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UK: INFLATION HAS PEAKED, BUT THE BOE SHOULD STILL TIGHTEN

Berenberg Macro Flash

UK inflation, December 2017

	CPI	Core CPI
Actual	3.0%	2.5%
Previous	3.1%	2.7%
Consensus	3.0%	2.6%
Berenberg	3.1%	2.7%

Has the Brexit related inflation peaked? Probably, yes. Headline inflation eased to 3.0% yoy December. The headline inflation rate has risen to well above the BoE's mandated target of 2.0% as the fall in sterling since the Brexit vote temporarily caused import price growth to accelerate during 2017 – Chart 1. Raw material prices rose by 4.9% yoy in December (down from a peak of 19.9% in January 2017). Meanwhile factory gate prices rose by 3.3% yoy (from a peak of 3.7% in March 2017). The headline inflation rate should gradually track down this year as long as sterling remains at current levels or higher. However, the stable gains in domestic spending and improving external backdrop since the Brexit vote, amid cautious hiring and investment, is causing demand growth to exceed supply growth. Core inflation, which excludes volatile food and energy components, was 2.5% in December, a little below expectations but well above the BoE's 2% inflation target. Measures of underlying inflation have trended upwards during the past two years and will remain elevated as long as the imbalance between demand growth and supply growth persists.

Households are handling the higher inflation well: Currently, inflation is outpacing wage growth, causing real wages to decline temporarily. But instead of cutting back spending as inflation rises above wages, households are simply opening up their wallets to spend more in order to meet their growing real demand for goods and services. The good news is that households are probably past the worst of the real wage squeeze. While headline inflation might remain elevated at close to 3% in the coming months, with the appropriate monetary setting (gradual rate hikes) it should steadily trend downward towards a rate of c2.3% by late 2019. Meanwhile, nominal wage growth is likely to accelerate – see below. While household confidence dropped in 2017, continued gains in labour demand and a recovery in real earnings should underpin a rebound this year.

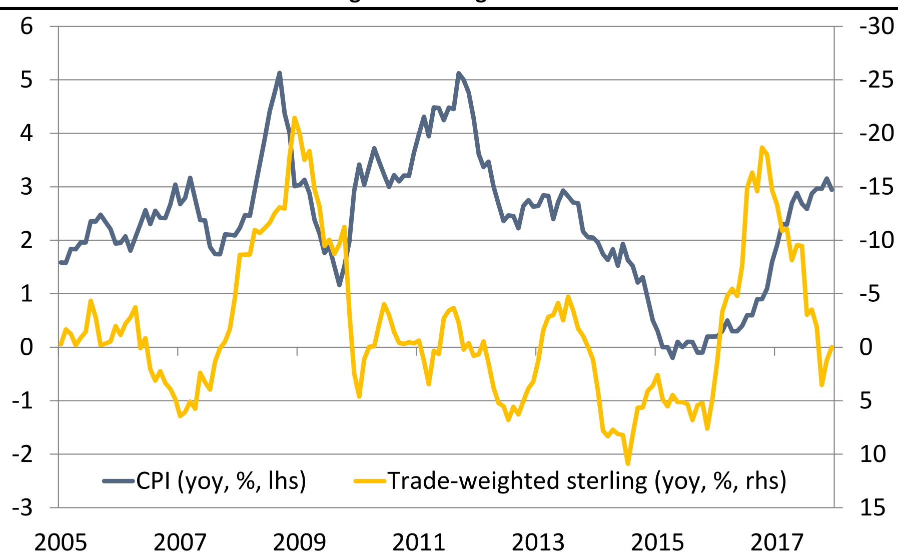
Households should have a better time of it in 2018: Typically, real wage growth tracks the degree of tightness in the labour market. The shock Brexit vote temporarily forced a gap in this relationship. But as the initial concerns of a collapse in short-term demand after the UK voted to leave the EU have not materialised in a serious way, labour demand has continued to tighten relative to supply. According to vacancy data, labour demand is currently at close to a record high – see Chart 2. When vacancies rise, it signals that firms want to increase their workforces. And, implicitly, that firms are willing to raise their wage bills. When labour is scarce, firms typically offer higher pay to the candidates they most prefer based on their skills and experience, thereby pushing up total wage growth. We expect real wage growth to turn positive by Q2 2018 before rising towards 1% per year by 2019.

Monetary policy outlook: Responding to tightening labour market conditions, growth at close to trend and rising wages, we look for the BoE to hike the Bank Rate twice in 2018, once in Q2 and once in Q4, followed by one further hike in Q3 2019. Even with a modest continued tightening in which the Bank Rate increased to 1.25% by the end of 2019, UK monetary policy would remain highly accommodative. The real policy rate would remain negative and the bank's balance sheet large by historical standards. Also note that the costs

of business and consumer credit and mortgages are set by market forces, not directly by the BoE. The rise in borrowing costs in the real economy is, therefore, likely to be less than any eventual increases in the Bank Rate. The risks to the outlook for a gradual monetary tightening depend on the outlook for wage growth. Continued tight labour market conditions point to rising nominal wage growth toward 3% by late 2018 from current rates of around 2.5%. We expect the BoE to tighten by more (or less) than our base case if wage growth surprises to the upside (or downside).

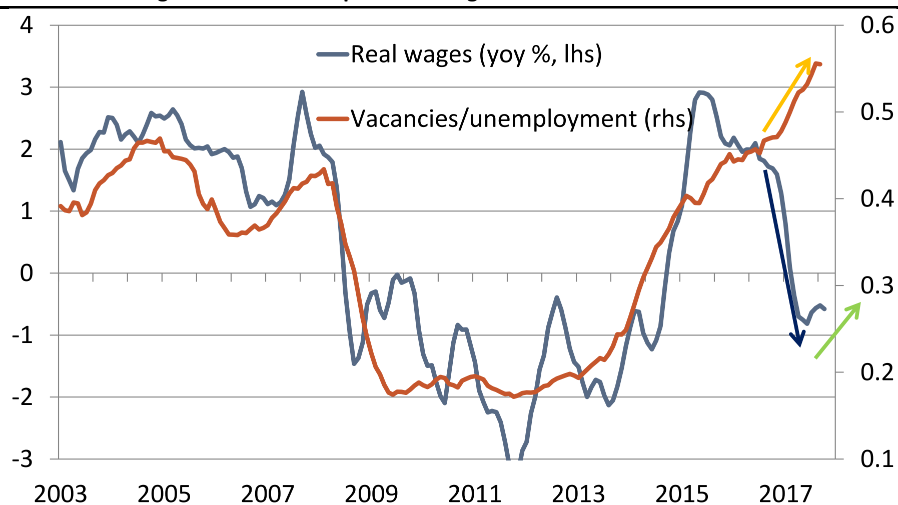
Please see '[UK: 8 questions for 2018]' for a detailed overview of our key UK calls for 2018.

Chart 1: Inflation versus trade-weighted sterling



Source: ONS, Bank of England, Berenberg calculations

Chart 2: UK's tight labour market points to wage rebound



Monthly data. Real wages = average weekly earnings adjusted by headline CPI. Source: Source: ONS, Berenberg calculations

yoy%	DEC	NOV	OCT	SEP	AUG	JUL
CPI	3.0	3.1	3.0	3.0	2.9	2.6
Core	2.5	2.7	2.8	2.7	2.7	2.4

Source: ONS

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