UK Economic Outlook

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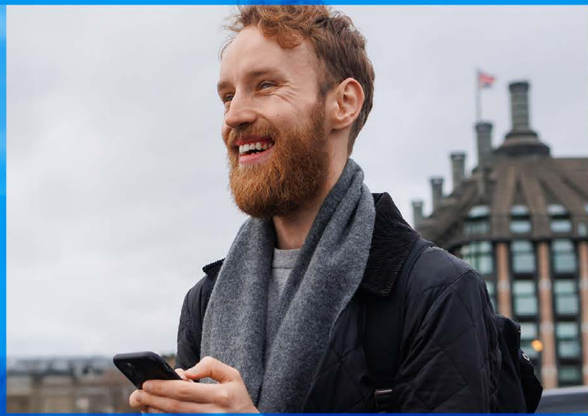

September 2026

- UK growth is expected to remain resilient but slow in the second half of the year as higher energy prices and borrowing costs weigh on activity. We forecast GDP growth of 1.3% in 2026, rising modestly to 1.4% in 2027.
- Consumer spending supported growth in the first half of the year, but rising energy bills and softer wage growth are likely to weigh on household spending power over coming months.
- Business investment remains an important driver of activity, with spending on technology and artificial intelligence continuing to support growth and productivity.
- Higher wholesale gas prices are expected to push inflation higher in the coming months, despite subdued domestic price pressures.
- The Bank of England faces a difficult trade-off between a softening labour market and rising energy-driven inflation, increasing the likelihood of an interest rate rise this year.
- Ahead of the Autumn Budget, higher borrowing costs and weaker growth prospects have reduced fiscal headroom, limiting the Chancellor's ability to fund additional spending commitments.
- Narrowing regional investment disparities could support growth in underfunded parts of the country, although public investment alone is unlikely to close long-standing regional economic gaps.

Table 1: KPMG forecasts for the UK economy

	2025	2026	2027
GDP	1.3	1.3	1.4
Consumer spending	0.9	1.1	1.0
Investment	4.0	2.5	2.7
Unemployment rate	4.8	4.9	5.1
Inflation	3.4	3.1	2.8
Base interest rate	3.75	4.00	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.

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UK growth remains resilient despite headwinds

Following a robust first half of the year, UK economic activity is set to slow in the second half, as higher energy prices and borrowing costs weigh on growth. Household spending remained a key driver of growth (see Chart 1), with consumers continuing to spend despite rising costs.

Warmer weather during the second quarter helped support spending. However, as higher energy costs feed through to household bills and wage growth slows further, households spending power is likely to moderate in the second half of the year, limiting the scope for further spending growth.

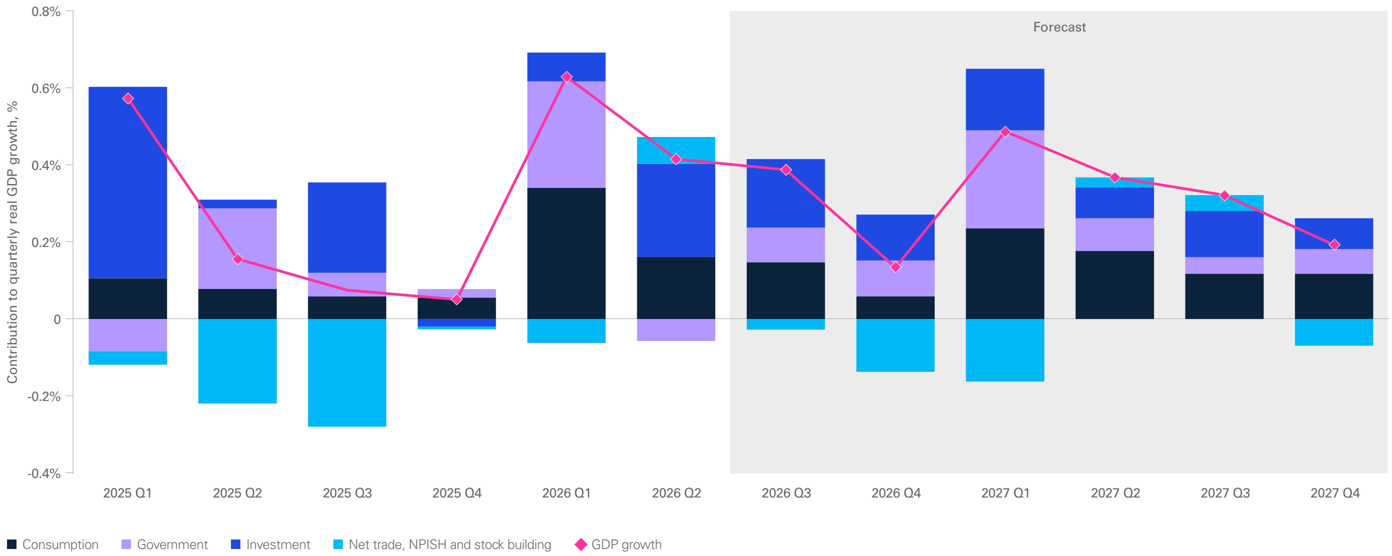
Business investment has also made an important contribution to growth. According to ONS data, much of the increase has been driven by spending on machinery, equipment and technology, with investment in artificial intelligence (AI) playing an increasingly important role. This has also supported activity in related professional services sectors involved in implementing the technology.

Nevertheless, higher costs and continued business uncertainty are expected to weigh on activity during the second half of the year, with GDP potentially rising by around 1.3% this year followed by a 1.4% growth in 2027.

After the Global Financial Crisis, UK GDP growth was greatly aided by a sustained increase in labour supply rather than supported by improvements in productivity. However, an ageing population, persistently high levels of economic inactivity since the pandemic, and lower migration have reduced labour supply growth. This increases the importance of productivity-enhancing investment to support stronger long-term economic growth.

AI has the potential to play an important role in this process, and there are some tentative signs that productivity growth may be starting to recover after a prolonged period of weakness. While the drivers remain unclear, recent evidence suggests the improvement has been broad-based across sectors, which could support a stronger medium-term growth outlook if sustained.

Chart 1: Investment set to remain an important driver of UK growth



Source: ONS, KPMG projections.

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Labour market softening

The UK labour market has continued to soften, with weaker business confidence and higher costs reducing firms' willingness to expand their workforce. The impact has been most pronounced in sectors that rely more heavily on lower-paid workers. Since 2024, businesses have faced a significant increase in employment costs through higher taxes and statutory wage increases, with vacancies falling by 28% in hospitality and 22% in retail (see Chart 2). By contrast, vacancies across the rest of the economy have risen by around 6% since summer 2024, suggesting that higher employment costs have weighed disproportionately on labour-intensive lower-paid sectors.

Younger workers have been particularly affected by the weakening labour market. Unemployment in the 16-24 age group has risen steadily and now stands at its highest level in nearly 12 years when excluding the pandemic.

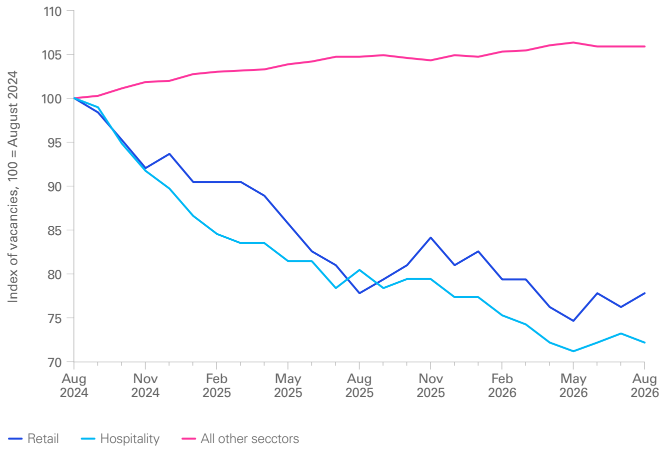
While a larger share of younger workers are employed in consumer-facing industries that were hit particularly hard by rising labour costs, the rise in youth unemployment has also coincided with a significant increase in AI investment by businesses. However, evidence that automation is driving widespread labour substitution remains limited.

While continued uncertainty and weak business confidence are limiting hiring intentions across parts of the economy, recent data suggesting that vacancy levels have stabilised may signal that the worst of the slowdown has passed. This could result in only limited further rises in unemployment, with hiring activity gradually recovering over the medium term.

The combination of weaker hiring activity and an increase in labour supply have contributed to a continued easing in wage growth, as workers' ability to negotiate higher pay diminishes. Headline regular pay growth slowed to 3.5% and was supported by public sector pay settlements. Private sector pay growth, which is generally viewed as a better indicator of underlying labour market conditions remained at 2.9% in July, its lowest since October 2020 and below the level the Bank of England typically associates with inflation returning sustainably to target.

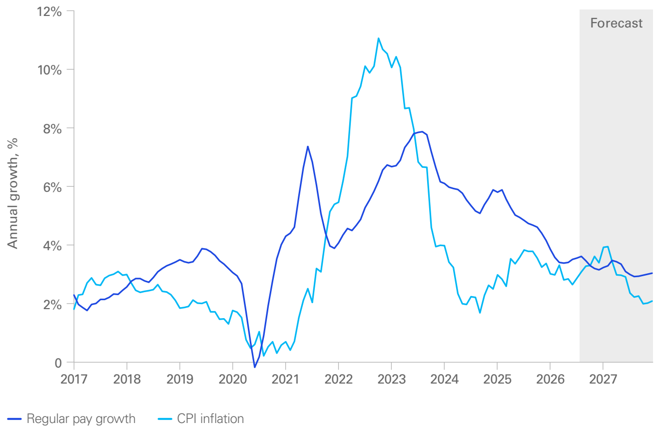
Slower hiring activity and a larger pool of available workers should continue to weigh on pay settlements, limiting the risk that higher wage growth leads to an accelerating inflation, with the rise in real pay potentially slowing even further (see Chart 3).

Chart 2: Higher labour costs have disproportionally weighed on vacancies in retail and hospitality sectors



Source: ONS, KPMG analysis.

Chart 3: Real pay growth is set to slow further



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Energy prices continue to cloud the inflation outlook

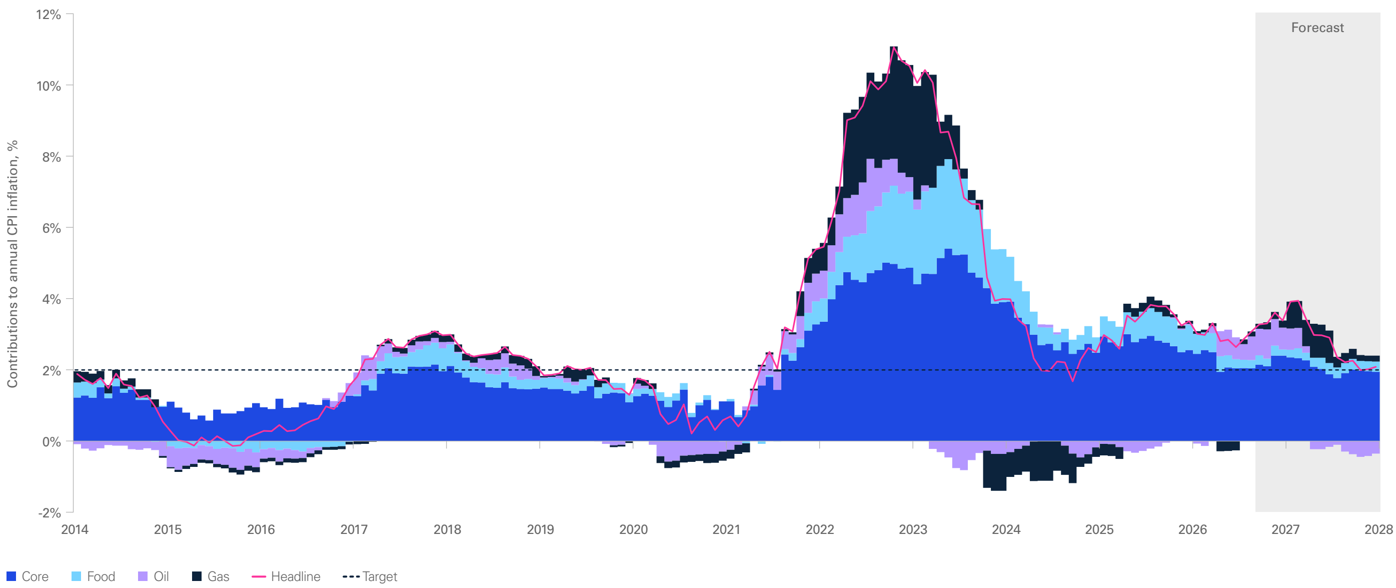
Headline inflation is expected to rise over the coming months as higher wholesale gas prices continue to feed through to household energy bills. While inflation has remained relatively contained since the onset of the latest energy price shock, supported by subdued domestic price pressures and a weak labour market, the impact of higher energy costs is now beginning to filter through to consumers. The Ofgem energy price cap is set to rise by around 4% this autumn, with the Government's reduction in VAT on household energy bills only partially offsetting the increase.

The outlook beyond the autumn is more precarious. At current wholesale gas price levels, households face around a 20% increase in energy bills in January. Lower gas storage levels ahead of winter, combined with the possibility of colder weather, could add further pressure to energy prices over the coming months. As a result, we expect headline CPI inflation to rise to around 3.5% this autumn before peaking at around 4% in the first quarter of 2027 (see Chart 4).

Domestic price pressures remain relatively subdued. Firms have so far shown limited willingness or ability to pass higher energy costs on to consumers, reflecting weaker demand and greater price sensitivity among buyers. At the same time, the easing in labour market conditions has reduced workers' bargaining power, helping to contain wage growth. Together, these factors suggest that underlying inflationary pressures are likely to remain relatively contained.

Assuming energy markets gradually stabilise and energy flows from the Gulf continue to recover, the energy-related boost to inflation should begin to unwind from the second half of 2027. This would see headline inflation fall back sharply, with inflation potentially returning to the Bank of England's 2% target towards the end of 2027.

Chart 4: Higher energy prices to feed through to headline inflation over the coming months



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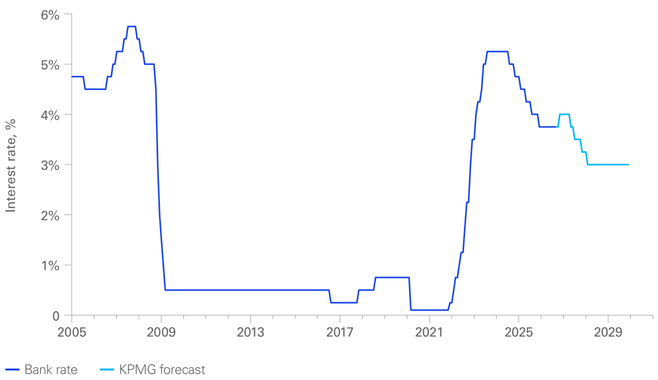
The Bank of England faces a conundrum with a weaker labour market

The expected rise in headline inflation raises the prospect of an interest rate hike this year. Since the start of the year, the Bank of England has balanced the impact of higher energy prices against signs of easing domestic inflationary pressures and a weakening labour market. With headline inflation now projected to approach 4%, the likelihood of a Bank of England rate hike has increased, particularly if energy prices remain elevated or rise further over the winter months.

Another consideration for the Bank of England is the shift in global monetary policy. The Federal Reserve raised interest rates at its September meeting and, while the US economy faces a different set of domestic challenges, the divergence in policy paths could have implications for the UK. If the Bank opts to keep rates unchanged while other major central banks continue to tighten policy, this could place downward pressure on sterling, particularly given the European Central Bank has already raised rates twice this year. A weaker pound at a time when energy prices remain elevated would increase the cost of imports and add further upward pressure to headline inflation.

The Bank of England is therefore expected to raise interest rates before the end of the year, most likely at its November meeting when updated forecasts are published. If energy prices remain around current levels, or move higher, the Bank's projections are likely to show headline inflation peaking close to 4%. In that scenario, we believe a slim majority on the Monetary Policy Committee would be inclined to vote for a rate hike. The outlook for next year will depend largely on developments in energy markets and the pace at which supplies normalise. Under our central scenario, as inflationary pressures from higher energy prices fade, the Bank is likely to gain greater confidence that inflation is returning sustainably to target, allowing it to resume its easing cycle from the summer of 2027.

Chart 5: Bank of England set to hike rates this year but may resume its rate cutting cycle in 2027



Source: Bank of England, KPMG projections.

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Public finances: ambitions for more spending could run into borrowing constraints

As the newly appointed Chancellor prepares to deliver his first Budget on 28 October, speculation is increasing on how far it will go in delivering the new Prime Minister's policy agenda. The Budget may include some measures to help with the cost of living, but the Chancellor will have limited room to offer significant support to help raise growth.

The greatest constraint facing the Chancellor comes from the fiscal rule on achieving a current budget balance in 2029/30, which limits the scope to increase day-to-day spending. So far, the cost of newly announced measures has been relatively modest, but the Chancellor has seen some of his previous fiscal headroom eroded.

The conflict in Iran has increased borrowing costs, which are estimated to have reduced the headroom of £23.6bn recorded in the Spring Forecast by around £9bn. Weaker growth and a likely downgrade to the OBR's migration projections could see the headroom fall by a further £2bn, leaving around £12bn in the autumn. Restoring the Chancellor's previous buffer would therefore require tax rises or spending cuts. With manifesto commitments of no tax rises on working people ruling out a swathe of tax options, potential options include changes to capital gains taxes or inheritance taxes among others.

There may be relatively more room on investment, where the target requires the stock of debt net of financial assets to be falling in 2029/30 as a share of GDP. However, here the Chancellor faces a range of competing pressures on defence, housing and economic development.

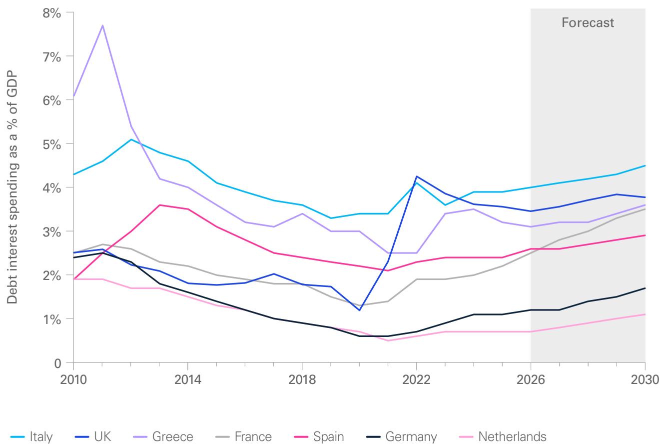
The Defence Investment Plan (DIP), unveiled in the summer, plans to bring UK defence spending to 2.7% of GDP by 2029-30, still well short of the 3.5% target, which the UK has committed to reaching in 2035. The Government promised credible plans to reach 3% will be announced at the next Spending Review in 2027. However, this leaves the difficult question of where to find the approximately £36bn per year needed to reach the 3.5% target for the future, with a large part to be included in procurement budgets.

There may also be a push for more funding for devolved authorities as a way of backing the devolution agenda. A wider rebalancing of public investment between England's regions could require an extra £9bn of public investment per year (see page 7 for details).

Addressing growth, the Chancellor has announced plans to deploy more funding through Public Sector Financial Institutions, such as the British Business Bank and the National Wealth Fund. These institutions provide loans to businesses, backed by government funding, which could be paid for through additional borrowing. The measure is attractive because the resulting increase in borrowing would be largely offset, in the Government's preferred measure of debt (Public Sector Net Financial Liabilities), by the creation of financial assets on the public sector balance sheet.

However, meeting the letter of fiscal rules may be seen as a necessary but not sufficient condition for ensuring the sustainability of public finances. Government bond yields have continued to rise on expectations of higher inflation and concerns associated with a larger debt pile. While the cost of long-term borrowing has steadily risen across Europe, the UK is projected to continue having one of the highest debt burdens in Europe (see Chart 6). With fiscal headroom likely to remain tight, looser fiscal policy could trigger another round of sell-off in gilts, sending government yields higher still.

Chart 6: The UK government faces one of the highest debt interest burdens in Europe



Source: OBR, European Commission.

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Regional investment: how far can it go to bridge the gap

Public investment spending remains uneven across England, with seven out of nine regions receiving below-average capital spending per head.

Bringing the underfunded regions up to the current England average would require around £47 billion of additional investment over the next five years.

Public investment can play an important role in supporting regional growth, but it is unlikely to be sufficient on its own. Sustained progress will also depend on higher levels of private sector investment and effective local growth leadership.

Improving growth outside of the UK's strongest performing regions forms a key part of the government's strategy. Greater devolution can help local authorities better align policies with regional economic needs, but without additional public investment altering regional disparities would prove harder to achieve.

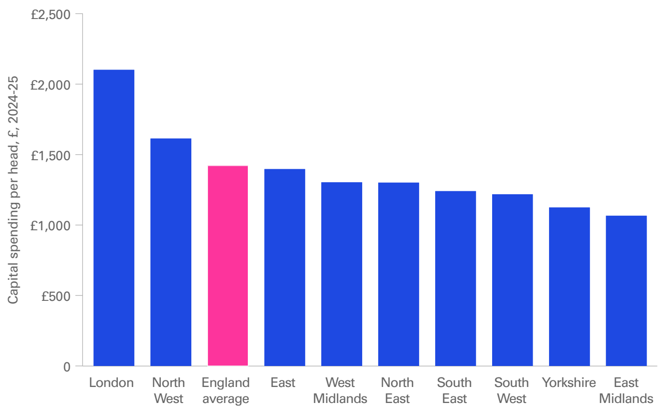
Public investment can support economic growth by improving infrastructure, which helps to raise productivity, making it an important lever for policymakers seeking to boost growth across the country. Investment in human capital, including lifelong learning, is also paramount but is largely covered by day-to-day departmental spending budgets.

Since 2017, efforts to increase government capital spending outside London have helped narrow some of the gap. However, government capital spending per person is still below the average in seven of the nine English regions and, on average, those regions received around 13% less capital spending per head than the England average in 2024-25 (see Chart 7).

If the regional investment gap were to narrow, by increasing public capital spending in underfunded regions to the current average level, it would require an additional £47 billion of capital spending over the next five years, equivalent to around £9 billion per year. Around two-thirds of this spending would be concentrated in four regions: East Midlands, Yorkshire, the South East and the South West.

An additional £47 billion of capital spending would narrow, but not eliminate, the gap in public investment levels between England regions. By 2029/30, capital spending per head in these regions would increase to around £1,844, reducing the gap with the England average from £183 per person (14.8%) in 2024/25 to £170 per person (9.2%). It may, nevertheless, address some of the more urgent investment needs in the affected regions, providing a disproportionally bigger boost to local productivity.

Chart 7: Regional disparities in public investment spending persist despite previous levelling up efforts



Source: HMT, KPMG analysis.

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The potential economic impact of higher regional investment

Narrowing the regional public investment gap could deliver benefits both in the short and long run. Higher capital investment has the potential to boost economic activity in the short term through increased demand, while also supporting longer-term growth by improving productivity and strengthening the economic foundations of the underinvested regions. The scale of these benefits, however, depends in part on how any additional spending is financed, as well as on what it is spent on.

Borrowing to invest may deliver a larger economic boost compared to funding through higher taxation, since it can allow investment to increase with less reduction in activity elsewhere in the economy. Assuming issuance through 10-year government debt at current market rates, annual debt servicing costs would rise by around £2.3 billion for a £9bn annual investment.

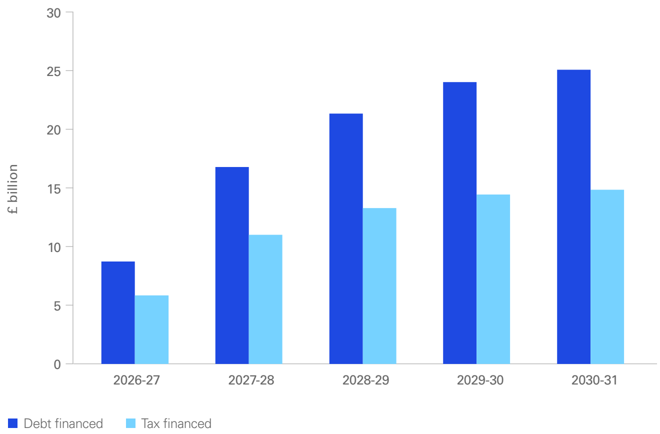
Using the Office for Budget Responsibility's fiscal multipliers suggests that an additional £47bn in public investment to close some of the gap in public regional investment could increase UK GDP increase by up to £25 billion under a debt-financed approach, compared with around £15 billion under tax financing over five years in the initial phase (see Chart 9). Reallocating existing spending would have little impact on aggregate UK demand, as activity would largely shift between regions rather than increase overall. These uplifts capture the construction and implementation phase, while the longer-term productivity impact can materialise afterwards.

The longer-term economic benefits could be more significant. Improved transport networks and other public assets can help raise productivity and support economic activity over a longer period.

Analysis from the OBR shows that higher investment in public infrastructure tends to increase the level of GDP by around 0.2% after a decade. However, because the additional spending would be concentrated in areas that have historically received lower levels of capital funding, the impact on regional economic output and Gross Value Added (GVA) could be larger.

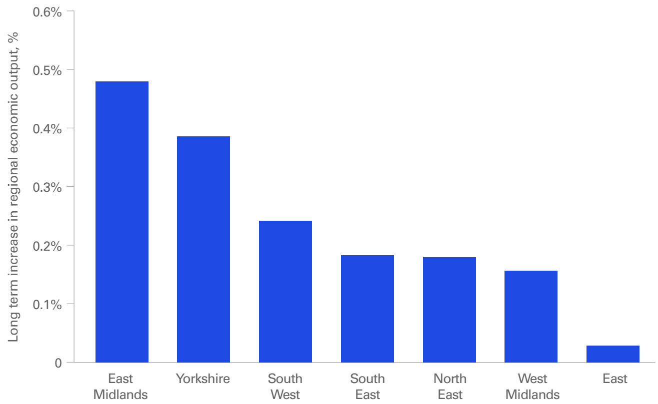
Using the national uplift estimates, the largest beneficiaries from the uplift to public investment, East Midlands and Yorkshire and the Humber, could see their level of GVA around 0.7% and 0.6% higher respectively after 10 years. Smaller but still meaningful increases are estimated for the South West, North East and West Midlands, where GVA could rise by between 0.2% and 0.3% (see Chart 9).

Chart 8: Higher spending on infrastructure construction could provide a temporary boost to real GDP



Source: OBR, KPMG analysis.

Chart 9: Narrowing the public investment gap can deliver longer-term improvement in regional growth



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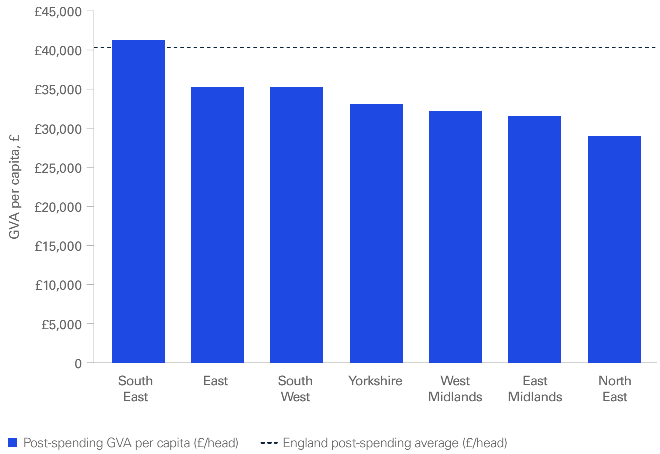
While these increases are not transformative on their own, they suggest that reducing regional investment disparities could help narrow the UK's long-standing regional economic gap. However, as with the remaining spending gap, the results also highlight the scale of the challenge. A £47 billion uplift over five years can improve economic outcomes in underinvested regions, but it is unlikely on its own to transform regional economies.

While additional government capital spending can support growth and improve economic capacity, higher spending does not automatically translate into proportionate improvements in economic performance. The economic returns on investment can vary significantly across projects and locations, with some areas better placed than others to translate new infrastructure into higher productivity, employment and business activity. As a result, simply increasing spending is unlikely to be sufficient to eliminate regional economic disparities on its own (see Chart 10).

UK regional inequalities have developed over decades and reflect a wide range of factors, including differences in skills, infrastructure quality, innovation capacity and levels of private sector investment. Public investment can play an important enabling role, particularly where it helps unlock private investment and improve connectivity, but sustained progress is also likely to depend on a broader package of policies. This includes measures to strengthen skills, support business investment, encourage innovation and ensure that local growth strategies are aligned with regional economic strengths. Closing regional economic gaps is likely to require a sustained and coordinated approach over many years, with public investment forming one part of a wider economic strategy rather than a standalone solution.

Chart 10: Despite higher infrastructure spending, gap in living standards will continue to persist across regions



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