National Institute of Economic and Social Research

NIESR Monthly CPI Tracker

Core Inflation Overtakes Headline CPI

Paula Bejarano Carbo

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"Annual CPI inflation rose by 6.8 per cent in July, down from 7.9 per cent in June, driven by falling gas and electricity prices as well as a softening in the pace of food inflation. However, measures of underlying inflation remain high: core CPI rose by 6.9 per cent in the year to July, unchanged from June; annual services CPI rose from 7.2 per cent in June to 7.4 per cent in July; and NIESR's trimmed-mean CPI estimate remains high at 8.6 per cent, though having fallen from 9.4 per cent in June. Altogether, these data indicate that, despite the welcome fall in the headline rate, we have yet to see a turning point in the underlying rate of inflation, which remains stagnant at around 7 per cent."

Paula Bejarano Carbo
Associate Economist, NIESR

Main points

- Annual consumer price inflation was 6.8 per cent in July, down from 7.9 per cent in June. This fall was largely driven by price decreases in gas and electricity, as well as monthly food inflation being lower in June 2023 than June 2022. These downward contributions to inflation were partially offset by price increases in restaurants and hotels.

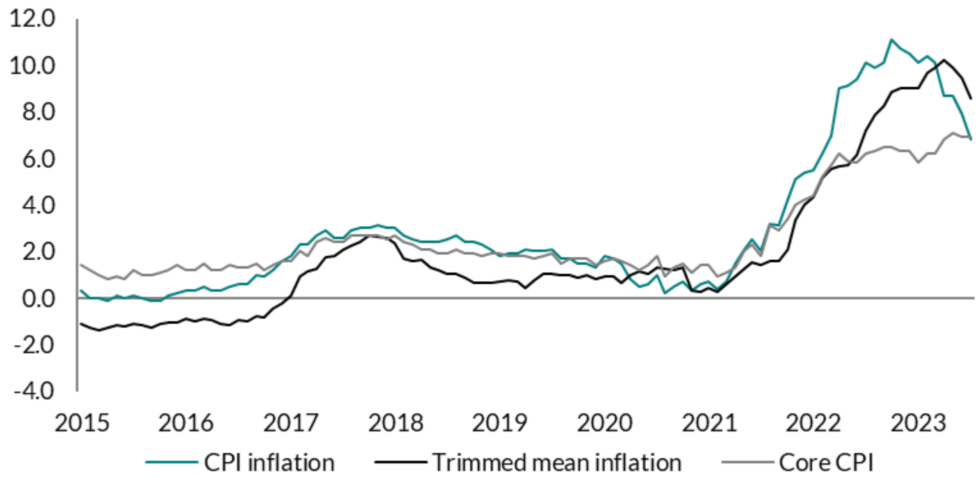
- Food inflation fell substantially to an annual rate of 14.8 per cent in July from 17.3 per cent in June. Still, that it remains so elevated is concerning since there is no government support to help households (especially lower income households, who spend a greater part of their incomes on food) offset this cost.

- Though this fall in the CPI rate was expected, given that the Ofgem energy price cap significantly decreased on 1 July, the latest figure of 6.8 per cent represents a downward surprise in headline inflation relative to the forecast in NIESR's Summer UK Economic Outlook. However, the rate of inflation of services rose to 7.4 per cent, while core CPI inflation remained at 6.9 per cent. At the same time, NIESR's measure of underlying inflation, which excludes 5 per cent of the highest and lowest price changes, also remains high at 8.6 per cent in July, though it fell from 9.4 per cent in June. So, while headline inflation seems to be easing by more than expected, we have yet to see a significant turning point in underlying inflationary pressures in the economy.

- NIESR's Summer UK Economic Outlook, published last week, expects inflation to fall to 5.2 per cent by the end of 2023. That said, we view the risks to inflation as tilted to the upside, given the latest data on underlying inflation as well as key risks to our forecast (such as a possible escalation of Russia's war in Ukraine or the risk of inflation expectations becoming embedded in household/firm behaviour).

- 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)



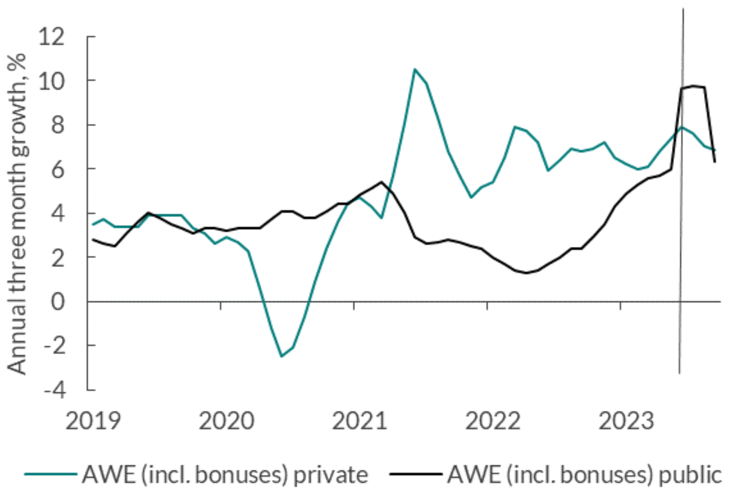
Note: Our measure of trimmed mean inflation excludes 5 per cent of the highest and lowest price changes. Source: ONS, NIESR Calculations.

Economic Setting

Last week, we released our GDP Tracker, which noted that, though monthly GDP grew by 0.2 per cent in the second quarter of 2023, 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 0.3 per cent in the third quarter of 2023.

The latest ONS labour market data suggested that the annual growth rate of average weekly earnings, including bonuses, was 8.2 per cent in the second quarter of 2023, while pay growth excluding bonuses was 7.8 per cent - representing the highest growth rate in regular pay seen since comparable records began in 2001. Our wage tracker highlighted that, though there are increasingly tangible signs that the labour market is cooling – such as a rise in the unemployment to vacancy ratio to 1.4 – the labour market remains quite tight, suggesting we will still see continued high pay growth this year. This elevated wage growth may contribute to generating further inflationary persistence, particularly by maintaining services inflation elevated.

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



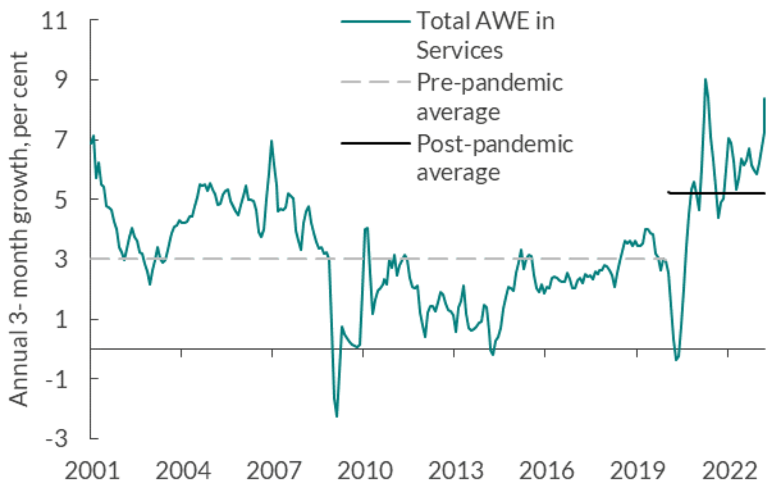
Source: ONS, NIESR Calculations.

Services sector total AWE annual growth has been on an increasing path since the initial pandemic-related plummet and currently stands at 8.4 per cent in the second quarter. As Figure 3 below shows, there seems to have been a shift in services sector total AWE growth pre- and post-pandemic; the average growth rate in AWE in this sector was 3.0 per cent from January 2001 to February 2020, while from March 2020 onwards this average has increased to 5.2 per cent (even accounting for the initial covid-related plummet). Seeing that pay in the services sector makes up most of the input costs in this sector, it is the main driver of services inflation, which today's data suggests was 7.4 per cent in July.

Inflation Analysis

Annual consumer price inflation was 6.8 per cent in July, down from 7.9 per cent in June. This fall was largely driven by price decreases in gas and electricity, as well as monthly food inflation increasing less in June 2023 than June 2022, which were partially offset by price increases in restaurants and hotels.

Figure 3 – Total average weekly earnings in the services sector



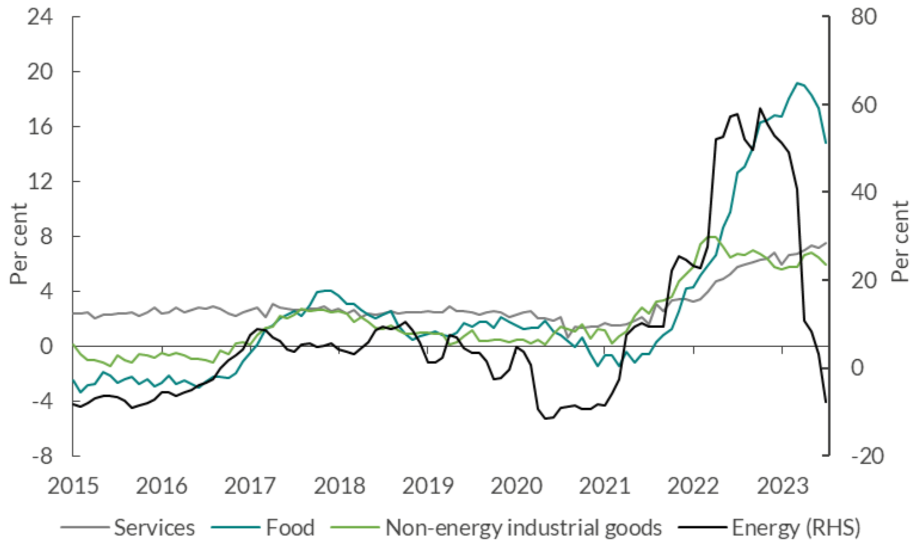
Source: ONS

NIESR's measure of underlying inflation, which excludes 5 per cent of the highest and lowest price changes, fell to 8.6 per cent in July from 9.4 per cent in June. Trimmed-mean inflation remaining higher than headline at the moment suggests that there are currently a lot more extreme price decreases (e.g, in energy) driving the fall in headline CPI.

The latest data suggest that annual energy price inflation decreased by 11 percentage points relative to June, falling to an annual rate of -7.8 per cent in July. With energy price rises 'falling out' of the CPI basket, the drivers of inflationary pressures have shifted towards rising food, non-energy goods, and services prices.

Services inflation and non-energy industrial goods inflation have plateaued at around 6 to 7 per cent over the course of 2023 (Figure 4). These figures are unsurprisingly close to the latest core CPI figure of 6.9 per cent, unchanged from June, which represents an upwards surprise in underlying inflation. Given that these components are currently driving inflation, it is worrying that they are persisting at such elevated levels and we have yet to see them hit a turning point, despite monetary tightening. These measures indicate that it is possible that we will see inflation decrease more gradually in the coming months.

Figure 4 – Inflation for elements of the consumer price index (annual per cent)

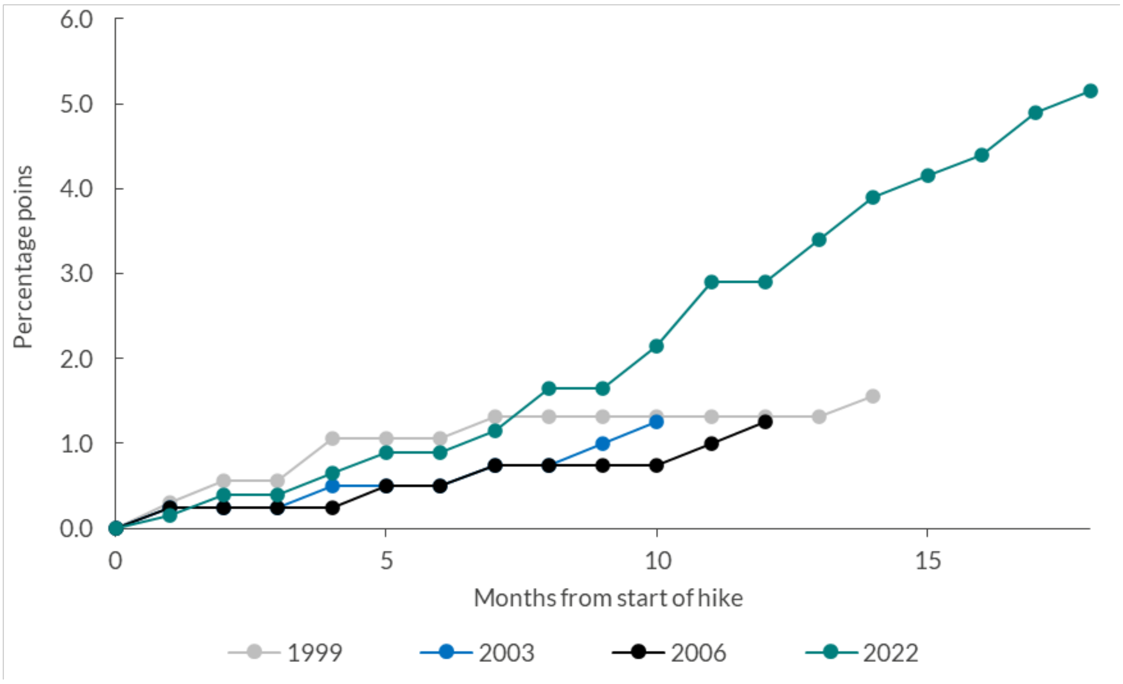


Source: ONS

Monetary Policy Analysis

The MPC opted to raise rates by 25 basis points at its August meeting, bringing the Bank Rate to 5.25 per cent. As shown in Figure 5, 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 5- Bank Rate historical tightening cycles



Source: Bank of England, NIESR calculations

Our recent Summer UK Economic Outlook conditioned our forecast on a path with the Bank Rate peaking at 5.50 per cent, indicating what we think the Bank of England should do (rather than what we necessarily think it might do) given the latest data at the time of writing. Today's data, particularly the core CPI and services inflation data, imply a continued need to tighten the Bank Rate, though whether this will be the case in the September MPC meeting will depend to a degree on the September data releases.

Regardless of where the Bank Rate peaks, the MPC needs to communicate more clearly and let markets as well as the public know when it thinks that it's done enough to bring inflation back to target. For instance, if the MPC opts for a Bank Rate path that is less aggressive than markets expect because of the output-inflation trade-off, it ought to be clear in communicating that; failing to do so risks incurring further criticism as well as further adverse market reaction (Chadha 2023).

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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