17 August 2024

UK in Focus

Economics
United Kingdom

Muddy waters

- Services inflation falls but goods price pressures re-emerging
- Robust growth in Q2 despite soft household consumption
- Unemployment rate falls and wage growth is elevated

Time for services inflation to take the lead

An easing of energy base effects nudged the headline inflation rate up to 2.2% in July from 2% in the prior month. The rise was expected but it does, along with a rise in 'core' goods – that excludes energy and food – highlight that the goods price disinflation that pulled downward on the headline rate has run its course. From here there is greater need for a moderation in services inflation to keep headline CPI sustainably at 2%. There was good news on that front: services price inflation fell to 5.2% in July from 5.7% previously. However, we see domestic price pressures easing only slowly, with services inflation ending the year around 5%. And as such, headline inflation will temporarily rise further in the coming months.

Household consumption is yet to bounce back

The UK economy grew a further 0.6% q-o-q in Q2 after a 0.7% rise in Q1. However, households continued to show a degree of caution and consumption rose 0.2% q-o-q. Instead, growth was largely driven by higher government consumption and public sector investment in the quarter. Such dynamics do raise questions as to how sustainable the current growth rates are. While there is potential for households to boost spending as real incomes recover, for now, they seem to be adjusting to the higher cost of living – retail sales volumes in July rose a modest 0.5% and are up just 0.8% y-o-y.

An uncertain labour market makes for an uncertain policy outlook

The rate of unemployment unexpectedly fell in the 3-months to June to 4.2%, down from 4.4% previously. We are not convinced by this sharp reversal: Q2 growth may back it up but redundancies rose, vacancies fell further, and while hiring intentions have picked up surveys point to slower jobs growth. Meanwhile, pay growth momentum remained elevated.

What does this mean for the path of interest rates? Well, if this apparent bounce back in labour market tightness does persist, perhaps driven by higher inactivity rather than higher employment growth, some MPC members may become rate cut shy. However, if inflation continues at least in line with their forecasts or household consumption growth stays subdued, the committee could judge that monetary policy is too restrictive despite a tighter labour market. What is certain is that the waters are well and truly muddied, and policymakers will likely prefer to see another round of data before making any decisions. Next BoE policy meeting is on 19 September.

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Disclosure appendix

Important disclosures

Additional disclosures

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