UNITED KINGDOM
2025-2026 SCENARIO

UNWELCOME POLICIES IN THE AUTUMN BUDGET 2024 COMPLICATE THE ECONOMIC OUTLOOK

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GROWTH SLOWS SHARPLY AFTER A SOLID H1-24, DOWNSIDE RISKS INCREASE

Scenario highlights

- **The Autumn Budget 2024 raised expectations for inflation and the key policy rate, sparking pessimism among businesses.**
- **Tax increases and higher interest rates will negatively impact the private sector, leading to lower business investment and a weaker job market.**
- **Following the recent increase in borrowing costs and stalling activity, fiscal policy is likely to be tightened later this year.**

- **In our central scenario, the UK economy grows modestly on a quarterly basis amidst fiscal and monetary policies that remain tight.**
- **Inflation remains consistent with the target in the medium term after reaching a peak in Q3-25.**
- **The BoE continues cutting rates once per quarter in 2025, before stepping up its easing cycle in late 2026.**

	2023	2024	2025	2026
% annual change				
GDP	0.4	0.8	1.1	1.6
Household consumption	0.4	0.9	1.5	1.9
Public consumption	1.0	1.9	3.2	4.1
Investment	0.3	1.6	2.2	3.7
Inflation	7.3	2.5	2.2	2.0
Unemployment rate %	4.1	4.3	4.2	4.2
Contribution to GDP growth, pp				
Domestic demand	-0.2	2.2	3.2	2.7
Net exports	0.5	-1.5	-2.0	-1.1
Change in inventories	-0.9	-0.1	0.6	0.0

Sources: ONS, Crédit Agricole S.A./ECO.

The UK economy is on course to slow sharply in H2-24. Real GDP was stable in Q3 against our expectation for an increase (0.3% QoQ) after 0.4% QoQ in Q2. Business surveys deteriorated during Q4. Furthermore, financial conditions have tightened since the Autumn Budget 2024 and quite meaningfully so since the beginning 2025: gilt yields have risen sharply (around 60bp since October) and sterling has depreciated (around 2% in trade-weighted terms). This has slid fiscal calculations into even worse territory. The government will have to announce more fiscal pain when the OBR's next forecasts are published in March.

In December, we revised down our forecasts to 0.8% and 1.1% annual growth in 2024 in 2025 (versus 1% and 1.5% respectively three months ago). Risks now appear tilted to the downside relative to our already cautious forecasts. The recent spike in inflation expectations owing to global factors, higher-than-expected public spending in the Autumn Budget 2024, and the increase in borrowing costs have raised stagflation risks for the UK economy.

The Autumn Budget 2024 prompted a downward revision of our forecasts for private consumption and corporate investment due to the higher tax burden announced by the Labour government as well as higher interest rates. Business labour costs will increase significantly in April 2025 due to the increase in the employer national insurance contributions (NICs) and the national living wage (NLW) announced in the Autumn Budget. This represents a new cost shock and will have repercussions on corporate margins, headcounts and investment projects.

Monetary policy is more restrictive than forecast in October as a result of the fiscal stimulus. We lifted the Bank Rate forecast by 0.5pp for 2025. This in turn serves to rein in any excess demand, offsetting any positive effects of fiscal easing on growth.

GROWTH SLOWS SHARPLY AFTER A SOLID H1-24, DOWNSIDE RISKS INCREASE

AUTUMN BUDGET HAS MIXED EFFECTS ON GROWTH OUTLOOK

A post-Budget slump in business optimism

November PMI surveys on business confidence indicated the lowest pace of expansion since October 2023. One of the reasons for the gloomy sentiment in the private sector is heightened uncertainty regarding economic prospects after the government's announcement of higher-than-expected tax increases in the Budget of 30 October. The Budget's policies increase spending by almost GBP70bn (a little over 2% of GDP) a year on average over the next five years, half of which is funded through tax increases. The other half of the increase in spending is funded by borrowing GBP32bn (1% of GDP) more annually over the next five years.

By far, the biggest tax measure is the 1.2pp increase in National Insurance Contributions (NICs) for employers. It implies higher labour costs for businesses which will likely translate into higher inflation in 2025 and 2026, but will also likely have negative effects on employment, wages, profitability and corporate investment. Consequently, the outlook for 2025 and 2026 has become more complicated for a number of reasons, not the least of which are the uncertain external environment and the threats to global trade implied by Donald Trump's re-election in the US.

The policy mix remains restrictive

Despite the significant fiscal easing announced in the Autumn Budget, fiscal policy will remain restrictive in the coming years. Moreover, Bank Rate expectations have been revised up due to the hawkish implications of the higher budget deficit. The easing of monetary policy by the BoE will be more gradual than previously expected. We expect 100bp in cuts for 2025, 50bp less than expected three months ago, followed by 125bp in 2026. Moreover, past rate hikes will increasingly weigh on household incomes as mortgage rates remain high and households with five-year, fixed-rate mortgages will have to refinance at higher rates. According to the BoE, around half of mortgages are expected to see payment increases by Q4-27.

Downward revisions to the outlook for household consumption and business investment

We revised down private consumption growth due to the higher tax burden announced in the Autumn Budget and the upward revision of the Bank Rate. Household consumption fundamentals remain strained. Real income growth is likely to slow in 2025 as wage growth continues to moderate and inflation remains slightly above target. The labour market is set to worsen by more than previously expected due to the impact on labour costs of the increase in employer NICs and the National Living Wage (NLW) announced in the Autumn Budget. Businesses will likely cut headcounts and wages while increasing prices in order to preserve margins.

The impact of the Autumn Budget is also expected to be negative on business investment due to the likely negative impact of the increase in labour costs on business profitability as well as higher-for-longer interest rates.

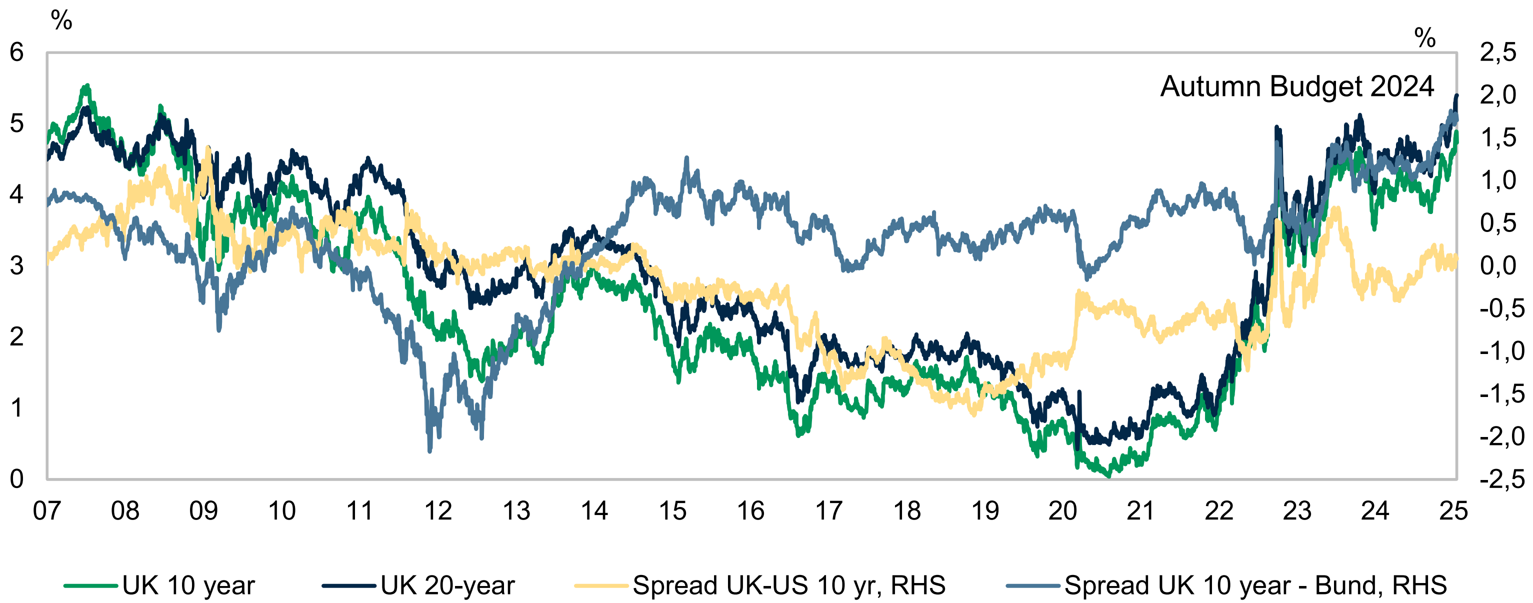
These mixed effects of the Autumn Budget on the private sector imply that any positive impact of fiscal easing on growth in the form of higher public expenditure and capital investment will likely be offset to a great extent by weaker private consumption and business investment than previously forecast.

In December, we revised down our forecast for Q4-24 growth to 0.1% QoQ (from 0.3% QoQ) which brings our forecast for annual growth in 2024 to 0.8% (versus 1% expected previously). Risks appear tilted to the downside. As a result of the carry-over effect of a weaker H2-24, our annual growth forecast for 2025 was reduced to 1.1% versus 1.5% expected previously. For 2026, we expect a slight acceleration to 1.6%.

FINANCIAL CONDITIONS

BORROWING COSTS HAVE INCREASED SIGNIFICANTLY, THREATENING THE ABILITY OF THE UK GOVERNMENT TO MEET ITS FISCAL TARGETS

UK government bond yields



Sources: Refinitiv Eikon Datastream, Crédit Agricole SA / ECO

The ongoing rise in UK long-term yields has different drivers, including higher rates globally and also fiscal easing that was greater than expected in October by the UK government amidst a precarious fiscal situation. Negative surprises in UK growth data since the Autumn Budget have added to market concerns, as lower-than-expected growth means weaker tax revenue and thus more borrowing, all else being equal. The 60bp rise in UK 10-year sovereign bond yields observed since the Budget (80bp for the 20-year yield) erode the slim margin of the UK government with respect to its fiscal targets (current budget surplus of 0.3% of GDP or around GBP10bn). The OBR will likely forecast more borrowing in its next forecast at the Spring Statement scheduled for 26 March. Meeting the target would require further tax rises and a cut-back on planned spending. An increase of 50bp across rates (similar to the observed increase in 10-year gilts over the last month) would, if sustained, be expected to add around GBP8bn (around 0.25% of GDP) to debt interest spending in four years' time.

THE INTERNATIONAL ENVIRONMENT

HEIGHTENED POLICY UNCERTAINTY

The US economy remained resilient in 2024, with growth continuing to surprise to the upside and currently tracking at 2.8% for the year as a whole, on an annual-average basis. We expect it to wane in 2025, but only to a still-solid pace of 1.9% before an uptick to 2.2% in 2026.

This pattern is largely reflective of our views on the sequencing of policy changes under the incoming Trump administration. As for the balance, **we expect the policy mix to be modestly growth-positive, with a boost from an aggressive fiscal policy focused on tax cuts, and de-regulation more than offsetting the weight of tariff hikes and stricter immigration policies**. However, we think some of the growth-negative policies will be implemented sooner, with growth-positive policies taking longer to materialise. As a result, our base case involves slower growth in 2025 compared to 2026.

The Eurozone saw its growth accelerate over the summer, though still at a much slower pace than in the US. Our GDP growth forecasts for 2024 and 2025 have therefore been reduced (from 0.8% to 0.7% and from 1.3% to 1%, respectively). In 2026, GDP growth would return to its potential rate of 1.2%, but the modest negative output gap would still not be closed. This pace would not be enough to halt a further widening of the growth gap with the US economy, fueled by a growing divergence in economic policies. The Trump administration's policies would have a moderately negative impact on growth in the Eurozone.

The US is the UKs' largest trading partner, and the resilience of the US economy has been a tailwind for UK growth. The expected US slowdown this year will weigh on UK exports. Furthermore, the UK is likely to suffer from the indirect effects of Trump's protectionist agenda through its impacts on global trade and growth.

As far as tariffs are concerned, the UK economy is relatively less exposed to the risks of tariff increases from the Donald Trump administration compared to other European countries such as Germany, Italy and Ireland. Its trade surplus with the US is large and rising (GBP72bn in the four quarters to the end of Q2-24), but is largely concentrated in the services sectors – especially business services. In goods, the UK has a relatively small trade surplus with the US (GBP4.5bn in the year to the end of Q2-24). The top three UK goods exported are pharmaceutical products followed by cars and mechanical power generators.

International background assumptions

	2023	2024	2025	2026	2023				2024				2025				2026			
					T1	T2	T3	T4	T1	T2	T3	T4	T1	T2	T3	T4	T1	T2	T3	T4
World GDP (y/y, q/q, %)	3.3	3.0	2.8	2.9	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
United States GDP (y/y, q/q, annualised, %)	2.9	2.7	1.9	2.2	2.8	2.5	4.4	3.2	1.6	3.0	3.1	2.2	1.9	1.4	1.2	1.8	2.5	2.5	2.4	2.4
Eurozone GDP (y/y, q/q, %)	0.4	0.7	1.0	1.2	0.5	0.1	0.0	0.0	0.3	0.2	0.4	0.0	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
China GDP (y/y, q/q, %)	5.2	4.8	4.2	3.9	1.8	0.7	1.5	1.3	1.5	0.5	0.9	1.1	1.1	1.0	1.0	1.0	0.9	0.8	0.9	0.9
ECB deposit rate (end of period, %)	4.00	3.00	2.25	2.25	3.00	3.50	4.00	4.00	4.00	3.75	3.50	3.00	2.50	2.25	2.25	2.25	2.25	2.25	2.25	2.25
Federal Reserve funds rate (end of period, %)	5.50	4.50	4.00	4.00	5.00	5.50	5.50	5.50	5.50	5.50	5.00	4.50	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Exchange rate (average, EUR/USD)	1.08	1.08	1.05	1.09	1.07	1.09	1.09	1.08	1.09	1.08	1.10	1.07	1.05	1.04	1.05	1.07	1.07	1.08	1.09	1.10
Brent (average, USD/barrel)	82.2	79.9	78.3	79.3	82.2	77.9	85.9	83.0	81.9	85.0	78.9	74.0	75.0	80.0	80.0	78.0	75.0	80.0	80.0	82.0

Sources: BEA, ECB, Eurostat, IMF, Refinitiv, Federal Reserve, Crédit Agricole S.A./ECO.

CYCLICAL DEVELOPMENTS

UK GROWTH HAS SLOWED SHARPLY, AND BUSINESS SURVEYS DO NOT SUGGEST MUCH OF AN IMPROVEMENT

H2-24 will likely see no growth in activity

As expected, the robust rates of growth which the UK economy experienced in H1-24 (0.7% QoQ in Q1 and 0.4% QoQ in Q2) proved unsustainable. Real GDP slowed to 0.0% QoQ in Q3-24. There was an increase in net trade, household spending, gross fixed capital formation and government spending. These increases were offset by a fall in gross capital formation, specifically acquisitions less disposals of valuables. Within domestic demand, household consumption increased by 0.5% QoQ, while business investment is estimated to have grown by 1.9% QoQ.

Monthly GDP data as of November shows no growth in the three months leading up to it. Real GDP rose by just 0.1% MoM in November following two consecutive monthly drops. The services sector remained the main contributor to growth in November, though it climbed only 0.1% after falling 0.1% MoM in October. Output in the sector was flat over the three-month period and would have been negative were it not for the healthcare sector, where output bounced back following strikes in August.

Production output continued to fall in November, largely due to declines in manufacturing. It is estimated to have fallen by 0.7% in the three months leading up to November 2024 compared with the three months leading up to August 2024, mainly because of a 1.0% fall in manufacturing over this period.

The carry-over effect for real GDP growth in Q4 (i.e. quarterly growth in Q4 assuming no growth in December) stands at -0.1%, suggesting a strong probability of zero or negative growth in the final quarter of the year. There are clearly downside risks to our meagre 0.1% QoQ forecast for Q4 following the 0.0% QoQ outturn in Q3. This suggests a real risk of no growth at all in H2-24.

Private sector activity is weakening more than expected

Business confidence has deteriorated sharply in the wake of the Autumn Budget, disappointing those (including us) who were expecting some rebound in confidence once the uncertainty ahead of the Autumn Budget 2024 was lifted. Concerns about the impact of an unexpected shock to payroll costs related to the increase in employers' national insurance contributions and the minimum wage which will come into force in April were reported among the main factors weighing on growth prospects for 2025. Price pressures are rising. Global market conditions, alongside lackluster domestic and overseas economic conditions, are also providing a growing headwind, with export sales reportedly hit by lower demand from Europe, Asia and the US.

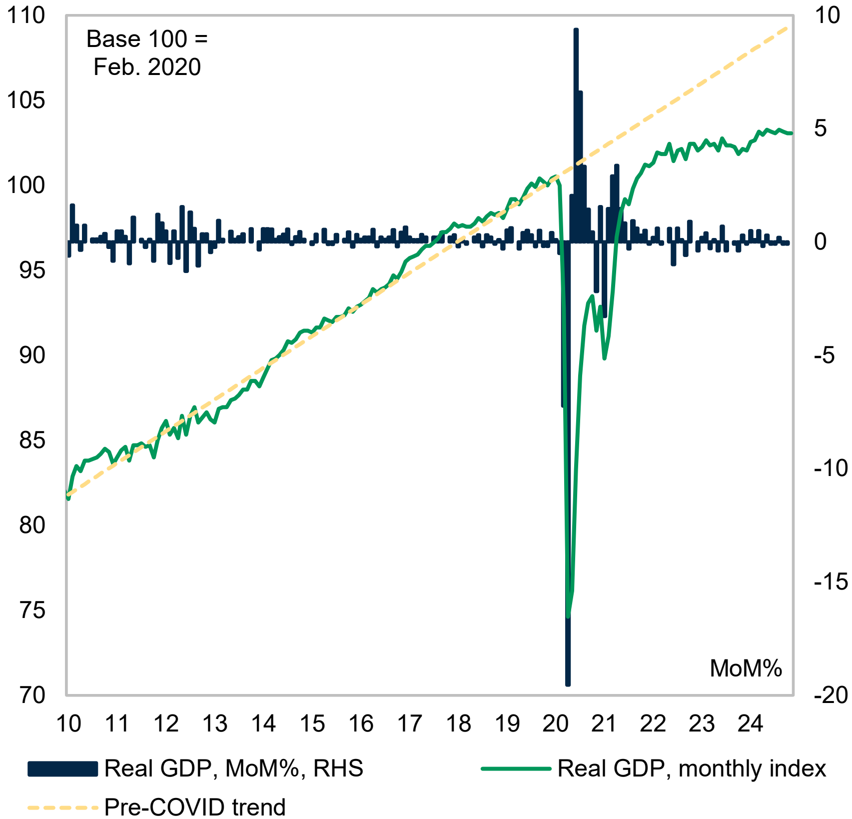
The deterioration in business confidence is notable across both the industrial and the services sectors. The manufacturing PMI fell to an 11-month low of 47 in December, remaining below 50 in each of the past three months with output contracting for the second consecutive month. A stalling domestic economy, weak export sales and concerns about future cost increases led to the steepest contraction of UK manufacturing production for almost a year in December. Employment levels are falling as some companies are acting now to restructure operations ahead of the rises in labour costs.

The services PMI managed to remain in expansion territory, rising slightly to 51.1 in December after a dip to 50.8 in November. But it signals only a marginal expansion of business activity and on average in Q4-24, the index was the lowest it had been for one year. Facing higher labour costs, many service providers are curtailing their headcounts: employment has contracted for the third month in a row and the corresponding index reached its lowest since January 2021 (a period when activity and employment were impacted by lockdowns due to COVID). PMI surveys also suggest rising cost inflation, especially in the services sector where input cost pressures reached an eight-month high in December. Prices charged inflation increased less sharply than input cost inflation and remained well above its pre-pandemic levels.

CYCLICAL DEVELOPMENTS

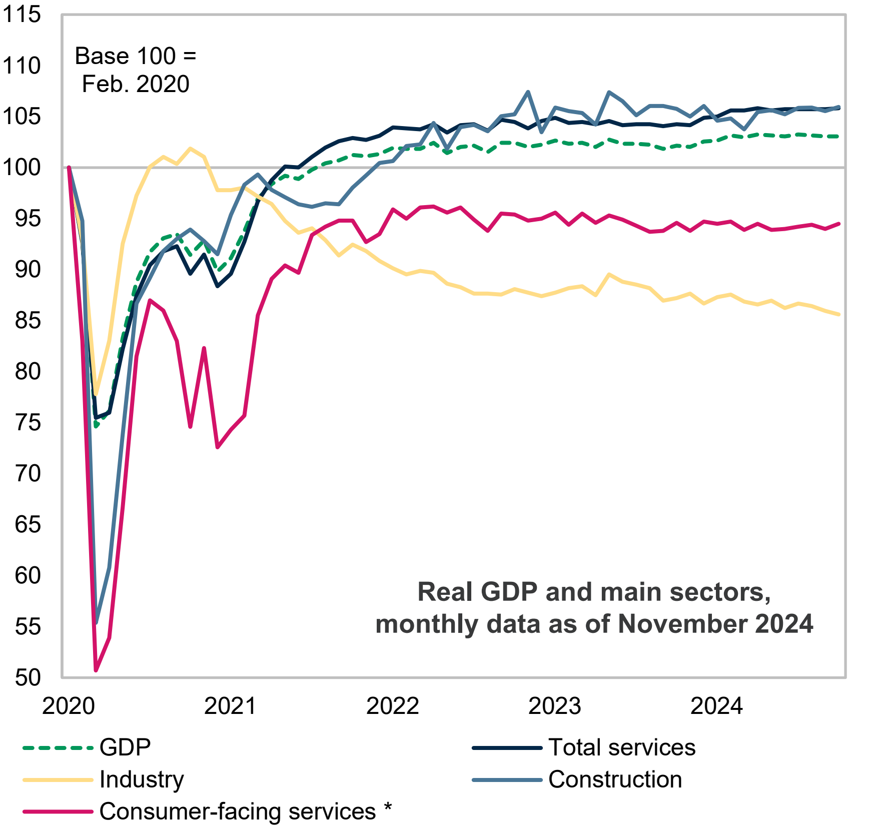
REAL GDP SHOWED NO GROWTH IN THE THREE MONTHS LEADING UP TO NOVEMBER

Real GDP (monthly index) leading up to November 2024: activity well below its pre-crisis trend and flatlining



Sources: ONS, Crédit Agricole S.A./ECO.

A continued contraction in the industrial sector, stability elsewhere

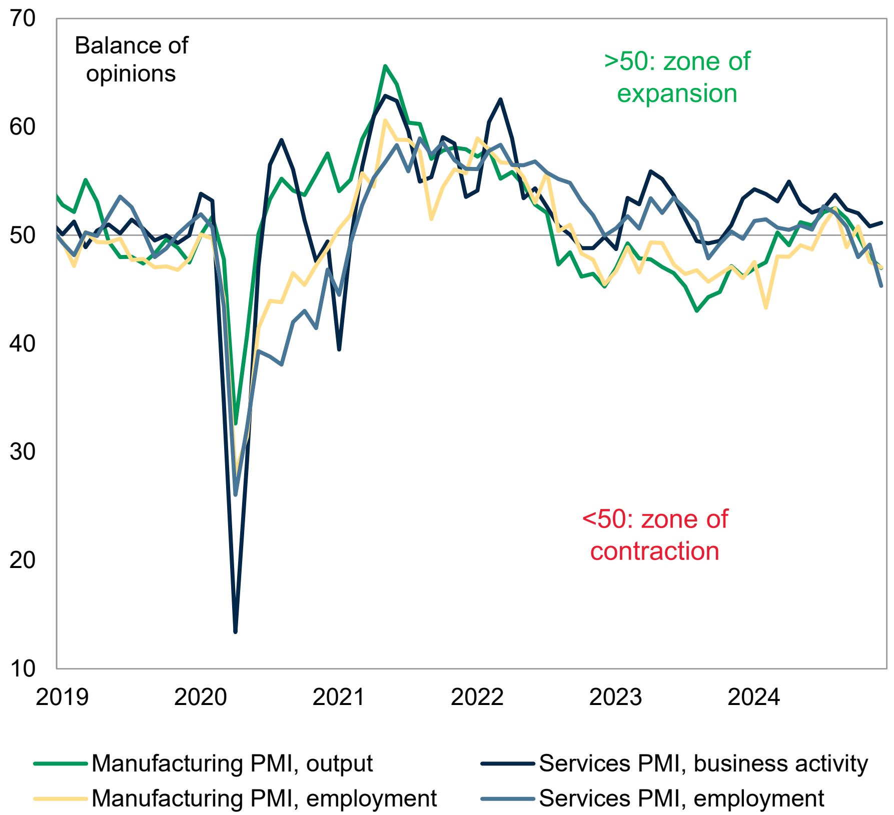


** Retail, catering, transport and travel, leisure and entertainment.*
Sources: ONS, Crédit Agricole S.A./ECO.

CYCLICAL DEVELOPMENTS

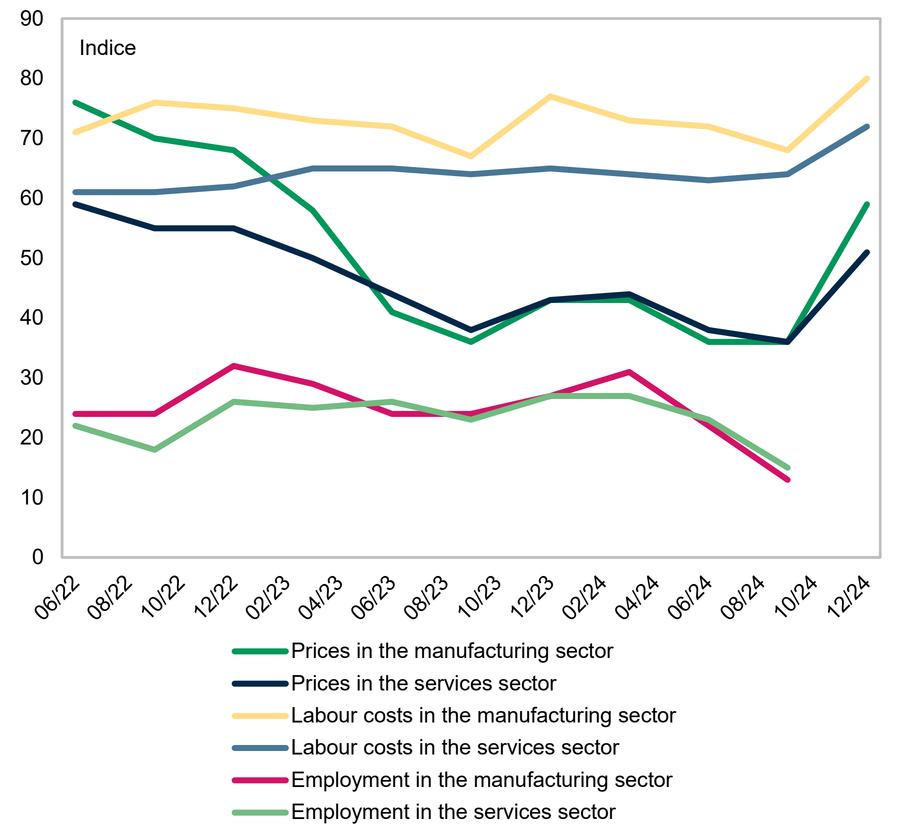
BUSINESS CONFIDENCE HAS WEAKENED AFTER THE AUTUMN BUDGET 2024 DUE TO HIGHER LABOUR COSTS STARTING IN APRIL

Business surveys: PMI output and employment indices point to a potential contraction in Q4-24



Sources: S&P Global, Crédit Agricole S.A./ECO.

Price pressures are on the rise again owing to a jump in labour costs; employment expectations deteriorate

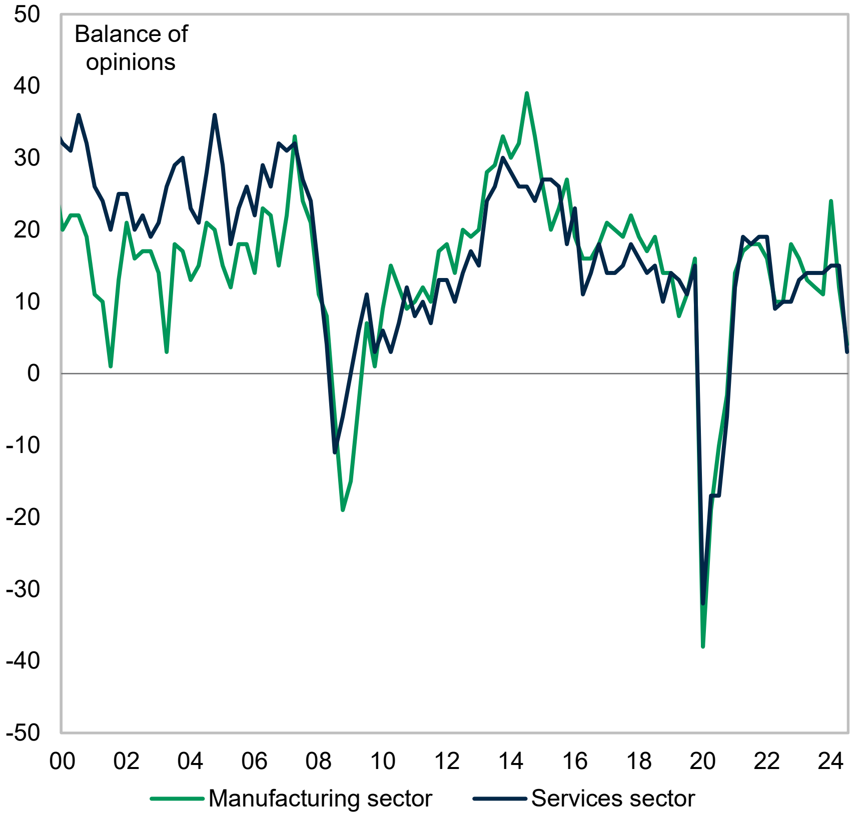


Sources: BCC, Crédit Agricole S.A./ECO.

CYCLICAL DEVELOPMENTS

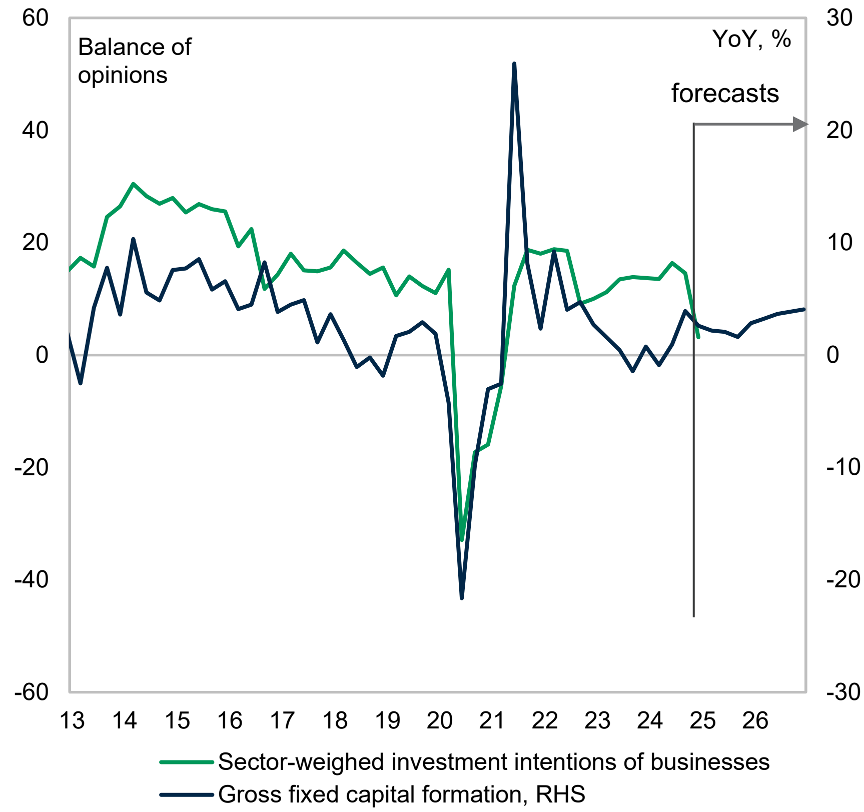
BUSINESSES CUT THEIR INVESTMENT PROJECTS IN RESPONSE TO THE AUTUMN BUDGET

Investment intentions fell in Q4-24



Sources: BCC, Crédit Agricole SA / ECO

We forecast positive albeit sluggish growth in overall investment as the BoE cuts rates



Sources: BCC, ONS, Crédit Agricole SA / ECO

HOUSEHOLDS

INCOMING TAX INCREASES WILL WEIGH ON SPENDING, PROMPTING DOWNWARD REVISIONS TO FORECASTS FOR HOUSEHOLD CONSUMPTION

Households remain cautious

Worries about higher taxes and potential cuts to social spending ahead of the Autumn Budget have been weighing on consumer confidence, in a context where prices and rates remain above their pre-Covid levels. Although real incomes have been growing strongly in recent quarters (1.1% QoQ on average per quarter in the year to the end of Q3-24), fueled by strong nominal wage growth (5.2% YoY in Q3) and disinflation (CPI inflation fell from a peak of 11.1% in October 2022 to 2.5% YoY in December 2024), household spending is still lagging the increases in real household disposable income, pushing up the saving ratio to 10.1% in Q3-24. Some precautionary savings motives are likely underpinning these higher savings. Still, household consumption increased each quarter between Q1-24 and Q3-24, with growth of 0.5% QoQ on average, close to its average pre-Covid quarterly growth rate of 0.6%.

Retail sales data as of December suggests weaker household spending in Q4 relative to Q3, as the volume of retail sales fell by 0.8% QoQ in Q4 after an increase of 1.2% QoQ in Q3. Retail sales were down by 0.3% MoM in December and well below their pre-pandemic level (-2.5%). We expect a slowdown in household consumption to 0.2% QoQ growth in Q4-24 after 0.5% QoQ in Q3. If our forecast is correct, annual growth of household consumption would come in at 0.9% after 0.4% in 2023.

We expected consumer confidence to improve once the budget was delivered on 30 October, albeit with a certain degree of persistent caution. Indeed, GfK's Consumer Confidence Index did rebound in November and December, rising to -17 versus -21 in October, however it remains weaker than it was in the summer. Concerns over further tax increases and possible cuts in social spending alongside a deteriorating labour market outlook and higher interest rates are likely to continue to depress household consumption.

Furthermore, although the BoE is gradually easing its stance on monetary policy, mortgage rates remain high and some households have yet to see an increase in their debt-servicing cost. According to the BoE’s financial stability report of November 2024, around half of mortgages are expected to see payment increases by Q4-27, as some households with fixed-rate mortgages will have to refinance their loans at higher rates once they reach their term.

We expect still-positive but weaker growth in household consumption compared to three months ago

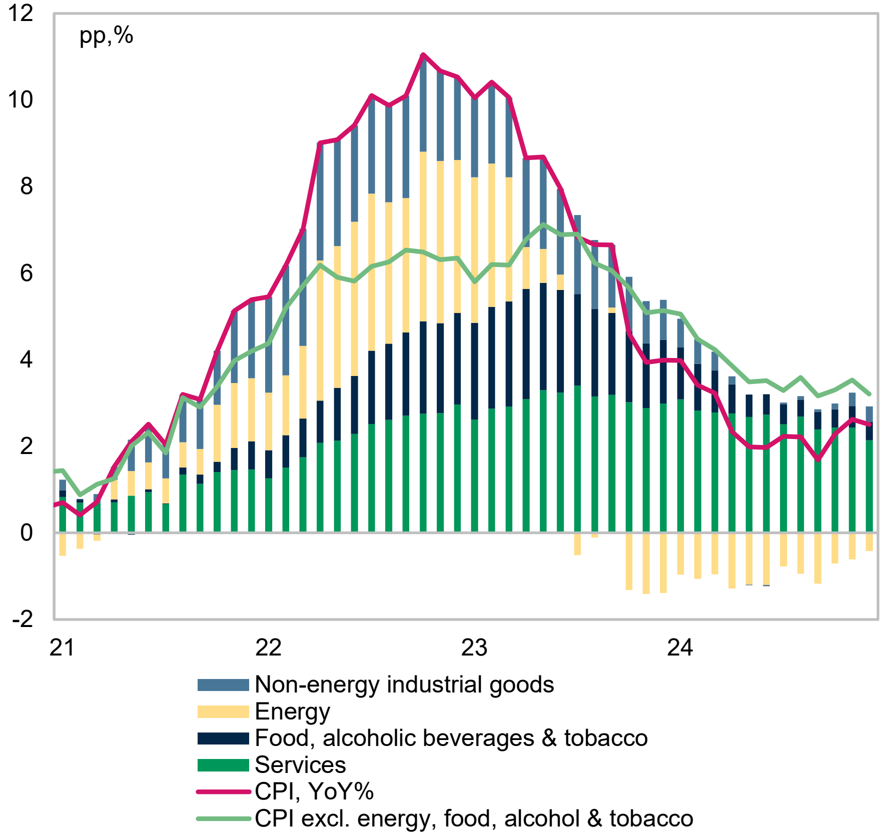
We revised down private consumption growth due to the higher tax burden announced in the Autumn Budget as well as higher interest rates. Real income growth is likely to slow in 2025 as wage growth moderates and inflation remains slightly above target. The labour market is also likely to worsen by more than previously expected due to impact on business labour costs of the increase in employer NICs and the National Living Wage (NLW) announced in the Autumn Budget. Indeed, businesses will likely cut on headcounts and wages while increasing prices in order to preserve margins.

All in all, we expect household consumption growth of 0.4% QoQ per quarter on average during 2025, before a slight acceleration to 0.5% QoQ per quarter over the course of 2026. Annual growth would accelerate gradually to 1.5% in 2025 (versus 1.9% expected previously) and to 1.9% in 2026.

HOUSEHOLDS

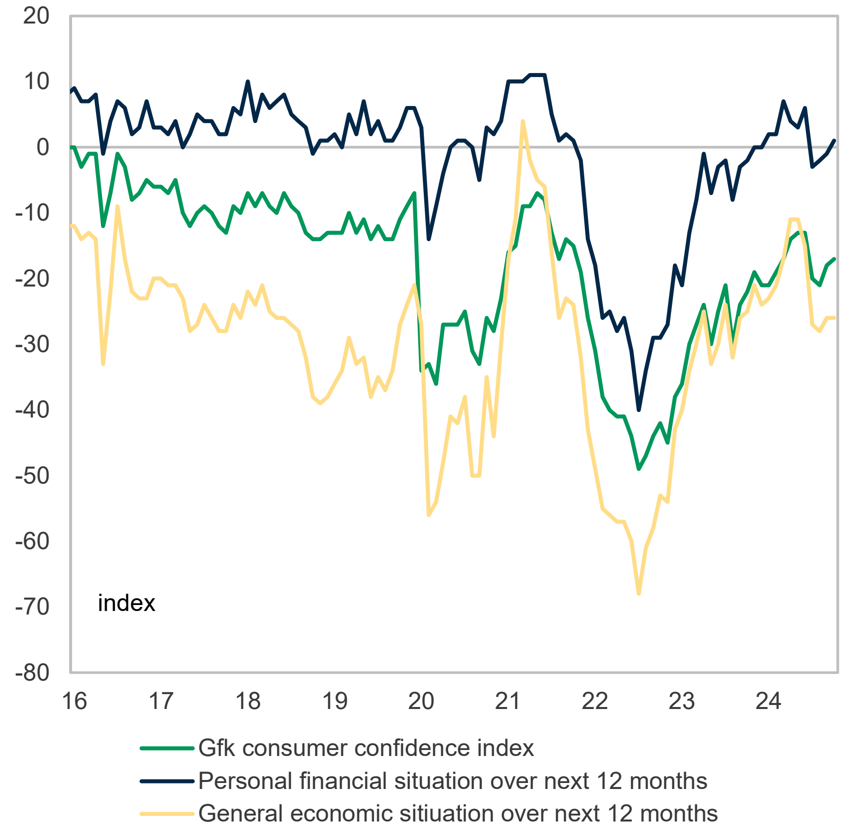
HOUSEHOLDS STILL CAUTIOUS AFTER PRICE AND INTEREST-RATE SHOCKS

CPI inflation rebounded to 2.5% YoY in Q4-24 from 2% YoY in Q3-24 mostly due to energy prices



Sources: ONS, Crédit Agricole S.A./ECO.

Consumer confidence in the economic outlook remains weak

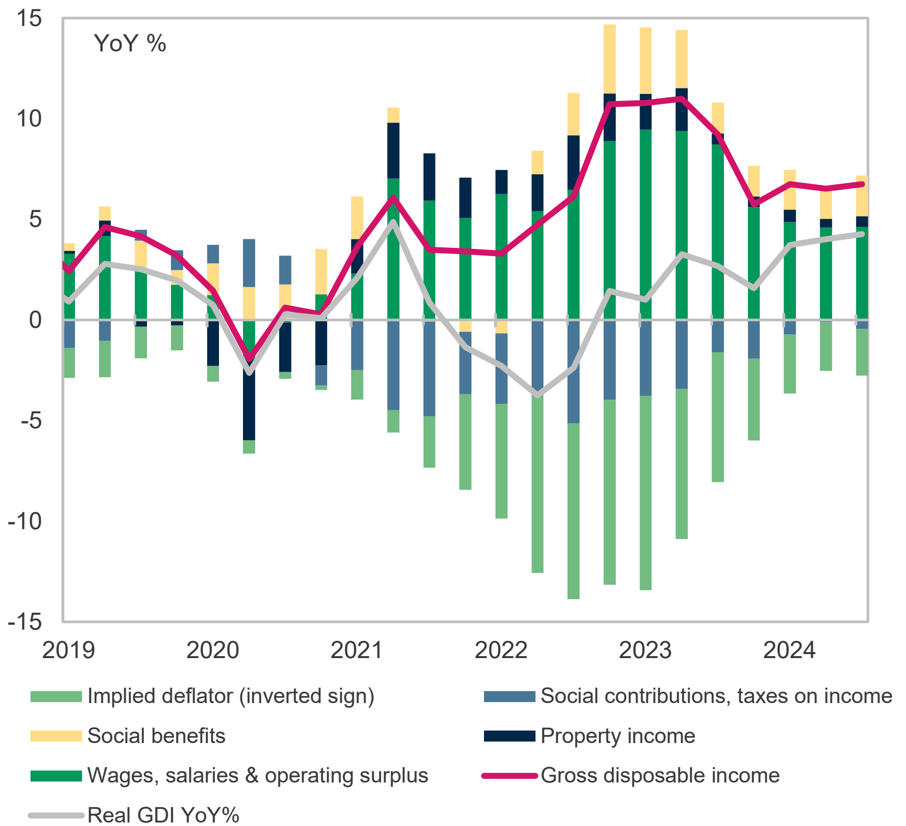


Sources: Gfk, Crédit Agricole S.A./ECO.

HOUSEHOLDS

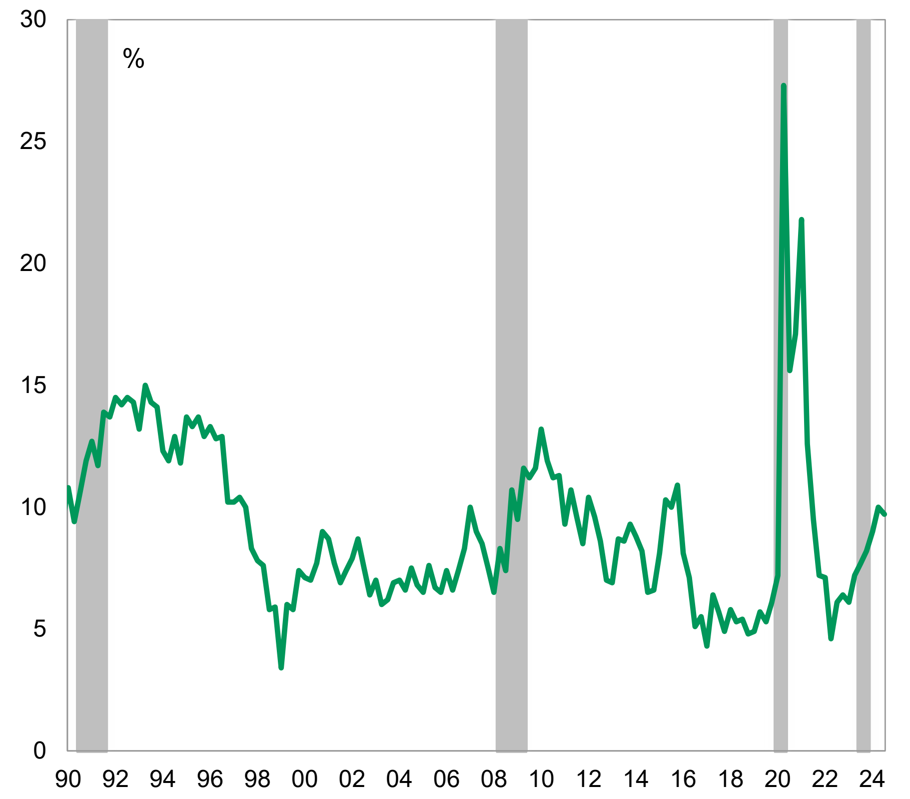
PURCHASING POWER IS STILL GROWING SIGNIFICANTLY, BUT SO IS THE SAVING RATIO

Real incomes continue to rise significantly



Sources: ONS, Crédit Agricole S.A./ECO.

The saving ratio reached 9.7% in Q3-24

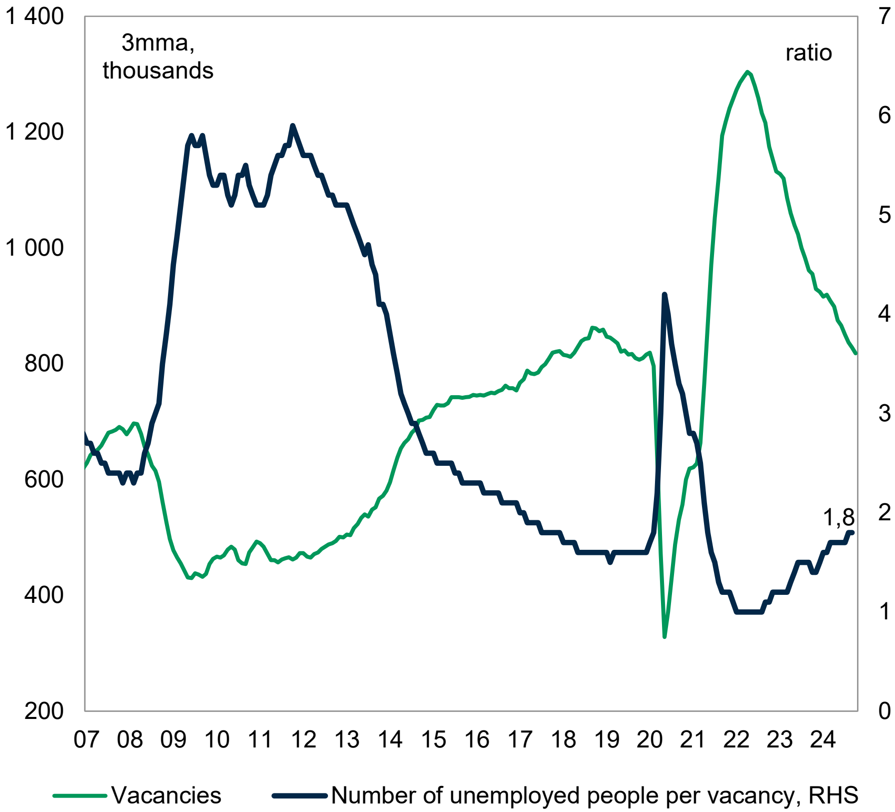


Sources: ONS, Crédit Agricole S.A./ECO.

JOB MARKET

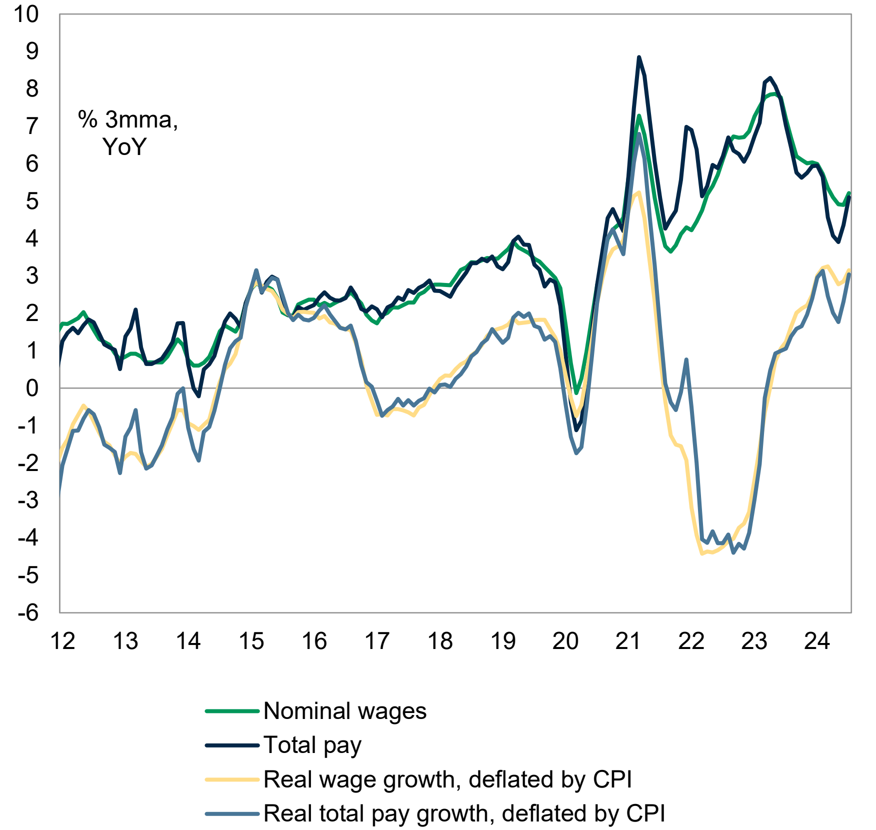
THE LABOUR MARKET HAS CONTINUED TO COOL BUT REMAINS TIGHT

The ratio of unemployed people per vacancy hit 1.8 in October, but continues to indicate a tight labour market



Sources: ONS, Crédit Agricole S.A./ECO.

Growth in both nominal and real earnings inched up in the three months leading up to October



Sources: ONS, Crédit Agricole S.A./ECO.

PUBLIC FINANCES UNDER STRAIN

THE AUTUMN STATEMENT PROMISED TO REDUCE AUSTERITY AND BOOST INVESTMENT

At her first Autumn statement delivered on 30 October 2024, Chancellor Reeves announced significant increases in public spending, tax and public borrowing. The key objectives are to repair the damage by the previous government (GBP22bn "black hole"), to stop austerity for some public services and to fund more public investment. **The Budget represents "one of the largest fiscal loosenings of any fiscal event in recent decades", according to the OBR.** Indeed, the figures are much higher than announced during the election campaign and compared to what was leaked immediately prior to the Autumn Statement:

– Public spending increase by almost GBP70bn (around 2% of GDP) a year on average over the next five years, of which two-thirds on current and one-third on capital spending; the public spending increase is significantly front-loaded (4.3% in 2024/25, 2.6% in 2025/26, 1.3% in each year thereafter); decisions include materially higher spending on public services, including the NHS, education, defence, Home Office and justice.

– Tax increases of GBP40bn – including a GBP26bn increase in employer National Insurance Contributions (NICs) – which push the tax take to an all-time high of 38.2% of GDP in 2029-30 (from 36.4% this year);

– And on average GBP30bn of additional borrowing per year. Part of the borrowing will be used to finance an increase in the current budget deficit (GBP9bn a year), as the policy-driven increase in current spending is not fully offset by the increase in revenue, but the bulk of it will be used to finance an increase in capital spending.

– **The budget represents a meaningful increase in public capital spending of over GBP100bn over the next five years**, reflecting the new government's key objective of boosting investment in the hopes of providing long term benefits to the economy, raising productivity and potential growth. This focus on the long term is welcome. However, the extra capital spending would allow public investment to merely stabilise as a fraction of GDP in the coming years, instead of falling as per the plans of the previous government.

Budgetary policy will still remain restrictive in the coming years. Higher taxes will replace the significant (and impossible to deliver) cuts in the unprotected departments that were left out of plans by the previous government.

The main tax increases are:

- **An increase in employer NICs via a higher rate (from 13.8% to 15%) and a lower threshold (from £9,100 to £5,000 p.a.), by far the biggest tax measure, raising GBP26bn by 2029-30;**

– Employment allowance increases from £5,000 to £10,500, alongside a higher minimum wage and expanded employment rights;

– Several tax compliance measures and debt collection measures;

– Changes to the regimes for capital taxes and for non-domiciled taxpayers;

– Levies of VAT on private school fees;

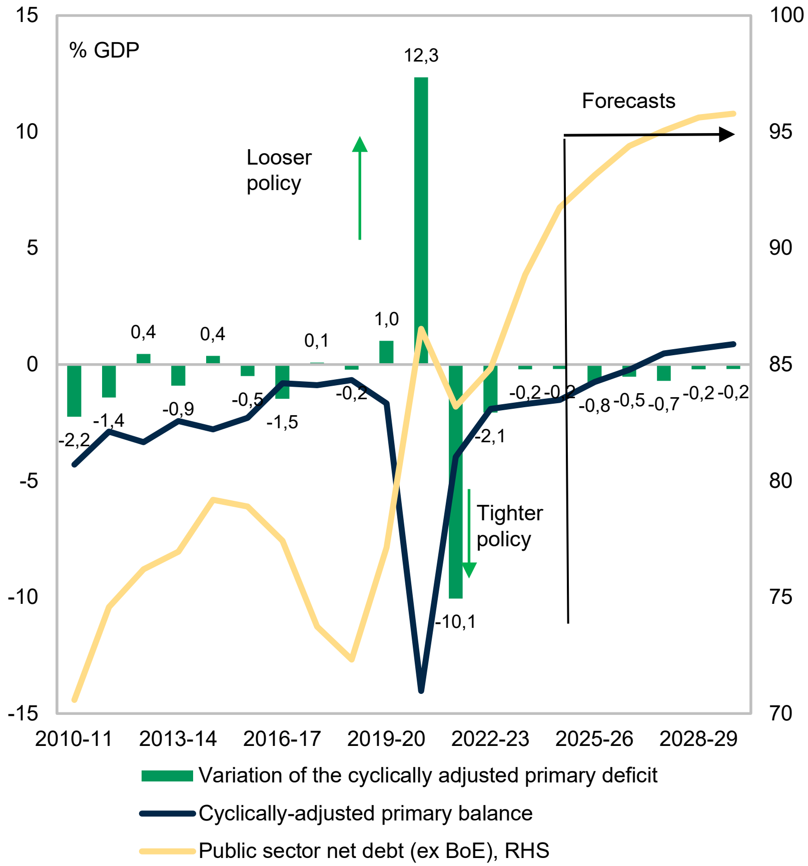
– Other net tax changes, including increasing the rate of the energy profits levy and extending it to 2029-30 and increasing air passenger duty rates.

These are slightly offset by an extension of the freeze and the five-pence cut in fuel duty rates for 2025-26, costing GBP3bn in 2025-26 and GBP1bn by 2029-30.

PUBLIC FINANCES UNDER STRAIN

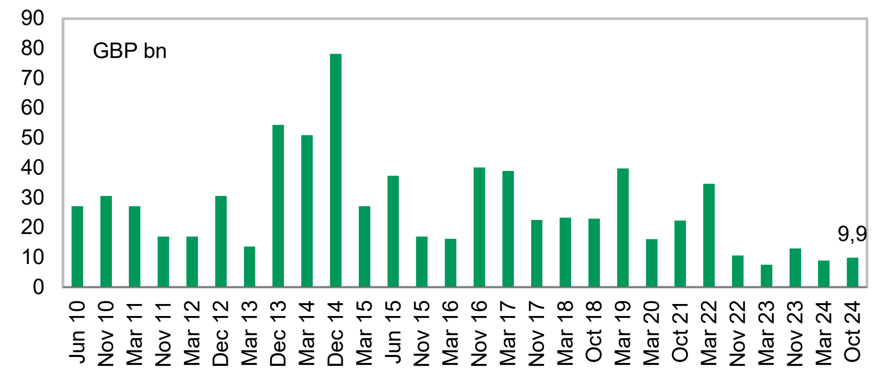
TOUGH CHOICES FURTHER DOWN THE ROAD

The fiscal impulse will remain negative going forward, failing to stabilise the debt ratio



Sources: OBR EFO October 2024, Crédit Agricole S.A./ECO.

The GBP9.9bn in headroom for the current budget's fiscal mandate is the third-lowest on record



In the Autumn Statement, the Government announced new fiscal targets:

- a fiscal mandate for the **current budget** to be in surplus by 2029-30 (until 2029-30 becomes the third year of the forecast period, from which point the mandate applies to the third year);
- a supplementary target for **public sector net financial liabilities** to fall as a share of GDP by 2029-30 (again until 2029-30 becomes the third year of the forecast, from which point this target applies to the third year).

The OBR estimates that the fiscal targets are on course to be met, but by relatively small margins of GBP9.9bn and GBP15.7bn, respectively. The estimated probabilities of meeting the targets are also low at 54% and 51%, respectively.

The margins could be easily eroded by the combination of weaker growth and higher borrowing costs since October. Chancellor Reeves will most likely tighten fiscal policy this year (maybe as soon as on 26 March, when the OBR's next forecasts will be published, or at the July Spending Review at the latest). This will most likely take the form of cuts in public spending or deferred spending, while leaving difficult decisions on tax to the Autumn Budget.

MONETARY POLICY

MORE LIMITED ABILITY TO CUT RATES DUE TO HIGHER INFLATION EXPECTATIONS

We increased the Bank Rate forecast following the fiscal loosening announced in the Autumn Budget

The BoE cut its key policy rate in August and November by a total of 50bp, bringing it down to 4.75%. It stayed put in December, in line with expectations, and continued to signal that a gradual approach to removing policy restraint remained appropriate. Higher inflation expectations following the fiscal plans outlined in the Autumn Budget 2024 amidst persistent domestic inflationary pressures and continued modest upside surprises in services inflation justify a cautious approach to setting the rate. The fiscal plans of the new government represent a substantial near-term loosening of fiscal policy compared with the plans outlined by the previous government in March (even though the stance on fiscal policy will continue to tighten), with government expenditure projected to rise on average by around GBP70bn (2% of GDP) per year from 2025-26 compared with the OBR's March projections, partially offset by tax measures. As a result, the BoE revised its inflation forecasts upwards in its November 2024 Monetary Policy Report "by just under ½ of a percentage point at its peak, reflecting both the indirect effects of the smaller margin of excess supply and direct impacts from the Budget measures". The BoE expects CPI inflation to increase to around 2.8% by H2-25 versus 2.4% expected back in August. As a result of the higher near-term forecasts for inflation, we have raised our forecast for the Bank Rate for 2025 by 50bp, foreseeing only one rate cut per quarter (in February, May, August and November) to a rate of 3.75% as of the end of 2025. We forecast slightly more easing in 2026 to a terminal Bank Rate of 2.50%, as we expect inflation to fall below target in late 2026.

Risks are two-sided

Crucially for the inflation outlook, businesses are facing a significant increase in labour costs starting in April 2025 as a result of changes to employer National Insurance Contributions (NICs), increases in the National Living Wage and costs associated with the employment rights bill. The changes to employer NICs are estimated to result in an average annual tax increase in excess of GBP800 per employee. The impact of the Budget announcements on inflation will depend on the degree to which and speed with which these higher costs are passed on to prices, profit margins, wages and employment. The degree of pass-through of labour cost increases to prices will depend on the state of domestic demand; in a context of subdued consumer confidence and elevated interest rates, firms are less able to pass their cost increases on to consumer prices and may decide to make more cuts in headcounts or wages instead.

The implications for monetary policy are two-sided risks depending on how firms respond to the measures: higher prices in the near term but also the possibility of lower wages and more labour market slack, implying a weaker medium-term outlook for inflation. We have revised both our inflation and unemployment rate forecasts to the upside. But, while the BoE expects CPI inflation to rise "½ of a percentage point at its peak", we believe that the weak demand will result in lower pass-through to prices than expected by the BoE. Still, CPI inflation will remain above target for longer as a result of the Autumn Budget measures, reaching a peak at 2.8% in Q3-25 according to the BoE (2.3% in our forecasts), but still falling below target in the third year of the forecast period (Q2-27 versus Q4-26 in our forecasts). The recent tightening in financial conditions (the UK 10-year sovereign rate has risen 30bp year to date and more than 60bp since the Budget), if it persists, would weigh further on the inflation outlook by depressing the outlook for demand, which in turn alleviates some of the hawkish pressures on the BoE. By contrast, the depreciation of the sterling (1.9% in trade-weighted terms since the beginning of the year) is something to which the BoE is unlikely to respond, "looking through it" as it does not impact the inflation outlook beyond the first year of the forecast period.

CENTRAL SCENARIO: SLUGGISH GROWTH CYCLE AMIDST PERSISTENT UPSIDE RISKS TO INFLATION

Downside risks to activity

Risks linked to public finances: weaker-than-expected growth and/or persistently high borrowing costs lead to fiscal tightening; conversely, a slippage in budgetary discipline may lead to a fresh crisis on the gilt markets

Persistently deteriorated financing conditions

Escalation of geopolitical conflicts and new inflation spike

Weaker-than-expected global growth

Upside risks to activity

The promise of political stability with the Labour party's majority government prompts a swift recovery in confidence and private investment

A decline in geopolitical risks

Stronger-than-expected growth in the US

No shock to global trade

THE SCENARIO IN FIGURES

FORECASTS

	annual average, %				quarterly variation, %															
United Kingdom	2023	2024	2025	2026	2023				2024				2025				2026			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (%)	0.4	0.8	1.1	1.6	0.1	0.0	-0.1	-0.3	0.7	0.4	0.0	0.1	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
household consumption	0.4	0.9	1.5	1.9	-0.5	0.6	-0.9	-0.1	0.7	0.4	0.5	0.2	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5
public consumption	1.0	1.9	3.2	4.1	-0.7	2.2	1.1	-0.4	0.3	0.8	0.1	0.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
investment	0.3	1.6	2.2	3.7	2.7	-1.2	-1.6	0.9	1.0	0.7	1.3	-0.4	0.6	0.6	0.8	0.8	1.0	1.0	1.0	1.0
change in inventories*	-0.9	-0.1	0.6	0.0	0.4	-0.4	-0.3	0.1	-0.5	0.5	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
net exports*	0.5	-1.5	-2.0	-1.1	-2.0	-0.4	0.3	0.1	0.1	-2.2	0.7	-1.8	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3
Unemployment rate (ILO)	4.1	4.3	4.2	4.2	3.9	4.3	4.0	4.1	4.4	4.2	4.3	4.4	4.3	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Inflation (CPI, YoY%)	7.3	2.5	2.2	2.0	10.2	8.4	6.7	4.2	3.5	2.1	2.0	2.5	2.3	2.1	2.4	2.2	2.2	2.1	2.0	1.8
Core CPI (YoY%)	6.2	3.7	2.4	2.1	6.1	6.9	6.4	5.3	4.6	3.6	3.3	3.3	3.1	2.2	2.0	2.1	2.3	2.2	2.0	1.8
Current account (% GDP)	-2.2	-2.6	-1.1	-2.0	-2.4	-3.4	-1.6	-1.4	-1.7	-3.4	-2.5	-	-	-	-	-	-	-	-	-
General gov. balance, % GDP	-5.8	-4.7	-4.1	-3.6	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Public debt % GDP	100.0	101.4	102.2	104.1	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Bank rate**	5.25	4.75	3.75	2.50	4.25	5.00	5.25	5.25	5.25	5.25	5.00	4.75	4.50	4.25	4.00	3.75	3.50	3.25	3.00	2.50

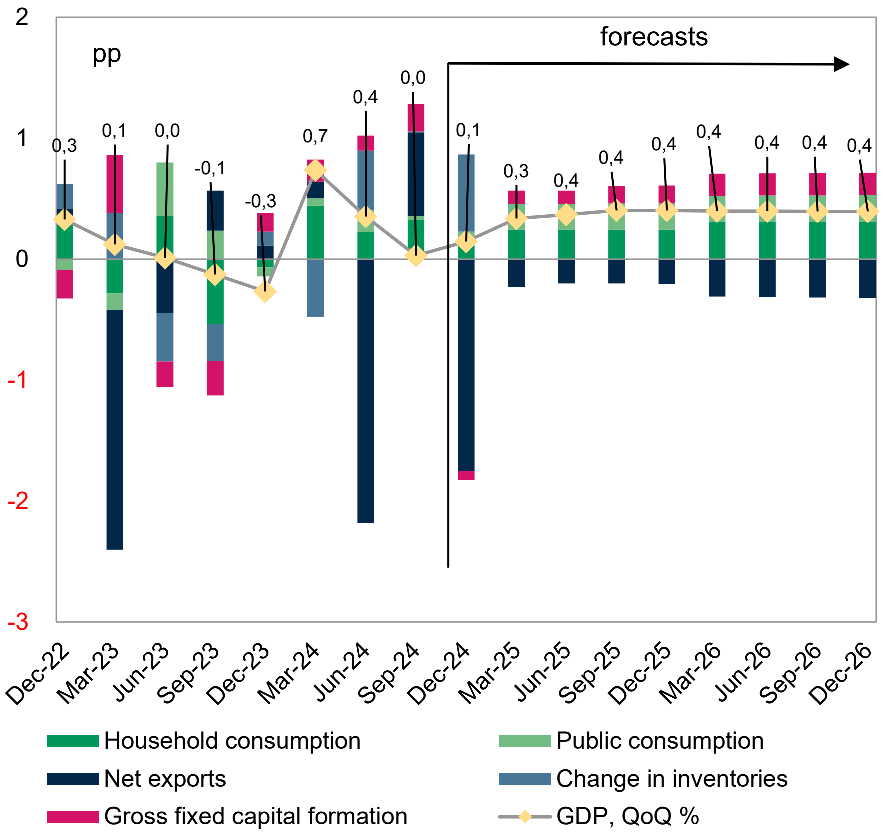
** Contributions to GDP growth*

*** End of period*

Sources: ONS, BoE, Crédit Agricole S.A./ECO.

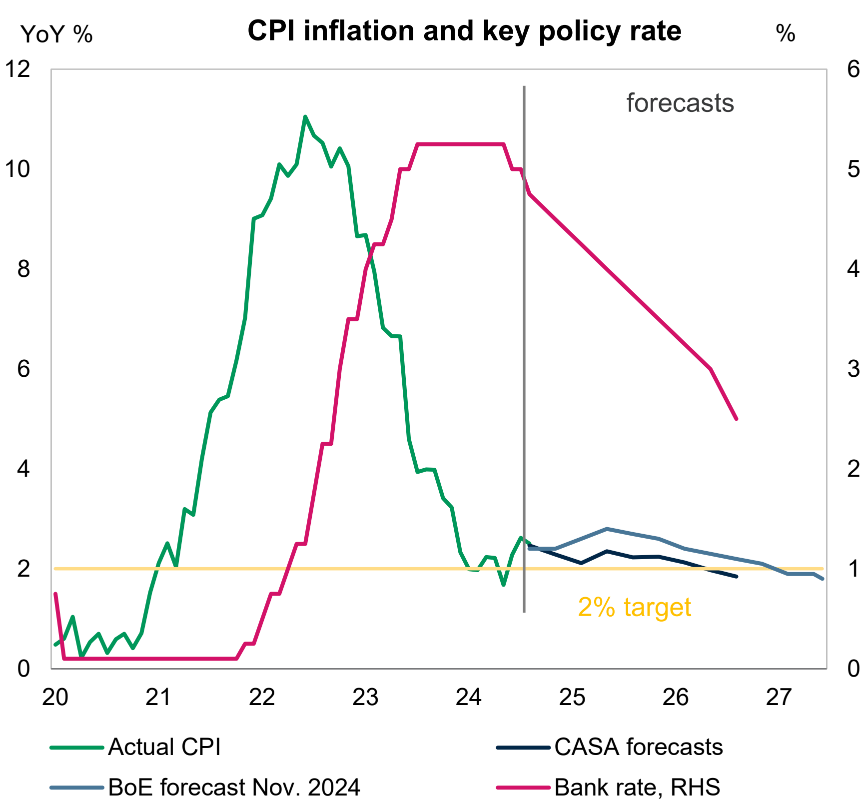
SLOWDOWN IN THE SHORT TERM AFTER A STRONG START TO THE YEAR

Growth to be driven by households and private investment…



Sources: ONS, Crédit Agricole S.A./ECO forecasts.

… owing to the decline of inflation and to monetary easing

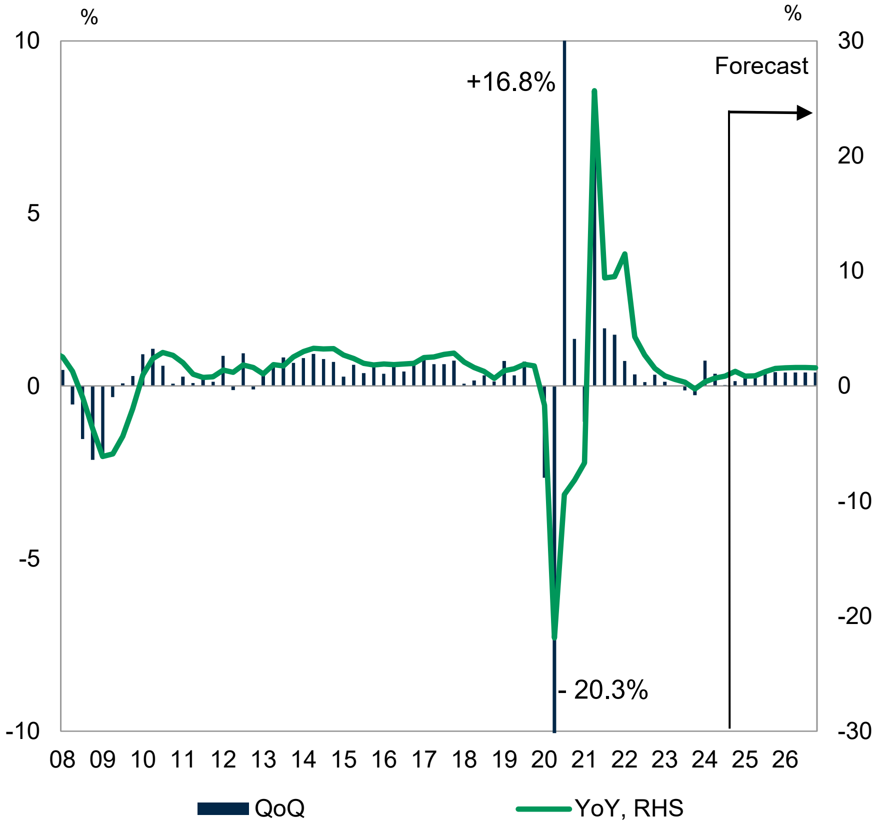


Sources: ONS, BoE Monetary Policy Report of November 2024, Crédit Agricole S.A./ECO

THE SCENARIO IN PICTURES

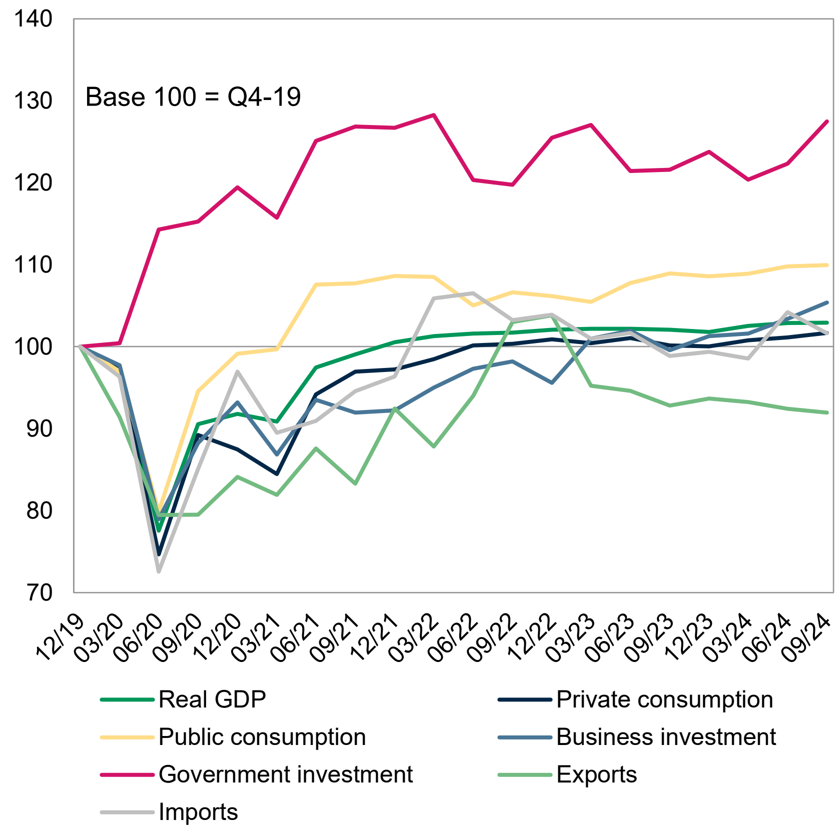
WE EXPECT AN IMPROVEMENT IN GROWTH IN 2025 AND 2026 TO BELOW POTENTIAL RATES

Real GDP showed no growth in Q3-24 and there is a downside risk to our forecast of 0.1% QoQ in Q4



Sources: ONS, Crédit Agricole S.A./ECO.

Change in real GDP and its components since Covid: growth will likely continue to be driven by the public sector

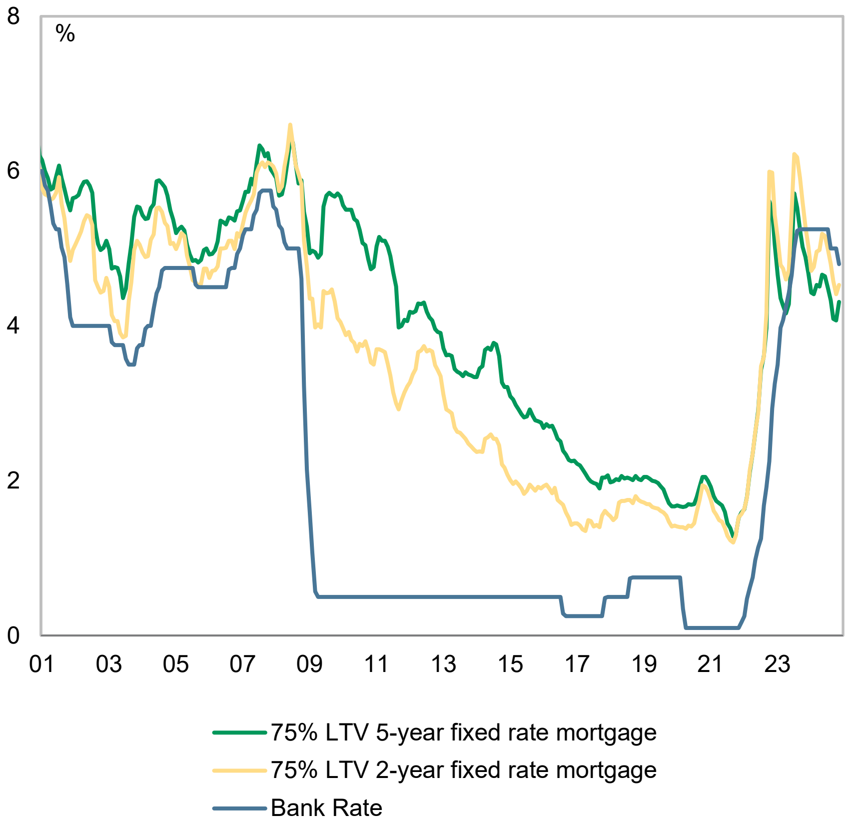


Sources: Gfk, Crédit Agricole S.A./ECO.

THE SCENARIO IN PICTURES

THE LAGGING IMPACT OF PAST RATE HIKES WILL PREVAIL

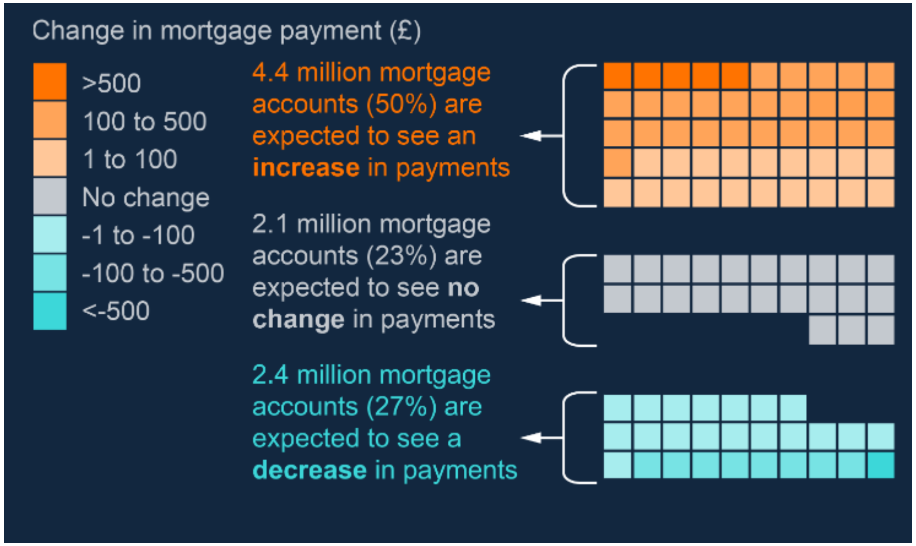
Mortgage rates remain high



Sources: BoE, Crédit Agricole SA / ECO

Around half of mortgages are expected to see payment increases by Q4-27

Proportion of owner-occupier mortgages by estimated change in monthly mortgage costs, from December 2024 to Q4-27

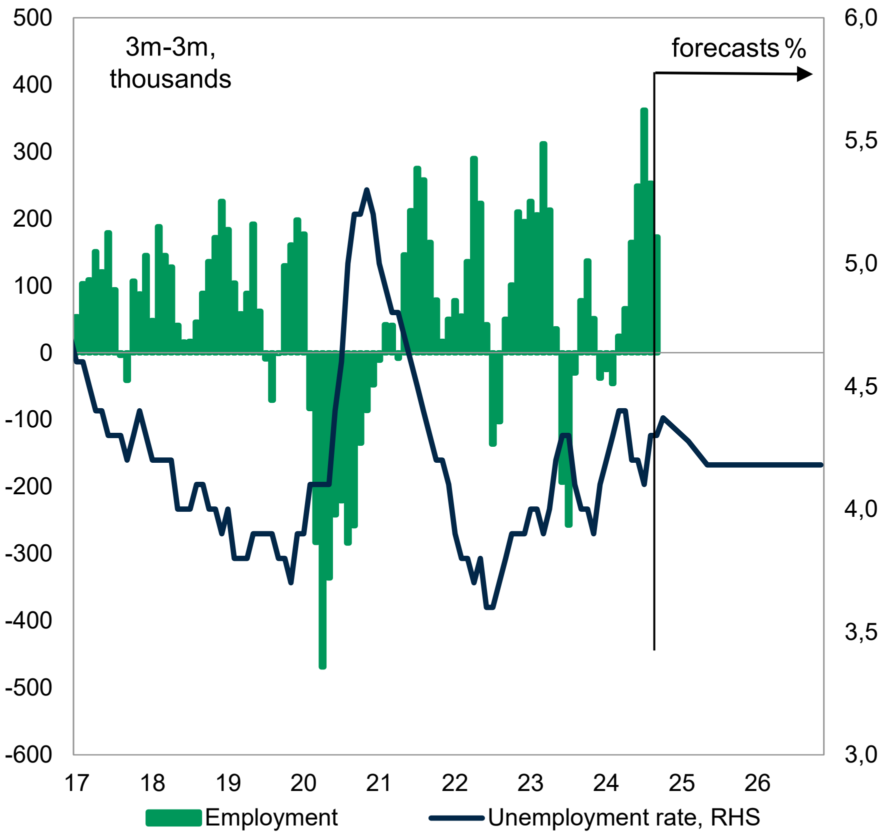


Sources: BoE's Financial Stability Report – November 2024, Crédit Agricole SA / ECO

THE SCENARIO IN PICTURES

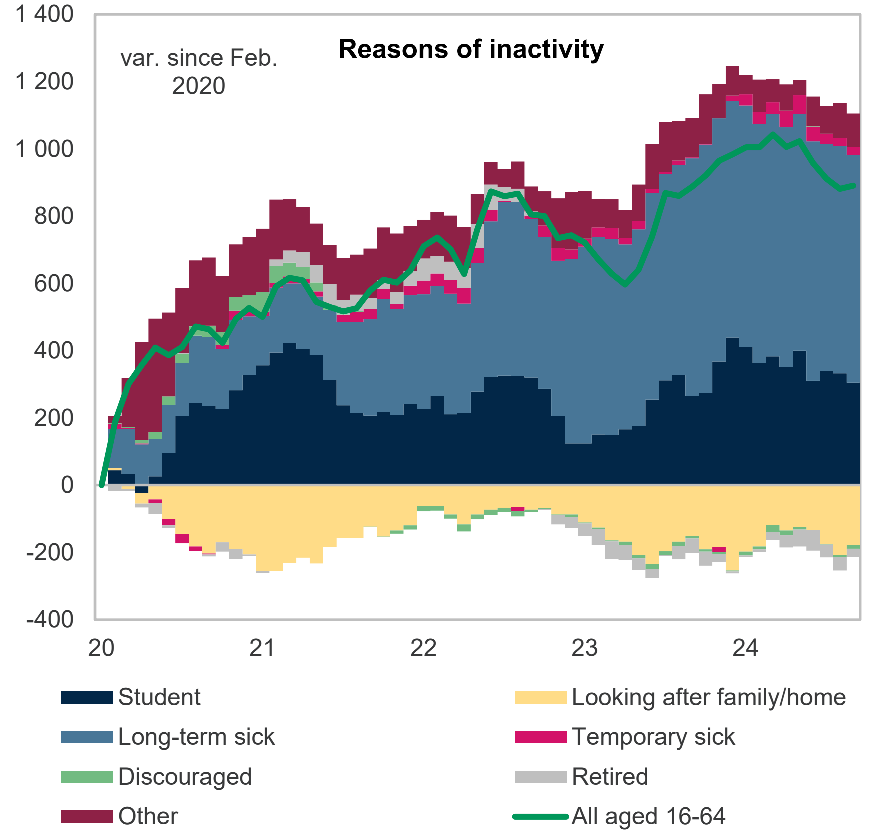
DESPITE SOME EASING, THE LABOUR MARKET REMAINS TIGHT DUE TO A HIGH ECONOMIC INACTIVITY RATE

We forecast a broadly stable unemployment rate, but risks are tilted to the upside



Sources: ONS, Crédit Agricole S.A./ECO.

The economically inactive population has risen significantly since COVID

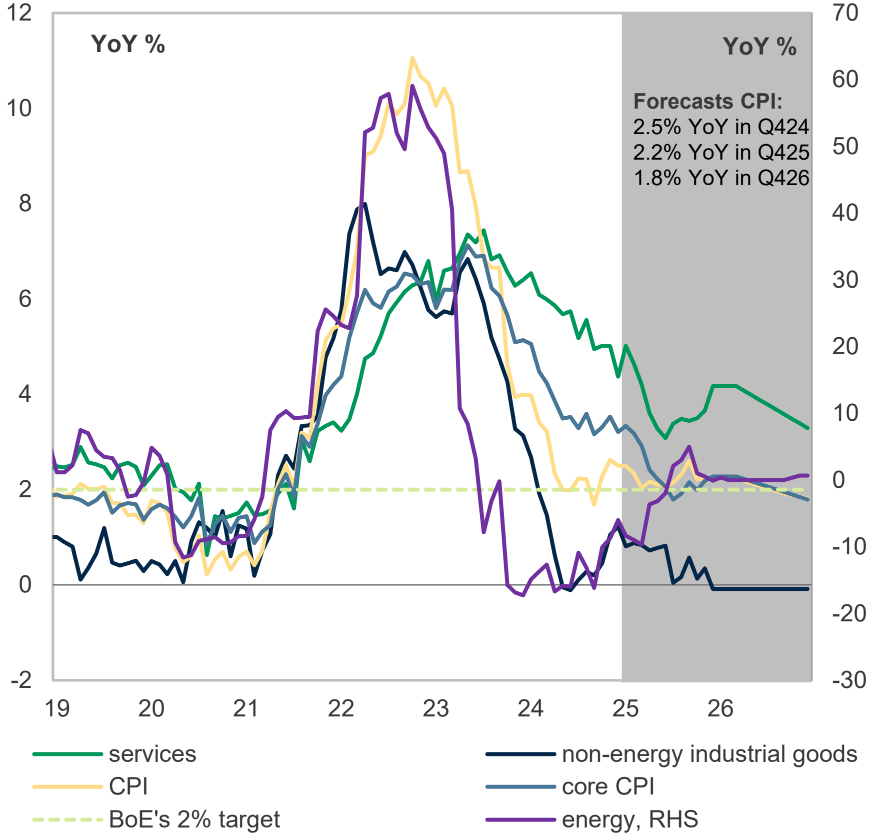


Sources: ONS, Crédit Agricole S.A./ECO.

THE SCENARIO IN PICTURES

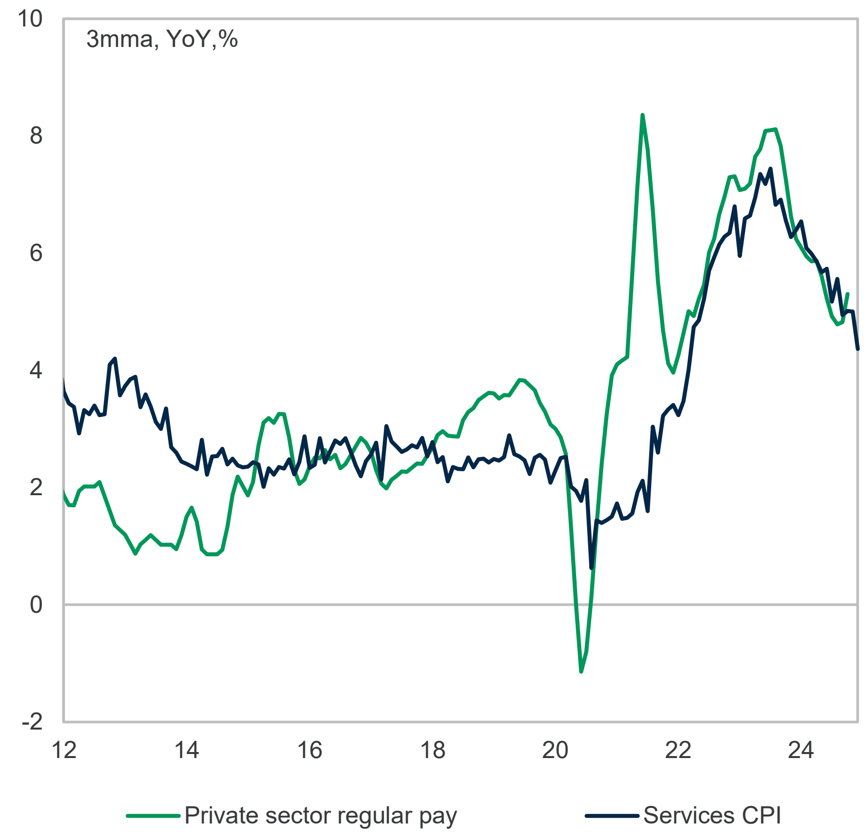
INFLATION: VOLATILE IN THE SHORT TERM BUT NOT MOVING FAR ENOUGH FROM THE TARGET TO CALL MONETARY EASING INTO QUESTION

Inflation to hover around target over the forecast period



Sources: ONS, Crédit Agricole S.A./ECO.

Wage growth and service inflation: continued moderation



Sources: ONS, Crédit Agricole S.A./ECO.

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