NIESR
Monthly CPI Tracker

Unexpected Rise in Inflation Complicates Tomorrow's MPC Decision

Paula Bejarano Carbo

22nd March 2023

"Annual CPI inflation rose unexpectedly to 10.4 in February from 10.1 per cent in January, driven by price increases in restaurants and hotels (mainly due to price rises in alcohol) and food and non-alcoholic beverages (in part due to price rises from vegetable shortages). Core inflation rose to 6.2 per cent in February from 5.8 per cent in January while NIESR's measure of trimmed-mean inflation rose to 9.7 per cent in February from 9.0 per cent in January. Taken together, the data suggests that inflationary pressures in the economy have yet to be tamed. Despite these elevated figures, markets do not expect the MPC to raise its policy rate tomorrow in the wake of the current financial market turbulence. Given today's data, and the expected effect of incoming wage rises on inflation in the coming months, we wonder if this would be a mistake."

Paula Bejarano Carbo
Associate Economist, NIESR

Main points

- Annual consumer price inflation unexpectedly increased to 10.4 per cent in February from 10.1 per cent in January, following three consecutive months of falling inflation. This rise was driven by price increases in: restaurants and hotels - largely reflecting price rises in alcohol; food and non-alcoholic beverage - in part a consequence of vegetable shortages leading to increased prices; and clothing and footwear - which is an expected rise as new stock enters this time of year following the new year sales period.

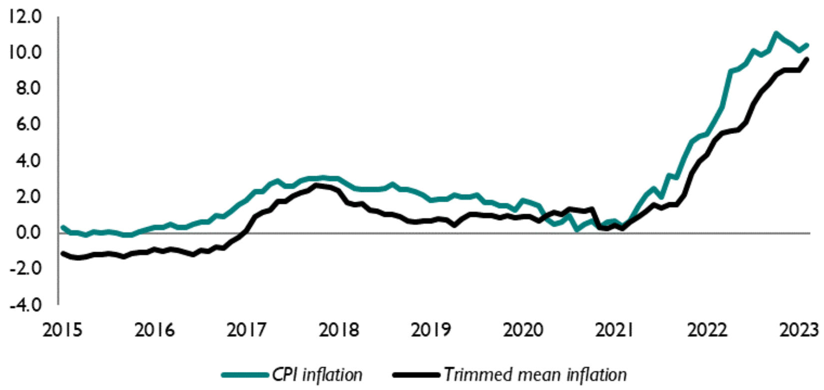
- Food inflation grew at an annual rate of 18.2 per cent in February, a significant rise from 16.7 per cent in January – the highest rate for this category observed in over 45 years. This is concerning since there is no government support to help households (especially lower income households, who spend a greater part of their incomes on food) offset this cost.

- NIESR's measure of underlying inflation, which excludes 5 per cent of the highest and lowest price changes, rose to a new series high of 9.7 per cent in February, after remaining flat at 9.0 per cent for three months. At the same time, the ONS's measure of core inflation – CPI excluding food, energy, alcohol and tobacco – rose to 6.2 per cent in February from 5.8 per cent in January. These figures suggest that the increase in headline inflation is not a one-off movement, but rather reflects rising inflationary pressures.

- NIESR's measure of underlying inflation rose in each of the 12 UK regions. It is notable, however, that regional trimmed-mean inflation dispersion has risen for the first time since September 2022. For instance, the North of England experienced a trimmed-mean inflation rate of 10.31 per cent in February, while Northern Ireland experienced 8.67 per cent.

- Market expectations, as implied by the most recent Overnight Index Swaps (OIS) curve, sees the Bank Rate peaking at 4.16 per cent in summer, notably lower than the 4.50 per cent expected at the time of last month's tracker, following the recent spell of financial turbulence. This OIS curve implies that markets do not expect the MPC to raise rates further at tomorrow's meeting, despite inflation remaining far above the 2 per cent target.
- For a breakdown of what inflation is and how it is calculated, read our blog post here.

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



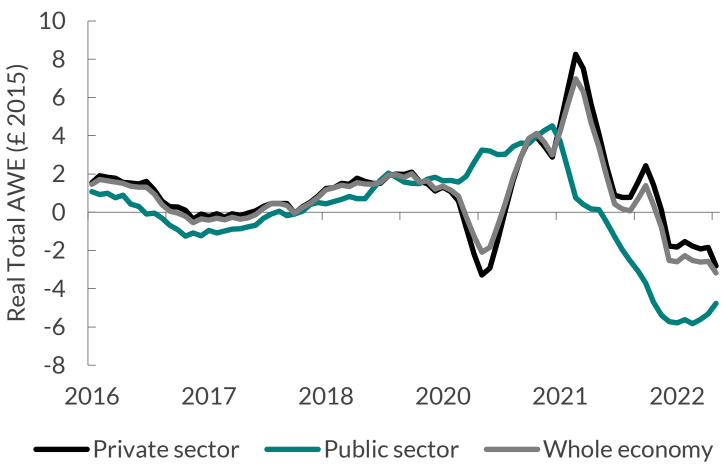
Note: Our measure of trimmed mean inflation excludes 5 per cent of the highest and lowest price changes. Source: ONS, NIESR calculations.

Economic Setting

Earlier this month, we released our GDP Tracker, which noted that the UK economy has largely flatlined, with GDP remaining flat in the three months to January relative to the previous three months and also flat compared to January 2022. At the same time, we believe the outlook for the first quarter of 2023 has improved relative to previous forecasts: in particular, optimistic high frequency data, including PMIs and spending and hiring indicators, suggest that upward risks to our forecast have materialised. We thus forecast GDP growth of -0.1 per cent in the first quarter of 2023, representing a shallower contraction than our previous forecast.

Last week's ONS labour market data suggested that average weekly earnings, excluding bonuses, grew by 6.5 per cent in the three months to January. Despite this elevated growth in nominal wages, real total (including bonuses) wage growth fell by 3.2 per cent in the fourth quarter of 2022 compared to the third quarter. As shown in figure 2 below, workers in different sectors felt this real squeeze asymmetrically: real pay fell by 4.7 per cent for public sector workers over this period, on average, while for private sector workers the fall was 2.8 per cent.

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



Inflation Analysis

Today's data suggest that annual headline consumer price inflation (CPI) increased by 0.3 percentage points to 10.4 per cent in the year to February 2023 from 10.1 per cent in January. The latest increase in inflation was mainly accounted for by price increases in: restaurants and hotels - largely reflecting price rises in alcohol; food and non-alcoholic beverages - in part a consequence of vegetable shortages leading to increased prices; and clothing and footwear - which is an expected rise as new stock enters this time of year following the new year sales period. These price rises outweighed the effects of price decreases in recreational and cultural goods and services (especially recording media, like DVDs) and transport, driven by a decrease in motor fuels.

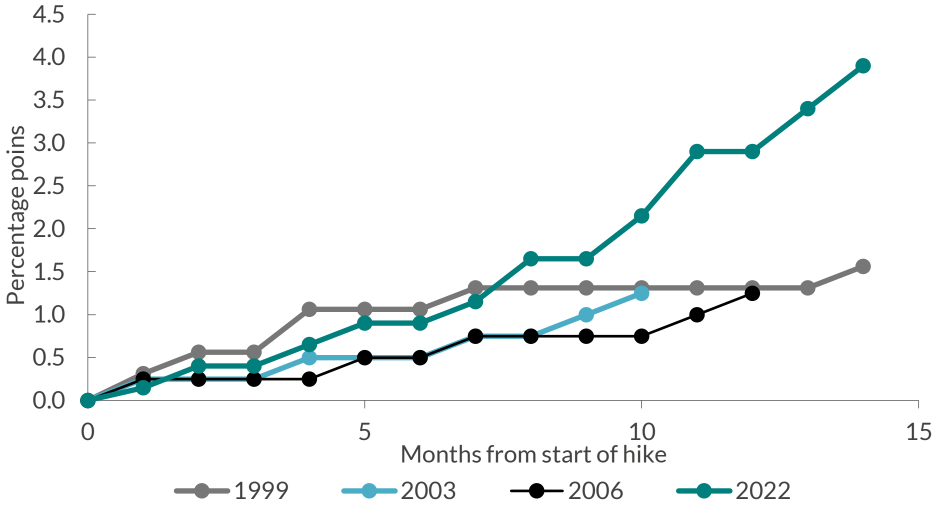
It is notable that food inflation grew at an annual rate of 18.2 per cent in February, a significant rise from 16.7 per cent in January – representing the highest rate for this category observed in over 45 years. This is especially concerning given that there is no government support to help households (especially lower income households, who spend a greater proportion of their incomes on food) offset this cost.

In February, CPI excluding energy, food, alcoholic beverages, and tobacco grew at a rate of 6.2 per cent, rising, from 5.8 per cent in January, for the first time since August 2022. 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, rose to a new series high of 9.7 per cent from 9.0 per cent in January. These figures suggest that the increase in headline inflation is not a one-off movement, but rather reflects rising inflationary pressures.

Our regional decomposition suggests that trimmed-mean inflation increased in each of the 12 UK regions in November. Additionally, regional trimmed-mean inflation dispersion has risen for the first time since September 2022. For instance, the North of England experienced a trimmed-mean inflation of 10.31 per cent in February, while Northern Ireland experienced 8.67 per cent.

Monetary Policy Analysis

Figure 3- Bank Rate during historical tightening cycles



On 2 February, the Monetary Policy Committee (MPC) opted to raise the Bank Rate by 50 basis points, bringing it to 4.0 per cent, to maintain the inflation rate at its 2 per cent target. Tomorrow, the MPC will gather for their March meeting. The latest marked expectations, as implied by the most recent Overnight Index Swaps curve, see this rate peaking at 4.16 per cent in July, meaning that markets do not expect a policy rate rise at tomorrow's MPC meeting but think the Bank may pursue one final rate hike by 25 basis points at its June meeting.

As shown in Figure 3 above, since the Bank of England gained 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.

Still, with rates rising by as much and as quickly as we have experienced in this past year, vulnerabilities in financial markets - particularly widespread illiquidity – have been exposed; the latest sign of this is the ongoing financial market turbulence that began with the Silicon Valley Bank closure in the United States. The subsequent contagion to other American and international banks has since shifted market expectations regarding the path of interest rates. This implies that markets are betting that the Bank of England will prioritise financial over price stability at its meeting tomorrow.

Given today's data, and the expected effect of wage rises on inflation in the coming months, we wonder if holding rates flat would be a mistake, as inflationary pressures continue to threaten to embed themselves in household and business expectations.

Table 1 – Regional trimmed mean inflation (per cent)

	2022							2023	
Region	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**		**Jan**	**Feb**
London	7.2	7.7	8.1	8.7	9.1	9.1		9.4	9.9
South East	6.6	7.4	7.9	8.4	8.6	8.7		8.8	9.6
South West	7.4	8.0	8.5	9.0	9.2	9.1		8.9	9.7
East Anglia	7.4	8.1	8.6	9.1	9.2	9.5		9.5	10.0
East Midlands	8.0	8.6	8.9	9.2	9.4	9.2		9.3	9.9
West Midlands	8.0	8.3	8.6	9.2	9.1	9.2		9.0	9.4
Yorkshire and the Humber	7.2	7.9	8.3	8.9	9.2	9.1		9.1	9.6
North West	7.0	7.7	8.0	8.7	9.0	8.9		8.9	**9.7**
North	7.4	8.3	8.9	9.5	9.6	9.5		9.5	10.3
Wales	6.7	7.5	7.9	8.7	8.8	9.0		9.0	9.8
Scotland	7.4	8.0	8.5	9.1	9.2	9.2		9.1	9.8
Northern Ireland	6.4	7.5	7.6	8.5	8.4	8.2		8.2	8.7
United Kingdom	7.2	7.8	8.3	8.8	9.0	9.0		9.0	9.7

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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