Economic Deep Dive

For CEOs, FDs, and business leaders

Your quarterly guide to the UK economy; making sense of the key trends and what's driving them.

Q4 2024: October - December

Quarterly economic highlights

1

Steady pace ahead for the UK economy

Our latest forecast projects that UK GDP will have grown by 0.9% in 2024. Looking ahead, economic activity will increase at a steady, but unimpressive, pace of 1.6% in 2025 and 1.5% in 2026.

2

Inflation set to remain above 2% through 2026

CPI inflation began rising again in the latter part of 2024, reaching 2.5% in December. We expect inflation to remain consistently above the Bank of England's 2% target rate in 2025 (2.6%) and 2026 (2.5%), partly reflecting the passthrough of Autumn Budget measures to higher prices.

3

Bank of England to cut rates more gradually in 2025

Higher inflation over our forecast means that we now expect a more gradual pace of interest rate cuts. Specifically, we anticipate that the Bank's Monetary Policy Committee (MPC) will reduce Bank Rate by 25 basis points each quarter, until reaching a terminal rate of 3.50% in Q1 2026.

1.6%

The latest CBI forecast expects the UK economy to grow by 1.6% in 2025

UK Economic Forecast: Steady pace ahead

What does this mean for business?

- Our forecast expects the UK economy to see steady growth over the next couple of years. The expansion will be primarily driven by household spending, but government spending and investment are anticipated to play a bigger role in the economy following the Autumn Budget. Some private sector firms in healthcare, education, and construction may see an indirect boon from higher government spending in these areas.
- Autumn Budget measures are expected to have a significant impact on businesses across the UK. Policies such as the increase in employers' National Insurance Contributions (NICs) are expected to negatively affect firms' workforce plans, costs, and future investment, particularly in sectors like hospitality and retail.
- We expect the Bank of England MPC to reduce Bank Rate by a gradual quarterly pace of 25bp until it reaches 3.50% in Q1 2026. Lower interest rates should help support a partial pick-up in consumer spending and investment.

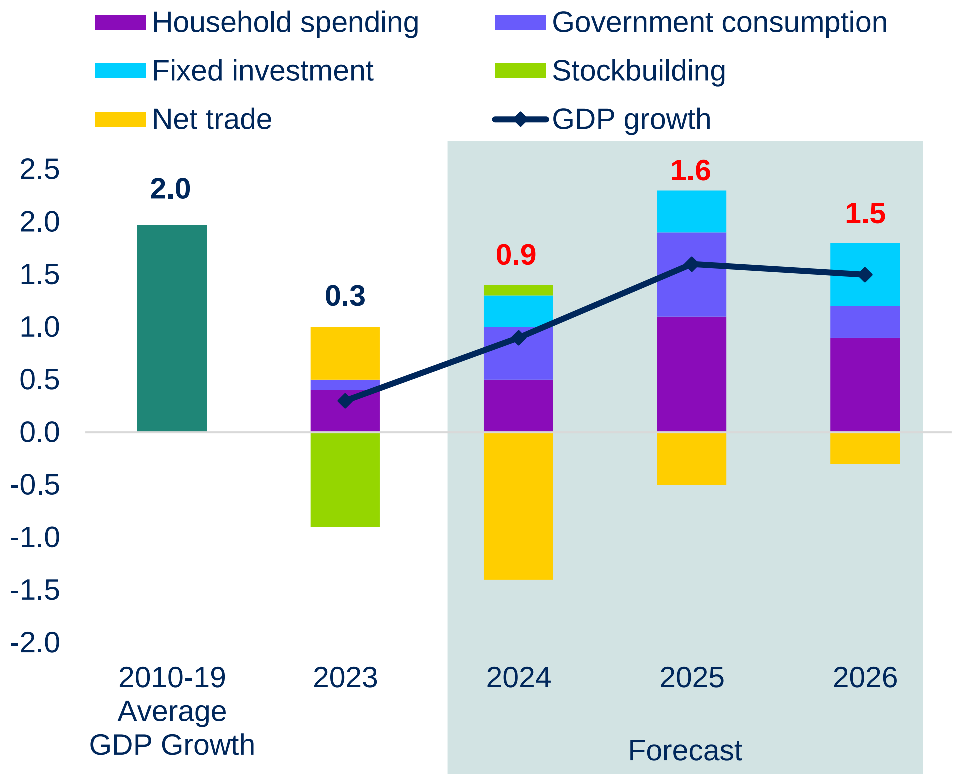
Our latest economic forecast expects that the UK economy will grow at a moderate pace through 2026. Specifically, we project that the UK economy will grow by 0.9% over 2024, before picking up to 1.6% in 2025. The UK economy then maintains a steady, but unimpressive, pace of growth in 2026, at 1.5%. It's worth noting that our latest projections represent downgrades from our June 2024 forecast, which expected growth of 1.0% in 2024 and 1.9% in 2025.

Growth in consumer spending has been relatively restrained over much of 2024, partly reflecting cautious behaviour following recent economic shocks. We still expect households to increase spending over 2025, but to a lesser extent than in June. This is due to real incomes growth being dragged back by higher inflation following the net fiscal loosening in the Autumn Budget. Consumption growth then slows slightly over 2026, as incomes growth eases further.

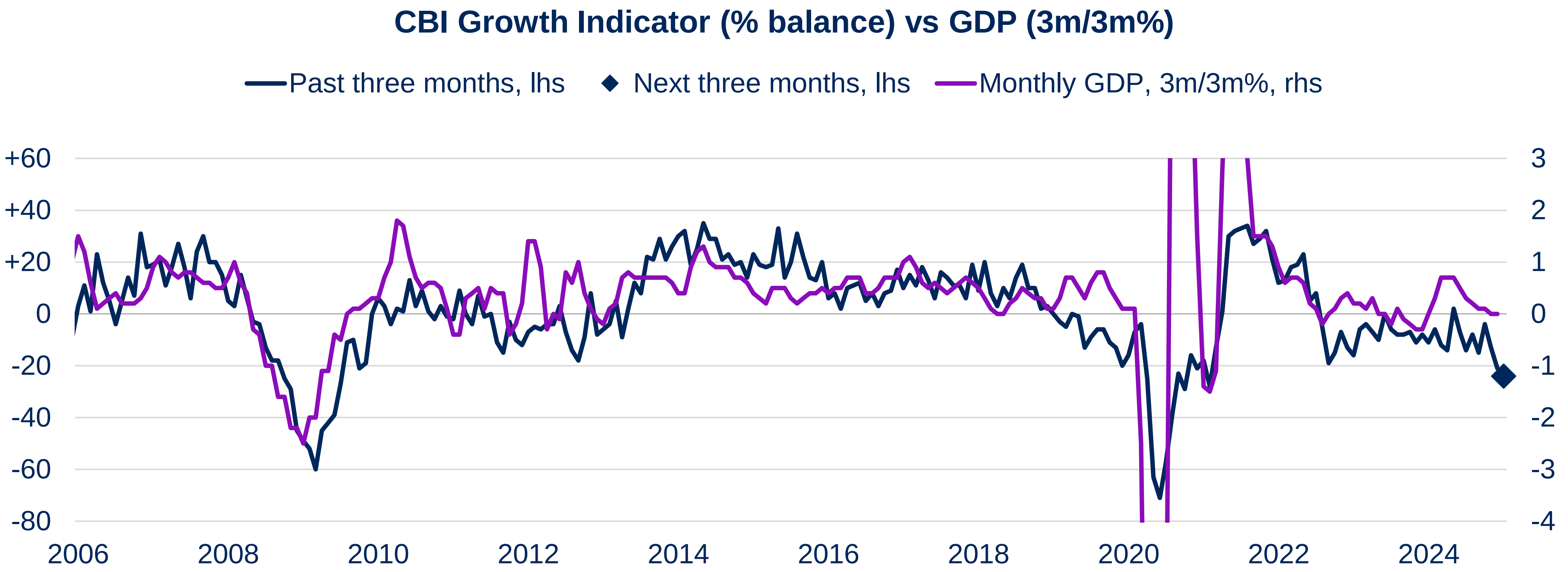
Business investment is now expected to have grown over 2024, primarily reflecting historical data revisions. We expect capex growth to pick up in 2025 (as GDP growth improves), but it then eases slightly in 2026. Despite a firmer outlook, our forecast for investment is weaker than what we would have expected before the Autumn Budget, reflecting the drags from higher employment costs and crowding out from government investment.

We project that productivity (output per worker) will lag slightly behind its lacklustre pre-pandemic trend through 2026. This weak outlook underlines the need to turbocharge growth and improve the UK economy's competitiveness.

GDP Growth (Y/Y%) and Contributions (pp)



UK economy began to recover in 2024

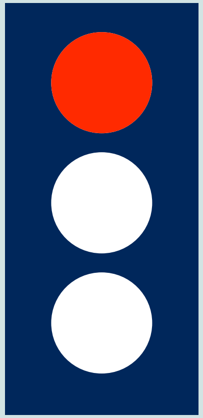


Source: ONS, Bank of England, Macrobond, CBI projections

The UK economy got off to a promising start in 2024, with two quarters of strong growth. GDP subsequently flatlined in Q3, but this mostly reflected a drag from volatile changes in flows of non-monetary gold. Domestic demand, by comparison, was relatively firm, with household spending, government consumption, and business investment increasing over the quarter.

We expect the economy to grow at a relatively steady pace over the next couple of years, with GDP growth averaging 1.6% over 2025-26. Household spending is a key driver, as growth in real incomes powers spending. However, the Autumn Budget has altered the composition of growth over our forecast, with government spending and investment now a greater driver of the expansion at the expense of private sector activity.

The CBI's Growth Indicator, a composite measure of private sector activity, expects private sector activity to decline in Q1 2025. The predicted fall in activity is set to be broad-based across the distribution, manufacturing, and services sectors.



-21%

CBI Growth Indicator: **red**

Private sector activity contracted notably in the three months to December

Private sector growth expectations deteriorate

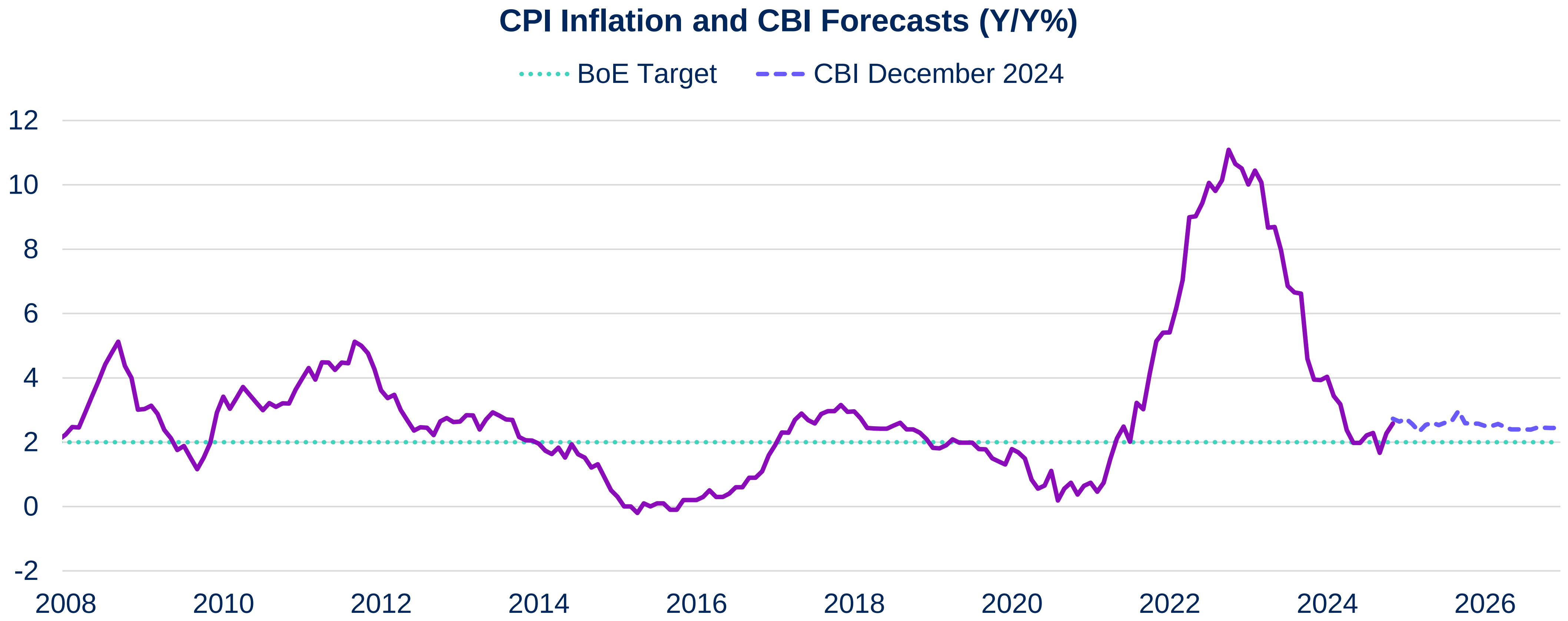
The latest CBI Growth Indicator reported that private sector activity fell in the three months to December, at a faster pace than in the quarter to November. Activity declined across the services, distribution, and manufacturing sectors.

Private sector activity is expected to fall over the next three months, with expectations at their weakest since November 2022. The disappointing outlook is broad-based across all three major sectors, with manufacturer's expectations, in particular, at their lowest balance since May 2020.

Hiring intentions in the private sector are at their weakest since October 2020. The fall in employment is set to be broad-based over the next three months, with the steepest declines expected in consumer services and manufacturing.

Selling price expectations for the next three months have strengthened to an above-average balance. The pick-up in expectations has been especially sharp in consumer services and distribution.

Inflation to remain above Bank's 2% target through 2026



Source: ONS, Bank of England, Macrobond, CBI projections

CPI inflation has picked up in recent months, sitting at 2.5% in December 2024 (broadly in line with our latest forecast's expectations). This comes after inflation settled around the Bank of England's 2% target in the early summer. The recent inflationary uptick has been mostly driven by energy base effects, but it's worth noting that underlying price pressures have remained firm throughout (as evidenced by stick services inflation).

Looking ahead, we expect inflation to remain consistently above the 2% target rate in 2025 (2.6%) and 2026 (2.5%). Our upgraded projection (relative to June) primarily reflects the expected passthrough of higher employment costs to increased prices following the Autumn Budget. In particular, we expect Budget measures to put upward pressure on prices in sectors such as hospitality and retail. Fuel prices remain a key upside risk to the outlook for inflation due to ongoing tensions in the Middle East.

Labour market cools and pay growth is set to ease

Although there remains uncertainty about UK labour market conditions due to the sampling issues with the ONS' Labour Force Survey, other measures– including CBI surveys – suggest that employment growth has weakened recently. Payroll and workforce jobs data indicate that employment has remained broadly unchanged, while vacancies continue to decline (but remained historically elevated). Recent CBI data have shown a material weakening in private sector hiring intentions following the Autumn Budget. This deterioration in hiring plans has been broad-based across the distribution, manufacturing, and non-financial services sectors.

Our latest forecast expects that Autumn Budget measures will weigh on private sector employment going forward, but public sector employment will see a boost from the announced fiscal loosening. We project that the unemployment rate will remain low by historical standards through 2026, although there is uncertainty around the forecast due to the aforementioned ONS data issues.

Private sector wage growth remains elevated, despite having eased from its recent peak in mid-2023. Indeed, annual private sector wage growth has picked up marginally in recent months (to 5.4% in the three months to October), suggesting that underlying pay pressures continue to be firm. Looking ahead, though, wage growth is set to slow, with recent surveys suggesting that private sector pay growth will be between 3-4% next year. Many firms have mentioned that they expect higher employment costs following the Budget measures to weigh on future pay growth.

Business view

- The prospect of higher employment costs following the Budget come against the backdrop of a cooling labour market, while many firms continue to report skills shortages.
- Many businesses are now focused on reducing costs going forward, which will likely include reviews of their headcount and hiring plans. Firms are also adjusting plans for pay, pensions, and other benefits.

Employment rate

(Aug '24 – Oct '24)

74.9%

The employment rate increased by 0.2pp from the previous quarter.

Unemployment rate

(Aug '24 – Oct '24)

4.3%

The unemployment rate increased by 0.1pp from the previous quarter.

Real wage growth

(Aug '24 – Oct '24 on a year ago)

2.2%

Real regular pay growth was unchanged from the previous quarter.

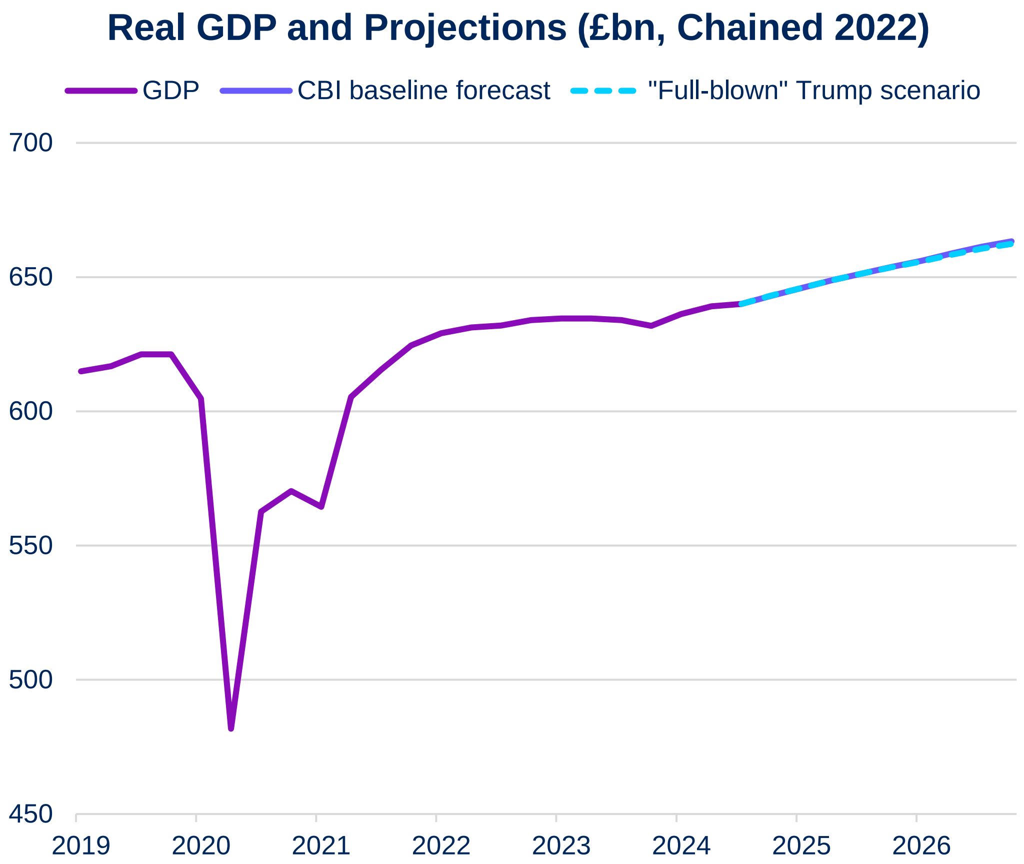
Productivity growth

(Output per hour, flash estimate, Q3 2024 on a year ago)

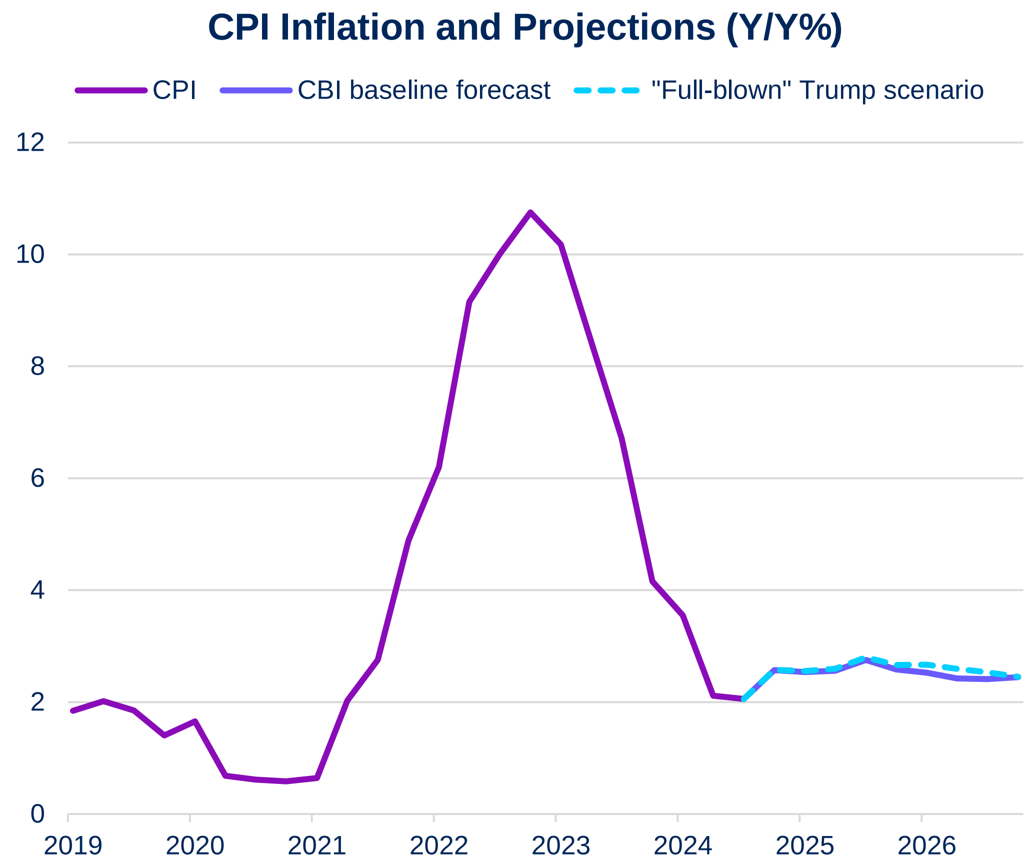
-1.8%

Productivity decreased by 1.5pp from the previous quarter.

Trump presidency poses modest risk to the UK



Source: ONS, Macrobond, CBI forecast, Oxford Economics Global Model, CBI analysis



Source: ONS, Oxford Economics Global Model, CBI forecast, CBI analysis

One of the key uncertainties facing the global economy is the potential impact of the second Trump presidency. Higher tariffs on goods exports to the US have been touted as a possible policy that the incoming administration could implement when it comes into office. In order to capture some of this potential impact from higher tariffs, our latest forecast assumes a “limited” Trump presidency (in line with Oxford Economics’ scenario assumptions) in which the US raises tariffs on imports from China and the EU, but not the UK. This scenario also expects looser fiscal policy in the US, which boosts US demand and, subsequently, provides a slight tailwind to UK growth in 2026.

However, a more extreme scenario (i.e. “full-blown” Trump) could see the US imposing universal tariffs of 10% on imports from the UK (and other major trading partners), and the UK retaliating with its own proportional tariffs. Due to its relatively low exposure to US goods trade, we estimate that the impact on the UK economy would be quite modest, even under this extreme scenario. The level of GDP would be only 0.1% lower than our baseline forecast in 2026, while CPI inflation would be 0.1pp higher. However, some UK-based sectors that are more exposed to US goods trade, such as pharmaceuticals, would likely see a more noticeable negative impact.

Bank of England to cut rates more gradually in 2025

UK interest rates have been on a gradual downwards trajectory since the summer of 2024, following on from an easing in inflationary pressures. Bank Rate was cut by 25 basis points in August and November, to reach a level of 4.75%. The Bank of England's MPC subsequently maintained the Bank Rate at 4.75% in December. The MPC has stated in its forward guidance that they will take a "gradual approach" to loosening policy. This reflects their view that underlying price pressures need to abate further for inflation to remain sustainably at the 2% target. December's MPC minutes also highlighted that the committee would consider the potential trade-off between weak demand and persistent price pressures when making future interest rate decisions.

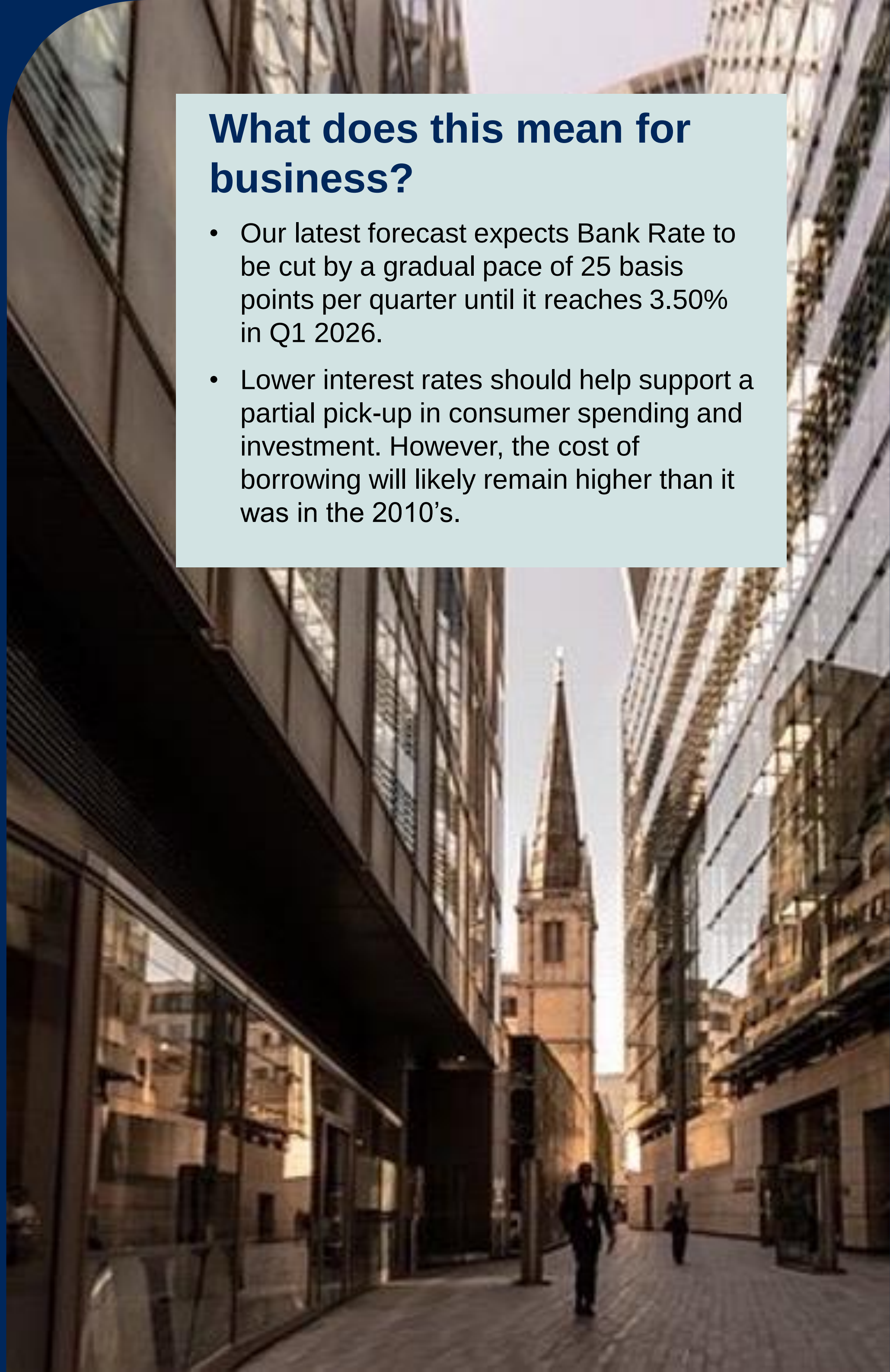
Looking ahead, our latest forecast expects that the MPC will reduce Bank Rate by 25 basis points each quarter until reaching a terminal rate of 3.50% in Q1 2026. This would leave monetary policy in a slightly restrictive stance, as the MPC looks to bring inflation down to the 2% target in the medium-term.

The more gradual pace of interest rate cuts in our latest forecast, compared to June, reflects our higher inflation forecast and the cautious forward guidance of the MPC. Notably, Governor Bailey has emphasised that the Bank expects inflation to return to target in the medium term (i.e., 2027, which is beyond our own forecast horizon) under a similar interest rate trajectory.

Alternatively, we could see a scenario in which structural changes in price and wage pressures, combined firmer inflation post-Budget, could potentially lead to the Bank Rate reducing at an even slower pace than what's assumed in our baseline forecast.

What does this mean for business?

- Our latest forecast expects Bank Rate to be cut by a gradual pace of 25 basis points per quarter until it reaches 3.50% in Q1 2026.
- Lower interest rates should help support a partial pick-up in consumer spending and investment. However, the cost of borrowing will likely remain higher than it was in the 2010's.



Global growth set for steady growth, but divergences persist

The IMF's World Economic Outlook update for January projects that global GDP will grow steadily at 3.3% in 2025 and 2026, broadly unchanged from their October projections. Global inflation is set to decline to 4.2% in 2025 and 3.5% in 2026, which should allow major central banks to continue loosening policy.

The IMF expects that the US will experience stronger GDP growth than previously projected, driven by robust demand and strong productivity growth. Meanwhile, modest increases in output are anticipated in the Eurozone, reflecting headwinds such as low consumer confidence and persistently high energy prices. UK growth is set to be moderate in 2025 and 2026, with the IMF projections mirroring our recent forecast. Growth in China is expected to gradually ease due to weak domestic demand and trade policy uncertainty, while India is set for continued solid expansions in GDP through 2026.

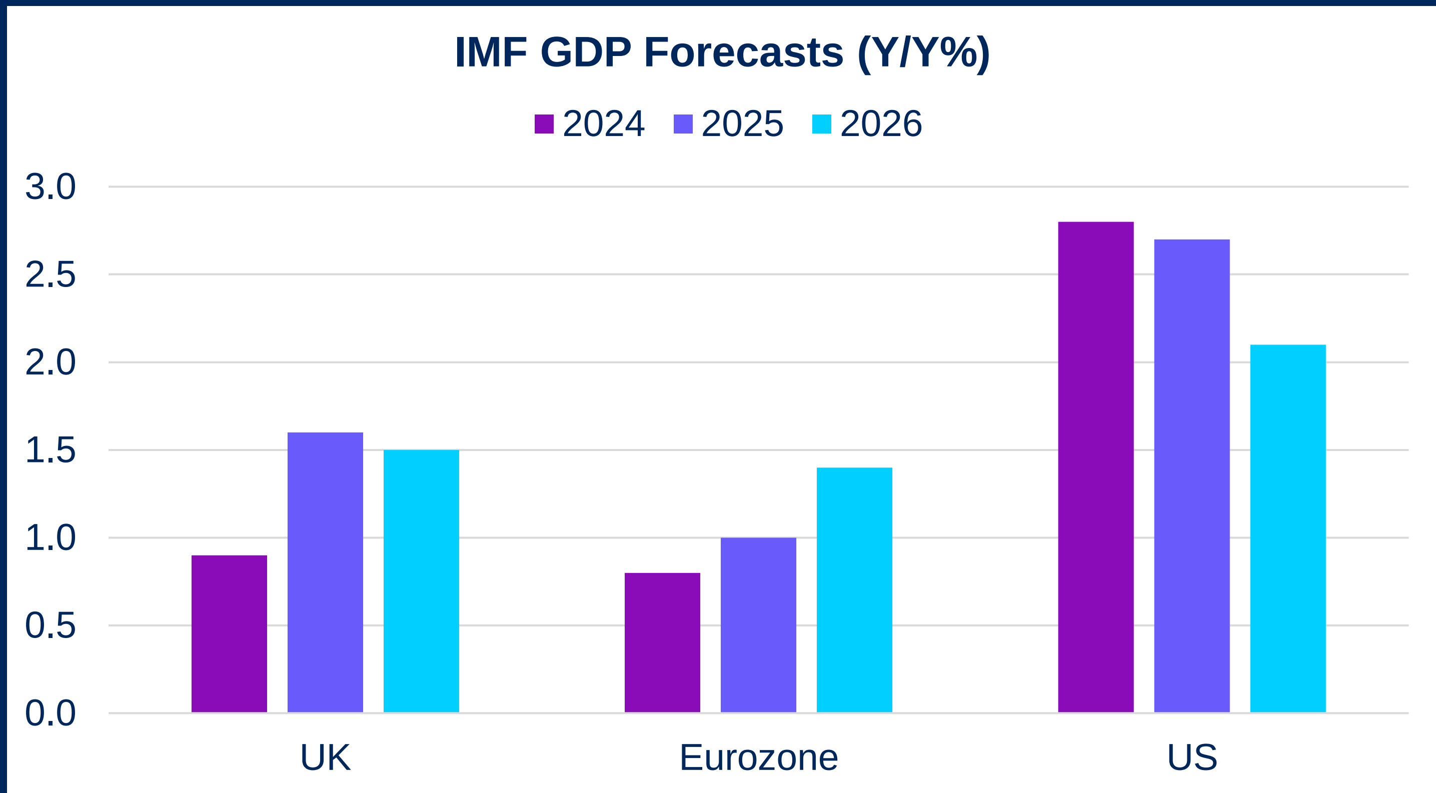
Global risks are centred around economic policy uncertainty, with noticeable divergences across countries and regions in the near-term. China and the Eurozone are vulnerable to downside risks, such as continued weak demand and elevated trade policy uncertainty. In contrast, risks are tilted to the upside for the US, particularly due to expectations of looser fiscal policy. It's worth noting that the IMF's forecast does not include specific assumptions about potential US policies under the second Trump administration; however, they warn that higher tariffs could result in firmer price pressures.

3.3%

Projected global growth in 2025

3.3%

Projected global growth in 2026



Source: IMF World Economic Outlook

The business view

How are businesses reacting to changes in the UK economy?

Demand conditions

Businesses reported mixed sectoral performances in recent months.

- Business-facing services firms observed a stop-start environment, while consumer-facing services continued to see weak consumer confidence holding back sales.
- Manufacturing sector performance was mixed, although the aerospace/defence industry reported persistently strong demand.
- Many businesses appeared to be somewhat pessimistic about the near-term economic outlook following the Budget.

Labour market

The Autumn Budget is expected to have significant implications for the labour market, due to the impact of higher employment costs.

- Some businesses announced immediate pauses on hiring following the Budget, while others said they had scaled back hiring plans.
- Recruitment firms reported cautious hiring behaviour from firms, in addition to an up-tick in contracting, rather than permanent, roles being advertised.
- Some global engineering and manufacturing firms said they were considering shifting roles overseas to avoid additional costs.

Cost pressures

Many businesses are expecting to see higher costs as a result of the increase in employer NICs and NLW, with some likely to pass them on to customers where they can.

- Firms in lower margin sectors – such as food services, retail, parts of manufacturing, and logistics – indicated they would have little choice but to try to pass on cost increases through higher prices.
- Large firms appeared more confident about their ability to pass on higher costs, where contracts allowed. Smaller firms, who tend to have less pricing power, said they were more likely to have to absorb cost increases.

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