

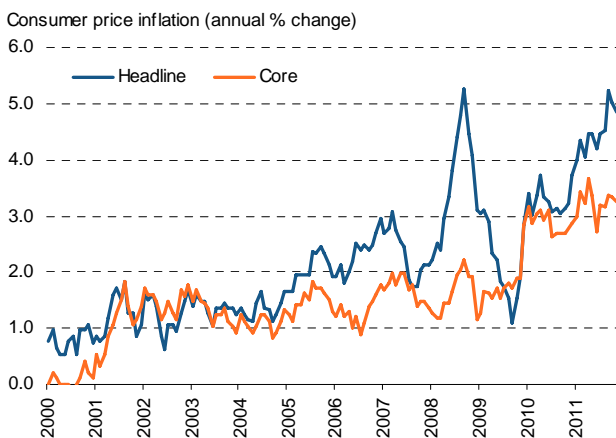
UK inflation

Inflation easing gains traction with steep falls likely in early 2012

- **Inflation falls for second month running**
- **Income squeeze likely to hit consumer spending in near-term, but impact to wane next year**

The much anticipated easing in UK inflation appears to be gaining traction. Inflation fell for the second month running in November, dropping from 5.0% in October to a three-month low of 4.8%. Supermarket price wars, lower petrol costs, falling food prices and retailer discounts for winter clothing lines that struggled to sell in November's warm weather all contributed to the easing. However, even the 'core' rate of inflation, which excludes volatile items such as energy, food, alcoholic beverages and tobacco, fell from 3.4% to 3.2%.

UK consumer price inflation



Source: ONS via Ecwin.

Despite the easing, however, the rate of inflation signals more pain for households in the coming months, as prices for goods and services continue to rise more than twice as fast as incomes. With inflation at 4.8% but employee pay growth at just 2.3% per annum, real incomes are still falling at a rate which will inevitably squeeze consumer spending in the lead up to Christmas and early next year.

With consumer spending accounting for around two-thirds of all spending in the UK economy, this will act as a substantial dampener on economic growth, and

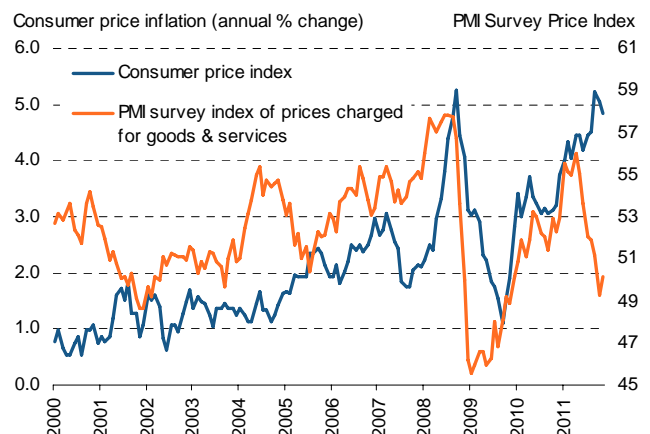
the combination of weak consumer spending with public sector spending cuts and falling demand for UK exports means there is a strong chance of the UK dipping back into recession as we move into 2012.

Looking further ahead, inflation is likely to fall sharply in the new year, which will reduce the squeeze on incomes and should help to lift economic growth later in the year. With last January's VAT rise falling out of the annual comparisons, and global food and energy price inflation dropping sharply, a marked fall in inflation to a rate of perhaps 3% could be seen as early as the end of the first quarter.

How far inflation falls later in 2012 remains a big uncertainty. The Bank of England is projecting that the rate will drop to nearer 1.5% by the middle of next year, below the Bank's 2% target. That may be a little optimistic, given the steep rises in utility prices that have been pushed through by the energy companies in recent months.

On the other hand, the recent steep downturn in survey measures of prices charged for goods and services by companies suggests that inflation has a long way to fall, and that deflationary pressures have grown considerably as the economic outlook at home and abroad has darkened. An inflation rate close to the Bank's target looks a reasonable forecast for mid-2012.

UK consumer prices and PMI business surveys



Sources: Markit, ONS via Ecwin.

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