 6.2% to 6.8% to reach a new multi-decade high.

Chart 1: Inflation remains at multi-decade highs



Source: ONS, MUFG Bank Economic Research Office

Chart 2: Core rates surged in April



Source: ONS, MUFG Bank Economic Research Office

The rise in core prices (Chart 2) was driven by a few sectors in particular. There was a strong contribution from telecoms (+7.9% Y/Y) with mid-contract price rises for phone and broadband normally introduced in April, typically by January CPI or RPI inflation +3.9pp. This is a one-off and we expect flatter M/M rates through the rest of the year. Inflation in vehicle insurance (+41% Y/Y) was another figure that stood out. Unlike in

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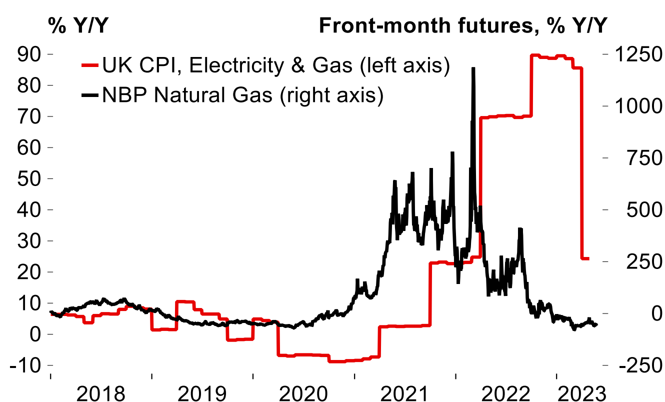
the euro area, there's not much clear evidence of 'profit-driven' inflation in the UK overall data, but this could be an area where firms are increasing their margins.

Looking ahead, headline inflation will fall again in July when the household energy price cap will be lowered by 17%. Recent gas price movements then point to another, smaller drop (perhaps ~5%) in the cap from October (Chart 3). The rate of food inflation is also likely to slow over coming months – there was a sharp fall in producer input prices after international wholesale prices have eased. We now expect headline inflation to be around 4% by year-end, with the fall mostly driven by base effects.

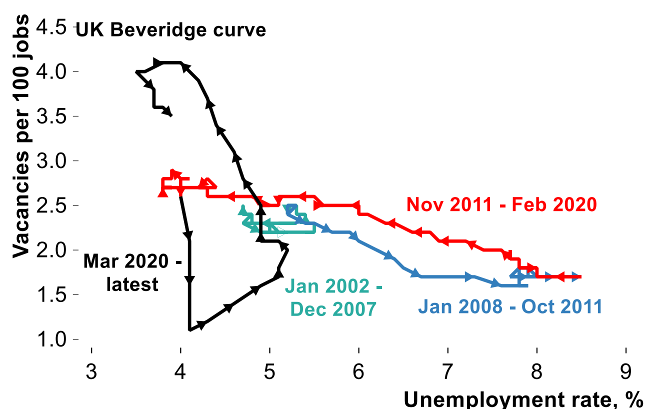
The path for core inflation looks trickier. Private sector wage growth is still at 7% Y/Y and shows little sign of slowing. There are still very few signs of any cracks appearing in the UK labour market (Chart 4). The unemployment rate may have edged up slightly to 3.9%, but is still only just above historical lows. Similarly, job vacancies have fallen since the post-pandemic reopening peak in 2022 but are still elevated, reflecting ongoing labour shortages in some sectors.

Chart 3: The lagged effect of lower gas prices on inflation



Source: ONS, NASDAQ OMX, Macrobond, MUFG Bank Economic Research Office

Chart 4: The UK's labour market remains tight



Source: ONS, MUFG Bank Economic Research Office

The services sector, with wages a high share of total costs, remains key to the core outlook. The UK services PMI output price index increased slightly in May and it's hard to see how 7% wage growth and a fairly resilient economy translates into anything other than persistently high core inflation over coming months. We still expect the annual rate will edge slightly lower – along with lower PPI rates, the ONS's business conditions survey points to *some* easing of inflationary pressures (18% of firms expect that prices will increase next month, down from an average of 27% over the previous year). But the core inflation rate will probably move above headline at some point in the autumn and we now look for a year-end annual rate close to 5%.

Our current forecast is for muted annual average GDP growth of 0.7% in 2024. The UK economy has shown its resilience through the winter but the effect of restrictive monetary policy on the real economy will become increasingly clear. 1.4m households will see their mortgage deals expire this year, with most previously fixed below 2%, and so higher monthly payments will increasingly become a drag on aggregate demand. While gas prices have fallen sharply, household energy costs through the 2023/24 winter are still likely to be around 50% higher than was the case in 2021/22 – and there will be no repeat of the government support payments in place from October 2022 to March 2023. Other headwinds for consumer spending such as negative wealth effects from a weaker housing market and some rebuilding of saving buffers could also weigh on overall demand. With this in mind, we expect price pressures will continue to ease – but some of the longer-term, supply-side problems for the UK (see below) could delay the process. Overall, we expect core inflation to average around 3% in 2024.

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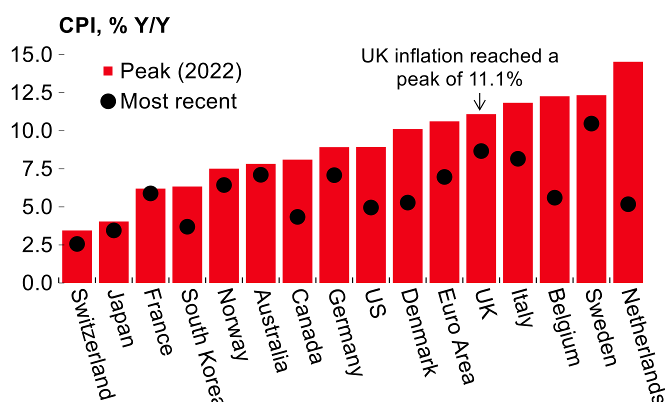
Supply-side issues will remain a challenge

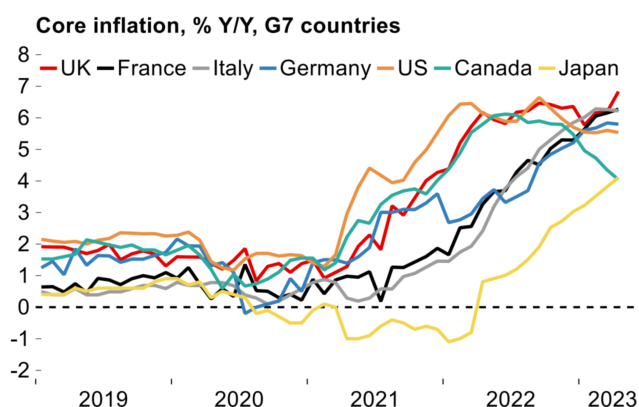
UK inflation, both headline (Chart 5) and core, is now higher than in most European countries. Part of the story has been the UK's system of domestic energy price limits (with the aim of protecting consumers from unfair price rises) which has delayed the pass-through of lower wholesale gas prices to households. As mentioned above, the price cap will fall significantly from July and the path for household energy prices after that looks set to be smoother, with gas futures now more settled.

Chart 5: UK inflation has passed the peak, but remains high



Source: Macrobond, MUFG Bank Economic Research Office

Chart 6: The highest rate of core inflation in the G7



Source: National sources, MUFG Bank Economic Research Office

However, inflationary pressures do seem to be more persistent in the UK (Chart 6). The obvious UK-specific factor is Brexit, which was always going to mean higher prices (as well as less choice) for UK consumers due to the extra trade friction with the EU. This friction will increase over coming months. The UK government has now announced its plans (see here) for post-Brexit border controls, the implementation of which has repeatedly been delayed. New checks on food will be introduced in October this year, and then broadened in January. Full checks on all goods imports entering the UK from the EU will be introduced by October 2024. This means that food price inflation, which is already higher in the UK than in Europe (19% Y/Y vs 15% in the euro area), could prove a bit more persistent on this side of the Channel.

There is also a labour supply story. The UK still has an issue with inactivity which have since normalised in other economies (Chart 7). There are ongoing distortions from the pandemic (e.g. more young people in education following fewer job opportunities in 2020) which will continue to unwind. But there has also been a clear increase in workers leaving the labour force citing long-term sickness. The UK's health service is still grappling with pandemic-related backlogs – the median wait time for treatment stood at 14 weeks in March (versus 7 weeks in March 2019).

Data released this week also confirmed that migration flows to the UK have re-orientated away from the EU and towards the rest of the world. As well as initial friction as employers switch to different recruitment networks, etc., there will be a long-term drag from greater costs due to visas and paperwork. Combined with the increase in inactivity rates, the result is that the UK labour market functions less effectively and cannot react as well to external shocks. The UK faces a range of longer-term, supply-side issues without easy fixes, and as a result UK inflation may fall more slowly than elsewhere in Europe.

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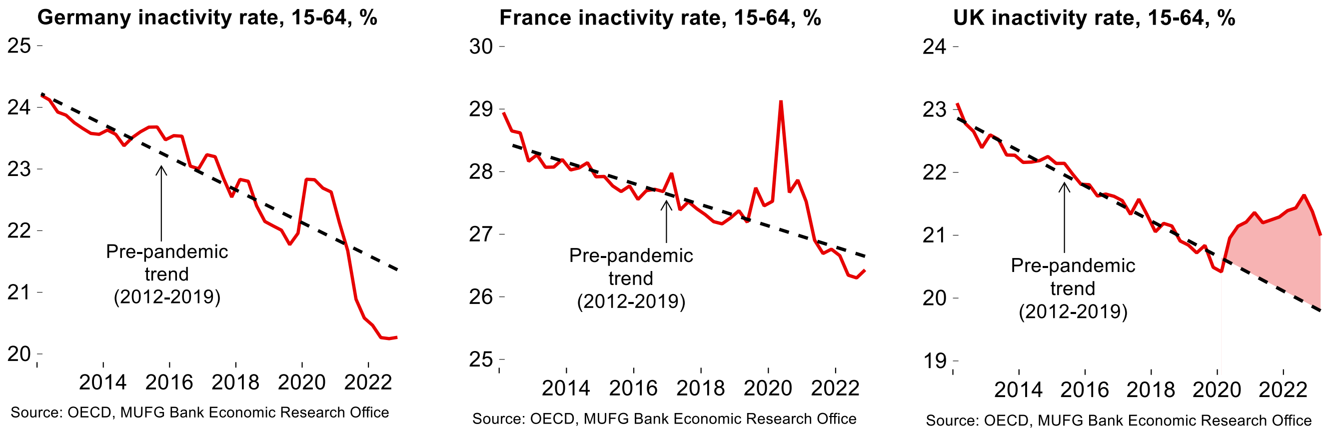
Chart 7: The UK still has a problem with labour market participation



The BoE clearly has more work to do

The higher-than-expected April inflation data has shaken up the Bank of England rate outlook. The BoE had started to ease off the brakes by shifting down to 25bp hikes in March and May, but deliberately left the door open to further tightening in case of unfavourable data rather than laying any groundwork for a pause. The current guidance is "*if there were to be evidence of more persistent [inflationary] pressures, then further tightening in monetary policy would be required*". Well, there's certainly been plenty of evidence of that – both in the inflation and the labour market data, as noted above. It had felt as though we may have been approaching the peak of this rate hike cycle, but it's clear now that the BoE has more work to do.

Chart 8: A sharp repricing of the BOE outlook

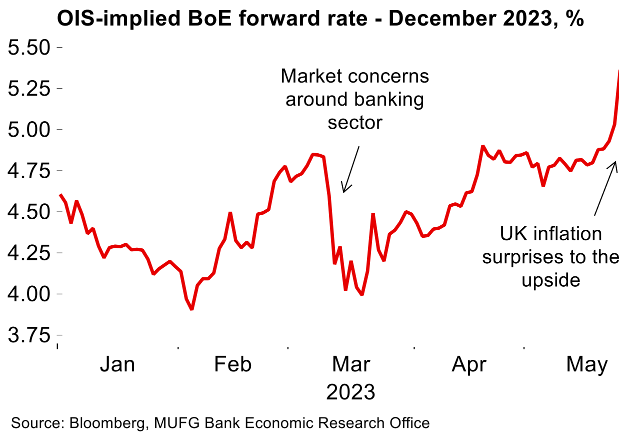
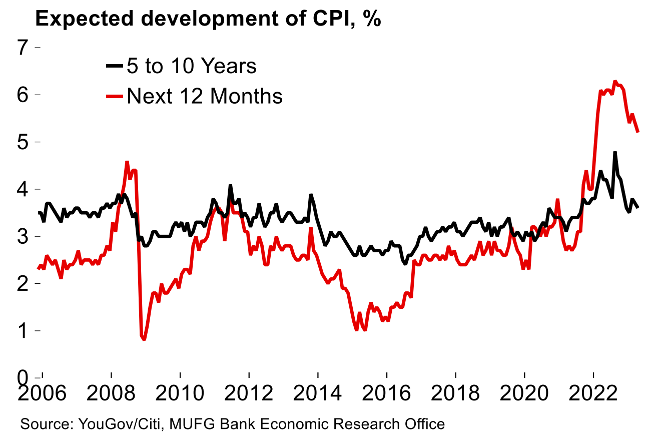


Chart 9: Inflation expectations are not rising



The change in market pricing has been stark (Chart 8). At the start of the week, the market-implied peak BoE rate stood at 4.9% (from 4.5% currently). After the CPI release this has now increased to around 5.5% – so an additional two 25bp hikes. Certainly, a rate increase in June now looks nailed-on, and another after that in August feels likely.

The peak could still fall short of what's now priced in markets, however, with the lagged effects of monetary policy tightening likely to become increasingly apparent. The BoE will probably continue its current flexible, data dependent approach and by the autumn we expect that there will be some more concrete signs of increased slack in the labour

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market against a backdrop of slow growth and some recovery in the labour supply. Inflation – core as well as headline – should be clearly moving in the right direction after the summer. There could also be concerns about the UK housing market – as mentioned above, the pass-through of rate hikes to mortgage payments occurs with a lag for most households. The BoE will also take heart from the fact that medium-term consumer inflation expectations have remained fairly well-anchored (Chart 9). So, with sluggish growth, a more challenging external environment and falling inflation, we still think that there should be enough reasons to pause this rate hike cycle before year-end.

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