Research Briefing | United Kingdom

New wage data threatens to lock-in rate hikes

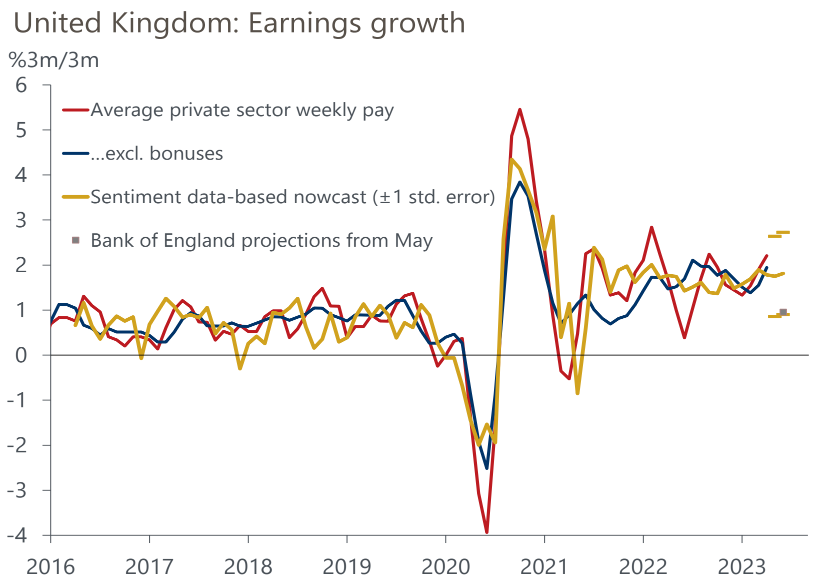
- **Momentum in UK wage growth is much stronger than the Bank of England's Monetary Policy Committee thinks, according to our proprietary sentiment data developed in collaboration with Penta. And in about six weeks when the official data catches up to our timelier indicators, this will pile more pressure on the MPC to tighten policy to get inflation under control.**
- **As well as strong wage growth, our unique dataset also suggests that employment growth has remained strong despite weak UK GDP growth. The implication is that productivity is falling and an even stronger inflation impulse from wages is coming.**
- **This reinforces our view that the MPC will have to hike another 50bps at the August meeting and tighten further in September. But strong wage growth also raises the chances that market pricing of another 125bps of hikes this year is close to the mark.**

Recent upside surprises to wage growth and inflation have forced the Bank of England's Monetary Policy Committee to turn abruptly hawkish in recent weeks, forcing a dramatic repricing on UK fixed income and banking markets. Having already established a new precedent for this hiking cycle with a 50bps hike in June, we think inflation and labour market data will have to be surprisingly weaker to allow the MPC to throttle back on the pace of rate increases.

But based on our proprietary labour market indicators we see very little chance of this happening in the near term. If anything, the labour market is likely to continue to surprise to the upside.

Our sentiment data, developed in collaboration with Penta, pointed to strong wage growth in the UK as early as December last year. Now, our data suggests that wage growth eased only marginally in May and June and is growing at around 1.8% on a 3m/3m basis (**Chart 1**). This is far above the MPC expectation of 1% growth in private sector wages in Q2, and will heap more pressure on the committee at a time when its credibility relies on limiting the second-round impacts of high inflation.

Chart 1: Sentiment data showing strong wage growth in May and June make further rate hikes likely



Source: Oxford Economics/Penta/Haver Analytics/Bank of England

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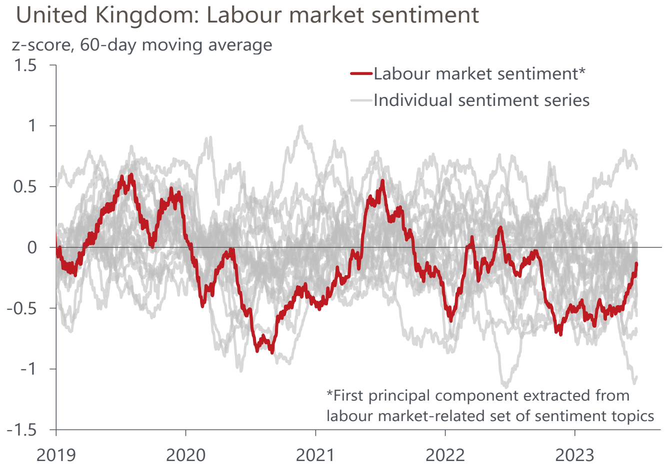
UK labour market sentiment is improving

In this environment of heightened economic uncertainty, a noticeable shift by the major central banks has been the far greater weight they put on current economic data than their forecasts. But the key weakness of this approach is that economic data tend to lag real time developments substantially. For example, UK labour market data – crucial for assessing the second-round impacts of high inflation – is published around six weeks in arrears.

Add in the long transmission period that changes in monetary policy take before affecting economic activity, and monetary policy starts to resemble steering an oil tanker using the rear-view mirror. In this context, sentiment indicators can be crucial in spotting turning points and the need for a course correction.

Our own indicators suggest the UK labour market has improved significantly in recent months (**Chart 2**). This likely reflects improving real wages, as nominal wage growth remains strong and inflation falls back. But while good news for working households, policymakers will view strong wage growth as a worrying development in the fight to limit the second-round impacts on inflation.

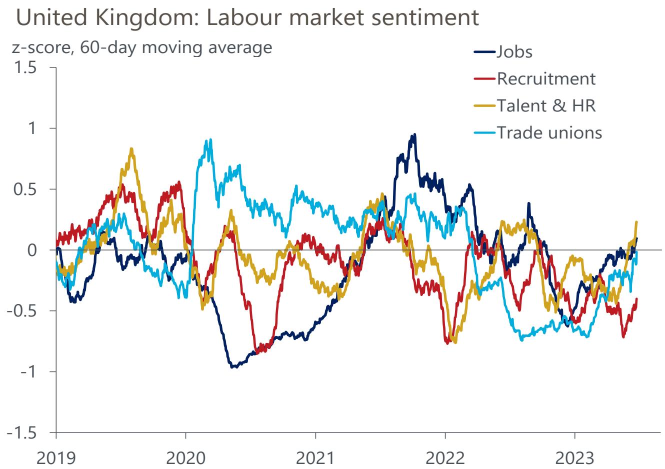
Chart 2: Sentiment has been improving in the labour market despite the monetary tightening



Source: Oxford Economics/Penta

A few notable drivers underlie this overall improvement in sentiment. In particular, increased strike action and the resulting improvements in pay conditions appear to be key factors (**Chart 3**).

Chart 3: Labour market quantities also seem to be behind the improvement



Source: Oxford Economics/Penta

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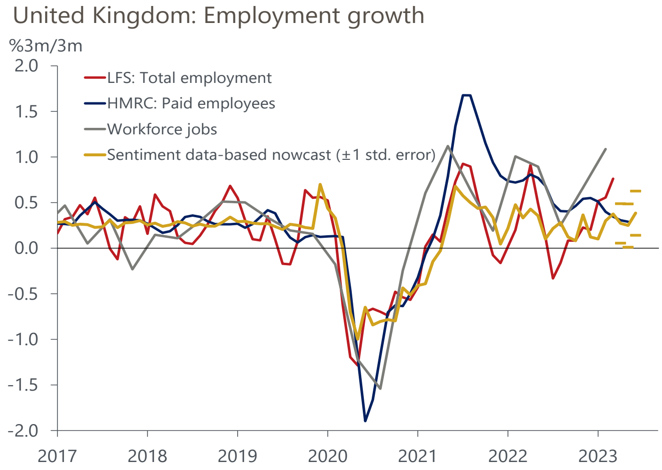
At the same time, sentiment towards terms related to hiring and employment growth such as "jobs" and "talent & HR" continue to improve, suggesting that employment growth remains robust. Indeed, the type of terms that are leading the turnaround in sentiment may suggest that firms are actively seeking to recruit rather than simply hoard workers.

Our nowcast based on these and other terms suggest employment growth was almost 2% annualised in recent months. Even though this would be towards the bottom of the wide range of growth in official employment metrics, it would still be considerably above our estimates from growth in the labour supply (**Chart 4**). That implies an ongoing tightening in the labour market, consistent with ongoing robust wage growth.

Chart 4: Many conflicting official signals on employment growth, but our indicators suggest expansion



Source: Oxford Economics/Penta/Haver Analytics

Bad news for productivity

This surprising strength in the labour market comes at a time when the UK economy is stagnating. UK GDP growth in the year to Q1 was just 0.2%, while growth in employment was somewhat higher at 0.7%. The signs of ongoing growth in employment in recent months alongside weak economic activity suggest that productivity – output per worker – may have even started to shrink (**Chart 5**).

The gap between productivity and wage growth will worry the MPC even more. Typically wage growth should be around 2ppts higher than productivity growth to be consistent with the 2% inflation target, so a gap of more than 7ppts points to significant inflationary pressure.

Chart 5: Robust earnings and shrinking productivity are even more worrying for the inflation outlook

Source: Oxford Economics/Haver Analytics

If the official labour market data that will be published by the ONS in July and August bear out these findings, then the MPC will likely be forced to tighten policy further. That would dampen economic activity even more in 2024, pushing the UK economy to the brink of recession. But the MPC may view this as the price of getting inflation back down to target.