United Kingdom

Inflation drops below Bank of England target for first time since 2009

- **Consumer prices rise 1.9% on a year ago in January**
- **Easing means wages dropping 1.0% in real terms, down from 1.9% last March**
- **Sterling's appreciation should help keep inflation low in coming months**

A drop in UK inflation to the lowest since November 2009 means the UK economy is enjoying a welcome combination of strong economic growth and low inflation. This "Goldilocks" scenario adds to the scope for policymakers to keep their foot on the accelerator for longer via lower interest rates to help drive a strong and more sustainable recovery.

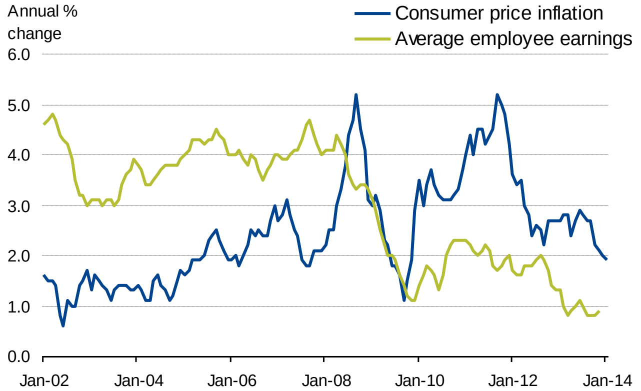
The rate of inflation has fallen below the Bank of England's 2% target for the first time since November 2009. The annual rate of consumer price inflation was 1.9% in January, down from 2.0% in December and representing a further easing from the recent peak of 2.9% seen back in June.

The easing in the rate increase in the cost of living goes some way to ease the squeeze on household incomes, which have fallen continually in real terms since late-2009. The latest official data showed regular employee pay (excluding bonuses) growing at an annual rate of just 0.9% in the three months to November. Although this means that regular pay continues to fall in real terms at an annual rate of 1.0%, that's a near-halving from the 1.9% rate seen early last year.

Survey data, notably recent growth in starting salaries reported by recruitment consultancies, also suggest that average salaries should start to rise at a stronger pace as we move through 2014 and, if inflation remains under control, a return of real wages growth is likely by the second half of the year.

Higher real wage growth should help lift consumer spending, but the overall impact is likely to be limited as pay growth remains relatively muted by historical standards, reflecting still high levels of unemployment.

Consumer prices and wages

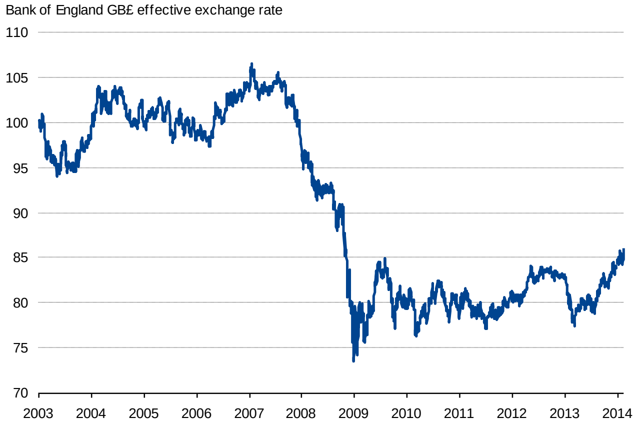


Sources: Markit, Office for National Statistics

Real wages growth

Sources: Markit, Office for National Statistics.

Exchange rate



The upside of weak pay growth and low inflation is of course that it allows the Bank of England to keep interest rates ultra low for longer, thereby helping ensure the recovery remains on track to deliver robust economic growth in the next few years. The Bank of England has updated its 2014 growth forecast to a punchy 3.4%, up from 2.8% late last year, but this assumes that price pressures will be kept in check by excess capacity to prevent rates from having to rise in such a strong growth environment.

While the amount of slack in the economy remains a great unknown, one certainty is that the exchange rate should help keep inflation down. Sterling has appreciated over 9% against a trade-weighted basket of currencies since last summer, which has effectively reduced the cost of imported goods.

The most likely path for inflation is therefore that it will hover around the Bank's 2.0% target over the next year, but beyond that the outlook is more uncertain, reflecting uncertainties about the ability for wage growth to revive, energy prices and the exchange rate.

Chris Williamson
Chief Economist
Markit
Tel: +44 207 260 2329
Email: chris.williamson@markit.com

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