INFLATION IN THE UK: WHAT LIES AHEAD?

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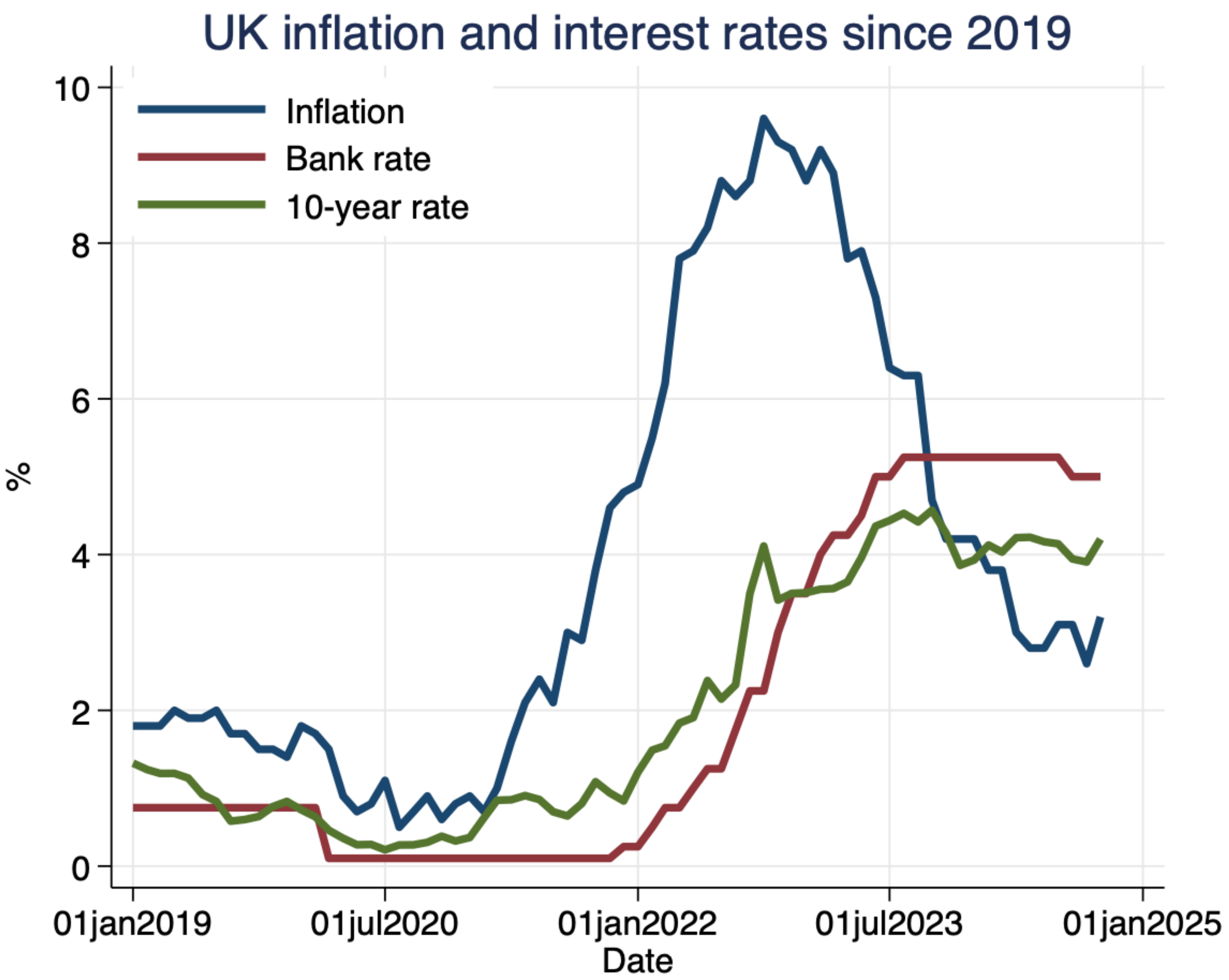
London

The 2021-24 brief history



- **2021 rise**: pentup demand + reluctance to back to work + supply chains + fiscal stimulus + monetary stimulus.
- **2022 explosion**: energy shocks + unanchoring of expectations + loose monetary policy
- **2023-4 decline**: tightening of monetary policy, expectations re-anchoring, supply shocks dissipate

Inflation is behind us, inflation may be ahead

Chart 8: Household and business inflation expectations

Sources: Citigroup, DMP Survey, YouGov and Bank calculations.
(a) Left hand panel shows the 1 year and 5-10 year inflation expectations measures from Citi. Dashed lines represent the series averages over 2010-19. The latest data points are for October 2024.
(b) Right hand panel shows data from the DMP Survey and are based on three-month averages of responses to the question: 'What do you think the annual CPI inflation rate will be in the UK, one year from now and three years from now?'. The latest data points are for October 2024.

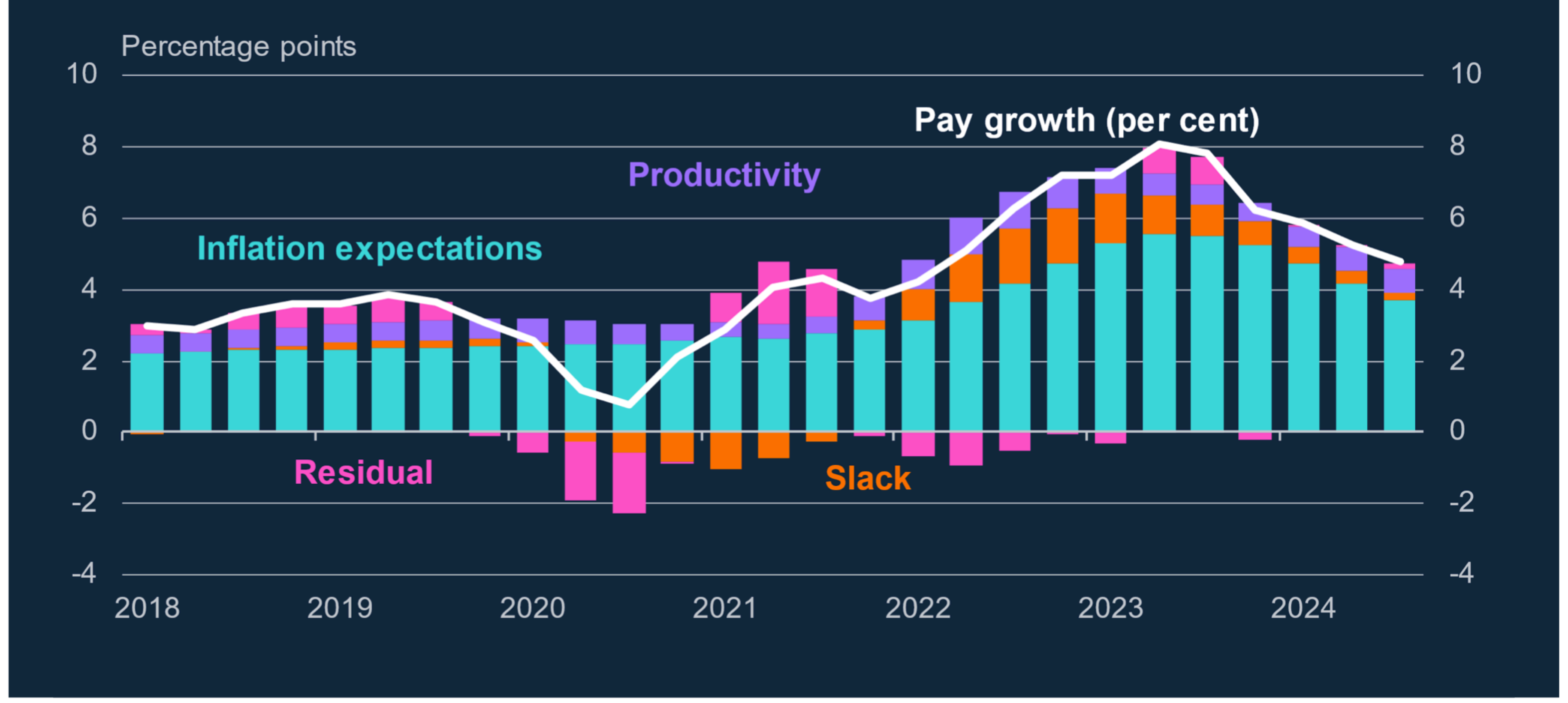


Chart 9: Contributions to annual private sector regular pay growth

Sources: Barclays, Citigroup, ONS, YouGov and Bank calculations.
(a) Wage equation based on **Yellen (2017)**. Pay growth is Bank staff's estimate of underlying pay growth between January 2020 and March 2022 and the ONS measure of private sector regular AWE growth otherwise. Short-term inflation expectations are based on the Barclays Basix Index and the YouGov/Citigroup one year ahead measure of household inflation expectations and projected forward based on a Bayesian VAR estimation. Slack is based on the MPC's estimates, informed by the vacancies to unemployment ratio. Productivity growth is based on long-run market sector productivity growth per head. The final data point is 2024 Q3.

Short-run shocks upside

- Fiscal expansion, supply shocks
- Confusing supply shocks for supply trends

Short-run shocks downside

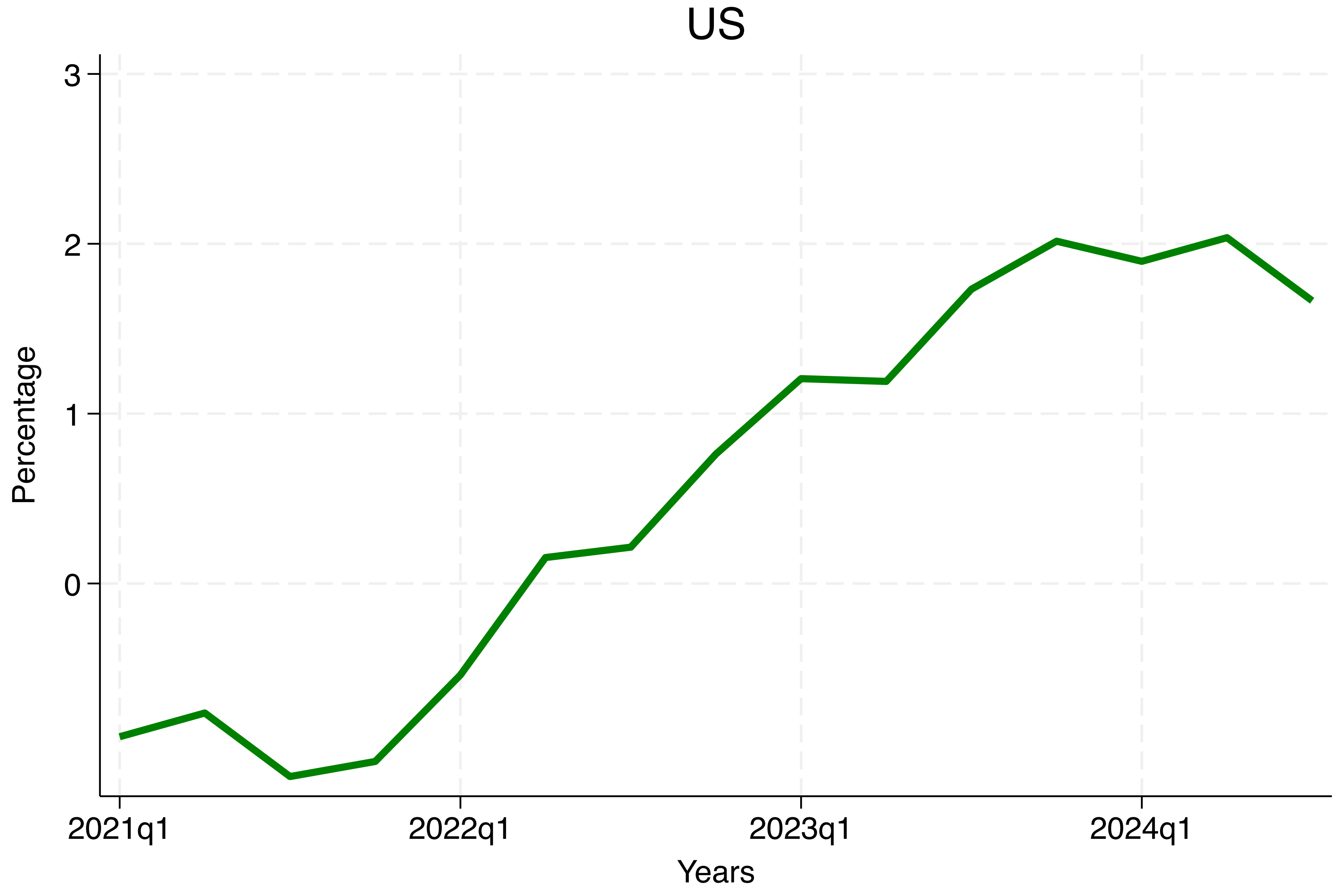
- Exchange rate, supply opportunities
- Being too gradual and present-looking

Return to principles-based monetary policy

- Markets keep getting surprised and over-reacting to data, meetings, and speeches

The new normal: biases versus traps

10-year yield on US Treasuries minus expected inflation



	m - y (%)
2019	5.6
2021	6.5
2022	4.7
2023	3.8

Conjecture: long-run gilts r* persistently higher

One scenario: inflation bias is back

- Cut bank rate too fast and too far
- Pursue lower interest rate (Friedman '68)
- Pressure to inflate away the debt

Another scenario: a double deflation trap

- Higher term premium (QT, repression)
- Fiscal policy constrained by interest burden
- Monetary policy constrained by ZLB