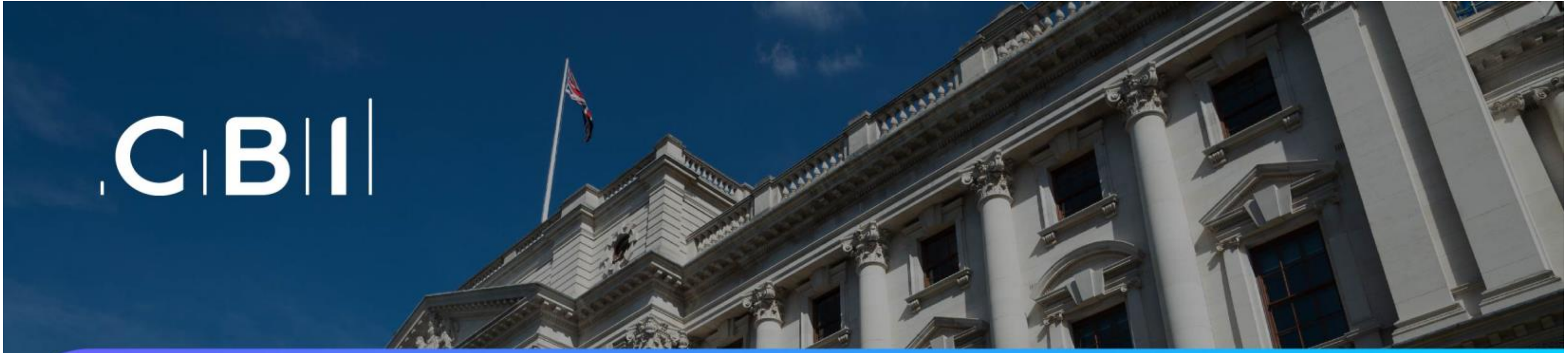


Falling inflation gives Bank of England pause for thought

September 2023

The Bank of England decided against raising interest rates in September, voting by a narrow majority to keep the policy rate unchanged at 5.25%. This marked the first time that interest rates have not risen since December 2021. Although CPI inflation remains well above the Bank's target, several measures of price pressures cooled more quickly than had been expected in August. Inflation remains on course to fall over the rest of the year, but further rate rises cannot be ruled out just yet, particularly if pay growth manages to sustain its historic pace.

Tightening cycle put on pause as inflation delivers rare downside surprise

The Bank of England's Monetary Policy Committee (MPC) voted to leave interest rates unchanged in September, holding Bank Rate at 5.25%. In doing so, the MPC halted (at least for now) a tightening cycle that stretches back almost two years.

This followed the news that annual CPI inflation had nudged down to 6.7% in August (from 6.8% in July), confounding consensus expectations of an uptick to 7.0%. A surge in motor fuel prices, coupled with the introduction of new alcohol duties, had been expected to push headline inflation back up in August.

Even more striking than headline fall in inflation was the deceleration in services inflation, a key indicator of domestic price pressures for the MPC. In August, the services measure fell back to 6.8% (from 7.4% in July), comfortably below the Bank's forecast of 7.2%.

But the MPC's decision to pause was very finely balanced, with the Committee split 5-4 in favour of keeping rates on hold. Indications of weaker activity and disinflationary momentum were sufficient to convince some of the MPC's hawkish contingent to keep interest rates unchanged this month, alongside an explicit acknowledgement that the current policy stance was restrictive.

Those in the minority (i.e. the members that voted for another 25 basis point rate rise) put more weight on more positive forward-looking indicators of output, and a still-tight labour market. In particular, the persistent strength in private sector wage growth – another closely-watched measure of domestically-generated inflationary pressure – was undiminished in the latest data, pointing to the risk that inflation expectations remain undesirably elevated.

Inflation is on downward trajectory but tighter financial conditions are here to stay

Most analysts expect the MPC's latest announcement to mark the end of the Bank's tightening cycle. However, the MPC appear to have left the door open to further rate rises, with their forward guidance largely unaltered: "further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures".

Notably, the suggestion that policy would have to remain restrictive for an extended period of time ("sufficiently restrictive for sufficiently long") also remained in place. This makes it unclear if rates will be cut any time soon, as financial markets still expect. As in the recent past, the decisions around monetary policy are likely to be heavily dictated by movements in activity and domestic price pressures.

Looking ahead, we 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 pass through to lower goods inflation, while emerging labour market slack should exert downward pressure on wage growth and services inflation. However, the recent uptick in global oil and domestic fuel prices suggests that the path back down may be bumpier than previously expected.

CBI surveys also show that business' expectations for price growth over the next three months have stabilised at their lowest level since April 2021. Lower annual growth rates notwithstanding, our members continue to report that costs still pose a significant challenge to their businesses.

Further detail

UK CPI inflation fell to 6.7% in August (down slightly from 6.8% in July), coming in well below consensus expectations of an uptick to 7.0%.

- Food & non-alcoholic beverages (-0.13 percentage points) and restaurants & hotels (-0.15 ppts) led the fall in the annual rate. The latter mostly reflected lower prices of hotel accommodation.
- Headline disinflation was partially offset by an upward contribution from the transport category (0.22 ppts), which was largely a consequence of rising prices for motor fuel this month (chiming with the recent pick-up in global food prices). But there was some offset from falling air fares: the decline in August was the first for the month on record (outside of the pandemic).
- But the decline in inflation appeared to be broader, with core inflation (which strips out food, fuel and energy) also defying expectations, dropping to 6.2% (from 6.9% in July).
- Nonetheless, despite the latest fall in the headline rate, the UK continues to have the highest consumer price inflation of the G7 countries, ahead of Germany (6.4%) and France (5.7%).

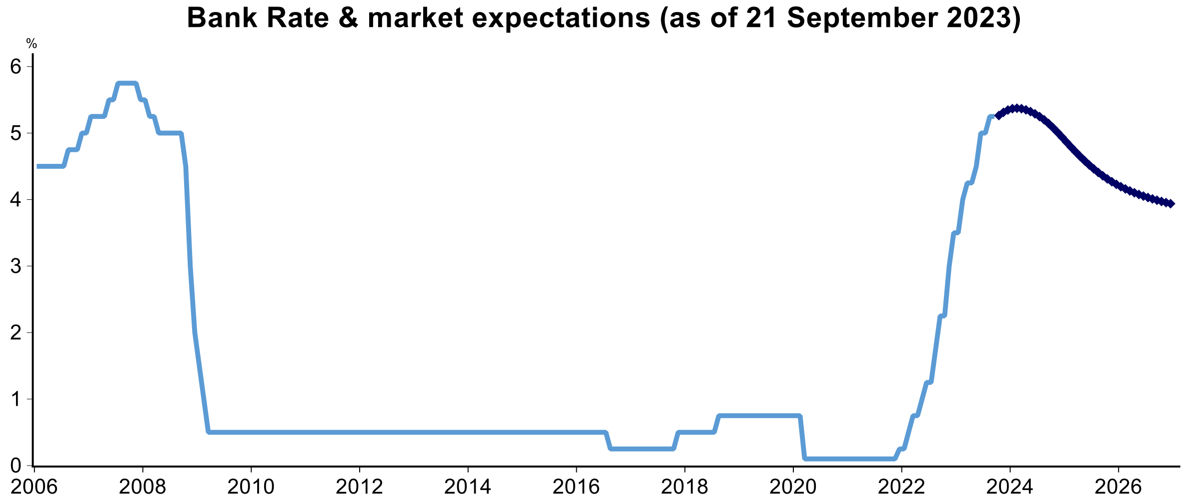
A weaker outlook for activity and downside surprises in recent data outturns featured prominently in the MPC's deliberations, according to minutes of the meeting.

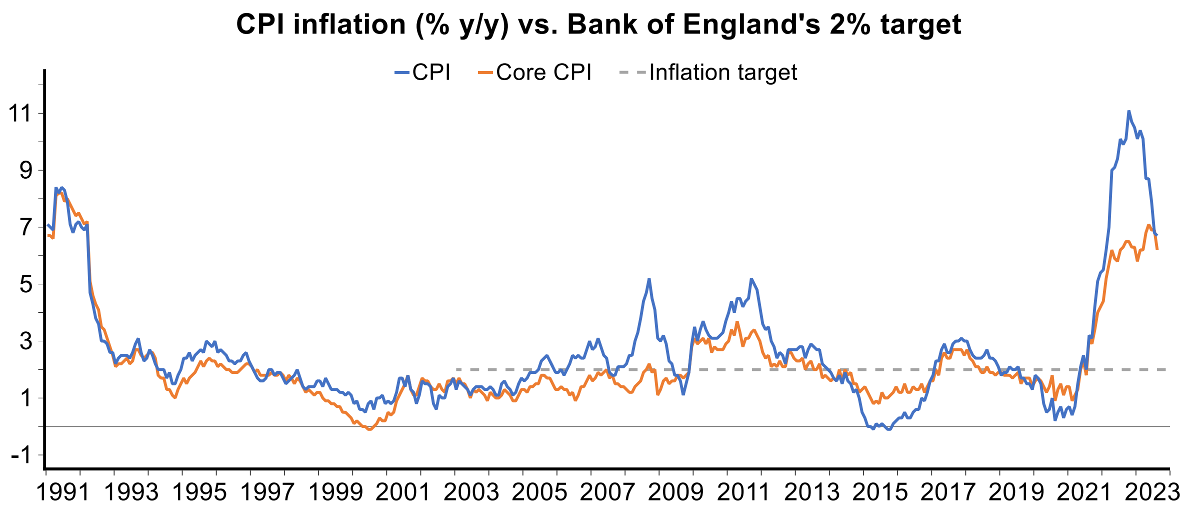
- Bank staff have revised down projections for Q3 GDP growth to 0.1%, from 0.4% in their previous set of forecasts. The MPC noted weakness in the housing sector and corporate spending, amid signs of an impact from rising interest rates. Anecdote from the Bank's regional Agents had also been more downbeat (chiming with recent feedback from our members).
- Wage growth data – a closely-watched indicator of domestic inflationary pressure – presented seemingly contradictory signals, with strong growth in the official Average Weekly Earnings measure difficult to reconcile with softer readings from surveys and HMRC data.
- Even though an unexpected fall in services inflation over August was accounted for in part by volatile categories (airfare, accommodation), underlying momentum in this segment of price growth appears to be subsiding. An alternative underlying measure

of services inflation produced by Bank staff had begun to decline, which was corroborated by survey data and Agents' intelligence.

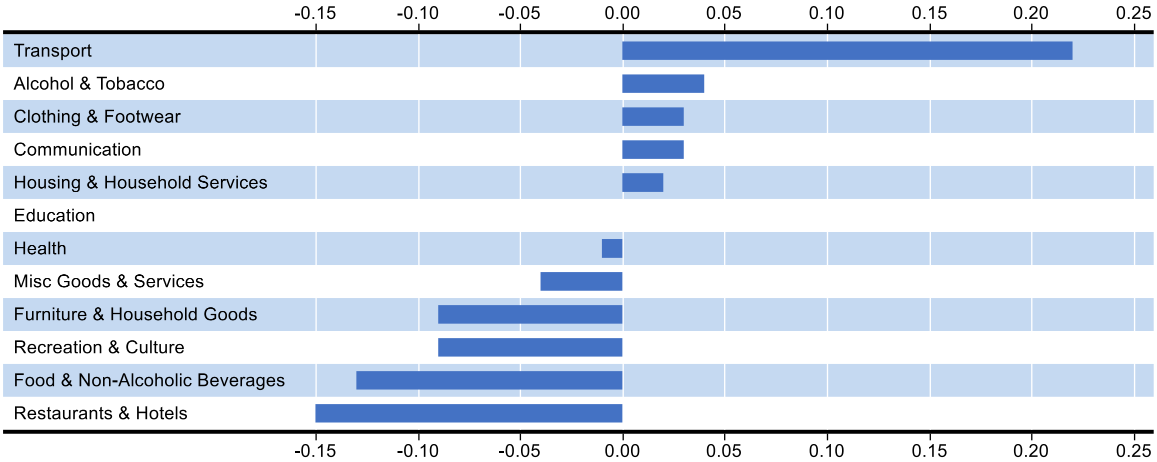
The MPC also voted unanimously to accelerate the pace at which the Bank of England's Asset Purchase Facility is being unwound (the Bank's programme of quantitative tightening). Over the next year, the stock of UK government bonds held for monetary policy purposes will be reduced by £100 billion over the next year (compared with £80 billion over the last year).

- The decision had been widely expected, after being hinted at heavily in a recent speech by Deputy Governor Dave Ramsden.
- There was little evidence that gilt sales had a material impact on market functioning or broader financial conditions, in the Committee's view. Nevertheless, the minutes reiterated that sales would be conducted in a gradual and predictable manner over a period of time.
- Bank Rate remains the MPC's primary policy tool for adjusting the stance of monetary policy. However, it is thought that shrinking the bank's balance sheet will allow for greater policy flexibility when interest rates are close to zero.





Contributions to change in annual CPI rate (pp)



CPI inflation across G7 countries (% y/y)