EY ITEM Club Winter Forecast

Back to growth in an uncertain world

February 2025

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The UK economy's school report card for 2024 would read 'disappointing – please do better'. The year started well, with the economy shrugging off a mini-recession in H2 2023 and recording growth at an annualised rate of roughly 2% for H1. However, this didn't last as activity stagnated in the second half of the year, and as a result, growth for the whole of 2024 is likely to be just 0.8% – hardly likely to get the pulse racing.

The path of inflation and interest rates also disappointed. Although headline inflation did fall briefly below target in the summer, as the drag from energy prices waned, sticky services inflation dragged the headline rate back up to 2.5% by the end of the year. As a result, the Bank of England (BoE) remained hawkish – cutting rates by a total of 50 bps – less than the 100 bps–125 bps that markets were hoping for at the beginning of 2024.

Consequently, inflation and rates continued to drag on performance, partly explaining some of the H2 slowdown. This was not helped, as even perhaps the Government would admit, by some of the post-election messaging on the state of the economy by the new administration and nervousness by business and households as to what the October Budget might hold. This likely dragged on consumer and business confidence over the course of the summer, whilst nervousness about the US election also acted as a headwind.

As we head into 2025, the UK is also being buffeted by the current focus in global financial markets on the sustainability of government finances. This is largely being driven by events in the US, where markets are concerned about the inflationary impacts of tariffs and tax cuts, which is, in turn, driving up US bond yields. However, there does appear to be a UK-specific risk premium – yields have risen further in the UK than in some of our European neighbours, reflecting concerns about the additional borrowing and tax rise announced in the Budget and scepticism about the prospects for growth.

Bringing all of this together – and in particular, the poor finish to the year – the EY ITEM Club has downgraded its forecast for 2025 – with GDP growth now expected to be just 1.0%, down from 1.5% in their autumn forecast. Some of this downgrade is purely mathematical – a weak 2024 Q4 impacts the calculation of annual GDP growth for 2025 – but there is no doubt that the UK economy, in common with much of Europe, is really struggling, even as the US economy roars ahead.

So, are there any grounds for optimism? Well, as any business knows, there is always opportunity regardless of the external circumstances. Firstly, the underlying growth rate should improve over the course of 2025; unemployment remains low, wages continue to outstrip inflation and the BoE should continue to cut interest rates – all of this should lead to a recovery in consumer and business confidence over the year. Secondly, we have also seen some interesting policy announcements recently from the UK Government on their approach to AI, accelerating house building and delivering big infrastructure – with, for example, airport expansion back on the agenda. As more details follow, investors should start to listen and perhaps notice that the UK looks like a bastion of stability, with its centrist government sitting on a large majority, compared with some of the instability elsewhere.

So, whilst the geopolitical environment remains uncertain, financial markets remain temperamental, and the US Government's tea leaves should be closely studied to understand the likely path of tariffs. Ultimately, as has been the case for at least the last five years, businesses need to remain agile in the face of uncertainty and focus on the fundamentals of serving their customers and managing their bottom line.

Highlights

- Having made a strong start to 2024, the economy lost momentum in the second half of the year. This has fed into our forecast for 2025, which we have downgraded from 1.0% from 1.5%. However, saying that, we continue to think underlying quarter-on-quarter growth in 2025 may be better than the headline figure suggests at around 0.4% QoQ (i.e., around trend rates). This should provide a basis for better performance in 2026 of 1.6% and 1.5% after that.

- We do expect a recovery of sorts in consumer spending – as continued real income growth should see a recovery in consumer confidence leading to a continuation of some of the recent strength in consumption. In contrast, the recent tightening in financial conditions and sustained political uncertainty will weigh on private investment over the next couple of quarters.

- The easy progress on inflation has been made, but the hard work is still to come, and we forecast inflation to remain well above of the 2% target through most of this year, averaging 2.8% over 2025. Inflation had been dragged down below target by past falls in energy and goods prices, but these effects have started to wane and will continue to do so through the start of this year. Real progress on inflation will only come from a reduction in domestic inflation pressures, and we expect this process to be protracted. The labour market has loosened in recent months, so we do expect pay growth to normalise. However, the rise in employers' National Insurance contributions (NICs), which comes into force in April 2025, will mean employers continue to face elevated labour costs even as pay growth slows.

- We predict that the BoE will cut interest rates by more than financial markets currently expect. Recent market moves have seen UK interest rate expectations move in sympathy with the US. However, with the Monetary Policy Committee (MPC) becoming increasingly worried about the UK's growth outlook, we think this move is overdone. Even with inflation above target, we forecast that the MPC will dial back interest rates to keep UK growth on track. We see Bank Rate falling to 3.75% by the end of this year and settling at 3.5% in early 2026.

- Extremely challenging fiscal dynamics will see the UK facing relatively high longer-term interest rates over the coming year. Through the pandemic, the UK built up a significant amount of public debt, and with a track record of weak growth, longer-term interest rates will have to remain high to continue to attract funding. We do expect bond yields to fall back over the course of the year, but the decline will be pretty gradual. If the economy and interest rates play out as we expect, then in the fullness of time, we think the Government will meet its fiscal rules. However, it has left itself little margin for error in hitting its fiscal targets, so it continues to run the risk of being blown off course by economic and financial market gyrations before it gets there.

- When it comes to the risk of leaving little fiscal headroom, recent market moves are a case in point. The Office for Budget Responsibility (OBR) will update its assessment of the UK's economic and fiscal outlook in late March. If, at that point, market interest rates are around the highs seen at the start of this year, there is a real possibility that its updated forecast will leave the Chancellor having to deliver further fiscal consolidation to ensure her fiscal rules are met. Any further consolidation announced will need to be carefully calibrated to not put too much additional pressure on businesses and the labour market.

- Global growth is likely to be stable into 2025. It seems most likely that the new US administration will impose a modest increase in tariffs, with the UK unlikely to be singled out as a trading partner that should face a particularly high schedule. In this scenario, we see the change in international trade policy as having a relatively small impact on the UK's growth and inflation prospects. However, a more significant rise in tariffs and possible retaliation from the UK Government would see a material deterioration in trade flows and a surge in inflationary pressure, with a corresponding impact on the economic outlook.

1

Introduction

In our autumn forecast, we set out why we thought the UK had taken another step forward on its road to recovery.[1] Economic activity has hit a soft patch since then, but we think this will be short-lived. Whilst we now expect GDP growth to be 1.0% in 2025, the downward revision to our 2025 forecast is really as a mathematical result of the weak end to 2024. We continue to expect quarter-on-quarter growth to continue around trend rates through 2025 as the consumer becomes less cautious.

Inflation is on the rise again, but whilst it will be elevated through most of this year, we see it eventually settling around 2% in the latter half of 2026. The recent pickup is largely the result of a waning drag from past energy and goods price falls. Domestic inflationary pressures remain sticky, but we expect them to slowly ease over the course of the year with the labour market less tight than at the start of last year. With part of the recent rise in inflation likely to be transitory and some concerns amongst the MPC around the UK's growth prospects emerging, we expect interest rates to fall further over 2025, ending the year at 3.75% and stabilising around 3.5% at the start of next year.

The UK's challenging fiscal dynamics mean that the Labour Government has established a framework that is expected to see fiscal policy tighten over the coming years. However, the Chancellor's updated tax and spending plans left little wiggle room against her new fiscal rules, and since the October Budget, our view has been that further fiscal tightening may be required to keep things on track. With the recent rise in UK and international borrowing costs, the Government may be forced to put in place more consolidation when the OBR updates its economic and fiscal forecasts in late March. However, it will have to tread cautiously to make sure it does not put too much pressure on firms and the labour market.

Our latest forecast begins by discussing recent economic developments. Section 3 examines the key elements of our new forecast. Section 4 examines how the recent rise in government bond yields may influence fiscal policy and impact the labour market. Section 5 looks at key changes in the global economy and how they will shape the UK outlook over 2025 and beyond. Section 6 concludes.

2

A loss of momentum

Since our autumn forecast, there have been three major economic developments. Growth and inflation have disappointed, changes to fiscal policy at home and abroad have led to a tightening in financial conditions and continued geopolitical tensions risk further inflationary pressure. At first glance, these factors might challenge our core view that the UK's economic recovery remains on track. However, below the surface, we still see reasons to be optimistic. As we will discuss, more downside risks are emerging.

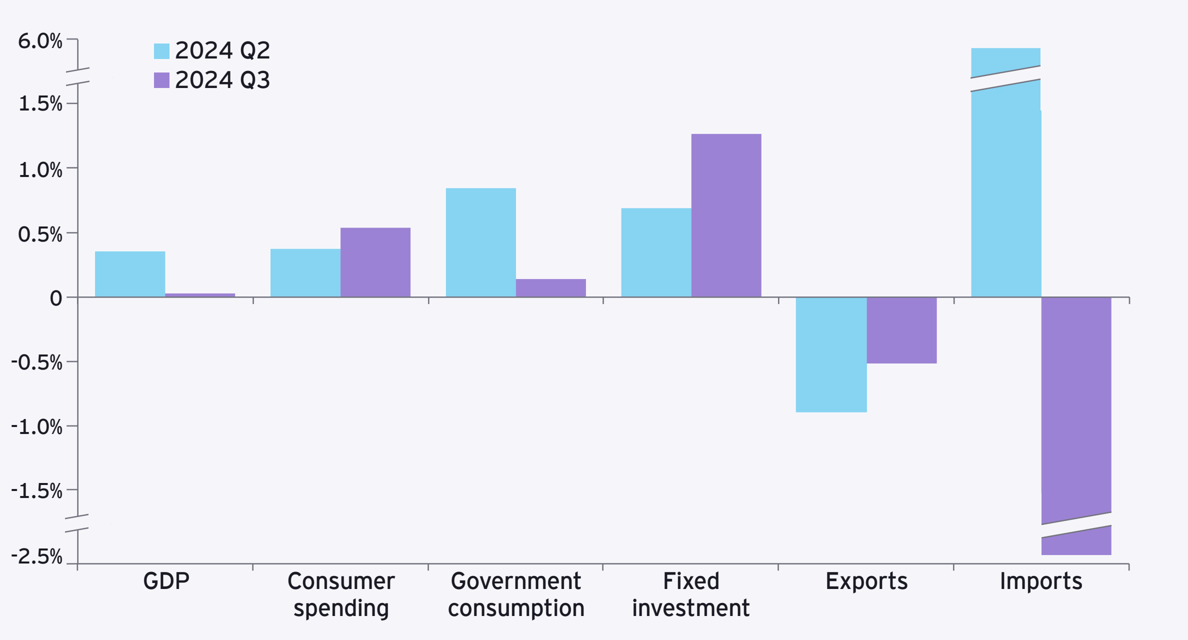
After a strong start to the year, growth ground to a halt in H2

2024 appears to have been a year of two halves, with GDP growth averaging 0.5% per quarter in the first half of last year before flatlining in H2. Whilst we had expected a slowdown into H2, the extent to which momentum has been lost has come as a surprise. The Office for National Statistics estimates that growth slowed to zero in Q3, which is 0.2ppt below our previous projection. Whilst there is yet to be a complete set of data for Q4, activity estimates we have received to date point to a similar-sized undershoot in the final quarter of last year.

At this stage, we think there are good reasons to view the surprisingly sharp growth slowdown as temporary. In each of the last three years, growth has slowed sharply into Q3, which may be indicative of the official data for recent quarters being weighed down by residual seasonality. This problem is known to impact GDP estimates in other countries, including the Bureau of Economic Analysis estimates of US growth.[2] Indeed, the expenditure split of GDP paints a much more optimistic picture of private domestic demand into Q3.

In contrast to the recent growth slowdown, the consumer has continued to spend. Household expenditure grew by 0.5% in Q3, a slight improvement on the 0.4% in Q2. But consumer sentiment has been volatile over the last couple of months and it has is yet to translate into significantly less consumer caution. Households' saving ratio remains elevated by historical standards – almost 2ppt above its pre-pandemic average – and continues to offer plenty of scope for a less hesitant consumer to support growth.

UK: GDP growth and expenditure components



Source: EY ITEM Club/ Haver Analytics

It is becoming harder to find a job, but we are yet to see big layoffs

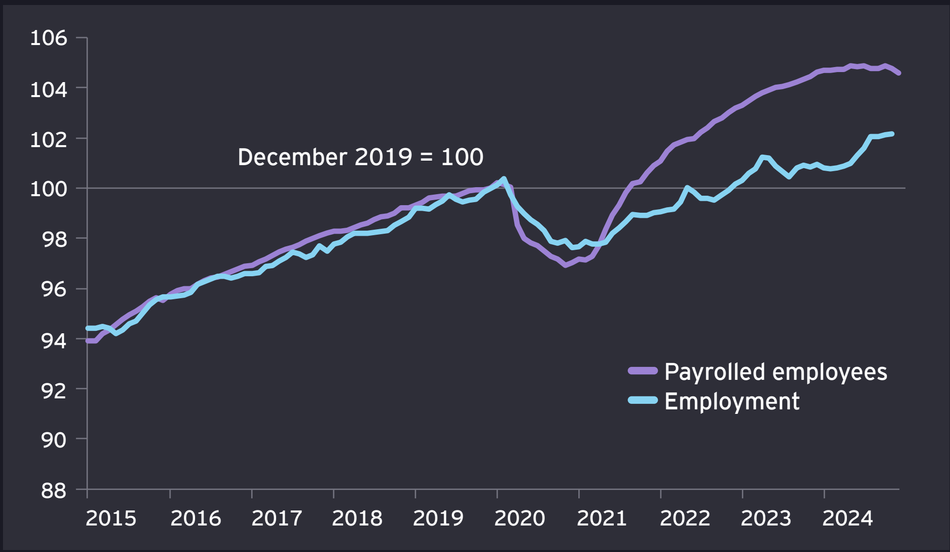
Broadly speaking, the autumn forecast judgement that the labour market was broadly back in balance and would remain there as cooling labour demand would see vacancies continue to normalise without widespread redundancies looks on track.

Continued issues with the Labour Force Survey's (LFS) sample size make the current official labour market statistics unreliable, so it is more difficult than usual to assess the current position of the labour market. Employment estimates from the LFS suggest that growth has been muted since the pandemic, with a large rise in labour market inactivity. However, alternative employment measures based on different data sources, such as those derived from PAYE returns, point to stronger growth in the workforce over the last couple of years.

Whilst the size of the workforce remains uncertain, the direction of travel in the last few months has been clearer, and the demand for workers has eased. Data not impacted by the LFS's methodological issues suggested that firms are posting fewer vacancies and that the overall number of people in employment is declining. Whilst firms are clearly not taking on many new workers, estimates of redundancies remain around normal levels, and there has yet to be a significant increase in the number of redundancy notifications to the Government.

Despite the labour market remaining in balance, pay growth has remained elevated. Although there are still indications that inflation remains sticky. Surveys of firms' hiring intentions are weakening and there are clear signs that a loosening labour market is gradually feeding through into pay settlements. This is consistent with our view that earnings growth will slow to rates consistent with the 2% inflation target in the middle of next year. The interim cut of the annual pay survey by the BoE's regional agents estimated that 2025 wage growth would be in a 3%–4% range. Other surveys currently point to stronger settlements, for example the BoE's survey of corporate decision-makers points to earnings growth of around 4%.

UK: Employment and payrolled employees



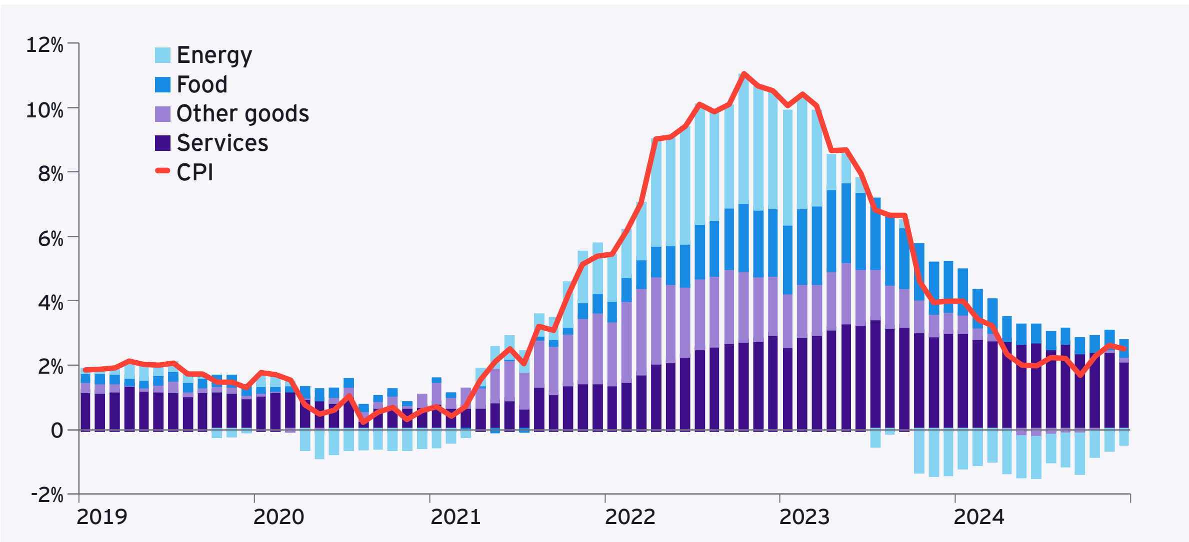
Source: EY ITEM Club/ Haver Analytics

Inflation has risen as easy progress has been made

As the quick wins on inflation have passed, inflation has risen from 1.7% in September 2024 to 2.5% by December 2024. The drag from falling energy prices is fading, and weak goods price readings from the end of 2023 are being removed from the annual inflation calculation. Combined with a further rise of 1.2% in the energy price cap in January, this will push up annual inflation close to 3.0% in the near term.

Past these external factors, it still looks like domestically generated inflation will remain sticky. Services inflation, which relies more heavily on labour inputs and is more sensitive to development in pay growth, remains elevated. With services inflation still at 4.4%, it remains far in excess of the roughly 3.0% mark that has previously seen headline inflation be sustained at close to the 2.0% target. The strength of the current reading can be partly explained by large rises earlier on in 2024 in prices that only change once per year, for example, phone contracts. Even after excluding these one-off price increases, services inflation remains above the 3% mark.

UK: Contributions to inflation



Source: EY ITEM Club/ Haver Analytics

Financial conditions have tightened, and geopolitical uncertainties have risen

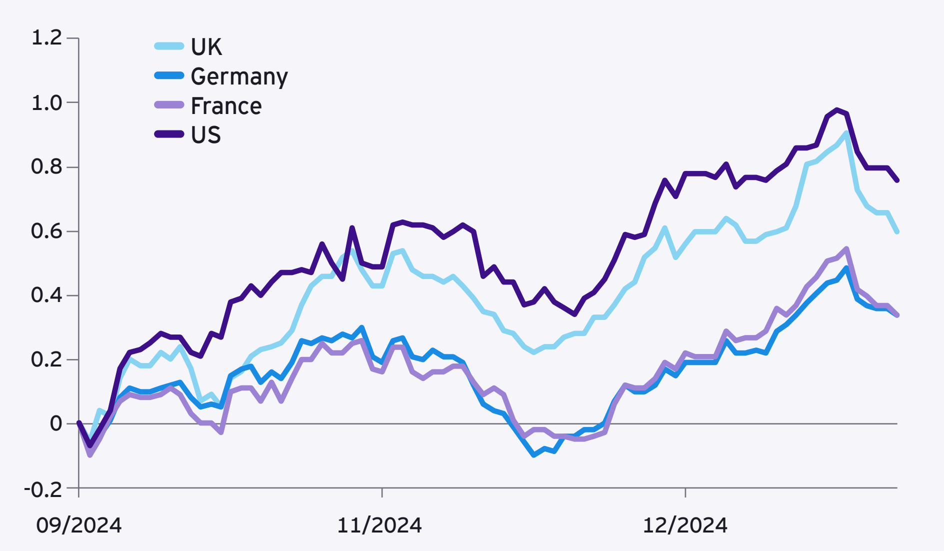
Since our autumn report, two major events have shaped the UK and global economic outlook: the Labour Government's first Budget and the US presidential election. Later in the report, we will examine these two events' impacts in more detail.

Financial markets have viewed both events as ushering in a period of looser fiscal policy, and interest rate expectations have risen as a result.

Across the final quarter of 2024, gilt and US treasuries yields rose by 57 and 77 bps, respectively. At the same time, financial markets now expect fewer interest rate cuts over 2025, with the BoE now only expected to cut Bank Rate between two and three times, compared to three months ago when Bank Rate was expected to end the year below 4.0%.

Global: Ten year government bond yields

% ppt change since end Q3



Source: EY ITEM Club/ Haver Analytics

The Bank of England is becoming more concerned about the growth outlook

In the face of rising inflation, the BoE indicated that it would continue to cut Bank Rate at a gradual pace. Having cut Bank Rate at its August and November meetings, the MPC followed its established 'cut-hold' tempo, leaving it unchanged at its December meeting, as we were expecting.

More of a surprise was the split on the MPC, where three members voted for an immediate reduction in interest rates to 4.5%. This was significant and marked a shift in the reaction function of BoE rate-setters towards the growth outlook, down-weighting the importance of inflationary pressures.

So far, the BoE has been clear that the consensus view among MPC members is that a margin of spare capacity will be required to lower inflation sustainably back to the 2% target. MPC members have also suggested they want to see how the uncertainty around April's changes in employers' NICs and global trade policy play out. So, we expect the BoE to continue with its current pace of rate changes whilst monitoring how these policy changes impact growth, the labour market and inflation.

3

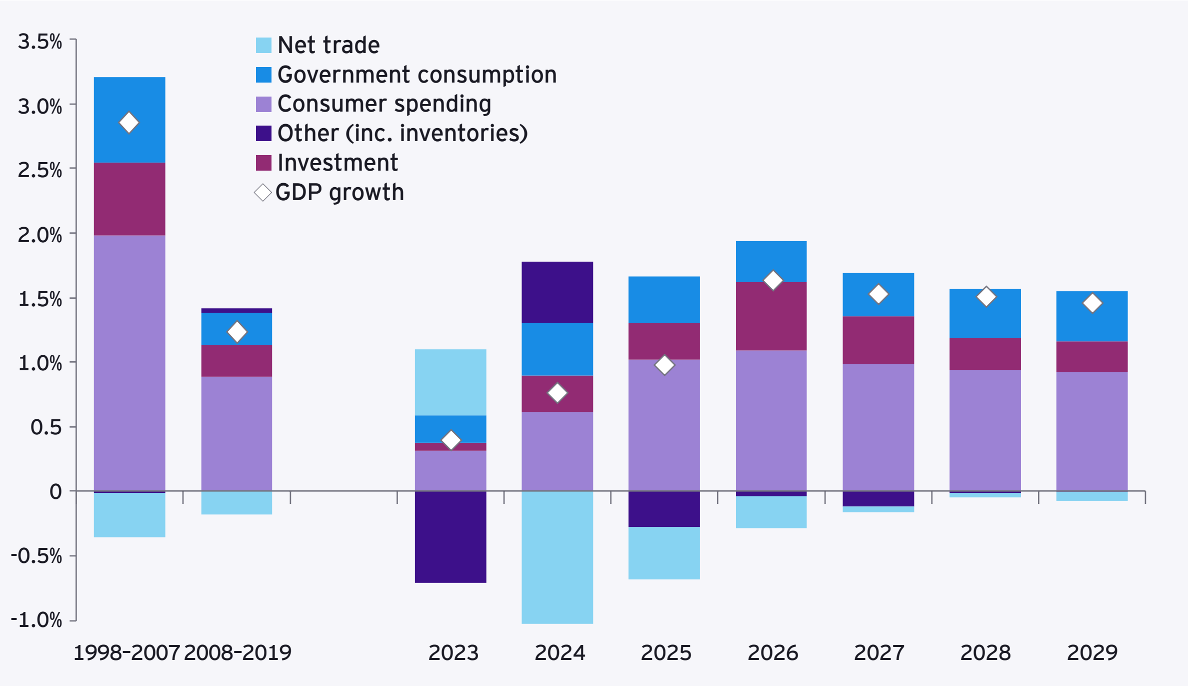
Growth slowdown is a blip, not a trend

Growth downgrade doesn't point to a sustained slowdown

On the face of it, the downgrade to our 2025 GDP growth projection to 1% from 1.5% looks like we expect the recent loss of growth momentum to continue, but that is not the case. It is a trick of calendar year growth rates where how growth ends the previous year is just as important as growth during the year itself.[3] Instead, we continue to think that there are good reasons to believe that growth will continue at a steady but unspectacular pace over 2025. We forecast that to continue into 2026 where we again forecast growth of 1.6%.

Across 2025, a less cautious consumer and, to a smaller degree, falling interest rates are likely to present tailwinds to growth. However, corporate uncertainty, tightening fiscal policy, and the fact that a minority of households still have to refinance their mortgages to higher interest rates will lean against activity. The net effect is that through 2025, we expect growth to hold steady around trend rates of 0.4% per quarter.

UK: Contributions GDP growth



Source: EY ITEM Club

Forecast for the UK economy, winter 2025

% changes on previous year except borrowing, current account and interest and exchange rates

	GDP	Domestic Demand	Consumer spending	Fixed investment	Exports	Imports
2022	4.8	5.1	7.4	5.1	12.6	13.0
2023	0.4	-0.2	0.5	0.3	-3.2	-4.5
2024	0.8	1.7	1.0	1.6	-1.6	1.5
2025	1.0	1.4	1.6	1.6	1.4	2.5
2026	1.6	1.8	1.7	2.9	1.6	2.2
2027	1.5	1.5	1.5	2.0	1.4	1.4
2028	1.5	1.5	1.5	1.4	1.4	1.4
2029	1.5	1.5	1.5	1.3	1.4	1.5
	Net govt. borrowing (*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank rate**	**Effective exchange rate**
2022	4.8	-2.2	6.2	9.1	1.5	79.6
2023	4.8	-2.2	6.9	7.3	4.7	80.4
2024	4.8	-2.4	5.2	2.5	5.1	83.5
2025	3.9	-1.9	4.3	2.8	4.2	83.7
2026	3.0	-2.1	3.0	2.3	3.5	83.7
2027	2.3	-2.0	2.8	2.0	3.5	83.7
2028	2.2	-1.9	2.8	2.0	3.5	83.7
2029	2.1	-1.9	2.9	2.0	3.5	83.7

(*) Fiscal years, as % of GDP

Source: EY ITEM Club

Further progress on inflation will be a slow process

We continue to expect inflation to remain materially above the inflation target through 2025 and only fall back to 2.0% in the latter half of 2026. However, the upward revision to our 2025 inflation forecast, now 2.8%, masks some contrasting developments that paint a slightly more positive story.

External factors will push up inflation, but these effects will likely be temporary. Notably, the current drag on inflation from falling energy prices will disappear by spring. At the same time, core goods inflation will rise back towards more normal levels as the effects of supply chain normalisation ease.

Ultimately, services inflation will slow, causing overall inflation to head back and stabilise at the 2% target. This will be a slow process as the competing forces of a looser labour market and an increasing tax burden for employers feed through to final prices. Admittedly, there is a lot of uncertainty about how this will play out, but we forecast that services inflation will return to rates consistent with 2% inflation by around the middle of next year.

Upcoming tax changes will see continued pressure on UK labour costs

Following the announcement of changes to employers' NICs in the October Budget, we expect labour costs growth to remain elevated even as earnings growth slows. Over the last year, the labour market has loosened, so we expect private sector pay growth to slow from around 5% to closer to 3.5% by the end of this year. On the face of it, firms' labour cost growth has slowed. However, if you allow for the upcoming tax changes, this is not necessarily the case. The Institute for Fiscal Studies estimates that, on average, the changes announced to employers' NICs will push up the cost of an employee by £900 per year.[4] The net effect is that even for pay growth in a 2%–4% range, the cost of most employees will increase by around 4%–7%. Consequently, growth in businesses' total labour costs is unlikely to slow much over 2025. Whilst firms will absorb some of the increased cost, the BoE's Decision Maker Panel survey reports that their most likely response is to lay off workers and raise prices. The net effect is that even though we see the unemployment rate rising in 2025, services and headline inflation only falls back to target consistent rates in the second half of next year. However, how firms respond is uncertain and we cannot rule out a larger rise in unemployment if firms opt to reduce headcount sharply in response to higher costs.

The impact is likely to be felt particularly heavily by firms with high concentrations of lower-paid staff. This is partly because a large chunk of the revenue from higher NICs will come from reducing the threshold at which firms start paying tax. It also reflects April's 6.7% increase in the National Living Wage (NLW), which will also spill up the pay distribution. For a worker earning the NLW, the increase in employment costs could be more than 10%. This may be particularly damaging for some of the sectors hardest hit by the pandemic and that have been slow to recover, such as hotels and restaurants, that provide a labour-intensive service and typically employ more lower paid staff.

In addition to the NICs changes, changes in employment rights will also increase labour costs. The Government's impact assessment estimates that the legislative changes may cost businesses around £5bn.[5] On its own, this is a small increase in relation to the UK's overall labour bill, which exceeded £1.3tn in the four quarters ending 2024 Q3. However, it is around 20% of the size of the overall cost associated with changes in employers' NICs, so adds to the additional cost burden facing firms, putting particular strain on firms that are already operating with thin margins. Once again, combined with the NICs changes, there is a risk that unemployment rises more than we forecast.

UK: Change in labour cost in 2025–2026

Source: EY ITEM Club/ Institute of Fiscal Studies

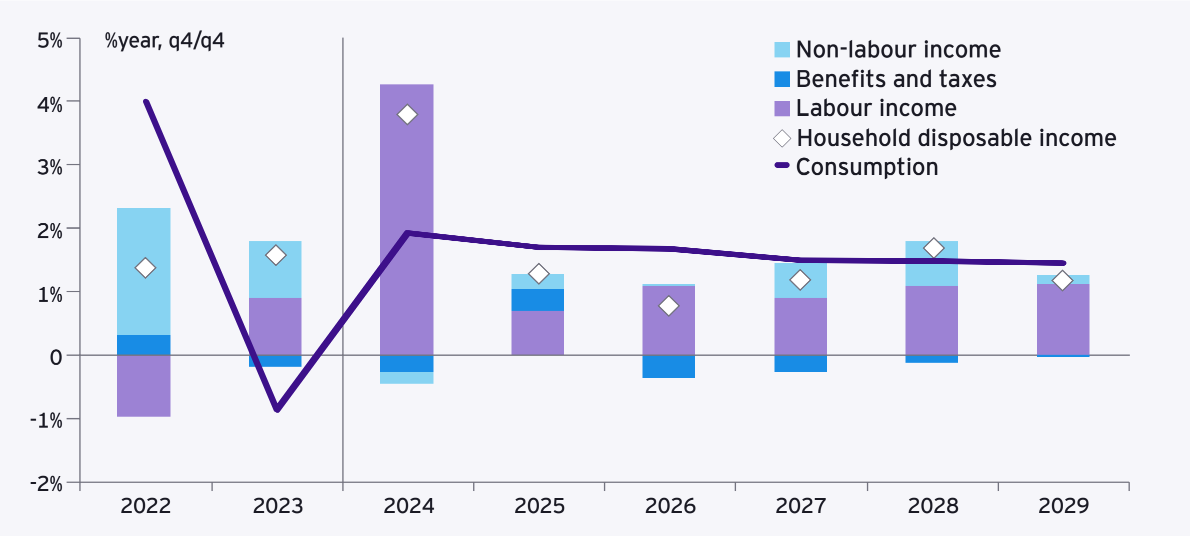
Less consumer caution underpins the growth recovery

With sustained pay gains and inflation that is much lower than the 2023 highs, we continue to see real pay rise over the coming years, which, alongside only a very modest rise in unemployment, points to continued real income growth. Nonetheless, we think that real income growth will be weaker across the coming years than through 2024 as cooling pay growth and fiscal drag come to the fore. We still see consumption growth continuing around its recent pace as consumers make up for weaker real income growth by saving less as they become more confident in the economic outlook.

Consumer sentiment is particularly sensitive to inflation, so as the UK emerged from the energy price shock, households continued to save rather than spend a lot of their real income gains, pushing up the household saving ratio. However, with consumer confidence now back towards more normal levels and inflation likely to remain in a range familiar to households, sustained resilience in the labour market and healthy household balance sheets, we expect a less cautious consumer over the next couple of years.

Consistent with recent consumer caution, spending on durable goods has lagged wider consumption. Durable goods are typically not essential purchases and are an area that households will typically cut back when saving more than normal. Given its recent underperformance, we see scope for some catch-up in durable goods spending as the consumer becomes less cautious.

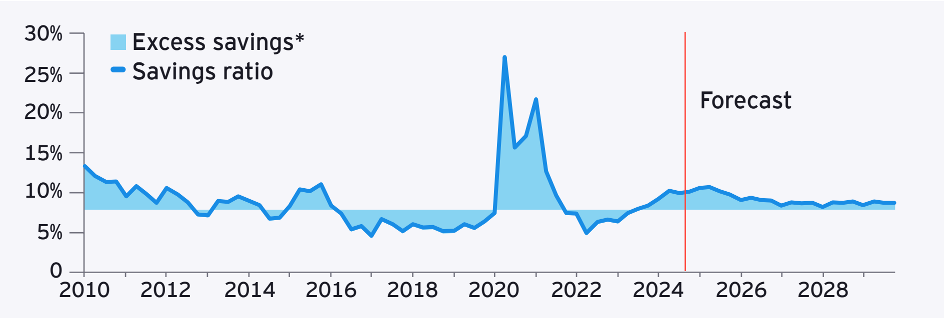
UK: Real disposable income and consumption



Source: EY ITEM Club/ Haver Analytics

UK: Household saving ratio

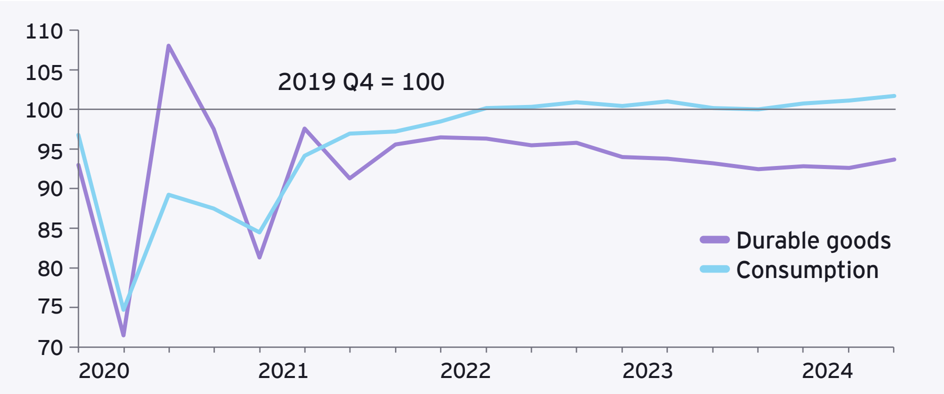
% of disposable income



* Relative to 2010-2019 average

Source: EY ITEM Club/ Haver Analytics

UK: Total and durable consumption



Source: EY ITEM Club/ Haver Analytics

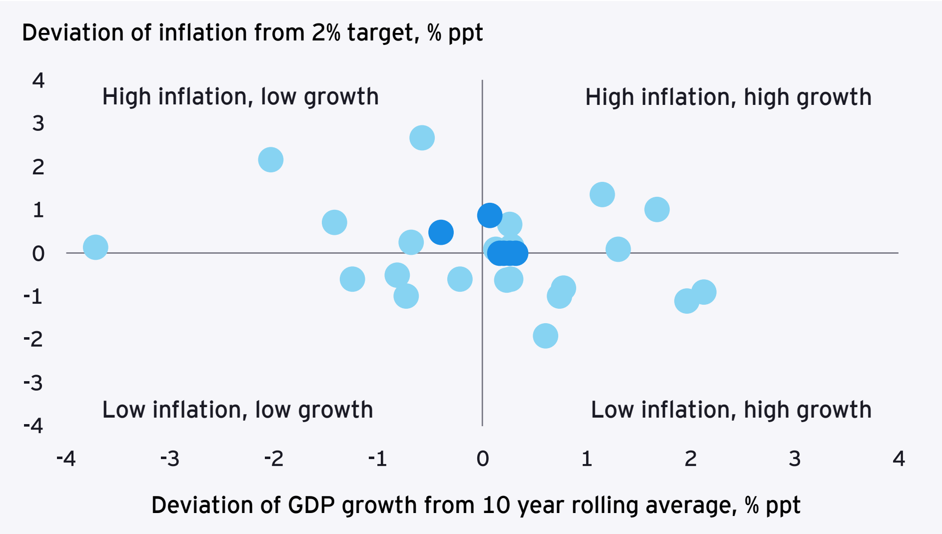
Interest rates will continue to fall, but relatively slowly

With growth expected to pick up to trend rates, the labour market in balance and key inflation indicators falling but elevated, we do not think that the BoE will rush to cut more quickly than 25bps per quarter. We see Bank Rate ending 2025 at 3.75% before stabilising at 3.5% in February 2026.

The December meeting marked a shift in the BoE's reaction function. Having spent much of 2023 and 2024 focused on the incoming inflation data, at the final meeting of 2024, the MPC indicated that it's beginning to weigh growth prospects more heavily when setting interest rates. Indeed, three of nine rate-setters voted for an immediate rate cut, citing concerns about the slowdown in activity.

Whilst we expect the BoE to deliver another 25bps reduction in Bank Rate in February, we think that the bar to speeding up the pace of interest rate cuts is high, particularly in the first half of 2025. We forecast that through 2025, the MPC will not face the sub-trend growth, above-target inflation trade-off that it was presented with at the end of 2024. Meanwhile, most of the MPC have been clear that they will proceed with caution as they monitor the implications of the changes in employers' NICs and global trade policy for growth and inflation. That said, we think the risks skew towards more interest rate cuts than our central case.

UK: Growth and inflation trade off

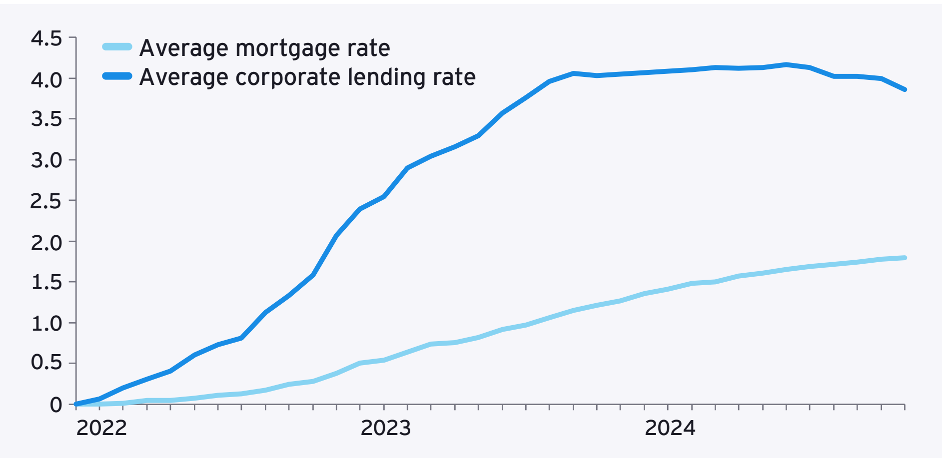


Source: EY ITEM Club

However, we expect the boost to demand from falling interest rates to be dampened by the structure of the UK's mortgage market. The vast majority of UK mortgages have their interest rate fixed for either two or five years. So, despite there being no increase in Bank Rate since August 2023, the average mortgage rate has continued to rise as borrowers re-fixed their mortgage at a higher interest rate than the very low levels that preceded the rate hiking cycle. This trend is set to continue over the next couple of years. The BoE estimates that around a third of fixed-rate mortgages still have not had their rates re-fixed since 2021. So, despite falling interest rates, the average mortgage rate looks set to rise through 2025 and into 2026. Recent BoE analysis suggests that the typical monthly mortgage payment will rise £146 or 22% over the next two years.[6] In contrast, the corporate sector will more quickly benefit from falling interest rates as around 80% of its debt is issued at a variable interest rate.

UK: Change in household and corporate lending rates

% ppt change since December 2021



Source: EY ITEM Club/ Haver Analytics

A strong start to 2025 will slow to a more gradual recovery in the housing market

The housing market picked up over the second half of last year as new mortgage rates declined. However, financial markets now expect fewer interest rate cuts than in late summer. By the end of 2024, this had translated into a slight rise in the quoted cost of mortgage finance, and given the lag between changes in swap rates and mortgage rates, borrowing rates are likely to rise further. Still, the average interest rate on new mortgages will likely remain lower than in the first half of last year.

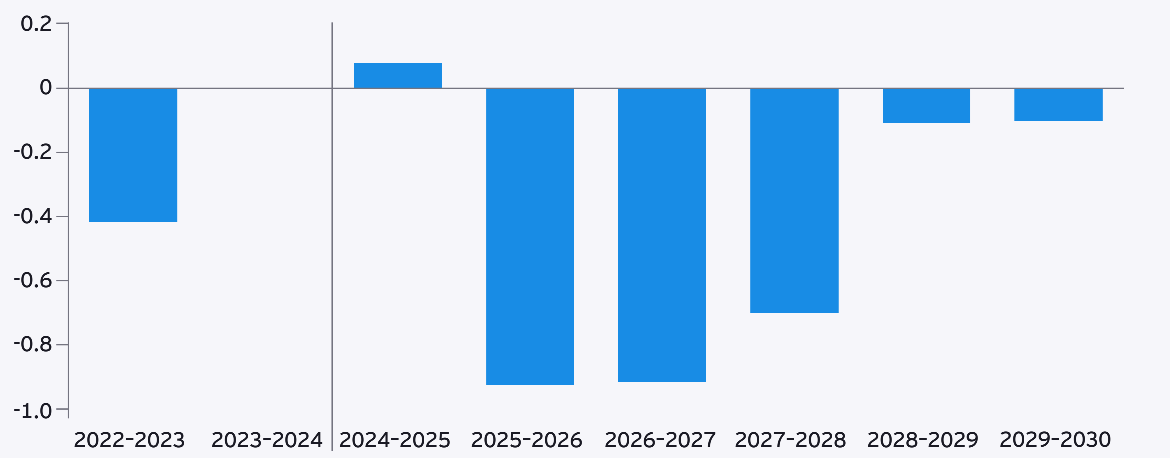
With forward-looking house buyers still keen to move before the temporary increase in Stamp Duty thresholds expires in March, housing market transactions and prices (based on Land Registry data) will likely continue at a decent clip in the first quarter of 2025. We expect a brief period of calm after the threshold changes, given some house purchases that would have taken place in the middle of the year are likely to have been brought forward. However, as interest rates are expected to fall relatively slowly through 2025, remaining at rates above those seen pre-pandemic and with housing valuations still quite high, we expect only a gradual improvement in the housing market to reappear later in the year.

Fiscal policy to continue to tighten

At its first Budget, the Labour Government replaced notional, future spending restraint with more immediate and certain tax rises. The additional expenditure in the Budget was funded almost in equal part by greater tax revenues and more government borrowing. Nonetheless, over the next five years, fiscal policy will continue to tighten, with tax revenues increasing more quickly than government spending, weighing on growth prospects. On the face of it, the Government's Budget boosts near-term growth relative to the fiscal plans it inherited.[7] However, we judge that this broadly has been offset by tighter financial conditions and increased uncertainty.

UK: Change in public sector borrowing

% ppt of nominal GDP

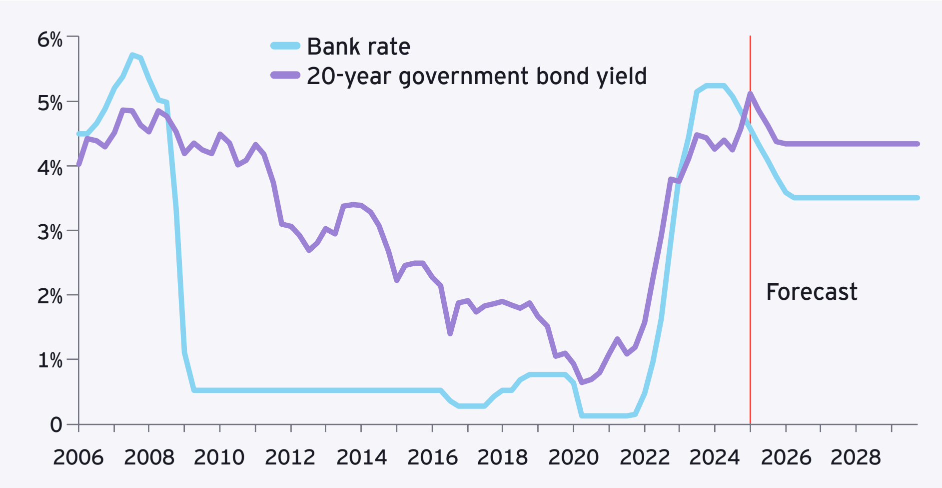


Source: EY ITEM Club

A central feature of the Budget was changing the Government's fiscal targets. By adjusting the definition of public sector finances used to judge the sustainability of its balance sheet, the Government opened space to increase borrowing to finance public investment. An increase in day-to-day public spending was largely funded by a tax on businesses, with an increase in the NICs that employers would have to pay.

Nonetheless, the UK continues to struggle with challenging debt dynamics. For an economy to fund its borrowing sustainably, its output must grow more quickly than its interest payments. However, as the UK has emerged from the twin shocks of the pandemic and energy crisis, growth has fallen below the interest rate that financial markets demand on UK debt. In light of these challenging fiscal fundamentals, the Chancellor continues to have to raise tax revenue more quickly than Government spending to keep the UK's public finances on a stable footing. To do this, the Chancellor has pledged only to borrow to invest. However, as we will discuss in more detail in Section 4, the Budget does not leave much wiggle room to hit this target, and we cannot rule out further consolidation.

UK: Bank rate and 20-year bond yield



Source: EY ITEM Club

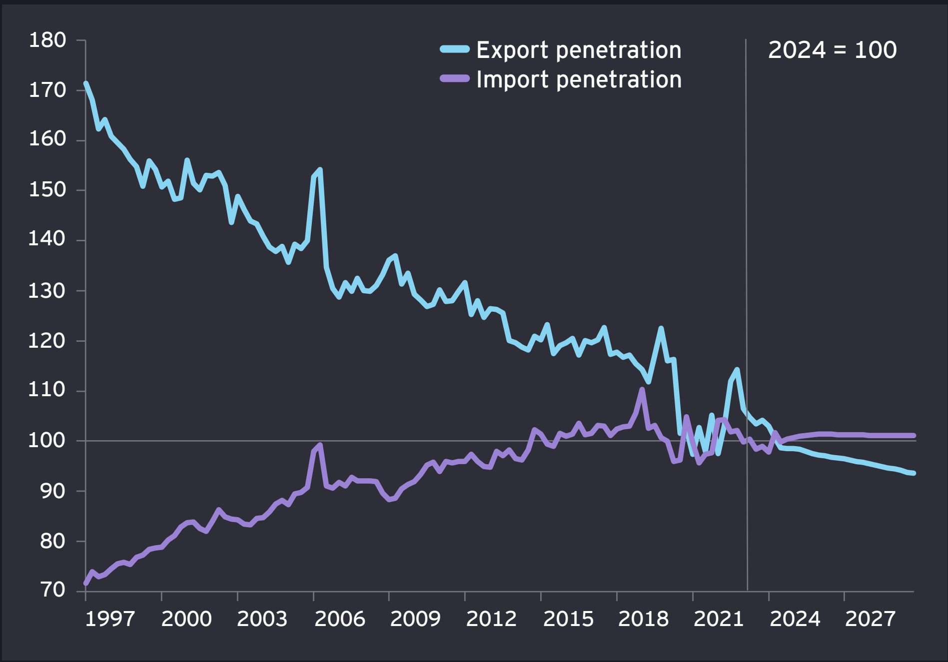
Tighter financial conditions alongside domestic and global uncertainty weigh on growth

We expect the risk premiums that have forced up market interest rates around the globe to persist over the coming year. A loosening of fiscal policy in the UK and other major economies will require financial markets to digest additional government debt, whilst the extent to which productivity and fiscal trajectories will recover continues to remain uncertain. This will keep gilt yields relatively high, even as Bank Rate falls an additional 125bps. We forecast gilt yields to slowly fall back, levelling off around 4.3% in early 2026.

As we will examine in more detail in Section 5, we think the impact of changes in US trade policy will likely have no major direct impact on the UK's growth outlook. However, in concert with the wider geopolitical situation, this does mean the outlook for firms is more uncertain than usual.

Combined with the higher cost of capital associated with higher market interest rates and the additional costs associated with the change to employers' NICs, we think business investment will be relatively weak at the start of 2025. With uncertainties surrounding how global trade policy will play out over the coming years, we expect firms to ensure they are not becoming too reliant on goods and services from abroad. Having increased through the 2000s and early 2010s, UK import penetration – which is the amount of goods and services from abroad that are either consumed or used in production – flatlined following the change in its trading arrangements with the EU. We forecast import penetration to go sideways over the next few years as the UK reinforces its supply chains after the disruption of the pandemic and energy price shock.

UK: Export and import penetration



Source: EY ITEM Club/ Haver Analytics

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Challenging fiscal dynamics will continue

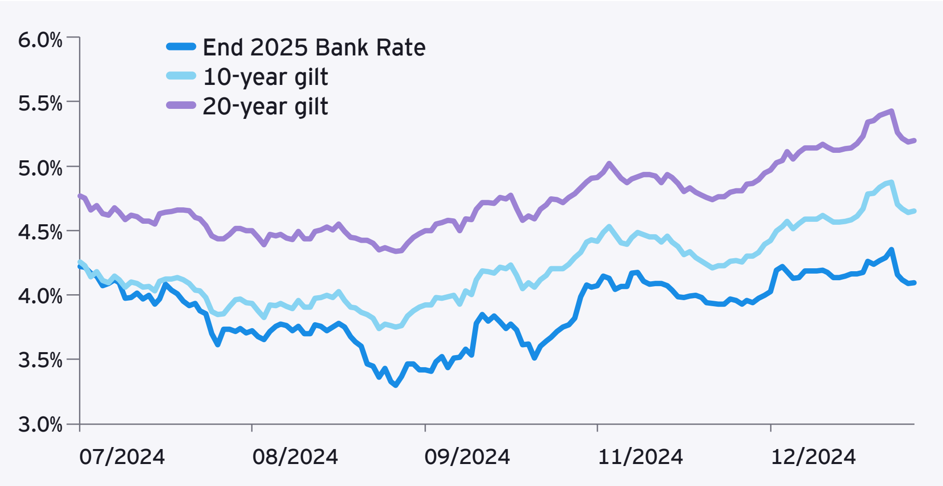
The Chancellor's updated tax and spending plans announced in the Autumn Budget left little wiggle room against her fiscal rules. Consequently, there was always a risk that unforeseen events would force the Government to raise additional tax revenues or implement further spending cuts. The recent rise in UK borrowing costs has shone a spotlight on this challenge. Though the Chancellor pledged to deliver only one Budget annually, we may see further fiscal tightening when the OBR updates its forecasts in March. There are no easy solutions, with current pledges limiting the tax changes available to raise revenue, and some government departments are already likely to face tough spending settlements.

Recent asset price moves put pressure on UK fiscal framework

To ensure the credibility of its fiscal plans, the Government set out two rules in the October Budget. Its stability rule is that the Government will ensure that Public Sector Net Financial Liabilities as a share of GDP is falling by the end of this parliament. However, the rule that is more likely to bind is that by the end of this parliament, the Government will only borrow to invest. Based on the Autumn Budget forecasts, this is met with only £9.9bn of breathing space.[8]

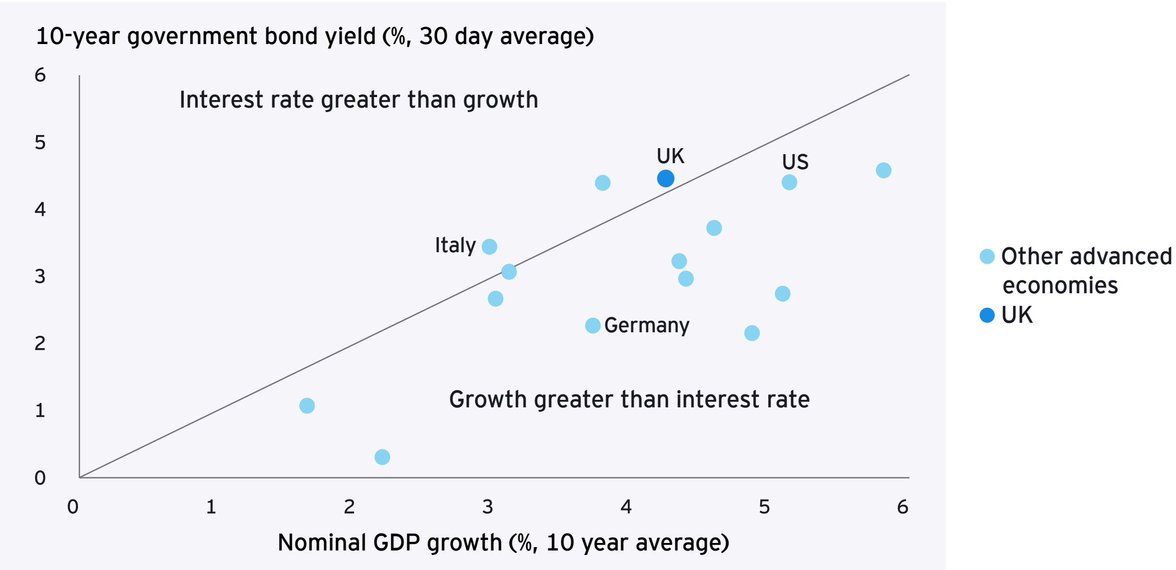
Whilst this leaves comparable wiggle room to the recent Conservative administration's Budgets, it is still much smaller than the historical average of around £25bn to 30bn. By leaving such a small margin for error, the Government always ran the risk that relatively normal economic or financial market gyrations would potentially leave it in breach of its own rules.

UK: Financial market interest rates



Source: EY ITEM Club/ Haver Analytics

Global: Advanced economy debt dynamics



Source: EY ITEM Club/ Haver Analytics

Since the Autumn Budget, UK Government borrowing costs have risen. Over Q4, the interest rate on UK debt had increased by 57bps and has been ever higher at points in January. However, this phenomenon is not specific to the UK and reflects broader global concerns around loosening fiscal policy, political uncertainty and persistent inflation. Over the same period, the interest rates on government debt rose by 77bps, 22bps and 27bps in the US, Germany and France, respectively. At the same time, shorter-run interest rates in the UK have also risen. Markets have consistently expected that the BoE will only cut interest rates by 50 to 75bps over the course of 2025. A hawkish reappraisal of this magnitude looks unjustified by the UK economic data and recent commentary from the BoE. It is more consistent with financial markets now expecting fewer interest rate cuts in the US.

In the coming weeks, there are potential catalysts for near-term UK interest rate expectations to fall back. However, elevated longer-term interest rates look likely to persist for some time.

Our expectation is that the BoE will cut interest rates more quickly than markets currently expect, and the February BoE meeting offers the MPC the opportunity to deliver a similar message. However, the UK's debt dynamics are likely to remain challenging. A significant build-up of debt through the pandemic and continued weak productivity and GDP growth are likely to see investors continue to seek a high return on lending to the UK. As a result, we expect longer-term bond yields to fall back over 2025, but only slowly and remain high by recent standards. We forecast the yield on the 20-year note to fall back to around 4.3% into 2026, where we expect them to stay.

Whilst the recent poor performance of UK bonds may largely reflect global rather than UK-specific concerns, this has important implications for UK fiscal policy and the economic outlook. Higher market interest rates mean that the Government will have to pay more to finance its outstanding debt, which can pose a challenge to its fiscal framework.

The recent market moves illustrate the risks of leaving such a small margin of error against the fiscal rules. If the economy and interest rates play out as we expect, then we think it's likely that in the fullness of time, the Government will meet its goal of only borrowing to invest without any additional policy changes. However, when the UK's fiscal watchdog — the OBR — produces its economic and fiscal forecasts, it bases them on the prevailing financial market expectations of future interest rates. Its next set of projections will be published on 26 March. If, at that time, interest rates are close to the highs seen in the middle of January, there is the possibility that the Chancellor will be faced with a forecast that requires further consolidation for her fiscal rules to be met.

The Chancellor does not have many levers to pull

The Chancellor may face a tough choice in keeping her fiscal framework on track if the OBR produces a forecast at the fiscal event in March showing that she is in breach of her fiscal rules.

The Chancellor has previously made clear her intention to hold only one Budget per year, with the next one not scheduled until autumn 2025. There is no firm commitment from the Chancellor to respond and change tax policy immediately in response to the OBR's March forecast. However, having previously stated that their fiscal rules are "non-negotiable", and with the UK's borrowing costs already elevated, waiting to see how the economy develops over the course of 2025 before adjusting fiscal policy may risk a further and unwanted rise in gilt yields.[9] Given these constraints, the Chancellor does not have many easy options if further fiscal consolidation is required.

On the tax side of the ledger, pledges not to raise the major taxes have left the Chancellor relatively few options to bolster revenues. The Labour Party manifesto committed to not raising taxes on working people, making raising income tax rates or employee NICs difficult, whilst Labour's Plan for Business pledged not to raise corporation tax from its 25% rate over the course of this parliament. At the Autumn Budget, the OBR estimated that in 2029–30, income tax, employee and employer NICs and corporation tax would make up around half the tax base.

A single Budget per year may indicate spending cuts are more likely

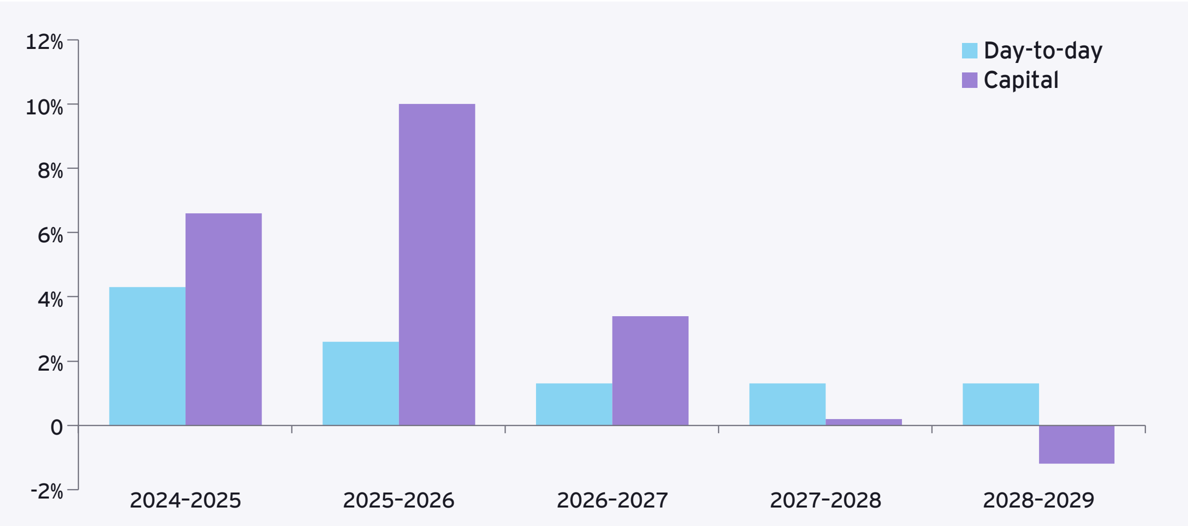
Sticking to her commitment to only deliver one Budget per year may mean any consolidation is more likely to come through reduced spending totals. But trimming public spending is fraught with difficulty, too. Whilst the Budget removed the implausibly low real public spending plans that the Labour Government inherited, it still contained challenging settlements for some government departments. For beyond 2025–26, the Chancellor has yet to confirm departmental spending totals and will do so at the Spending Review later this year. From 2026–27, the Budget pencilled in a 1.3% annual increase in the aggregate, real day-to-day spending. However, accounting for protected departmental spending in areas such as health and defence, real spending in 'unprotected' areas is estimated to fall on average by 1.1% per year over this period.[10] So, further spending cuts would add pressure to some already challenging departmental spending totals.

Reducing public spending may lead to a weakening of the labour market

Although it loosened over the course of 2024, the UK labour market remained resilient, transitioning from a very tight position to one closer to normal. However, this decent performance has relied heavily on the public sector. Government borrowing hasn't fallen over 2024–25, and this supported public sector job creation, with vacancies in areas of the economy heavily reliant on the public sector performing relatively well. Across the education, health and public administration sectors, vacancies remain above their pre-pandemic levels.

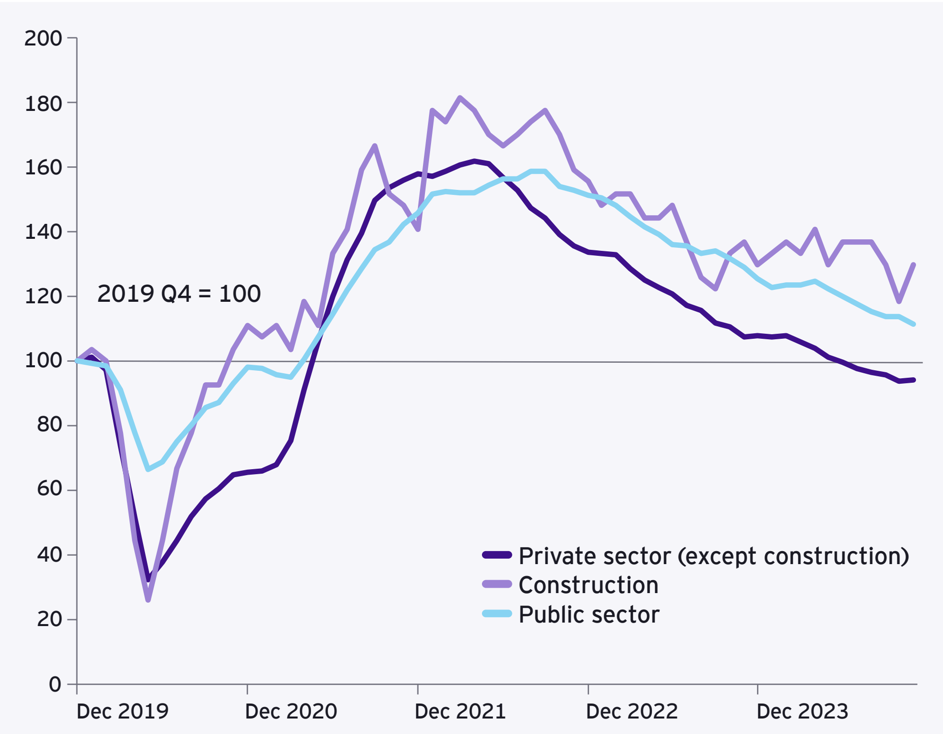
The same cannot be said about the private sector, which, allowing for the recruitment difficulties in the construction sector, now sees fewer job openings than before the onset of the pandemic. With real day-to-day spending set to increase by 2.6% across 2025–26, the public sector labour market should hold up well over the coming year. With more challenging spending plans already set for further into this parliament, further reductions may put more medium-term pressures on a labour market that may already be more fragile than appears at first glance.

UK: Real government spending



Source: EY ITEM Club/ Institute of Fiscal Studies

UK: Vacancies by sector



Source: EY ITEM Club/ Haver Analytics

5

Changing trade policy key to global growth

We continue to see good reasons for global growth to be stable, albeit modest. Looser fiscal policy in some major economies, alongside the continued normalisation of interest rates, will support growth. In contrast, internationally tight financial conditions will weigh on demand. That said, this year's global outlook is highly uncertain, given potential changes to international trade policy and broader geopolitical tensions.

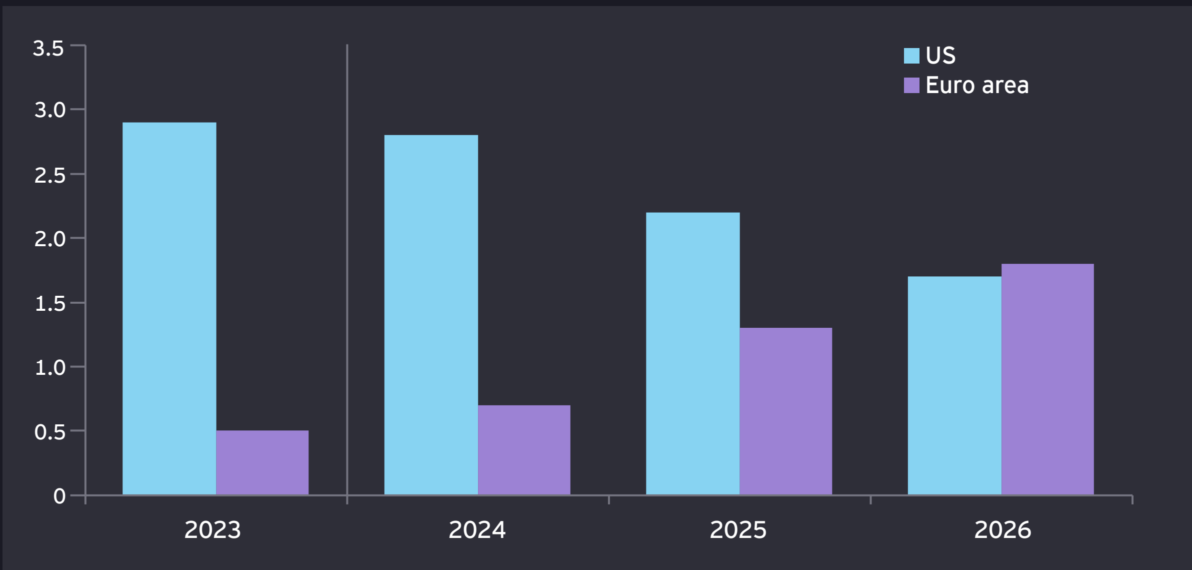
The global growth backdrop remains stable

The narrative of the last few years has been a story of US exceptionalism, and that will likely continue in 2025. Sustained productivity growth, a large fiscal stimulus, and high inward migration have all contributed to faster growth in the US than was seen in most advanced economies over recent years. The conditions remain in place for continued strong growth across the pond. The incoming Republican administration will extend personal and business tax cuts, offering a stimulus to growth. At the same time, interest rates will likely fall a little further. With inflation closer to target, the Federal Reserve kicked off its cutting cycle with a jumbo 50bps cut. Since then, it has slowed the pace of reductions to 25bps. At its December meeting, the Federal Open Market Committee's median projection indicated they expected to cut the Federal Funds Rate twice more over 2025. However, these policy changes will, to some extent, be mitigated by the impact of a more restrictive immigration policy.

Relative to the US, the eurozone's growth prospects are softer but positive. Recent indicators suggest European growth has been going through a weak patch, so the European Central Bank (ECB) has indicated it could continue cutting interest rates until around the middle of the year. And falling interest rates will support growth. Whilst the ECB may cut more quickly than the Fed, Europe is unlikely to have the same fiscal support. But, of course, the extent of any fiscal tightening will vary across European nations. Political uncertainty in some major European countries will also weigh on continental demand.

Consistent with this view of fundamental drivers in the US and Europe, we see decent growth prospects in both jurisdictions. In its latest global economic outlook EY forecasts that growth in 2025 will be 2.2% and 1.3% in the US and the euro area.[11] Similarly, its January update of its World Economic Outlook, the International Monetary Fund (IMF) forecast grow across 2025 of 2.7% and 1.0% in the US and euro area respectively.[12]

Global: US and euro area GDP growth



Source: EY ITEM Club/ EY-Parthenon

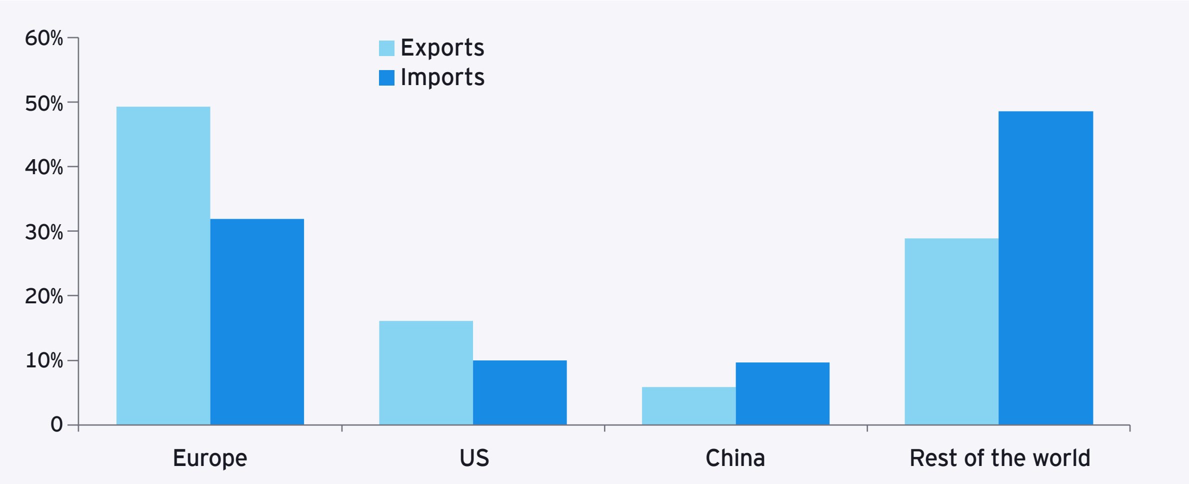
Moderate changes in global trade policy will have little impact on the UK

One of the big unknowns for the UK and the global economy is how trade policy will develop. The Republican administration has indicated that it will impose tariffs on some US imports. However, the scale and breadth of the policy is yet to be determined. One of the criteria for US tariffs is likely to be that they will be targeted at those countries with which the US operates a large trade deficit. On this basis, the UK is unlikely to be a priority as the US currently runs a trade surplus with the UK.[13]

In the event of modest tariff increases, which appears to be the most likely scenario, the broader demand implications will likely be small, too. IMF scenario analysis estimates that if 10% of bilateral tariffs are levied between the US, China, and Europe, there would be some growth impact on the UK's key trading partners.[14] However, the effects, particularly on Europe, are likely to be small, with the larger impact coming from the tighter financial conditions worldwide in recent months. Europe is by far the UK's largest trading partner, which is unsurprising given its geographic proximity. So, we estimate the indirect impact of a shift in global trade policy to be minor, too.

UK: Trade flows by destination or source

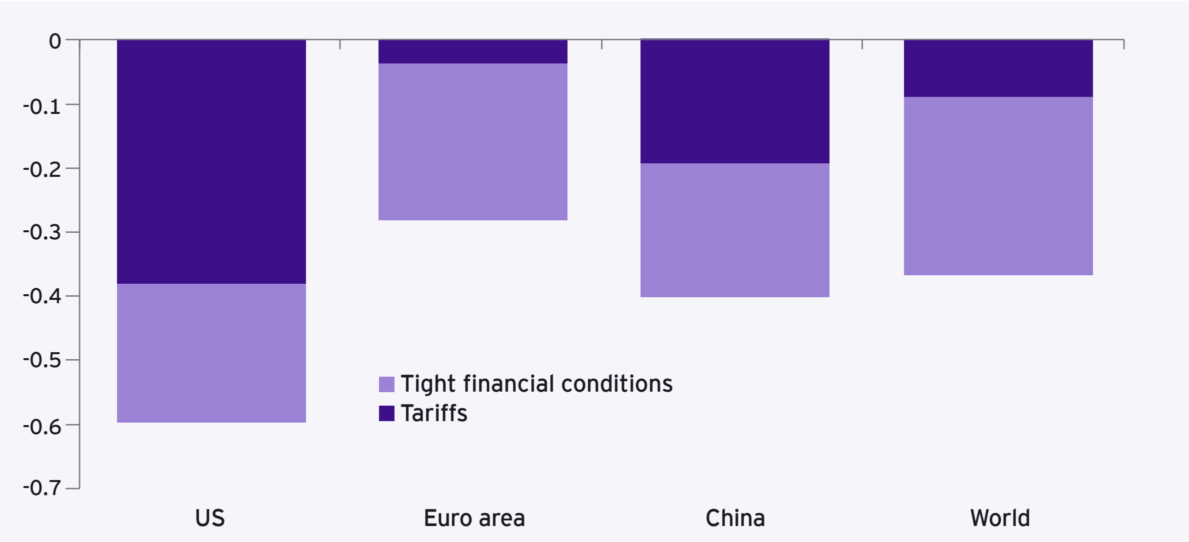
% of total goods



Source: EY ITEM Club/ONS

Global: Impact of global trade policy and financial conditions

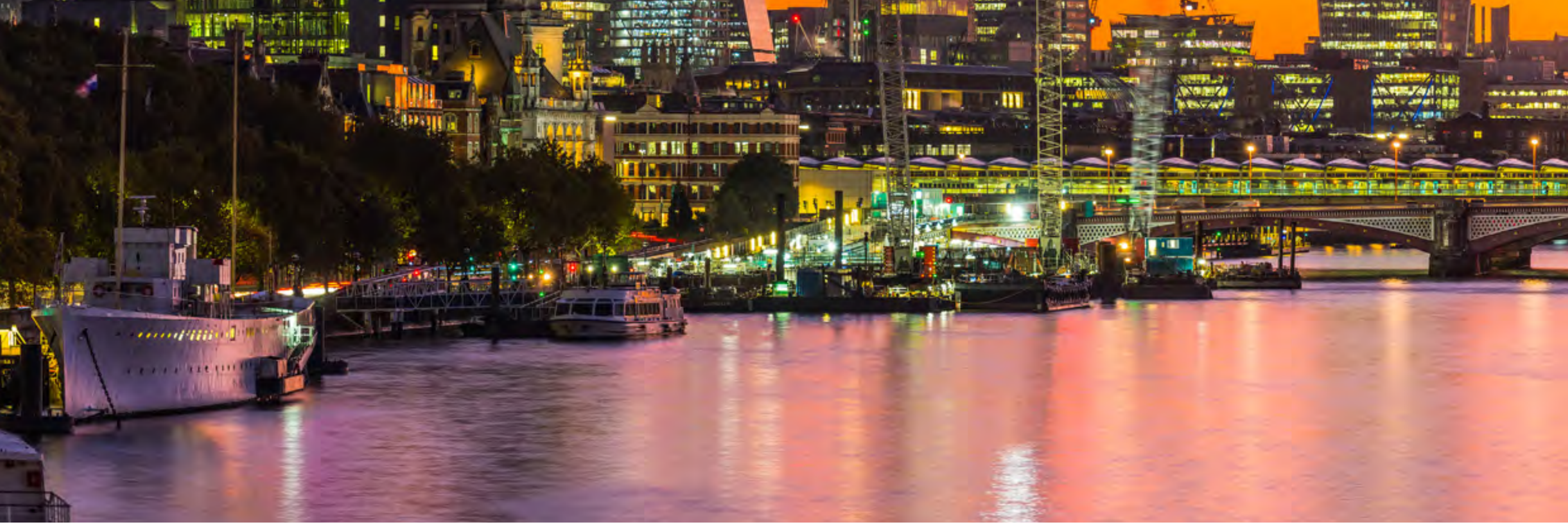
% ppt change in 2025 GDP growth



Source: EY ITEM Club/IMF

Whilst the aggregate impacts may be minor, it will nonetheless mean that some sectors are impacted more than others, with the pharmaceutical, transport equipment and fishing sectors some of the areas of the economy that would feel the most significant impact.[15] And a more aggressive set of measures presents the risks of both a sharper growth slowdown and higher inflation than our baseline. In 2023, around 16% of all UK goods exports were to the US, which equates to around 7% of total UK exports.[16]

A 20% increase in tariffs could result in a fall in UK goods exports, equivalent to around 1% of all UK export flows.[17] If the UK were to retaliate with equivalent tariffs on the US, around 10% of imported goods would see a 20% tariff increase. If this price rise were to be fully passed on to the consumer and given the import intensity of UK consumer prices of around 25%, this would lift the price level by around 0.5%. If most of this change were passed to consumers within one year, it would lead to an equivalent rise in inflation.



The impact of sterling weakness may be overstated, but broader geopolitical tensions risk sparking inflationary pressures

On a trade-weighted basis, the pound has not weakened as much as the depreciation against the dollar alone would imply. Across Q4, the pound fell by around 1.4%. However, it was under further pressure at the start of 2025.

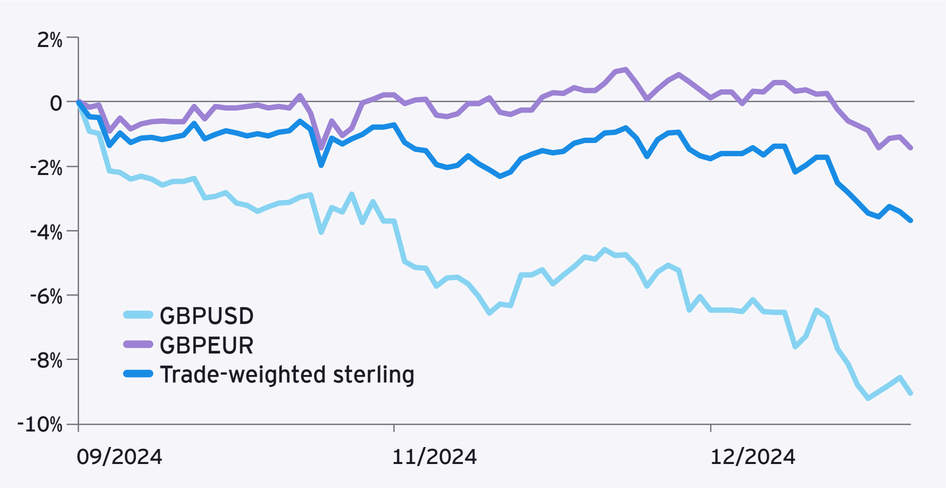
The election of President Trump has seen the pound depreciate against the dollar. With the Republican party taking control of the White House, the Senate Party and the House of Representatives, financial markets expect the US Government to loosen fiscal policy and introduce tariffs. Given these changes would likely result in higher inflation, US interest rate expectations have risen. As a consequence, the value of sterling fell against the greenback. However, trade with the US makes up around 20% of total UK trade. On a trade-weighted basis, sterling's performance against the euro is more critical as it commands almost 40% of all UK trade.[18] Over the end of 2024, the pound performed better against the euro, as it became clear interest rates would fall more slowly in the UK than in Europe, nullifying some of the impact of the pound's depreciation against the dollar. Both currency pairs have depreciated at the start of 2025.

Beyond trade policy, geopolitical uncertainty remains elevated. One impact is that wholesale energy prices remain elevated and have risen in recent months. Continued tensions in the Middle East have kept upward pressure on oil prices, whilst European gas and electricity prices have risen through recent weeks. Whilst the recent moves are small compared with those seen in the energy price crisis of 2022 and 2023, they will lean against normalising headline inflation to the 2% target.

More importantly, inflation expectations are particularly sensitive to the most easily observed prices, such as food and fuel. Surveys of household inflation expectations have normalised as CPI inflation has headed back to more normal levels. However, given the UK's recent experience, further gyrations in inflation could lead to higher expectations becoming embedded. Another significant inflation shock would present a material downside risk to our forecast as monetary policy would have to remain more restrictive for longer than we currently expect, and households' real incomes would once again be squeezed.

FX: Sterling currency pairs

% change since end of 2024 Q3



Source: EY ITEM Club/ Haver Analytics

6

Conclusions

The UK will bounce back from a weak end to 2024, although growth over 2025 will be steady rather than spectacular as less consumer caution helps drive household spending. Falling interest rates will support growth as the BoE normalises Bank Rate, but challenging fiscal dynamics will see the UK Government continue to raise tax revenues more quickly than it increases public spending.

We expect the BoE to cut Bank Rate again at its February meeting but then stick to the cut-hold tempo established over the second half of 2024. Although some MPC members have shown some concern about the UK's growth outlook, we think that with activity set to continue around trend rates and inflation above the 2% target, Bank Rate will be reduced gradually through 2025. Given the uncertainty around how changes to fiscal and international trade policy will impact the UK's growth and inflation outlook, we see a high bar to the BoE deviating from one 25bps cut per quarter over the first half of 2025.

With high debt and a poor track record of growth over the last decade or so, the UK's fiscal dynamics continue to present the incumbent Government with a policy challenge. The Government have set out a framework that ensures the sustainability of the public finances by putting in place fiscal rules that see it only borrow to invest.

However, despite the tightening of the belt pencilled in for the coming years, the Chancellor left herself only a small margin for error with which to meet this goal. If the recent highs in the interest rates on government debt are seen when the OBR updates its economic and fiscal projections in late March, the Government may have to announce further fiscal consolidation.

Economic fundamentals continue to point to stable growth around the world. One key uncertainty is international trade policy. A moderate change in tariffs between the US and the rest of the world is unlikely to significantly impact the UK, with the key influence being the recent tightening in global financial conditions. However, a more significant rise in tariffs risks a larger impact on UK trade flows and an increase in inflationary pressure. Broader geopolitical tensions continue to simmer, and if they lead to another spike in wholesale energy prices, there is the risk of another bout of persistently elevated inflation in the UK.

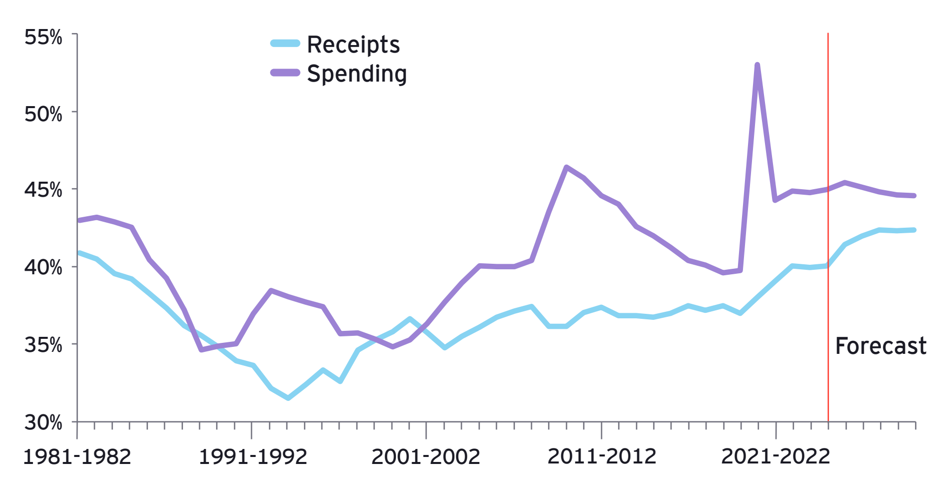
Forecasts in charts

Fiscal policy

- At the Autumn Budget, the Chancellor replaced notional future spending cuts with more certain, near-term tax rises.
- Nonetheless, the UK's challenging fiscal dynamics mean that the current tax and spending plans will still see taxes rises more quickly than spending over the course of this parliament.
- If our forecast comes to pass, we expect the Government to meet its fiscal rules in the fullness of time. However, the very small margin of error against its fiscal rules means that further consolidation may be required.

UK: Tax receipts and public spending

% of nominal GDP

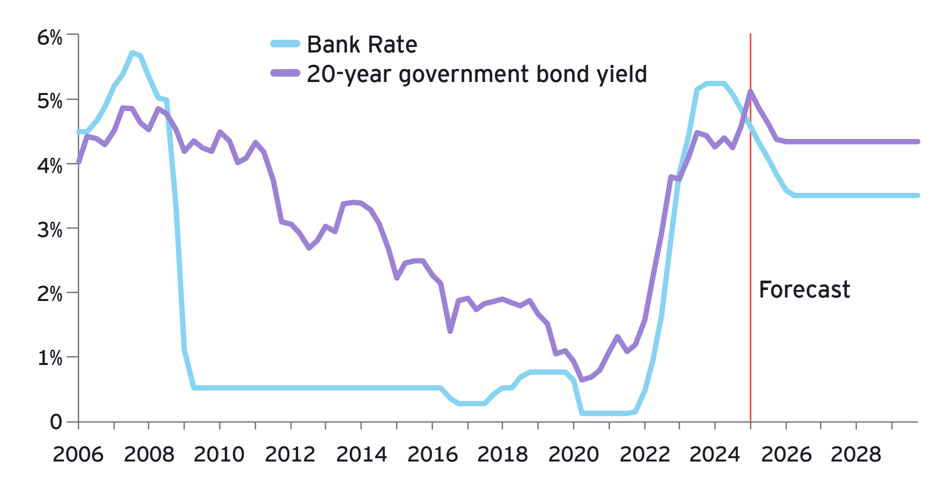


Source: EY ITEM Club

Monetary policy

- The MPC has established a cut-hold tempo reducing Bank Rate 25bps every other meeting since August. We expect another 25bps cut to 4.50% at its February meeting.
- With the MPC becoming more concerned with growth prospects, we expect further interest rate cuts this year and into next, even with inflation forecast to be above target through 2025. We expect Bank Rate to reach 3.75% by the end of the year and settle at 3.5% in February 2026.
- However, the UK's challenging fiscal dynamics mean that its debt will continue to attract a premium. So, we expect longer-term bond yields to decline gradually to around 4.3%.

UK: Bank Rate and 20-year bond yield

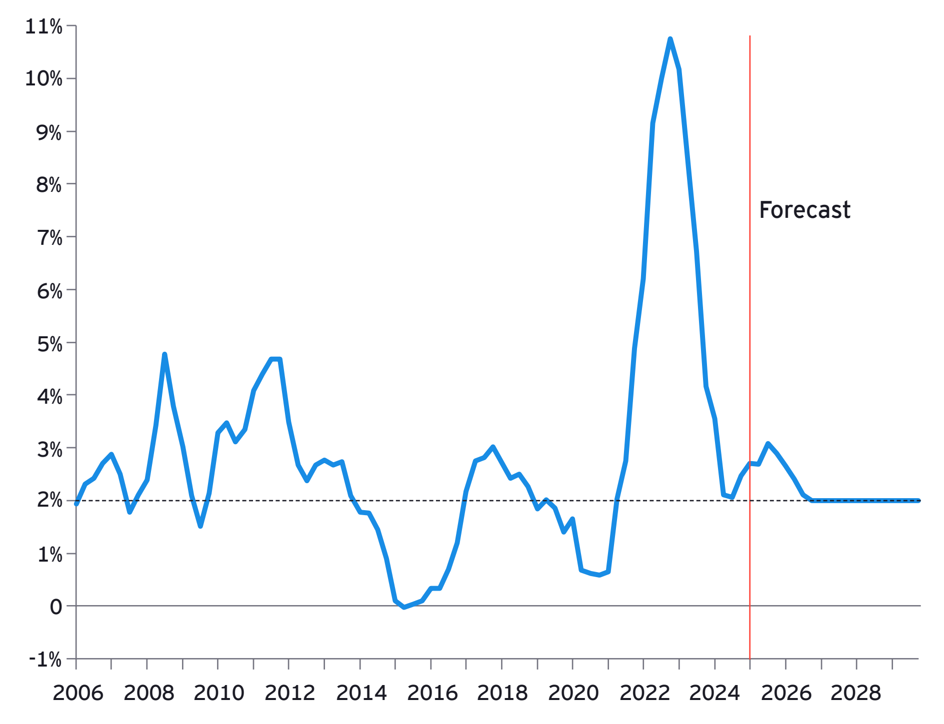


Source: EY ITEM Club

Prices

- CPI inflation has picked up above the 2% target in recent months and looks set to rise further in the near term.
- However, a lot of the recent pressures are external as the drag from previous energy and goods price falls wane. Nonetheless, domestic inflationary pressures have remained sticky.
- With the labour market now in balance, we forecast domestic price pressures to normalise over the next year or so and head back to rates consistent with inflation hitting the 2% target. We project inflation to fall back and remain at 2% in the latter half of 2026.

UK: CPI inflation

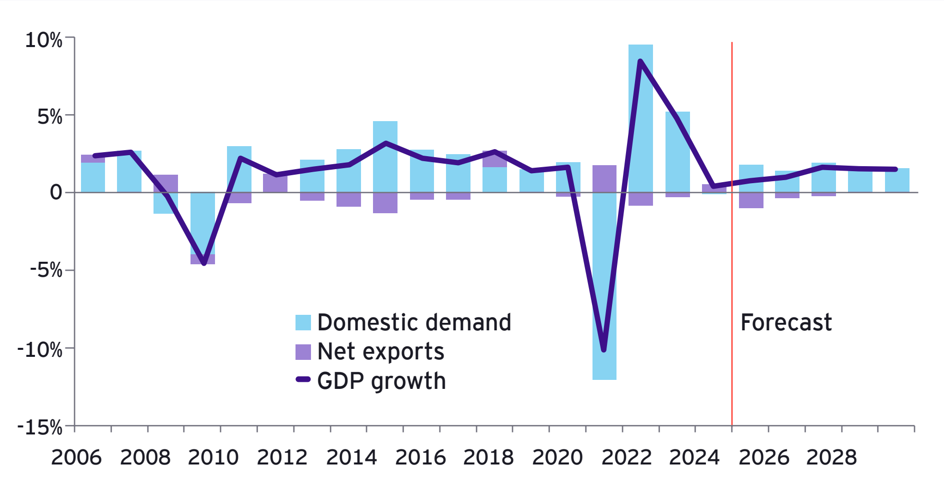


Source: EY ITEM Club

Activity

- Having made a strong start to last year, growth slowed to a standstill in the second half of the year.
- However, we think this is a blip rather than a sustained growth slowdown. Behind the headlines, the expenditure split has been more positive with decent consumption and private investment growth.
- We expect growth to return to trend rates over 2025 as interest rates fall, but fiscal policy becomes more restrictive.

UK: Contributions to GDP growth

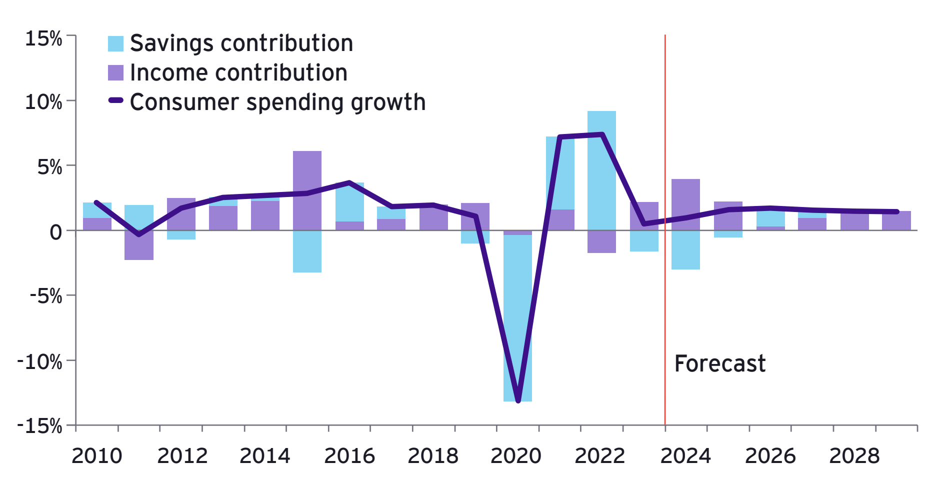


Source: EY ITEM Club

Consumer demand

- Despite the recent growth slowdown, consumption has performed well growing by 0.5% q/q in Q3.
- Nonetheless, the consumer remained cautious as the economy emerged from the energy price shock. Recent strong growth masks the fact that a lot of the real income gains over 2024 were saved rather then spent.
- With consumer sentiment closer to more normal levels and with a more regular economic backdrop, we expect less consumer caution over 2025. A falling saving rate is expected to drive consumption growth above real incomes over 2025.

UK: Contributions to consumer spending growth

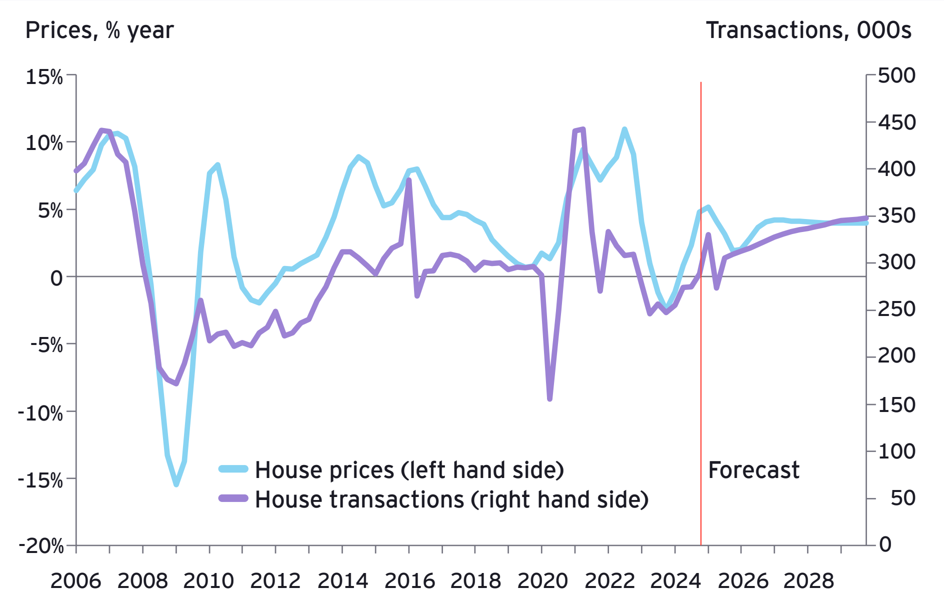


Source: EY ITEM Club

Housing market

- Through the summer and into the autumn, the housing market picked up as the BoE promised and then delivered interest rate cuts. However, the market now expects fewer interest rate cuts than it did in late summer, and this has fed through to a small rise in mortgage rates.
- With the temporary increase in Stamp Duty thresholds in March, the housing market recovery will likely continue in the near-term, before it takes a breather in the middle of the year.
- Towards the end of the year, we expect a modest housing market recovery to bed in as interest rates continue to decline but remain high by pre-pandemic norms.

UK: House prices and transactions



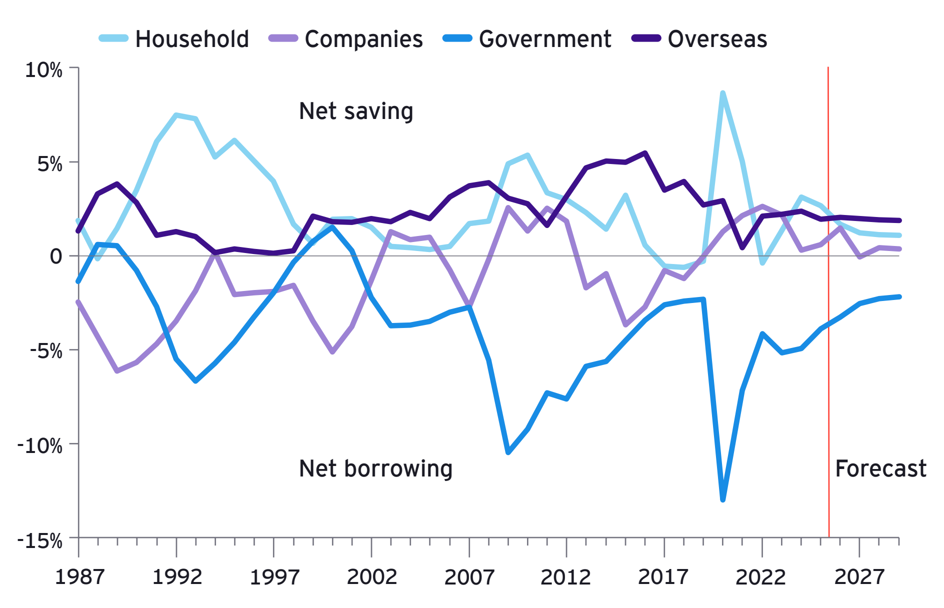
Source: EY ITEM Club

Company sector

- Business investment has performed well over much of 2024, growing by 1.8% q/q and 1.9% q/q in Q2 and Q3, respectively.
- In the near term, heightened uncertainty and sustained elevated labour cost growth will slow investment growth. Whilst corporate liabilities respond more quickly to interest rate cuts, firms will continue to face elevated cost growth as the changes in the NLW and employers' NICs come into effect.
- Nonetheless, the UK remains an attractive place to invest, so we expect firms to continue using overseas funding to support investment.

UK: Sectoral balances

% of GDP

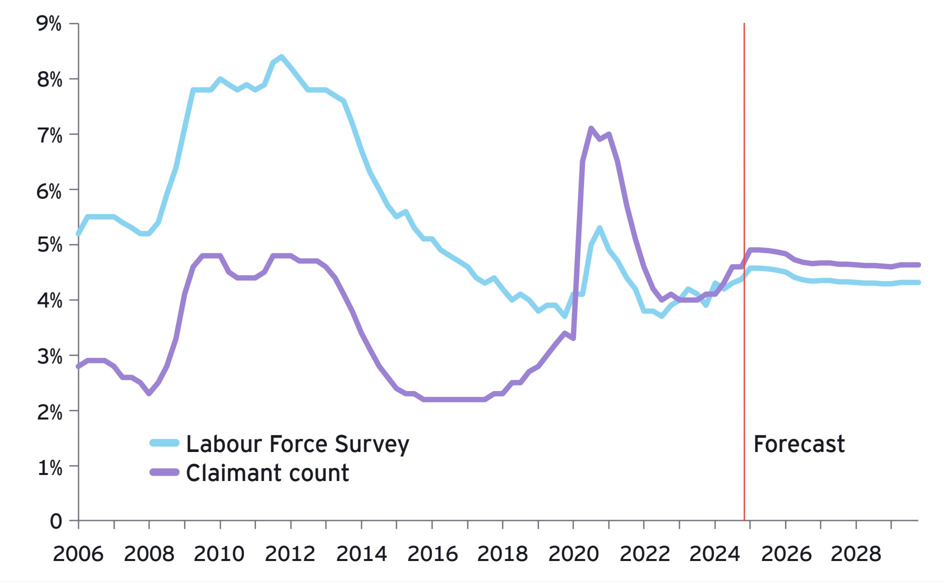


Source: EY ITEM Club

Labour market and wages

- The labour market looks to have loosened over the last year. However, whilst the number of job openings has continued to fall, we have not yet seen a large increase in layoffs.
- Given the upcoming rise in the NLW and employers' NICs, we expect a small rise in the unemployment rate to 4.6%. Broadly speaking, we expect the labour market to remain in balance over the new few years.
- We think that the loosening in the labour market will see pay growth to fall back towards the 3% rate that is consistent with inflation at the 2% target around the middle of next year.

UK: Unemployment rate

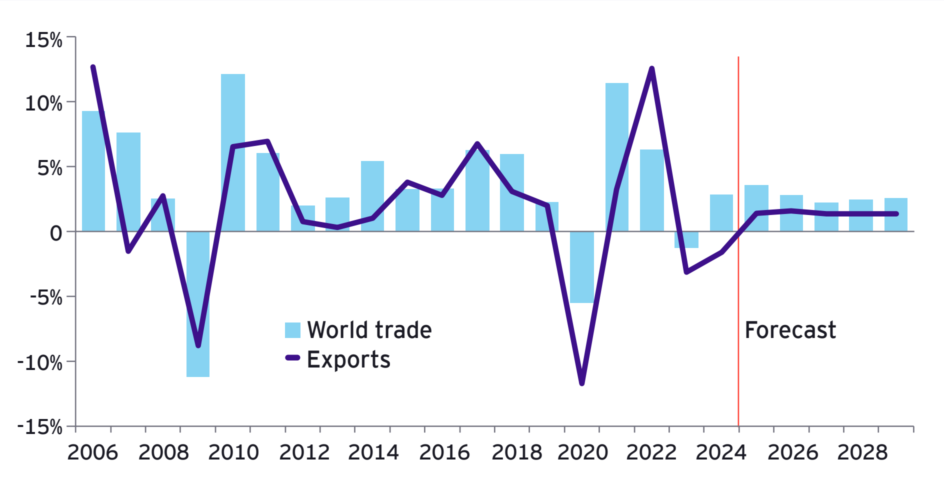


Source: EY ITEM Club

Trade and the balance of payments

- We forecast UK trade to slow over the coming years as countries worldwide, including the UK itself, ensure the integrity of domestic production. But broadly speaking, this is equivalent over both imports and exports, so does not impact growth.
- The UK's export penetration was declining over the decade before the pandemic, and we expect that to continue over the next five years.
- Since the 2010s, the UK's import penetration has flatlined as its trading arrangements changed. We expect this to continue as UK firms secure their supply chains amid uncertainty around international trade policy.

UK: Exports and world trade



Source: EY ITEM Club

Endnotes

1. See EY ITEM Club (2024), "EY ITEM Club Autumn Forecast – October 2024".
2. For more detail, see Lengerman et al (2017), "Another look at residual seasonality in GDP".
3. Calendar year growth rates are effectively a weighted average of the quarterly growth rates in the current and preceding year with the final quarter of the year before carrying a large than typical weight. For more detail, see Cross and Wyman (2011), "The relationship between monthly, quarterly and annual growth rates".
4. Institute for Fiscal Studies (2024), "Increase in employer National Insurance contributions by employee earnings, 2025-26".
5. HM Government (2024), "Employment Rights Bill: impact assessment".
6. Bank of England (2024), "Financial Stability Report – November 2024".
7. The Office for Budget Responsibility estimated at the Autumn Budget new policy measures would increase growth by up to 0.5ppt.
8. Office for Budget Responsibility (2024), "Economic and Fiscal Outlook – October 2024".
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EY ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. EY ITEM Club's use of the model enables it to explore the implications and unpublished assumptions behind government forecasts and policy measures.

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