National Institute of Economic and Social Research

NIESR Monthly CPI Tracker

High Core Inflation May Warrant Rate Hike Tomorrow

Paula Bejarano Carbo

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"Today's ONS figures suggest that annual CPI inflation was 8.7 per cent in May, unchanged from April, as price decreases for motor fuels were offset by rising prices for food, travel, and recreational and cultural goods and services. Worryingly, core CPI inflation rose to a 31-year high of 7.1 per cent in May from 6.8 per cent in April, while NIESR's measure of trimmed-mean inflation fell only slightly from 10.2 per cent in April to 9.9 per cent in May. Moreover, services inflation rose to 7.4 per cent in May following last week's wage data showing economy-wide regular pay growth of 6.5 per cent. These indicators of underlying inflationary pressure suggest that we can expect CPI inflation to remain high through 2023 and that high inflation may be embedding itself in expectations. Taken together, today's data may well warrant a further hike at tomorrow's MPC meeting, despite the fact that much of the 'heavy lifting' has already taken place."

Paula Bejarano Carbo
Associate Economist, NIESR

Main points

- Annual consumer price inflation was 8.7 per cent in May, unchanged from April. This resulted from price decreases in motor fuels being offset by price increases in food, travel, and recreational and cultural goods and services.

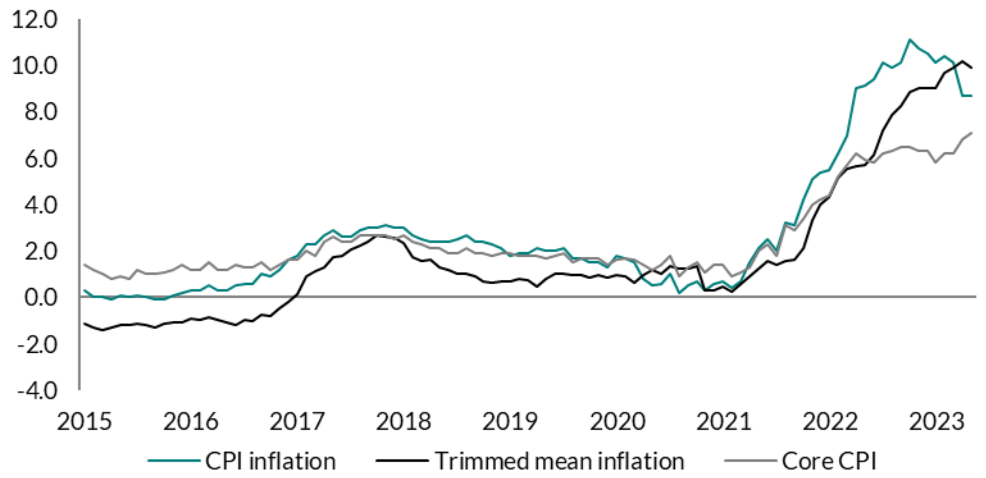
- Food inflation fell to an annual rate of 18.3 per cent in May from 19.0 per cent in April. That it remains so elevated is concerning since there is no government support to help households (especially lower income households, who spend a greater part of their incomes on food) offset this cost.

- The latest figure of 8.7 per cent represents an upside surprise in headline inflation. Though annual energy price inflation has decreased by 44.3 percentage points between May 2022 and May 2023, food inflation has increased by around 10.3 percentage points in this time. Food is weighted higher than energy in the CPI: Electricity, Gas and Other Fuels is weighted by 49/1000 whereas Food is weighted as 107/1000. At the same time, the rate of inflation of services and non-energy industrial goods has plateaued around 7 per cent, unsurprisingly close to today's core CPI figure of 7.1 per cent. This positive surprise is thus a story of increasing food inflation and persistent core inflation overtaking dropping energy prices.

- Core CPI inflation (CPI excluding energy, food, alcoholic beverages, and tobacco) rose to 7.1 per cent in May, its highest rate since March 1992, from 6.8 per cent in April. 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, fell only slightly to 9.9 per cent in May from 10.2 per cent in April. Trimmed-mean inflation being higher than core inflation indicates that the energy price fall which has driven headline CPI down is a rather volatile price movement. Overall, these figures suggest that we have yet to see a meaningful turning point in underlying inflationary pressure in the UK.

- For a breakdown of what inflation is and how it is calculated, read our blog post here.

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



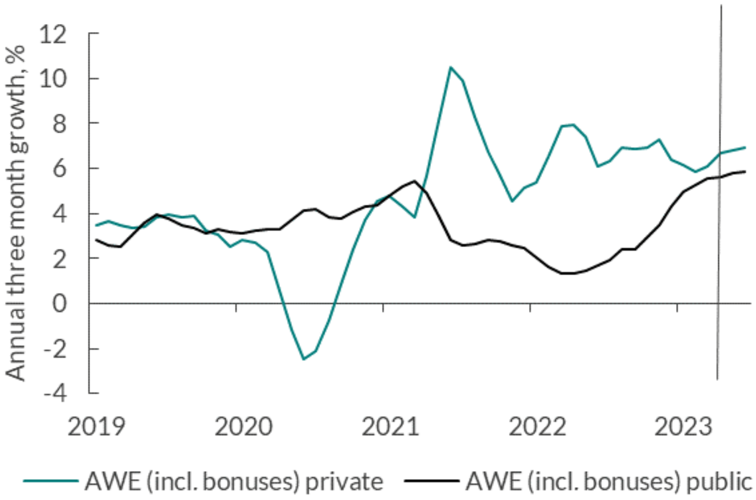
Note: Our measure of trimmed mean inflation excludes 5 per cent of the highest and lowest price changes. Source: ONS, NIESR Calculations.

Economic Setting

Last week, we released our GDP Tracker, which noted that, though GDP grew by 0.2 per cent in April, the UK economy has largely flatlined since the initial stages of the post-pandemic recovery. Consistent with this longer-term trend of low but stable growth, we forecast GDP to grow by 0.1 per cent in the second quarter of 2023.

The latest ONS labour market data suggested that the annual growth rate of average weekly earnings, including bonuses, was 6.5 per cent in the three months to April, while pay growth excluding bonuses was 7.2 per cent. Our wage tracker forecast for the second quarter of this year sees these figures at 6.8 and 6.7 per cent, respectively. These elevated forecasts, alongside today's services inflation rate of 7.4 per cent (which tracks private sector wage growth quite well) indicate that high nominal wage growth may be exacerbating the persistence of domestic inflationary pressures.

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



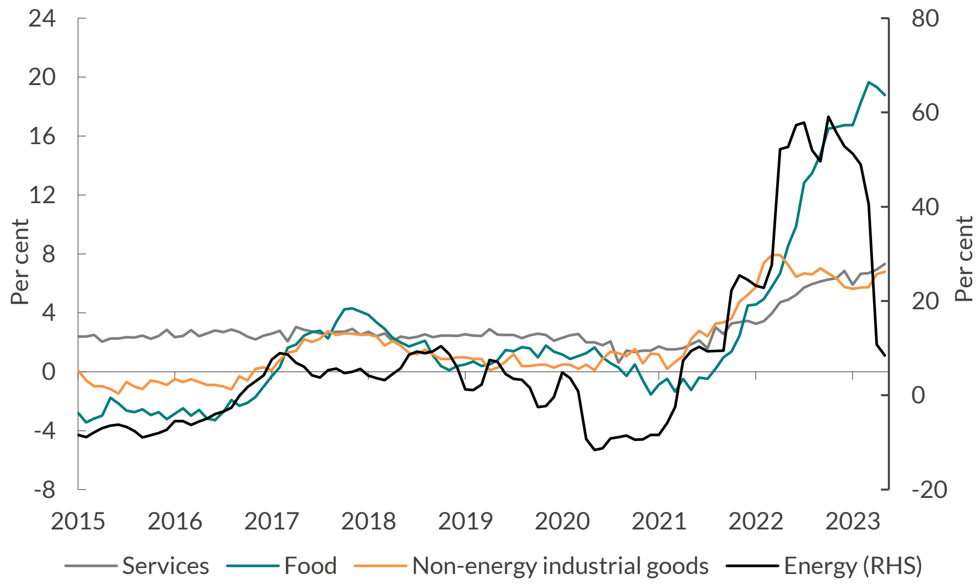
Source: ONS, NIESR Calculations.

Inflation Analysis

Annual consumer price inflation was 8.7 per cent in May, unchanged from April. This resulted from price decreases in motor fuels being offset by price increases in food, travel, and recreational and cultural goods and services.

Looking at an aggregate measure of energy (not just motor fuels), gives us a better insight into the extent to which falling energy prices are affecting headline CPI. As seen in Figure 3, the rate of energy inflation fell to 8.4 per cent on the year in May 2023, down 52.7 per cent in May 2022.

Figure 3 – Inflation for elements of the consumer price index (annual per cent)



Source: ONS

Though falling energy price inflation is driving an overall fall in headline CPI inflation, this is being partially overtaken by a significant rise in food price inflation. As seen in Figure 3 below, food prices rose at an annual rate of 18.3 per cent in May 2022. It is notable that Food is weighted higher than energy in the CPI: Electricity, Gas and Other Fuels is weighted by 49/1000 whereas Food is weighted as 107/1000 currently.

The latest figure of 8.7 per cent represents an upside surprise in headline inflation. Though annual energy price inflation has decreased by 44.3 percentage points between May 2022 and May 2023, food inflation has increased by around 10.3 percentage points in this time. At the same time, the rate of inflation of services and non-energy industrial goods has plateaued around 7 per cent, unsurprisingly close to today's core CPI figure of 7.1 per cent. This positive surprise is thus a story of increasing food inflation and persistent core inflation overtaking dropping energy prices.

Core CPI inflation (CPI excluding energy, food, alcoholic beverages, and tobacco) rose to 7.1 per cent in May, its highest rate since March 1992, from 6.8 per cent in April. It remains well above the series average of 2 per cent. This measure indicates that, as a result of the original inflation shock, inflationary pressures have permeated indirectly (sometimes referred to as 'second-round inflation effects') to other areas of the economy.

At the same time, NIESR's measure of underlying inflation, which excludes 5 per cent of the highest and lowest price changes, fell to 9.9 per cent from 10.2 per cent in April. Trimmed-mean inflation being higher than core inflation indicates that the energy price fall which has driven headline CPI down is a rather volatile price movement.

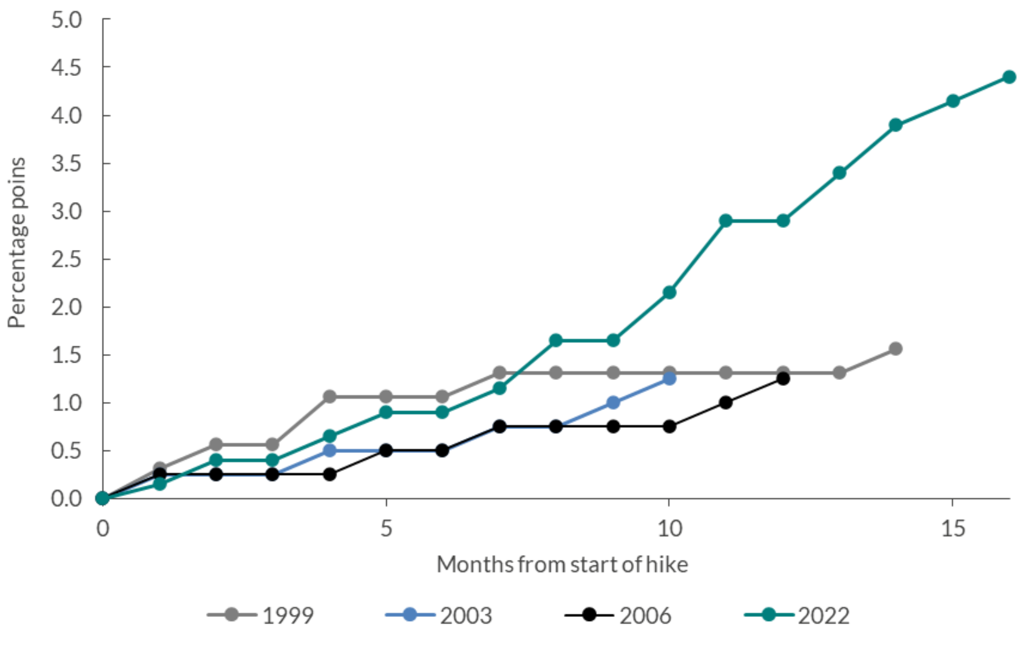
Overall, these figures suggest that we have yet to see a meaningful turning point in underlying inflationary pressure in the UK.

Our regional decomposition suggests that trimmed-mean inflation increased in each of the 12 UK regions in November. Trimmed mean inflation was highest in the North of England at 10.7 per cent in May, while Northern Ireland experienced the lowest trimmed mean inflation at 9.3 per cent.

Monetary Policy Analysis

Tomorrow, the Monetary Policy Committee (MPC) will meet against the backdrop of today's stubbornly high inflation figure. At its previous meeting, on 11 May, the MPC opted to raise the Bank Rate by 25 basis points, bringing it to 4.50 per cent, to bring the inflation rate to its 2 per cent target in the medium run. As shown in Figure 4, 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.

Figure 4- Bank Rate historical tightening cycles



Source: Bank of England, NIESR calculations

With core inflation now at 7.1 per cent and our trimmed mean estimate at 9.9 per cent, alongside elevated wage growth, it is possible that high inflation may have become embedded. Given this, a possible further tightening has already been reflected in market expectations of interest rates. That said, with much of the 'heavy lifting' having already taken place, the MPC walks a fine line in not over-tightening over the course of the coming months.

Table 1 – Regional trimmed mean inflation (per cent)

	2022						2023				
Region	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
London	7.2	7.7	8.1	8.7	9.1	9.1	9.4	9.9	10.0	10.2	9.9
South East	6.6	7.4	7.9	8.4	8.6	8.7	8.8	9.6	9.8	10.0	9.5
South West	7.4	8.0	8.5	9.0	9.2	9.1	8.9	9.7	9.8	10.1	9.8
East Anglia	7.4	8.1	8.6	9.1	9.2	9.5	9.5	10.0	10.2	10.4	10.1
East Midlands	8.0	8.6	8.9	9.2	9.4	9.2	9.3	9.9	10.1	10.6	10.1
West Midlands	8.0	8.3	8.6	9.2	9.1	9.2	9.0	9.4	9.7	9.9	9.7
Yorkshire and the Humber	7.2	7.9	8.3	8.9	9.2	9.1	9.1	9.6	10.0	10.2	10.3
North West	7.0	7.7	8.0	8.7	9.0	8.9	8.9	9.7	9.9	10.3	9.9
North	7.4	8.3	8.9	9.5	9.6	9.5	9.5	10.3	10.7	10.9	10.7
Wales	6.7	7.5	7.9	8.7	8.8	9.0	9.0	9.8	10.1	10.8	10.4
Scotland	7.4	8.0	8.5	9.1	9.2	9.2	9.1	9.8	10.0	10.5	10.1
Northern Ireland	6.4	7.5	7.6	8.5	8.4	8.2	8.2	8.7	8.9	9.6	9.3
United Kingdom	7.2	7.8	8.3	8.8	9.0	9.0	9.0	9.7	9.9	10.2	9.9

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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