

## United Kingdom

### Income squeeze lowest for over four years as inflation falls to 1.7%

- **Consumer prices rise 1.7% on a year ago in February, lowest rate since October 2009**
- **Reduced squeeze on incomes as real pay falls at slowest rate since April 2010**
- **Wage growth holds key to policy**

UK inflation fell to its lowest for over four years in February, reducing the squeeze on the cost of living while at the same time enabling to Bank of England to keep interest rates low for longer. The big uncertainty for the outlook for inflation lies with wages and salaries, which are finally starting to show signs of rising. The question is whether they will rise enough to worry policymakers into tightening policy sooner than currently envisaged.

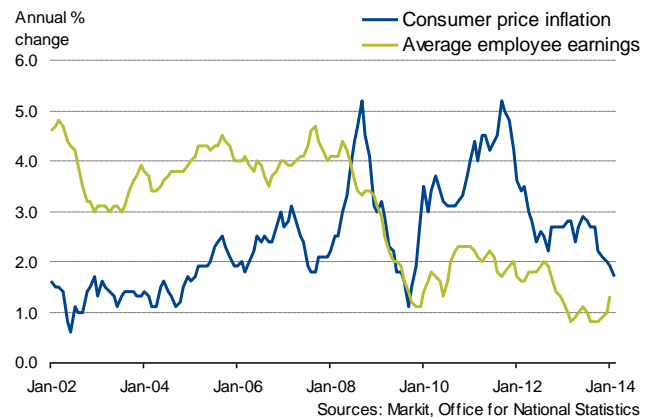
Consumer prices rose just 1.7% on a year ago, the lowest annual rate of increase since October 2009, down from 1.9% in January. Inflation has fallen sharply since peaking at 2.9% last June, while at the same time unemployment has plummeted and the economy has grown rapidly.

The general expectation is that inflation is likely to continue to run at or below the Bank of England's 2.0% target for some time, subdued by lower import costs, resulting in turn from sterling's appreciation this year, as well as lower global commodity and energy prices. This means policymakers have greater leeway to keep interest rates at the record low of 0.5% for longer, as the economy goes through a 'sweet spot' of robust economic growth, falling unemployment and low inflation.

The big uncertainty is pay growth, a revival of which will threaten the Bank's easy-money stance. The potential for wages to start rising strongly should not be underestimated, given the speed with which the labour market is improving. The latest official data showed average wages and salaries rising 1.4% on a year ago in the three months to January.

While this means the squeeze on real pay from inflation is now at its lowest since April 2010, helping to engender a long-awaited consumer feel-good factor, it

#### Consumer prices and wages



#### Real wages growth



raises the possibility that the Bank could grow more worried about the possibility of wage inflation. There are already some signs of this: digging deeper into the official data reveals that pay growth has already in fact risen to an inflation-busting 3.2% in manufacturing, 3.0% in construction and 3.7% in retail, hotels and restaurants. Weak financial services and public sector pay growth remains an overall drag on earnings, but elsewhere the tightening labour market is finally feeding through to higher real-terms pay.

Without the fall in inflation, there would undoubtedly be a rising clamour for policymakers to tighten policy to ward off fears of overheating, especially given the recent housing market upturn. Key to how long the Bank of England can keep rates low therefore will be

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earnings growth. If we see growth of wages and salaries pick up sharply in coming months, concerns about the feed-through to higher inflation will intensify, as will the pressure on policymakers to take some of the heat out of the economy via a first hike in interest rates.

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