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Markit Economic Research
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United Kingdom

Inflation falls to 14½ year low

- **Inflation slows to 0.5%, lowest since mid-2000**
- **Factory prices decline as lower oil costs feed through**
- **Lower price pressures to boost consumer spending and allow policy to remain loose**

UK inflation fell to its lowest since May 2000 at the end of last year. Consumer prices were only 0.5% higher than a year ago in December, down from a 1.0% rise in November and lower than economists' expectations of a 0.7% increase.

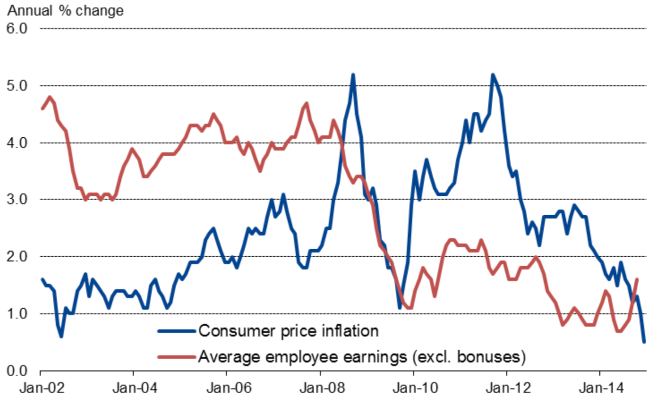
The biggest factor behind the drop in inflation has been the halving in the price of oil since last summer. Lower oil prices are not only cutting household motoring costs but are also reducing costs for a wide variety of goods and services which use oil as an input, for example cutting the price of transport and petroleum-based inputs in the manufacturing sector, notably plastic packaging. Factory gate prices fell 0.8% in December, the steepest decline since September 2009.

The Office for National Statistics also reported lower prices for electricity and gas compared to a year ago, and food prices were down 1.7%. Retailers (and supermarkets in particular) are engaged in fierce competition, which is driving down prices for many goods.

With inflation falling below 1%, Bank of England Governor Mark Carney will need to write to the Chancellor to explain the shortfall against the 2% inflation target. The letter will no doubt also indicate that inflation could fall further in coming months as lower oil prices continue to feed through to the consumer alongside intense competition among supermarkets.

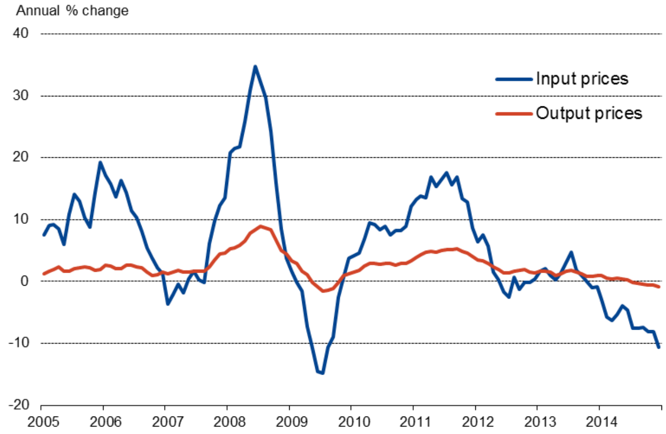
The drop in inflation is good news for consumers. December saw household optimism rise to a post-crisis high, according to Markit's HFI survey, driven higher by signs of rising wages and greater job security alongside the increasingly benign inflation outlook. The Misery Index, which combines unemployment and inflation data to give a basic but useful view on the economic headwinds facing households, has plunged to its lowest since February 2005.

UK inflation and pay



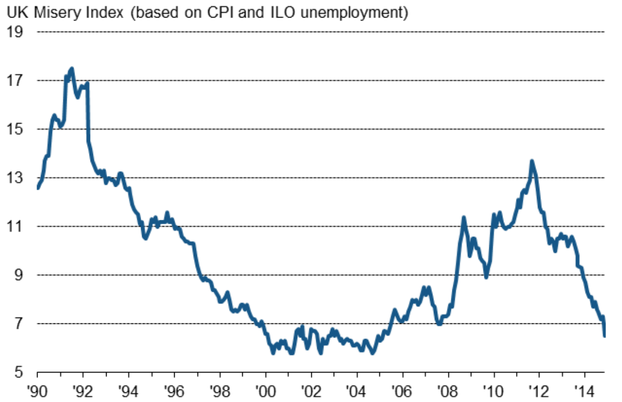
Sources: Markit, Office for National Statistics

Producer prices



Source: Office for National Statistics.

Misery Index



Source: Markit.

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Rising real wages

Wage growth is also now beating inflation for the first time since 2009, and looks set to pick up further in coming months. This will provide a meaningful boost to real incomes, which should in turn feed through to rising consumer spending. With fuel prices falling, more of this real income gain should also be spent on goods other than fuel.

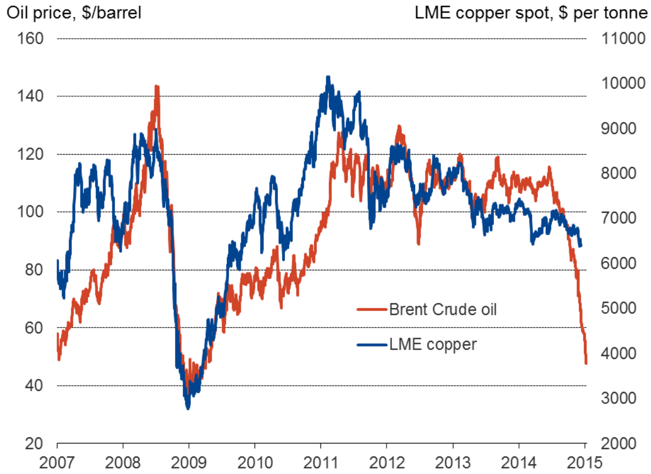
It is therefore likely that UK economic growth will start to revive again, having waned late last year, on the back of increased consumer spending.

Interest rates to stay low for longer

The drop in inflation will meanwhile add to scope for policymakers to keep interest rates on hold for longer as the economy picks up steam again, although there is an argument for the Bank of England to 'look through' a drop in inflation caused by lower oil prices (in the same way that the Bank did not hike rates when higher oil prices drove up inflation in the past).

The hawks will be watching the wages data carefully for signs that inflation could pick up again in the medium term, but a fall in inflation to this extent surely kills off any likelihood of UK interest rates rising for the foreseeable future, and probably not until 2016.

Commodity prices



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