Inflation persistence forces the Bank of England's hand

June 2023

CPI inflation confounded expectations in May, staying unchanged (at 8.7%), instead of continuing to fall as most analysts had predicted (to around 8.4%). The latest data has reinforced concerns that the UK's inflation problem may prove more difficult to shift than previously expected.

On the plus side, the data showed signs of more globally-centric price pressures receding: food price inflation softened (but was still very high, at 18.3%) and fuel prices fell by 13% on a year ago – the largest decline since the height of the first COVID lockdown in June 2020. Encouragingly, there were also signs of pipeline price pressures receding, with manufacturing input prices falling in annual terms, for the first time in two-and-a-half years.

However, the data also stoked concerns around the persistence of inflation. The drags from food and fuel prices were offset by a broad range of price rises elsewhere – such that "core" CPI inflation (which excludes food and fuel) actually rose in May (to 7.1%). Combined with the uptick in services inflation (to 7.3%) and the recent strength in private sector wage growth, this paints a picture of greater persistence in more domestically-focused price pressures.

This is something that the Bank of England's Monetary Policy Committee (MPC) have explicitly flagged concern about in their recent communications. The latest inflation data came a day before the MPC's June meeting, and so further bolstered expectations that the Committee would raise interest rates again. The MPC did not disappoint, raising rates by an outsized 50 basis points (to 5%). Minutes of the Committee's meeting stated that they were responding to the "significant upside news" in a range of data – headline and services CPI inflation, private sector wage growth and labour market activity – which indicated more persistence in price pressures.

The latest rate rise comes after much scrutiny around movements in market interest rates over the last few weeks, which have led many lenders to re-price fixed mortgage deals. The latest move from the Bank of England will likely reinforce this further, particularly given the larger-than-expected hike in rates.

Looking ahead, we still expect CPI inflation to fall over the course of this year, despite the upside surprise in May – particularly as large base effects from food, fuel and energy price inflation continue to run off. But inflation is still set to remain relatively high this year; we expect it to stand at over 4% at the end of 2023, more than double the Bank of England's target. And the persistence of domestic price pressures reiterates that the risks to our inflation forecast are firmly to the upside.

This also raises the likelihood of more rate rises from the Bank of England. Financial markets are pricing in a peak in interest rates of around 6% next year. It's unclear how likely a scenario this is at present, with further moves by the MPC heavily dependent on developments in economic data over next few months. But while such strong expectations for rates looked unwarranted a few weeks ago, they now seem very much within the realms of possibility.

For more detail on the outlook for economic growth, inflation and monetary policy, see the CBI's latest economic forecast

Strongest core inflation in 30 years ramps up pressure on the Bank of England…

- UK CPI inflation held firm at 8.7% in May, unchanged from the previous month and well above consensus expectations of a fall (to 8.4%).
    - Food & non-alcoholic beverages was the most significant drag on the headline rate (-0.07pp). Nevertheless, food prices still rose strongly in the year to May, with the annual rate (18.4%) not far off the 45-year high seen in March (19.2%).
    - Notable downward pressure also came from transport (-0.03pp), where falling motor fuels prices outweighed strength in air fares and second-hand cars.
    - Recreation & culture provided the largest upward contribution (+0.06pp), which the ONS attributed to cultural services (particularly admission fees to live music events); games, toys and hobbies (particularly computer games); and package holidays.
- Core CPI inflation (which strips out food, fuel, and energy) rose to 7.1% in May (from 6.8% in April), its strongest reading in over 30 years.
- Of the G7 countries, the UK continues to see the fastest growth in consumer prices, ahead of Italy (8.0%) and Germany (6.3%).

Domestic price pressures remain firm…

- A silver lining in the data was a slight easing in goods price inflation (to 9.7%, from 10.0% in April), which chimes with reports of waning global price pressures.
- Indeed, manufacturing input prices *fell* by 0.5% in the year to May (from +4.2% in April) while output price inflation also slowed considerably (to 2.9%, from 5.2%).
- But in contrast, the latest release points unambiguously to the resilience of more domestically-focused price pressures. Alongside the acceleration in core inflation, services price inflation gained momentum, rising to 7.4% (up from 6.9% in April). Further reinforcing this picture was by a pick-up in private sector wage growth in the latest labour market data (to 7.9% y/y in April, from 7.4%%).
- The MPC have explicitly flagged concern over domestic price pressures, and closely monitor movements in these measures to judge the degree to which stronger inflation may become embedded in wage-price setting.

…presenting upside risks to our inflation forecast

- Despite the resilience in May, we still expect CPI inflation to fall over the rest of this year – especially as base effects in food, fuel and energy price inflation continue to unwind.
- Later this year, some households will also see steep rises in mortgage payments, which will weigh on demand, taking some of the heat out of price pressures (though there will be some offset from an emerging recovery in other components of real household incomes).
- However, evidence of broad-based, domestically-generated inflationary pressures presents considerable upside risk to our forecast.

…who responded with an outsized rate rise in June

The Bank of England's Monetary Policy Committee (MPC) voted to increase interest rates by 50 basis points in June, bringing Bank Rate to 5.00%. This was more forceful than most analysts expected (predicting a smaller 25 basis points hike), and a larger rate increase than was delivered in the last two MPC meetings.

The Committee voted by a majority of 7-2 to raise Bank Rate, swayed by the strength of recent inflation and labour market outturns. Together, the recent data was taken to imply a degree of resilience in domestic price pressures that warranted a firmer response.

- Headline CPI inflation has surprised to the upside (relative to the Bank's forecasts) in each of the last four months.
- Services price inflation has also outpaced the Bank's forecasts, supported by a pick-up in private sector wage growth (which, once again, has exceeded the Bank's expectations).
- Core inflation (which excludes food, fuel and energy prices) rose to its highest level in more than 30 years in May.

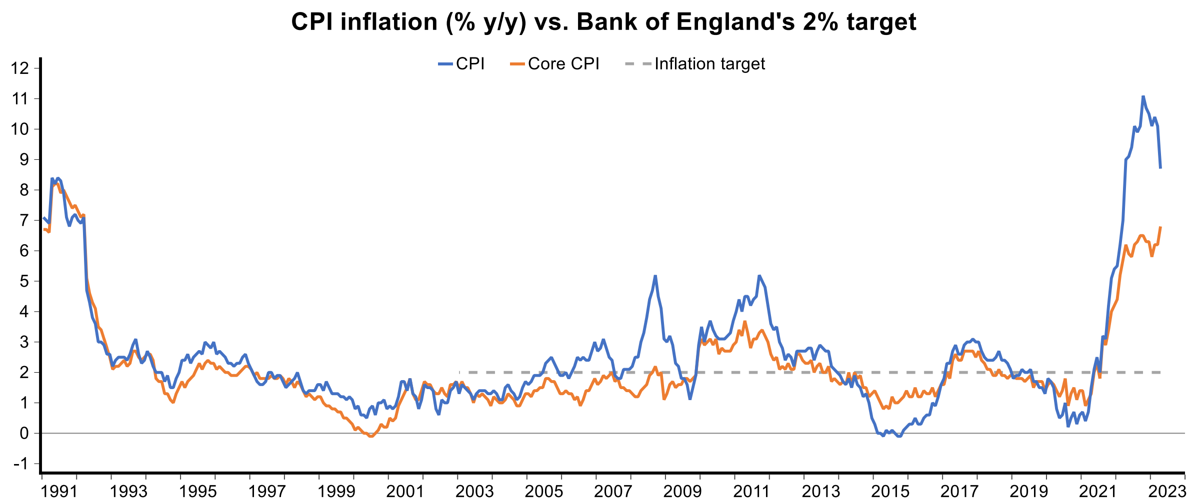
Dissenting views (with two members of the Committee favouring no change in Bank Rate) pointed to the delayed effect of accumulated monetary tightening so far, and put more weight on global price pressures fading and forward-looking indicators of price and wage growth moderating.

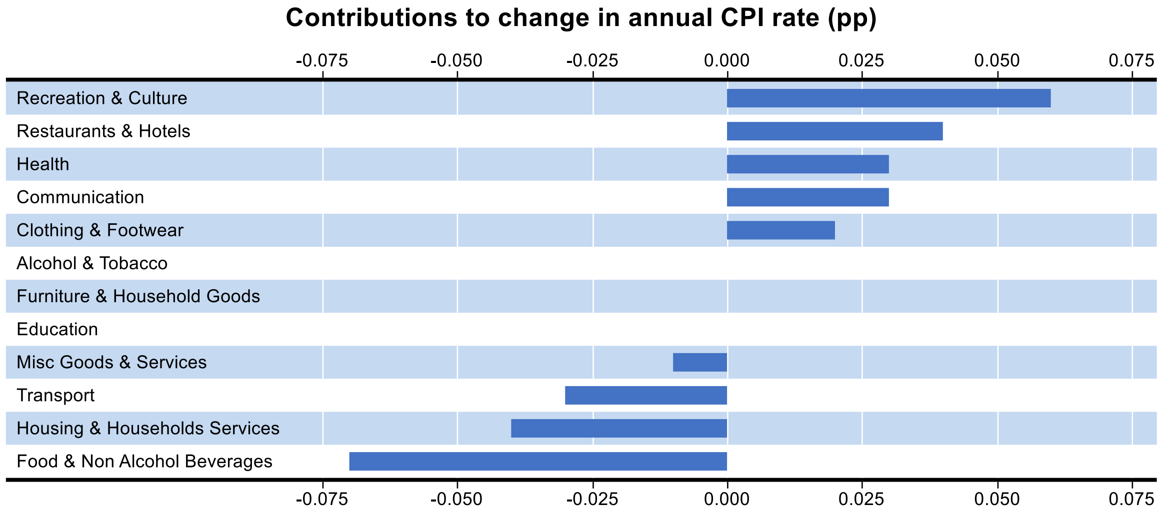
The MPC minutes also acknowledged that the full impact from rate rises had yet to come, given the greater share of fixed-rate mortgages in this tightening cycle. Even so, the Committee noted that fixed-term mortgage rates have picked up materially since May, while the availability of mortgage products has declined.

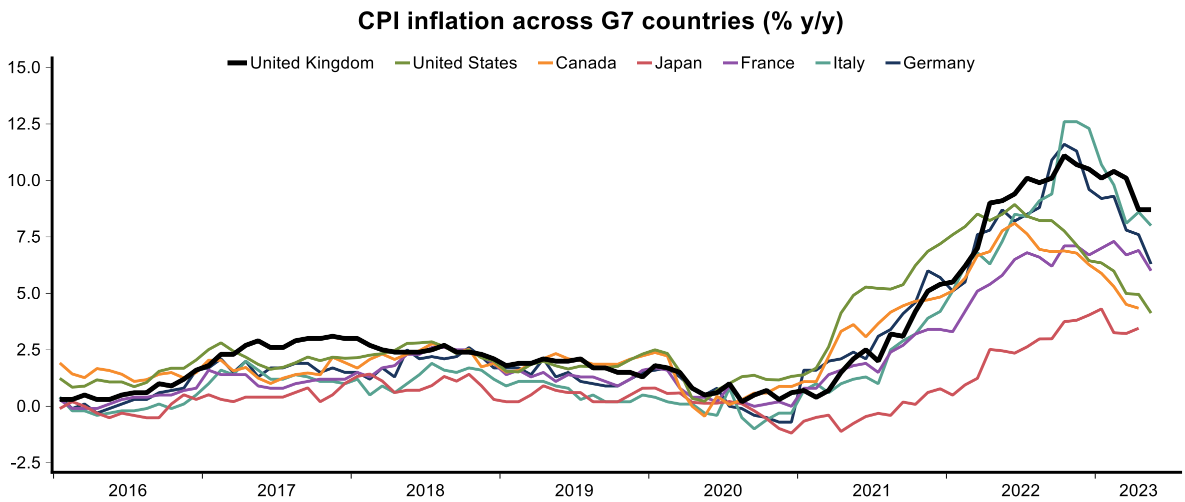
The Bank's forward guidance on monetary policy was broadly unchanged. The MPC committed to monitoring "indications of persistent inflationary pressures in the economy as a whole, including the tightness of labour market conditions and the behaviour of wage growth and services price inflation" (new qualification underlined). The significance of this seemingly minor addition is not clear, but the MPC may want to signal that their assessment of inflation persistence is taken on a more holistic basis, rather than looking solely at pay growth and services inflation.

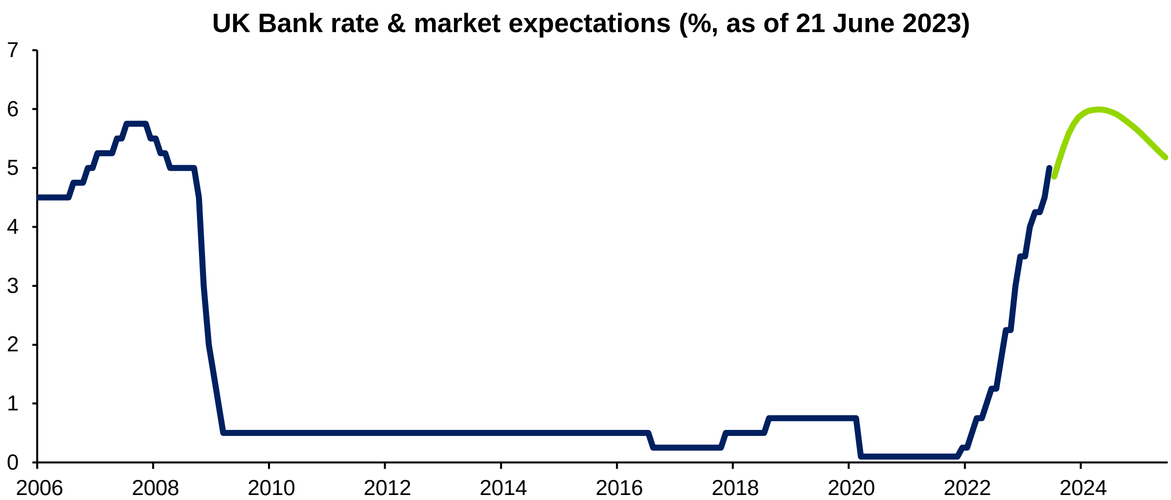
The MPC reiterated that "further tightening in monetary policy would be required" if there was evidence of more persistent inflationary pressures. Our latest forecast expected rates to peak at 5.00% in August; given that today's announcement has already surpassed this, interest rates will now almost certainly be higher than this. The extent of further rate rises will largely be dependent on how long data around inflation and domestic price pressures continue to run ahead of the MPC's expectations. Financial markets are expecting rates to peak at around 6% next year, but this is likely to remain sensitive to data flow and MPC commentary over the coming months.

Elsewhere, other central banks moved more cautiously this month. The US Federal Reserve decided to forgo a rate hike, and the European Central Bank stuck to a 25 basis points rise (bringing the ECB rate to 3.5%). While inflation has fallen more rapidly in the US and in the Eurozone than in the UK, the Fed and the ECB both signalled clearly that further monetary tightening was to be expected.




Contributions to change in annual CPI rate (pp)
-0.075
-0.050
-0.025
0.000
0.025
0.050
0.075
Recreation & Culture
Restaurants & Hotels
Health
Communication
Clothing & Footwear
Alcohol & Tobacco
Furniture & Household Goods
Education
Misc Goods & Services
Transport
Housing & Households Services
Food & Non Alcohol Beverages


CPI inflation across G7 countries (% y/y)
United Kingdom
United States
Canada
Japan
France
Italy
Germany
15.0
12.5
10.0
7.5
5.0
2.5
0.0
-2.5
2016
2017
2018
2019
2020
2021
2022
2023


UK Bank rate & market expectations (%, as of 21 June 2023)
7
6
5
4
3
2
1
0
2006
2008
2010
2012
2014
2016
2018
2020
2022
2024