Further pick-up in inflation likely this year

- **Despite the persistence of low oil prices we still think that inflation in the major advanced economies will rise this year**. That said, it is only likely to increase substantially above 2% in the US, while in the euro-zone and Japan, underlying inflation will remain well below target.
- **Many commentators have suggested that policymakers face a big challenge raising inflation to their 2% targets in almost all advanced economies. In reality though, the prospects are more mixed**. Today's US CPI data showed headline inflation increasing to 1.4% in January. And looking ahead, inflation in the US, euro-zone, Japan, and UK is set to rebound in the second half of this year as the drag from falling oil prices will finally fade. (See Chart 1.)
- **In the US, there is growing evidence that the tightening labour market is putting upward pressure on wages**. Admittedly, the pace of payroll gains fell from an average of 250,000 in Q4 to 151,000 in January. But these data are volatile and the US economy is in any case near to full employment. Other indicators, including the high number of job openings, point to a further pick-up in wage growth in the months ahead. (See our *US Economics Weekly*, "Domestic price pressures continue to mount", 12th Feb.)
- Indeed, **there has already been a marked acceleration in US services inflation** (see Chart 2), which pushed core CPI inflation up to 2.2% in January. The rise in underlying inflation has been tempered by the 20% appreciation in the US dollar over the past 18 months, which is temporarily weighing on the prices of imported goods. But assuming the dollar does not continue rising rapidly, this drag will fade and **US headline and core inflation should climb well above the Fed's 2% target next year**.
- **In contrast, services inflation remains subdued in the euro-zone and Japan, indicating that domestic price pressures in these economies are much weaker**. (See Chart 2 again.) The continued decline in inflation expectations is another headwind to policymakers' efforts to raise underlying inflation towards 2% any time soon. For now, inflation in the euro-zone and Japan is being boosted by previous falls in their currencies. But **unless the euro and yen continue to depreciate, the upward pressure on imported goods prices will wane and inflation will drop back again**. (See our *Japan Economics Update*, "Will a stronger yen derail the BoJ's efforts to hit 2% inflation?", published on 15th February.)
- **Meanwhile, inflation in the UK is likely to remain below the MPC's 2% target for some time yet**. Wage growth has slowed in recent months and we think that broader labour costs are set to rise only gradually. Unlike the euro-zone and Japan however, there is little threat of deflation because underlying price pressures are stronger and inflation expectations have held steady.
- **If our inflation forecasts prove accurate, monetary policy is still set to diverge**. In the US, the chances of a rate hike in March are now very slim, but **the Fed will eventually have to respond to rising core inflation**. We expect the Bank of England to raise rates more gradually than the Fed because inflation should rise only slowly. Finally, policy will need to be loosened significantly further in the euro-zone and Japan if they are to hit their inflation targets on a sustained basis. **We expect the ECB and BoJ to step up their asset purchases and cut deposit rates further into negative territory next month**.

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Chart 1: Headline CPI Inflation (%)

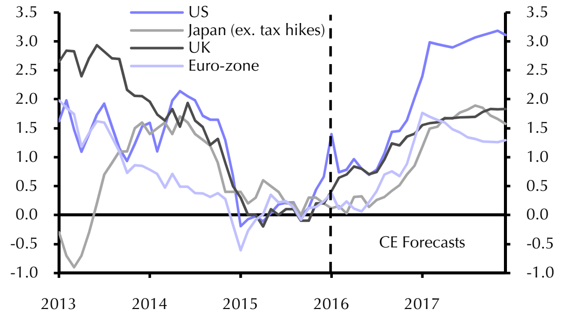
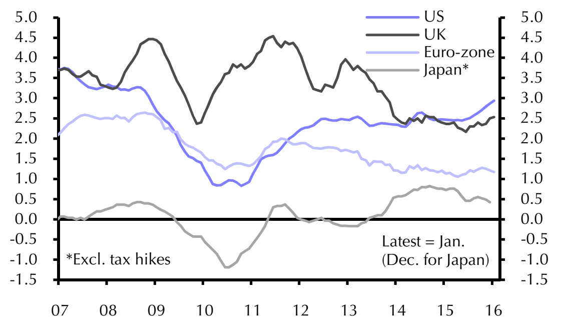


Chart 2: Services Inflation (%, 3-month rolling average)



Sources – Thomson Datastream, Capital Economics