Inflation Outlook

2014

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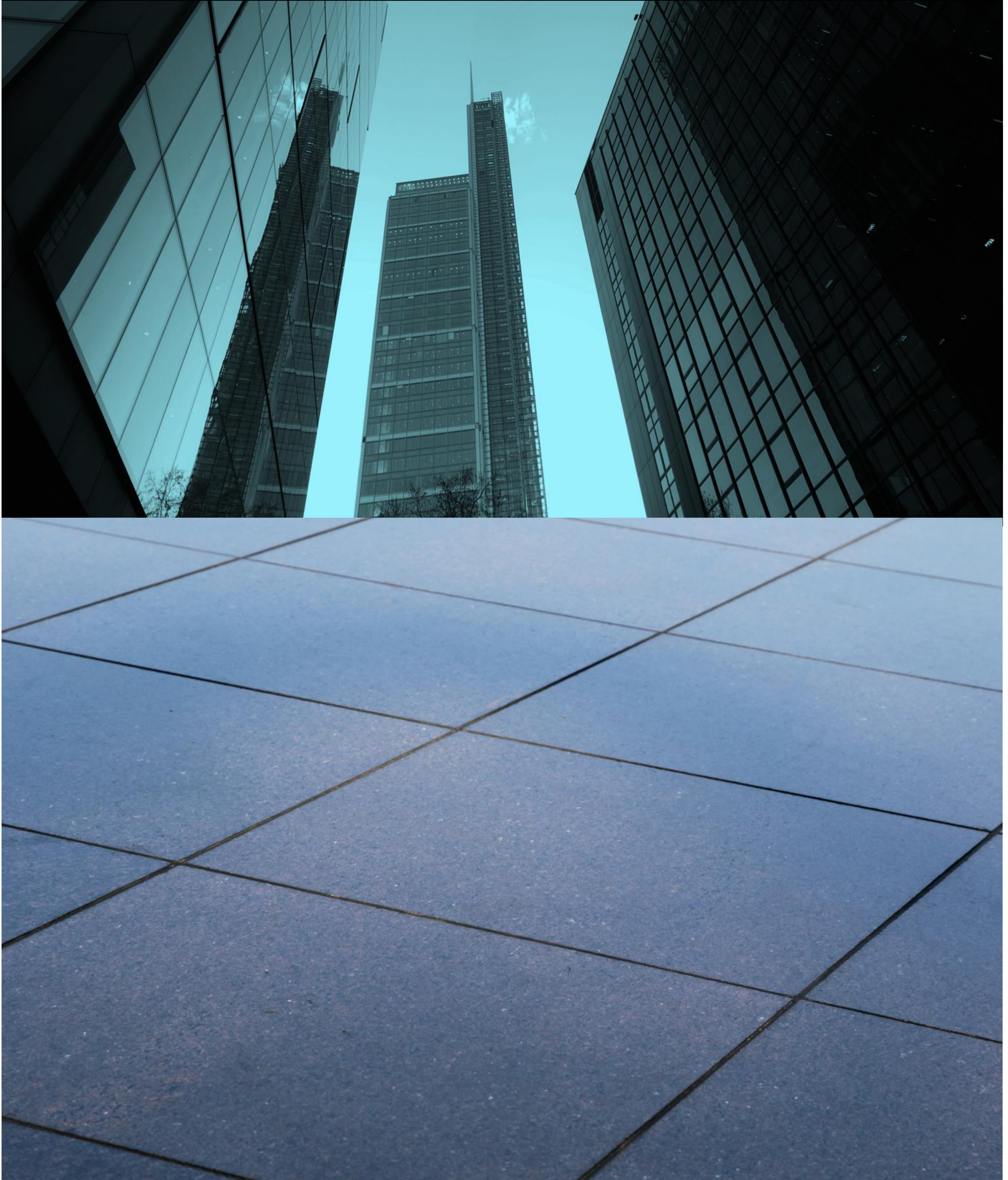

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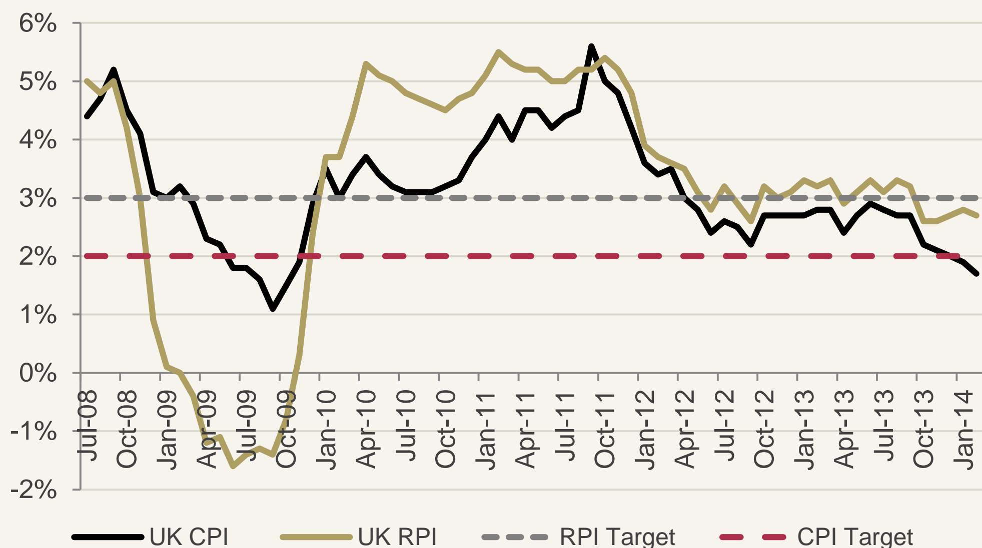
Over the last few years, economists have been firmly divided into two camps; are we facing a period of deflation, or will inflation take off again?

Looking back to March 2009, as Quantitative Easing began (QE), most City analysts were concerned about deflation and the dangers of falling prices were cited as justification for QE (expanding the UK's monetary base).

By late 2011, prices were rising with CPI at 5.2%, matching the record high set in September 2008. RPI rose to 5.6%, the highest annual rate since June 1991.

Since then, both measures have fallen back again, with CPI now below the Bank of England's 2% target rate for the first time since November 2009.



Source: Office for National Statistics, February 2014

So it seems that the deflationary scenario has in fact been the winner, as real private sector wages have fallen four years in a row – thanks largely to stubborn inflation.

The question to ask now is whether or not high price rises in the UK are a thing of the past. The political involvement in cost of living crisis debates will continue to roll on and will put meaningful downward pressure on inflation in the short term, whilst continued Sterling strength through the rest of the year will further add to this downward pressure.

So, whilst it appears that we do in fact have inflation under control, in our opinion this is only a temporary situation as the path going forward points to higher inflation.

There has been a large discrepancy between official inflation figures and the actual price rises that we have experienced in the real world.

Figures produced by the Office of National Statistics (ONS) have understated inflation due to the exclusion of council tax rises and housing cost inflation (which has been extremely high over the last 12 months).

RPI numbers have been higher than CPI figures in 15 of the 16 years since CPI was introduced. This would perhaps explain why the government decided that the RPI (an inflation measure that has existed since 1947) would no longer be used.

The UK has experienced a period of remarkably 'sticky' inflation, despite being embroiled in the deepest recession in living memory. Given the macroeconomic environment over the last four years one would typically have expected significant deflation over this period.

Whilst CPI & RPI have been persistently above target, weak consumer demand has at least helped to keep UK inflation relatively contained in recent years. However, the picture going forward could look entirely different.

The UK economy grew by 1.9%, in 2013, its strongest rate since 2007, and a recovery that has been greater than anyone could have anticipated at the beginning of the year. There is now a belief that the UK economy is on firmer footing and that the recovery will indeed be sustainable and with demand now growing quickly, we could easily see further price pressures add to the existing pressures coming from higher energy and food costs.

In any typical economic cycle, inflation would be influenced by normal economic parameters; however, we are yet to understand the full implication of QE. This is an unprecedented monetary experiment of which no-one presently truly understands the long-term consequences.

There has been little inflationary impact of QE so far. Instead, we have seen equities hit record highs, despite little growth and weak earnings. Bonds have also benefited and it can be easily argued a bubble has formed.

The lack of inflation so far could be explained by the fact that banks have kept the money in reserve as opposed to lending to businesses and consumers. Since March 2009 Britain's monetary base has increased by 321%. The majority of this is in the form of increased bank reserves, up 642%.

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The government is now very keen to get banks lending again, as evidenced by the Funding for Lending scheme in 2013. This was designed to allow banks and building societies to take cheap cash from the bank and pass it on to mortgage borrowers and businesses.

Unlike US Banks, UK banks are still behind the curve in fixing their balance sheets (i.e. writing down bad debts). Once this has happened and they start to reduce their excessive reserves to lend money, the velocity of money will increase significantly, and unless the BOE is able to reduce money supply quickly, then so will Inflation.

Current inflation levels appear to be negligible, as energy and food prices have fallen in the short term and expectations on inflation are further subdued due to the overall lack of global growth. However, the view that we shouldn't be concerned by inflation going forward could well be misplaced.

The long term trend in both energy and food prices remains upward. Furthermore, House prices have shot up over the last 12 months whilst interest rates, and subsequently mortgage payments, are at historic lows. With the economy now looking better, a rise in the base rate is more than inevitable. This will have a significant impact on RPI vs CPI (which excludes rises in mortgage payments, rents, and council tax).

And finally the biggest unknown "elephant in the room" - the difficulty of removing the huge reserves created by QE - could ultimately prove to be inflationary.

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