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Markit Economic Research

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United Kingdom

Inflation eases to three-month low of 2.7% in August

- **Inflation eases for second month running**
- **Producer price inflation also slows**
- **Oil poses biggest risk to price outlook**

UK inflation eased for the second month running in August, following the downward path expected by policymakers. However, oil poses a major risk to the inflation outlook. There also remains a very real possibility that price pressures could remain stubbornly high in the coming months, especially as the economic recovery gathers momentum, adding to the difficult task faced by policymakers.

Inflation slows

Data from the Office for National Statistics showed consumer price inflation easing from 2.8% in July to 2.7% in August, in line with consensus expectations.

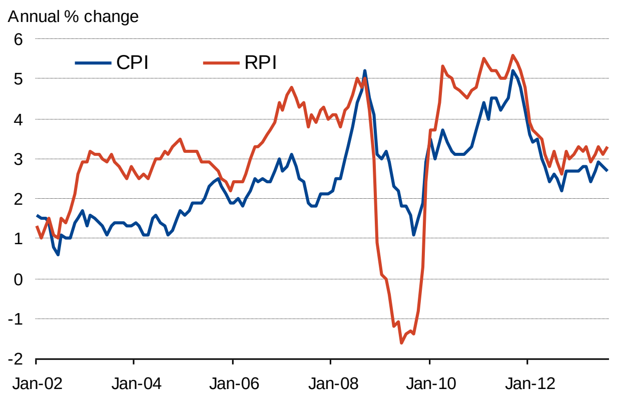
Manufacturing input costs and selling prices meanwhile rose less than expected in August. Producers' input costs rose 2.8% on a year ago, compared with expectations of a 3.0% rise. This was down sharply from 5.1% in July and the weakest rate of increase for three months. Selling prices rose just 1.6% on a year ago (also a three-month low) against an expected 1.8% increase.

On-going wage squeeze

Although moderating, having come down from 2.9% in June, inflation still remains far higher than wage growth. Wages, excluding bonuses, are growing at an annual rate of just 1.0%, meaning pay continues to fall in real terms as it has done continually since late-2009. While this squeeze will dampen economic growth, it will also help to keep down inflation, as falling real pay means shoppers resist price rises.

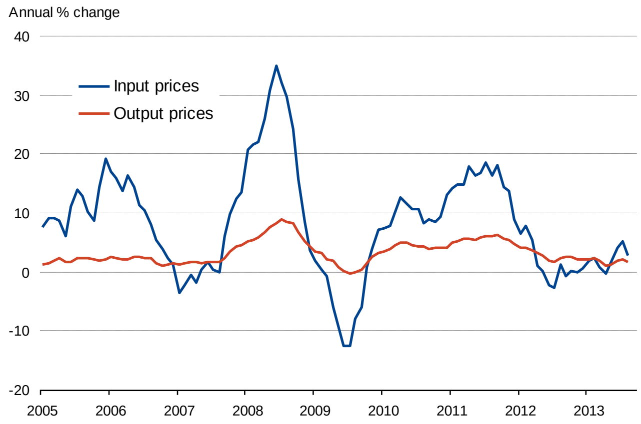
Overall, the picture is one of fairly benign underlying inflationary pressures, and further downward movements in the annual rate of increase are widely expected in coming months. Such is the expectation of the Bank of England, which sees inflation dropping below the target of 2.0% at the end of 2014.

Inflation



Source: Office for National Statistics (via Ecowin).

Producer prices



Source: Office for National Statistics.

Income squeeze: wage growth after inflation

Sources: Markit, Office for National Statistics.

Oil risk

However, oil poses a big risk to this outlook. Brent crude has fallen from almost $119 per barrel in late-August to $113 as the likelihood of military action by the US in Syria has abated somewhat. But any flaring up of tensions will drive up oil prices again, which could blow the Bank of England's projections off target.

At the same time, economic growth has picked up sharply. Survey data point to GDP rising by at least 1.0% in the third quarter. Faster economic growth usually brings inflationary pressures. There are signs from recruitment consultancies that pay growth is already picking up alongside an improving labour market, and as demand rises, firms will inevitably seek to boost profit margins by hiking prices.

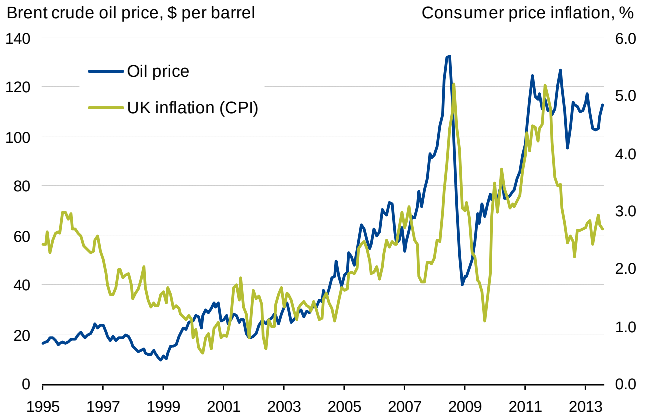
With the Bank of England focusing on a threshold of unemployment dropping below 7.0% before rates start to rise, we should not forget that inflation remains an important aspect of policymaking. One of the Bank's 'knock-out clauses' for interest rates being hiked earlier than its forward guidance is the prospect of inflation running above 2.5% in the next 18-24 month period. Oil prices, wage growth and inflation will therefore need to remain under close scrutiny alongside the unemployment rate for policy signals.

In the detail of the CPI release, the main downward forces behind the drop in consumer price inflation were lower fuel cost inflation (petrol and diesel prices, for example, rose 2p per litre this year against 3.5p and 3.3p rises respectively last year) and lower clothing price increases. Clothes prices usually rise in August, reflecting the new autumn lines, but the 2.2% increase this year compared with a 2.8% rise last year.

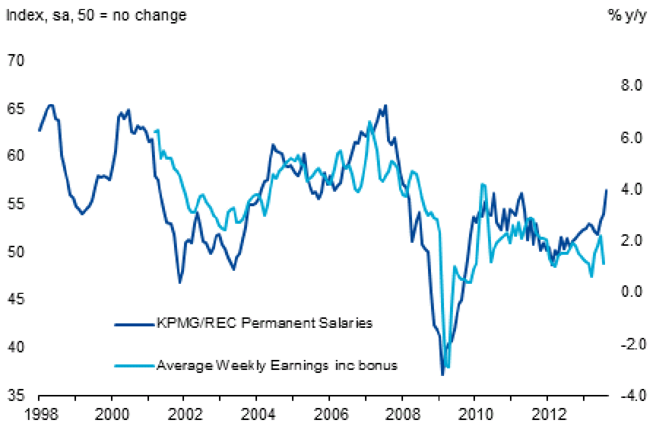
Offsetting these weaker increases were upward price pressures from food & alcohol, furniture & household goods and recreation & leisure.

Retail price inflation meanwhile picked up from 3.1% to 3.3%. The differences in these two measures reflect the latter being more influenced by housing costs.

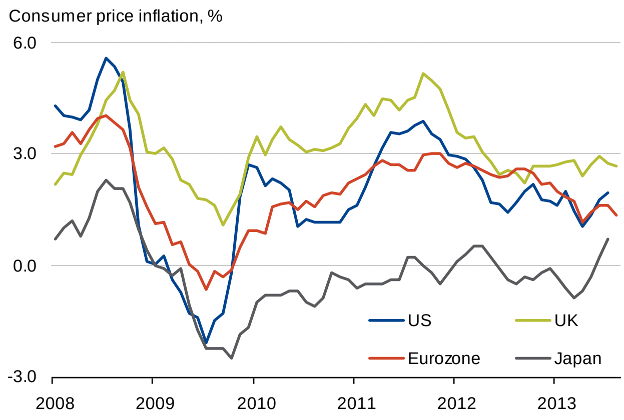
Oil prices and inflation



Recruitment agency wage pressures



Inflation rates compared



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