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UK INFLATION EDGED HIGHER IN DECEMBER, STILL SUBDUED

Berenberg Macro View

Tentative signs that the disinflation from the virus-shock is fading

Inflationary pressures picked up a little in December despite the severe drag on economic activity following the reintroduction of harsh pandemic restrictions from November onwards. The 0.3% mom estimated rise in the consumer price index in December lifted the annual rate to 0.6% from 0.3% in November. The increase was a little above our and the market's expectation of 0.5% yoy.

Headline inflation has fallen to well below the BoE's 2% target ever since the pandemic struck in Spring 2020. Although the December rate came in above the low of 0.2% yoy in August, it remained in line with 0.6% yoy average since April. The current lockdowns, which squeeze demand and supply, may temporarily slow the rebound in inflation while they last (probably until late February). However, the continued pass-through of aggressive monetary and fiscal support to economic activity, [as well improving growth expectations for growth and inflation](#), should lift demand and inflation through 2021 and beyond.

Other takeaways from the December data

- Core price inflation rose a little more than expected - accelerating to 1.4% yoy from 1.3% in November (expected 1.3%) (Chart 1);
- Goods prices continued to decline on an annual basis (-0.3% yoy) – although the rate of decline was less than in November (-0.8%). The annual rate of inflation in domestic-orientated services remained unchanged from November (1.4% yoy). Services inflation has remained stable since September (Chart 2);
- Producer prices continued to recover after significant deflation through mid-2020 (Chart 3). Producer input prices increased sharply by 0.8% mom in December, lifting the annual rate to 0.2% from -0.3% in November. Output prices declined by 0.4% yoy, a smaller annual decline than the 0.6% drop in November.

Inflation outlook: heading into a 2%+ world – the BoE can relax a bit

Despite the subdued rate of inflation and current economic difficulties linked to the ongoing pandemic restrictions, we do not expect the BoE to step up its monetary stimulus at its upcoming 4 February monetary policy meeting. The already planned £150bn of additional asset purchases for 2021, alongside the positive economic outlook from spring onwards, should return inflation to the BoE's 2% target by early 2022.

Over the course of 2021, falling spare capacity should lift production costs while declining unemployment will contribute to faster wage gains. Prices in the hospitality and tourism sectors will jump in April if the planned normalisation of VAT to 20% from 5% takes place on 1 April 2020 – depending on the rate of pass through, it may contribute a few tenths of a percentage point to annual headline inflation. A sustained appreciation of sterling may slow the rise in inflation through mid-year 2021.

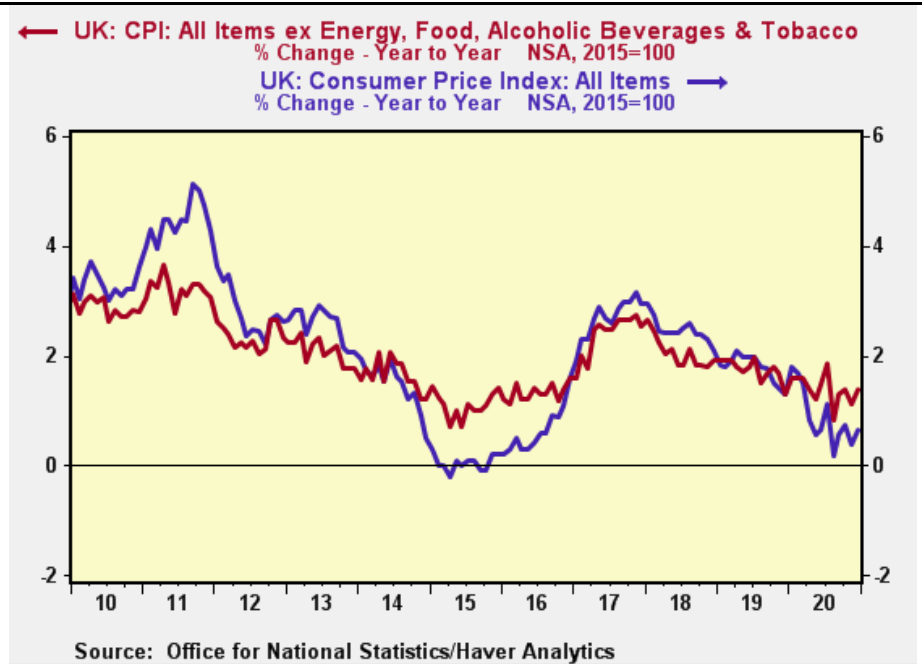


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As our base case, we expect core inflation to rise to slightly above the BoE's 2% target by end-2022. The recovery in inflation may be most prominent in many consumer services as well as travel and entertainment that benefit from the unleashing of pent-up demand once virus restrictions are finally eased. Elevated inflation expectations, which are factored into price and wage setting, can support the recovery in inflation. Households expect inflation to rise to 2.7% by the end of 2021, according to the BoE's latest Q4 2020 results.

[See here](#) for our view on the long-run inflation outlook for advanced economies.

Chart 1





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Chart 2

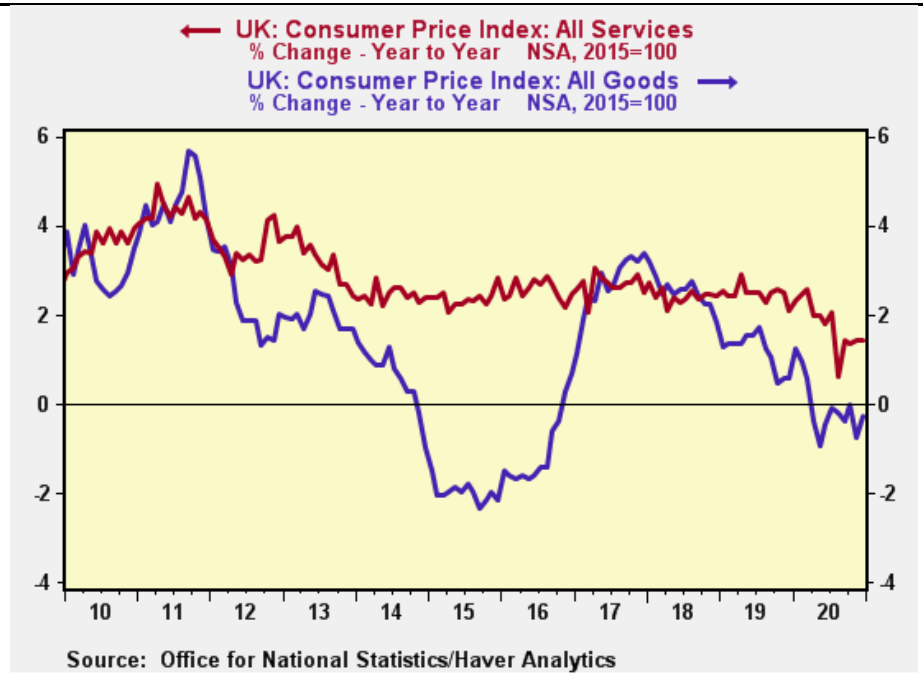
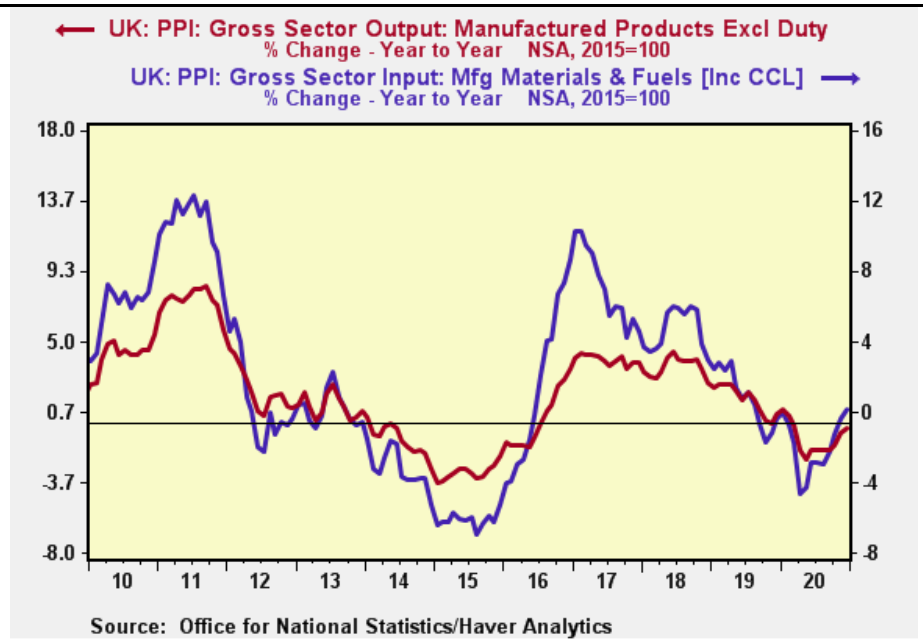


Chart 3





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yoy%	DEC	NOV	OCT	SEP	AUG	JUL
CPI	0.6	0.3	0.7	0.5	0.2	1.0
Core	1.4	1.1	1.5	1.3	0.9	1.8

Source: ONS.



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