European Economics Analyst

UK Inflation—Higher for Longer (Quadri)

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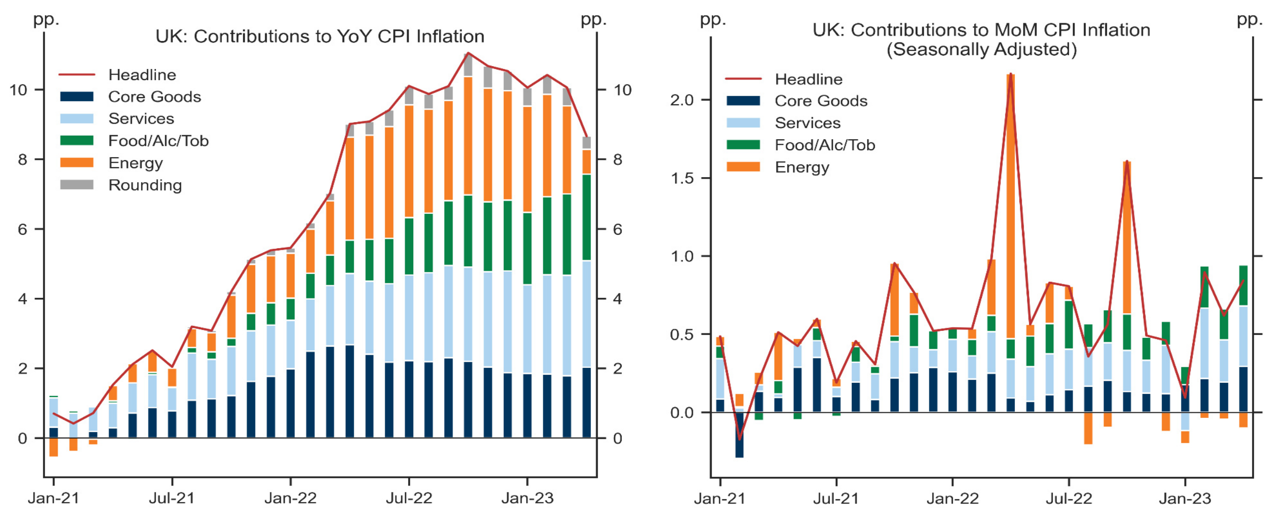
- The April inflation print delivered yet another upside surprise on the back of a broad-based re-acceleration in core pressures. In this *Analyst*, we take stock of inflationary pressures across the major inflation components and update our outlook for UK inflation.
- Starting with energy, electricity and gas prices have continued to decline in recent weeks and household energy bills are set to decline by 17% in July. Taken together with the expectation of energy bills remaining broadly flat thereafter (based on latest energy forward curves), energy inflation should decelerate sharply in H2, especially in year-over-year terms.
- Food inflation, on the other hand, remains at record levels and has shown limited signs of slowing so far. Our analysis suggests that this strength in food inflation has largely been due to high input costs being faced by food producers as supply bottlenecks, the conflict in Ukraine, and adverse weather shocks pushed up energy and agricultural commodity prices sharply higher. More recently though, commodity and energy prices have declined, and this has been accompanied by a meaningful decline in food input PPI. Going forward, we therefore expect sequential food inflation to moderate, albeit at a more gradual pace.
- Turning to core inflation, indicators of global supply constraints have eased notably recently and point towards a slowing in core goods inflation going forward. That said, we also find that sequential core goods pressures have historically tended to be very sticky, which suggests that near-term goods inflation may remain elevated for a while. We expect services inflation to stay elevated for longer, however, largely because we remain concerned about wage growth not cooling sufficiently and sustainably over the medium term.
- Taken all together, we revise up our core inflation forecast further, and now expect core inflation at 6.0%yoy (vs 5.6%yoy previously) in December 2023 and at 3.3%yoy (vs 2.9%yoy previously) in December 2024. Taken together with a lower energy price cap forecast but a more gradual decline in food inflation, we keep our end-2023 headline inflation projection unchanged at 4.7%yoy but revise up our end-2024 headline inflation projection to 3.2%yoy (vs 2.7%yoy previously).
- Our analysis reinforces our view that resilient growth, a tight labour market, and persistent inflationary pressures will convince the MPC to deliver significant

additional tightening. We maintain our forecast of two further 25bp hikes at the upcoming June and August meetings for a terminal policy rate of 5%, but see risks to our terminal rate forecast as skewed to the upside.

UK Inflation—Higher for Longer

The April inflation print delivered yet another upside surprise as sequential core pressures re-accelerated sharply. And while headline inflation moderated on the back of falling energy contribution, food inflation—which in both sequential and year-over-year terms has recently been running at its highest level on record—ticked up even further, thereby surprising both consensus and BoE's projections meaningfully to the upside (Exhibit 1).

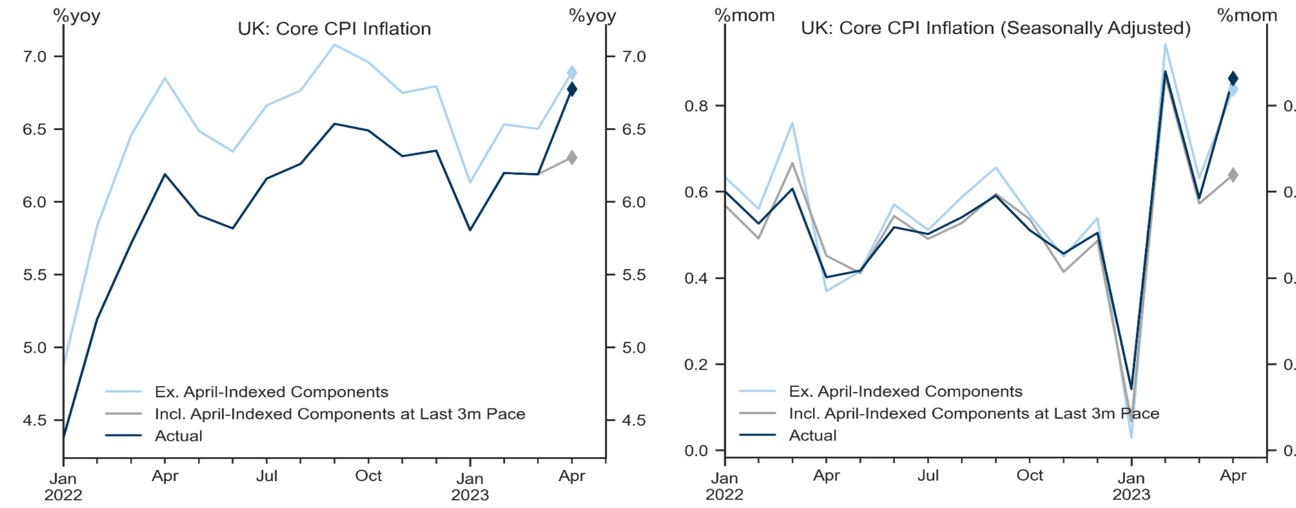
Exhibit 1: Sequential Pressures Re-accelerated in April



Source: Goldman Sachs Global Investment Research, Haver Analytics

While part of the increase in the sequential pace last week was accounted for by the so-called April effect, the overall acceleration was far more broad-based. Specifically, April tends to be a month where several household services prices—such as rents and telephone bills—in the UK are reset higher (via inflation indexation). However, as illustrated in Exhibit 2, core inflation excluding such components also increased sharply and overall core inflation would have accelerated even if these April-specific components had increased at the pace observed over the last three months.

Exhibit 2: The Acceleration in Sequential Pressures Was Broad-Based Across Core Components



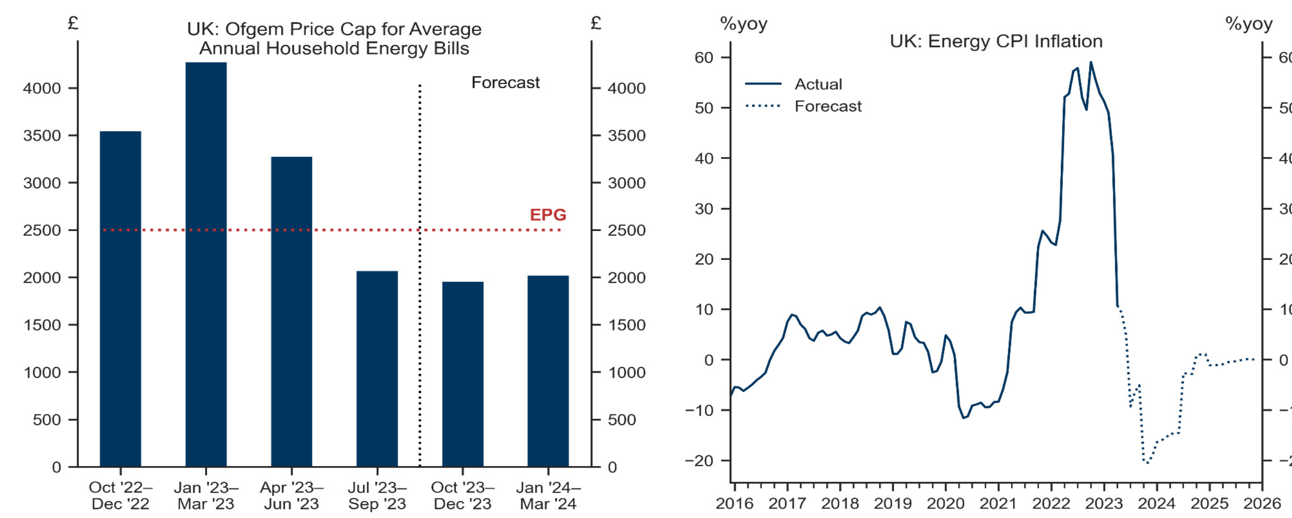
Source: Goldman Sachs Global Investment Research, Haver Analytics

In this *Analyst*, we take stock of inflationary pressures across the major inflation components and update our outlook for UK inflation.

Energy Inflation

Energy prices have continued to decline in recent weeks, and the Ofgem recently announced that average household energy bills will be capped at £2,074 (annualized) in Q3, implying a 17% fall in household energy bills in July. Based on the latest energy forward curves, the Ofgem price cap is expected to remain broadly flat thereafter until Q1 next year, which in turn should imply a sharp deceleration in headline inflation in H2, especially in year-over-year terms (Exhibit 3).

Exhibit 3: Energy Inflation Should Continue to Decelerate Sharply

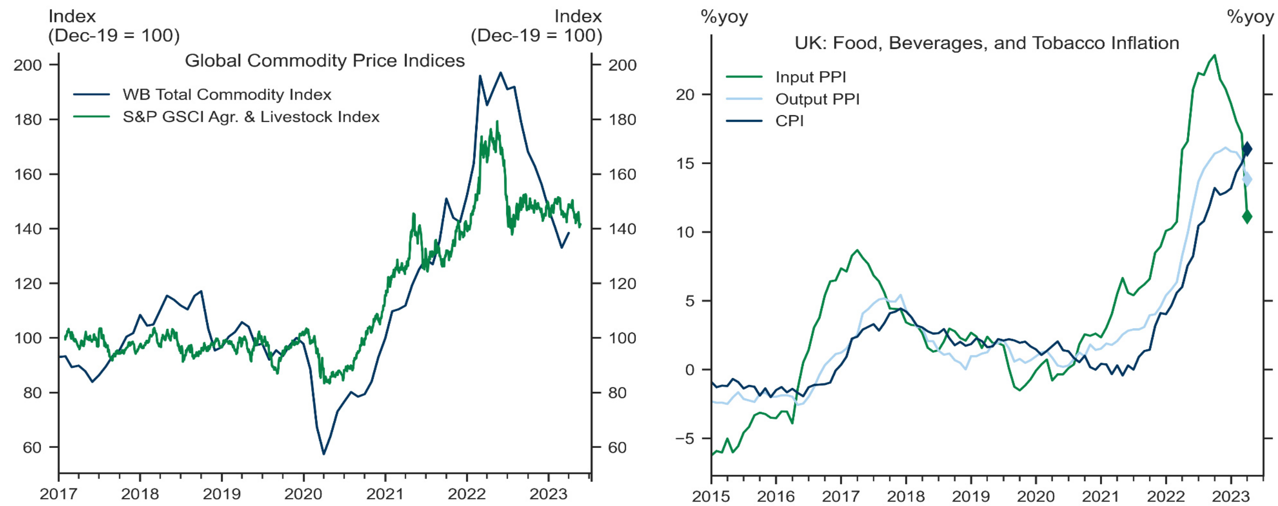


Source: Goldman Sachs Global Investment Research, Ofgem, Haver Analytics

Food Inflation

Food inflation, on the other hand, remains at record levels and has shown limited signs of slowing so far. The strength in food inflation is largely due to the high input costs being faced by food producers. As illustrated in Exhibit 4, food input PPI increased sharply over the past two years, as supply bottlenecks, the conflict in Ukraine, and adverse weather shocks pushed up energy and agricultural commodity prices sharply higher. More recently, commodity and energy prices have declined, and this has been accompanied by a meaningful moderation in input PPI, suggesting that food CPI inflation should moderate going forward.

Exhibit 4: Food Inflation Remains Remarkably High but Forward-Looking Indicators Point Towards Slowing in the Pipeline



Source: Goldman Sachs Global Investment Research, Haver Analytics, Bloomberg

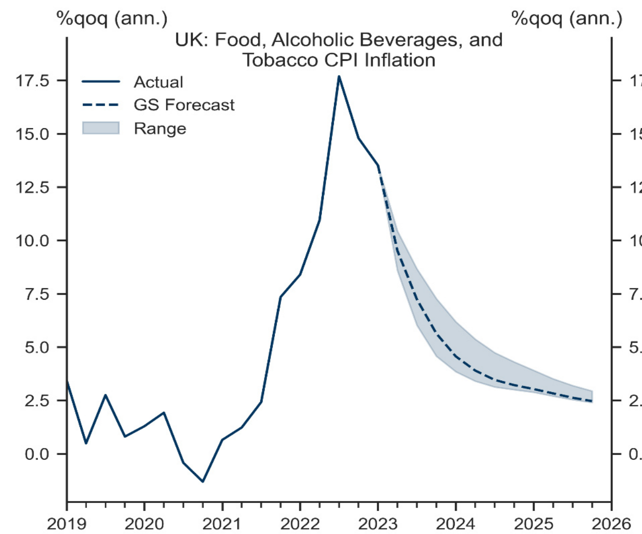
To gauge the outlook for food inflation, we start by regressing sequential food input PPI inflation on its lags, agricultural commodity prices, and the trade-weighted exchange rate. Next, we regress sequential food output PPI and CPI inflation on their respective lags, and on input PPI and output PPI inflation, respectively.

We see three main takeaways from this analysis. First, as expected, global commodity prices and exchange rate movements tend to be important drivers of food inflation. Second, the statistical significance of the lag coefficient suggests that food inflation can be somewhat sticky. Third, sequential food CPI inflation tends to follow sequential food input PPI inflation with a lag of around two quarters (Exhibit 5, left). This is consistent with what was observed in 2017 when input PPI peaked in April 2017, but food CPI continued to increase until its peak in December 2017 (Exhibit 4, right).

Going forward, given the recent moderation in global commodity prices as well as in food input PPI, we expect sequential food CPI inflation to also moderate going forward—albeit at a more gradual pace—from 13.5%qoq (annualized) in Q1 to 6.7%qoq by Q4 (Exhibit 5, right).

Exhibit 5: We Expect Food Inflation to Moderate Going Forward

UK: Food Inflation Regressions (%qoq, ann.)	Input PPI	Output PPI	CPI
Lag	0.463*** (0.098)	0.224*** (0.076)	0.199*** (0.069)
Commodity Prices	0.121*** (0.019)		
Exchange Rate	-0.193*** (0.038)		
Input PPI		0.528*** (0.052)	
Output PPI			0.666*** (0.048)
Constant	1.167** (0.522)	0.308* (0.169)	0.811*** (0.283)
R-squared	0.582	0.861	0.701
Observations	106	105	107

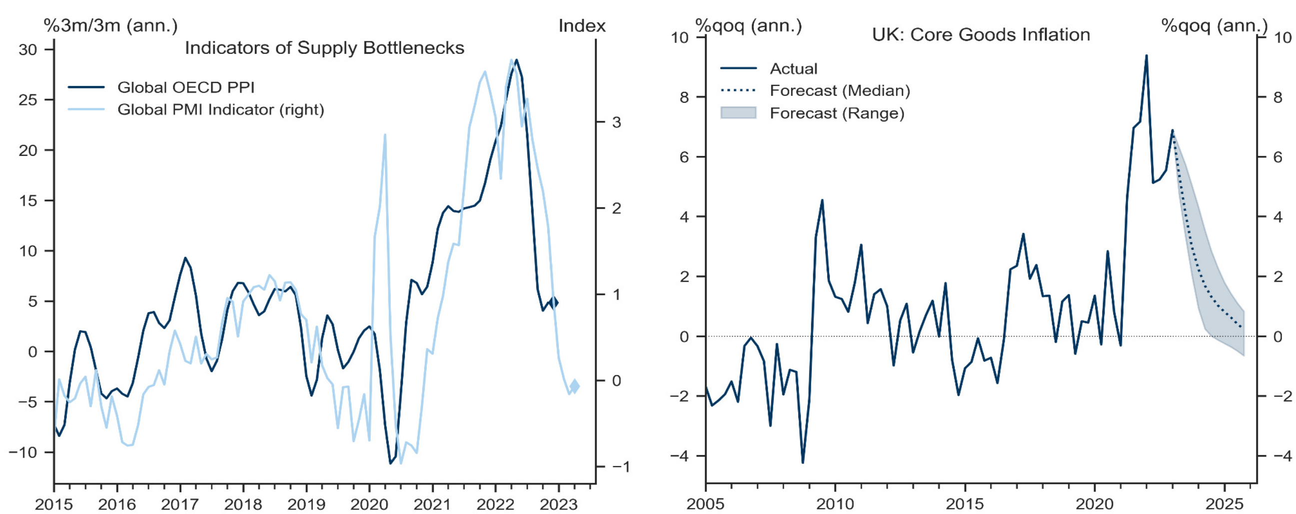


Source: Goldman Sachs Global Investment Research, Haver Analytics

Core Goods Inflation

Turning to core goods, we recently noted that pandemic and supply bottlenecks have been a significant driver of the strength in core goods inflation over the past year, and that easing supply constraints are likely to weigh down on goods inflation meaningfully going forward. But at the same time, we also found that sequential core goods pressures have historically tended to be very sticky, suggesting that near-term pressures may remain elevated for a while. All told, we expect sequential core goods inflation to slow from 6.9%qoq in Q1 to 3.7%qoq by Q4 (Exhibit 6, right).

Exhibit 6: Near-Term Persistence, Medium-Term Slowing in Core Goods Inflation

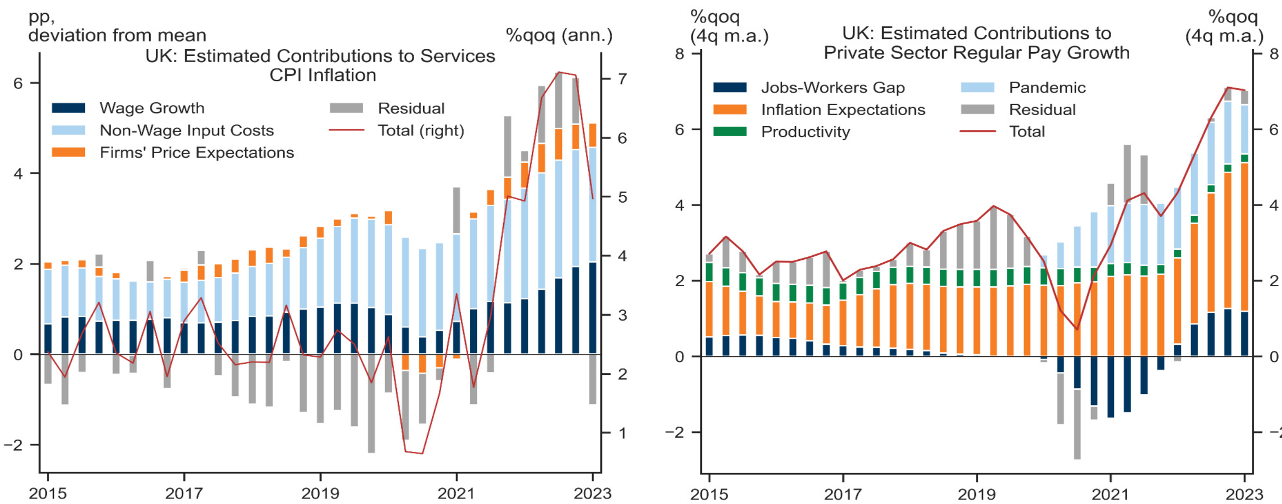


Source: Goldman Sachs Global Investment Research, Haver Analytics

Services Inflation

The outlook for services inflation—which is considered as a proxy for domestic inflationary pressures—remains concerning, however. In recent research, we had highlighted that the recent strength in services inflation had been driven largely by a mix of remarkably high wage growth and non-wage cost increases (Exhibit 7, left). Such high wage growth has, in turn, been driven by a combination of elevated inflation expectations and a tight labour market (Exhibit 7, right).

Exhibit 7: Drivers of Services Inflation

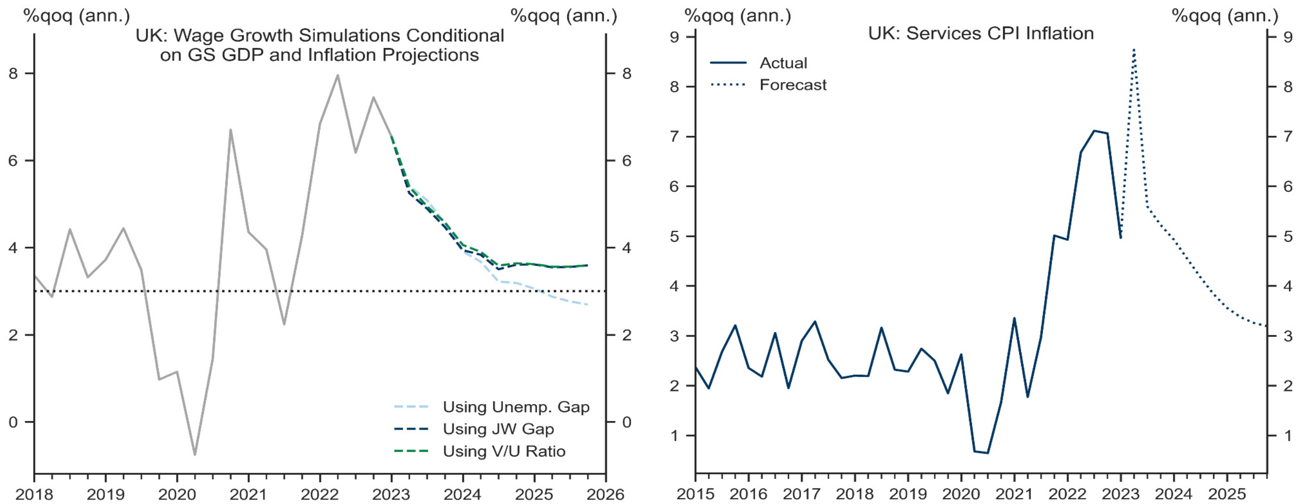


Source: Goldman Sachs Global Investment Research

As headline inflation decelerates this year, we would expect inflation expectations and, in turn, wage growth to also moderate. Indeed, our composite measure of long-term inflation expectations has already declined meaningfully from the peak observed late last year and is now tracking at just above its historical average, and wage pressures have eased somewhat as well.

But given the tightness in the labour market, we remain concerned about the risk of wage growth not cooling sufficiently and sustainably over the medium term. Indeed, as we have noted recently, wage Phillips curve estimated using broader slack measures such as the jobs-workers gap and vacancy-unemployed ratio—which have tended to perform better in explaining the recent strength in wage growth—point towards wage growth flattening at around 3½% by end-2025 (Exhibit 8, left). Accordingly, we expect sequential services inflation to remain elevated at 5.2%qoq by Q4, lower than the 7.1%qoq pace observed in 2022Q4 but above the 5.0%qoq pace observed in 2023Q1 (Exhibit 8, right).

Exhibit 8: We Expect Services Inflation to Remain Elevated Through 2023

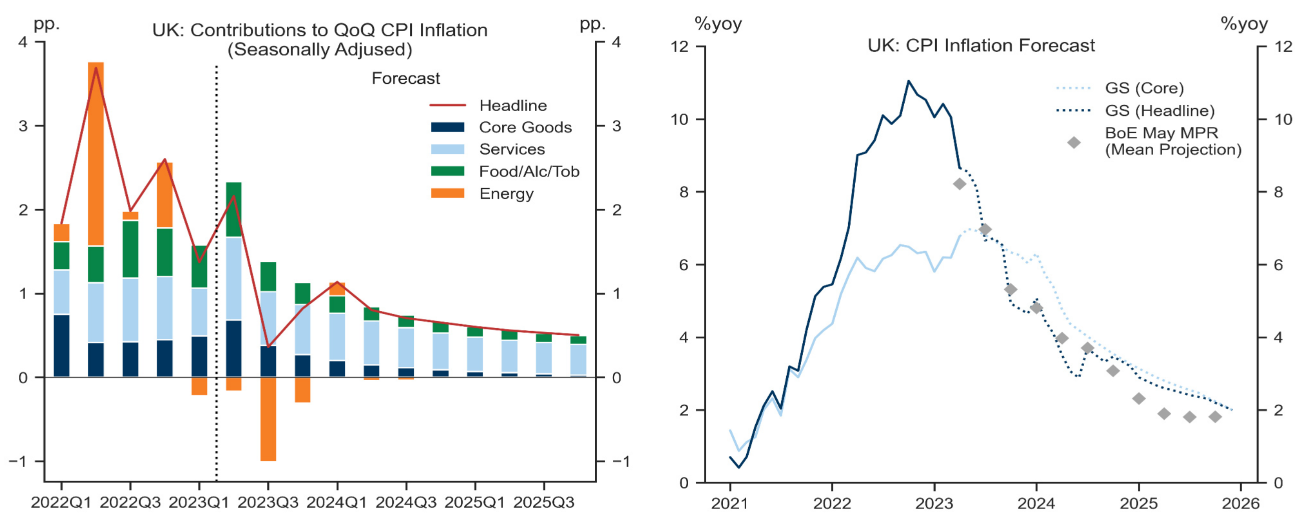


Source: Goldman Sachs Global Investment Research, Haver Analytics

Pulling It All Together

Taken all together, we revise up our core inflation forecast further, and now expect core inflation at 6.0%yoy (vs 5.6%yoy previously) in December 2023 and at 3.3%yoy (vs 2.9%yoy previously) in December 2024. Taken together with a lower energy price cap forecast but a more gradual decline in food inflation, we keep our end-2023 headline inflation projection unchanged at 4.7%yoy but revise up our end-2024 headline inflation projection to 3.2%yoy (vs 2.7%yoy previously).

Exhibit 9: Persistent Inflationary Pressures



Source: Goldman Sachs Global Investment Research, Haver Analytics, Bank of England

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Ibrahim Quadri

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