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Headline RPI inflation could halve in next six months

Gilt market is rightly worried about the PSBR, but wrong about inflation

The PSBR has been a great disappointment so far in 1995/6 and the authorities will undoubtedly step up their funding efforts in coming months, partly in order to bring M4 closer to the middle of its target range. However, the adverse PSBR news is a by-product of the slowdown in the economy and - as we have consistently argued over the last year - the slowdown will lead to favourable inflation surprises in late 1995 and early 1996. The recent behaviour of the index-linked/conventional differential implies that the market still has not realised just how good inflation could be.

The purpose of this fax is to suggest that the headline rate of annual retail inflation (i.e., including mortgage interest costs) could halve from 3.6% in August 1995 to 1.8% in April 1996. Indeed, by April next year it is more likely to be under 1.8% than above it.

This encouraging change reflects a combination of positive special influences, which are listed below, and the continuing impact of the "negative output gap" (and of course the slowdown) on underlying inflation pressure. The positive special influences are as follows:

1. The mortgage rate increase of September 1994 is about to fall out of the annual comparison. (Annual headline RPI increase down by 0.2%.)

2. The building societies' and banks' unilateral decision to cut mortgage rates in recent weeks will take 0.15% or 0.2% off the RPI, although the impact will be spread over a few months.

3. A base rate cut will probably accompany only limited tax cuts in the Budget. The knock-on effect on mortgages could take another 0.15% or 0.2% off the RPI, although it depends partly on how far the drop in the fixed mortgage rate extends to floating-rate mortgages.

4. The mortgage rate increase of December 1994 will fall out of the annual comparison at the end of this year and in early 1996. (Again, headline RPI increase down by 0.2%.)

5. The increase in the effective cost of a mortgage because of the

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reduction in mortgage interest relief in April 1995 added about 1/4% to the RPI. This drops out of the annual comparison in April 1996.

6. The Financial Times today has a story about a £50 rebate to electricity customers, when the National Grid is floated. The consequent reduction in electricity bills will take 0.4% off the RPI. Although the effect may be spread over three or four months, this would have come through by next April if the flotation date is in December. (The average household electricity bill is £280 a year. £50 is 18% of that and electricity has a 2.3% weight in the RPI, giving an impact of 0.4%.)

7. Cuts in water charges, gas bills and telephone charges are all proceeding at present. The benefits on water charges, like those on electricity, will come via customer rebates, and will be concentrated in October 1995 and April 1996, because that is generally when the bills are sent out. Favourable RPI effect is 0.1% to 0.15%. (Note that wholesale gas customers - industrial companies, hotels, offices and so on - can already "shop around" for different gas supplies, and some of the price cuts will be passed onto the retail level.)

8. Indirect tax increases in the Budget will almost certainly not be higher than in the 1994 Budget. The unfavourable impact of the special increase in excise duties in January 1995 (needed to make up for the loss of the second stage of VAT on fuel) will fall out of the annual comparison in January 1996, reducing the RPI by 0.15%.

The net effect of all this list is to cut the RPI - relative to where it would otherwise have been - by 1.7% or 1.8%, i.e., to halve inflation compared with August 1995's 3.6%. No allowance has been made here for a more deep-seated improvement because of

1. The sharp fall in manufacturers' price-raising intentions, as revealed by the latest CBI survey. (The August survey had only a 7% positive balance of companies with price-raising intentions, compared with 20% - 30% in the first half of the year.)

2. Discounting by distributors in order to shift stock, which seems likely, since anecdotal evidence of excessive stocks at retailers and even suppliers is mounting.

On our calculations the underlying RPI will not improve by anything like as much as the headline RPI, because mortgage costs are so important in the list of special factors. However, it is still plausible that the underlying RPI will be under 2 1/2% for most of 1996, in line with the Government's target.

In this environment the rate of increase in pay and unit labour costs will remain moderate, probably similar to current levels (3% - 4%, and 1% - 2%, respectively), during 1996 and early 1997, and inflation will not be "a problem" before 1998. (What happens in 1998 and 1999 depends on monetary policy. It has to be conceded that the present rate of monetary growth would cause trouble if it continued over the medium term.)

Index-linked continue to look unattractive compared with conventionals over the next two years. This conclusion is reinforced by the hints, in several quarters, that the Government wants to tilt the funding programme more towards index-linked and away from conventionals.

Professor Tim Congdon and Stewart Robertson 28th September, 1995

Special factors affecting the headline RPI over the next six months

1. Mortgage rate increase of September 1994 falls out of annual comparison (-0.2%)

2. Mortgage rate cut (building societies' unilateral decision) in September 1995. Effect of -0.15% to -0.2%. Slightly less of an influence now because the RPI now takes account of fixed and variable rate mortgages. This could of course mean that some of the effect is delayed until January or whenever fixed-rate mortgages are renegotiated.

3. Cuts in both water charges (via customer rebates) and electricity distribution charges. These effects are already feeding through to the RPI (electricity prices as measured in the RPI fell by 1% in the year to August). But there may be some concentration of the effect in October 1995 and April 1996 because that is generally when water bills are sent out. Overall effect of the order of -0.1% to -0.15%.

4. Assumed base rate cut in November of 0.5% (should this be in December?), which we assume will be followed by mortgage rate reductions.

5. Mortgage rate increase of December 1994 falls out of annual comparison (-0.2%)

6. Rebate to electricity customers following the flotation of the grid. Assumed to take place in December, with the effects on the RPI spread over the following three months. Total effect around -0.4%.

7. Indirect tax increases associated with the Budget. The Government stated that taxes on alcohol and tobacco would go up in real terms at a fixed rate each year. We are currently assuming that the increases will be the same as last year. If they are more, then the RPI will be adversely effected.

8. The increase in tax via the reduction in MIRAS tax relief in April 1994 falls out of the annual comparison Overall effect -0.2% to -0.3%.