



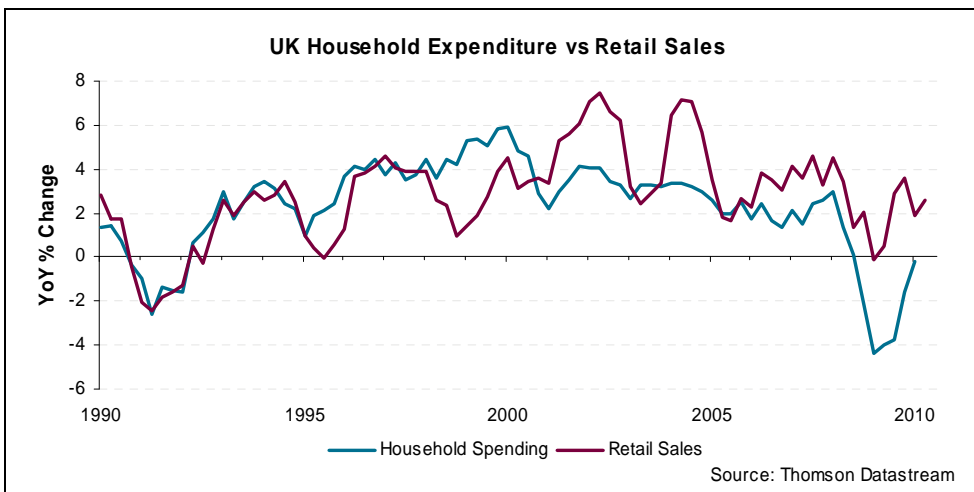
Solving the riddle of persistently higher-than-target inflation

Policy makers and economists have been faced by a conundrum over the past couple of years: why has inflation remained so high when growth has been so weak? Conventional economics would lead to the opposite conclusion – that against a weak economics backdrop, inflationary pressure would tend to diminish. And, indeed, this is exactly what the Monetary Policy Committee of the Bank of England has been assuming. In the fourth quarter of 2008, the consensus view on the MPC was that, based on market interest rate expectations, CPI inflation would have fallen to 1.7% by the fourth quarter of 2009, compared to the then prevailing rate of 4.9% (the latest data available when the forecast was made was for the third quarter of 2008). In fact, the inflation rate in the final three months of 2009 averaged 2.1%. In other words, the MPC thought that inflation would fall appreciably below the 2% target rate as the recession began to bite, whereas it ended the year slightly above target, despite the weakness in the economy being considerably greater than expected and also despite a cut in the VAT rate, which had not been announced when the MPC made its forecast.

In the *Inflation Report* published in November last year, the MPC predicted that inflation in the second quarter of this year would be 2.3%; in fact, it was 3.4%. Again, the higher outturn has occurred despite growth being weaker than predicted. Looking to future expected inflation, at one stage the MPC was predicting that it would be as low as 0.5% in the first quarter of 2011. In its latest forecast, that had been raised to 3.0%.

For one member of the MPC, higher than expected inflation has caused a policy rethink. Although he is alone in his views, Andrew Sentance has voted at the most recent three MPC meetings for interest rates to be raised a notch. His concern is that higher inflation will become embedded in expectations. To be fair, there is little sign of this happening as yet, at least not in wage demands. In fact, the very low rate of increase in average earnings is one of the reasons that we believe that economic activity could decelerate over the next few quarters, since in real terms, average incomes are falling appreciably. So, for the time being, Andrew Sentance is likely to remain a lone voice, and interest rates are likely to remain at their current low level despite inflation being significantly above target (the current rate is 3.1%).

But this still leaves us with the conundrum: why has inflation remained so high during 2010, and should we be worried? I believe that there are two fairly simple explanations for recent trends; I also think that inflation could moderate in 2011 more appreciably than widely expected.



First, but of probably lesser importance, it is evident that there have been a number of pressure points that have caused inflation to be higher than the MPC expected. Most obviously, transport costs have risen very sharply, mainly, although not only, as a consequence of rising fuel prices. The average year-on-year increase in transport costs in the first seven months of this year was 10.1%. More generally, cost pressures in the economy have risen due to earlier weakness in sterling.

Even so, it remains evident that the general price environment has been more inflationary than might have been expected, and this leads us to a second and more interesting explanation. The peak to trough fall in GDP during the eighteen months to the third quarter of 2009 was 6.4%. Over the same period, household final consumption (including net tourism) fell 5.0% in real terms. Nothing surprising here. However, retail sales (excluding petrol) posted a rise in volumes of 2.3% over the same period. During 2009 as a whole, household spending fell 3.4%, while retail sales (ex-fuel) rose 1.7%.

What seems to have happened within consumption trends is that households were very focused on the way they economised. For instance, spending on air travel fell very sharply. On the other hand, helped by the cash flow boost from falling mortgage interest rates, day-to-day high-street spending continued to grow – witness a 4.8% rise in spending on clothing and footwear (in real terms). Clearly, the overall environment for household spending in 2008 and 2009 was not propitious. Nonetheless, as we have commented many times, households were not under as much pressure as is normally the case during a downturn. The crucial contrast can be seen between the meagre 0.1% rise in average earnings in 2009 and the 3.2% increase in disposable income – the former being wholly consistent with the downturn and the latter reflecting largely the impact of falling interest rates.

So, despite being in the midst of the deepest recession in living memory, households were able to continue to grow their retail spending levels. This contrasts with the situation during the early 1990s recession when retail sales fell very much in line with household spending. The consequence has been that the high street has not been as competitive as it might have been, and retailers have had more pricing power than might have been anticipated, given the wider economic backdrop. Hence, inflation has remained higher.

So, what does this imply for 2011? As noted above, households are currently being squeezed by CPI inflation rates that are considerably higher than the pace of growth in incomes. As the benefits from lower mortgage rates begin to diminish, this will have a greater impact on disposable incomes. The consensus view is that total household disposable income will grow by 0.3% in real terms next year. On the basis of current trends, even this looks too optimistic. According to current official data, in the first quarter of this year, real disposable income was still 2.1% higher than a year earlier. However, the position from here is likely to have deteriorated, and during the second half of 2010 as a whole, it seems probable that real disposable income will be around 1.5% lower than in the same period of 2009. Likewise, it seems probable that this will begin to impinge more heavily on high-street spending as we move towards the year end, leading to the possibility that total household spending will actually decline in real terms during the quarters around the turn of the year – a trend that will not be helped by the impending rise in VAT.

If this view proves correct, then inflation trends are likely to become more benign as we move through 2011. Generally speaking, trends in demand tend to feed through to inflation with a lag of three to four calendar quarters. So, weaker growth (or possible falls) in household spending will most likely be reflected in more competitive high-street pricing in the second half of 2011. This suggests that the MPC will feel it appropriate to remain in its over-easy mode for a considerable period to come.

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