In the dread of winter

Prospects for inflation in the coming months ahead of the Bank of England's Monetary Policy Report

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In the face of the highest inflation rate for 40 years, many are predicting that the Bank of England will announce the largest interest rate rise in 27 years this week. This spotlight focuses on the challenges and uncertainties facing both the Bank of England and UK families from rising inflation this winter.

Contrary to many reports, there have been some recent encouraging signs for lower inflation: a range of key imported commodity prices have fallen materially – by up to 61 per cent – since their peaks earlier in the year, reducing global inflationary pressures. But these positive trends have likely been more than offset by a deterioration in the outlook for gas prices, with the energy price cap now expected to top £3,600 early in 2023. This means that consumer price inflation will now peak higher and later than the Bank of England previously thought, with CPI inflation plausibly moving above 15 per cent next year (without Government measures to reduce prices).

There is also substantial uncertainty about how prices will evolve over the coming year. Even if underlying inflation rates fell immediately for all goods and services, the headline rate would not return to the Bank of England's 2 per cent target until the autumn of next year. Higher and more persistent inflation both mean that the Bank of England faces a protracted period of challenging policy making. More importantly, low-to-middle income families are likely to face disproportionately higher living cost *levels* for the foreseeable future.

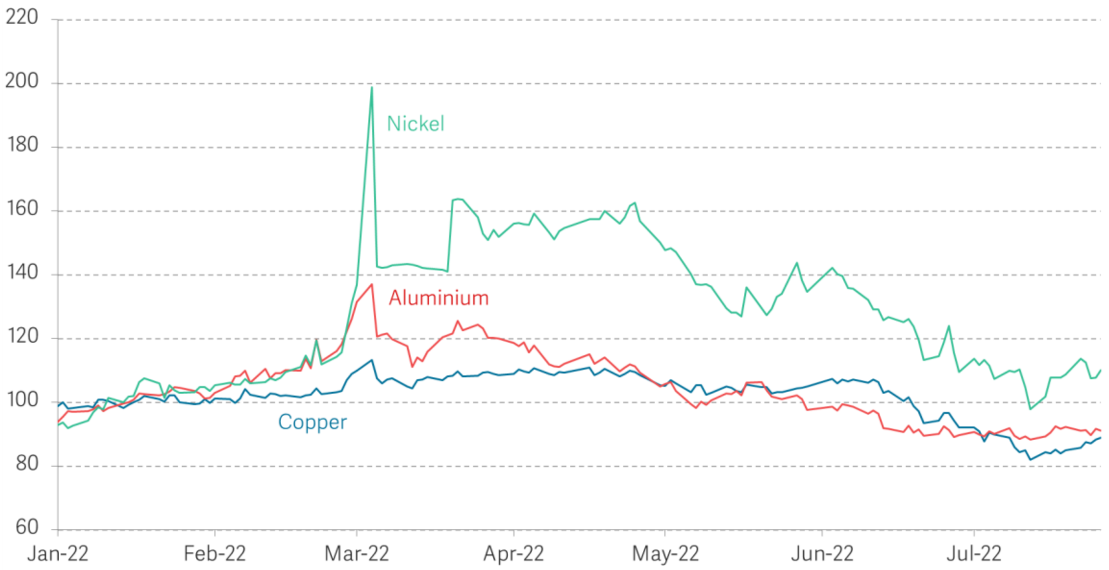
With inflation already at a 40-year high (CPI inflation was 9.4 per cent in June), further rises in the energy price cap due to be announced soon, and a slowing global economy, the Bank of England faces a big challenge for its August interest rate decision. Markets are expecting an interest rate rise, and the Governor recently heavily hinted at the first 50 basis point increase in the policy rate since 1995. But rate changes have a relatively small impact on living standards, especially when compared to the biggest economic issue facing the country: how bad will the cost of living crisis be this winter? Alongside the Bank of England's interest rate decision, it will also publish new inflation forecasts and its assessment of economic developments likely over the coming months. So, this Spotlight focuses on how the outlook for inflation has changed since the Bank of England's last Monetary Policy Report (with more research on what all this means for living standards due to be published by the Resolution Foundation in the coming weeks).

At first glance the outlook for inflation is deeply concerning. Input prices for manufacturers, a key leading indicator for consumer prices, have risen at their fastest rate on record: annual producer price inflation hit 24 per cent in June 2022 (8.9 percentage points higher than the pre-2022 peak inflation rate). This largely reflects the concentration of inflationary pressures from global goods, commodity and energy prices, rather than domestic factors to date. Indeed, that is clear when comparing manufacturing producer price inflation to services producer prices where inflation is still elevated but 'only' hit 5.4 per cent in Q2 2022.

But more timely indicators show that the news is far from uniformly bad. In fact, there has been a significant fall in the price of many key commodities. As shown in Figure 1, many commodity prices spiked when Russia invaded Ukraine, remaining elevated for months. More recently, though, prices have started to fall with sterling copper prices now 11 per cent below levels in January, and aluminium prices 9 per cent lower. These recent price falls should help to moderate the price pressures facing manufacturers.

Figure 1 **The good news is that a range of commodity prices have fallen**

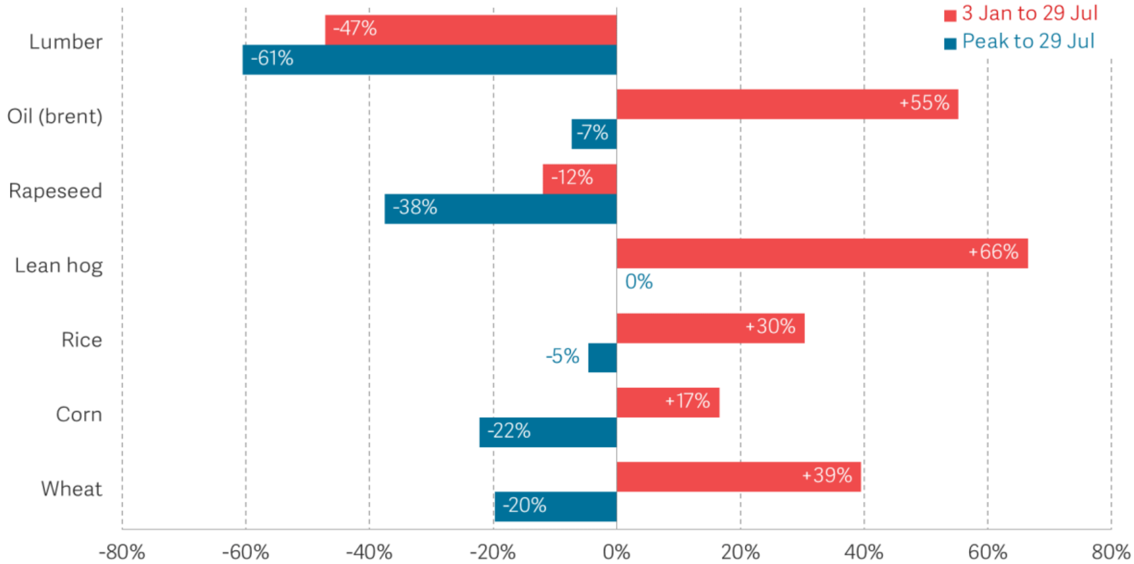
Index of sterling price for key metals (January 2022 = 100): global indices



Source: RF analysis of London Metal Exchange; Bank of England.

These trends are not isolated in metal prices: oil, lumber and market food commodity prices are mostly materially below the peak prices seen earlier this year (Figure 2). Lumber prices have fallen particularly sharply from their heights towards the start of the year, with prices now 61 per cent below that peak. But, crucially, this is not a panacea for inflation: sterling prices across most commodities are still above the *level* at the start of the year, and it takes time for these cost increases to make their way through supply chains and ultimately to consumers. So, while some cost pressures are likely to ease, that does not immediately presage a quick fall in inflation.

Figure 2 **Most commodity prices are still up on levels at the start of 2022**
Change in sterling prices for key commodities



Source: RF analysis of Business Insider; Bank of England.

Figure 3 **The bad news: gas prices have risen to new heights**
Winter 2022-23 natural gas futures contract price: UK

Notes: Price is pence per therm.
Source: ICE.

Substantially more concerning for households and businesses is the recent (and sustained) rise in European natural gas prices. Figure 3 shows the price of the futures contract for natural gas in the coming winter, which rose to record levels, following the recent reduction in supply of gas to Germany from Russia. Although these markets are sometimes thinly traded and so prices can be volatile, it is clear that current expectations for gas prices this winter are more than twice what they were prior to the Russian invasion of Ukraine and higher than the peak in March 2022. All of this has pushed [forecasts for the energy price cap](#) in October to £3,358 and then £3,615 in January 2023 (substantially higher than when [Ofgem wrote to the Chancellor](#) in May with the expectation that the price cap would be £2,800 come the autumn). High gas prices also push up electricity prices, with both leading to increased costs for businesses as well as consumers – costs which are ultimately passed through, meaning families will have to cope with higher and more persistent consumer price inflation.

So, what does all this mean for the inflation outlook? HMT's survey of forecasters shows that inflation is expected to remain high this year (averaging 9.6 per cent in Q4 2022) before falling back relatively rapidly in 2023 (averaging 4.7 per cent in Q4 2023). To assess the likelihood of that, Figure 4 shows two alternative 'thought experiments' on how inflation might evolve over the next year. The red line is a scenario which assumes the pace of monthly price increases immediately falls back to levels consistent with the inflation target and energy prices remain at around current levels rather than increasing further. The green line presents an alternative scenario based on past statistical dynamics of the key components of inflation and expected changes in the energy price cap.[1] In both cases it is assumed that the ONS decides not treat the energy rebate as reducing headline inflation.

Figure 4 Inflation is set to remain high for the next year

Annual CPI inflation, outturn and scenarios: UK

Notes: Both scenarios assume that the ONS decides not to account for the Government's energy rebate as reducing the *price* of consumer energy costs – rather representing an income transfer (and assumes no further support measures to reduce these costs). Were the opposite decision to be taken, that would lower peak inflation but raise inflation rates somewhat in late 2023.
Source: RF analysis of ONS, Consumer Prices; Cornwall Insight.

We take two conclusions from this analysis. First, the recent further increases in wholesale gas prices mean that the peak in inflation is likely to be higher than previously expected, and to come at a later date. The 'statistical relationship' scenario shows annual CPI inflation rising to over 15 per cent in Q1 2023 (the Bank of England previously thought inflation would peak around October 2022). Second, in order to deliver the fairly rapid falls in inflation expected by markets, it is likely that energy prices would need to fall back from current levels. Indeed, even in a fairly extreme scenario of underlying inflation immediately falling back to typical pre-pandemic levels (the 'return to target' scenario), headline annual inflation only returns to target in the autumn of 2023.

Ultimately, none of the analysis presented above changes the big picture that families are facing prices increases not seen for more than a generation. And these price rises hit those on low and middle incomes hardest. Those in this group have fewer, if any, ways to cut back on spending without impacting living standards; the average inflation rate they face is higher; and they have fewer financial resources to fall back on. After the Bank of England's decision, attention will rightly turn back to the Government – where the new Prime Minister, whoever it is, will have to set out new ways to support families in the autumn.

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[1] Specifically, we categorise the consumer price index into 28 sub-components which share similar economic drivers and time-series dynamics. We then estimate an unobserved components model (a form of model which allows for a parsimonious estimation of the seasonal, cyclical and trend dynamics of a time series), including an autoregressive component, for each of 27 of these sub-components. This provides a forecast based purely on historic statistical patterns – for example, food price inflation tends to be persistent (i.e. when it is high it stays high and when it is low it stays low). For the final sub-component, which is home energy costs, we use the most recent Cornwall Insight forecast for the energy price cap.