Group Economics

Ulster Bank

Inflation to remain an important topic, whether you're a chocolate lover or not

Contact: Richard Ramsey
Chief Economist, Northern Ireland
02890 276354 or 07881 930955

Richard.ramsey@ulsterbankcm.com
www.ulsterbank.com/economics
Twitter @UB_Economics

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This month marked the seventh anniversary of the start of the credit crunch, which led to the recent global recession. In Northern Ireland, this period was largely characterised by rising consumer prices and falling house prices, a scenario that resulted in consumers' incomes being squeezed and the value of their main asset being eroded.

In more recent times, these trends have actually been reversed, with consumer prices, such as food, beginning to fall, and house prices starting to rise. So, if the former scenario was bad, does this mean that all is now rosy? Of course, in economics, nothing is ever that simple. So it's worth taking a look at some of the key facts about, and implications of, inflation, and explore why it is currently so much talked about in economic circles.

I had some personal experience of deflation when I recently returned from holiday to find that my TV had 'packed in'. After cursing this unexpected expense, I was actually pleasantly surprised at the price of a replacement. A bigger, better, 'smart' TV was to cost me about 40 per cent less than its predecessor did 6 years previous. Indeed, this is indicative of the trend in technology generally, with the ONS consumer price index, for instance, showing that the price of audio-visual goods has fallen by 45 percent over the last 7 years and by a whopping 81 percent since 1998. Clothing and footwear have also generally declined in price - 14 percent since the start of the credit crunch, and by half since 1998.

But these are examples of deflation in specific categories, for specific reasons (e.g. advances in technology). This is very different from the deflation that characterised Japan's 'lost decade', when deflation was across the board. Over the last 20 years, Japan's annual rate of consumer price inflation averaged a paltry 0.4 percent, which is currently the annual inflation rate within the Eurozone. Meanwhile consumer prices in Japan have fallen in annual terms in nine of the last 15 years.

Deflation in this case is extremely dangerous as businesses and households stop spending, safe in the knowledge that goods will be cheaper in the future. Meanwhile, the lack of inflation fails to shrink debt, with deflation actually increasing debt in real terms. The prospect of this kind of deflation is haunting the Eurozone at present, with speculation mounting that the European Central Bank (ECB) will have to embark upon a Japanese-style asset purchase programme known as Quantitative Easing (QE).

Whilst the Eurozone is keen to avoid Japan's deflationary experience, it would actually be keen to swap its current rate of consumer price inflation for Japan's. Ironically, Japan's annual rate of CPI (aided by a recent hike in the VAT rate) at 3.6 percent year-on-year is higher than the US, UK and the Eurozone.

When it comes to the UK, deflation has occurred in a small number of categories, and not ones in which consumers have the bulk of their spending. Overall, since the credit crunch, more consumer prices in the UK have risen than fallen, particularly with household necessities such as food and fuel.

Therefore consumer price inflation has adversely affected households more than consumer price deflation has benefitted them.

Since August 2007, the overall UK consumer price index has risen cumulatively by 22 percent. Outside of Eastern Europe this is one of the steepest increases within the EU-28 and is largely due to the weakness of sterling over this period. Conversely, the Republic of Ireland has posted the lowest cumulative rise within the EU with consumer prices up less than 4 per cent.

Some categories of consumer spending have seen much sharper rises in prices. UK energy prices have shot up by almost 70 percent over this period, with petrol and food increasing by 38 percent and 36 percent respectively. Once again, these cumulative rises have exceeded most other countries within the EU. Meanwhile the price of food and drink in the Republic of Ireland is actually 2 percent lower now than it was when the credit crunch began.

As far as households are concerned, consumer price inflation on its own is not a problem, if incomes rise by at least the same amount. However, average UK earnings have increased by around half the cumulative rise in consumer prices. As a result, there has been an intense squeeze on household incomes.

The good news is that UK consumer price inflation (CPI) has begun to ease. The annual rate of UK CPI overshot the Bank of England Monetary Policy Committee's (MPC) 2 percent target on 69 occasions since August 2007. However, last week's July figure of 1.6 percent represented the seventh successive month below it.

The BoE is expected to raise interest rates ahead of both the US's Federal Reserve and the ECB, and Sterling has strengthened on the back of this 'first to hike' view, which has helped push food and fuel costs lower. Indeed, back in May, the UK posted its first year-on-year fall in food prices in nine years.

Not all food prices have been falling though. Lovers of Nutella chocolate spread and Ferrero Rocher will probably find this out soon enough. A severe frost in Turkey, the world's largest producer of hazelnuts, has hit supply, with prices almost doubling since the start of the year. This comes hot on the heels of rising cocoa prices, the main ingredient of chocolate, which has risen by 70% in price over the last year. Fun size Topics may become the new norm.

While the good news, outside of chocolate, is that inflationary pressures in the UK are easing, the bad news is that average earnings growth is easing too, and the Bank of England has halved its forecast for earnings growth this year to 1.25 percent y/y. This will be below the anticipated rate of CPI and therefore the cost of living squeeze is set to continue.

We have had seven lean years since the credit crunch, and whilst we don't want wage growth so strong that it push the Bank of England to significantly hike interest rates, a few 'fatter' years when it comes to wage growth would not be unwelcome. Whatever happens, inflation is set to be an important topic for some time yet, whether you are a chocolate lover or not.

Richard Ramsey,
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