UK inflation moved below the Bank of England’s (BoE) target in December 2013 and has remained below target since. This is after staying above the BoE’s target for 49 consecutive months.

- Current low inflation readings could be providing a misread to ongoing inflation pressures and when the first interest rate rise by the BoE will be.

- However our research suggests there are some upside pressures for inflation over the coming year.

- This risk is likely to come from a rapidly reducing output gap as spare capacity falls driven by improvements in economic growth.

- There is also the potential for wages growth to return as the unemployment rate falls to the lowest rate since December 2008.

Introduction: a background to UK inflation?

Given the recent decline in the UK unemployment rate to 6.6%, from a peak of 8.4% in November 2011, some members of the Bank of England (BoE), and also financial market participants have turned their attention to the recent falls in the UK consumer price index (CPI).

UK inflation spent five years above the BoE 2% target leading up to 2011. As shown in Chart 1 on the next page, inflation rose sharply between 2009 and 2011, driven by a sharp depreciation in the pound (leading to imported inflation), strong gains in utility prices and VAT increases. BoE analysis indicated these factors added between three and five percentage points to inflation in 2011. Over this period inflation generated by the domestic economy was very low.

UK inflation peaked in September 2011 at 5.2% and has since fallen to 1.5% as at May 2014. Much of the recent fall since June 2013 has been driven by lower petrol prices and lower household energy price inflation. Services price inflation has also fallen, with large contributions from airfares (apart from April 2014) and tuition fees. Goods prices are being held down by food prices due to a heightened amount of competition between supermarkets. UK supermarkets are attempting to compete with large Europe supermarkets on price and wearing this through lower profit margins. This impact is likely to be temporary as there are only so low prices or profits can go.

The latest reading of 1.5%/yr in May 2014 appears artificially low and more a sign of short-term factors such as supermarket competition rather than a large output gap in the economy or lower inflation expectations.
Current forecasts, encompassing BoE, IMF and Bloomberg consensus forecasts are shown in Table 1 below. Overall forecasts indicate a gradual increase for the remainder of 2014, from 1.5% now to around 1.8% at year-end before moving slightly higher in 2015 and 2016.

### Table 1: UK CPI forecasts

<table>
<thead>
<tr>
<th></th>
<th>2013A</th>
<th>2014F</th>
<th>2015F</th>
<th>2016F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of England – mean</td>
<td>2.57</td>
<td>1.80</td>
<td>1.80</td>
<td>1.90</td>
</tr>
<tr>
<td>IMF</td>
<td>2.57</td>
<td>1.90</td>
<td>1.90</td>
<td>2.00</td>
</tr>
<tr>
<td>Bloomberg consensus forecasts (YoY%)</td>
<td>2.57</td>
<td>1.80</td>
<td>2.00</td>
<td>2.00</td>
</tr>
</tbody>
</table>

However, as Chart 2 below, sourced from the BoE May 2014 Inflation Report shows, the range of modal expectations for CPI Inflation is wide and mostly to the upside for inflation over 2015, 2016 and 2017. This suggests there is potential upside risk for inflation over coming years.

### Chart 2: Modal forecasts of CPI

There are a number of factors currently in the UK economy that have the potential to impact the outlook for UK inflation both to the upside and downside over coming years.

#### 1. Sterling appreciation

Over the second quarter of 2014, the Deutsche Bank GBP Trade Weighted Spot Index appreciated 3%. Primarily this was driven by an outperformance of the UK economy versus trading partners, particularly Europe, as well as rising expectations of tightening in the Bank Rate by the BoE.

This appreciation of the Sterling over the past three months will act to temporarily depress inflation over the next year at least. This is the opposite to the experience between 2009 and 2011 where depreciation of the sterling led to downward pressure on inflation.

The exact impact on inflation will depend on the pass-through of lower prices to consumers. Given the consumer environment remains in recovery phase, it can be assumed, most of the benefit of the recent appreciation would be passed through.

Over time though, firms could use the higher Sterling to rebuild profit margins dampening the positive impact on inflation. As the Chart 3 below shows, there is the potential for import prices to fall and negatively contribute to inflation over the next 12 months.

### Chart 3: UK import prices

a) Goods and services deflator excluding fuels and the impact of MTIC fraud.

b) Domestic currency export prices of goods and services of 52 countries weighted according to their shares in UK imports. The sample does not include any major oil exporters. In 2013 Q4, export prices for Iceland, Pakistan, the Philippines, Switzerland and Turkey are assumed to grow at the same rate as export prices in the rest of the world.

With Europe the largest import originator for the UK (close to 40%), this region is expected to be close to deflation over
coming years and weaker import price pressures could also be imported to the UK adding further downside risk to inflation.

2. Capacity Utilisation

A second factor influencing the path of inflation over the coming year is capacity utilisation. According to the BoE, the central view of most Monetary Policy Committee members is that spare capacity is still probably in the region of 1%-1½% of GDP. Given recent improvements in the economy, it is expected this output gap will close again over the coming quarter.

Some elements of spare capacity have closed quickly and easily, but the remainder of this spare capacity is expected to be closed more slowly. Productivity gains are also more likely so there could be slower falls in the unemployment rate going forward as the current labour force is used more efficiently. This could lower the impact on inflation.

One critical factor will be if the closing of the output gap leads to a capital expenditure cycle and expands the capacity of the economy. At this stage, there has been some improvements in business investment with the last three quarters growth in excess of 2%, as shown in Chart 4. However, further gains could be limited by bank funding constraints and costs or a preference to rely on productivity improvements to meet additional demand.

The April edition of CBI Industrial Trends Survey did indicate that businesses are operating around normal levels and that they may need to invest to satisfy increased demands. If there isn’t additional investment, there is a risk of higher inflation pressures.

This survey also indicates that the spare capacity currently in the economy is in the labour market. The chart below shows spare capacity moving back towards levels pre-Global Financial Crisis (GFC).

Chart 4: Survey indicators or capacity utilisation (a)


3. Wages outlook / labour market slack

UK employment growth has been strong over the past eight months with jobs growth now the strongest on record. As a result, the unemployment rate has fallen from 7.6% to 6.6% over this period. This fall in the unemployment rate was accompanied by an increase in the participation rate from 63.5% to 63.8% adding to the strength of the fall in the unemployment rate and suggesting that slack in the labour market is falling. The reason for this is the number of workers hired from the long-term unemployed pool is rising.

However, part of the strength in recent months is due to underemployment in 2013, where hours worked and productivity gains were relied on to satisfy increased demand rather than new employment. It appears this has come to an end and hiring has commenced. Therefore one potential upside for inflation will be wages growth in the near future.

However, at this early stage, wages growth is contained contrary to some expectations. Average weekly earnings has been volatile in recent months given timings of bonuses but is averaging around 1.5%. One explanation for this relatively weak figure is there is a lag between a strengthening labour market and a reaction in wages. We could see some catch up in the second half of 2014 and could provide one upside to inflation.

The key factor for the wages and inflation outlook is the degree of slack in the labour market. There is no doubt this is falling given the falls in the unemployment rate. However, spare capacity in the labour market could be higher than thought due to the large amount of self-employment that has occurred in the UK.

Both Charts 5 and 6 on the next page shows that, self-employment has been a key contributor to the employment growth since 2011, accounting for one-third of the overall gain in employment. Chart 6 shows that self-employment has reached a record high of near 15% of total employment and could indicate a higher amount of labour market slack than previously thought. BoE research1 shows that between 2008 and 2013, one-fifth of those that became self-employed moved to a job at a company within one year.

Research also indicates that self-employed are working fewer hours than desired and suggests with a pick-up in the UK economy and employment conditions, some of this self-employed pool could re-join those employed by businesses.

(a) Measures are produced by weighting together surveys from the Bank’s Agents (manufacturing and services), the BCC (non-services and services) and the CBI (manufacturing, financial services,

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1 BoE May Inflation Report.
4. Outlook for profit margins

One upside risk to inflation centres on businesses aiming to rebuild profit margins which remain at pre-GFC levels. This could either occur through a stronger sterling, with the risk being UK corporates aiming to rebuild margins by not passing on price falls.

At this stage, intelligence from the BoE’s liaison program suggests most businesses anticipate that a rise in margins will come about through further cost reduction and productivity but will only rise gradually. In various Confederation of British Industry business surveys, companies expect to instigate only modest price rises over the next twelve months, helping to hold down some possible pricing pressures.

5. Inflation expectations

One critical factor for the inflation outlook is inflation expectations. At this stage, inflation expectations remain well anchored and are moving roughly in-line with headline inflation. Chart 7 shows the correlation between the UK CPI and the GfK Current Inflation Expectation – next 12 months.

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Chart 5: Contributions to the change in whole-economy employment since Q2 2008

- Rolling three month measure. First data point is June 2008. Contributions may not sum to total due to rounding.
- Comprises unpaid family workers and those on government supported training and employment programmes classified as being in employment.


Chart 6: Self-employment share of employment

- Percentage of LFS total employment. Rolling three-month measure. First data point is May 1992.


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Inflation expectations did move higher with the increase in UK CPI over 2010, 2011 and 2012 but has fallen since to 2.6% and should continue to fall.

As seen in Table 2 on the next page, other measures of inflation expectations are falling but remain elevated, particularly in the long-term 5-10 year measure of inflation expectations, providing some upside risk to inflation over the medium term.
Table 2: Indicators of inflation expectations (a)

<table>
<thead>
<tr>
<th>For sent</th>
<th>2009 (Q4 avg)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2011</td>
</tr>
<tr>
<td></td>
<td>Q1</td>
</tr>
</tbody>
</table>

| Cityyear-ahead inflation expectations | 2.5 | 3.4 | 3.8 | 3.5 | 2.6 | n.a. |
| Bank of England | 2.8 | 2.2 | 2.1 | 2.6 | 2.2 | n.a. |
| Eurozone banks | 2.2 | 3.4 | 2.7 | 2.7 | 2.2 | 2.0 |
| YouGov/CitiGroup (Nov. 2009) | 2.5 | 3.0 | 3.4 | 2.6 | 2.1 | 2.0 |
| Companies | 0.5 | 0.7 | 0.6 | 0.4 | 0.7 | n.a. |
| Financial markets (Oct. 2009) | 2.6 | 2.9 | 2.1 | 2.6 | 2.9 | 2.9 |

| Three to five years ahead expectations | 2.5 | 3.0 | 3.4 | 3.1 | 3.3 | 2.8 | n.a. |
| Bank of England (2009 Q4) | 3.2 | 3.4 | 4.0 | 3.8 | 3.2 | 2.7 | n.a. |
| Eurozone banks | 2.2 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| Financial markets (Oct. 2009) | 2.5 | 3.0 | 3.0 | 2.9 | 3.2 | 3.1 |

| Five to ten year ahead expectations | 3.5 | 3.8 | 3.8 | 3.4 | 3.6 | 3.2 | n.a. |
| Bank of England (2009 Q4) | 3.9 | 3.8 | 3.9 | 3.8 | 3.6 | 3.6 | n.a. |
| Eurozone banks | 2.5 | 2.4 | 2.4 | 3.5 | 3.0 | 2.9 |
| Financial markets (Nov. 2009) | 3.0 | 2.6 | 2.5 | 2.1 | 2.5 | 2.4 |
| Average | 3.6 | 3.1 | 3.5 | 3.0 | 2.9 | 2.4 |

(a) Data are non seasonally adjusted.
(b) Dates in parentheses indicate start date of the data series.
(c) Financial markets data are averages from 1 April-7 May.
YouGov/CitiGroup data are for April.
(d) The household survey ask about expected charges in prices but do not reference a specific price index, and the measures are based on the median estimated price change.
(e) CBI data for the manufacturing, business/consumer services and distribution sectors; weighted together using nominal shares in value added. Companies are asked about the expected percentage price change over the coming twelve months in the markets in which they compete.
(f) Instantaneous RPI inflation one year ahead implied from swaps.
(g) Bank’s survey of external forecasters, inflation rate three years ahead.
(h) Instantaneous RPI inflation three years ahead implied from swaps.
(i) Five-year, five-year forward RPI inflation implied from swaps.

Source: BoE May Inflation Report.

Conclusion

In conclusion, research suggests that while inflation is currently at the lowest level since October 2009, there are upside risks to suggest inflation will move back up towards the BoE target. Any upside surprises to inflation over coming months could quicken the first Bank Rate hike by the BoE, especially if there are emerging signs of wages pressure, or if we see the BoE revise lower their view on spare capacity.

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