National Institute of Economic and Social Research

NIESR
Monthly CPI Tracker

Services Inflation Poses Risk to Summer Interest Rate Cuts

Paula Bejarano Carbo

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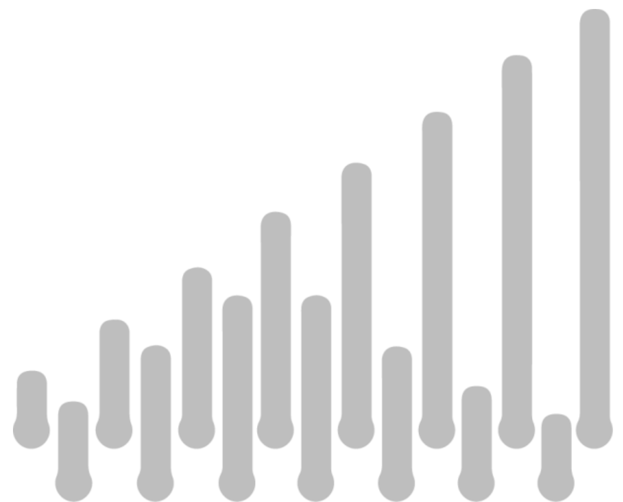
"Annual CPI inflation was 3.2 per cent in March, falling from 3.4 per cent in February, driven by downward contributions from food. Today's core inflation figure of 4.2 per cent indicates that underlying inflationary pressures continue to ease, but remain above their historical average. With inflation set to fall further in April, possibly below the Bank of England's 2 per cent target, the MPC will be closely watching movements in core CPI ahead of its upcoming meetings."

Paula Bejarano Carbo
Economist, NIESR



Main points

- Today's ONS figures indicate that annual CPI inflation was 3.2 per cent in March, falling from 3.4 per cent in February, and representing the lowest annual CPI inflation figure since September 2021. This figure reflects upward contributions, such as those from motor fuels, being offset by downward contributions, such as in food and alcoholic beverages.

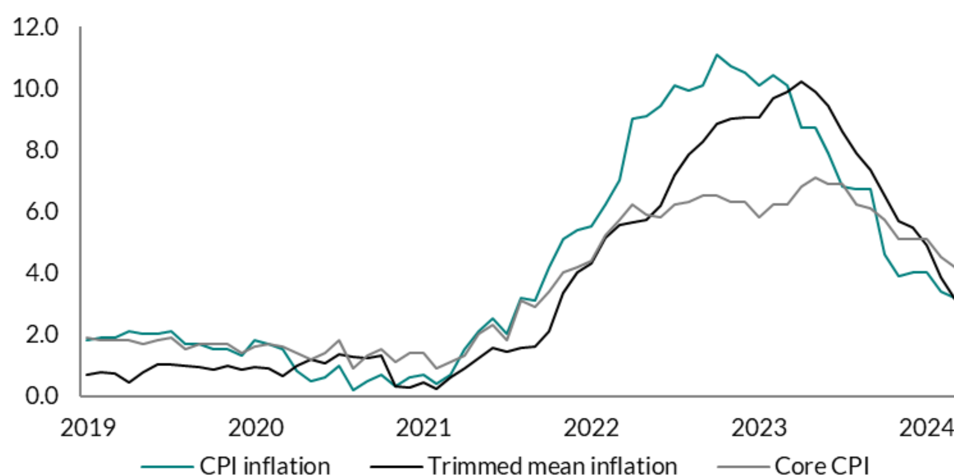
- This fall in the annual CPI inflation rate was expected, given base effects from the large energy and food price increases observed in March 2023. Inflation is set continue falling in the first half of 2024, partially due to further base effects as well as the April Ofgem energy price cap cut. Though this is positive, it will be important to keep an eye on month-on-month inflation figures (essentially 'new' inflation) to determine to what extent we will see inflation rebound in the second half of 2024. In fact, the pace at which inflation softened in March was slower than we expected, due to higher than projected month-on-month inflation.

- While indicators of underlying inflationary pressures all fell on the month, they remain high, which may require the MPC to exercise caution in monetary loosening. 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 3.1 per cent in March from 3.9 per cent in February; core CPI fell to 4.2 per cent from 4.5 per cent; and services inflation fell to 6.0 per cent from 6.1 per cent. These measures indicate that underlying inflationary pressures remain elevated – and well above the 2 per cent target.

- As a result, we think the Bank of England may need to exercise some caution in its expected upcoming monetary loosening. Indeed, we may not see a rate cut in May due to insufficient evidence of cooling underlying inflationary pressures. Whether a cut will come in June or August will become clearer next month.

- 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)



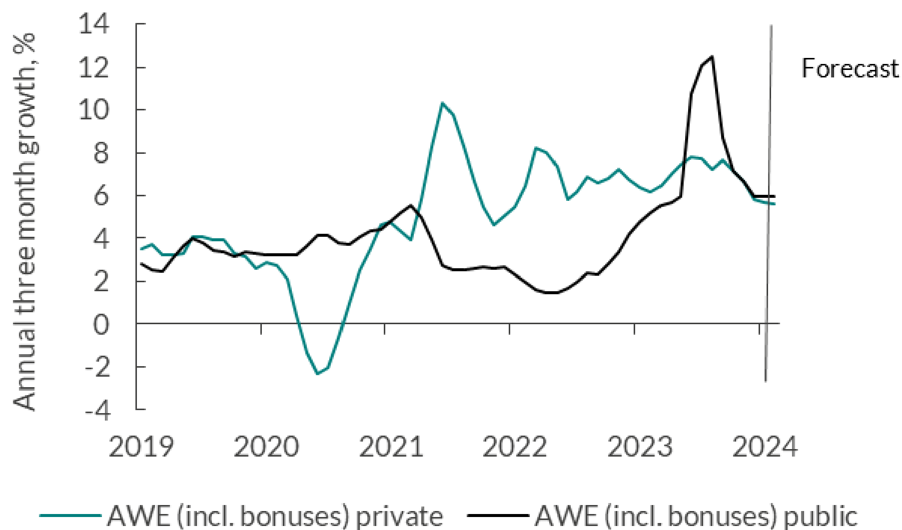
Note: Our measure of trimmed mean inflation excludes 5 per cent of the highest and lowest price changes. Source: ONS, NIESR Calculations.

Economic Setting

Last week, we released our GDP Tracker, which noted that GDP grew by 0.2 per cent in the three months to February and we estimated that GDP grew by 0.4 per cent in the first quarter of 2024. This estimate marked a positive departure from the technical recession recorded at the end of 2023.

Yesterday's ONS labour market data suggested that the annual growth rate of average weekly earnings, including bonuses, was 5.6 per cent in the three months to February 2024 while pay growth excluding bonuses was 6.0 per cent. These figures indicate that wage growth remained elevated by historical standards, but did soften somewhat at the start of 2024 after peaking over summer 2023 (Figure 2). Our Wage Tracker highlighted that the vacancy-to-unemployment ratio stood at 0.63 in February, compared to an average of 0.52 in 2015-2019 and a historical average of 0.42, indicating that the labour market continues to soften. While wage growth is expected to slow down to its historical levels in the medium-term due to this labour market cooling, the current persistence of high wage growth, together with the 9.8 percent rise in minimum wage in April (for those aged 21 and over) means inflation may be stickier in the near-term than previously thought, leading the Bank of England to remain cautious against an early rate cut.

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

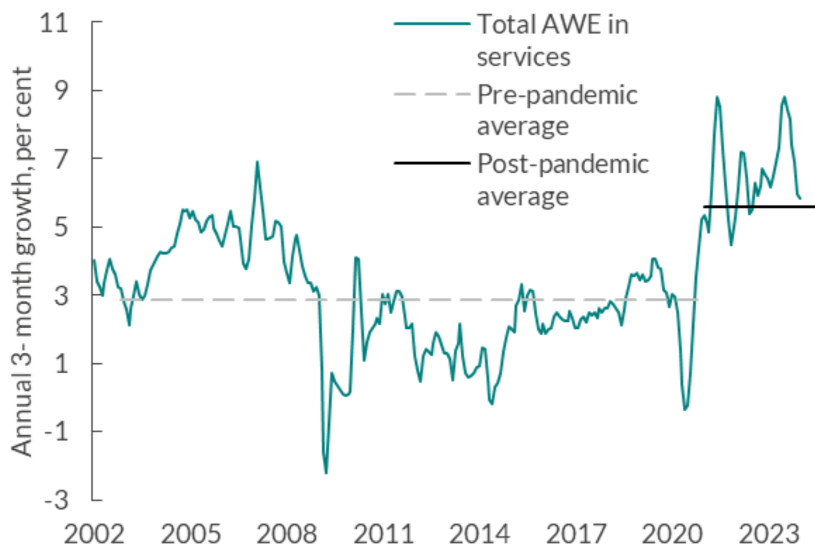


Source: ONS, NIESR Calculations.

Services sector total AWE annual growth has been on an increasing path since the initial pandemic-related plummet and currently stands at 5.7 per cent in the three months to February. 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 2.9 per cent from

January 2002 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 6.0 per cent in March, falling from 6.1 per cent in February.

Figure 3 – Total average weekly earnings in the services sector



Source: ONS

While this still-high wage growth may contribute to generating further inflationary persistence, particularly by maintaining services inflation at an elevated rate, it is good news that wage growth (economy-wide and in the services sector) has softened in recent months. If this trend continues, it may give monetary policymakers increased confidence around cutting interest rates soon (more on this below).

Inflation Analysis

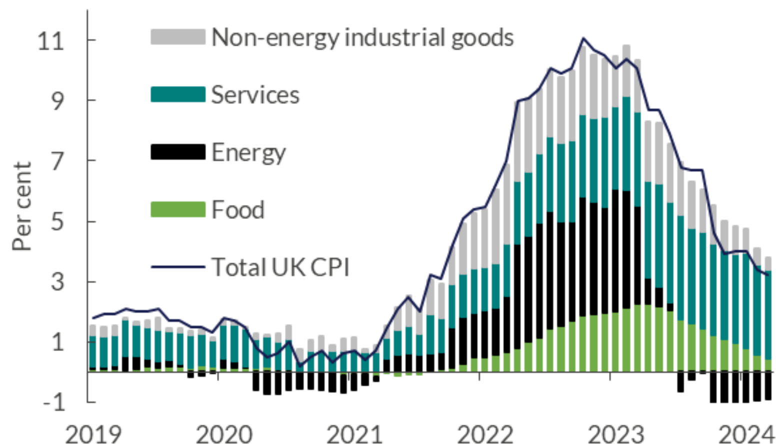
Annual CPI inflation was 3.2 per cent in March, falling from 3.4 per cent in February, and representing the lowest annual CPI inflation figure since September 2021. This figure reflects upward contributions, such as those from motor fuels, being offset by downward contributions, such as in food and alcoholic beverages. It is also important to note that CPI inflation in the UK fell below US inflation for the first time since early 2022.

The latest data suggest that annual energy price inflation decreased overall on the year by 12.7 per cent in March. Energy prices 'dropping out' of the CPI basket calculation have driven the recent 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).

Services inflation fell from 6.1 per cent in February to 6.0 per cent in March. Despite this welcome fall, we should note that this figure has averaged around 6 to 7 per cent since the second half of 2022, and has been the main contributor to headline inflation since March 2023 (Figure 4). 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 2.7 per cent in January to 1.9 per cent in February, and further to 1.4 per cent in March (Figure 5). As a result of the slight decrease in services inflation and the more considerable decline in non-energy goods inflation, core inflation fell from 4.5 per cent in February to 4.2 per cent in March (Figure 1).

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

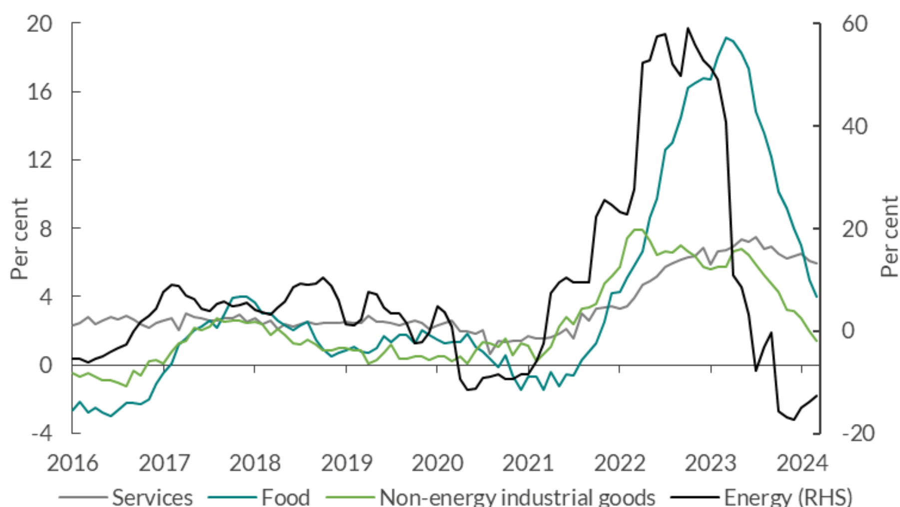


Source: ONS, author's calculations

As shown in figure 1, we have reached a turning point in underlying inflation. 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 3.1 per cent in March from 3.9 per cent in February. This indicates that, when we exclude volatile upwards price movements such as motor fuels, this measure of underlying inflationary pressure is now lower than headline inflation for the first time in a year. This suggests that in the past year, there had been, overall, more extreme price decreases (e.g. energy) driving the fall in headline CPI. This is no longer the case at the 5 per cent trim level in March. That said, this trimmed-mean inflation measure informs us that above-target inflationary pressures remain broad-based within the CPI basket.

Taken together, core inflation and our trimmed-mean inflation figure indicate that underlying inflationary pressures, particularly services, remain elevated (above the headline CPI rate) and therefore may pose an 'upside risk' to inflation. However, that they have eased significantly in recent months is a very good sign.

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



Source: ONS

Monetary Policy Analysis

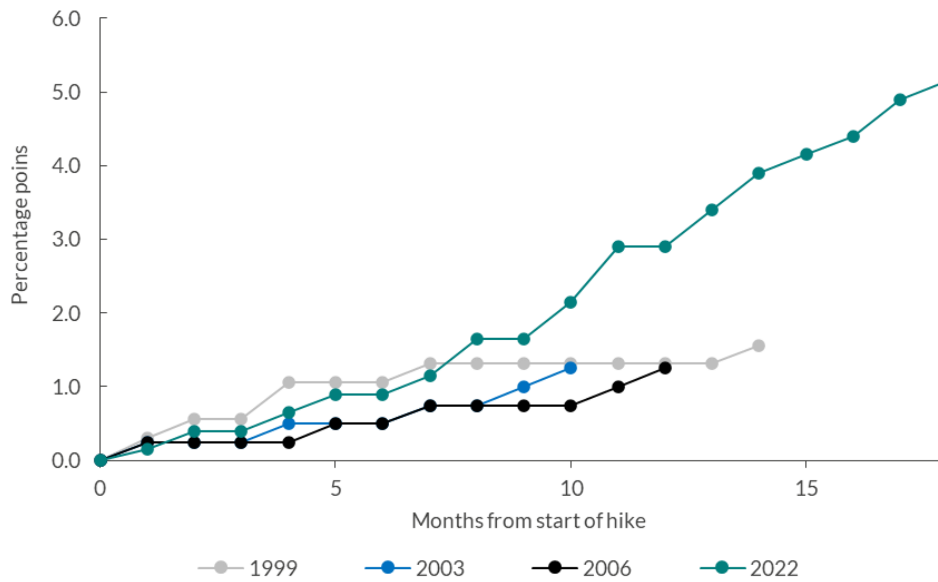
The MPC opted to maintain the Bank Rate at 5.25 per cent in its March meeting, and it last raised rates by 25 basis points in its August meeting.

Today's CPI inflation rate fell as expected, given base effects from the large energy price increases observed in early 2023. However, today's figure is higher than projected in my colleague Huw Dixon's blog last month, indicating that month-on-month inflation was actually higher than expected. While inflation is set to fall throughout the remainder of the first half of 2024 due to base effects, it will be important to keep an eye on month-on-month figures to determine to what extent we will see inflation rebound in the second half of 2024. Still, we expect these upcoming falls to enable the MPC start cutting interest rates soon.

That said, underlying inflationary pressures remaining high – most notably seen by March's services inflation figure of 6.0 per cent – may continue to worry the MPC. Paired with the possibility of an escalation of the conflicts in the Middle East and Ukraine that could affect transport costs and commodity prices, as well as yesterday's wage growth data remaining rather strong, the risks to inflation are on the upside.

In our last UK Economic Outlook, 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. This month's data suggests that we may not see a rate cut in May due to insufficient evidence of cooling underlying inflationary pressures. Whether a cut will come in June or August will become clearer next month.

Figure 6- 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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