19th Jan. 2010

UK DATA RESPONSE

UK Consumer Prices (Dec.)

MPC has no reason to panic

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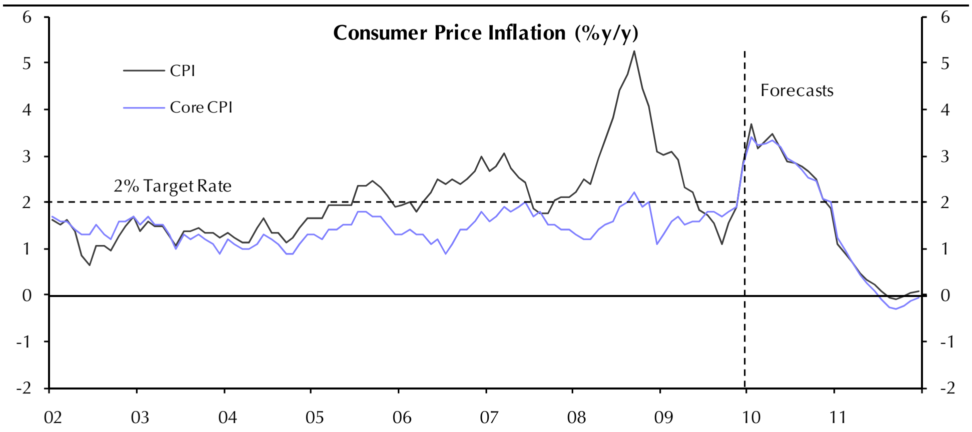
- December's consumer prices figures will clearly do nothing to ease the recent increase in inflation worries. **But they should not throw the Monetary Policy Committee into a blind panic.**
- The record monthly rise in headline CPI inflation from November's 1.9% to 2.9% was primarily driven by the anniversary of last year's cut in VAT. (The renewed rise to 17.5% will have a further upward effect in January).
- **Admittedly, VAT probably accounted for only about three quarters (about +0.7%) of the increase in inflation.** Energy inflation also rose sharply on the anniversary of a sharp fall in oil prices last December. Meanwhile, leaving the VAT effect aside, it looks like retailers generally discounted prices by rather less than last year, perhaps reflecting the apparent strength of high street spending in the Christmas run-up.
- **But this latter effect might partly reflect VAT effects too as shoppers brought purchases forward from January and beyond.** As such, we would not be surprised to see some of this reversed in the next month or two. And more generally, we still think that the impact of the recession and the vast amount of spare capacity created will eventually bear down strongly on underlying price pressures.
- **Of course, the MPC may be concerned that the surge in inflation will have "second-round" effects on inflation expectations and wages in the meantime.** But that seems unlikely to us. Remember that inflation rose above 5% in 2008 – at a time of stronger activity and lower unemployment – with little lasting effect.
- **Overall, then, inflation looks set to be rather higher than both we and, more importantly, the MPC expected in the early part of 2010.** We still believe that it will drop back sharply towards the end of the year and in 2011 – possibly even dropping into negative territory. (See Chart.) **Nonetheless, inflation nerves will be sorely tested in the next few months.**



CONSUMER PRICE INFLATION										
	CPI				RPI			RPIX	CPI Goods	CPI Services
	Index	%m/m	%y/y	Core	Index	%m/m	%y/y	%y/y	%y/y	%y/y
Sep	111.5	0.1	1.1	1.7	215.3	0.4	-1.4	1.3	0.0	2.5
Oct	111.7	0.2	1.5	1.8	216.0	0.3	-0.8	1.9	0.8	2.3
Nov	112.0	0.3	1.9	1.9	216.6	0.3	0.3	2.7	1.6	2.3
Dec	**112.6**	**0.5**	**2.9**	**2.8**	**218.0**	**0.6**	**2.4**	**3.8**	**3.2**	**2.6**

Source – Thomson Datastream