National Institute of Economic and Social Research

NIESR Monthly CPI Tracker

Moderate Fall In Inflation In January Masks A Serious Fall In Real Wages

Paula Bejarano Carbo

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"Annual CPI inflation fell in January to 10.1 per cent from 10.5 per cent in December, driven by price decreases in passenger transport and motor fuels, which were partially offset by price increases in alcoholic beverages and tobacco. CPI excluding food, energy, alcoholic beverages and tobacco –the standard measure of 'core' inflation - has fallen to 5.8 per cent in January from 6.3 per cent in December. However, NIESR's measure of trimmed-mean inflation remains at 9.0 per cent for a third consecutive month in January, possibly signalling that we have yet to see a turning point in underlying inflation."

Paula Bejarano Carbo
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Main points

- Headline consumer price inflation decreased to 10.1 per cent in January from 10.5 per cent in December. Despite the fall, this rate of annual inflation remains among the highest in four decades and markedly above the Bank of England's inflation target of 2 per cent for the eighteenth consecutive month. Further, NIESR's measure of underlying inflation, which excludes 5 per cent of the highest and lowest price changes, remained at its series high of 9 per cent for a third consecutive month.

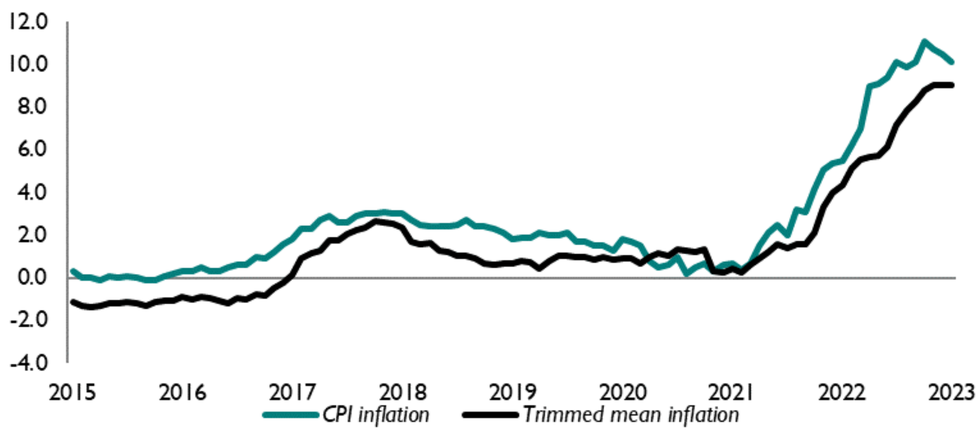
- Market expectations, as implied by the most recent Overnight Index Swaps curve, sees the Bank Rate peaking at 4.50 per cent in summer (likely entailing rate hikes by 25 basis points in the MPC's next two meetings). As discussed in our recent Winter Economic Outlook, while we think that the peak in rates is high enough to bring inflation back to target around the middle of 2025, a key question will be how long the MPC should maintain the Bank Rate at its peak level, and at what pace should they loosen.

- Today's revised CPIH data reveals that economy-wide real total (including bonuses) wage growth fell by 3.2 per cent in the year to the fourth quarter of 2022. Workers in different sectors felt this real squeeze asymmetrically: real pay fell by 4.8 per cent for public sector workers over this period, on average, while for private sector workers it was 2.3 per cent.

- Food inflation remains elevated, at an annual rate of 16.7 per cent in January. This is especially concerning given that there is no government support to help households (especially lower income households, who spend a greater proportion of their incomes on food) offset this cost.

- For a breakdown of what inflation is and how it is calculated, as well as why the MPC target an inflation rate of 2 per cent, read our blog post here.

Figure 1 – CPI and trimmed mean inflation (per cent)



Note: Our measure of trimmed mean inflation excludes 5 per cent of the highest and lowest price changes. The level of trimmed mean inflation is typically lower than CPI inflation due to differences in how the largest price changes are treated and to how the prices are weighted. Source: ONS, NIESR calculations.

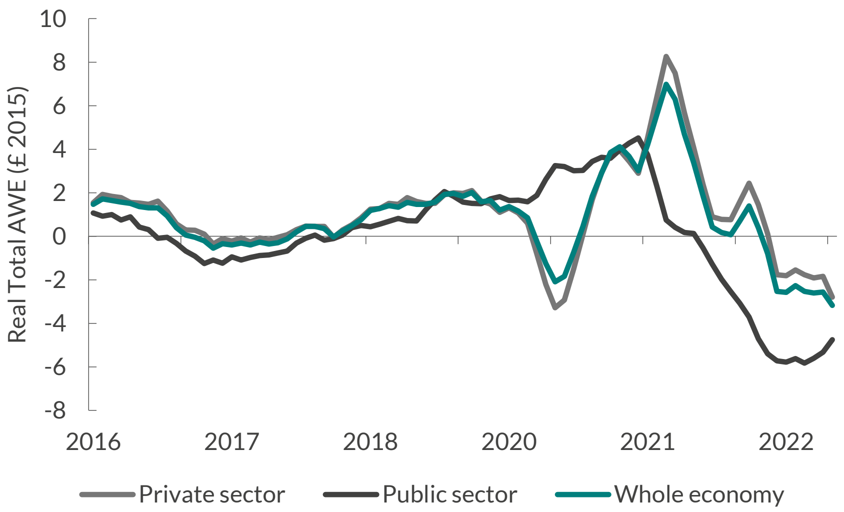
Economic Setting

Earlier this month, we released our GDP Tracker, which noted that GDP remained flat in the fourth quarter of 2022 relative to the third quarter, bringing annual growth to 4.1 per cent. We stressed that though this implies the United Kingdom narrowly avoided a technical recession (two consecutive quarters of contracting growth), it would be little consolation to most households which have seen significant hits to their real incomes over the last year.

Yesterday's ONS labour market data suggested that average weekly earnings, excluding bonuses, grew by 6.7 per cent in the fourth quarter of 2022 – a record growth rate in regular pay outside of the pandemic period. Despite this elevated growth in nominal wages, today's revised CPIH data reveals that economy-wide real total (including bonuses) wages fell by 3.2 per cent in the year to the fourth quarter of 2022. As shown in figure 2 below, workers in different sectors felt this real squeeze asymmetrically: real pay fell by 4.8 per cent for public sector workers over this period, on average, while for private sector workers it was 2.3 per cent.

Yesterday's Wage Tracker highlighted that this ongoing erosion of household real incomes may alter work patterns in 2023, as signalled by ONS December data and high-frequency January data. The December ONS data indicated that the UK employment rate increased by 0.2 percentage points in the fourth quarter of 2022 relative to the third quarter, driven by part-time workers, while this period also saw a record-high net flow out of economic inactivity driven by people moving into employment. At the same time, the most recent report by Hiring Lab - the economic research branch owned by and utilising the proprietary data of job-posting site Indeed – notes that rising searches for part-time, weekend and night shift work in the three months to January may signal workers taking on extra hours to offset cost-of-living pressures.

Figure 2 – Real average weekly earnings (including bonuses) in the public and private sectors



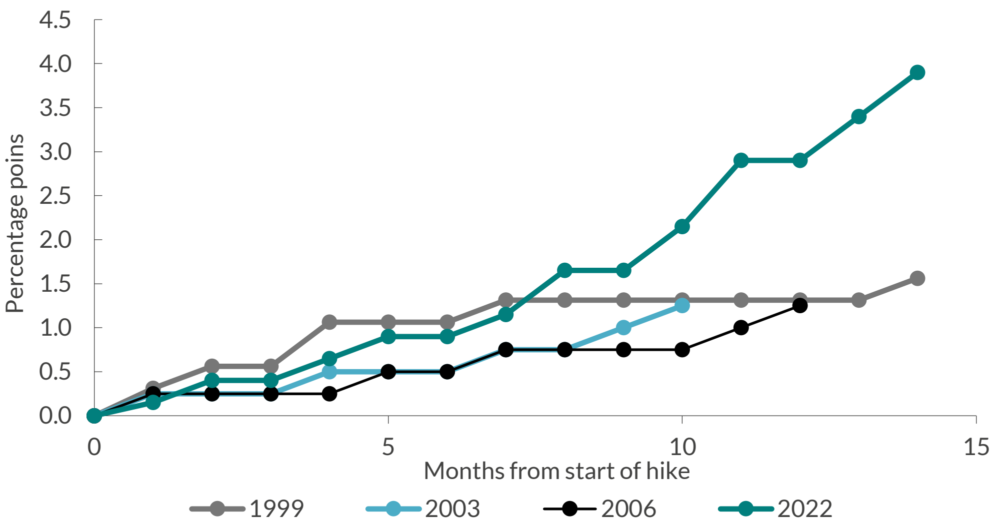
Inflation Analysis

Todays' data suggests that annual headline consumer price inflation (CPI) decreased by 0.4 percentage points to 10.1 per cent in the year to January 2022, from 10.5 per cent in December. The latest decrease in inflation was mainly accounted for by price decreases in motor fuels (and transport more generally), outweighing the effects of price increases in alcoholic beverages and tobacco. It is notable that food inflation remains elevated, at an annual rate of 16.7 per cent; this is especially concerning given that there is no government support to help households (especially lower income households, who spend a greater proportion of their incomes on food) offset this cost.

In the year to January, CPI excluding energy, food, alcoholic beverages, and tobacco grew at a rate of 5.8 per cent, a significant fall from 6.3 per cent in December and the lowest rate since July 2022. That said, it remains well above the series average of 2 per cent. At the same time, NIESR's measure of underlying inflation, which excludes 5 per cent of the highest and lowest price changes, remained at its series high of 9.0 per cent in January for a third consecutive month. Our regional decomposition suggests that trimmed-mean inflation increased in each of the 12 UK nations and regions in November. This measure of underlying inflation was the highest in the North and East Anglia at 9.5 per cent, while Northern Ireland had the lowest rate at 8.2 per cent. Evaluating these two indicators jointly, it is unclear whether core inflation has reached a turning point in the same way the headline measure has. Further, the most recent S&P Global/CIPS Services PMI highlights that businesses reported price rises during the course of the January survey that are higher than input costs (e.g. energy bills and wages), sparking the question of whether inflation will fall as much as had been expected in early 2023.

Monetary Policy Analysis

Figure 3- Bank Rate during historical tightening cycles



On 2 February, the Monetary Policy Committee (MPC) opted to raise its Bank Rate by 50 basis points, bringing it to 4.0 per cent, to maintain the inflation rate at its 2 per cent target. The latest

market expectations, as implied by the Overnight Index Swaps curve on 14 February, are for this rate to peak at 4.50 per cent in the summer, likely entailing hikes by 25 basis points in both March and May. As shown in Figure 3 above, since the Bank of England gained operational independence in 1997, the current tightening cycle is the most aggressive in terms of pace and magnitude of rate hikes. But the annual inflation rates we have seen throughout the course of 2022 are by far the highest we have seen during this period so the implied movement in real rates has been smaller. In addition, one of the reasons for the speed of the rises is that the MPC were 'behind the curve' in that they started the tightening cycle after inflation had already become set in. However, with rates rising by as much and as quickly as we have experienced in this past year, vulnerabilities in financial markets – particularly widespread illiquidity – will have been exposed.

As discussed in our recent Winter Economic Outlook, while we think that the peak in rates is high enough to bring inflation back to target around the middle of 2025, a key question will be how long the MPC should maintain the Bank Rate at its peak level, and at what pace should they loosen. Given the extent to which the Bank has received criticism for not tightening quickly enough when there were signs of the economy overheating in the post-pandemic recovery, it is possible that monetary policymakers will loosen too quickly to avoid the converse criticism. Equally, if the Bank errs on the side of caution with the pace of its loosening, and in doing so, aggravates the risk of a recession by more than is needed to bring inflation back to target, it will reignite familiar critiques. We advise that the key to dealing with potential criticisms will be increased communication and transparency on the part of the MPC, regardless of the path chosen.

Table 1 – Regional trimmed mean inflation (per cent)

	2022							2023
Region	Jul	Aug	Sep	Oct	Nov	Dec		Jan
London	7.2	7.7	8.1	8.7	9.1	9.1		9.4
South East	6.6	7.4	7.9	8.4	8.6	8.7		8.8
South West	7.4	8.0	8.5	9.0	9.2	9.1		8.9
East Anglia	7.4	8.1	8.6	9.1	9.2	9.5		9.5
East Midlands	8.0	8.6	8.9	9.2	9.4	9.2		9.3
West Midlands	8.0	8.3	8.6	9.2	9.1	9.2		9.0
Yorkshire and the Humber	7.2	7.9	8.3	8.9	9.2	9.1		9.1
North West	7.0	7.7	8.0	8.7	9.0	8.9		8.9
North	7.4	8.3	8.9	9.5	9.6	9.5		9.5
Wales	6.7	7.5	7.9	8.7	8.8	9.0		9.0
Scotland	7.4	8.0	8.5	9.1	9.2	9.2		9.1
Northern Ireland	6.4	7.5	7.6	8.5	8.4	8.2		8.2
United Kingdom	7.2	7.8	8.3	8.8	9.0	9.0		9.0

Note: Our measure of trimmed mean inflation excludes 5 per cent of the highest and lowest price changes. The level of trimmed mean inflation is typically lower than CPI inflation due to differences in how the largest price changes are treated and to how the prices are weighted. Source: ONS, NIESR calculations.

Notes for Editors:

This analysis builds on the work presented in the National Institute Economic Review, which constructs a measure of trimmed mean inflation based on the goods and services prices that underlie the consumer price index.

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