KPMG

UK Economic Outlook

April 2025

- An uncertain trading environment and a rising tax burden pose downside risks to UK economic growth this year.
- While healthy household saving buffers and strong public spending should support economic performance, the imposition of broader tariffs could reduce UK GDP growth to 0.8% in 2025 and 2026.
- Inflation is expected to peak at around 3.6% by the Autumn as businesses seek to pass on some of the increase in labour costs and consumers face higher utility bills, before returning to the Bank of England's target of 2% by mid 2026.
- Interest rates are expected to remain above the neutral rate while the MPC gradually eases monetary policy, with three more cuts pencilled in for 2025 and an additional two cuts in 2026.
- Rising labour costs and weak business sentiment have seen a weaker labour market and are expected to ease pay pressures, while unemployment may rise only marginally.
- The Chancellor faces a significant challenge to adhere to her fiscal rules while pursuing a growth agenda. The fiscal headroom remains tight with the risk of downgrade to the forecast high.

Authors

Yael Selfin
Chief Economist, KPMG in the UK
T: +44 (0)7766 362 369
E: yael.selfin@kpmg.co.uk

Dennis Tatarkov
Senior Economist, KPMG in the UK
T: +44 (0)7468 711 320
E: dennis.tatarkov@kpmg.co.uk

Moustafa Ali
Economist, KPMG in the UK
E: moustafa.ali@kpmg.co.uk

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

	2024	2025	2026
GDP	1.1	0.8	0.8
Consumer spending	0.6	1.3	1.1
Investment	1.5	1.5	1.2
Unemployment rate	4.3	4.5	4.7
Inflation	2.5	3.2	2.3
Base interest rate	4.75	3.75	3.25

Source: ONS, KPMG forecasts. GDP, consumer spending and investment are all measured in real terms. 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 the unemployment measure is LFS.

Contents

External environment 2

UK growth scenarios 4

Outlook for inflation and interest rates 6

The labour market 8

Public finances 10

© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

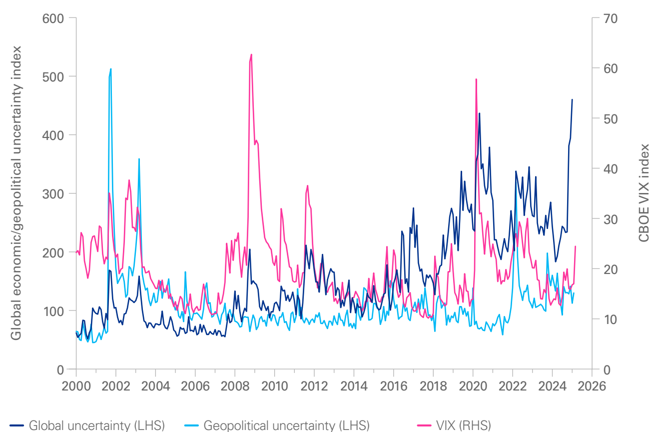
The external environment adds to uncertainty

Escalating trade tensions increase uncertainty around the UK outlook. Frequent and unexpected policy changes as well as a lack of a clear end-goal for US external policy has led to an unprecedented increase in uncertainty for businesses. While some measures have already been imposed, the risk of more tariffs could cause further damage to firms' operating environments.

The atmosphere of pervasive uncertainty has set the conditions for a weakening of business investment as firms respond by delaying investment projects. Measures of global uncertainty have risen (see Chart 1), with the news-based economic policy uncertainty having reached its highest recorded level. Further elevating the risks, frequent policy U-turns and policy adjustments have led to higher levels of volatility across global foreign exchange and financial markets.

The direct impact of uncertainty on growth could be significant, with global levels of business investment potentially held back in the short to medium term. Weaker investment risks impacting longer term growth potential and productivity as well.

Chart 1: Higher uncertainty risks discouraging investment



Source: Caldara, Dario and Matteo Iacoviello (2022), "Measuring Geopolitical Risk," American Economic Review, April, 112(4), pp.1194-1225; Davis, Steven J., 2016. "An Index of Global Economic Policy Uncertainty," Macroeconomic Review, October; CBOE Global Markets.

Note: VIX index represents market expectations for volatility of the S&P500 over the coming 30 days.

Uncertainty on US policy stance leads to a wide range of tariff scenarios

One of the key uncertainties for businesses is the potential exposure to new tariffs this year. Some tariff increases appear inevitable; however, the extent and the scope of measures remains unclear.

Given the damage that tariffs would cause, this creates strong incentives to seek a negotiated settlement that avoids or diminishes the need for tariffs. At the moment, this represents our **upside scenario**, which sees a modest slowing of global growth from 2.8% in 2024 to 2.6% in 2025 without creating a widespread recession. The announced measures incorporated into our **main scenario** include the impact of reciprocal US tariffs in addition to those announced previously.

Given the damage they inflict on the domestic economy, retaliatory measures are likely to fall short of the US tariffs. So far, they have generally been narrower in scope, with countries opting for a range of approaches. In response to steel and aluminium tariffs imposed by the US, the EU has chosen to reimpose retaliatory tariffs on a limited range of goods such as jeans, motorcycles and whiskey, which had been suspended since 2021. Alongside these tariffs we expect an additional 8% tariff on EU imports from the US, imposed in retaliation to US tariffs assumed in the baseline scenario.

1 Includes a lower 10% tariff on energy exports.

© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Higher tariffs create a significant downside risk

Given the uncertainty, we present a range of scenarios that capture some of the risks to trade in the current environment. A more severe escalation of trade tensions is captured in our **downside tariff scenario**.

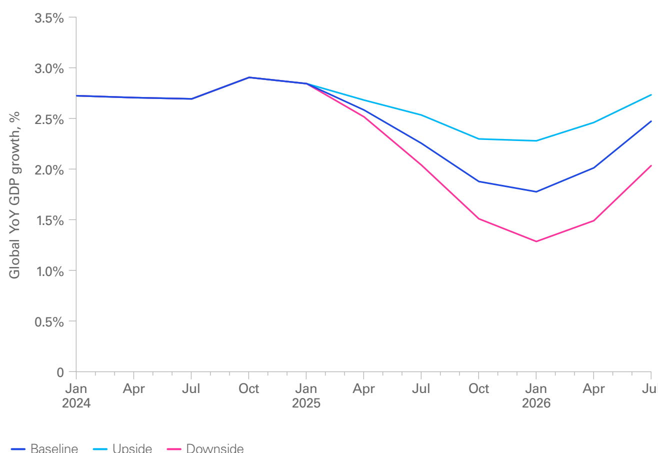
Reciprocal tariffs could lower global GDP by half a percentage point in our **main scenario**, compared to the **upside scenario** in which these tariffs are avoided (see Chart 2).

A **downside tariff scenario**, which sees a 25% tariff imposed on all US trading partners with an equal scale of retaliatory measures, represents a more extreme escalation of trade frictions. This could reduce global GDP by a further 0.5%, significantly raising the risk of recession in affected countries.

Once imposed, tariffs could raise the cost of consumer goods and imported intermediate products, putting upwards pressure on inflation. By suppressing trade flows with the US, tariffs may also lead to an appreciation of the US Dollar against other currencies. This will loosen the inflationary pressures in the US but will add upwards pressure on import prices outside the US. These shifts are usually judged as a one-off change in the price level that leads to a one-off spike in inflation. However, as many economies are still experiencing the fading inflationary impacts of the post-pandemic and energy price shocks, there is a potential risk that the rise in inflation could prove more persistent.

The longer-term impact on global inflation is expected to be negative due to a weaker level of global demand, however the uncertainty about the initial effect on inflation from the imposition of tariffs complicates the task of central banks. We therefore expect global monetary policy to be more restrictive initially although the severity of the tariff impact could prompt central banks to cut rates more quickly in 2026 to support economic growth.

Chart 2: Economic impact of escalating trade frictions



Source: KPMG analysis using Oxford Economics Global Macroeconomic Model.

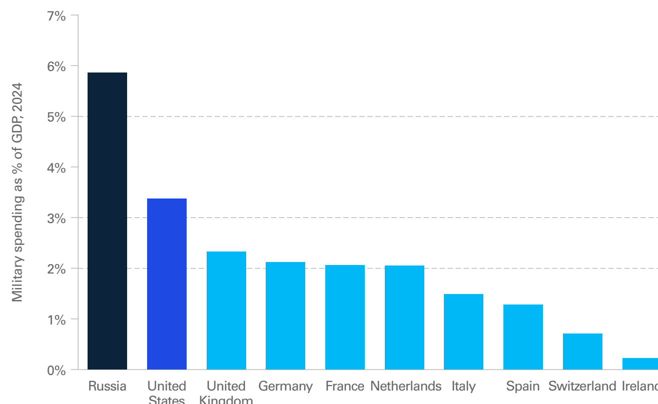
Higher defence spending could support economic growth in Europe

Rising geopolitical fragmentation has led European countries to commit to increased defence spending, which could support economic growth. An increase in public spending on defence represents a stark departure from the decades following the end of the Cold War, when persistent cuts to defence budgets diverted public spending on other areas, especially health and welfare.

The challenge for governments will be to sustainably fund such increases without fuelling voter resentment from higher taxes or cuts to welfare. In the short run, the increase in spending is likely to be funded by higher government borrowing. The scale of the increase is economically significant. Defence spending reaching 3% of GDP across Europe would imply spending an additional US$265bn per year in 2023 prices.

Increases in defence spending offer a potential boost to European manufacturing and other sectors such as energy and dual-use technology. It could also support a broader pick-up in productivity if it leads to an acceleration in the adoption of new technologies.

Chart 3: Significant potential for increases in European military spending



Source: SIPRI, NATO, KPMG analysis.
Note: Data for Russia, Switzerland and Ireland is for 2023.

© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

UK faces multiple headwinds to growth

External headwinds emerging from increasing global trade tensions, coupled with domestic worries over a rising tax burden, are expected to dampen UK growth prospects in the short term.

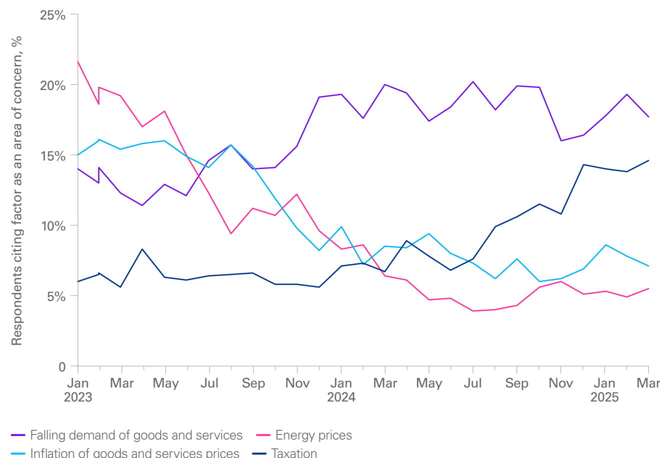
Rising tax burden has dented confidence and growth

The underlying UK economic picture is one of weakness, with both hard economic data and soft survey evidence pointing to feeble growth prospects across a range of economic sectors this year.

The UK economy slowed in the second half of 2024, coinciding with a steady decline in business and consumer confidence. While confidence has shown some tentative signs of recovery early this year, GDP growth continued to disappoint, with the economy shrinking in January.

As Chart 4 shows, concerns by businesses over taxation have increased, driven by the rising burden of employment taxes following changes introduced in the 2024 UK Budget. This has largely replaced worries over energy prices and elevated inflation, with both factors falling in prominence since 2023. Falling demand remains the biggest concern, reflecting the prevalence of uncertainty in the growth outlook.

Chart 4: Growth and tax burden have come to dominate business concerns



Source: ONS.

Global uncertainty could damage investment prospects

Global uncertainty and declining business sentiment may also damage investment intentions, leading to a slowdown in the pace of business investment growth, despite the gradual cuts to the Bank of England base rate. We expect weaker private sector investment to be partially offset by more rapid increases in public sector investment, which grew by 3.9% in 2024, and is expected to rise by 3.4% in 2025 and 3.6% in 2026. Overall investment is expected to increase by 1.5% this year, and 1.2% in 2026.

Global trade frictions threaten UK exports growth

The US imposition of tariffs and subsequent escalating trade frictions are expected to see the contribution from net exports remain negative in both 2025 and 2026. Weaker exports to the US, as well as a slowdown in growth among the UK's other trading partners, could weigh on growth.

Trade intensive manufacturing sectors, such as automotive manufacturing, are particularly exposed to the intensification of trade frictions given the complex supply chains of some producers, especially if these goods face a higher product specific tariff. Similarly, US steel and aluminium tariffs have the potential to damage the revenues of firms in the industry, both through the impact on lower sales to the US market and through the likely fall in prices. However, lower input prices could improve the profitability of construction and other manufacturing businesses in the UK.

© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Saving buffers to support consumer spending

Despite the decline in consumer sentiment, we expect to see some uptick in consumer spending. UK consumers have been saving more in recent years, with the ratio of savings to income reaching a peak of 12% in the fourth quarter of 2024. If households decide to spend a slightly larger share of their income, as per our forecast outlined in Chart 5, this could raise the growth rate in consumer spending in 2025 and 2026 to 1.3% and 1.1%, respectively; up from 0.6% in 2024.

Public sector to play an increasing role in driving growth

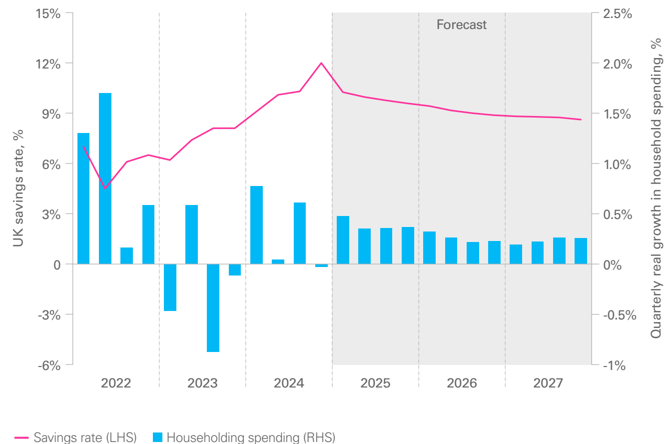
Following the surge in public sector spending during the Covid-19 pandemic, government spending has settled at a higher share of GDP (see Chart 6). By the end of 2024, the public sector has accounted for a quarter of overall UK GDP, up by seven percentage points since 1997. This increase has been accompanied by a rising tax burden and illustrates the growing role of the state in the economy.

The relatively frontloaded increases in spending announced in the 2024 Autumn Budget remain a key driving force for sustaining economic growth in the next two years.

UK manufacturing could benefit from increased European defence spending

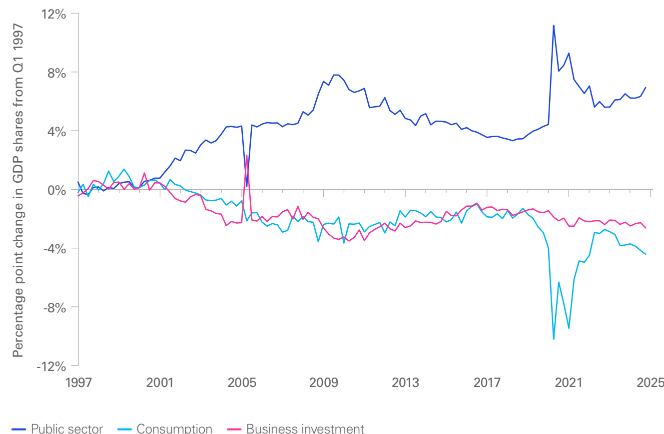
The announced higher defence spending commitments in the UK and Europe offer an upside to economic growth. The UK defence manufacturing sector could be well positioned to benefit from the increased spend, as it represents around 36% of total European arms manufacturing. In addition, a large part of the initial phase of the increase in spending is likely to be directed towards procurement as European countries invest in equipment and stocks needed to supply a larger military.

Chart 5: Savings could support household consumption



Source: ONS, KPMG analysis and projections.

Chart 6: Public spending accounts for an increasing share of the UK economy



Source: ONS, KPMG analysis.

© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Higher labour costs and tariffs add uncertainty to the outlook for inflation and interest rates

Inflation is expected to rise over the coming months and remain slightly above target over the next two years. Upward pressure to inflation will come from several sources, with households facing another steep rise in utility bills, and businesses look to pass on increases in the cost of labour.

Regulated utility prices for water and energy rose sharply in April, with the increase in the Ofgem energy price cap causing household energy bills to rise by more than 6%. That alone could add 0.3 percentage points to inflation in the second quarter. Water bills have also risen substantially, with average prices increasing by nearly 30% in April, adding another 0.1% to the headline inflation rate.

Higher labour costs will see prices rise in the near term

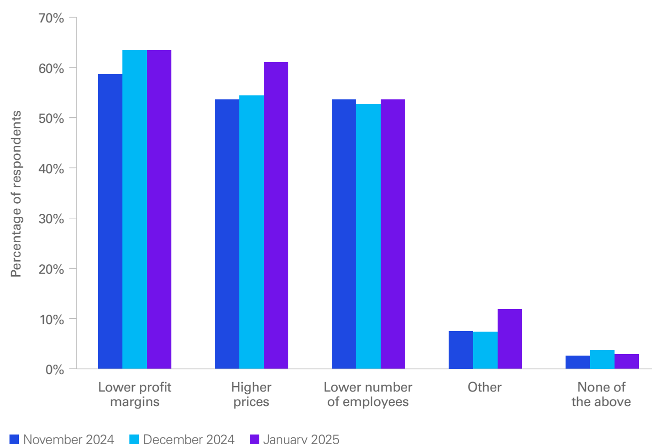
The National Living Wage increase of 6.7% in April, and the increase in employers' National Insurance Contributions (NICs) have seen labour costs rise substantially. The latest data from the Bank of England's Decision Maker Panel survey shows that 61% of firms intend to raise prices in response to the increase in employers NICs. However, a similar share of 63% are also expecting to absorb some of the higher costs through lower profit margins (see Chart 7).

Several factors are likely to limit the ability of businesses to raise prices. The weak domestic demand environment will erode firms' pricing power, making it more likely that they will adjust by cutting costs in other areas. More than 60% of businesses have also signalled their intention to reduce staff headcount.

We expect that a combination of cutting costs and absorbing the increase through lower margins will be the most common approach. Sectors that are labour intensive and employ a higher proportion of low wage workers, such as retail and hospitality will be facing the most acute cost pressures, with profit margins already thin. Nonetheless, we expect some price increases to feed through to consumers.

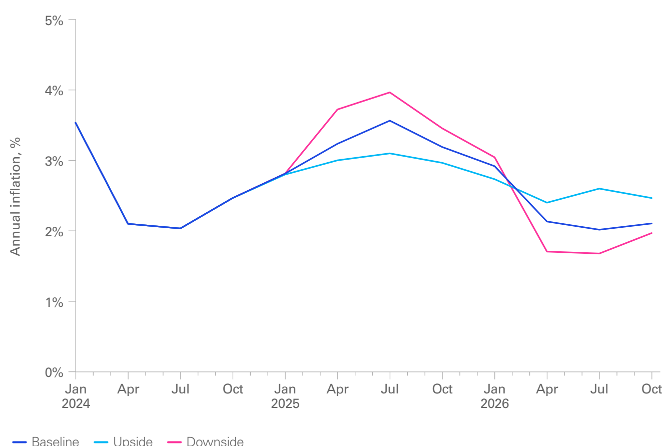
Increased price pressures for retailers will likely translate into higher food prices over the coming months. Food price inflation increased to 3.9% in February, and we expect it to rise further and peak at 4.5% by the summer. Overall, the combined impact of tax increases, higher energy costs and food prices will see headline inflation peak at around 3.6% by the Autumn (see Chart 8).

Chart 7: Most businesses are expecting to increase prices in response to the NICs hike



Source: Decision Maker Panel.

Chart 8: Outlook for inflation could be impacted by tariffs



Source: KPMG modelling based on Oxford Global Economic model.

© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Trade frictions add uncertainty to inflation outlook

External developments are also set to add further upside risk to the inflation outlook. In our baseline scenario we expect inflation to rise gradually from 2.8% in Q1 2025 to a peak of 3.6% in the Autumn. We then expect inflation to fall gradually, returning to target by mid-2026 as the impact of tariffs will weaken domestic demand over the medium term (see Chart 8). The overall outlook for inflation is clouded by uncertainty and as depicted in the alternative scenarios, the path for inflation could be higher or lower depending on changes in trade policy.

Downside risks to the inflation forecast could also come from potential trade diversion which could see countries divert exports to the UK and potentially attempting to sell any excess stock at discounted prices. This could add to disinflationary pressures in the short term.

BoE will continue to ease rates once clearer picture emerges

Heightened domestic and global uncertainty could make the Monetary Policy Committee (MPC) at the Bank of England more cautious about further rate cuts. The pace of cuts over the coming meetings will be determined by the extent to which the domestic shocks households and businesses are facing affect underlying inflationary pressures.

Both short- and long-term household inflation expectations have increased in recent months, and long-term expectations of inflation remain elevated. However, the labour market has significantly weakened since the tightness seen in 2022 and 2023. We expect this to limit workers' bargaining power and put downward pressure on wage expectations in the near term. This should help moderate any second-round effects of any price shocks over the coming months.

The minutes from the March meeting point to most members of the MPC leaving the door open for further interest rate cuts, contingent on the underlying disinflationary process continuing. Nonetheless, the Bank is likely to remain in favour of a cautious approach as it assesses the impact of domestic and global developments on the inflation outlook.

With interest rates currently in restrictive territory, a slow easing approach should help squeeze out remaining inflationary pressures while also continuing with a downward path towards neutral monetary stance. We expect the Bank to cut interest rates three more times this year, taking base rates down to 3.75% by the end of 2025. Next year we expect the BoE to cut interest rates twice more, with rates expected to settle at 3.25% over the coming years, lower than current market expectations of nearly 4% but somewhat above the neutral rate (see Chart 9).

Chart 9: Interest rates expected to fall gradually over the next two years

Source: Bank of England, KPMG projections. OIS as of 3 April.

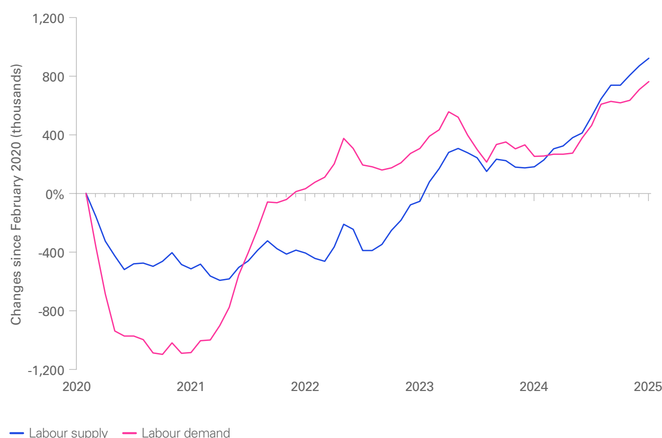
© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Labour market to cool further due to higher tax and uncertain outlook

Following a tight labour market in 2022 and 2023, a more balanced environment has returned, with demand for new hires weakening significantly in recent months in response to economic uncertainty and rising labour costs. A fall in demand for workers has helped reverse the gap between labour demand and supply, which was persistent until early 2024 (see Chart 10).

Higher employment costs, which came into effect in April have been a key driver of the recent weakness in the labour market, with businesses scaling back recruitment when the measures were announced last Autumn. Domestic pressures from higher labour costs and weak sentiment could see labour market activity ease further this year.

Chart 10: The gap between labour supply and demand has reversed



Source: ONS, KPMG analysis. Supply is total workforce participation. Demand is the sum of employment and vacancies.

Higher labour costs pose a challenge to most affected sectors

Nonetheless, not all sectors of the economy will be equally affected by the rise in labour costs. The retail and hospitality sectors could be particularly impacted by the increase in the National Living Wage (NLW) and rise in employers National Insurance Contributions, given the make-up of their workforce.

With labour becoming a more expensive input, this could incentivise firms to make efficiency gains by increasing investment in technology and machinery, boosting labour productivity. However, some of the sectors that are likely to be most impacted could find automation harder to implement.

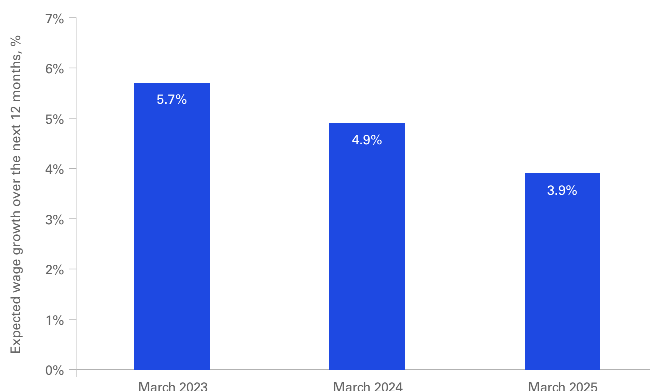
Pay growth expected to moderate despite recent pick up

Wage pressures have accelerated recently, with the latest data for January showing it stood at 5.9%, while the recent increase in the National Living Wage adding a potential upside in the near term. Nonetheless, we expect pay growth to moderate this year, with several factors set to constrain wage increases.

Forward looking survey evidence points to worker demand remaining weak in the near term, which should put downward pressure on wage increases. Additionally, firms have been reporting a steady improvement in staff availability. In the latest DMP survey, 33% of respondents reported they had difficulties in recruiting workers. This is a marked fall from early 2023 when 77% of respondents reported similar difficulties. Furthermore, 7% of firms also reported they are not looking to hire workers, the second highest share reported since the survey began in late 2021. A combination of improved staff availability as well as a fall in recruitment activity should see pay pressures moderate over the coming year. The recent increase in the NLW may provide only a one-off boost for pay growth.

Given the headwinds from labour demand and improvements to labour supply, businesses are also anticipating a fall in wage settlements. The DMP survey points to firms expecting pay growth to fall to 3.9% over the coming 12 months, down from 4.9% a year ago and 5.7% in March 2023 (see Chart 11). This tracks our own view that pay growth will ease over the coming year, closer to levels consistent with the Bank of England's inflation target. We expect pay to fall to 3.7% by the end of 2025.

Chart 11: Businesses expect wage growth to moderate over the coming year



Source: Decision Maker Panel.

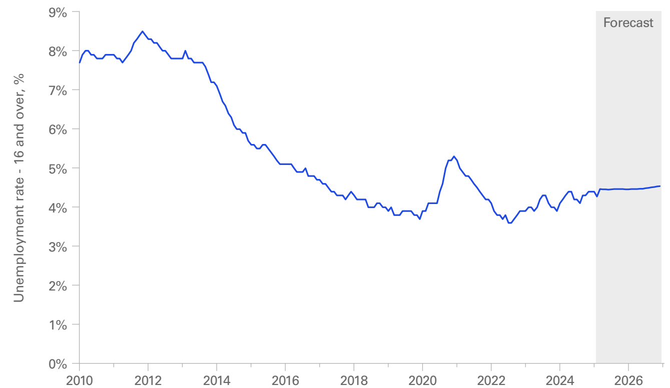
© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Unemployment to remain steady despite pressures

Despite domestic and global headwinds impacting business sentiment, the unemployment rate has remained broadly stable. Unemployment has increased marginally since the autumn, meanwhile vacancies have fallen back sharply from their peak in 2022 to pre-Covid levels. Recent quality issues with the Labour Force Survey may explain the disconnect between sentiment and outturn data – although more timely data from HMRC paints a similar picture of the labour market. While payrolled employee growth has fallen from 1.2% in February 2024 to just 0.2% in February 2025, the number of payrolled employees has been flat over the past six months, consistent with the LFS data that unemployment has not significantly picked up.

Over the coming year we expect unemployment to rise slightly given the increase in labour costs as well as weak business sentiment. However, with economic activity expected to gradually pick up and businesses' borrowing costs set to fall further, it could average just 4.5% in 2025 and 4.7% in 2026 (see Chart 12).

Chart 12: Unemployment is expected to rise slightly



Source: ONS, KPMG projections.

© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Finely balanced public finances create risk of policy instability

The outlook for public finances remains fragile as the small degree of fiscal headroom creates a risk that any deterioration in the economic outlook, however minor, would lead to a further fine-tuning of spending and revenue, potentially adding to policy instability.

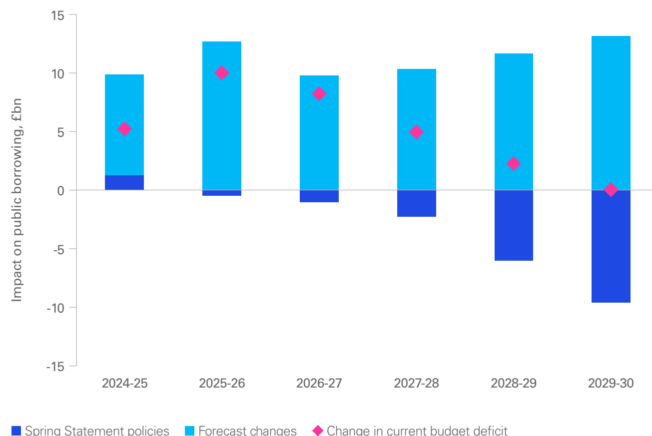
The Chancellor faced a modest downgrade in the outlook for public finances in her Spring Statement in late March, due to a worsening economic outlook. The Office for Budget Responsibility (OBR) recognised the ongoing weakness in the UK economy by revising down its growth forecast for 2025, while conditioning the updated forecast on a higher path of interest rates than at the time of the Autumn Budget last year.

The weaker economic outlook and anticipated higher cost of borrowing led to an expected £14bn deterioration in the current budget deficit in 2029/30, breaching the Chancellor's fiscal rule. This was largely offset by cuts to welfare spending, as well as the re-allocation of spending from aid to defence. Combined policy and forecast changes left the headroom against the government fiscal target of balancing the current budget unchanged at £9.9bn (see **Chart 13**).

Further downgrades at the time of the Autumn Budget are likely, potentially requiring the Chancellor to respond with further spending cuts or tax increases. The judgements of the OBR have remained relatively optimistic in comparison to other forecasters, especially on the projected recovery in the pace of productivity growth, which led the OBR to increase GDP growth forecasts from 2026 onwards. A scenario which instead sees productivity growth continuing in line with the trend since the Global Financial Crisis could lead to a £48.4bn current deficit in 2029/30 compared to a £9.9bn surplus in the main OBR forecast. An escalation of trade frictions with tariffs imposed on the UK and its trading partners is not incorporated into the OBR's current forecasts and represents a further downside risk to public finances.

The Autumn Budget could see another top-up to the overall spending envelope, especially as the Chancellor must now deliver a spending review that allocates the relatively tight spending envelope across government departments. The funding picture for unprotected departments, outside of health, defence, aid and schools is particularly challenging as the adjusted spending plans announced in the Spring Statement imply real terms cuts in funding of 0.8% per year from 2026/27. If these cuts prove unrealistic, overall spending may need to rise, requiring an increase in taxes.

Chart 13: Spring Statement policies offset changes in fiscal position due to a deterioration in economic environment



Source: OBR, KPMG analysis.

© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

kpmg.com/uk/en/**macroeconomics**

© 2025 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

CREATE | CRT160361 | April 2025