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MACRO MORNING BRIEFING

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BoE Moving Towards 'Live', Slowly

MPC is clearly split on timing of first rate cut

- Unlike for the Fed, no hawkish expectations to push back against
- Labour demand-and-supply mismatch still acute
- Renewed softness in real estate could support earlier move

BoE frustrated over wage growth but mindful of broader risks

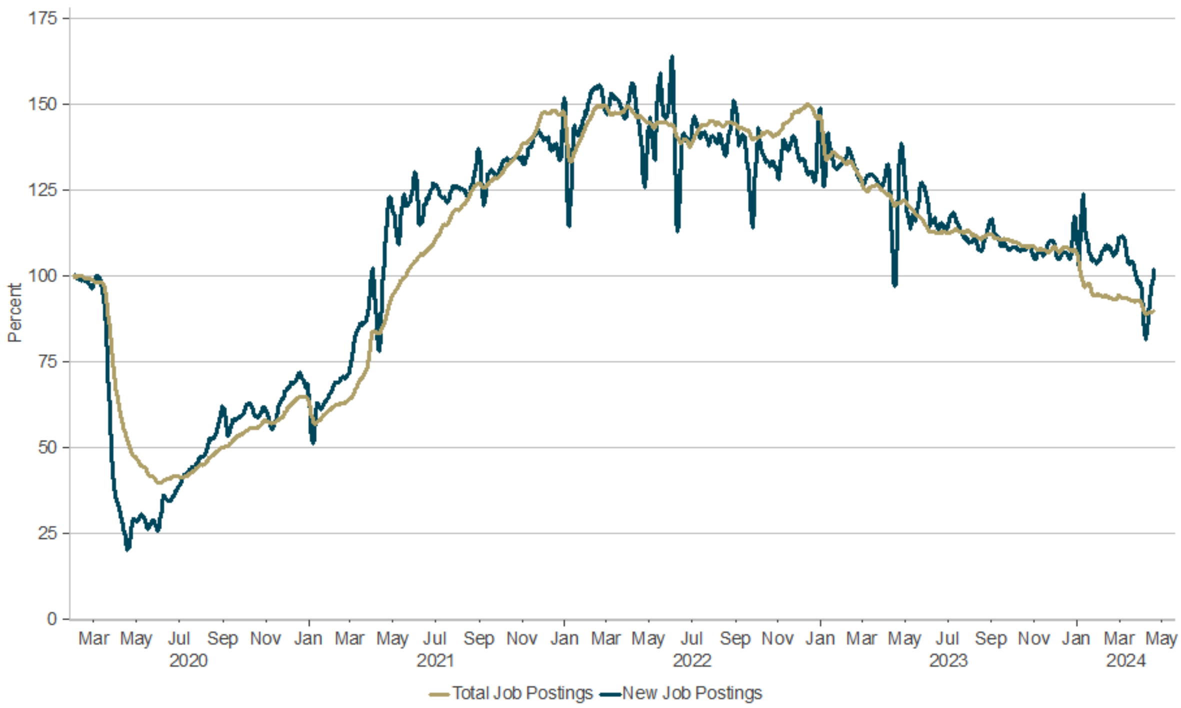
The Bank of England's policy decision this week is not expected to generate any changes in headline rates but, on balance, accompanying forecasts in the Monetary Policy Report will likely show sufficient progress towards inflation heading back to target to justify easing in the near term. Governor Bailey and much of the Monetary Policy Committee have in the past been clear that hitting the inflation target itself is not a pre-requisite for easing. However, there is the risk that acting too early could jeopardise the entire path, notwithstanding idiosyncratic issues regarding the UK labour market.

As the OECD recently highlighted, the UK is probably the worst-placed developed market economy in a stagflation context. Its latest economic update called service price inflation “sticky” and warned that “overestimating the actual availability of labour resources and faster reduction in the Bank Rate [would] possibly entrench wage inflation”. We stress that for the BoE, this iteration of the OECD’s Economic Outlook carries much weight as its lead author – OECD Chief Economist Clare Lombardelli – will become the BoE's Deputy Governor for Monetary Policy on July 1, succeeding Ben Broadbent. These are the conclusions she brings to her new job and should serve as a warning against overtly dovish expectations.

The OECD’s point about an “overestimation” of labour resources remains a very frustrating issue for the MPC and is probably holding them back from having cut rates earlier. Firstly, reliable data remains lacking as the Transformed Labour Force Survey will not be out until

September 2024 – by when the MPC would almost certainly have already cut rates, barring major surprises to current forecasts. The strongest argument in favour of easing is that labour market demand is clearly easing. Various vacancy indicators support this view. The highest-frequency data (exhibit #1) show that total job postings are now materially below pre-pandemic lows. On a seasonal basis a Q2 bounce is already taking shape, but the MPC will probably have enough confidence regarding the overall trend.

Exhibit #1: Job Openings Materially Lower

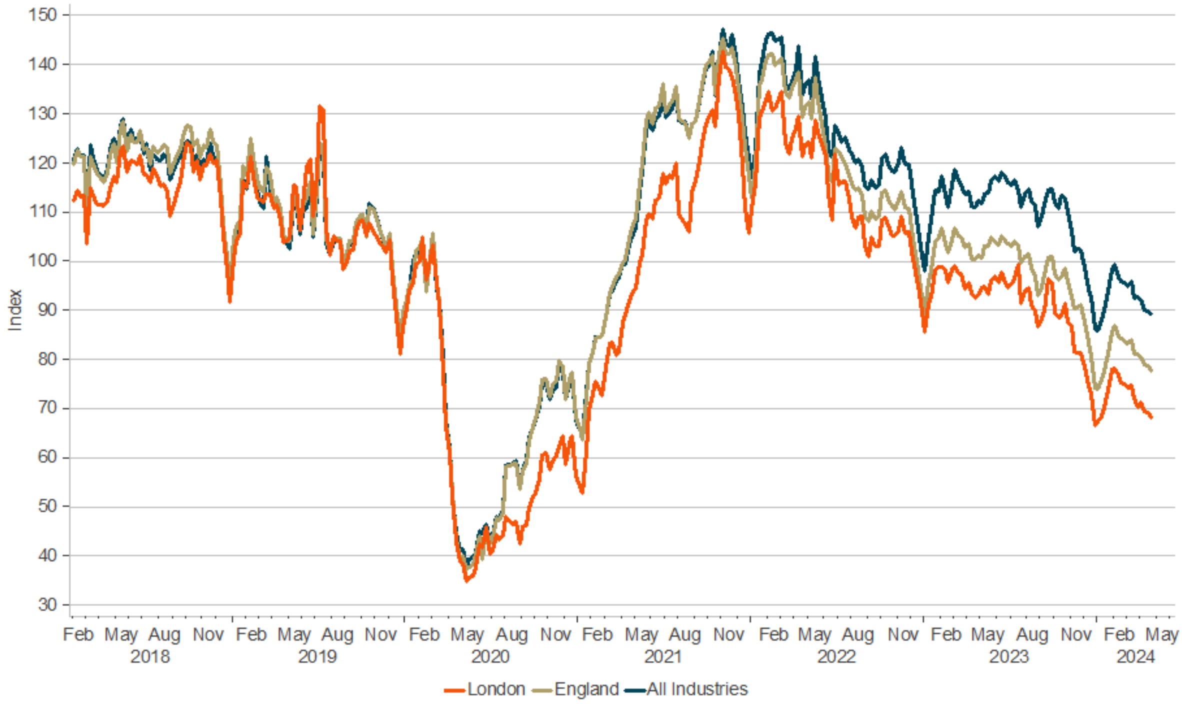


Source: Macrobond, BNY Mellon

What we think could prove even more concerning is that the largest declines have been in the traditionally highest-performing areas, especially London (exhibit #2). Measured by total vacancies, London is now close to half the levels seen during the 2021 peak. The City itself is underperforming the rest of England, as well as when measured on an all-country basis. Considering that London and the South East are the biggest net contributors to the country's growth, weakness in these regions would likely have consequences for growth as a whole.

Given the current political calendar and broader policy uncertainty, it is difficult to anticipate any structural recovery until after the General Election, which now looks set to be pushed back until late Q4 or even into early 2025 if the incumbent government seeks to maximise the time to attempt a recovery in support after last week's local elections. As such, it is not a surprise that the OECD's growth expectation for next year is extremely subdued at 1.0%.

Exhibit #2: London Leading Vacancies Weakness

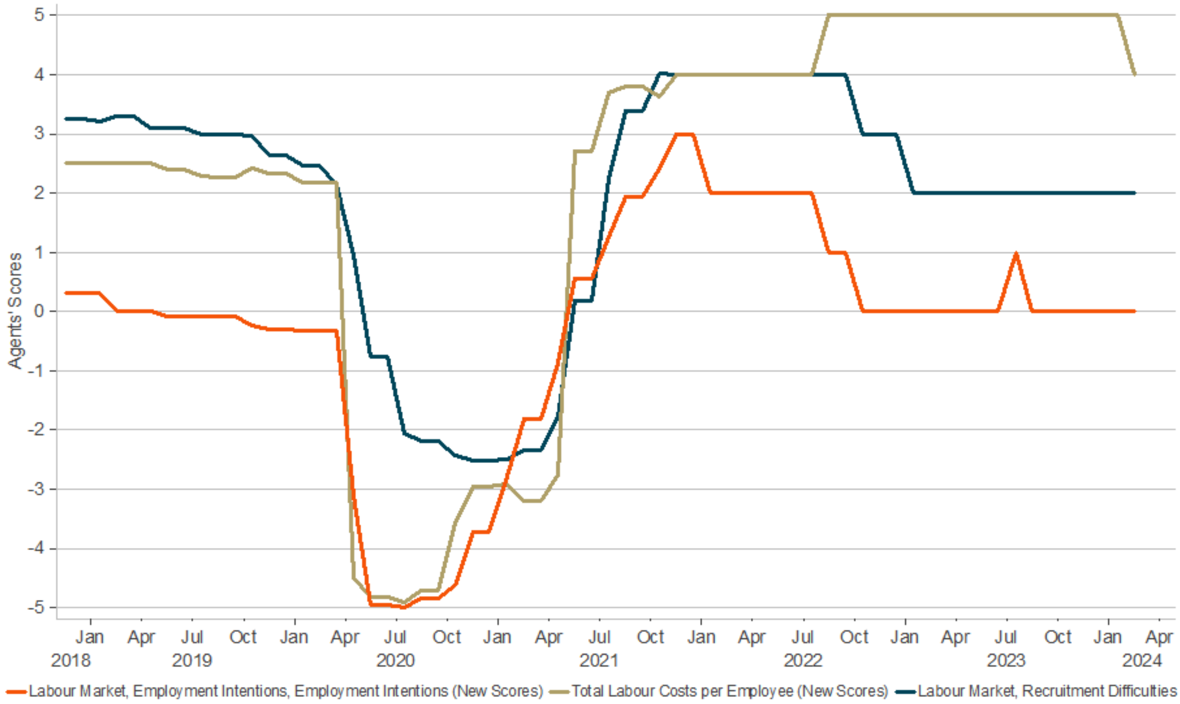


Source: Macrobond, BNY Mellon

Even with falling aggregate demand contributing to slower employment creation, there is no guarantee that wage growth – the decline of which is crucial for the MPC to be comfortable with rate cuts – will likely proceed at pace. The OECD's point on "overestimating the actual availability of labour resources" pertains not just to a data issue, but also the ongoing expansion in economic inactivity which is almost sui generis in the OECD. The bottom line for the UK labour market is that even in a contracting economy, if the supply of labour falls faster than labour demand then wages will remain sticky. Based on the BoE's latest agents reports, the situation with the labour market is almost unchanged from end-2022 to early-2023, when labour shortages were far more acute. Total labour costs per employee remains at the highs and recruitment difficulties have not eased for over a year.

There is no swift solution these issues. Even though the current government is seeking to tighten the eligibility criteria for off-work benefits, we doubt there will be immediate gains in the labour force as a result. The OECD stressed that fiscal policy should "focus on the supply side", with a particular emphasis on improving labour force participation and productivity, such as adult skills, childcare reform, and infrastructure. All of these factors are outside the purview of the BoE but appear fully necessary lest stagflation become a more permanent feature and heavily restrict monetary policy space.

Exhibit #3: Virtually No Change In Labour Supply Constraints

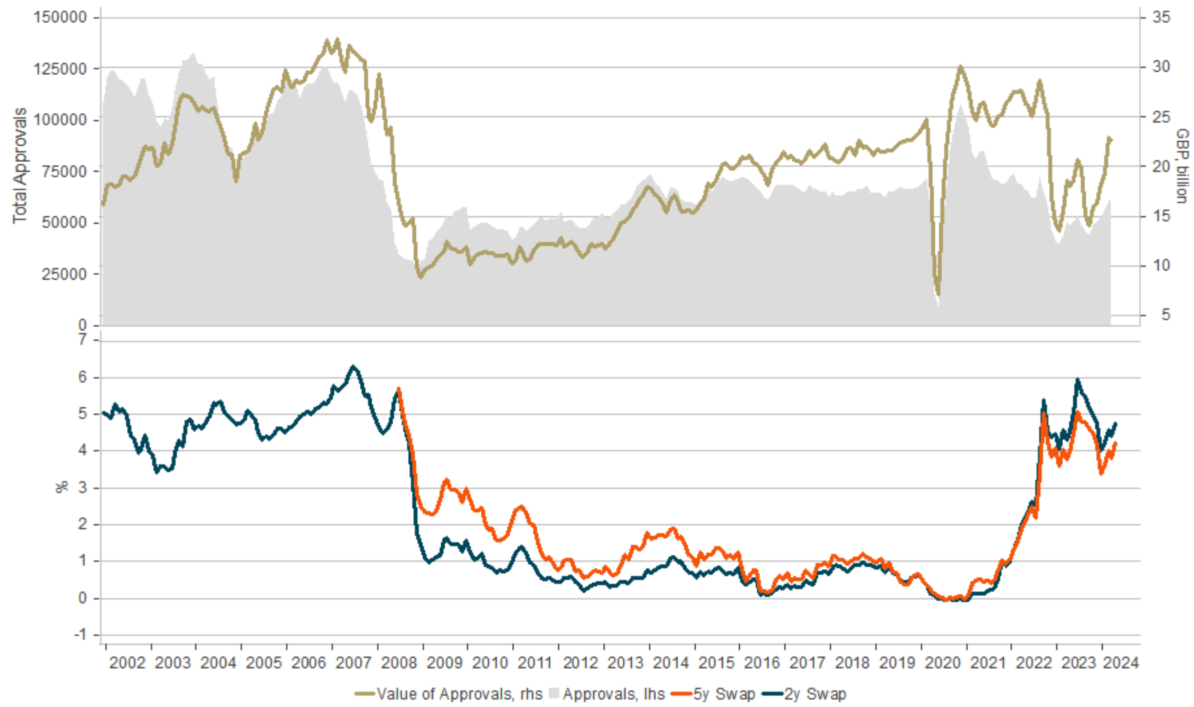


Source: Macrobond, BNY Mellon

One downside risk we see to UK rates, and a factor which has deteriorated more than expectations, is the real estate market. Despite a bright start to the year, prices are faltering again. What's more, credit data shows that households are feeling the impact of tighter financial conditions. As UK mortgages are linked to swap rates, the recent pushing back of easing expectations has lifted 2y and 5y swap rates. For households that were planning on entering the housing market in anticipation of lower mortgage rates and debt servicing, intentions are now weaker. On an absolute basis, we can see that even though mortgage approvals have recovered strongly (exhibit #4), this is not translating into higher levels of lending: UK net lending secured on dwellings increased by only GBP 325mn in March despite over 61,000 approvals – the most since September 2022.

This suggests that remortgages – which constitute a high proportion of approvals – are taking place with far lower balances as borrowers seek to limit rises in monthly repayments with higher rates for new mortgages. Factoring in fiscal drag (highlighted as another restrictive factor on household demand) and inflation, it appears that household cashflow in nominal and real terms is probably not as strong as the BoE expected, even accounting for wage growth remaining elevated. The obvious direct impact will be on consumer demand figures such as retail sales. If these factors deteriorate faster than expected, we would not rule out a rate cut being brought forward to June.

Exhibit #4: Mortgage Lending Underscores Rate Stress



Source: iFlow, BNY Mellon

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