NIESR Monthly CPI Tracker

Inflation Holds Steady at Four Per Cent, But is Set to Fall in Coming Months

Paula Bejarano Carbo

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"Today's ONS figures indicate that annual CPI inflation was 4.0 per cent in January, unchanged from December, as upward contributions, such as those from housing and household services, were offset by downward contributions, such as in furniture and household goods. This annual CPI inflation rate represents a downward surprise in inflation as our most recent UK Economic Outlook forecast a rise in CPI inflation in January, suggesting that there were less upward contributions to the monthly rate of inflation than expected. Given our forecast that inflation is set to fall throughout the remainder of the first half of 2024 due to base effects, today's downward surprise may signal that inflation is set to fall even faster than we projected. However, this is unclear given today's core inflation figure remaining unchanged at 5.1 per cent and services inflation rising to 6.5 per cent from 6.4 per cent in December, which indicate that underlying inflationary pressures remain elevated."

Paula Bejarano Carbo
Economist, NIESR

Main points

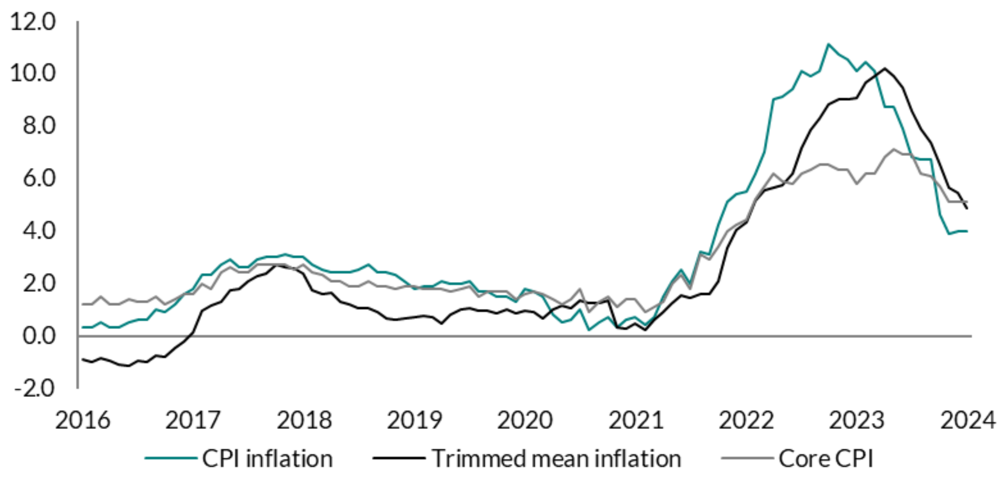
- Annual consumer price inflation was 4.0 per cent in January 2024, unchanged from December 2023. This figure reflects upward contributions, such as in the housing and household services, and transport categories, being offset by downward contributions in categories such as furniture and household goods, and food and non-alcoholic beverages.

- NIESR's measure of underlying inflation, which excludes 5 per cent of the highest and lowest price changes to eliminate volatility and separate the signal from the 'noise', fell to 4.9 per cent in January from 5.5 per cent in December. At the same time, core CPI remained unchanged at 5.1 per cent and services inflation rose marginally from 6.4 per cent in December to 6.5 per cent in January. These measures indicate that underlying inflationary pressures remain elevated – and well above the two per cent target.

- Today's data represent a downward surprise in the CPI data and may signal that inflation is set to fall even faster than we projected throughout the first half of 2024, as base effects (largely energy price increases) 'drop out' of the CPI calculation. If true, we may begin to see the MPC cut rates in spring. However, given that indicators of underlying inflationary pressure remain quite elevated and the possibility of an escalation of the conflicts in the Middle East and Ukraine that could affect transport costs and commodity prices, the risks to inflation are on the upside – especially in the second half of 2024, where we may well see inflation rebound again (though nowhere near as high as the levels experienced in 2022 and 2023). In our recent UK Economic Outlook, published last week, we noted that the MPC will not want to cut rates prematurely and have to raise them again. Thus, we think that some caution will be exercised in monetary loosening, though it is most likely that we will see several rate cuts this year.

- 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)



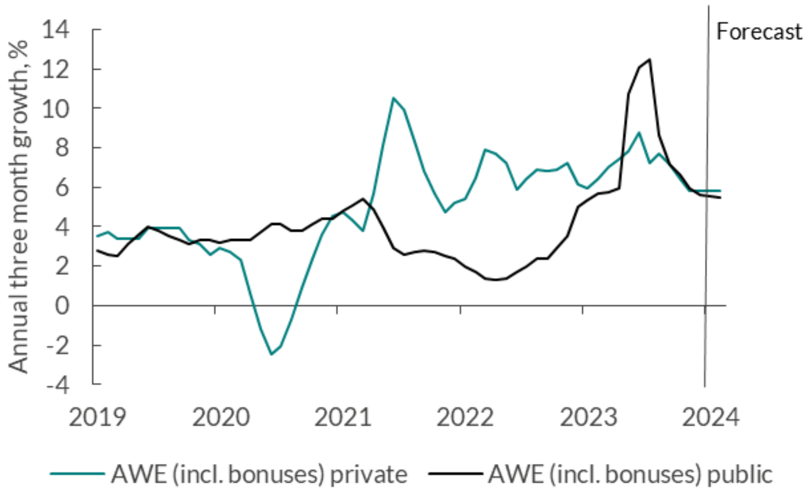
Note: Our measure of trimmed mean inflation excludes 5 per cent of the highest and lowest price changes. Source: ONS, NIESR Calculations.

Economic Setting

Last week, we released our [UK Economic Outlook](), which expects that the UK was in recession in the second half of 2023 and forecast GDP growth to remain low at around 0.9 per cent in the medium term. These projections are consistent with the longer-term trend of low, but stable economic growth in the United Kingdom.

Yesterday's ONS labour market data suggested that the annual growth rate of average weekly earnings, including bonuses, was 5.8 per cent in the fourth quarter of 2023 while pay growth excluding bonuses was 6.2 per cent. These figures indicate that wage growth continued to soften towards the end of 2023, after peaking over summer (Figure 2). Our Wage Tracker highlighted that, the vacancy-to-unemployment ratio stood at 0.71 at the end of 2023, compared to an average of 0.52 in 2015-2019 and a historical average of 0.42, indicating that the labour market is still somewhat tight. As a result, we forecast economy-wide total pay (incl. bonuses) and regular pay to grow on the year by 5.8 and 6.1 in the first quarter of 2024, respectively. Importantly, this still-high wage growth may contribute to generating further inflationary persistence, particularly by maintaining services inflation at an elevated rate.

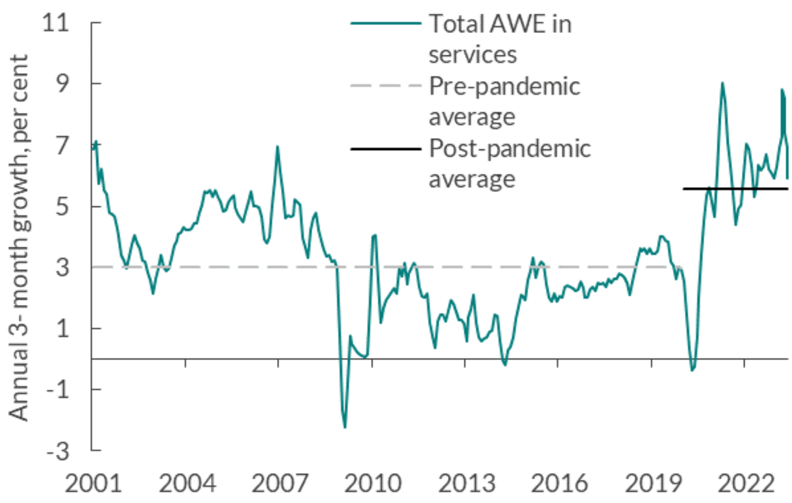
Figure 2 – Average weekly earnings growth (including bonuses) in the public and private sectors



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 5.9 per cent in the fourth quarter of 2023. 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 per cent from January 2001 to February 2020, while from March 2020 onwards this average has increased to 5.6 per cent (even accounting for the initial covid-related plummet). Given that wages in the services sector account for most of the sector's input costs, it is the main driver of services CPI inflation, which today's data suggest was 6.5 per cent in January, rising slightly from 6.4 per cent in December.

Figure 3 – Total average weekly earnings in the services sector



Source: ONS

Inflation Analysis

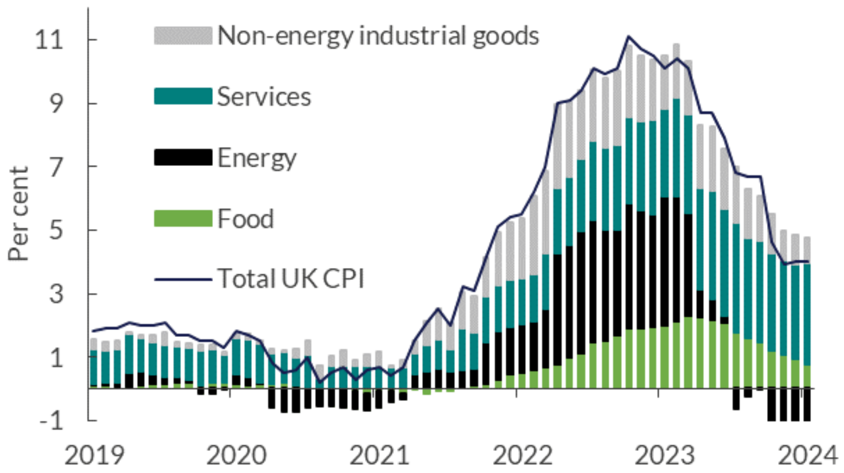
Annual consumer price inflation was 4.0 per cent in January 2024, unchanged from December 2023. This figure reflects upward contributions, such as in the housing and household services, and transport categories, being offset by downward contributions in categories such as furniture and household goods, and food and non-alcoholic beverages.

January CPI data can be difficult to analyse as this month is often affected by price distortions due to January sales as well as the introduction of new CPI weights for 2024 – which determine the relative importance of different CPI items in a typical household's 'basket'. Further, this month's figure also partially reflects an increase in the Ofgem price cap in January, which rose from £1,834 to £1,928 per year.

The latest data suggest that annual energy price inflation decreased overall on the year by 14.9 per cent in January. Energy prices 'dropping out' of the CPI basket calculation have driven the downward trend in the CPI rate (Figure 4). With energy price rises falling out of the CPI basket and becoming downward contributors to headline inflation, the drivers of inflationary pressures have shifted towards food, non-energy goods, and services prices, though the former have been easing since 2023 (Figure 4).

Today's annual CPI inflation rate represents a downward surprise in inflation, given that our most recent UK Economic Outlook forecast a rise in CPI inflation in January, suggesting that there were less upward contributions to the monthly rate of inflation than previously expected. As described in our UK Economic Outlook, we expect inflation to fall throughout the remainder of the first half of 2024 due to base effects (e.g. the energy price increases observed during the first half of 2023 continuing to 'drop out' of the CPI basket, see figure 4). Therefore, today's downward surprise may signal that inflation is set to fall even faster than we projected.

Figure 4 – Contributions of sectors to the consumer price index (annual per cent)



Source: ONS, author's calculations

Services inflation has averaged around 6 to 7 per cent since the second half of 2022, and this figure rose marginally from 6.4 in December to by 6.5 per cent in January. While services inflation remains entrenched in this range, non-energy goods inflation – which previously also averaged around 6 to 7 per cent – has been softening consistently since the second half of 2023, falling from 3.1 per cent in December to 2.7 per cent in January (Figure 5). As a result of the slight rise in services inflation and the moderate decline in non-energy goods inflation offsetting each other, core inflation held steady at 5.1 per cent in January (Figure 1).

As shown in figure 1, we have reached 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 suggested by recent ONS findings.

NIESR's measure of underlying inflation, which excludes 5 per cent of the highest and lowest price changes to eliminate volatility and separate the signal from the 'noise', fell to 4.9 per cent in January from 5.5 per cent in December. This indicates that, when we exclude volatile upwards price movements such as alcohol, tobacco and air fares, this measure of underlying inflationary pressure has decreased, signalling that some of the contributions holding the headline rate of inflation at 4.0 per cent may be volatile. That said, trimmed-mean inflation remaining higher than headline CPI suggests that there are, overall, more extreme price decreases (e.g., energy and food) driving the fall in headline CPI and that high inflationary pressures still remain broad-based within the CPI basket.

Figure 5 – Inflation for elements of the consumer price index (annual per cent)

Source: ONS

Taken together, core inflation and our trimmed-mean inflation figure indicate that underlying inflationary pressures remain elevated (above the headline CPI rate) and therefore may continue to generate persistence in the headline rate.

Monetary Policy Analysis

The MPC opted to maintain the Bank Rate at 5.25 per cent in its February meeting, and it last raised rates by 25 basis points in its August meeting.

Today's data represent a downward surprise following last month's upward surprise in the CPI data. As noted above, today's figure may signal that inflation is set to fall even faster than we projected throughout the first half of 2024. If true, we may begin to see the MPC cut rates in spring. However, given that indicators of underlying inflationary pressure remain so elevated, the risks to inflation are on the upside – especially in the second half of 2024, where we may well see inflation rebound again (though nowhere near as high as the levels experienced in 2022 and 2023).

In our recent UK Economic Outlook, published last week, we noted that the MPC will not want to cut rates prematurely and have to raise them again. Thus, we think that some caution will be exercised in monetary loosening, though it is most likely that we will see several rate cuts this year.

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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