National Institute of Economic and Social Research

# NIESR Monthly CPI Tracker

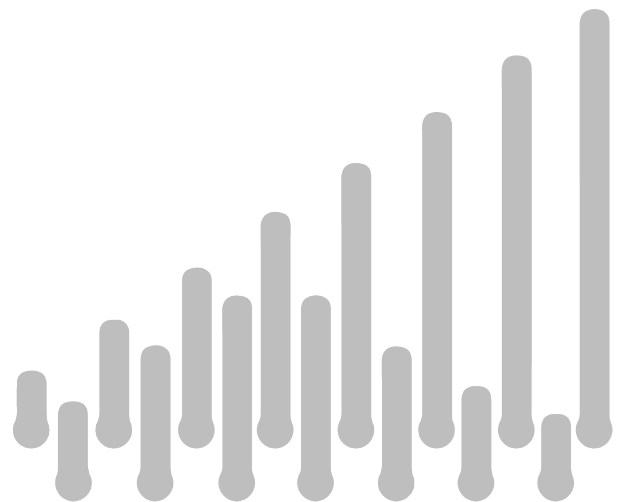
## Inflation Hits Bank of England 2 Per Cent Target in May

Paula Bejarano Carbo

June 2024

*"Annual CPI inflation has fallen to the Bank of England's 2 per cent target for the first time since July 2021. While this is positive news, we expect to see inflation rebound somewhat from June onwards. Given that today's data indicate that core inflation remains elevated, this rebound might be sharper than projected. As a result, we expect the MPC to exert caution at its upcoming meeting and hold interest rates, despite today's encouraging fall in the headline rate."*

**Paula Bejarano Carbo**
**Economist, NIESR**



## Main points

- Today's ONS figures indicate that annual CPI inflation was 2.0 per cent in May, falling from 2.3 per cent in April. This figure reflects upward contributions, such as those from transport, being offset by downward contributions from the majority of other item categories, particularly food and alcoholic beverages.

- While the fall in the annual CPI inflation rate to the Bank of England target in May is positive news, inflation will most likely rise again in in the second half of this year due to base effects. It is important to keep an eye on month-on-month inflation figures ('new' inflation) to determine to what extent we will see inflation rebound in the second half of 2024. In fact, the fall in May was consistent with my colleague Huw Dixon's projection in his blog last month, due to higher than projected month-on-month inflation. So, even though headline CPI inflation reached 2.0 per cent, we're not out of the woods yet.

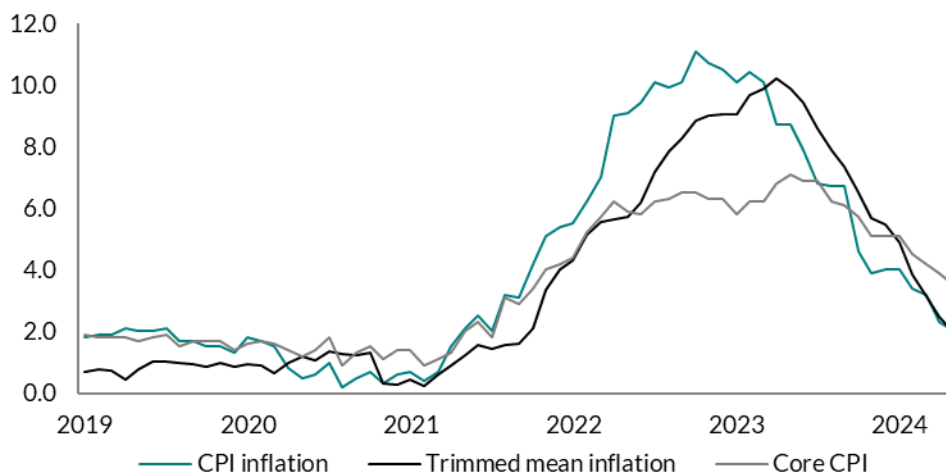
- Though indicators of underlying inflationary pressures all fell on the month, some remain high. Today's data show that core inflation remained elevated at 3.5 per cent, as did services inflation at 5.7 per cent. Given last week's elevated wage growth data, services inflation may remain elevated in the near-term, posing an upwards risk to headline inflation.

- However, it is encouraging that NIESR's trimmed-mean inflation measure (which excludes 5 per cent of the highest and lowest price changes to eliminate volatility) fell to 2.0 per cent, reaching this rate for the first time in nearly three years. This indicates that the fall in headline inflation is not driven by extreme price changes (e.g. energy price drops) but rather, reflects the average weighted price change in the basket – which is a good development.

- Altogether, we expect the Bank of England to exercise caution at its meeting tomorrow and hold interest rates, due to the presence of upside risks from still-strong services inflation.

- 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)



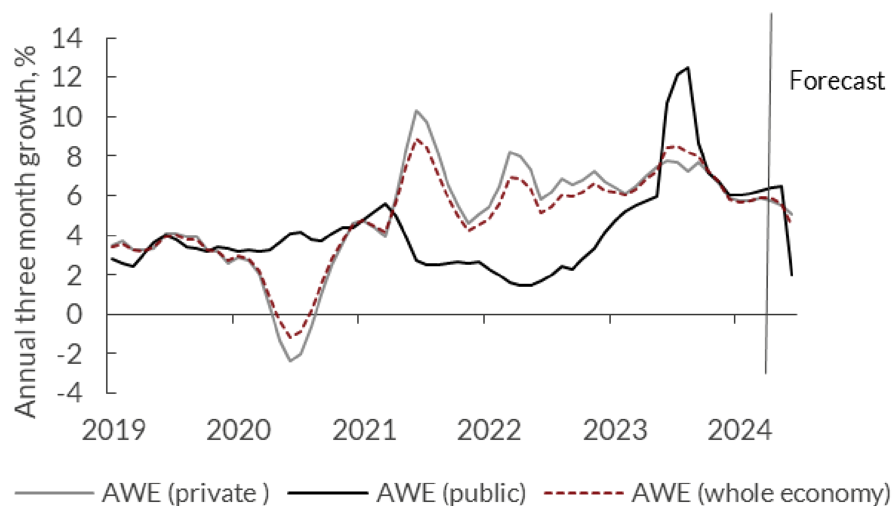

Note: Our measure of trimmed mean inflation excludes 5 per cent of the highest and lowest price changes. Source: ONS, NIESR Calculations.

## Economic Setting

Earlier this month, we released our GDP Tracker, which noted that GDP grew by 0.7 per cent in the three months to April, driven by growth in services and production. As noted in the Tracker, we expect that monthly GDP will continue its momentum in May, in line with high-frequency indicators. Indeed, the S&P Global/CIPS UK Composite PMI reported an optimistic balance of 53.0 in May, indicating overall growth in private sector output. Consistent with this positive sentiment, we now forecast GDP to grow by 0.5 per cent in the second quarter of 2024, mainly driven by service sectors.

Last week's ONS labour market data suggested that the annual growth rate of average weekly earnings, including bonuses, was 5.9 per cent in the three months to April 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 0.6 in April, compared to an average of 0.52 in 2015-2019 and a historical average of 0.42, indicating that while the labour market continues to soften, it remains somewhat tight by historical standards. While wage growth is expected to slow to its historical average in the medium-term due to this labour market cooling, the current persistence of high wage growth, together with the 9.8 per cent rise in minimum wage in April (for those aged 21 and over) means that wage inflation may be stickier in the near-term than previously thought, and may lead 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

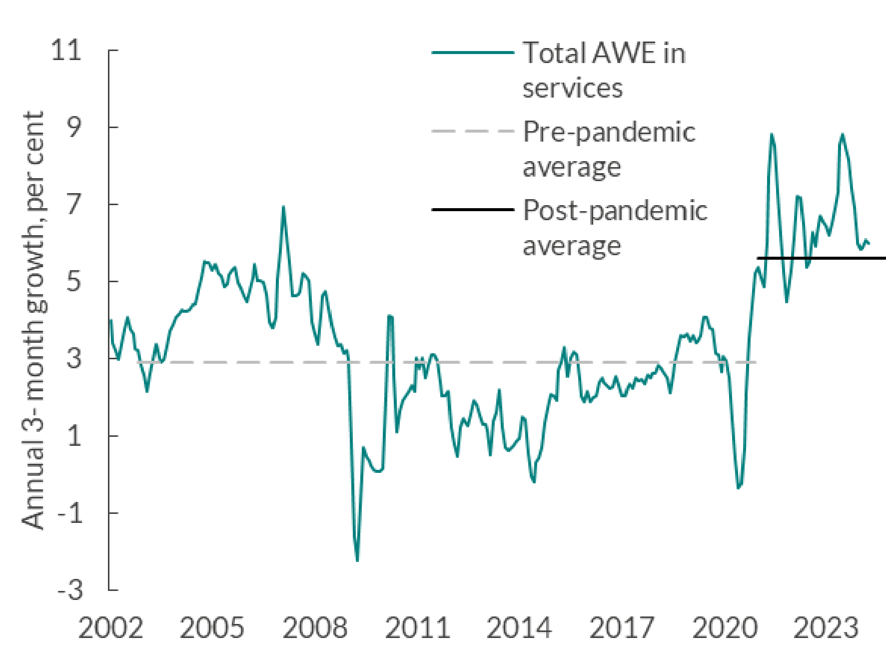



Source: ONS, NIESR Calculations.

Services sector total AWE annual growth has been on an increasing path since the initial pandemic-related plummet and currently stands at 6.0 per cent in the three months to April. As Figure 3 below shows, there seems to have been a shift in service-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 5.7 per cent in May, falling from 5.9 per cent in April.

**Figure 3 –** Total average weekly earnings growth 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

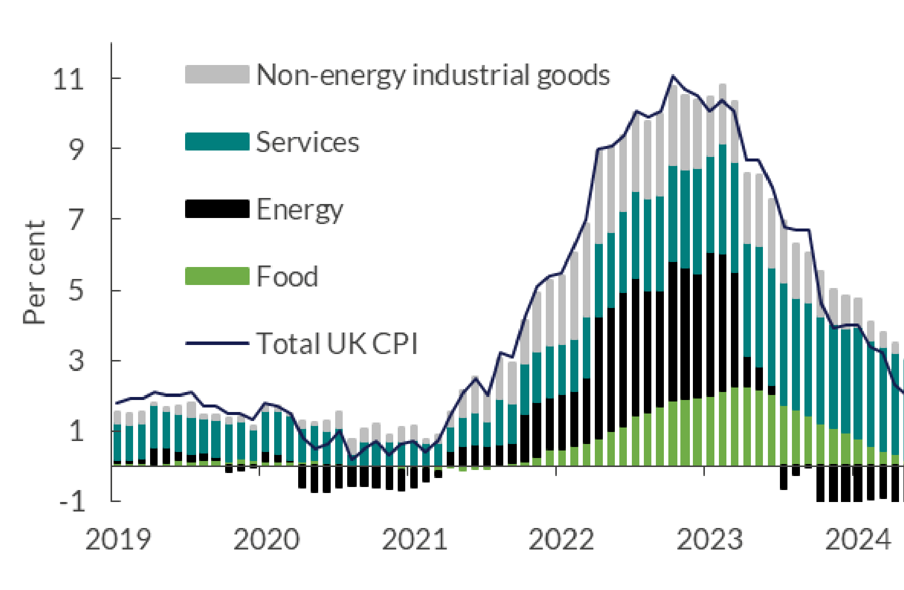
Today's ONS figures indicate that annual CPI inflation was 2.0 per cent in May, falling from 2.3 per cent in April. This figure reflects upward contributions, such as those from transport, being offset by downward contributions from the majority of other item categories, particularly food and alcoholic beverages.

The latest data suggest that annual food inflation was 1.7 per cent and energy price inflation was -15.9 per cent in May. Food and energy prices 'dropping out' of the CPI basket calculation have

driven the recent downward trend in the CPI rate (Figure 4). With food and energy prices becoming downward contributors to headline inflation, the drivers of inflationary pressures have shifted towards services (Figure 4).

Services inflation fell from 5.9 per cent in April to 5.7 per cent in May. It is encouraging to see this figure fall further below 6 per cent, as it had been entrenched in the 6 to 7 per cent rage since the second half of 2022. That said, services inflation remains the main contributor to headline inflation, and has been for over a year (Figure 4). On the other hand, 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 0.6 per cent in April to 0.0 per cent in May (Figure 5). As a result of the slight decrease in services inflation and the continued low rate of non-energy goods inflation, core inflation fell from 3.9 per cent in April to 3.5 per cent in May (Figure 1).

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

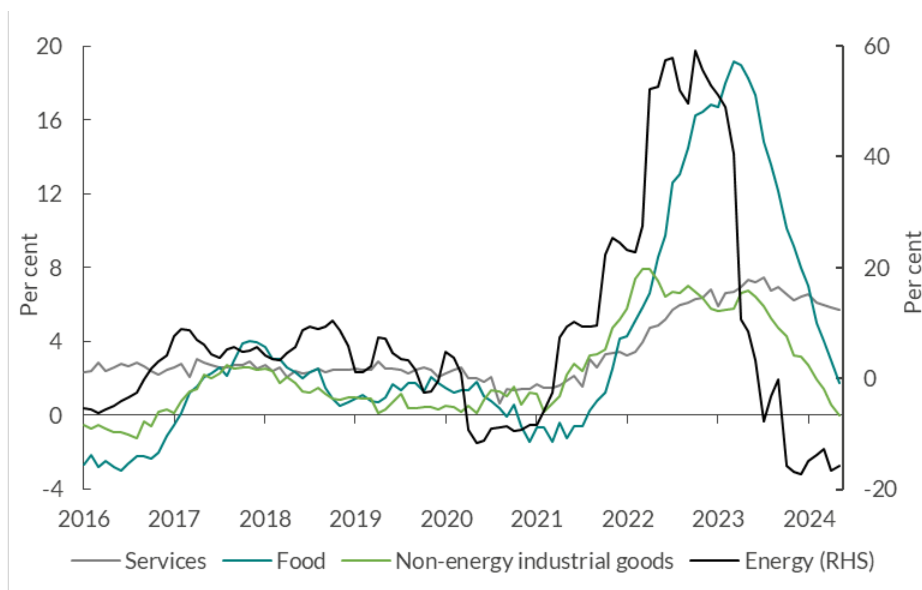



Source: ONS, author's calculations

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 from 2.5 per cent in April to 2.0 per cent in May, reaching this rate for the first time in nearly three years. This indicates that the fall in headline inflation is not driven by extreme price changes (e.g. energy price drops) but rather, reflects the average weighted price change in the basket – which is a good development.

So, though the core inflation figure indicates that underlying inflationary pressures, particularly services, may pose an upside risk to inflation, it is positive that the trimmed-mean measure suggests that these upside risks are not broad-based in the CPI basket.

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




Source: ONS

## Monetary Policy Analysis

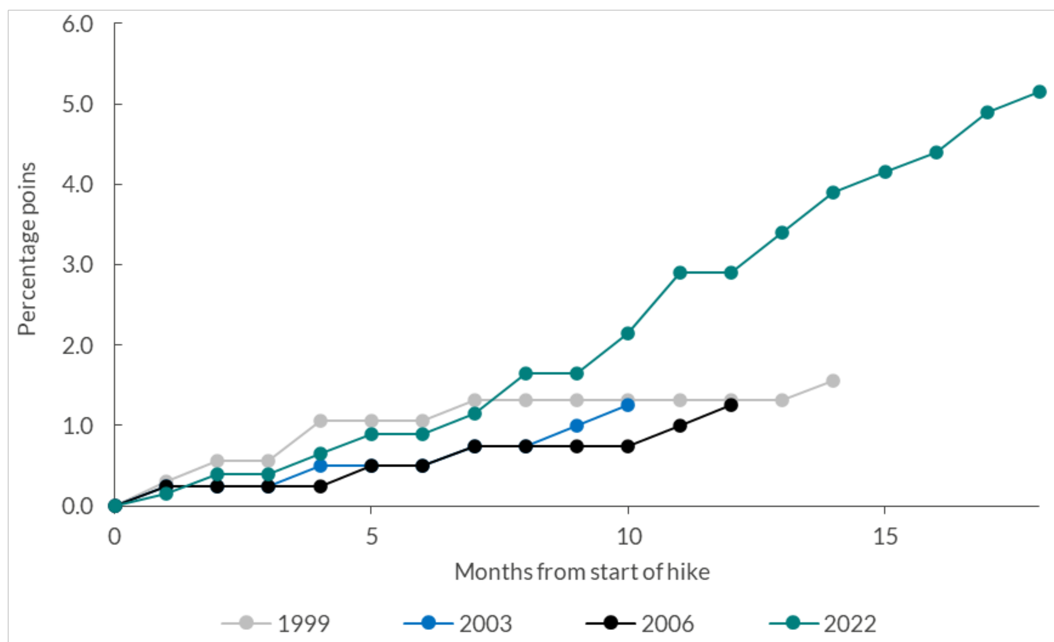
The MPC opted to maintain the Bank Rate at 5.25 per cent in its May meeting, and it last raised rates by 25 basis points in its August meeting.

While the fall in the annual CPI inflation rate to the Bank's target in May is positive news, inflation will most likely rise again in in the second half of this year due to base effects. 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 May was softer than projected in the central scenario in my colleague Huw Dixon's blog last month, indicating that month-on-month inflation was actually higher than expected. So, even though headline CPI inflation reached 2.0 per cent, we're not out of the woods yet.

Moreover, some underlying inflationary pressures remaining high – most notably seen by May's services inflation figure of 5.7 per cent – may continue to worry the MPC. Paired with last week's wage growth data remaining rather strong, in part reflecting the 9.8 per cent increase to the national minimum wage which we may see permeate further into prices, 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 and have to raise them again. Thus, we think that some caution will be exercised in monetary loosening, though it is still likely that we will see two rate cuts this year.  This month's data suggests that we may not see a rate cut tomorrow due to the continued upside risk that high services inflation poses to the headline rate.

**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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