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MACRO MORNING BRIEFING

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Producing Productive Public Services

Public Sector Productivity Growth Essential for Policy Outcomes

- Europe faces ongoing services inflation and further public sector wage hikes
- Better outcomes needed through productivity gains
- Austerity cannot be a last resort if inflation becomes sticky again

Wage rounds will continue to challenge the speed of easing

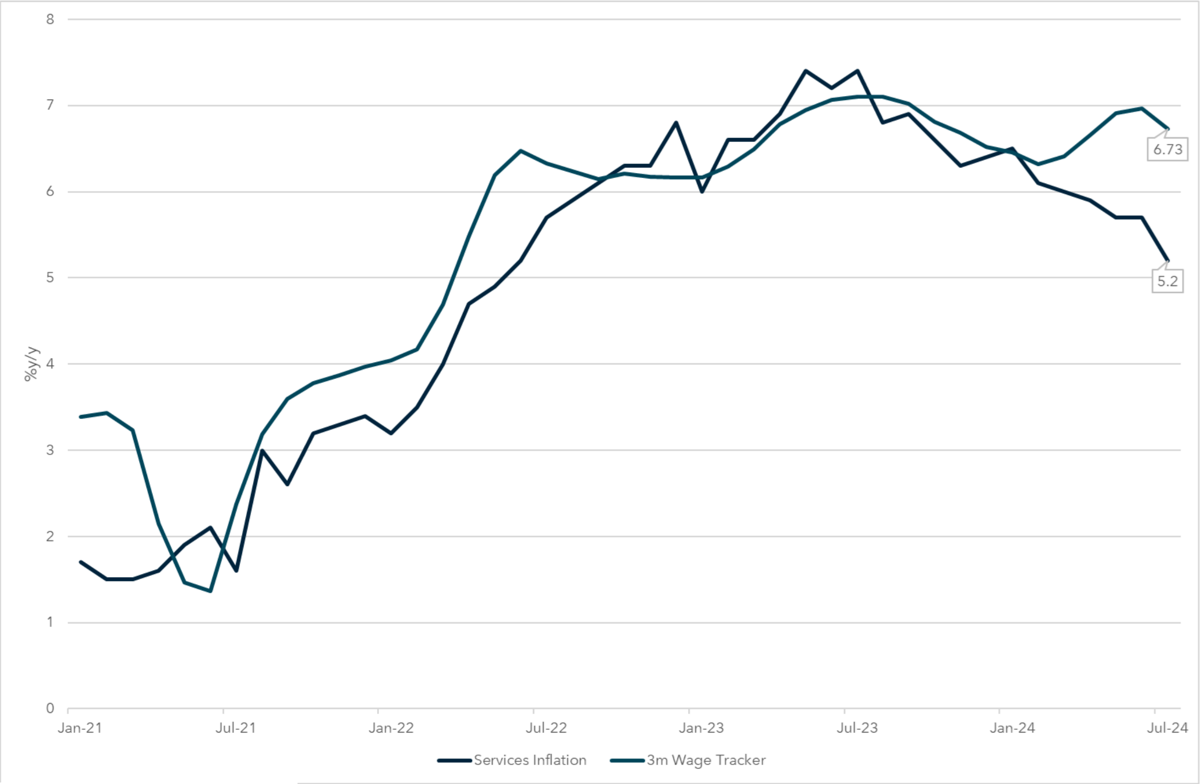
Yesterday, UK Prime Minister Keir Starmer stated that the upcoming budget would be ‘painful’ due to country’s need to rebuild public finances. Having stated that the deficit would be larger than previously anticipated, additional taxes would be needed, and spending cuts are needed to ‘fix the foundations’ of the economy. Similar spending constraints are happening across Europe the combination of weak growth, supply shocks and demographics risk vicious cycles in public finances.

Yet, it is inescapable that barely two months into the new administration, several wage settlements have been reached or proposed with public-sector unions in the U.K. Similarly, towards the end of 2023, state Governments in Germany agreed a large wage deal with public sector workers, amounting to 11% through 2025. The outcome of the government formation talks in France may also lead to public-sector pay increases up ahead or at least a large expansion in the size of the state – even by French standards. Time and time again, we have returned to Madame Lagarde’s Sintra speech from last year, which stated that Eurozone inflation was being driven by services inflation, especially in sectors with poor productivity such as construction and public services. The ECB has never been shy surrounding the need for fiscal restraint and in the context of productivity growth, the central bank clearly sees any upcoming fiscal expansion as inflationary. The productivity puzzle is even more acute in the UK and the Bank of England has also been vocal in highlighting its impact on the U.K., which has a disproportionate share of what Governor Bailey called in 2022 as ‘intangible-intensive’ industries, which have “experienced the strongest slowdowns in labour productivity since the financial crisis”.

With such warnings in mind, we believe that the market is perhaps excessively discounting the risks of sticky inflation in Europe as from public sector expansion without any associated offsets on spending cuts or other efficiencies. The latter segments always take time to achieve and sequencing matters: austerity in the UK and ‘troika’ mandates in the Eurozone have left a bitter legacy and governments over a decade on are very reluctant to put spending cuts at the centre of fiscal consolidation. As Prime Minister Starmer warned things would “get worse” before any improvement, this would likely include productivity challenges which would also continue to complicate the inflation narrative.

There are already signs of this taking place in the UK where productivity is further hampered by severe declines in labour market participation. Although services inflation is falling, wages are rising again (Exhibit 1, we used the INDEED wage tracker due to the Office of National Statistics’ lack of confidence in their current figures). As they are the key input into services inflation and tend to lead inflation trends, this represents a clear risk to the inflation outlook, even though there is clearer evidence of consumer spending coming down. As Governor Bailey highlighted in his own Jackson Hole speech, “intrinsic” inflation persistence where there is a change in price and wage setting behaviour is now being revised down, but not something that the Bank can take for granted. Out of the major Central Banks, the Bank of England is arguably most at risk of seeing easing expectations being pared back for the rest of the year.

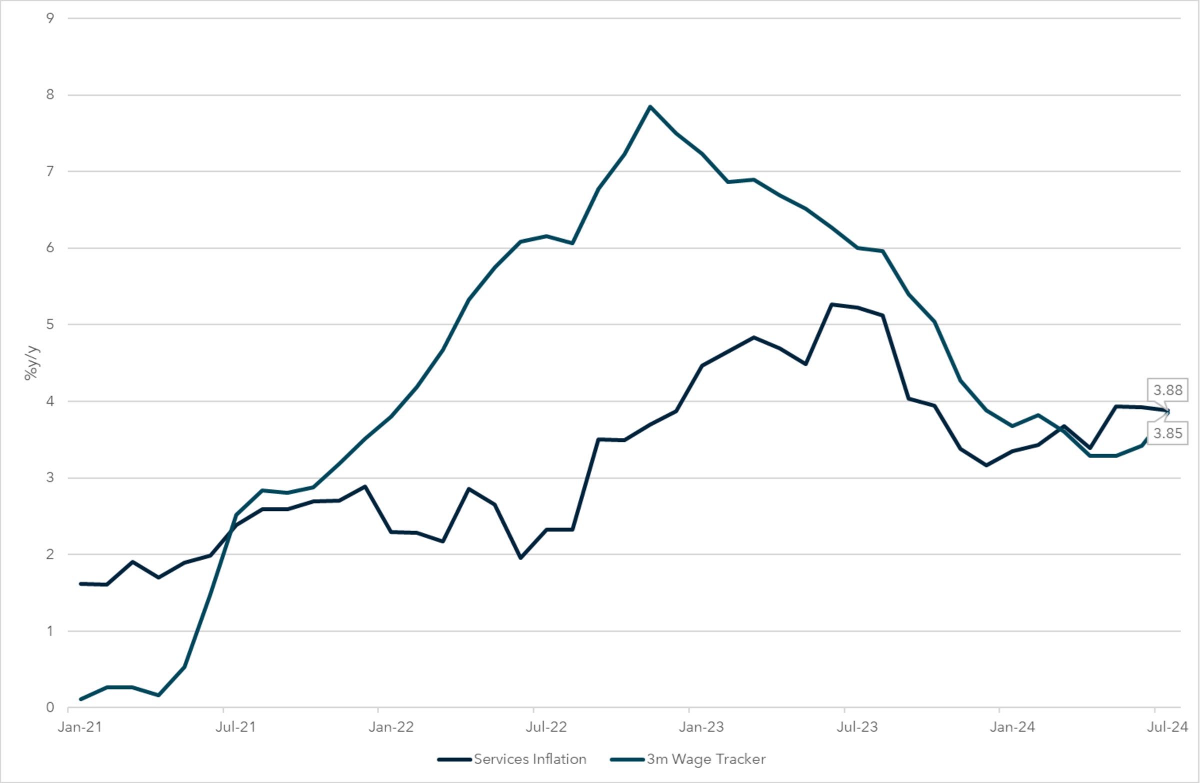
Exhibit #1: UK services inflation vs. wages



Source: Bloomberg, BNY

Simply based on commentary alone, the ECB is arguably even more hawkish even though market pricing is working in the opposite direction in defiance. Also in Wyoming, ECB Chief Economist Philip Lane warned that the ECB would need to keep policy “restrictive [for] as long as needed”. It is also quite striking that the euro has continued to strengthen despite the ramping up of easing expectations, suggesting that current FX moves are largely-dollar based. Having a stronger currency – which helps import disinflation – while rate expectations are also helping easing financial conditions should be a goldilocks environment for the ECB, but the trends in services inflation and wages are not encouraging (exhibit 2) as both have started to flatline.

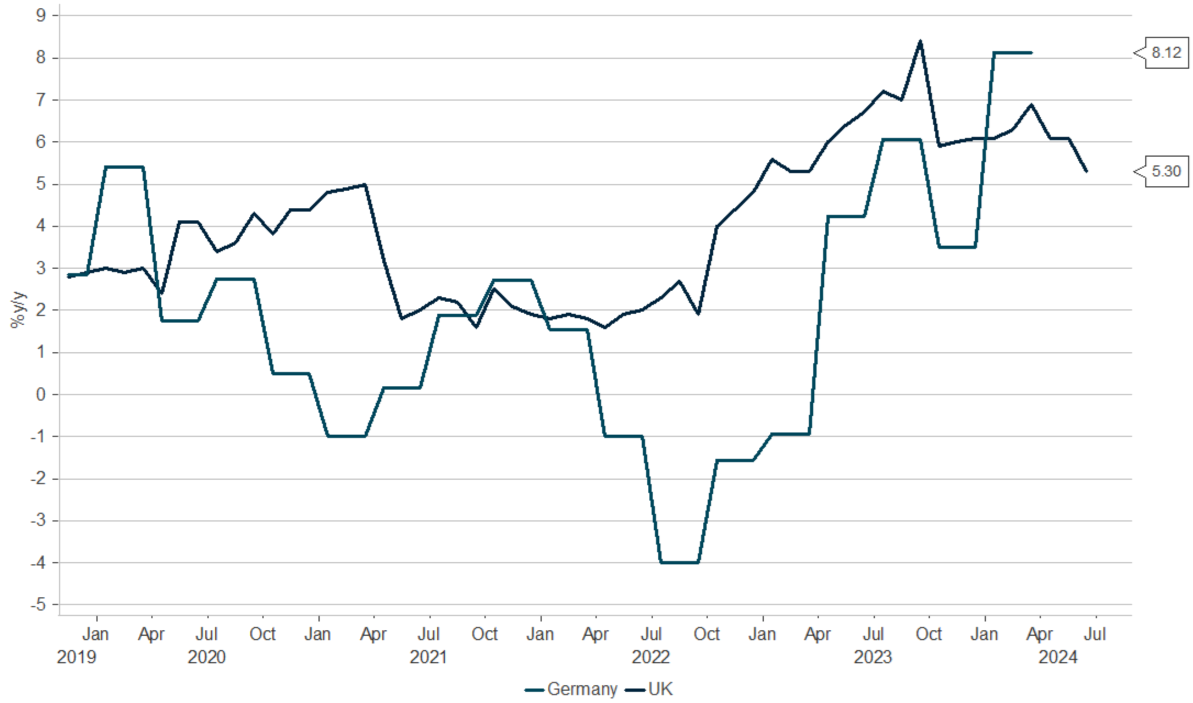
Exhibit #2: Germany services inflation vs. wages



Source: Bloomberg, BNY

Madame Lagarde refrained from repeating her warnings surrounding public sector productivity weakness this year in Sintra, ostensibly due to the situation in France. There does not seem to be any resolution in sight, and this could complicate the growth outlook. Furthermore, German public sector pay growth is not showing any sign of slowing momentum. The UK won’t be far behind as announced pay settlements with key public sector unions are very large. Even if it is an offset of reduced real-terms pay seen over the past decade and savings preferences have risen for U.K. households, the BoE will be extremely mindful of ‘intrinsic’ persistence reasserting itself in inflation expectations across the economy.

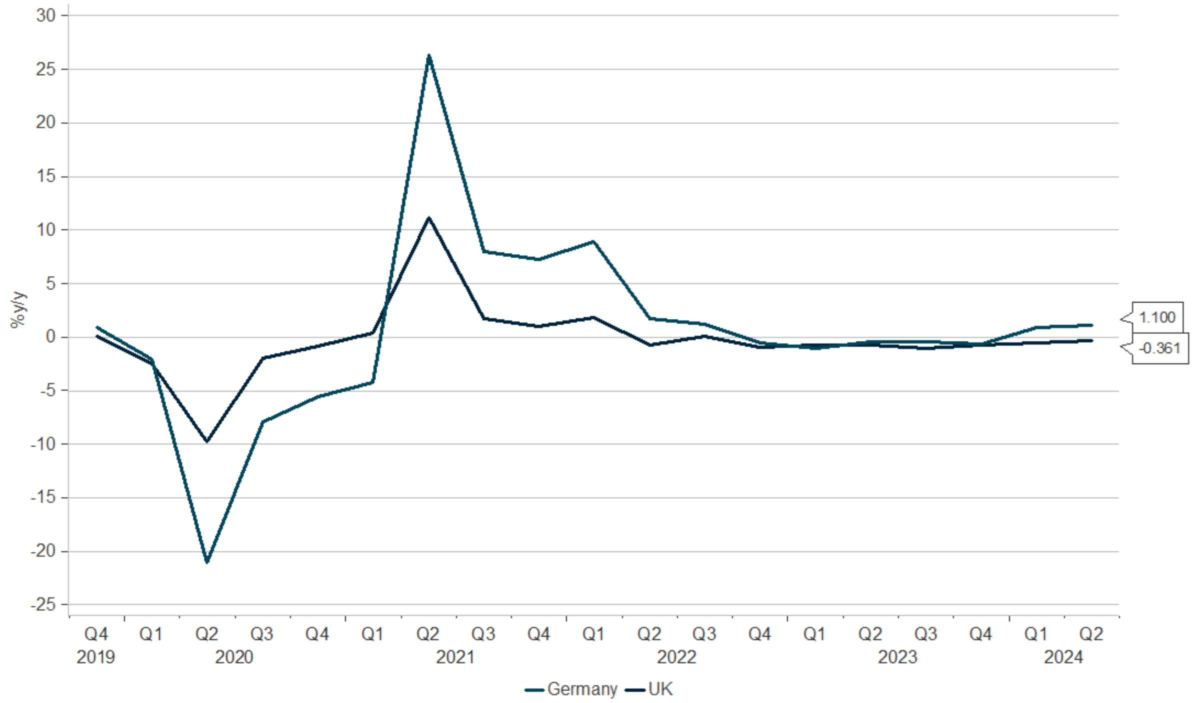
Exhibit #3: Public sector pay growth



Source: Macrobond, BNY

On a structural basis however, the risks are greater for European manufacturing economies which face unprecedented supply chain and demand challenges. Germany is not known as an economy prone to services inflation, but the wage surge through the last few years – which looks set to continue – has started to change the structure of the economy. As the share of income amongst services works rises due to high levels of wage growth – Germany and the Eurozone are rebalancing in favour of 'intangible' industries, as defined by Governor Bailey. Furthermore, the manufacturing sector has been contracting for almost two years based on the PMI figures and with no end in sight, thereby accelerating the rebalancing process. Unlike the UK and US, the services sector in Germany and the Eurozone is starting from a very low base and with a greater public sector component. This means that Germany will be prone to sustained weakness in productivity growth. The final Q2 national accounts data already point to such risks: capital investment and private consumption both contracted on a quarterly basis, and by more than expected. The entire economy is being held up by government spending which rebounded sharply to 1.0% q/q, against expectations of a mere 0.2% q/q expansion. Since the end of the pandemic, there has been very little gap between German and UK productivity growth until very recently. Consequently, a 'higher for longer' outlook is perhaps becoming more valid throughout a Europe that is solely reliant on the public sector. However, this effectively stagflation writ large, and hardly a strong case for asset allocation improvements away from the U.S. and emerging markets.

Exhibit #4: Productivity growth



Source: Macrobond, BNY

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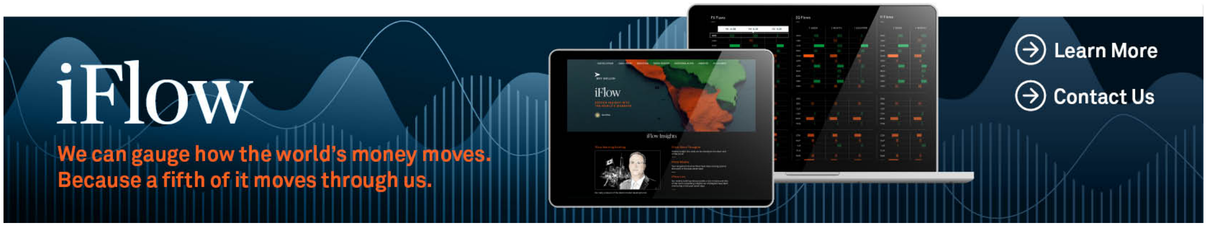

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