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United Kingdom

Inflation drops to 4½ year low, but rising house prices confuse the policy picture

- **Consumer prices rise at slowest rate since October 2009, up just 1.5% on a year ago**
- **Official measure of house prices shows 9.9% annual gain; largest increase since June 2010**
- **Policy debate set to intensify**

UK policymakers were confronted with more mixed news on the economy, as inflation fell to a four-and-a-half year low in May, but the official measure of house prices rose at an annual rate of 9.9% in April, regsietring the largest yearly increase since June 2010.

The divergent data will further complicate the discussion about the appropriate timing of the first increase in interest rates from their current record low.

Consumer prices rose at an annual rate of 1.5% in May, down from 1.8% in April, its slowest pace since October 2009, according to the Office for National Statistics. The easing in the rate was sharper than expected. Market expectations were for a slowing to just 1.7%, after costlier travel in April due to the Easter holidays had temporarily pushed inflation higher in April. Falling food and clothing prices in May also contributed to the easing.

The concern is that inflation could pick up again soon, as higher energy prices drive up the cost of living. Oil prices in particular are rising again due to tensions in the Middle East and the Ukraine.

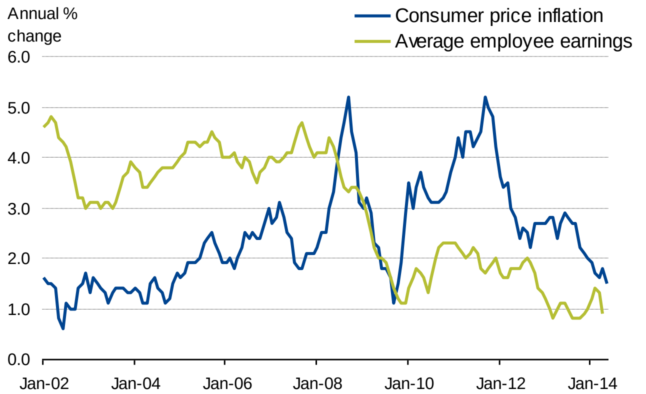
Speculation has also intensified that tomorrow's publication of the minutes from the June Monetary Policy Committee meeting will show that at least one Committee member voted for an early rise in interest rates to prevent the Bank of England from falling behind the curve, which would potentially result in larger rate hikes than would otherwise have been necessary next year.

Such an argument is quite convincing: the UK growing at a consistently strong pace, set to expand by at least 3.0% this year (even the Bank of England is forecasting 3.4%), unemployment has plummeted far faster than expected and policymakers are worried that the galloping housing market is threatening the stability of the economy. While the Bank's Financial Policy Committee will be considering how to rein-in the housing market, there is a concern that the FPC's 'macroprudential ' tools may have limited impact in the absence of an accompanying rate rise.

The doves, on the other hand, will be mindful of the fact that the economy has only just regained its pre-recession peak and that wage growth, according to official data, is still pitifully weak.

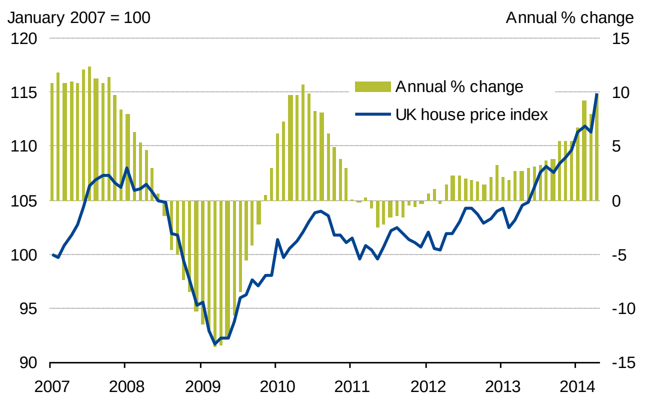
The lack of wage growth is perhaps the strongest argument to hold rates at their record low for longer and, as long as inflation also remains well below the Bank's 2.0% target, the case for keeping rates on hold will no doubt prevail. Our expectation, however, is that wages growth is picking up, and that more MPC members will consequently join the call for a tightening of policy in coming months, with the first rise in interest rates most likely coming in November.

UK inflation and pay



Sources: Markit, Office for National Statistics.

UK house prices (ONS)



Source: Office for National Statistics.

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