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BoE Staying Hand for Now

Rate cuts on the agenda but MPC conviction to remain low

- Case for cuts weak as fiscal agenda continues to cloud growth outlook
- Wage clarity a persistent problem, but external headwinds require monitoring
- Liquidity stress remains an issue as minimum reserve range approaches

BoE caution a double-edged sword for GBP

The Bank of England decision this week, unlike the impending Fed decision, is not expected to generate any fireworks as the risk of a cut is very low. Although the BoE somewhat surprisingly started its policy easing cycle earlier than the Fed, the initial 25bp cut in August was seen as more of a "downpayment" in the face of slowing growth, but the guidance since then has been far from compelling. As the ECB decision last week showed, without compelling evidence of material declines in wage growth, policymakers are not inclined to move more aggressively. Immediately after the August decision, Governor Bailey warned in his own Jackson Hole speech that he was "cautiously optimistic that inflation expectations are better anchored…but it is too early to declare victory."

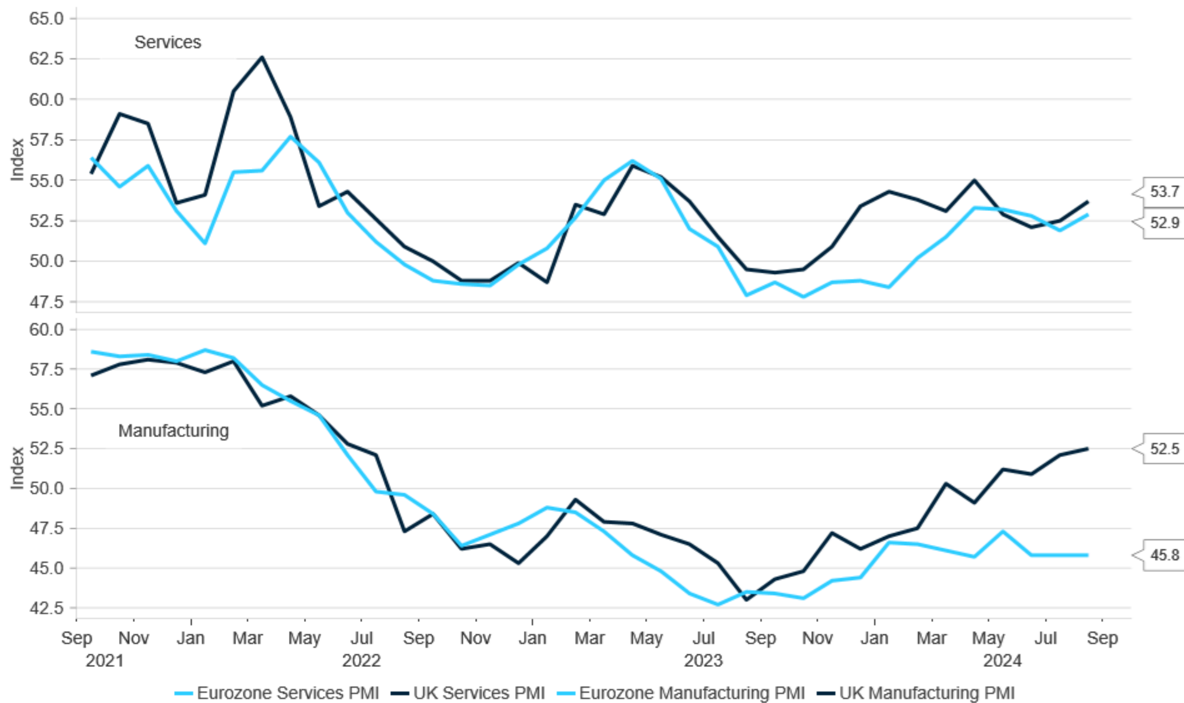
The BoE's struggles with wage and labor market data are well-established, but by most accounts there is clear evidence of slack emerging. As high-frequency numbers indicate, total job postings have fallen behind pre-pandemic levels for the first time in this business cycle (Exhibit #1). New job postings remain volatile, but the direction of travel is also clear. However, policymakers in Europe and developed markets in general have established that the link between job creation and wage growth remains unclear. This is especially acute in the UK, where economic inactivity remains high, though recent data (assuming they are accurate) indicate that the situation is not deteriorating.

Exhibit #1: Labor Market Developments

Source: Macrobond, BNY

Normally the Monetary Policy Committee (MPC) would not be particularly concerned about the external sector but the situation in the Eurozone – still the UK's largest trading relationship – could sway some members to adopt a more cautious outlook, especially as GBP valuations have improved of late, and in a way which is in line with fundamentals. As much as the ECB protests that the recent growth weakness in Germany was expected and reflected in their staff projections, we believe growth risks in Germany and the rest of Europe remain strongly skewed to the downside. The UK's services sector continues to show good expansion and has outperformed the Eurozone equivalent. Even though there are upside wage risks arising in both economies, the better productivity outcomes in the UK's services sector represent one of the bright spots in the UK economy. However, the divergence in manufacturing is now stark. The positive impact on the UK economy is smaller, but the hit to value-added growth will be material in the Eurozone. The bottom line is that the highest value-added components in the UK and Eurozone economies are moving in different directions, and this will be reflected in terms of trade to the UK's benefit. We believe the impact on UK inflation from FX pass-through is smaller compared to most developed economies, but current weakness in prices of finished and intermediate goods could prove disinflationary for the UK on the margins. As such, even if the BoE chooses to caution on easing, excessive GBP strength could have a strong disinflationary impact further down the line due to the external environment – this is arguably a policy input which has not played a large role in the past as the UK and Eurozone economic cycles are generally well-aligned.

Exhibit #2: UK vs. Eurozone PMI Divergence

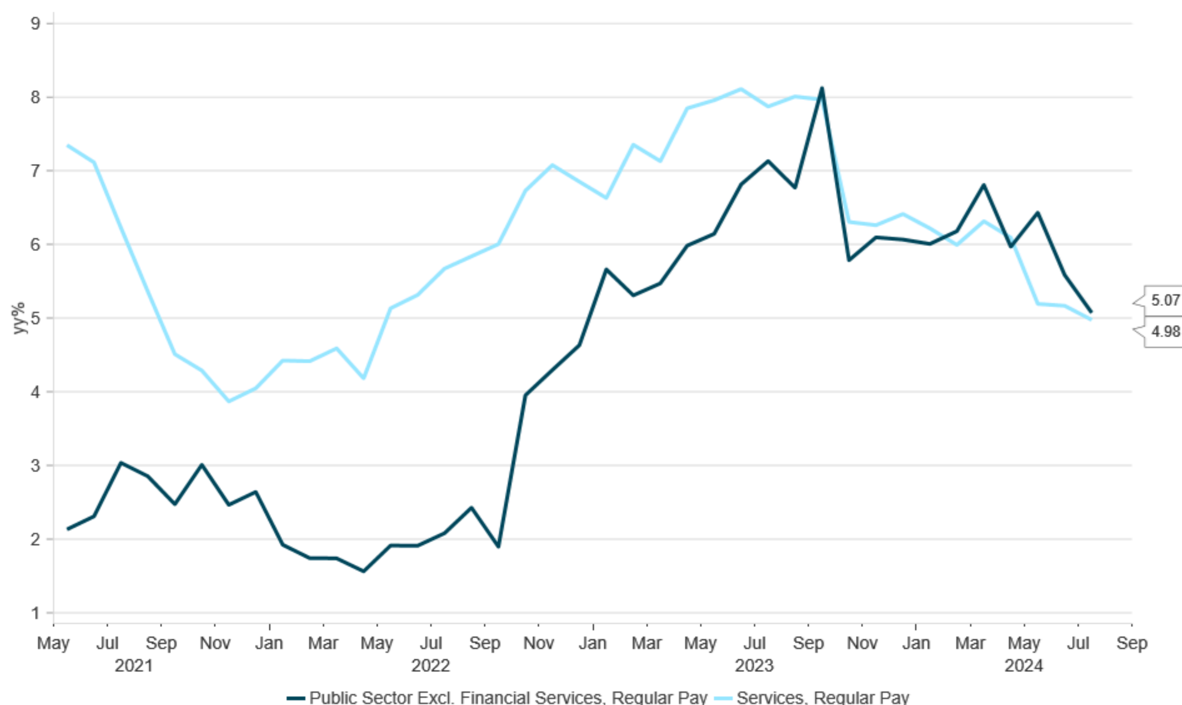


Source: Macrobond, BNY

Somewhere in the statement we also expect the Bank of England to reiterate its desire to see productivity improvements (or lament the lack thereof), and last week's long-term projections from the Office for Budget Responsibility (OBR) regarding the UK's potential debt burden has only increased the urgency for change. The OBR's current baseline sees the UK's debt burden rising to 270% of GDP in the next half-century, but under a low-productivity scenario of 0.5% in economy-wide productivity growth per year (1pp lower than the 1.5% baseline), the debt burden could rise to above a near-astronomical 650% of GDP. On the other hand, 2.5% in annualized GDP growth with additional fiscal tightening over the very long term can help keep the debt-to-GDP ratio below 100%. However, the government would also argue that higher levels of public investment are also required in the near term to help achieve the requisite gains in productivity. At present, public sector and general services pay growth are aligned at around 5%y/y – a high enough level in itself to limit additional BoE action as it is a sign of strong real wage growth across the economy. Unlike during the upswing between 2022 and 2023, the moves lower have been synchronized (Exhibit #3), but some degree of divergence will likely come through as public sector pay rises are gradually reflected in earnings figures. Public sector productivity featured prominently in the OBR report, but we doubt gains will be realized immediately, and the resulting wage growth stickiness remains a core BoE concern.

In this context, we also see the BoE holding back on the need to shift toward a more dovish rate profile until the upcoming budget is clearer. On the one hand, the government has repeatedly stressed that "difficult decisions" will be expected in the form of tax rises and fiscal restraint, implying some degree of demand retrenchment which would require a monetary policy offset. However, the government has also committed to public sector pay rises and efficiency drivers which would also be supportive of nominal and real earnings. For example, the Prime Minister has warned that the National Health Service will not receive cash injections without structural reform. As productivity gains take time to realize, the immediate risk from the budget remains stagflation, which ultimately would limit the MPC's willingness to commit to earlier and larger rate cuts.

Exhibit #3: UK Wage Trends

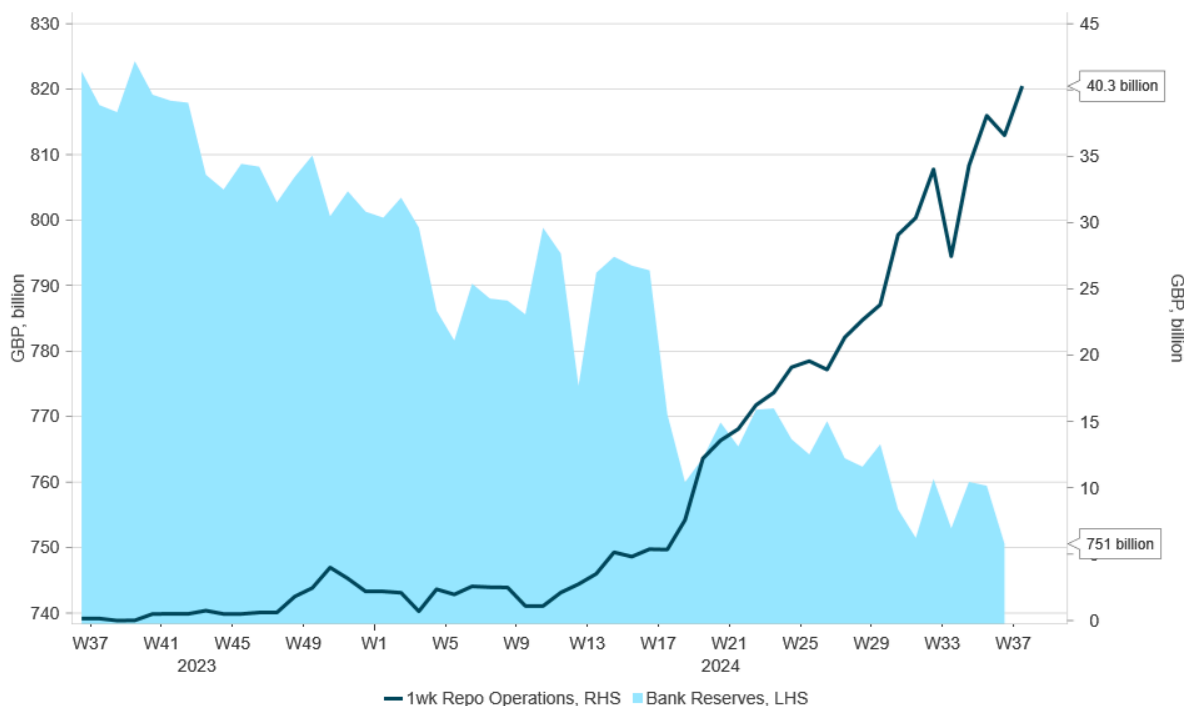


Source: Macrobond, BNY

Finally, on an operational level the MPC may also need to revisit its balance sheet wind-down. Volatility in front-end rates remains a concern and the relentless rise in usage of the BoE's short-term repo operations suggests that the "preferred minimum reserve range" is now in play. While this is another element in the tightening in financial conditions, arguably it is the hardest to manage and at a stretch, will have financial stability implications. Opening the door to a slowing or cessation of quantitative tightening (QT) during an easing phase does not impede policy credibility. A broader conversation regarding sales of BoE gilt holdings at a loss, which requires HM Treasury indemnification, may also feature behind the scenes as

the process continues to limit fiscal space and the government is looking to change its own debt calculation rules as mitigation.

Exhibit #4: Liquidity Discussion Likely to Dominate



Source: Macrobond, BNY

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