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Ernst & Young is the sole sponsor of the ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.
Highlights

► The first decade of monetary policy independence saw a period of low and stable inflation, but over the past six years this has given way to higher, and more volatile, inflation. The increase in inflation rates has both external and domestic origins. Higher commodity prices, in particular food, and rising prices of manufactured goods imported from emerging markets have been important. In both cases the sharp depreciation of the pound in the aftermath of the financial crisis has compounded the impact on the UK. There has also been a marked step upwards in domestic inflationary pressures which has largely come from administered & regulated prices, such as domestic energy prices and university tuition fees. These categories account for just 10% of the inflation basket, but over the past six years they have contributed 0.9ppt to an average CPI inflation rate of 3.1%.

► High inflation has been very damaging to the UK economy, particularly because of the way it has eaten into household spending power. We estimate that had inflation averaged 2% over the past three years – rather than 3½% – then the level of GDP would now be 2½ppt or £10bn higher.

► Given that inflation expectations have remained well anchored, the MPC has been able to use its credibility to avoid tightening monetary policy and has allowed inflation to overshoot. Our modelling suggests that this has been the right policy; a counterfactual scenario where the MPC uses a Taylor rule to set monetary policy suggests that interest rates would have had to rise to 3½% in mid-2011. This would have choked off the 2011 recovery even earlier, with the level of GDP being 2½ppt lower by the end of 2011 and unemployment being around 625,000 higher by end-2012.

► Base effects are likely to send CPI inflation above 3% in the summer. And though inflation should cool in the autumn, as domestic energy and food prices rise by less than they did last autumn, we think it unlikely that inflation will dip below 2½%. This is partly because the trend of rising prices of imported goods from emerging markets is likely to continue, but also because administered & regulated prices are set to continue to rise rapidly, particularly while the impact of higher university tuition fees continues to feed through. By the time that the tuition fees effect falls out of the calculation in late-2015, underlying inflationary pressures will be building again as a stronger economy improves workers’ wage bargaining powers and firms’ pricing power.

► The persistence of high inflation could undermine the MPC’s credibility. It will also make it difficult to implement the Chancellor’s ideas for forward guidance. In this environment, alternative monetary policy remits, such as setting ranges for intermediate or proximate statistics like core inflation and nominal GDP, would appear to be more attractive propositions.
ITEM Club special report on inflation

Inflation has now been above the 2% target for more than three years and for three-quarters of that period it has exceeded the target by more than 1 percentage point (ppt). Furthermore, the Bank of England has recently said that it expects it to be more than two years until inflation is brought back to target. In this special report we look at why inflation has remained so high, even in spite of persistently weak growth, and assess the impact that it has had on the economy. We then move on to look at the prospects for the next few years, asking whether the Bank is right to be so gloomy about its ability to keep inflation under control.

The NICE decade has given way to higher, and more volatile, inflation

The first decade of monetary policy independence coincided with the so-called ‘NICE decade’ of low and stable inflation. The CPI measure averaged 1.5% a year over that period and on only one occasion was it more than 1ppt above the target. However, the six years since have seen much higher, and more volatile, inflation; the CPI measure has averaged 3.1% over the past six years, having spent almost 90% of that period above the 2% target and more than half of the time higher than 3%.

What’s more, this protracted period of high inflation has come at a time when the wider economy has performed poorly, with GDP having fallen by around 2% over the past six years. Indeed, it has been the weakness of the wider economy, and the high

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1 NICE – Non-Inflationary Constant Expansion – phrase coined by Sir Mervyn King to describe the inflation and growth performance for the ten years from 1997

2 From May 1997 to December 2003 the MPC was required to target RPIX inflation of 2.5%; from December 2003 the target reverted to CPI inflation of 2%
degree of spare capacity that it implied, which has consistently led commentators – most notably the Bank of England – to predict that inflation would rapidly come to heel. But this has not been the case and the Bank has regularly been forced to revise up its inflation projections.

**Surging commodity prices are partly to blame…**

External price pressures have played an important part in the story. Food prices, in particular, have soared in recent years, with data from the IMF reporting that global food prices have risen by almost 38% since 2007. This has ensured that the contribution of food costs to CPI inflation has more than doubled compared with the NICE decade, rising from 0.3ppts a year from 1997-2007 to 0.8ppts a year in the period since.

The past year has seen these pressures being particularly fierce, with droughts in several countries, most notably the US, and floods in the UK ruining harvests and causing supply shortages. Corn and wheat prices rose by more than 30% over the first half of last year, raising not just the prices of corn and wheat-based products, but also increasing meat prices because they are key foodstuffs for livestock.

At certain times, the impact of high oil prices has also been felt, both directly through the impact on retail petrol prices, but also indirectly through suppliers passing on their higher transportation costs. These effects were seen most clearly in 2010 and 2011, when petrol prices contributed 0.7ppts and 0.6ppts respectively to CPI inflation. But while petrol prices have certainly contributed to the added volatility of inflation, taking the period from 2007 as a whole their contribution to inflation (0.3ppts a year) has been only marginally higher than in the decade before (0.2ppts a year).

…while the cost of other imported goods has also risen

Oil and food are far from the only commodities which have seen sharp rises in prices in recent years; most metals have also seen high rates of inflation, caused by the strength of demand from fast-growing, resource-intensive, emerging economies. Furthermore, the emerging economies have also seen substantial increases in labour costs, as their economies have matured and, in many cases for political reasons, workers have been increasingly rewarded with higher wage increases. The transformation has been such that Chinese export prices\(^3\) have moved from a situation where they were falling persistently through the 1990s and the early part of the last decade, to one where they have risen by almost 4% a year over the past five years.

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\(^3\) Export prices are measured using the export price deflator. This is a national accounts concept of inflation, which is used to convert current price (or value) export data into constant price (or volume) data.
The impact on the UK economy has been compounded by exchange rate movements. The pound had been heavily overvalued prior to the financial crisis and this strength had magnified the downward pressure on import prices coming from cheaper imports from emerging markets. However, the reverse has been true over the past five years, with costlier exports from emerging markets combining with a weaker pound. This has meant that UK import prices have risen by around 5% a year over the past five years, in contrast to deflation of 0.7% a year in the decade prior. The impact on consumer prices is clear to see from the trend in the goods element of the CPI, which is particularly import intensive; the NICE decade saw goods prices fall by 0.1% a year, yet over the period since they have risen by 2.6% a year.

Higher inflation also has domestic origins...

While external pressures have been important in explaining higher inflation rates, there has also been a marked step up in domestic inflationary pressures. This has largely come from what the Bank of England has termed “administered and regulated prices”, which covers a broad range of categories where prices are either regulated by an independent regulator or the Government, or heavily affected by Government policy, such as the rate of VAT and the level of excise duties. This group, which covers around 10% of the CPI basket, contributed around 0.4ppt to CPI inflation over the NICE decade. This contribution had been disproportionately large given its relatively small weight in the inflation basket, yet over the past five years its contribution has more than doubled to 0.9ppt a year. Three factors account for these changes:

- The two VAT rises of 2010 and 2011 are an important part of the story and account for just under a third of the contribution to inflation since 2007.
- Increases in domestic energy bills contributed a similar amount, with gas and electricity prices having risen by around 7½% a year over the past six years. This has largely been a function of rising wholesale prices, particularly for gas, but it also reflects regulatory influences, with Ofgem permitting higher charges for using distribution networks in order to pay for large-scale investment in the sector and the Government’s climate change programme having added further costs.
- Finally, education costs have also risen much more quickly because of the changes to university tuition fees. Education as a whole has a weight of just 2% in the inflation basket and university tuition fees are only a subset of this category. However, since they were introduced in 1998, the scale of the various increases in tuition fees has been so large that they have had a disproportionately large impact on inflation. The biggest change has been the autumn 2012 increase from a maximum of £3,000 a year to £9,000 a year. Though this change only affects new students, and therefore will enter the inflation calculations gradually over three years, it has been sufficient to add 0.4ppt to inflation since October 2012.

In our analysis we have included the following categories from the CPI basket: education; electricity, gas & other fuels; water supply; passenger transport by road; passenger transport by rail; sewerage collection; dental services. We have also accounted for changes in the VAT rate and the level of excise duties by taking the difference between the CPI and CPIY measures of inflation.
...though profit margins have remained under pressure

However, outside of these administered and regulated prices there is little evidence of domestically generated inflation. The steep decline in output during the financial crisis and the weak recovery since have left a large amount of spare capacity in the economy, with the output gap likely to be in excess of 5% of GDP. The impact of this spare capacity can be seen through two main channels. First, it has led to unemployment rising to close to 8%, well above historical norms, which has weakened workers’ wage bargaining power. Second, it has compromised firms’ ability to protect profit margins; the GVA deflator at basic prices, a measure of firms’ pricing power and one which excludes the impact of the changes in indirect taxes, has grown by just 1.4% a year over the past three years, more than 1ppt lower than the previous decade. This lack of pricing power has meant that corporate profitability has weakened significantly over the past few years, falling to 20.1% of GDP at the end of 2012, its lowest level for ten years.

The pickup in inflationary pressures has been relatively broad-based

Bringing these factors together, it is clear that the pickup in inflation has been relatively broad-based; as shown in the table on the next page, each of the categories that we have identified has seen its contribution to inflation increase in the past five years, relative to the ‘NICE decade’. The largest increase in contribution has come from food prices, though the strong growth in administered & regulated prices – partly a function of the two VAT rises – has also been important.

There has also been a pickup in ‘core’ inflationary pressures, something which is at odds with the weak economic backdrop. Given the weak pricing power of corporates and lack of wage growth, we attribute this to the impact of higher import prices, caused both by a weaker pound and by rising costs of goods produced in emerging markets. The fact that all of the increase in inflation has come from goods categories would appear to corroborate this idea.

Some commentators also link the pickup in core inflation to the introduction of quantitative easing. As a means of loosening monetary policy after interest rates had reached their effective floor, the Bank of England has purchased £375bn (24% of GDP) of assets – mainly gilts – from the private sector. The theory behind this policy was that the asset purchases should increase broad money holdings, push up asset prices and stimulate spending by lowering borrowing costs and increasing wealth; as a by-product, inflation would be expected to rise because of the increase in demand. The fact that this policy had been largely untried prior to 2009, as well as the difficulty in establishing a counterfactual scenario, makes it difficult to quantify the likely impact of QE on inflation. Research by Bank of England economists estimated that the first round of QE between March 2009 and January 2010 raised the level of UK inflation by around 1¼ppts at its peak, before falling back, which would seem to be a reasonable estimate. Many commentators have argued that the second round of QE, from October 2011 to October 2012, was less effective in stimulating demand than the first, which would suggest that the impact on inflation would also be smaller. But even if it was as large as the

5 Different commentators use different definitions when referring to ‘core’ inflation. Here we define it as CPI less food, petrol, energy and other administered & regulated prices
first round, together their impact would appear to be no larger than the other factors that we have analysed in this report.

### Contributions to CPI inflation

<table>
<thead>
<tr>
<th>% points per year</th>
<th>1997-2007 ('NICE' decade)</th>
<th>2008-date</th>
<th>Difference</th>
</tr>
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<tbody>
<tr>
<td>Food</td>
<td>0.3</td>
<td>0.8</td>
<td>0.5</td>
</tr>
<tr>
<td>Petrol</td>
<td>0.2</td>
<td>0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Energy</td>
<td>0.1</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td>Other administered &amp; regulated prices</td>
<td>0.2</td>
<td>0.6</td>
<td>0.4</td>
</tr>
<tr>
<td>'Core' inflation</td>
<td>0.7</td>
<td>1.0</td>
<td>0.4</td>
</tr>
<tr>
<td>CPI</td>
<td>1.5</td>
<td>3.1</td>
<td>1.6</td>
</tr>
<tr>
<td>Goods</td>
<td>0.0</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Services</td>
<td>1.6</td>
<td>1.7</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Note: Rows and columns may not sum exactly due to rounding

Source: ITEM Club

### Could measurement problems mean that inflation is being overstated?

We are also concerned that technical and measurement factors, connected with the changing structure of the economy, might be responsible for inflation being overstated. In particular, the persistent strength of services inflation, which has continued to rise by 3-5% a year despite the weakness in the wider economy, gives us cause to question the services data. While some of the other factors already stated, such as the VAT rises and increasing energy costs, will also have had some impact on services firms, labour tends to account for the bulk of their costs and the once close relationship with service sector earnings and prices has broken down.

The ONS attempts to keep up with changing trends and tastes by updating the inflation basket on an annual basis, excluding goods and services which have lost popularity (examples in recent years include photo developing and disposable cameras) and introducing newer products (such as tablet computers and ebooks). However, incorporating the rise of e-commerce presents an array of challenges. For example, rapid technological improvements mean that it is difficult to identify a ‘standardised’ product across two time periods and, therefore, it follows that it is hard to separate out genuine price increases from quality improvements. Similarly, consumers who previously used stores are increasingly accessing services through the internet – using the internet to access entertainment for free or at very low prices would be a prime example of this – and it is equally difficult to capture genuine price changes for these types of services.

It is also very difficult for the ONS statisticians to allow for discounting. For a start, they do not take account of multibuy offers nor discounts linked to customer loyalty schemes. Furthermore, the prices charged in stores can be very different to those charged over the internet and the rapid take-up of online retailing – the ONS estimates that 10% of retail sales take place over the Internet which is twice as much as 4 years ago – makes it very difficult for the ONS to keep up. These are potentially serious problems at the moment because of the changing shape of the retail sector, which is in the throes of a major shift to discounted online...
High inflation has been damaging for the UK economy...

This run of persistently high inflation has been very damaging for the UK economy, mainly through the impact that it has had on the household sector. All of the main measures of inflation have exceeded earnings growth for a large part of the past five years and household spending power, as measured by average weekly earnings deflated by CPI, has declined by 7\% since the start of 2008; this contrasts with growth of 17\% over the period from 2000-07. Coming at a time when households have also been under pressure to deleverage, the squeeze on household purchasing power has compounded the dampening effects on consumer spending.

In order to quantify the impact that high inflation has had on the UK economy, we have used the Treasury model to run a counterfactual scenario where CPI inflation was held at 2\% a year from 2010 onwards, the period over which inflation has consistently been above the target. Our modelling suggests that had inflation averaged 2\% over this period, and both monetary and fiscal policy had been unchanged, then the level of GDP would have been 24ppts higher by the end of 2012. This is mainly because of the impact on consumer spending, which we find would have been almost 4ppts higher had inflation remained in line with the target and, therefore, spending power been stronger. We also find that because growth would have been stronger with lower inflation, this would have generated improved results for the labour market, with the ILO unemployment rate falling back to around 6\% by the end of 2012, rather than nearly 8\%; this would equate to around 650,000 fewer people out of work.

...and has hampered the ability of the MPC to offer monetary stimulus

High inflation has also affected the behaviour of the MPC. The MPC has rarely been close to tightening policy over this six-year period of high inflation – the nearest it has been was in the first half of 2011 when the recovery appeared to be strengthening and three members consistently voted for higher rates. For most of this time, the MPC sought to justify its decisions not to tighten by arguing that the overshoots were temporary and by producing forecasts where inflation returned to target within two years. Latterly, it has been more explicit about its tolerance of high inflation, arguing that it has no control over the pressures from either commodity prices or administered and regulated prices; in this context the only way to keep inflation down would have been to raise rates to try and suppress domestic demand even further, which would be undesirable given how weak growth has been. Indeed, looking at the period from 2010-12, we calculate that
'core inflation' would have had to have averaged just 0.4% a year for inflation to have remained at 2%, rather than the 2.5% a year that it did average. 

In our view, the MPC has been correct to take such a view. In order to test this hypothesis, we ran a counterfactual scenario which assumed that the MPC used a Taylor rule to set policy which targeted CPI inflation of 2%. Under this scenario the MPC would have had to increase Bank Rate to 3½% by mid-2011. This would have choked off the recovery even earlier, with GDP falling by 0.3% in 2011 rather than growing by 1%. By the end of 2011, the level of GDP would have been 2½ppts below the baseline, while unemployment would have been around 625,000 higher by end-2012. Furthermore, this policy would only have been sufficient to return inflation to 2% by late-2012. 

Nevertheless, while high inflation rates have not led the MPC to tighten policy, at regular intervals the Committee has cited high inflation rates as a reason not to loosen policy any further. This has been primarily because of concerns about the possibility that they will pass through to inflation expectations and push up wage settlements, triggering a wage-price spiral. In many ways this has been the dog which hasn’t barked; surveys of inflation expectations – the value of which is very much open to question, although the MPC appears to place some weight on their results – have shown that respondents’ expectations of future inflation rates have increased over the past five years or so, moving from a range of 2½-3% to around 3½-4% now. However, this has not been reflected in wage settlements, which have rarely risen above 2% over the past few years. It could certainly be argued that the recovery would have been stronger had the MPC not allowed itself to become worried about a wage-price spiral in 2011 and had instead provided further monetary stimulus, particularly when it became clear that the recovery was beginning to falter.

**External pressures should ease a little this year...**

There are reasons to be optimistic that the pressures from rising commodity prices will ease this year. Oil prices had risen to $120 per barrel in February on the back of renewed concerns about supply due to political tensions in the Middle East, which increased the risk premia. However, oil prices have fallen back sharply in recent weeks, dropping back towards $100 per barrel and, in the absence of any further escalation in political tensions, we think it is likely to remain at this level for the remainder of the year. 

We typically see such movements in oil prices feed through to retail petrol prices after a short lag and there are signs that this is beginning to happen with data from the Department of Energy & Climate Change (DECC) showing that unleaded petrol prices fell by around 3 pence per litre in April, while more timely industry surveys suggest there have been further declines in early-May. However, two factors suggest that the impact on retail petrol prices is likely to be far more muted than the sharp decline in oil prices might imply. First, the decline in the value of the pound over the first half of this year, and the likelihood that it will drop further over the coming months given the UK’s poor relative growth prospects verses the US, means that the

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7 A Taylor Rule is a monetary-policy rule that stipulates how much the central bank should change the nominal interest rate in response to divergences of actual inflation rates from target inflation rates and of actual GDP from potential GDP.
fall in sterling terms has been smaller; for 2013 as a whole we expect oil prices to fall by 5% in dollar terms but by just 0.7% in sterling terms. Second, fuel duties and VAT account for just under 60% of the retail price of a litre of petrol, so changes in wholesale costs tend to have a proportionately smaller impact on retail prices. As such, retail petrol prices are likely to stabilise at around 135 pence per litre this year, reducing their contribution to CPI inflation to close to zero.

It is a similar picture for food prices. After the sharp rise last summer, wheat and corn prices have fallen back, while the UN and IMF measures of world food prices have declined in recent months. This, in turn, has resulted in the inflation for the food component of CPI cooling and we expect to see this trend continue over the coming months, providing that there are no unexpected weather-related disruptions to harvests this summer.

...but we’re unlikely to return to the experience of the NICE decade

Beyond this year the picture for commodities and import prices looks less clear. On one hand, the development of the shale oil and gas industries in the US raises the possibility of both a substantial increase in energy supply through the medium term and a reduction in the pricing power of the OPEC countries. Given that emerging markets are likely to continue to grow rapidly, and that increasing efficiencies in energy usage typically take time to come through, demand for oil and gas will continue to increase so such an expansion in supply would be welcome and should limit the degree to which oil prices increase. The benefits to the UK could be even greater if it is able to develop a strong shale gas sector of its own, though at present the extent of recoverable resources remains unknown.

However, on the other hand, the trend of rising prices of imported goods from emerging markets is likely to continue. China, in particular, is likely to see sustained upward pressure on wage growth emanating from the pressures of an abrupt slowdown in the growth of its labour supply – a legacy of the one child policy – as well as attempts to rebalance their economy towards consumption and the desire to head off any potential social problems caused by growing inequality. As such, we are far more likely to see Chinese export prices grow at the types of rates that we have seen since 2007, than a return to the deflation of the previous decade.

For the UK these upward pressures are likely to be compounded by the impact of a weak exchange rate. As suggested earlier, we expect sterling to continue to weaken this year and this trend is likely to continue in future years too. Weaker growth prospects vis-à-vis the US points to later, and less aggressive, tightening of monetary policy, while the on-going restructuring of the financial sector will prevent the volumes of capital inflows that had underpinned the strong pound prior to the financial crisis.

**Domestic factors also point to only a modest easing in inflation**

Domestically the picture is similar, with most factors pointing to a modest easing in inflationary pressures in the short-term, but raising questions over the ability to reduce it any further beyond that. Underlying conditions remain weak, with widespread evidence that there is plenty of slack in the economy. This is particularly true of the labour market where, despite the very strong job creation of the past year, the
unemployment rate is still almost 8%, well above pre-crisis norms. Such a large amount of spare capacity has weighed on wage settlements, with workers seemingly accepting that lower pay rises represent a good trade-off for higher levels of employment. Looking forwards we think it unlikely that unemployment will fall particularly quickly, given the weak outlook for economic growth and the pressure on the public sector to shed jobs in order to achieve the desired level of spending cuts. As such, workers’ bargaining power will remain compromised and it is likely to take several years before earnings growth returns to more normal rates of 4% or more.

All other things being equal, such weak earnings growth would imply downward pressure on inflation. However, other domestic factors will mitigate against this, in particular the persistence of high inflation rates in sectors with administered or regulated prices. With the impact of the large increase in university tuition fees feeding into the index gradually, we should see education continue to contribute 0.4ppt a year to CPI inflation until the autumn of 2015. We expect gas & electricity prices to continue to rise at relatively high rates given that the agreement around higher distribution charges in return for investment is due to last for eight years and that suppliers’ costs will be increased by the need to comply with climate change targets. Rail fares are due to rise by 3ppt above RPI until 2015, while the Government has a history of over-indexing certain duties – the so-called “sin taxes” – so these are also likely to continue to rise sharply. Therefore, while the contribution of administered and regulated prices may be smaller than in the past six years, because of the absence of any further VAT rises, it is likely to remain much higher than in the NICE decade. While the rise in tuition fees continues to feed through, we expect it to be as high as 0.7ppt a year, though it should drop back to 0.3-0.4ppt from late-2015, once the tuition fees effect has washed through.

We think it unlikely that inflation will return to 2% for the foreseeable future…

Bringing these factors together, it is clear that inflation is unlikely to slow to any great extent in the near future. Indeed, unfavourable base effects mean that CPI inflation is likely to briefly move above 3% during the summer, ensuring that one of Sir Mervyn King’s final acts will be to write to the Chancellor explaining yet another overshoot of the target. After that inflation is likely to cool, but only due to base effects with food and domestic energy bills unlikely to rise by as much as they did last autumn, and CPI inflation is expected to average 2.9% for the year as a whole.

Beyond this year we expect CPI inflation to settle close to 2½%. Though the impact of higher tuition fees will eventually fall out of the calculation towards the end of 2015, by this time we expect the economy to be growing more strongly, leading to both stronger wage growth and greater pricing power amongst firms, which will translate into firmer underlying inflationary pressures.
The ITEM Club inflation forecast
% changes on previous year unless specified

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Assumptions:
- Oil price ($ per barrel)
  - 49.6 79.5 111.3 111.7 106.0 108.1 113.0 116.3
- US$/£ exchange rate
  - 1.70 1.55 1.60 1.59 1.52 1.49 1.47 1.46
- Bank rate (%)
  - 4.33 0.50 0.50 0.50 0.50 0.50 1.02 2.02

Source: ITEM Club

...and RPI inflation will be higher still

The RPI measure of inflation tends to be higher than CPI due to differences in coverage and different methods of aggregation. Over the NICE decade RPI inflation averaged 2.7% a year, compared with CPI inflation of 1.5% a year, although this differential has narrowed over recent years, mainly because of the impact of low interest rates and a depressed housing market.

The RPI measure has come in for significant – and wholly warranted – criticism because of its in-built upward bias which means that it shows an increase in prices if they fluctuate during a period even if they return to where they were at the beginning. Over the past couple of years this so-called “formula effect” has led RPI inflation to be between 0.8-1.0pptds higher than CPI. This level of distortion is wholly unsatisfactory, particularly given how important the RPI measure is in the setting of regulated prices, as a benchmark for pay settlements and in offering investors in UK government debt protection against inflation through index-linked gilts. The recent decision by the ONS not to reform the methodology was disappointing and means that it would be reasonable to expect this 0.8-1.0pppts difference caused by the formula effect to continue in the future.
Furthermore, while the contributions to RPI inflation of both mortgage interest payments (MIPs) and housing depreciation have been smaller than usual – or even negative at some points – in recent years, they are likely to rise over the forecast horizon. Once interest rates begin to increase – assumed to be mid-2015 in our forecast – we will see an unusually large contribution from MIPs to RPI inflation because their current low level means that even a small increase in rates would have a proportionately large impact on interest payments. This effect will last until interest rates stabilise, which could mean that the gap between RPI and CPI remains wide for four years or possibly even longer. We are also optimistic that the government’s Funding for Lending and Help to Buy schemes will underpin a pickup in housing activity which should, by 2015, feed through into higher house prices. Our forecast shows house prices rising by 5% in 2015 and 6% in 2016, which will also push up the RPI measure. Taking all of these factors together, we expect RPI inflation to move above 4% by 2016. This implies a differential between RPI and CPI inflation of more than 1½ppt and, because of the influence of rising interest rates, this could easily persist for several years beyond 2016.

High inflation might tie the hands of the MPC, despite the change in remit

The likelihood that inflation will remain high has important implications for monetary policy. Recently the MPC has been more explicit about its tolerance of high inflation and the rhetoric has evolved to the extent that many expect policy to be loosened further over the coming months. Expectations of further loosening are based upon there now being three members of the MPC voting for an extension of QE and the perception that Mark Carney’s arrival in July will signal a change of direction. Furthermore, due to the constraints that he has placed on fiscal policy, the Chancellor has increasingly been looking for monetary policy to play a greater role in stimulating growth, with the changes to the Bank’s remit, announced in the Budget, clearly being a nudge in this direction.

As part of the changes, the Chancellor suggested that the MPC could offer the market forward guidance by saying that base rate would not be increased until intermediate thresholds were met, while maintaining the over-riding importance of the inflation target. However, we think that the persistence of high inflation will make it difficult to specify a more flexible system without setting up hostages to fortune. With inflation still above 2½% it would be hard for the MPC to emulate the US Fed and say that it would not increase base rate before unemployment had fallen below 6½%, with an inflation override of 2¼%. In any case, to be consistent with such guidance the MPC would need to keep rates on hold until the thresholds were reached, but wouldn’t it be expected to raise them once that happened?
It would be less risky to announce ranges for intermediate or proximate statistics like core inflation and nominal GDP which can be designed to reflect the ultimate inflation target. We made the case for the core inflation model in 2008 on the grounds that it is not directly affected by world energy and food prices and that the headline inflation rate moves back into line with the core rate once these pressures ease. Nominal GDP targeting would also be an appropriate option as it would allow the MPC to give some weight to what is happening in the real economy. It would also handle the effect of external supply side shocks very neatly, although theoretically it would result in more volatility in inflation rates. The basic idea is that a central bank can control the money value of output but not the way that this is split between real output and prices, which is determined by the private sector. The central bank can however steer the inflation trend indirectly by setting the growth in the money value of output in line with the trend in real productive potential and a medium term inflation target. If an adverse supply side shock (like a rise in world commodity prices) occurs, then output falls below trend and inflation moves above trend for a while, with the opposite happening for a favourable shock. Either way, inflation departs temporarily from trend without seriously disrupting the real economy or damaging the central bank’s reputation.

The move to a higher inflation environment also has wider implications

This transition towards an environment where inflation is permanently higher would also have implications outside of the policy sphere. In the absence of a rapid improvement in their bargaining power – a scenario that we think unlikely given the high level of unemployment and weak recovery – the household sector would be notable losers in the short-term. More persistent inflationary pressures will mean that household spending power improves only gradually, constraining the pace of the recovery in consumer spending and making it even more important that exports and business investment step up.

The likelihood of even higher RPI inflation rates, particularly now that the methodology will not be reformed, means that those industries where prices are regulated and linked to inflation should see prices increase more rapidly. We would expect companies in sectors such as energy, rail transport and infrastructure to be notable beneficiaries and the combination of persistently strong price growth and – in most cases – relatively inelastic demand is likely to make these industries more attractive to investors.

Indeed, the level of inflation is not only important in terms of the relative attractiveness of different industries; research carried out for the Investment Property Forum suggests that investors will determine the balance of assets in their portfolios depending upon their perception of the inflation environment. The research found that a higher inflation environment would lead investors to favour equities – which history shows tends to offer a better hedge against inflation – over other assets, such as commercial real estate.

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8 ‘Property and inflation’, Investment Property Forum, April 2011
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