National Institute of Economic and Social Research

NIESR Monthly CPI Tracker

Large Falls in Underlying Inflation Ahead of Tomorrow's MPC Meeting

Paula Bejarano Carbo

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"Annual CPI inflation was 6.7 per cent in August, marginally down from 6.8 per cent in July, driven by falling food price inflation which was partially offset by rising motor fuel prices. Despite the minimal fall in the headline rate, it is encouraging that measures of underlying inflation fell substantially: core CPI rose by 6.2 per cent in the year to August, down from 6.9 per cent in July; annual services CPI inflation fell to 6.8 per cent in August from 7.4 per cent in July; and NIESR's trimmed-mean CPI inflation estimate decreased to 7.9 per cent in August from 8.6 per cent in July. Today's data imply that if the MPC opt for a rate hike at tomorrow's meeting, it could potentially be the last hike of the current monetary tightening cycle, conditional on future inflationary developments."

Paula Bejarano Carbo
Associate Economist, NIESR

Main points

- Annual consumer price inflation was 6.7 per cent in August, marginally decreasing from 6.8 per cent in July. This fall was largely driven by decreasing inflation rates in the food and non-alcoholic beverages as well as restaurants and hotels categories, though this was partially offset by increasing motor fuels prices.

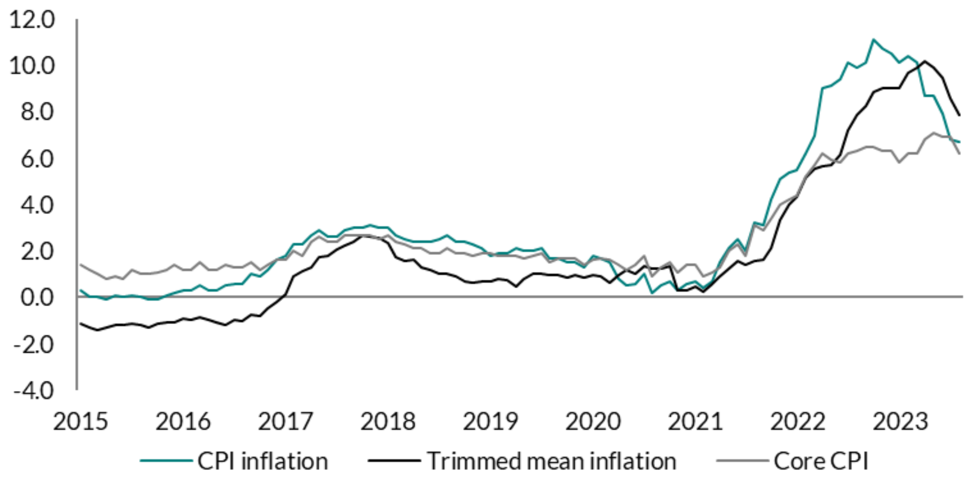
- Food inflation fell to an annual rate of 13.6 per cent in August from 14.8 per cent in July. Still, that it remains so elevated is concerning since there is no government support to help households (especially lower income households, who spend a greater part of their incomes on food) offset this cost.

- Though the slight fall in the headline CPI rate was expected, and indeed in line with my colleague Huw Dixon's 'very high' forecast last month, the underlying inflation data fell more significantly than expected. Core CPI rose by 6.2 per cent in the year to August, down from 6.9 per cent in July; annual services CPI inflation fell to 6.8 per cent in August from 7.4 per cent in July; and NIESR's trimmed-mean CPI inflation estimate decreased to 7.9 per cent in August from 8.6 per cent in July. These measures may indicate that the monetary policy tightening is finally bringing core inflation back under control.

- The ONS recently released a new measure of persistence in CPIH inflation, identified as the part of inflation which is common to all goods and services in the index. The most recent data finds that, over the past two years, five of the ten most persistent components of CPIH inflation are labour intensive items, such as hairdressing, indicating that elevated inflation expectations feeding into wage growth has been a significant contributor to inflationary persistence in this time. The authors note that this finding is consistent with Federal Reserve research that proposes that services inflation is a more important driver of core inflation than goods inflation.

- 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)



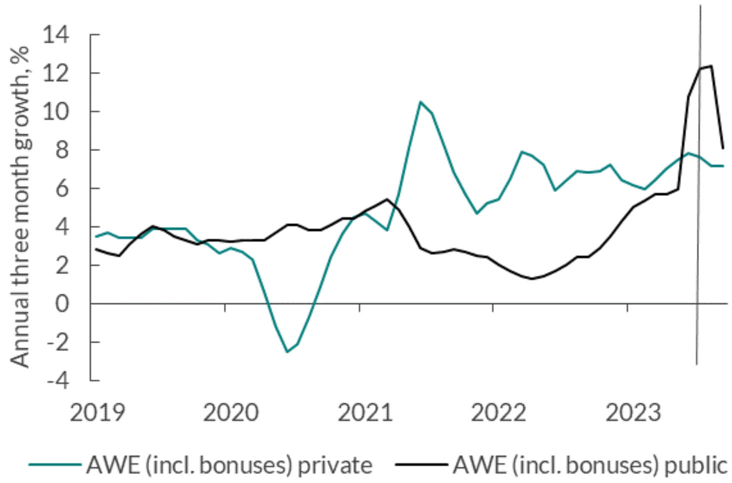
Note: Our measure of trimmed mean inflation excludes 5 per cent of the highest and lowest price changes. Source: ONS, NIESR Calculations.

Economic Setting

Last week, we released our GDP Tracker, which noted that, monthly GDP fell by 0.5 per cent in July due to decreasing output in all major sectors. Looking at the broader picture, GDP grew by 0.2 per cent in the three months to July; however, the UK economy has largely flatlined since the initial stages of the post-pandemic recovery. Consistent with this longer-term trend of little to no growth, we forecast GDP to contract by 0.1 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 8.5 per cent in the three months to July, 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 quarterly unemployment rate to 4.3 per cent – the labour market remains quite tight, suggesting we may 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 growth (including bonuses) in the public and private sectors



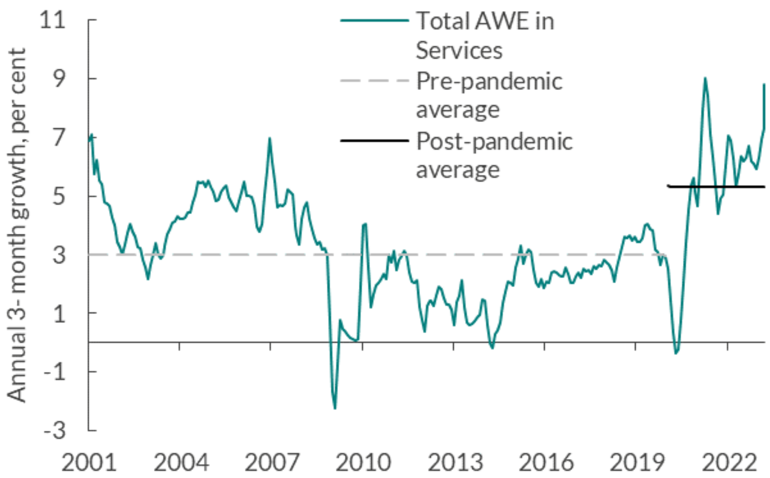
Source: ONS, NIESR Calculations.

Services sector total AWE annual growth has been on an increasing path since the initial pandemic-related plummet and currently stands at 8.8 per cent in the three months to July. 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 5.3 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 CPI inflation, which today's data suggests was 6.8 per cent in August.

Inflation Analysis

Annual consumer price inflation was 6.7 per cent in August, down from 6.8 per cent in July. This fall was largely driven by falling inflation in the food and non-alcoholic beverages as well as restaurants and hotels categories, which was partially offset by rising motor fuel prices.

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 7.9 per cent in August from 8.6 per cent in July. Trimmed-mean inflation remaining higher than headline CPI suggests that there are currently more extreme price decreases (e.g., energy) driving the fall in headline CPI.

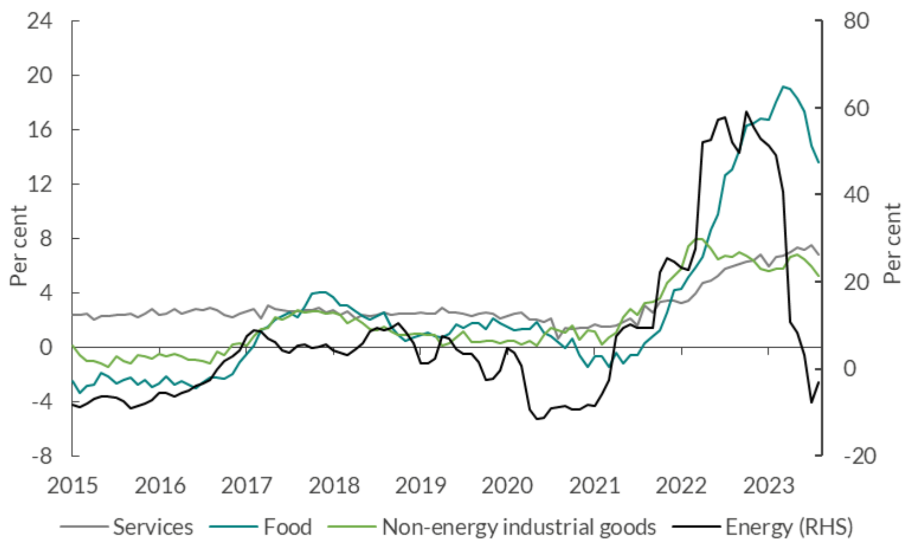
The latest data suggest that, though motor fuel prices increased in August, annual energy price inflation decreased on the year by 3.2 per cent in August. With energy price rises 'falling out' of the CPI basket, the drivers of inflationary pressures have shifted towards food, non-energy goods, and services prices.

The ONS recently released a new measure of persistence in CPIH inflation, identified as the part of inflation which is common to all goods and services in the index. The most recent data finds that, over the past two years, five of the ten most persistent components of CPIH inflation are labour intensive items, such as hairdressing, indicating that elevated inflation expectations feeding into wage growth has been a significant contributor to inflationary persistence in this time. The authors note that this finding is consistent with Federal Reserve research that proposes that services inflation is a more important driver of core inflation than goods inflation.

Services inflation and non-energy industrial goods inflation have averaged around 6 to 7 per cent over the course of 2023 (Figure 4). Both measures decreased in August, from 7.4 per cent and 5.9 per cent to 6.8 per cent and 5.3 per cent, respectively. These falls are unsurprisingly consistent with the fall in core CPI from 6.9 per cent to 6.2 per cent. As shown in figure 1, today's data appear to show that we have reached a potential a turning point in underlying inflation.

That said, with services CPI inflation being a key component of underlying inflationary persistence in the United Kingdom, and wage growth remaining strong in the services sector, there is a risk that inflation will continue to exhibit persistence in the months to come. It should be noted that, though wage growth poses an upwards risk to inflationary persistence, there is little chance that a wage-price spiral will ensue, as proposed by recent ONS findings.

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.

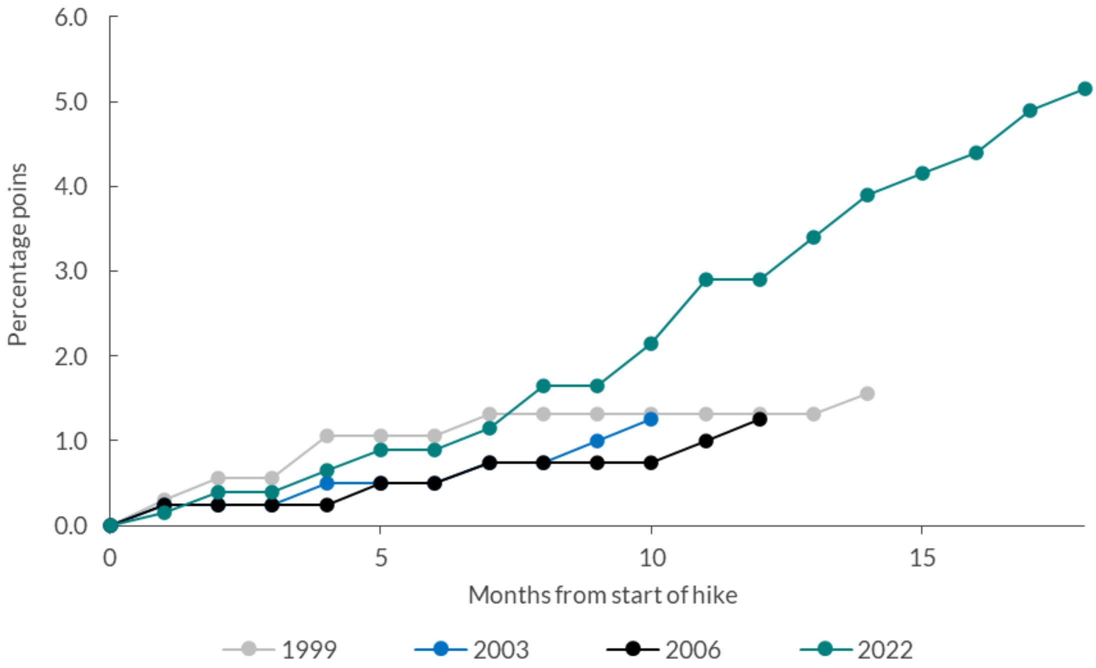
Our recent Summer UK Economic Outlook conditioned our forecast on a path with the Bank Rate peaking at 5.50 per cent, indicating what we thought the Bank of England should do (rather than what we necessarily thought it might do) given the latest data at the time of writing.

The MPC will meet tomorrow against a backdrop of a possible turning point in measures of underlying inflation alongside a still-high headline CPI rate. While the MPC may opt for a rate hike at tomorrow's meeting, we believe that, due to today's underlying inflation data, it could potentially be the last hike of the current monetary tightening cycle, conditional on future inflationary developments.

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).

Figure 5- Bank Rate historical tightening cycles



Source: Bank of England, 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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