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BoE May Struggle for Easing Case

MPC will be wary of cutting into tight labour market and fiscal easing

- Budget more inflationary than projected
- Labour market loosening still not reflected in wages
- Voting split will reflect increasing divergence within committee

Markets materially underpricing risk of a hold or “hawkish cut”

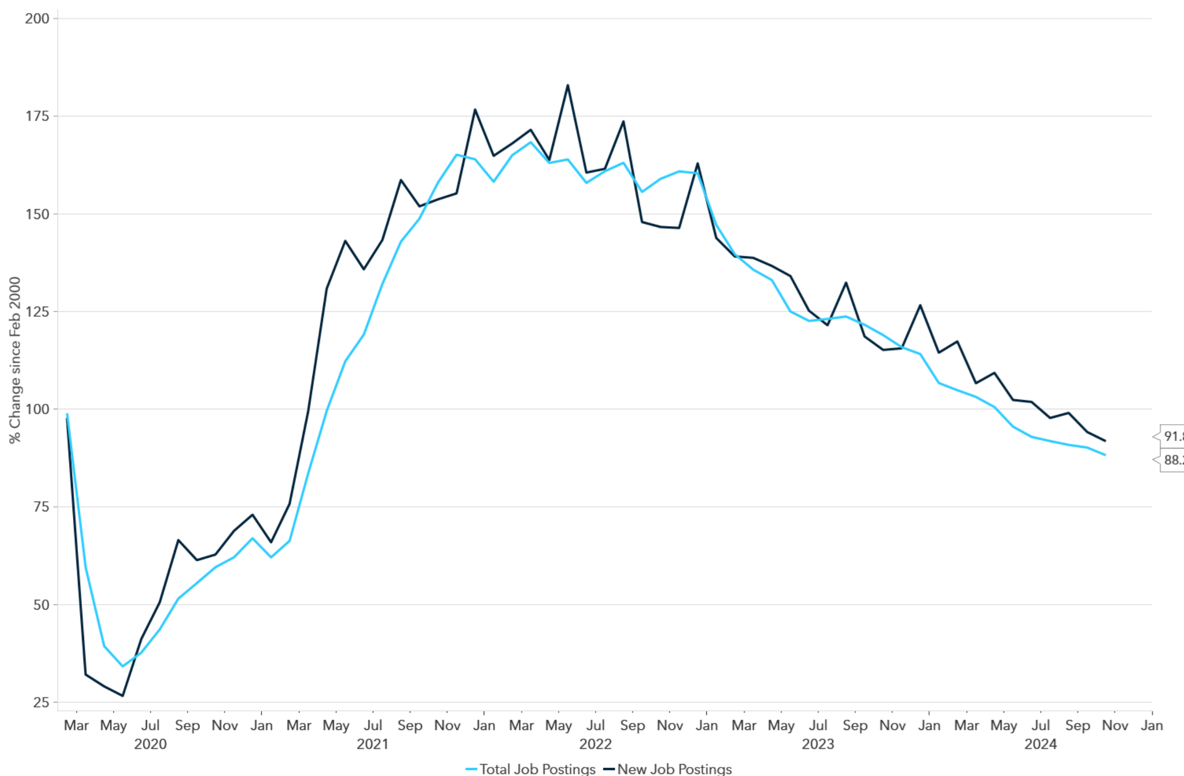
The market is unanimous in expecting the Bank of England’s Monetary Policy Committee (MPC) to hold rates today, and frankly MPC members will probably be distracted by developments in the US and its global economic ramifications. With two American economists on the MPC, surely the biggest number and share amongst policy-setting bodies globally other than the Fed, the body will have unique expertise on such matters. However, rather than focus on the election and even the Fed decision, we believe the market’s reaction in October to the Fed’s 50bp cut in September is far more relevant for the UK. What was originally a surprisingly dovish move was subsequently seen as policy error in some areas as labour market and activity data remained robust, with the potential for more fiscal stimulus in tow.

The parallels are striking: The budget last week is already being framed as fiscal easing and by the Office for Budget Responsibility’s own admission, inflationary in the short term. Secondly, the market is strikingly dovish with regard to expectations, with surveys unanimously pointing to a 25bp cut, and with a near-unanimous vote (i.e., 8-1 or 7-2). Expectations were shifting in a similarly dovish direction for the Fed in September. Thirdly and most importantly, the most relevant labour market data have not shown any sign of marginal deterioration from the previous cycles would justify a very dovish outcome. The only

difference perhaps is a clear sense of division on the MPC, as Governor Bailey and Chief Economist Huw Pill have clearly divergent views on the policy outlook. Consequently, the risk of a much tighter decision or even a hold should not be discounted. In effect, the MPC may opt for a “hawkish cut,” which in our view is inferior to not cutting in the first place, if inflation vigilance is the intended message.

MPC doves will point to further deterioration in the labour market despite the easing which has already taking place. The BoE will remain cautious in its data interpretation, but high-frequency figures (Exhibit #1) suggest that total job openings have now fallen to over 10% below pre-pandemic levels. The pace of decline in new and existing openings, however, has not accelerated so this alone should obviate the need for a more dovish outlook compared to the September decision, where the MPC deemed that despite ongoing loosening, the labour market “remained tight by historical standards.” Furthermore, the MPC noted that the easing in labour markets as a contributory factor to “moderation in pay growth” was “to a lesser extent” than the normalisation in inflation expectations. This is where the budget could throw a spanner in the works, as the government’s first fiscal announcement is expected to reverse said moderation.

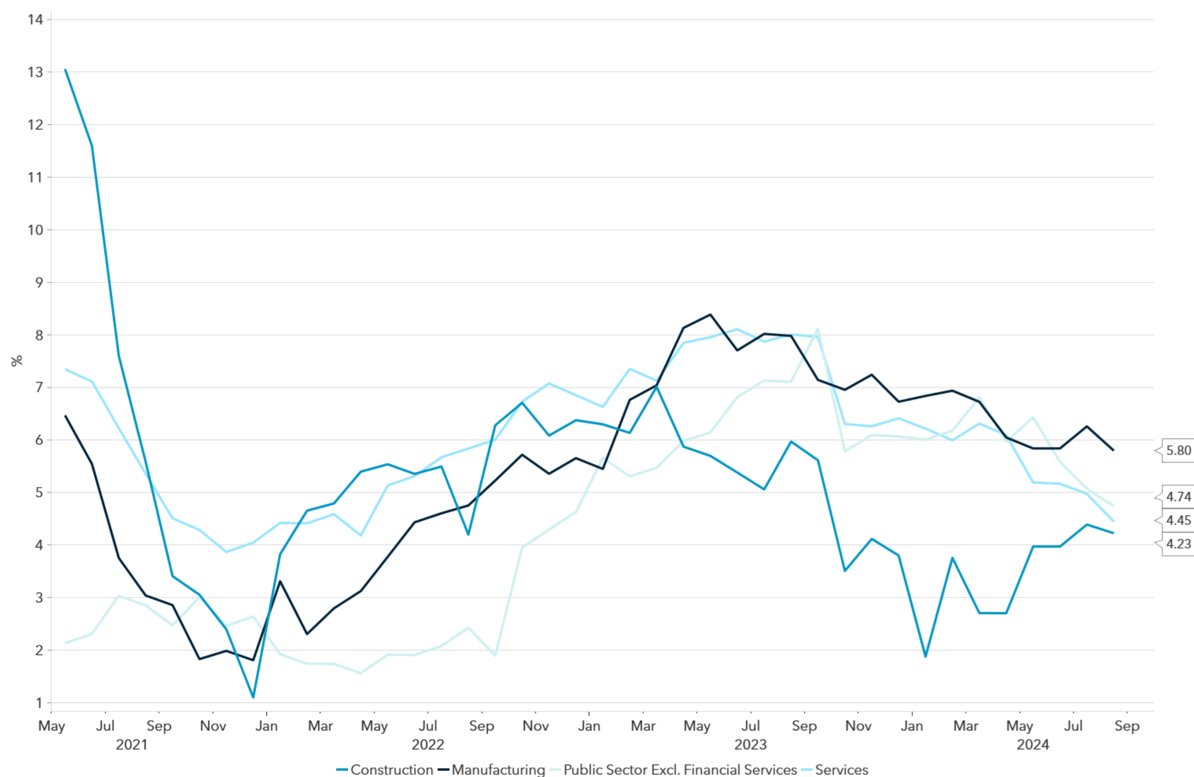
Exhibit #1: UK Job Openings, New and Existing



Source: Macrobond, BNY

Fiscal expansion is normally deployed in a countercyclical manner against recession and deflation. Stagflation is the more prominent feature of the UK economy and much of the budget's intent is to remove the "stagnation" aspect by investing in productivity to improve growth. Changes in the fiscal rules to increase borrowing were deployed to this effect, though the market and the Bank of England had fully expected such adjustments. However, the need to "top up" public sector wages after years of real-term erosion, in addition to the changes in employer National Insurance contribution will have a near-term inflationary effect. The OBR was blunt in this respect, calling the raising of the inflation forecast compared to the March outlook as "driven mainly by greater-than-expected persistence in wage growth and the impact of the near-term fiscal loosening in [the] Budget." Wage growth persistence has been well documented by the Bank of England, but it probably did not expect the budget to aggravate such risks, especially when the starting point for wage growth remains high by historical standards.

Exhibit #2: UK Wage Growth by Sector

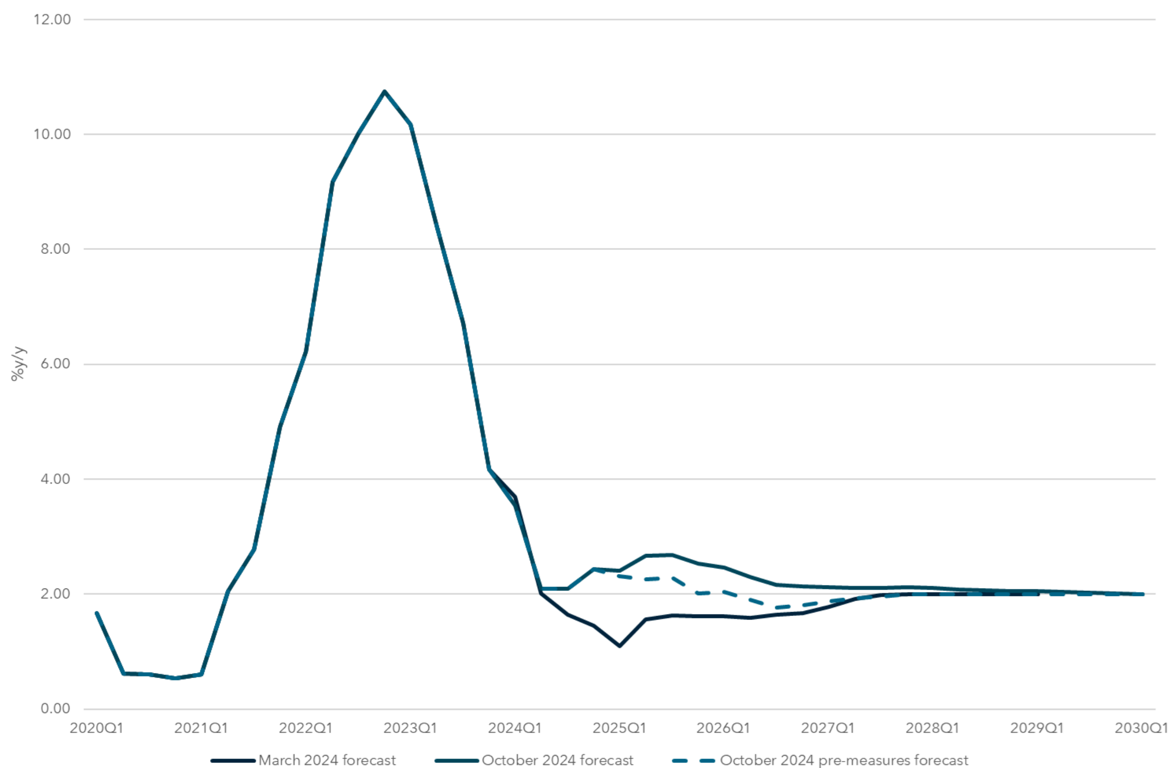


Source: Macrobond, BNY

As Exhibit #2 shows, on a headline basis key sectors continue to show wage growth above 4%. Furthermore, as the positive wage effect of fiscal easing will disproportionately fall upon public services, any reversal or even just stabilisation would put public sector wage growth at close to 5%, which even considering the higher inflation forecast from the OBR (Exhibit #3) would push real wage growth in the sector to 2%y/y. On a simple headline inflation basis, the

OBR judges that “budget policies push up CPI inflation by around half a percentage point at their peak, meaning it is projected to rise to 2.6% in 2025, and then gradually fall back to target.” Above-target inflation with limited margin for error being sustained into 2027 is hardly a backdrop which favours easing at all, let alone the “bit more activist” approach which Governor Bailey surmised last month. If the MPC views keeping debt servicing ratios high as the only effective method to offset growth nominal and real incomes, the MPC has reason to provide guidance which would limit the downside in swap rates to avoid lower mortgage servicing costs.

Exhibit #3: OBR Inflation Forecast Lift Post-Budget

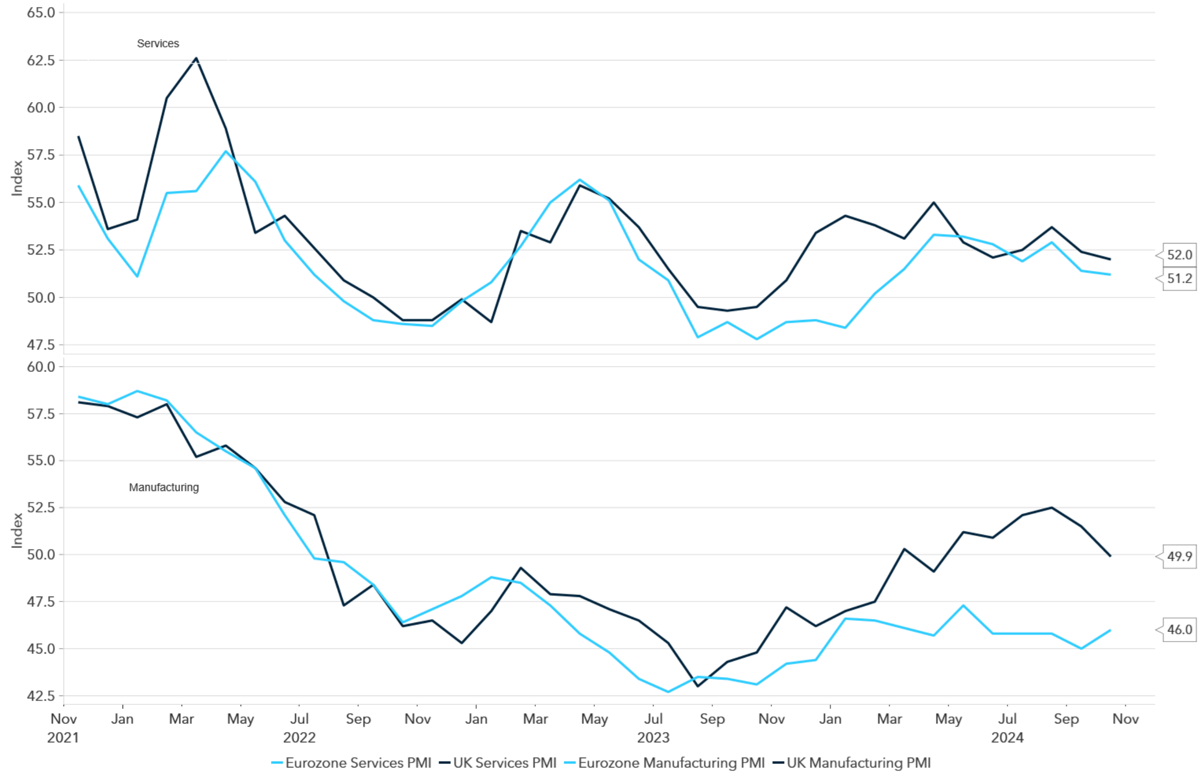


Source: Office for Budget Responsibility, BNY

On the external front, either way the US is unlikely to prove a drag on the UK economy and the dollar's surge will re-introduce pass-through risk. However, a more dovish approach by the ECB, where more aggressive easing in December cannot be ruled out, is a more valid reason for the BoE to remain on an "activist" footing. Even so, services demand (Exhibit #4) in the Eurozone is certainly not proving a drag on the UK economy, while the country’s manufacturing prowess is showing surprising resilience despite concerns on the Continent and even globally. After all, US and Chinese manufacturing figures have been less than stellar for some time. This is backed up by the fact that manufacturing wages are growing at a faster pace than other sectors (Exhibit #2). The sector itself is less of a growth driver in aggregate terms of the UK economy, but either way cross-sector PMIs indicate that the

economy is expanding healthily, and a demand injection is coming from the public sector. As such, we believe the BoE can be comfortable in retaining "ample caution" as stressed by Pill last month, in what was a clear retort to the Governor's position.

Exhibit #4: UK vs. Eurozone PMIs



Source: Macrobond, BNY

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