Note: The following is a redacted version of the original report published November 15, 2024 [13 pgs].

European Economics Analyst

UK Outlook 2025: A Gradual Pace, but More Cuts Than Priced

- The recent UK macroeconomic news points to more near-term growth and inflation. The Autumn Budget was notably more expansionary than anticipated – raising the prospect of stronger demand in the near term – while the increase in employer National Insurance Contributions is likely to add to inflationary pressures. Moreover, recent MPC commentary has leant hawkish, emphasising that the Committee expects Bank Rate to fall gradually. These factors suggest that the MPC is likely to retain its cautious approach and cut more slowly than we had previously expected. We maintain our forecast for a hold in December and expect a quarterly pace of cuts next year.
- That said, we continue to think that the BoE will ultimately cut notably further than the current market pricing of 4% for the terminal rate. Although demand is likely to be firmer in H1, we think that growth is likely to cool later in 2025. Disposable income growth is set to weaken in H2, uncertainty around trade policy under the Trump administration is likely to weigh on confidence, and the recent rise in yields is likely to extend the drag from financial conditions. And despite the expansion announced at the Budget, the updated fiscal plans still imply a consolidation next year. Overall, we expect annual GDP growth of 1.2% in 2025, three-tenths below the BoE's latest forecasts.
- We also expect underlying inflationary pressures to ease materially through 2025. We look for wage growth to fall back notably given that headline inflation is now close to target. And while our analysis suggests that services inflation is likely to remain elevated, we expect that persistence will principally be driven by private rents and regulated prices. Measures of underlying services inflation are consequently likely to normalise more rapidly. We look for headline inflation to come in at 2.3% in 2025Q4, four-tenths below the MPC's latest forecast, and see core inflation at 2.5% at end-2025.
- We therefore expect the MPC to continue its gradual cutting cycle for longer than the market expects, until Bank Rate hits 3.25% in 2026Q2. Risks around our baseline forecast run in both directions. We see a 30% chance of sequential cuts if inflationary pressures ease more quickly than anticipated. But we also see a 20% probability that more persistent inflationary pressures and stronger growth see the Bank cut only semi-annually. On a probability-weighted basis, our forecast is similar to market pricing in the near term but materially below from 2025H2.

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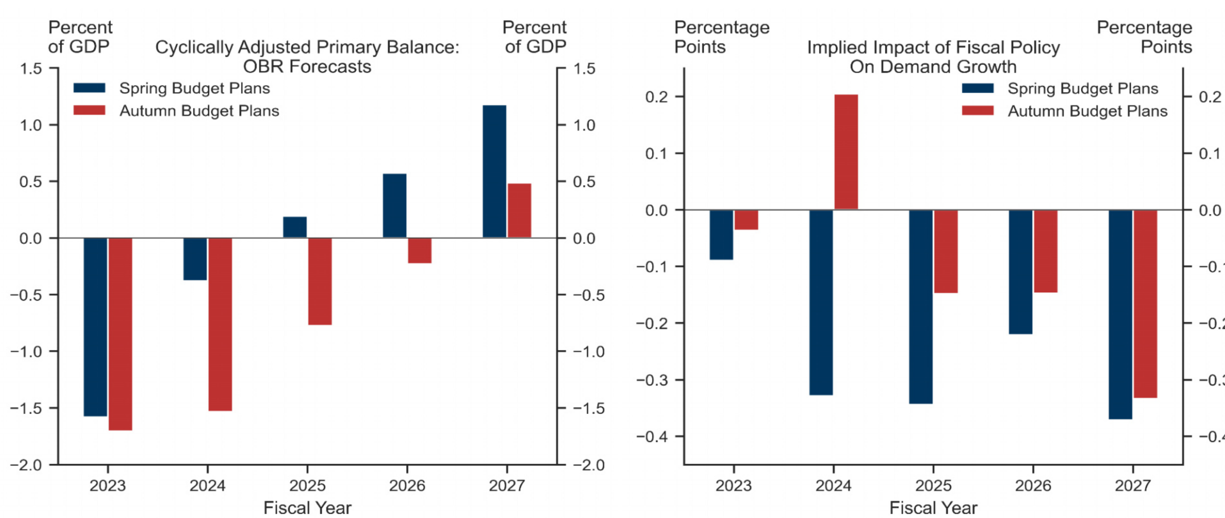
- Aside from the cyclical outlook, several structural issues are likely to be in focus next year. On the fiscal side, the OBR's forecast update in the spring could highlight the government's limited fiscal headroom and challenging debt trajectory. We see increased uncertainty around the UK's future trading arrangements with the US following Trump's re-election, but the government will likely see progress on trading relations with the EU. Finally, the growth impacts of changes to the planning system will likely be at the centre of the debate on the long-run growth outlook as the government provides more details around its proposed reforms.

UK Outlook 2025: A Gradual Pace, but More Cuts Than Priced

The recent UK macroeconomic news points to stronger near-term growth and inflation than we had expected. The Autumn Budget was notably more expansionary than we anticipated. The OBR revised up its forecast for the cyclically adjusted primary deficit by 1.1% of GDP in the current fiscal year, with departmental day-to-day spending now expected to be notably higher than expected at the Spring Budget. The magnitude of the implied boost to growth is large; our fiscal impulse model implies a total impact on demand growth of around 0.5pp in the current fiscal year relative to the Spring Budget plans. While some of the increase in the primary deficit reflects overspends in 2024Q2 and 2024Q3, much of the change is driven by public sector pay deals that will be effective in the second part of the fiscal year. That suggests that there is a notable demand boost still to come through in 2024Q4 and 2025Q1. We therefore pencil in strong growth in government consumption in the next two quarters.

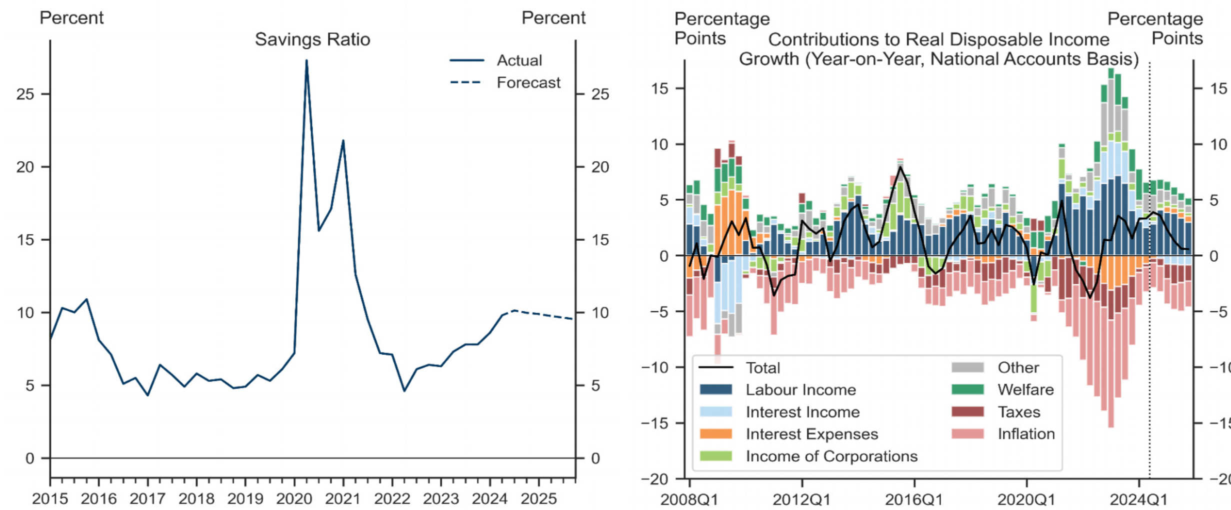
Exhibit 1: An Expansionary Budget



Source: Goldman Sachs Global Investment Research, OBR

Increased public sector pay will also filter through into private consumption growth. In addition, we are expecting a gradual normalisation in the savings rate, which is likely to push up on private consumption in the near term. Overall, then, we expect firm demand growth in late 2024 and early 2025, supporting the case for the MPC to lower Bank Rate gradually.

Exhibit 2: Near-Term Rebound in Consumption, Fading Momentum Later in 2025



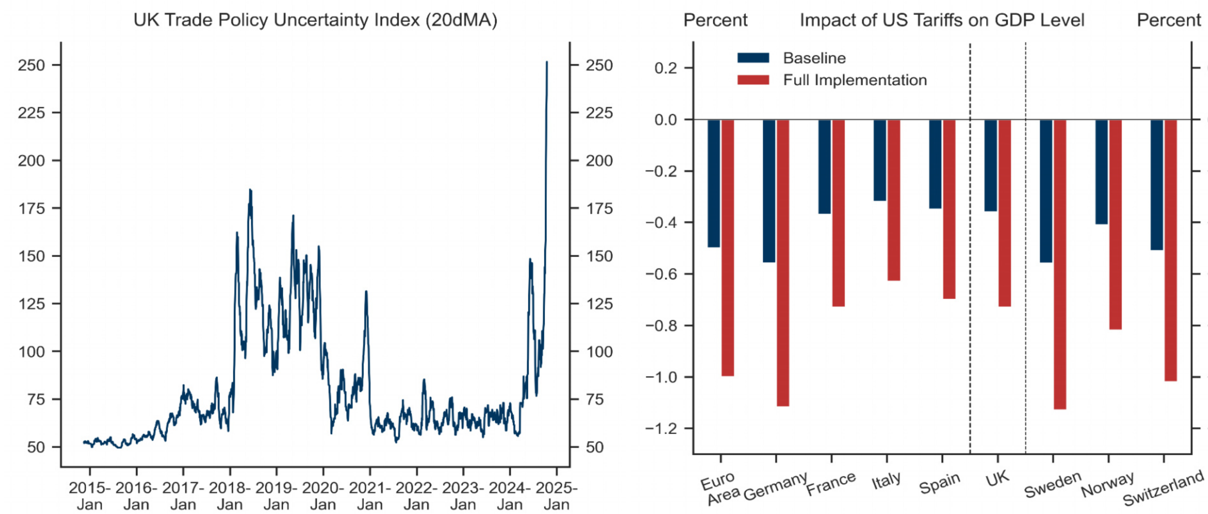
Source: Goldman Sachs Global Investment Research, Haver Analytics

That said, we think that growth is likely to cool later in 2025. We expect consumer spending growth to moderate in H2 next year as real disposable income growth falls back. This partly reflects slowing real wage growth; we expect private sector pay increases to cool, partly because of the employer National Insurance Contributions increase being passed on to consumers. Net interest is likely to become a headwind as effective mortgage rates continue to drift up while deposit rates gradually decline. And there is likely to be a continued drag on disposable income from the ongoing freeze on personal income tax thresholds.

Moreover, we think that the fiscal boost from the Autumn Budget is likely to be front-loaded. Our fiscal impulse model implies that the Autumn Budget is likely to provide a larger boost to growth in the current fiscal year than in FY2025. With the cyclically adjusted primary deficit likely to shrink from 1.5% of GDP in FY2024 to 0.8% of GDP in FY2025, fiscal policy is still likely to exert a modest drag on growth in the latter part of next year, even allowing for a higher multiplier on planned increases in investment spending.

Beyond this, we expect rising trade tensions under the Trump administration to weigh on growth through 2025. Although our base case is that the US only imposes very limited tariffs on the UK, the threat of more significant tariffs is likely to generate uncertainty in the near term, which should weigh on demand. And we expect that uncertainty around tariffs will notably reduce Euro area growth, which is likely to generate spillovers to the UK.

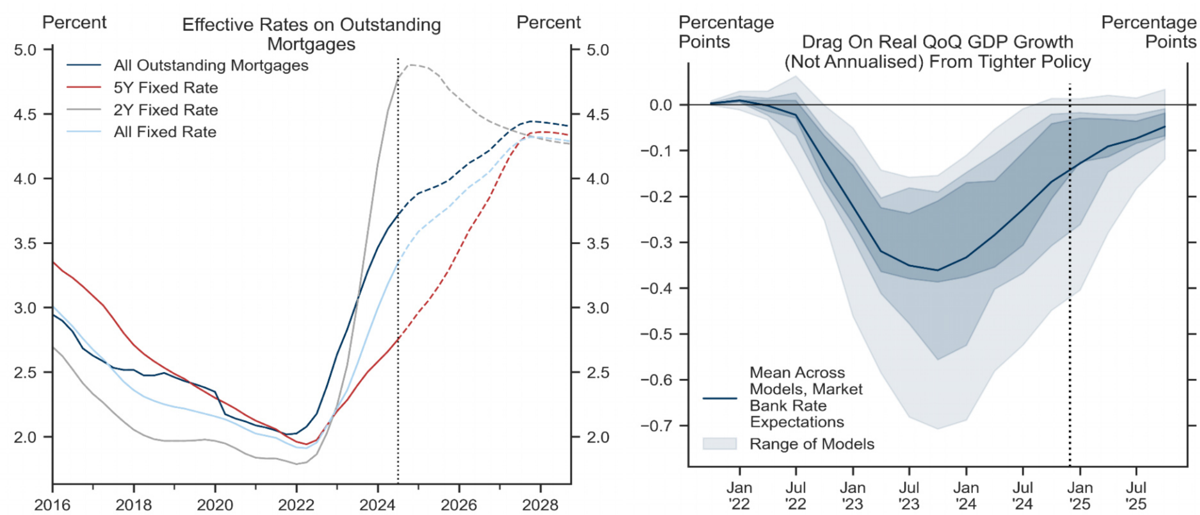
Exhibit 3: Uncertainty Around Trade Outlook Likely to Weigh on Growth



Source: Goldman Sachs Global Investment Research, Bloomberg

While we expect the drag from monetary policy to diminish through next year, the recent rise in long-term yields—up 75bp since September—is likely to slow the fading of the financial drag on growth. Effective rates on outstanding mortgages are likely to continue to drift up as five-year fixed rate mortgages continue to reset.

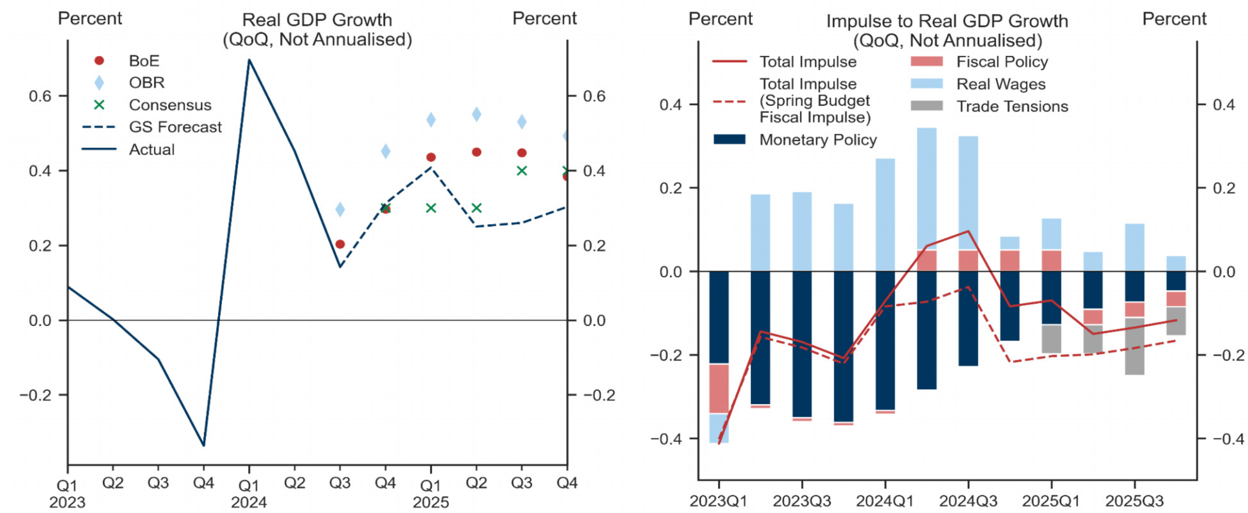
Exhibit 4: Higher Yields Imply More Extended Growth Drag



Source: Goldman Sachs Global Investment Research, Haver Analytics

Taken together, we look for 0.3%qoq growth in 2024Q4 and 0.4% in 2025Q1 but think that growth will then slow to around 0.25-0.30%qoq in the rest of 2025. Overall, we expect annual GDP growth of 1.2% in 2025, two-tenths below the BoE's latest forecasts and notably below the OBR's estimates.

Exhibit 5: Firm Demand in Near Term, Slower Growth in 2025H2



Source: Goldman Sachs Global Investment Research, Haver Analytics, Bloomberg, Bank of England, OBR

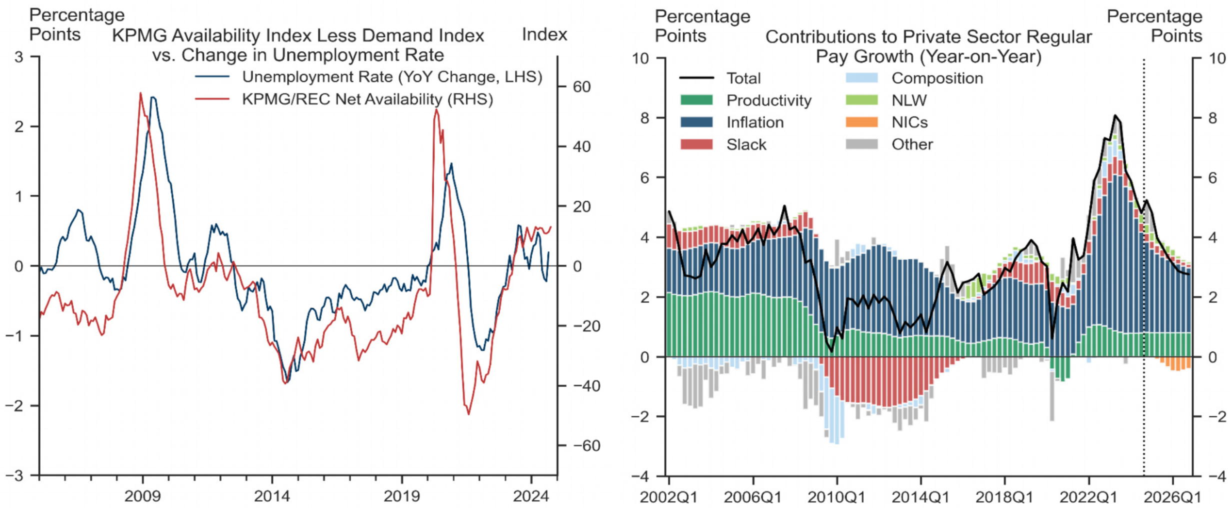
Gradual Disinflation

The Budget also implies firmer near-term inflation. That partly reflects the impact on demand, but also the likelihood that part of the increase in employer National Insurance Contributions is passed through to prices. In addition, increases in vehicle excise duty and the introduction of VAT on private school fees should push up on services inflation. The 6.7% increase in the National Living Wage is also likely to push up wage growth by around ¼pp and thereby raise service companies' costs, particularly in the hospitality sector, which accounts for around 30% of the services CPI basket.

That said, we still expect underlying domestic inflationary pressures to fall back next year. The survey data are consistent with continued reductions in labour market tightness in the near term, while our forecast for a modest deceleration in growth in the second part of the year suggests further easing is likely.

This continued easing in labour market tightness – together with reduced catch-up effects now that inflation has returned close to target – are likely to result in a notable slowing in pay growth next year, despite the rise in the Living Wage. Early indications suggest that pay settlements are likely to decline to around 3%, down from 5.5% in 2024.

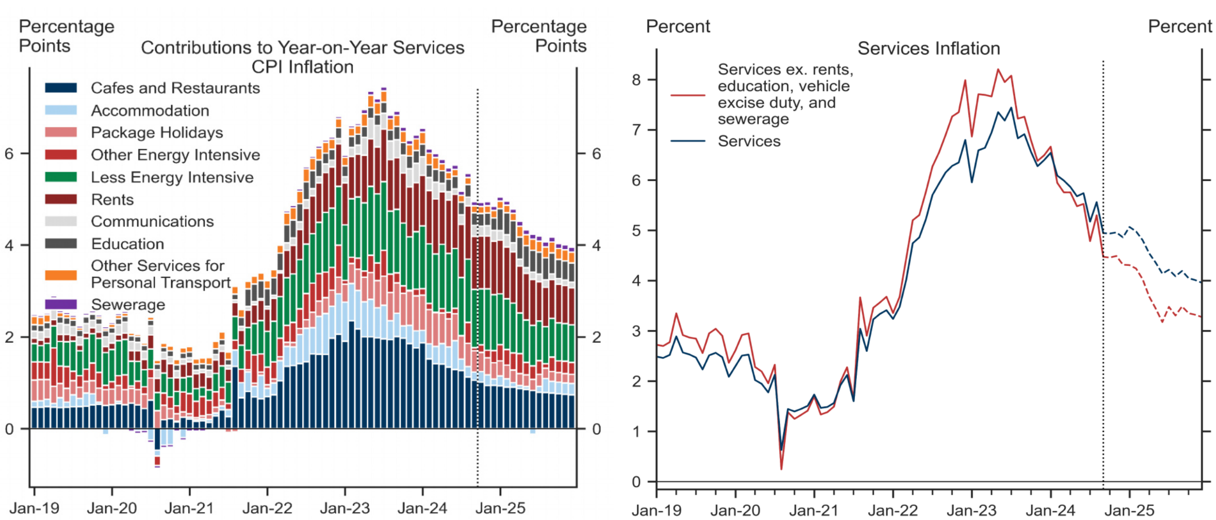
Exhibit 6: Easing Labour Market Tightness and Pay Pressures



Source: Goldman Sachs Global Investment Research, Haver Analytics

Reduced pay pressures are likely to result in underlying services inflation measures slowing notably. While we expect services inflation to decline only gradually – ending the year at 3.9% – most of the strength in our forecast is driven by rents and regulated prices, which we expect the MPC to place less weight on. Excluding these components, we anticipate that underlying services inflation will be much closer to target-consistent levels by the middle of next year.

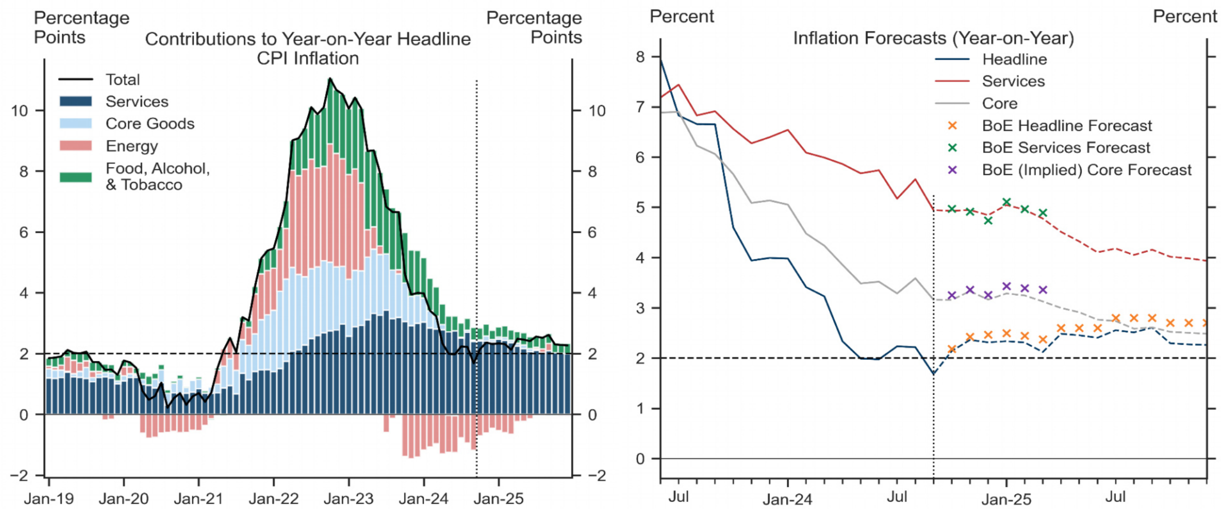
Exhibit 7: Services Inflation Set to Slow Gradually, but More Progress Likely on Underlying Measures



Source: Goldman Sachs Global Investment Research, Haver Analytics

Given this progress on underlying services inflation, we expect headline inflation to somewhat undershoot the Bank's latest projections by the end of the year. In particular, we look for headline inflation of 2.3% in 2025Q4, four-tenths below the November Monetary Policy Report forecast, and forecast core inflation at 2.5% at end-2025.

Exhibit 8: Inflation Likely to Come in Below the BoE's Latest Projections



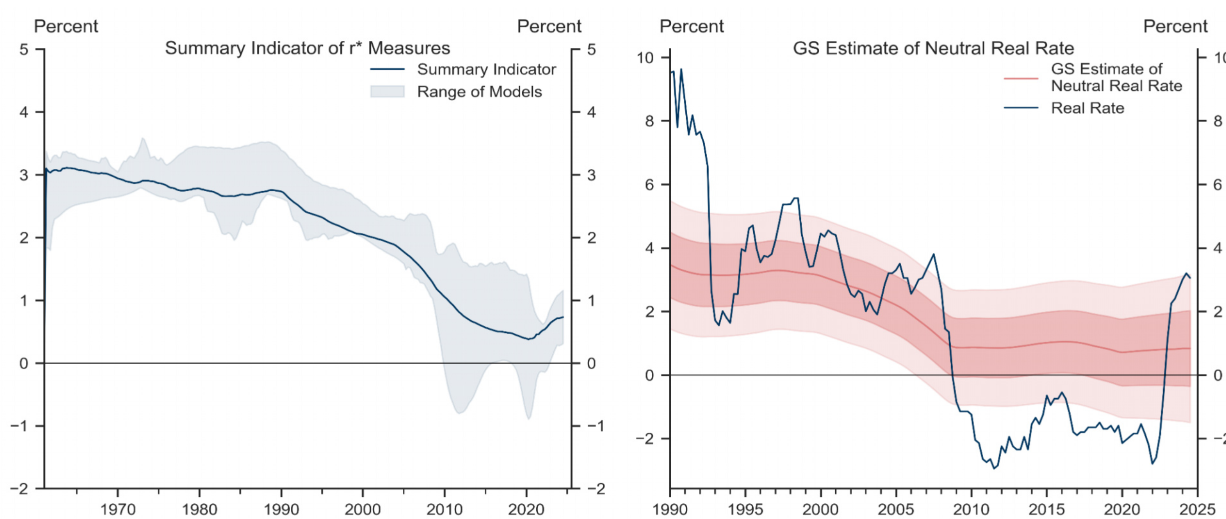
Source: Goldman Sachs Global Investment Research, Bank of England

We Expect the MPC to Cut in Quarterly Steps to 3.25%

The latest commentary from the MPC indicates that the Committee plans to stick to its gradual approach to policy easing if the economy evolves broadly in line with their latest forecasts. Given that we expect growth and inflation to remain firm in the near term, we continue to expect a hold in December, but now expect the BoE to continue to cut in quarterly steps in 2025.

That said, with the market pricing a terminal rate of around 4%, we continue to think that the BoE will likely cut further than the market currently expects as measures of underlying domestic inflation fall back and demand comes in somewhat weaker than the MPC's latest forecast. We therefore expect the MPC to continue gradually lowering Bank Rate until it hits 3.25% in 2026Q2.

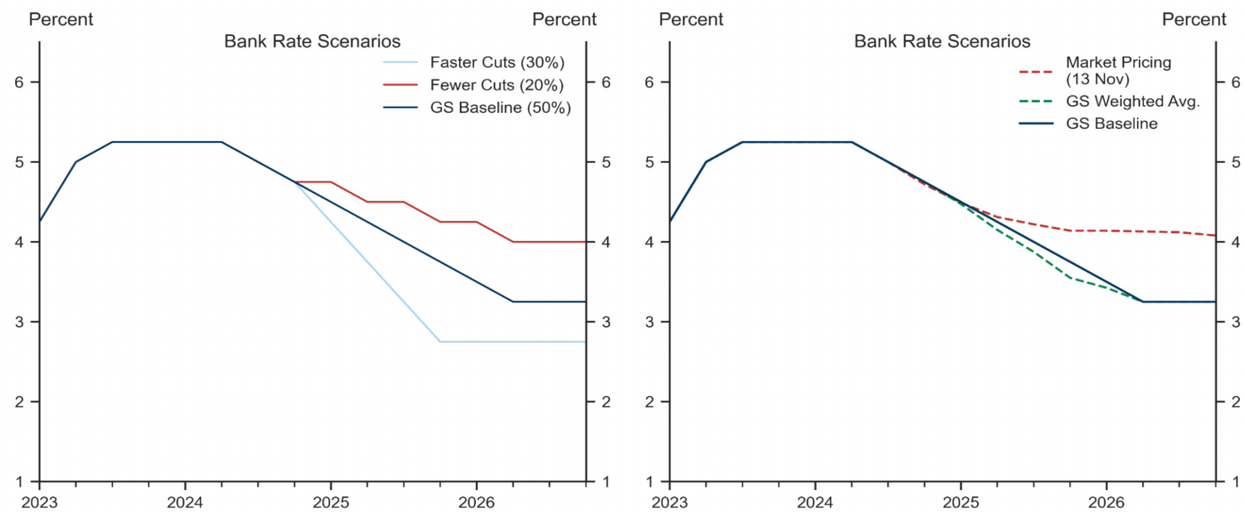
Exhibit 9: High Uncertainty Around Neutral, but Our Central Estimate Implies a Long Way to Go



Source: Goldman Sachs Global Investment Research

Our baseline is similar to market pricing in the near term but notably lower at the end of next year and into 2026. We see two-sided risks around our central forecast. We see a 30% chance of a scenario in which inflationary pressures prove less persistent or demand weaker than our forecast, causing the Bank to cut faster than our baseline. But we also see a 20% probability of a scenario in which inflation proves more persistent than our baseline expectations, resulting in the Bank cutting more slowly and stopping at a higher level.

Exhibit 10: We See Four Cuts in 2025 as Base Case, with Five on a Probability-Weighted Basis



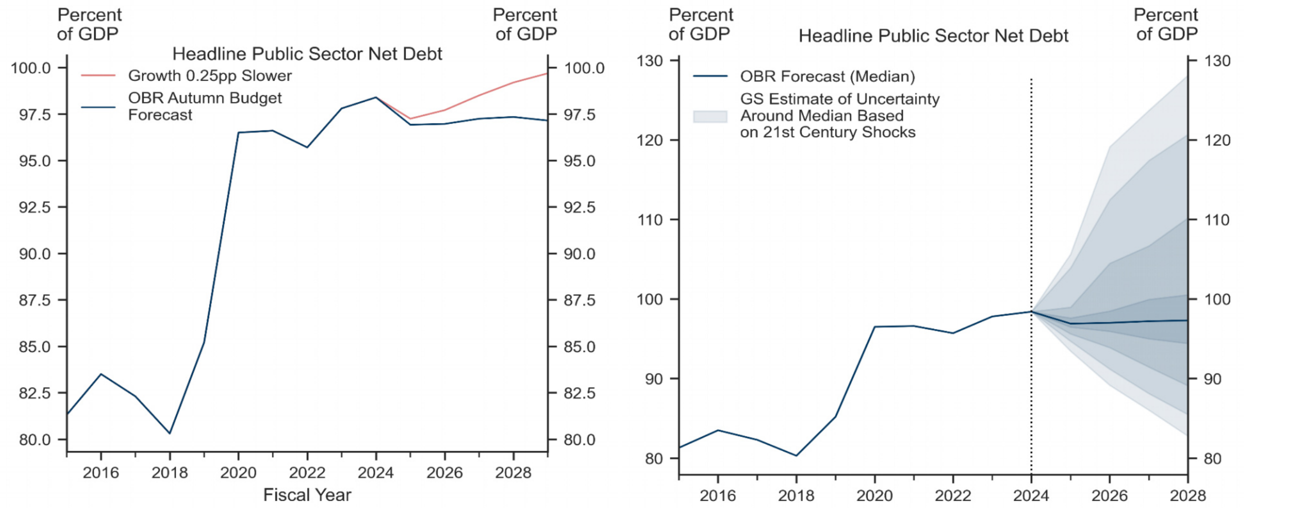
Source: Goldman Sachs Global Investment Research

Fiscal, Trade, and Planning Likely to be in Focus

Aside from the cyclical outlook, several structural issues are likely to be in focus next year.

First, the government has left limited headroom against its new fiscal targets and relatively small changes in the OBR's macroeconomic forecasts could eliminate this headroom entirely. While the government has planned to hold one major fiscal event a year—and so is not due to update its fiscal plans until next autumn—the OBR will still deliver a forecast update in the spring. It remains unclear whether the Chancellor would respond immediately if that forecast update showed a reduction in the government's headroom against its fiscal targets, or whether she would wait until the next budget in the autumn to reshuffle tax and spending plans. But more broadly the forecast update is likely to bring into focus the challenge that the government faces in reducing the deficit and getting debt to fall as a share of GDP in the context of significant spending pressures and its commitments on tax. We view the risks around the OBR's debt-to-GDP forecast as skewed to the upside, given that we think growth is likely to come in below the OBR's projections. In addition, the shocks to the fiscal trajectory have been skewed to the upside over the past twenty years. That said, we expect the increase in public investment announced at the Budget to boost potential supply over the longer term, mitigating the impact of the fiscal expansion on the debt-to-GDP ratio.

Exhibit 11: Upside Risks to Debt Trajectory



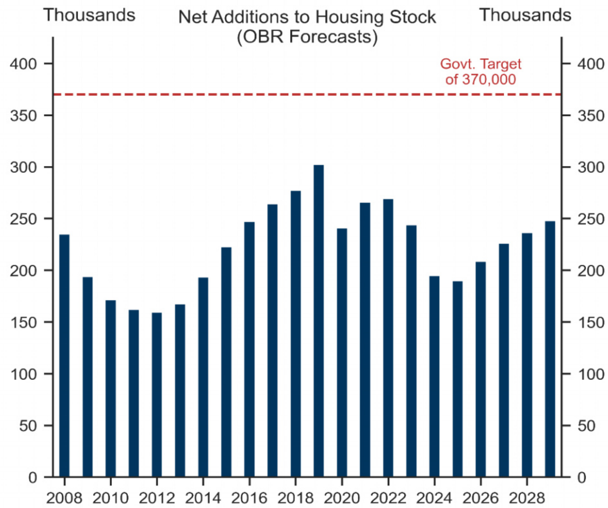
Source: Goldman Sachs Global Investment Research, OBR

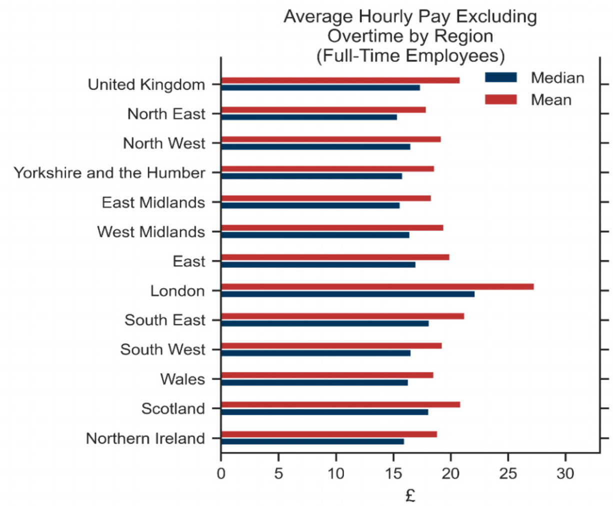
Second, the outlook for the UK's trading arrangements is likely to be in focus. From a cyclical perspective, uncertainty around possible tariffs under the new Trump administration is likely to lead to weaker near-term demand. But from a structural perspective, the UK faces opportunities as well as risks. On the one hand, a global shift towards increased tariffs could notably weigh on growth prospects given the UK's openness. Indeed, our analysis of the impact of Brexit on the UK economy suggests that greater barriers to trade can significantly impact long-term investment and productivity. On the other hand, recent reports have indicated that the US could consider offering the UK a free trade agreement. However, this might require the government to accept changes in food standards and greater market access for US healthcare companies.

The UK also has opportunities to foster closer ties with the EU; the government intends to pursue a veterinary agreement and Chancellor Reeves has indicated that regulatory harmonisation could also take place in the chemicals sector. That could provide a modest growth boost, although it would take a much more significant realignment to meaningfully reduce the costs of Brexit. It is possible that there will be some tension between pursuing closer trading relations with the US and Europe; accepting changes in food standards as part of a trade deal with the US would likely make a veterinary agreement with the EU more difficult.

A third area of focus is likely to be planning reform. The government has indicated that it will respond to the consultation on its proposed reforms to the National Planning Policy Framework by the end of the year. The proposals include reclassifying some areas of the green belt as "grey belt" to allow for development, and reintroducing mandatory housing targets for local authorities. While the effects of the reforms are difficult to quantify without further policy details, we would broadly expect changes to the framework to result in a notable boost to residential investment over the next five years.

Exhibit 12: Some Upside to Productivity Growth if Planning Reform Increases Labour Mobility, but Impact Likely to be Very Gradual





Source: Goldman Sachs Global Investment Research, OBR, ONS

But the extent to which these reforms boost GDP growth over the medium term will depend on whether they increase labour productivity. Increased residential investment may have an indirect impact on labour productivity; evidence from a range of studies shows that wages and productivity are higher in large cities, and so relaxing planning restrictions could boost aggregate productivity by allowing urban areas to expand. Some previous studies have indicated that this effect could be sizeable in the very long run, but we would expect any boost to productivity to occur gradually over an extended period of time.

European Economics Team

Disclosure Appendix

Reg AC

We, Sven Jari Stehn, Filippo Taddei, Alexandre Stott, James Moberly and Katya Vashkinskaya, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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