For the UK, Is the Real Risk Above- or Below-Target Inflation?
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SUMMARY

- Non-energy goods prices have risen steadily over the past six to nine months, while service sector inflation has been more benign. Some might argue that without a pickup in service sector inflation, the bank could face an undershoot of the 2% inflation target in two to three years' time.
- A cyclical (short-term) rise in productivity is possible, based on the view that productivity improves as resources become scarce, but a secular (longer-term) return to 2% productivity growth does not appear likely.
- Assuming that the Brexit negotiations do not heavily disrupt the UK economy and that underlying momentum continues to tighten labor market conditions, we would expect to see some modest upward drift in wages as the pool of workers shrinks and employees feel more confident about asking for a raise. This in turn could lead to a rise in domestically generated inflation over the next few years.

In its recent quarterly inflation report, the Bank of England gave the market some fascinating insights into the challenges it will face in setting appropriate monetary policy over the coming years. In particular, the bank will need to weigh the risk posed by the current period of above-target inflation against the medium-term challenge of maintaining inflation at the 2% target.

Too much or too little?

Given the current above-target inflation and better-than-expected GDP growth, the report’s primary focus (not unreasonably) was on how much inflation overshoot the bank is willing to accept and how quickly it expects inflation to move back toward the 2% target. We would agree with the bank’s forecasts that Consumer Price Index (CPI) inflation will rise toward 3% by the end of the year before slowly drifting back toward 2% over 2018 and 2019. Similarly, the bank expects UK GDP growth to weather the Brexit-related uncertainty and average 1.75% over the next two to three years, which should support a narrowing of the output gap and thus medium-term wage growth and domestic prices.

However, as we look two to three years out, is inflation risk still skewed to above-target prints, or will
the UK (like many other developed markets) instead find itself with the challenge of below-target inflation? As my colleague Tiffany Wilding pointed out in a recent PIMCO Blog post, even the U.S. economy looks on track to undershoot its inflation target, despite continued improvement in employment growth and historically low unemployment. Similarly, Europe and Japan are exhibiting very benign underlying inflationary pressures despite historically low measures of unemployment. Can the UK buck this trend over the medium term, or will it succumb to the same global forces? And what are the implications for UK monetary policy, and for asset prices more broadly?

Starting with the here and now, the Bank of England’s assessment is that the current rise in inflation can be explained by the pass-through effect on import prices of the 10% drop in the pound sterling following the Brexit vote last June. One way to look at this is to separate the rate of inflation in non-energy goods prices, which tends to be correlated with import prices, from service sector inflation, which tends to be more reflective of domestic price pressures (see Figure 1).

Figure 1: Sharper price movements for UK non-energy goods than for services

[Graph showing price movements for UK non-energy goods and services]

Already the picture becomes much clearer. While prices for non-energy goods have risen steadily over the past six to nine months, price movements in the service sector have been much more benign. With the exception of some volatility around the Easter holiday in April, service sector inflation has remained steady between 2% and 3%. This would certainly support the view that there is little sign of any secondary effects putting sequential upward pressure on the inflation rate. Indeed, one might argue that without some pickup in service sector inflation, the challenge facing the bank in two to three years’ time could be a potential undershoot of the 2% level. The weight on wages
The most likely route to a medium-term rise in domestically generated inflation seems to lie with the labor market. The UK unemployment rate has fallen steadily from a peak of 8.5% in late 2011 to just 4.6% today – below the pre-crisis low of 4.7%, and a level last seen in 1975! However, unlike in the pre-crisis period, wage growth has not accelerated this time around. Earnings growth has averaged 2.4% annually over the past six to seven years and has shown no upward drift (see Figure 2).

Observers have offered a number of explanations for the sluggish wage growth. Perhaps the relationship between wages and unemployment has broken down completely. Or the unemployment rate that would generate upward pressure on wages is comfortably below the current 4.6%. Maybe workers are still feeling the legacy effects of the post-crisis period and are not yet emboldened to demand higher wages. It could be that the labor market has become more efficient. Or, more simply, companies just cannot afford sharper wage growth.

Of these, we believe there is more support for the arguments related to the labor market’s flexibility and employees’ low perceived bargaining power than for pressure on corporate finances. For example, UK GDP data show that compensation to employees has grown by 3.0% annually over the past five years compared to a 20-year average of 4.45%, whereas UK corporations’ profitability (as measured by their gross operating surplus) has grown 3.5% annually over the same period compared to a 3.1% 20-year average. If these patterns hold, and if the economy continues to grow above trend, then we should start to see higher wage growth over the next two to three years as the pool of available workers shrinks further and employees start to feel more confident about asking for a pay raise. The caveat, of course, is that one could have made the same argument for several years now.

**Productivity to the rescue?**

So what are the risks around this expectation for some modest upward drift in wage settlements and
domestic prices in the years ahead? The area that gets the most attention is productivity growth, which has barely budged for the last five years (see Figure 3). It’s possible that we’ll see a cyclical (short-term) rise in productivity, based on the view that productivity improves as resources become scarce, but a secular (longer-term) return to 2% productivity growth does not appear likely. Clearly, an uptick in productivity would be good news for potential wage settlements, and without putting upward pressure on inflation – a welcome development for the economy as a whole.

**Figure 3: UK productivity growth has been stagnant**

![UK productivity growth chart]

Source: Office for National Statistics as of 30 April 2017

**An amiable Brexit?**

Less favorable domestic risks tend to revolve around the UK’s Brexit negotiations. Our current view is that the negotiations will likely yield some sort of cooperative outcome. This is based on the UK’s apparent willingness to walk away from a “bad deal,” which provides some negotiating leverage (the UK is not necessarily a “price taker”), and the so-called “Brexit Bill.” Moreover, logic suggests that as long as European policymakers can demonstrate that the UK would not have all the same privileges post-Brexit that it had with full EU membership, they would not want to risk a disruptive outcome just as the outlook for European growth is looking better.

That said, politics is not always logical, and the risk remains that negotiations may not proceed in a
cooperative fashion and that firms may start to assume that the UK will revert to World Trade Organization (WTO)-style trading arrangements. This could easily lead to a self-fulfilling disruptive separation. Such an outcome, and the ensuing slowdown, would do little for UK employees’ bargaining power and could skew the longer-term inflation forecast toward an undershoot of the 2% target – not our base case, but a material risk nonetheless.

**Key takeaways**

So given the various potentialities, what is our central expectation, and how does our outlook compare to broader market expectations? Starting with the view that the Brexit negotiations will not heavily disrupt the UK economy and that underlying momentum will continue to sequentially tighten labor market conditions, we would expect to see some modest upward drift in wages and in turn in domestically generated inflation over the next few years.

If this scenario comes to pass, we would agree with Governor Carney’s comments that the slope of the UK yield curve – the so-called “term premium” – seems to be on the low side. Ten-year gilts are currently yielding 1.07%, and market-implied expectations for the first hike in interest rates is mid-2019, coincident with the deadline for concluding Brexit negotiations. Moreover, with a period of above-target inflation upon us and official interest rates already near the zero lower bound (at 0.25%), the flatness of the UK yield curve does seem somewhat anomalous. With interest rates on intermediate U.S. bonds a full 1.15 percentage points higher, there appears to be a bigger inflation hedge in the U.S. bond market than in the UK.

Circling back to our initial question: How might the Bank of England respond to the near-term inflation overshoot or a longer-term undershoot, and which will prove the bigger challenge? We think the bank is correct to look through the current bout of above-target inflation. We see no signs of second-round effects, as evidenced by the benign domestic inflation backdrop and low and stable wage settlements. The direction of medium-term inflation risks remains an open question, so for now, we believe the bank is right to wait for further clarity.

**DISCLOSURES**

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