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The U.K.'s Inflation Problem

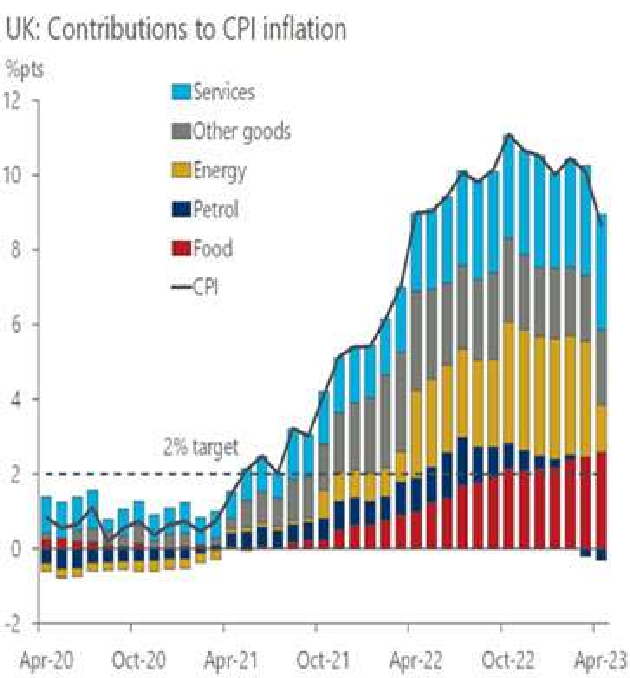
Inflation is one way the U.K. is paying for leaving Europe.

Earlier this month, we performed a dissection of eurozone inflation. On the back of another upside surprise in this week's U.K. inflation report, we thought it would be appropriate to explore why inflation remains higher in Britain than in any other major developed market.

81% of the basket used to measure British inflation is seeing prices increase by more than 4% annualized in the past six months. Due to Britain's reliance on imported natural gas for heating and electricity, energy has been a major contributor to inflation. Happily, these costs are now receding.

Even though global food price indices have been trending lower, there is no relief for British households. Brexit has added to delivery times and costs for British imports, an aspect that appears to have been passed on to households. The scarcity and rising cost of vegetables like tomatoes is only partly due to unseasonably cold weather in parts of Spain and Morocco. But there were no severe shortages or empty shelves in major European markets. According to the London School of Economics, Brexit trade barriers contributed 8 percentage points of the 25% increase in food prices between 2019 and March 2023.

On top of supply chain disruptions and energy costs, worker shortages are also having an impact. A rise in early retirement, sickness and migration trends have depleted the pool of workers. Tougher entry standards established in the wake of Brexit have limited the number of newcomers. Their absence is most keenly felt in sectors such as hospitality, where employers used to rely more on European workers. Wage growth in Britain has been averaging about 6% over the past two years, the highest among major advanced economies and well above the level consistent with the Bank of England's (BoE) inflation target.



Sources: Oxford Economics, OECD, Eurostat

A meaningful moderation in headline inflation is expected on the back of a sharp decline in the year-over-year energy contribution. However, unless we see a broader rebalancing in labor market dynamics, core inflation is unlikely to decelerate meaningfully. As a result, we think the BoE will hike again at the June meeting and keep its options open.

While the BoE uses interest rates to fight price increases, the British government may have to **consider relaxing some of its post-Brexit regulations** to help douse the inflation fire. Establishing a broader set of trade agreements to diversify sourcing would also help. As expected in the wake of the 2016 watershed, the U.K. is paying a steep price for divorcing from Europe.

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