Falling inflation masks domestic price pressure

August 2023

UK CPI inflation slowed to 6.8% in July (from 7.9% in June), largely as a result of a downward adjustment in the Ofgem energy price cap. Therefore, the fall in the headline rate was widely anticipated. However, an unexpected acceleration in services inflation, accompanied by a pick-up in wage growth in June, firmly underscored the stickiness of domestic price pressures.

Continued strength in these measures will limit how far and how quickly the headline rate can fall. It will also likely concern the Bank of England, thus raising the likelihood of further rises in interest rates ahead. Although the Bank appears to be approaching the peak of its rate tightening cycle, the Monetary Policy Committee (MPC) has stated that interest rates will have to be "sufficiently restrictive for sufficiently long" to bring inflation back to target. Therefore, businesses can reasonably expect tighter financial conditions to prevail for the foreseeable future.

We do still expect that inflation will fall over the coming months, as base effects in food, fuel and energy unwind further and pipeline cost pressures continue to ease. Higher interest rates will also increasingly weigh on household spending, especially as some households face rising mortgages payments later this year. Even so, the cost pressures generated by a tight labour market will likely keep inflation well above the Bank of England's 2% target for the rest of this year at least.

Fall in household energy bills belies strength in underlying inflationary pressure

- UK CPI inflation fell to 6.8% in July (from 7.9% in June), the lowest headline reading in since February 2022. Despite the sizeable drop, July's outturn represented a slight upside surprise, coming in marginally above consensus expectations (of 6.7%).
- Household services was the primary driver of the fall in the annual inflation rate. This reflected a 37% cut in Ofgem's energy price cap in July, which reduced household energy bills last month.
- Headline disinflation was broad-based though, with downward contributions from 8 of the12 main categories. Another notable drag came from food and non-alcoholic beverages, where price growth eased to 14.8% in July, from 17.3% in the previous month (and down from a peak of 19.1% in March 2023).
- There are also encouraging signs of pipeline inflationary pressures fading further. Both input and output prices, which had levelled off since June last year, have begun to fall. Input price inflation (the price of materials and fuels bought by UK manufacturers for processing) is now -3.4% having reached a peak of +24.4% in June 2022, while output price inflation (the amount received by UK producers for the

goods that they sell to the domestic market) is now -0.8%, down from 19.7% in July 2022.

- However, core CPI inflation (which strips out food, fuel, and energy) remained unchanged at 6.9% in July (and not far off the 32-year high of 7.1% recorded in May 2023). Strength in this measure is partly a reflection of strong and resilient services price inflation, which accelerated slightly last month (to 7.4% from 7.2%).
- Furthermore, despite the latest fall in the headline CPI rate, the UK continues to have the highest consumer price inflation of the G7 countries, ahead of Germany (6.5%) and Italy (6.4%).

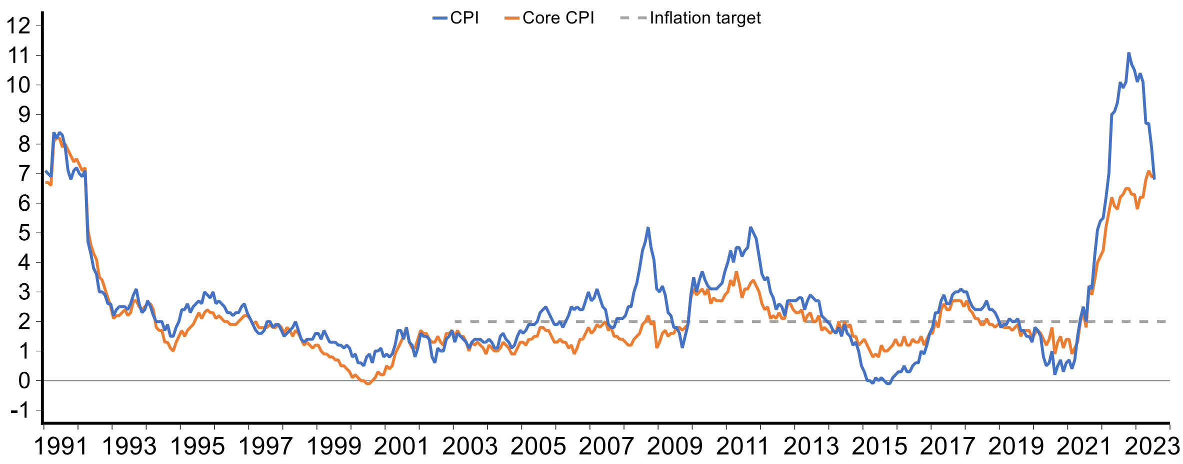
Headline disinflation leaves risks of further interest rate hikes undiminished

- The Bank of England's Monetary Policy Committee (MPC) will welcome the latest fall in inflation, which reflects a meaningful deceleration in year-on-year price growth across the energy and goods components of the CPI basket. Goods inflation fell back to 6.1% in July, which reflects waning pipeline cost pressures, and chimes with the fall in producer input and output prices.
- However, the MPC's closely-watched measures of domestically-generated inflationary pressures showed no improvement last month, as core inflation held firm and services inflation accelerated. Moreover, private sector pay growth climbed to 8.2% in the three months to June (from 7.9%), marking a record high (outside of the pandemic).
- Another pick-up in both services inflation and wage growth will stoke the Bank's fears about high inflation becoming embedded in price and wage setting. Consequently, it seems likely the MPC will judge a further rate hike is appropriate at their September meeting, and perhaps even beyond (click here for a more detailed examination of the outlook for monetary policy).

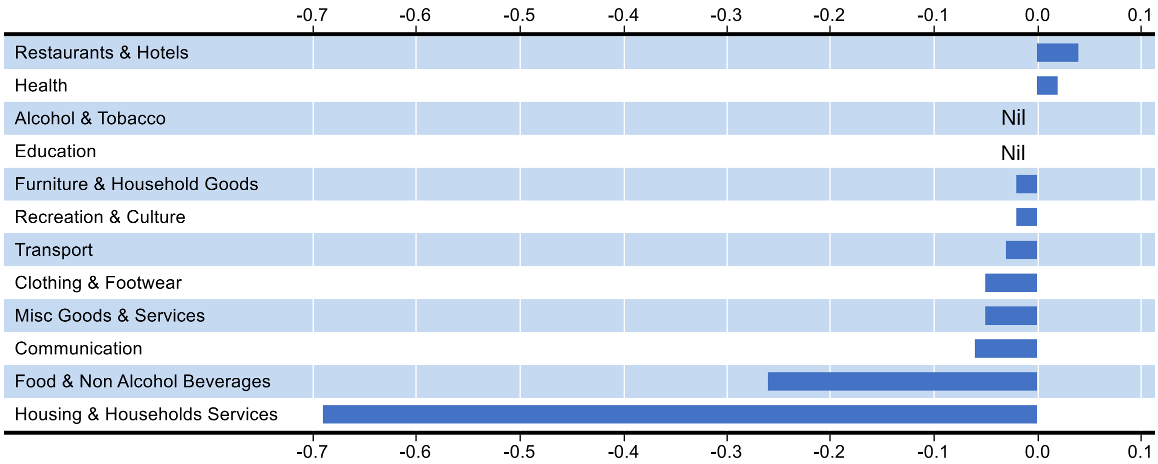
Inflation to fall through the end of 2023, but upward pressures will persist

- Looking ahead, we still expect headline inflation to continue falling over the rest of the year, as base effects in food, fuel and energy unwind. Cooling pipeline pressures will continue to pass through to lower goods inflation, while emerging labour market slack should exert downward pressure on wage growth and services inflation. Furthermore, the steep rises in mortgage payments due to come through later this year will likely restrain demand by weighing on household spending.
- However, the persistent strength in domestic price pressures to date, notably pay growth, has added considerable upside risk to the inflation outlook. Although the labour market appears to be loosening gradually, further improvement in labour supply will likely be limited by the record numbers inactive due to long-term sickness (for a detailed analysis of current labour market conditions, click here).

CPI inflation (% y/y) vs. Bank of England's 2% target



Contributions to change in annual CPI rate (pp)



CPI inflation across G7 countries (% y/y)