UK Economic Outlook

September 2024

- Inflation could fall below the Bank of England's target in September but is projected to rise to 3% in early 2025, driven by higher energy prices and a persistent high level of services inflation.
- The Bank of England is likely to take a more cautious approach to easing monetary policy compared to the Fed and the ECB, with a series of gradual rate cuts taking UK base rate to 3.5% by the end of 2025.
- The labour market is set to continue to loosen, with fewer vacancies, slowing pay growth but a relatively modest increase in the unemployment rate.
- UK consumers continue to adopt a cautious approach to spending, while building up savings at a significant pace. This is likely to hold back spending growth, despite steady improvements in household incomes.
- Business investment could recover next year if geopolitical uncertainties ease, and the effect of lower interest rates and the improving growth outlook give businesses the confidence to commit to investment plans.
- The outlook for trade is heavily influenced by the outcome of geopolitical arrangements, including any additional future trade restrictions, while UK exports also continue to be weighed down by the higher value of the pound.
- The UK economy could see growth momentum improving as a result of easing uncertainties and lower interest rates, with GDP growth rising to 1.2% in 2025.
- The Autumn Budget offers a tough test for the new Chancellor as a growing host of spending priorities compete for limited fiscal space even in the event of a minor change to the fiscal rules.

Table 1: Summary of KPMG's latest forecasts for the UK economy

	2023	2024	2025
Real GDP	0.1	1.0	1.2
Consumer spending	0.2	0.4	1.4
Investment	2.2	1.0	1.2
Unemployment rate	4.0	4.3	4.4
Inflation	7.3	2.6	2.5
Base interest rate	5.25	4.75	3.50

Source: ONS, KPMG forecasts. Average % change on previous calendar year except for unemployment rate, which is average annual rate, while interest rate represents level at the end of calendar year. Investment represents Gross Fixed Capital Formation, inflation measure used is the CPI, and unemployment measure is LFS.

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Inflation: Not out of the woods yet while interest rates could stay higher for longer

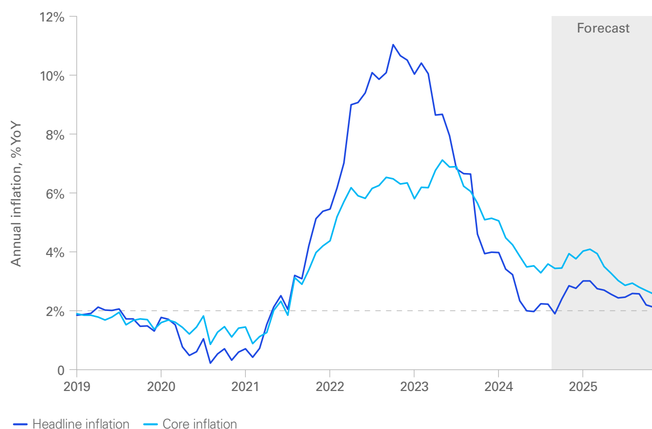
UK inflation is projected to fall below 2% in September but is set to rise again over the coming months, peaking at 3% in early 2025. Until recently, lower energy prices offset the more persistently high core inflation, in particular services price inflation; but this effect was only temporary. After returning to target in May for the first time since September 2021, inflation reached 2.2% in August.

The new Ofgem price cap is expected to see household energy prices rise by 10% in October, while at the same time the effects from past falls in gas prices drop out of the annual comparison. In addition, while growth in food prices has slowed significantly since the start of the year, forward-looking indicators point to only marginal further easing in food price inflation towards the end of the year.

Core inflation, which excludes more volatile categories such as energy and food prices, could peak early next year and gradually moderate to 2.4% by the end of 2025. Increases in core inflation are being indirectly fuelled by the impact of higher energy prices, and a faster pace of increase in producer prices points to some upwards momentum. Nonetheless, we expect this to be partially offset by moderating services inflation, as wage growth slows, as well as the impact from a stronger pound. Headline inflation is therefore projected to return to the 2% target by the end of next year in line with slowing core inflation (see chart 1).

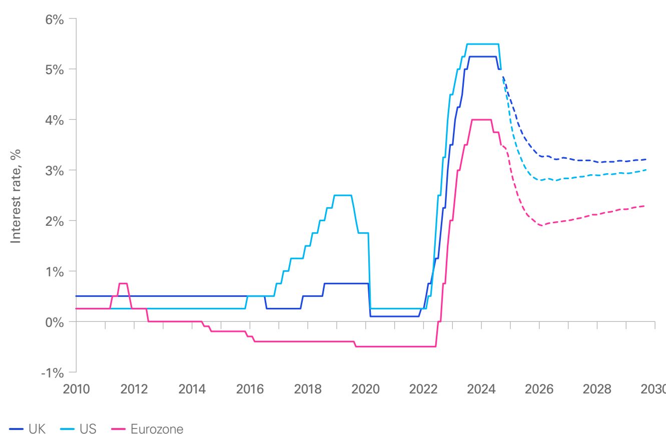
The Bank of England (BoE) opted to hold interest rates in September at 5%. The BoE is expected to cut rates in November only this year. The UK economy's relatively strong growth in the first half of the year reduces the need to urgently bring interest rates down to support activity, while some Monetary Policy Committee (MPC) members are still accentuating the risk of inflation remaining persistently above target. The BoE may therefore favour a more gradual series of small cuts. We expect interest rates to be cut next year at a quarterly pace, and reach the neutral rate of around 3.5% by the end of 2025. This contrasts with the Eurozone where growth has been more sluggish, creating an expectation for multiple rate cuts this year. Deeper cuts are also expected in the US following signs of a weakening labour market (see chart 2).

Chart 1: Inflation has risen above target again



Source: ONS, KPMG projections.

Chart 2: UK rates to ease more gradually than in the US and the Eurozone



Source: BIS, FRED, LSEG Datastream, Bank of England, ECB, KPMG analysis.
Yield curves shown as of 19 September.

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Labour market: Firms could see easier hiring and weaker wage growth ahead

The UK labour market is continuing to loosen despite strong economic growth over recent quarters. Vacancies have continued to trend downwards, falling to their lowest level since mid-2021, and returning close to pre-pandemic levels. While uncertainty remains regarding the ONS' Labour Force Survey estimates, more timely survey evidence points to a more pronounced loosening in the labour market than unemployment figures alone would convey. The latest 'KPMG and REC, Report on Jobs' suggests employer hiring intentions remain muted, continuing a near two-year decline in permanent placements.

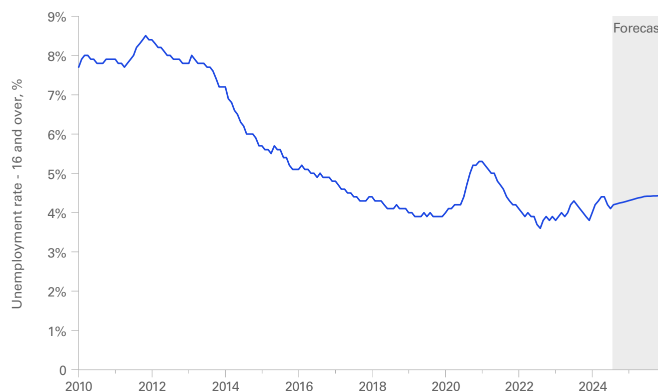
A recurrent theme in the UK labour market since the pandemic has been a steady rise in inactivity, which has increased from 20.5% in February 2020 to 21.9% in July 2024. This has been driven in part by an increase in the number of people who are long-term sick. The rise in inactivity has contributed to employment remaining below pre-pandemic levels despite the strength in activity and has meant more persistent labour market tightness compared to some of the other major western economies. The backlog in NHS waiting lists is expected to remain elevated in the near term and this will likely see inactivity due to ill health continuing to act as a constraint on labour supply.

Nonetheless, firms have been reporting steady improvements in staff availability and fewer difficulties in recruiting workers. We expect unemployment to remain relatively low in historical terms, potentially rising to 4.4% by the end of 2025 (see chart 3). The rise may further ease some of the constraints on labour supply.

Private sector pay growth has eased significantly over the past year, falling to 4.9% in July 2024 compared to 8.1% a year earlier. Public sector pay on the other hand remained more elevated at 5.7% and we expect a pick-up over the coming months, aided by the recently announced pay settlements. This is unlikely to change the overall direction for pay growth, however, partly because the recent pay settlements reflect a catch-up of public sector pay, which has grown by around 22% since the pandemic compared to private sector pay which has risen by 27% during the same period.

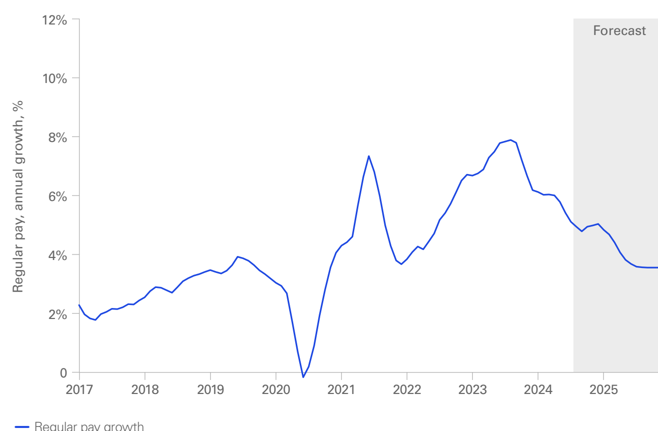
Pay growth is expected to continue to moderate over the coming year, as a slowing labour market reduces workers' bargaining power, while lower inflation reduces the need for higher nominal wage growth to sustain workers' purchasing power. Pay growth is therefore expected to ease to levels that are more consistent with the inflation target by the end of 2025, falling to around 3.5% (see chart 4).

Chart 3: Unemployment is expected to rise slightly



Source: ONS, KPMG projections.

Chart 4: Pay growth could ease further in the coming months



Source: ONS, KPMG projections.

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In focus: Higher savings one of the headwinds for consumer spending outlook

UK consumers have been putting a significantly higher proportion of their income aside since the pandemic, which may continue dampening spending growth. Some of the increase in savings reflects a response to higher interest rates and would be expected to at least partially unwind as interest rates fall back towards their long-term equilibrium level. But a significant part of the increase in savings could prove more persistent, owing to longer term demographic trends, as well as increased caution in response to a more volatile economic environment.

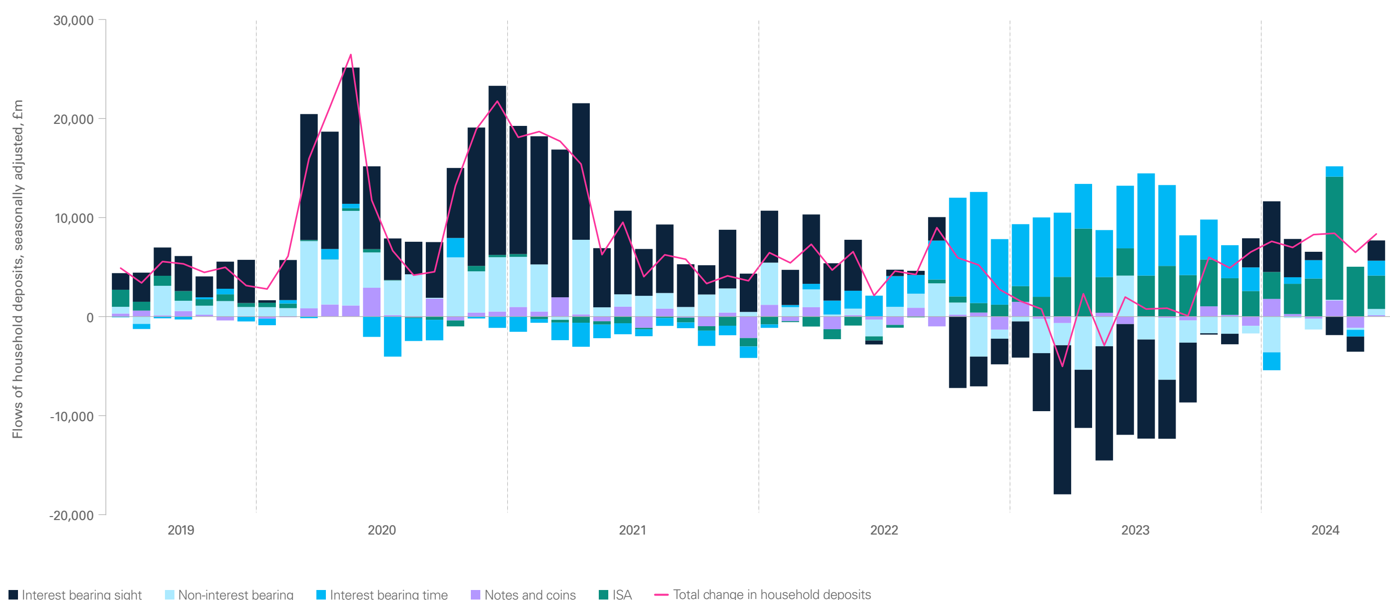
As chart 5 shows, the difference between the saving rate before and after the pandemic has been more pronounced in the UK than in some of the other advanced economies; in the UK, it almost doubled from the average in 2019. While the UK saving rate remains below the level in France and Germany, it is now similar to that in Italy, and well above the US, which saw savings decline compared to 2019. Other European economies, such as Spain and Portugal, have also experienced a significant rise in the saving rate, although not to the extent of the rise in the UK.

Households' new saving habit may be more permanent given where they hold their savings. While during the pandemic extra savings were largely held in easily accessible deposits, such as current accounts, since 2022 more savings have gone to time deposits, and 70% of the changes in household deposits with financial institutions since the start of 2024 went into individual savings accounts (ISAs) (see chart 6).

Chart 5: Saving rates for a selection of advanced economies

Source: ONS, US Federal Reserve Bank of St Louis, Eurostat, KPMG analysis.

Chart 6: Household deposit flows



Source: Bank of England.

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Higher saving has come at the expense of consumer spending, particularly on the categories of goods and services seen as non-essential by households. Chart 7 shows that spending on delayable categories, such as furnishings, has in 2024 been persistently below the level of the preceding two years. This coincides with evidence from consumer confidence surveys, which shows lower willingness to make major purchases compared to 2019 and points to increasingly cautious consumers. GfK Consumer Confidence Barometer dipped in September in anticipation of potential changes to tax and benefits in the Autumn Budget.

If the increased saving reflects a more persistent shift in household preferences and outlook, it could mean that a recovery in spending levels, particularly for delayable expenditure items, could take longer. Modelling conducted by the ONS[1] suggests that around half of the increase in savings so far could not be explained by either the effect of higher interest rates or increases in precautionary saving against a higher risk of unemployment. Instead, according to the ONS analysis, this may reflect a combination of consumers' response to heightened economic uncertainty and the cost-of living crisis.

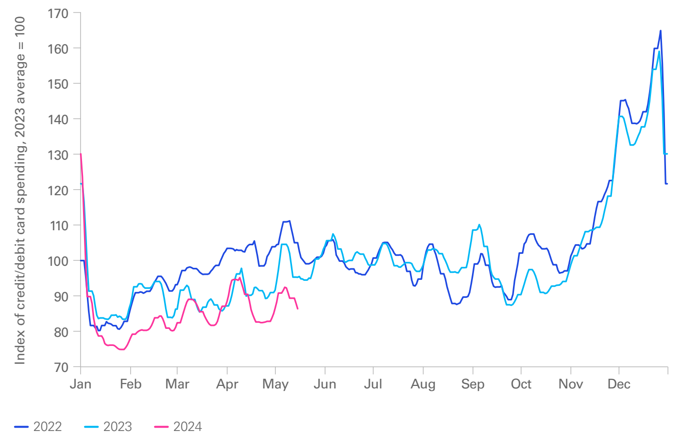
The continuing drag from higher levels of saving could lead to only moderate growth in consumer spending over the course of 2024 and 2025, estimated to reach 0.4% and 1.4% respectively. While household real incomes have seen steady increases from the middle of 2023, driven by positive real wage growth, this has led to only modest increases in consumption, with households instead choosing to increase savings.

Consumer spending remains below its pre-pandemic level and under current growth projections may only regain that level by the second half of 2025 (see chart 8). The shortfall is driven by a 9% reduction in spending on transportation and communication services, which has been largely caused by changes in working patterns and may reflect a more durable trend, although most other categories are also down and could take some time to return to their 2019 levels.

Longer term trends in demographics, with people expected to live longer in retirement, are unlikely to be responsible for the sharp increases in savings since the end of the pandemic, as these changes have been much slower and gradual. Nevertheless, these trends are likely to reinforce the need for higher savings in the long run. The latest demographic projections for the UK show that the size of the 60+ age group is expected to increase by more than 22% by 2040 compared to 2023, supported in part by increases in life expectancy.

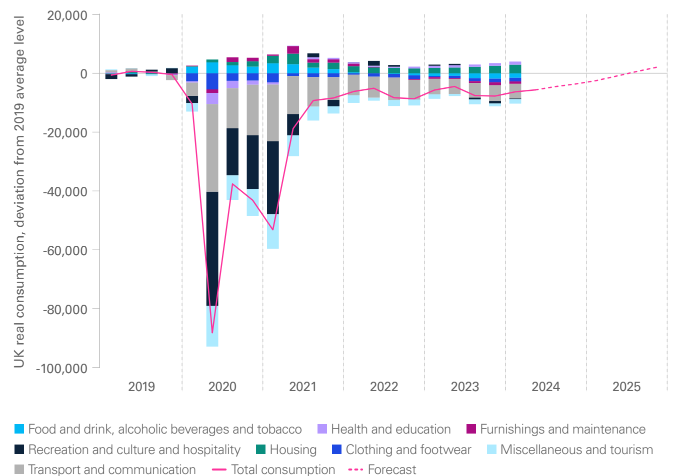
Looking ahead, with base interest rates expected to settle at a somewhat higher level than prior to the pandemic and the effects of an ageing population taking hold, higher saving stocks could continue dampening consumer demand.

Chart 7: Consumer credit and debit card spending on delayable categories



Source: Bank of England via ONS, KPMG analysis.

Chart 8: Outlook for consumer spending compared to 2019 levels



Source: ONS, KPMG projections and analysis.

1 Office for National Statistics (ONS), released 22 July 2024, ONS website, article, Households' finances and saving, UK: 2020 to 2024

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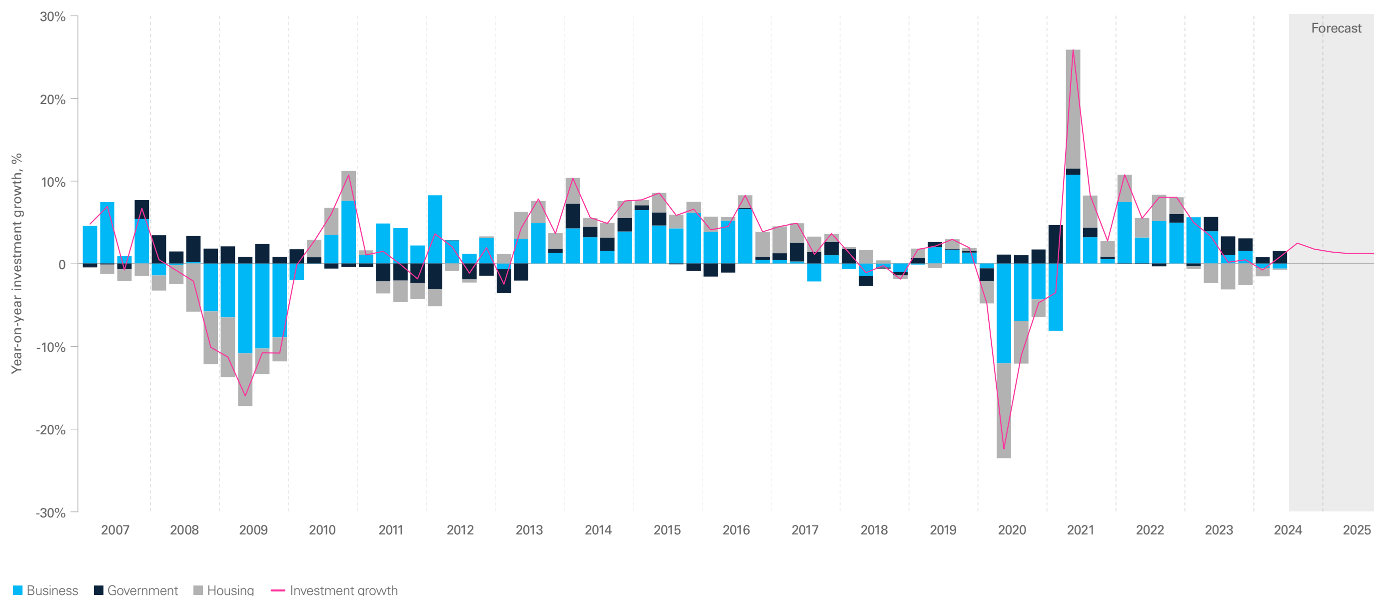
Investment: Picking up the pace

Overall investment growth is expected to accelerate, as further interest rate cuts reduce the drag on business investment, while the new government's focus on accelerating economic growth could also help spur a positive momentum. This follows a weak start for business investment in 2024, which was partly offset by stronger housing and government investment. Surveys suggest that this pattern may persist through the second half of the year as businesses wait for a more substantial reduction in borrowing costs before committing to new investments later in 2025. And while there is some uncertainty regarding the scope for further increases in public sector investment due to the limits on public sector borrowing, we expect a moderate pace of increase, as these investments would naturally form an essential component of policies aimed at accelerating economic growth, which the government has committed to. We expect that overall investment growth could reach 1% in 2024 and rise to 1.2% in the following year (see chart 9).

After a strong first quarter, housing investment fell back slightly in the second quarter, coinciding with expectations for a more gradual path of cuts in interest rates. We expect a renewed expansion in housing investment, although recent government announcements of changes to the planning regime could take several years to fully make an impact.

Chart 9: Composition of investment and outlook



Source: ONS, KPMG analysis and projections.

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Trade: Uncertain outlook ahead

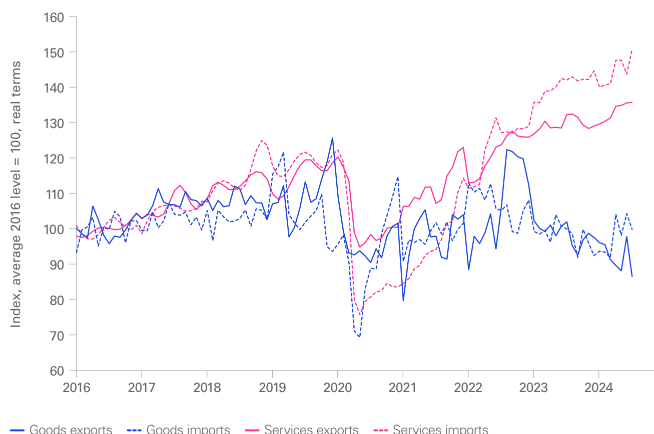
UK exports could see a modest pace of growth, with continuing strength in services exports offset by relative weakness in the trade of goods. While UK goods exports in the second quarter of this year were still 15% below the average level for 2019, UK service exports were up by 17% (see chart 10). The differing fortunes of goods and services exports potentially reflects changes to the structure of the UK economy, as well as higher trade costs for goods in the aftermath of Brexit. However, a potential regulatory divergence with the EU would likely raise trade costs for services over time, although the impact is likely to be more gradual.

The pound appreciated, largely due to diverging expectations for interest rates compared to some of the UK's major trading partners, hurting the competitiveness of UK exports. Since the start of the year, the value of the pound has risen by 3.7% against the basket of currencies of countries that the UK trades with.

The growing threat of additional protectionist measures by some of the UK's major trading partners is adding to uncertainty about future demand for UK exports. Measures could include higher tariffs, which would raise the relative cost of UK goods abroad, and likely lead to a weakening of global demand.

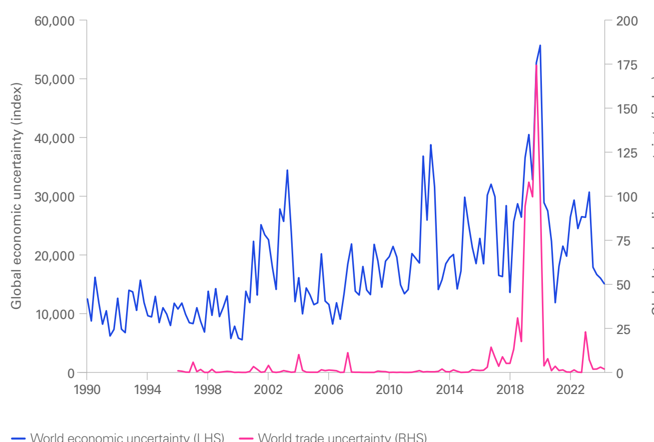
For example, our analysis found that if a country like the US imposed a flat 10% tariff on most intermediate goods it imports, this could lead to a reduction in UK GDP growth of around 0.3%. It may also cause firms to postpone investment due to higher levels of uncertainty, further damaging growth, however it is difficult to quantify such impact. Chart 11 contrasts the steady increases in global economic uncertainty over the past three decades with the sharp spike in 2019, which was driven by higher uncertainty in trade policy due to an expansion of US tariffs on imports from China.

Chart 10: UK goods and services trade flows



Source: Bank of England, LSEG Eikon, KPMG analysis.

Chart 11: Global trade and economic uncertainty have increased



Source: Ahir, H, N Bloom, and D Furceri (2022), "World Uncertainty Index", NBER Working Paper.

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GDP: Muted economic growth momentum ahead

Following a rebound at the start of the year, UK GDP growth is expected to have slowed again in the second half of 2024, with the economy on course to grow by 1% this year overall. A pick-up in investment and a weakening of import demand, as well as stronger government spending supported the first half of the year. The absence of these factors in the second half of the year could see growth slow in line with a more muted pace of consumption and investment growth (see chart 12).

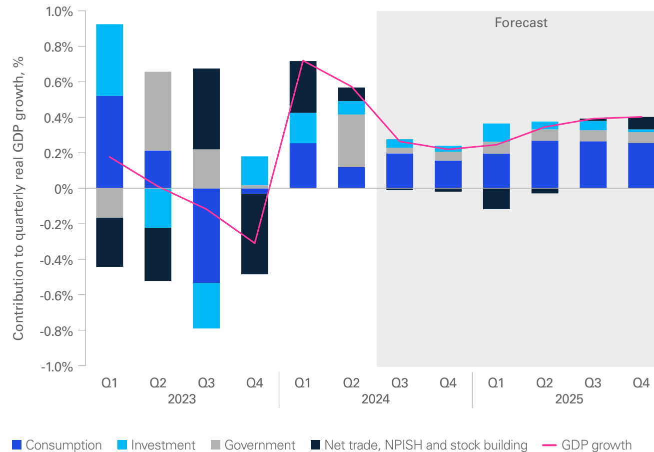
GDP growth could pick up slightly in 2025 to 1.2% as a less restrictive monetary policy and continued improvements to real wages are expected to support stronger growth in consumption and business investment.

Among the main sector groups, growth momentum picked up in manufacturing and construction while easing for services (see chart 13). Going forward, the more uncertain geopolitical environment is a particular source of uncertainty for manufacturing growth. A potential downside scenario, which sees an increase in global tariffs, could impair overall goods trade flows and disrupt existing supply chains leading to a weakening of demand for export-oriented manufacturing.

Longer term GDP growth is challenged by a historically weak pace of productivity growth, which could limit growth in the medium term to around 1.1% per year, assuming average annual productivity growth of around 0.6%. This represents a significant slowdown compared to the pace of growth prior to the Financial Crisis of 2008 and reflects the global slowdown in productivity improvements, although UK productivity growth has performed worse than many other advanced economies, in particular the US.

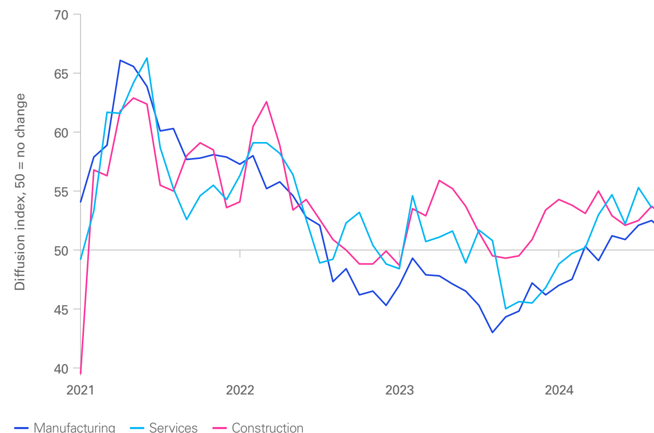
There may not yet be sufficient evidence to point at either new technology or changes in public policy that could deliver a meaningful boost to UK productivity growth. While the new government has made achieving stronger growth one of its key priorities, policy details are still outstanding and available funding limited in the context of tight public finances. The potential of new technologies such as AI to lift productivity growth hinges on whether they can fulfil the promise of a true general-purpose technology. Estimates of the potential impact of AI on productivity vary, and while there is a chance for it to become an outsize influence on growth, our own analysis points to a relatively modest impact over the next decade[2].

Chart 12: GDP growth expected to slow after a strong start to 2024



Source: ONS, KPMG projections.

Chart 13: Growth has slowed but broadened across the main sectors of the economy



Source: LSEG Datastream.

2 KPMG, 2023, Generative AI and the UK labour market.

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Public finances: Making ends meet

The newly elected Labour government faces a difficult set of choices in the upcoming Autumn Budget, as it has limited room for manoeuvre and a long wish list for additional spending on public services and public investment.

Higher than expected outlays on asylum, health, military spending and rail services by the outgoing government, together with the new Chancellor's decision to raise public sector pay, have added an additional £16.4bn to spending pressures in the current fiscal year. Assuming that some of the needs for higher spending are permanent, such as the increases to public sector pay, it could see higher borrowing also in future (see **chart 14**). This further shrinks the already limited headroom against the current fiscal targets to an estimated £7.6bn, from £9.3bn at the time of the March Budget.

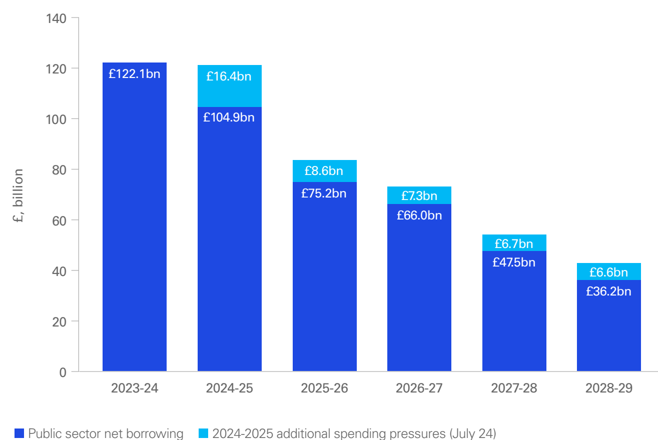
The limited headroom and political constraints leave little space to address urgent spending needs. We estimate these could total in excess of £100bn if the government wants to restore spending closer to historic trends. The largest and most acute area where spending pressures are apparent is health. As health spending tends to rise over time due to demographic pressures and innovation, a given level of service corresponds to a rising spending on healthcare in proportion to GDP. UK spending on health saw steady increases as a share of GDP in the lead up to 2010, but then remained broadly flat until the outbreak of the global pandemic. Bringing health spending back in line with the pre-2010 trend would require an estimated £60bn of extra spending in the current fiscal year. If the government chose to also unwind the reduction in spending since 2010 on public order and safety, environmental protections, and education, as well as increase defence spending to 2.5% of GDP, the total figure rises to £125bn of additional current annual spending. As this represents a permanent increase in spending, for this to be sustainable, it would need to be covered by increases in taxation rather than increases in borrowing, or alternatively by finding cuts in other spending areas. As noted above, we do not believe this is feasible in the short term but it gives a sense of the scale of the challenge the government faces to improve public services.

Additional funding will also be needed to achieve the highest sustained growth in the G7, one of the government's stated missions. That would require lifting the pace of long-term productivity growth. While achieving this goal may be difficult, it would inevitably require higher levels of public sector investment upfront, which could put further strain on public sector finances.

The potential options for raising revenues through taxes are limited, as many of the largest yielding tax increases, such as NI and income taxes have been ruled out in the Labour government's election manifesto commitments. This still leaves some areas of smaller revenue sources where higher taxes could raise more, but these are unlikely to deliver a sufficient boost to public finances to cover all the spending needs detailed above.

Another option for the Chancellor is to make changes to the fiscal targets. For example, switching to the a debt measure that includes the Bank of England borrowing – which is currently excluded – while retaining the target of debt falling in the fifth year of the forecast, could add around £16bn of extra headroom. Other, more substantial changes to fiscal targets could be considered, however this also carries risks. While imperfect, the current set of fiscal targets represents some of the least stringent constraints on public borrowing over the past decade and relaxing these further could undermine the ultimate rationale of fiscal targets altogether.

Chart 14: Spending pressures identified in current fiscal year expected to persist



Source: HMT, OBR, KPMG analysis.

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