UK inflation data could portend a soft landing ahead

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The latest data showing UK inflation at 7.9 per cent in the year to June was a welcome break from the past seven months and a potential turning point in taming the cost of living crisis.

Yes, inflation had been falling from its peak of 11 per cent last October but too slowly to prevent the rise in mortgage rates or to be sure that policy was on track. While the Bank of England is likely to increase its rate somewhat further, the latest figures suggest that inflation is now firmly on a downward track. The probability of a soft landing, rather than a recession, has risen.

The good news goes beyond the headline consumer rate, which itself is the lowest since March 2022. Producer input prices actually fell by 2.7 per cent since June of last year, mainly due to the fall in oil prices, which affects manufacturing and transport costs. Even imported food prices fell by 4 percentage points in June compared with May.

It takes time for input prices to feed through to consumer prices but this is now happening and becoming more widespread. On a month-to-month basis, producer prices have been falling since March and the consumer price index has been slowing since April.

Beyond energy and food, the core CPI is an indication of how embedded inflation has become in the rest of the consumer's market basket.

The annual rate of core CPI fell from 7.1 per cent in May to 6.9 per cent in June. This is still too high for the BoE to relax but at least core CPI has finally turned a corner.

Another measure watched by the BoE is services annual CPI, where most jobs are found and where wage costs are most significant. This, too, fell from 7.4 per cent in May to 7.2 per cent in June.

Of course, monthly data can be erratic. Moreover, new shocks threaten, with Russia again blocking grain exports from the Black Sea and heatwaves in southern Europe damaging fruit and vegetable crops. One swallow does not make a summer, of course, but these latest inflation figures arguably show at least a small flock arriving.

With inflation on the decline, two related questions become pressing.

First, how much higher will rates need to be to maintain downward pressure on inflation? And, second, how resilient will the economy be to interest rates that remain higher for longer?

Both questions present a challenge to the BoE's forecasting model, which last November predicted a lengthy recession and a rapid fall in inflation.

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Neither has happened and, indeed, BoE governor Andrew Bailey has told the Treasury select committee that there are "very big lessons to learn about relying on their forecasting model in setting policy.

In this transition period, while the economy is adjusting to a higher interest rate environment, it is right that policymakers rely more on current data developments than on an analytical forecasting model. This should also apply to the BoE's communications strategy. Consumer confidence and business investment can take unwarranted hits from misplaced emphases.

The problem is that the model's parameters are derived largely from the abnormal period since the global financial crisis, when real interest rates were negative and quantitative easing distorted normal market signals.

Even rates rapidly rising from their near-zero levels since 2009 have had less impact than expected on inflation and the real economy because they started from such a low base with the markets awash with liquidity. And even now, with inflation at 7.9 per cent, a Bank rate of 5 per cent is negative in real terms. The two-year gilt rate is hovering around 5 per cent.

Given the uncertainty around how fast inflation will fall, a guiding objective for the BoE should be to aim for positive real rates at the two-year horizon until inflation is back to target. On current assumptions, this might imply a plateau of about 5.5 per cent in the Bank rate that lasts for an extended time.

Could the UK economy withstand such rates without a long recession? The historical evidence is encouraging.

Consider the decade before the triple shocks of the financial crisis, the Covid-19 pandemic and the war in Ukraine. Between 1997 and 2007, the Bank rate averaged 5.4 per cent, while gross domestic product grew at an average annual rate of between 2.8 and 2.9 per cent. Inflation averaged 1.8 per cent. Households could enjoy positive real returns on simple savings products and business investment was strong, rising by 4 percentage points per year in real terms.

While economic growth depends on many factors, and no two decades are alike, the combination of moderately higher interest rates with significantly lower inflation may make for a soft landing ahead.

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