

# Inflation Outlook

## Quarter 3 2010

Issue Date - 18th August 2010

### Introduction

This is the third quarter edition of 'Inflation Outlook': a Policy Council report providing forecasts for inflation. The forecasts are based on econometric models and provide a composite forecast of RPIX and RPI. These forecasts are revised and published on a quarterly basis in the month following the Policy Council's publication of official Guernsey quarterly inflation rate and timed to follow the Bank of England's quarterly inflation outlook.

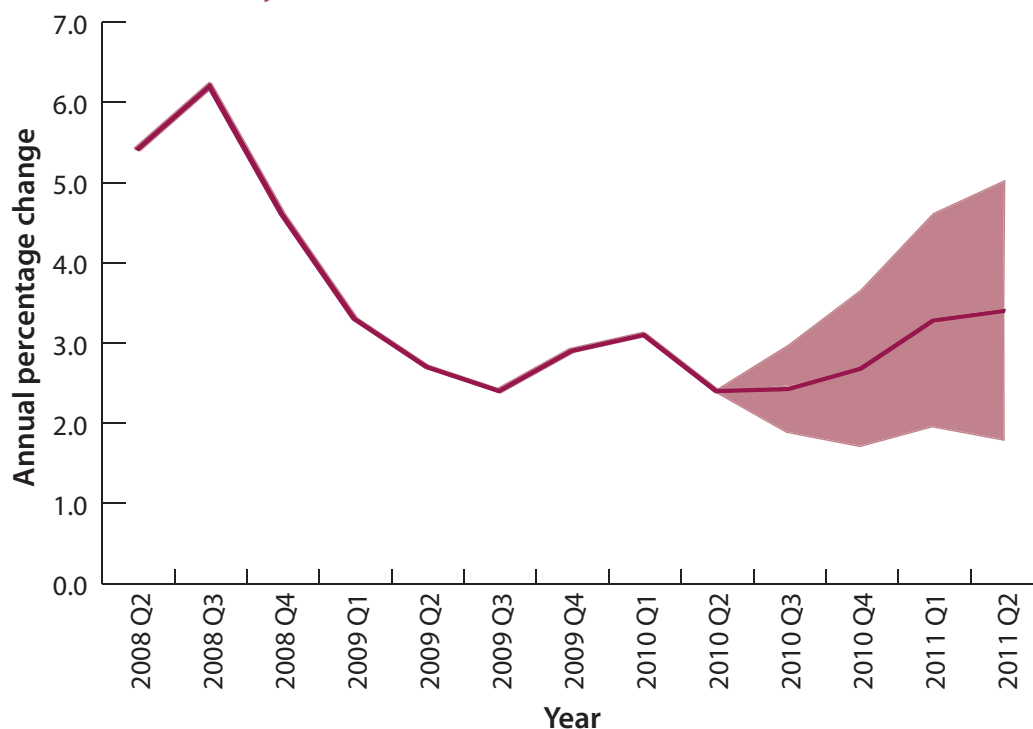
*NB - Forecasts are presented with statistical confidence (or error) bands (the shaded area). These represent the range of possible outcomes with (in this case) a 95% statistical certainty.*

### Headlines

- As anticipated, the most recently reported Guernsey inflation rates were somewhat lower than the those in the UK. This is forecast to continue although the expectation is for UK inflation to subside in the next quarter.
- RPIX, the official headline rate, is forecast to remain relatively benign over the next few quarters. Second quarter RPIX was actually below the target maximum of 3.0% (as set out in the Fiscal and Economic Plan) at 2.4%. It is anticipated to rise marginally over the next three months but remain below the target rate.
- There may be some continued upward pressure from oil prices although at reduced levels to those experienced over the past year. However this could be mitigated or even reversed if Sterling continues its recent improved performance against the dollar.
- Both measures of inflation (RPIX and RPI) are expected to rise gently towards the end of the year but, absent any unforeseen circumstances, they should remain at 'comfortable' levels, with RPIX on or around target.
- Risks to the UK economy of reduced domestic demand could well act to dampen inflation through the course of 2011, but our belief is that rising expectations and VAT increases will most likely keep UK inflation above target.

### Inflation Outlook

**Figure 1: Forecast Guernsey RPIX**



## Inflation Outlook (continued)

Figure 2: Forecast Guernsey RPI

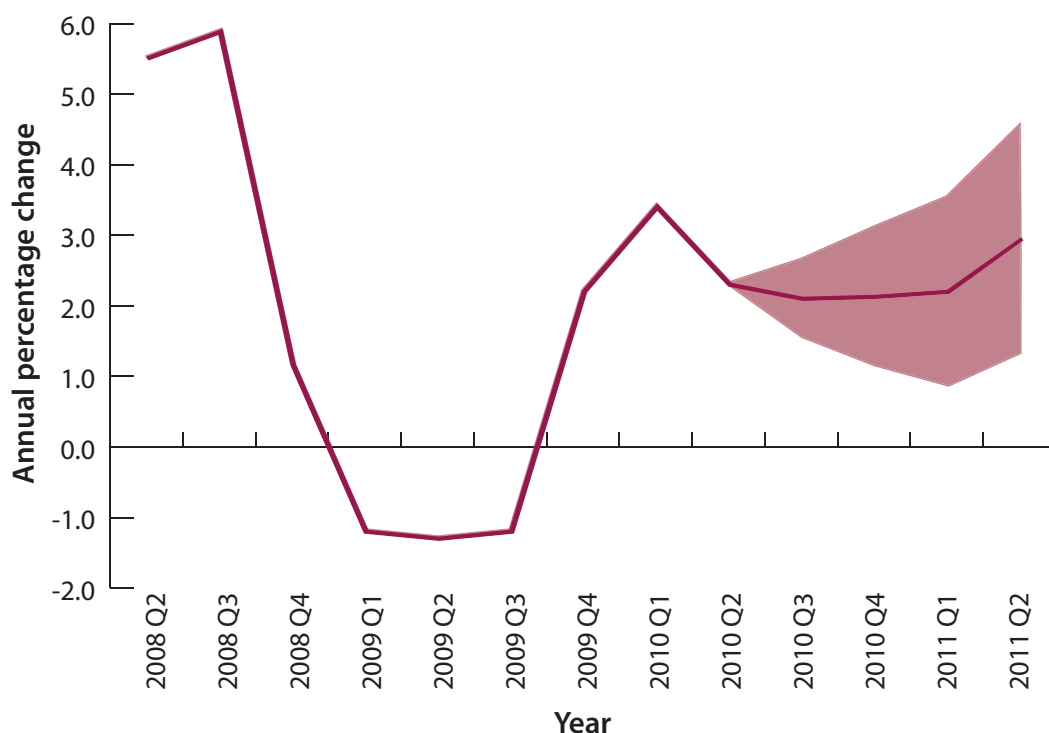
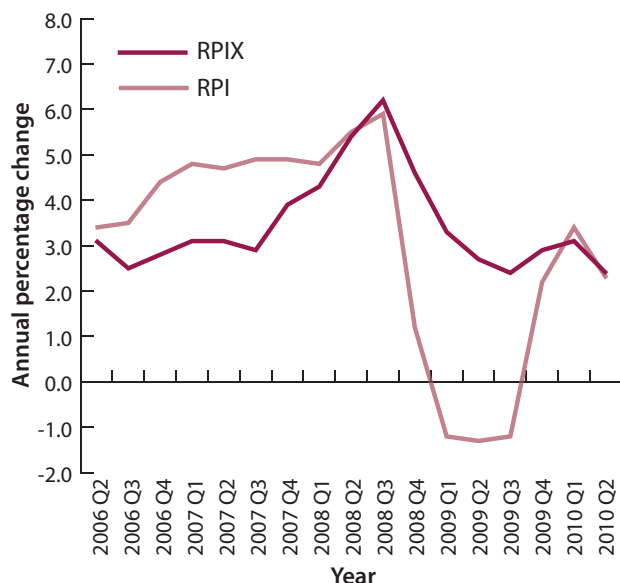


Figure 3: Guernsey Inflation Rates



Whilst, in our last Inflation Outlook, it was forecast that second quarter inflation rates in Guernsey would remain lower than the UK, the size of the difference was not fully anticipated. UK inflation remained higher than previously forecast by the Bank of England and the decline experienced in Guernsey was slightly larger than we had anticipated.

The decline in Guernsey inflation was due to reduced upwards pressure from the housing, fuel and light and motoring baskets. The pressures from oil prices had been expected to continue (albeit in a reduced manner) to positively impact on inflation. However, what had not been anticipated at the time of writing the last Inflation Outlook (May 2010) was the subsequent strengthening of Sterling. Current consensus forecasts for Sterling are that it will continue to weaken against the dollar over the next couple of months. However, if the US economy's growth continues to stall, Sterling may well remain at current levels throughout the remainder of the year. If this proves to be the case, it would most likely be good news for our local inflation as imports to the UK would be cheaper.

In the early stages of this year higher than expected inflation rates were attributed, by the Monetary Policy Committee (MPC), to factors such as the rise in VAT and rising fuel and import prices driven by the weakness of Sterling. Some of these effects should have been reversed over the course of the

## Inflation Outlook (continued)

last few months. However, the return of VAT to its standard rate of 17.5% in January 2010 will continue to have an upwards impact on UK inflation rates until the end of the year. Similarly, the planned increase of VAT to 20% in January 2011 will exert a similar upwards pressure on next year's inflation rates. Whilst rising taxes have no effect on the underlying rate of UK inflation, we remain concerned about the possible effects on the public's inflationary expectations.

The Bank of England's previous estimates of the large degree of spare capacity in the UK economy underpinned its previous confidence that UK inflation will subside towards the end of this year. However the Bank's most recent report now pushes back, until 2011, the period for the return of UK inflation to near target levels. Our view is that the scale of spare capacity may have been overstated but that the fiscal retrenchment planned by the UK government could have a significant negative impact on domestic demand during 2011 and act to curtail UK inflationary pressures.

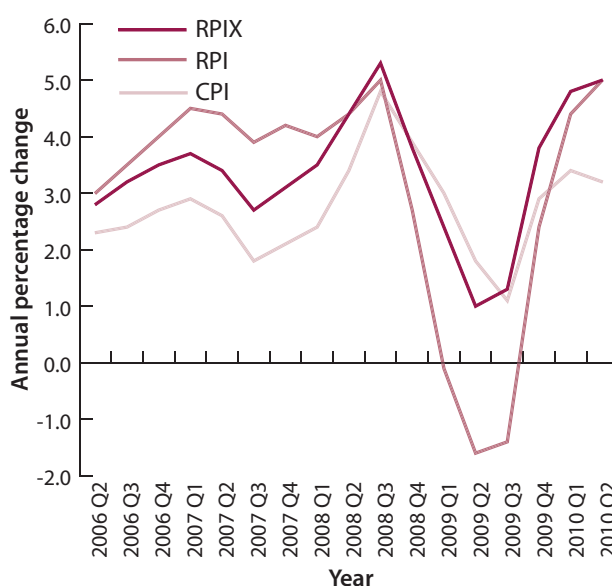
We have deliberately focussed on the inflationary environment in the UK as, despite the recent divergence in inflationary performance between Guernsey (and Jersey) and the UK, in the longer run, our common currency should result in similar long term inflation trends.

Turning our attention to local matters, it is clear from recent reports that retailers in Guernsey continue, in general, to experience pricing pressures, most probably from continued internet sales penetration. Goods that are substitutable via the internet, such as clothing and electrical goods, have continued to see general price declines over the last few quarters. Where such substitution is not possible, food and petrol for example, positive inflation rates are the norm.

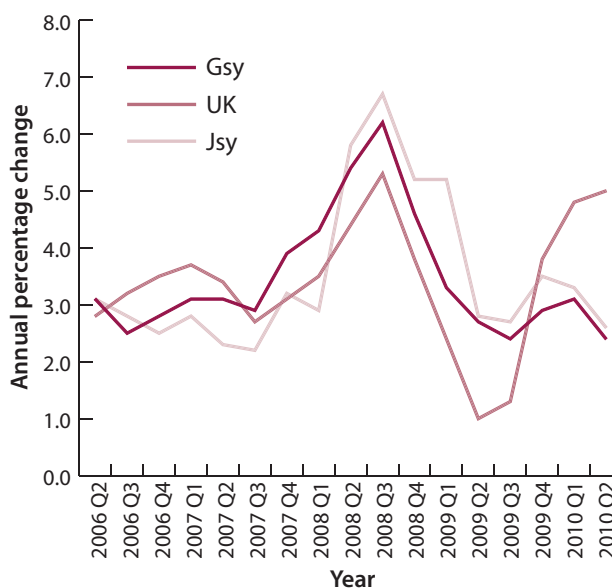
In the very short term, the Russian export ban on wheat, if prolonged, may exert an upward pressure on commodity prices. This may lead to a short term spike in prices of staples such as bread and the food basket in general. It is difficult to predict this effect with much certainty at the time of writing, but this could result in inflation being higher than we are presently anticipating next quarter.

So far in 2010, Guernsey's has experienced rates of inflation lower than the UK mainland. This should continue through into the third quarter.

**Figure 4: UK Inflation Rates**



**Figure 5: Comparison of Inflation Rates**



## Further Information

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Please contact Dr Andy Sloan (Economist) for further information.

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