

## UK inflation report

### Executive summary

Against the background of an economy growing at around trend, inflation pressures have increased. CPI inflation has risen above the Bank of England's target, retail prices are edging up and there are signs of price pressures in the supply chain. While we think interest rates could well have peaked at 5¼%, there is still a significant chance of a further tightening in monetary policy during the first half of 2007.

### Key trends

- **Annual CPI inflation hits 3% in December 2006.** Inflation is now well above the Bank of England's 2% target. If CPI inflation heads higher over coming months, as expected, Governor King will have to write a letter to the government explaining why inflation is more than 1% above target and how it will be brought back to the target rate.

- **Modest increase in supply chain price pressures.** While the data has been mixed, price pressures in the supply chain have edged up. In particular, survey data points to higher output prices in the months ahead as firms look to pass on some of the increase in their input costs.

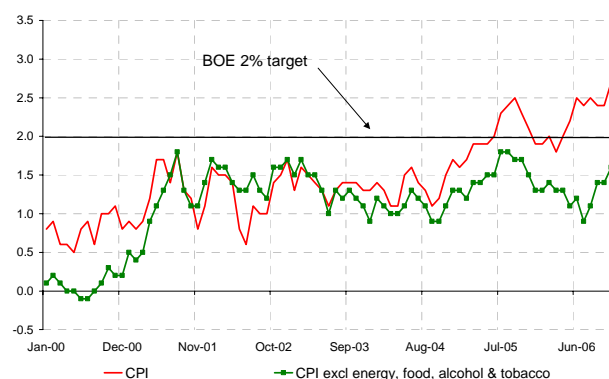
- **Retail prices no longer declining.** After a sustained period of declining prices, consumers are now seeing modest price increases in the high street. Price rises have been highest for food, with non-food items showing only small price gains.

- **Wages remain under upward pressure.** The recent increase in CPI inflation, RPI inflation and inflationary expectations has added to concerns that

wage inflation could head higher in the near term. Data on average earnings suggests that wage inflation remained contained in late 2006 but there have been reports of higher wage settlements in January 2007.

- **Interest rates forecast to remain on hold but risks are to the upside.** We forecast that interest rates have peaked at 5¼% but have not ruled out a further interest rate increase by the Bank of England by mid-2007. The release of the February 2007 Inflation Report will provide us with a clearer view on the Bank of England's projection for the path of inflation over 2007 and hence the outlook for interest rates.

### Annual CPI inflation (percent)



## CPI annual inflation highest on record

The upward trend in CPI inflation gathered momentum during the autumn and winter months of 2006 and by December 2006 had risen to 3.0%, well above the Bank of England's 2% target. Core CPI inflation (excluding energy, food, alcohol & tobacco) increased to 1.8% in December 2006. Recent trends in supply chain prices should act as a guide to future trends in consumer price inflation as price pressures in the supply chain generally feed through into prices for consumer goods and services. While the data has been mixed, the overall trend is one of increased inflationary pressures in the economy.

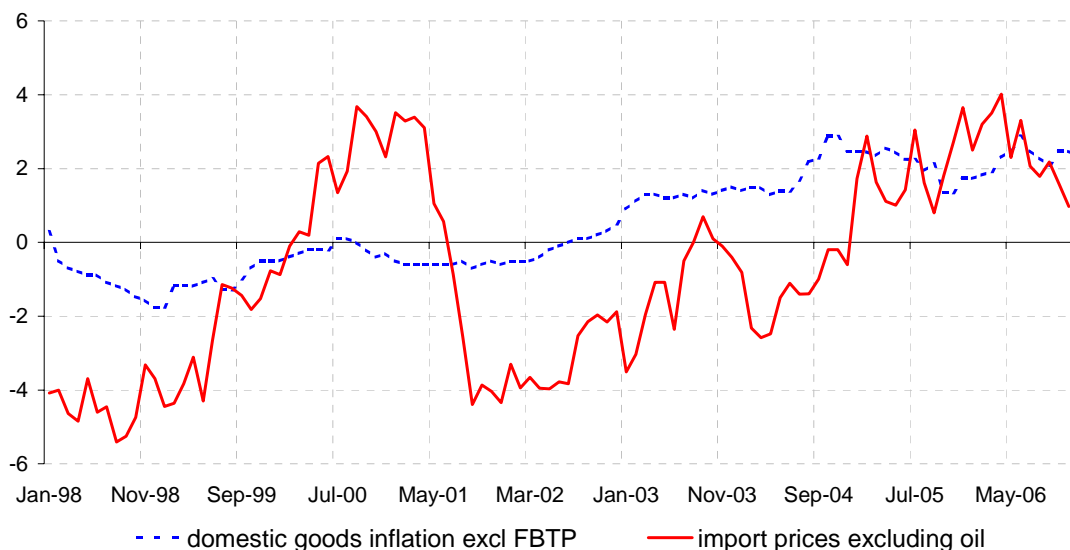
## Some evidence of higher price pressures in the supply chain

Import prices can be an important influence on firms' costs and consumer prices. After falling between late

2001 and early 2004, this downward trend was reversed with annual growth in import prices picking up during 2004 and 2005. Much of the rise in prices reflected higher commodity prices related to strong global growth, particularly in emerging markets. After peaking just above 7% yoy in early 2006, the rate of growth in import prices has eased and by November 2006 import price inflation was up by 0.5% on year earlier levels. When the price of oil is excluded, the rate of increase in import prices in recent year has been more modest, peaking at 4% in early 2006.

The rate of increase in prices for domestically produced goods has remained relatively steady over the past few years, with annual inflation averaging around 2%. In December 2006, prices for domestically produced goods (excluding food, beverages, tobacco and petroleum) were up by 2.4% on year earlier levels.

**UK imported goods prices and domestic goods prices (percentage change, year on year)**



Until recently, there has been little evidence that higher prices at the factory gate had been passed onto the consumer. In the past, variations in factory gate prices showed up in the higher street with a lag of about one year. In early 2004, this relationship broke down, with factory gate prices rising while retail prices declined. Since early 2005, however, the rate of decline in prices for core retail goods (excludes food, alcohol and tobacco) has gradually eased and by late 2006, prices were up slightly on year earlier levels. The BRC shop price index also points to a modest pick-up in shop prices during the second half of 2006, underpinned by higher food prices. By December 2006, total shop prices were up by 2.3% on year earlier levels, with non-food prices up by 0.7% year on year.

Survey results on price pressures faced by manufacturers and service providers have been mixed. The UK RBS/PMI surveys indicate that businesses in both manufacturing and services have increased their output prices at a modest rate in

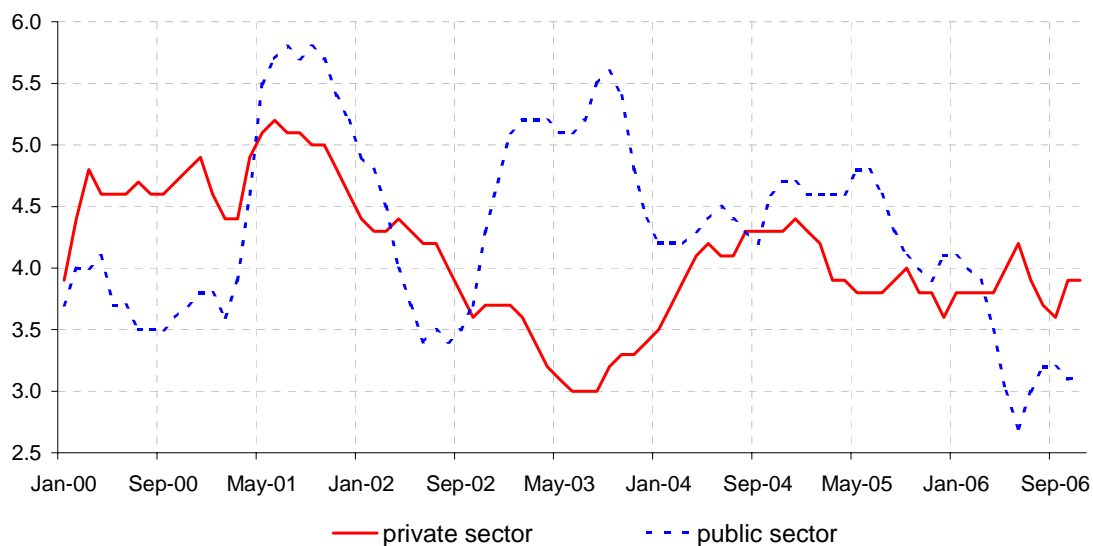
response to higher input costs. Results from the BCC Quarterly Economic Survey for December 2006, on the other hand, show that the net balance of firms expecting to increase their output prices had risen to its highest level since the survey began in 1997.

### Upward pressure on wages

Respondents to the latest Bank of England’s quarterly survey of public attitudes to inflation, undertaken in November 2006 by GfK NOP, indicated that they expected the rate of inflation to pick-up over the coming year. Median expectations for inflation over the next 12 months were 2.7%, compared with 2.5% in August.

Higher inflation expectations can affect wage bargaining as employees seek to preserve the future purchasing power of their earnings. The data suggests that wage inflation has remained contained thus far. Average earnings for the private sector excluding bonuses were running at 3.9% yoy in the three months

**Average earnings excluding bonuses  
(percentage change, year on year)**



to November 2006, unchanged from the previous month. In the public sector, average earnings excluding bonuses were up by 3.1% on year earlier levels in the three months to November 2006, also unchanged from the previous month. By sector, the strongest growth in average earnings was in manufacturing, up by 4.4% on year earlier levels.

The Bank of England Agents' noted that their contacts' concern about pay pressures had intensified in December, with many citing the increase in retail price inflation (which rose to 4.4% in December 2006) as a potential catalyst for higher wage demands. Most settlements, thus far, had remained close to 3%, with little sign of a widespread upturn in pay growth. That said, there were some sectors, such as financial services, where pay awards had been higher, reflecting both skill shortages and strong profitability. These higher pay awards often reflected rises in components of pay other than settlements, such as bonuses.

A report from Income Data Services showed that early wage settlements in 2007 had resulted in a median settlement of 4%, up from a median of 3% in the final quarter of 2006. As these early settlements related to only 10% of the employees normally covered by January agreements and they included the later stages of some multi-year agreements, a larger sample is required before drawing any firm conclusions about wage trends in early 2007.

## Upside risks to interest rates

The first estimates of GDP growth for the December 2006 quarter indicate that economic activity gathered momentum in the final months of the year. GDP rose by 0.8% in the December 2006 quarter, underpinned by strong growth in services. Over 2006 as a whole, GDP grew by 2.7%, up from 1.9% in 2005.

While we think that interest rates have now peaked at 5¼%, there is still a significant chance of a further increase in interest rates by the Bank of England during the first six months of 2007. The minutes of the January 2007 meeting revealed that the decision to increase interest rates to 5¼% was a close call, with five members voting to increase rates while four members preferred to leave interest rates unchanged. The minutes also stated that the decision to increase rates in January should reduce the need for larger increases later. In a recent speech, Bank of England Governor, Mervyn King, stated, "the Committee's central view remains that inflation is likely to fall back in the second half of the year, possibly quite sharply." While we will be watching the outcome of upcoming wage negotiations, data on money and credit growth, housing market activity and spare capacity within firms will also be important in assessing pressures on inflation. The release of the February 2007 Inflation Report will provide us with a clearer view on the Bank of England's projection for the path of inflation and hence the outlook for interest rates.

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