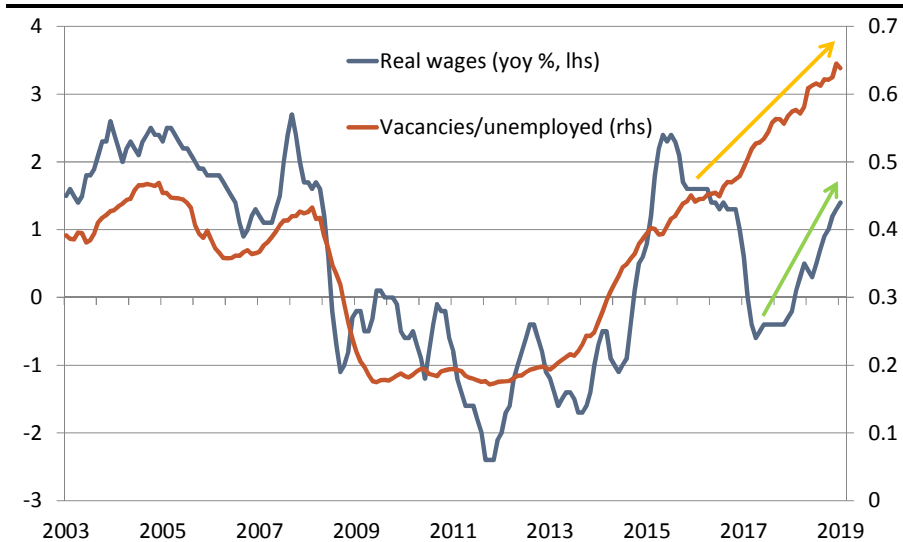


20 March 2019

UK: wage outlook warrants rate hikes, even in a long Brexit delay

Real wages rising strongly again after temporary Brexit vote-related hit



Monthly data. Real wages = average weekly earnings including bonuses adjusted by yoy % change in headline CPI. Source: ONS, Berenberg calculations.

- The fundamental strength:** Nothing marks economic progress like rising living standards. While Brexit uncertainty has stripped the UK of some of its erstwhile economic vigour, with notable softness during the past two years in [the most risk-sensitive parts of the economy, like business investment](#), the labour market has remained solid. As our favourite UK chart shows, continued rising labour demand and falling unemployment are driving real wages higher. Latest data for January show that real average weekly earnings rose 1.4% annually.
- Initial Brexit vote shock over:** The sharp 15%+ fall in trade-weighted sterling after the Brexit vote in June 2016, as market expectations of UK long-term growth fell, caused a temporary jump in import prices and pushed the inflation rate to 3%. Real average weekly earnings declined for much of 2017 as inflation outpaced nominal wage growth. But the recovery that began in earnest in 2018 has continued at the start of 2019.
- Further improvement ahead:** Despite the recent healthy gains, there remains a large gap between labour market tightness and current real wage growth. Providing the UK manages to avoid a hard Brexit (15% risk), this gap should close further. Real wage growth can rise towards 2% yoy by the second half of 2019 as nominal wage growth improves from the 3.5% yoy rate in January. A sharp jump in sterling that would likely follow from the UK and the EU finally sealing a deal for future relations, most importantly on trade, would drive down import prices and offer a nice one-off boost to real wages, partly undoing the 2017 hit.
- A hard Brexit would reverse the recent rise in UK living standards:** By harming firms' demand for labour, a hard Brexit would reduce labour market tightness and dampen nominal wage gains. Meanwhile, a likely sharp drop in sterling would cause headline inflation to jump. A hard Brexit would risk a repeat of 2017, or worse. Luckily, this remains an unlikely outcome. While a quick Brexit resolution would be optimum, if the UK and EU [agreed to delay Brexit by up to two years](#), we would continue to expect real wages to rise over the medium term.
- BoE outlook:** Because of Brexit uncertainties, the BoE has proceeded cautiously over the past two years, only hiking rates twice when the balance of demand and supply in the UK domestic economy would have justified a slightly faster pace of tightening. Now inflation expectations exceed 3%, according to BoE surveys. Coupled with improving wage growth, inflationary pressures are likely to build over the medium term. A continued normalisation of UK monetary policy thus makes sense. Even if the Fed and ECB retain their current dovish tilts, we expect the BoE to gradually normalise its policy at a pace of [one 25bp rate hike every six months beginning in August](#). We would assume such an outcome in all scenarios apart from a hard Brexit, including that of a long Brexit delay. In a surprise scenario where Brexit is quickly resolved, the next hike could come sooner.

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