

Summary

- Forecast was finalised before President Trump's 'Liberation Day': some tariffs were anticipated, but the delivery, breadth and consequences were unexpected
- UK CPI inflation to reach 3.5% by the summer on back of higher regulated prices and stubborn wage growth, remaining above 2% target throughout projection
- Bank of England to favour protecting weak growth over above-target inflation in policy "trade-off", delivering two further rate cuts in '25

Group Economics

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Conditioning assumptions

- US pursues an isolationist agenda, including tariffs and an aggressive anti-immigration programme. We expect goods from UK, China and the EU to face higher tariffs.
- Absence of global conflict escalations are assumed to imply no major disruption to commodity prices and no major disruption to global trade. The EU is expected to raise defence spending from 1.8% of GDP to 2.5% over 5 years.
- Chancellor rebuilds c.£10bn of 'fiscal headroom' through back-loaded cuts to spending plans as outlined in Spring Statement.

UK Macro, annual average	2024	2025	2026	2027
GDP growth	0.9	0.8	1.4	1.6
Latest consensus ¹		0.8	1.0	1.5
Unemployment rate	4.3	4.7	4.8	4.6
CPI inflation	2.5	3.4	2.8	2.5
UK Macro, end year ²	2024	2025	2026	2027
GDP growth	1.4	1.0	1.5	1.6
Unemployment rate	4.4	4.8	4.8	4.6
Latest consensus ¹		4.7	4.7	4.7
CPI inflation	2.5	3.5	2.7	2.4
Latest consensus ¹		2.9	2.3	2.1
House prices	3.4	1.7	1.8	1.9
Global Macro, annual average	2024	2025	2026	2027
GDP growth	3.0	2.5	2.4	2.4
CPI inflation	7.1	4.6	3.6	3.3
UK Interest Rates, end year	2024	2025	2026	2027
Bank Rate	4.75	4.00	3.50	3.50
2y yields	4.34	3.89	3.82	3.85
10y yields	4.43	4.58	4.38	4.39
Exchange Rates, end year	2024	2025	2026	2027
GBP USD	1.25	1.30	1.30	1.30
GBP EUR	1.21	1.18	1.18	1.17
Global Interest Rates, end year	2024	2025	2026	2027
Fed Funds Upper Bound	4.50	4.00	3.75	3.75
US 10y yield	4.57	4.31	4.40	4.51

Source: LBG, position as of 31/03/2025 and disclosed in LBG's Q1 2025 financial reporting

¹ Median consensus as of HMT's 'Forecasts of the UK economy', April 2025 and February 2025.

² Q4/Q4 for GDP, CPI and house prices; Q4 for unemployment rate.

Known unknowns

- Extent of global trade barriers and consequences for global supply chains.
- Ability of China's policy makers to address both domestic weaknesses and trade barriers.
- Extent of US downturn in response to very high level of policy uncertainty.
- Future of US dollar and Fed swaps in the international monetary system.
- Ambition of UK's 'Industrial Strategy' and extent this policy provides support for growth.
- Lack of clarity regarding the UK labour market, pending results from 'Transformed' Labour Force Survey.

International context

This economic forecast was finalised in mid-March 2025. The global outlook has shifted in response to President Trump's 'Liberation Day' announcements of so-called 'reciprocal tariffs' on 2 April, later modifications of the policy, rounds of retaliation – notably from China – and the ensuing market reaction. Against a backdrop of increased policy uncertainty, European prospects have simultaneously been buoyed by pledges on additional defence spending. While we had included some of these matters, the magnitude and market response was greater than in our conditioning assumptions.

The thrust of US economic policy under President Trump continues to follow pre-election pledges. But the speed of implementation and the effervescent nature of reversals and exemptions has meaningfully increased perceptions of policy uncertainty (Chart 1). Our US outlook has worsened on the back of this larger policy uncertainty, with a weaker quarterly profile of US growth in 2025 flattered by the carryover from stronger data at the end of 2024. Recent falls in US consumer and business confidence, higher inflation expectations and more volatile financial markers all point to downside risk for the world's largest economy. At proposed tariff rates, direct trade between the US and China will be severely restricted.

The response of European and Japanese leaders to ambiguity around Article 5 (joint defence) of NATO is highly significant. In Germany, Chancellor-elect Merz has proposed a possible EUR800bn in additional defence spending over the next four years, complemented by EU-wide funds. If enacted, these would raise EU defence spending from 2% to 3.5% of GDP. The additional fiscal boost to the region has driven an upward revision in our GDP growth outlook for the Eurozone. Although we have assumed a more gradual ramping up of spending for now, further revisions may come as plans are fleshed out and we learn how quickly funding streams will be activated.

UK outlook

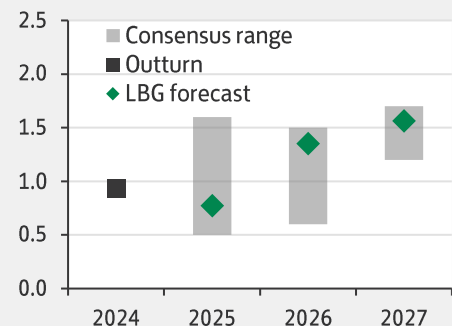
The outlook is slightly weaker than at year-end 2024. While our expectations around the Spring Statement in March were largely realised, the commotion and international trade consequences of US policy changes appear to have damaged UK business sentiment and investment intentions. We assume that the global backdrop of uncertainty will persist. Consequently, UK GDP growth has been revised down in the first half of the year and for the whole year to 0.8%, with growth next year unchanged at 1.4%.

On a more positive note, households (on average) have enjoyed healthy real income growth, and the saving ratio is already high. While consumer spending slowed in the autumn of 2024, there are signs of resilience at the beginning of 2025. We take particular comfort from the housing market, where taking account of the recent pattern of activity reflecting stamp duty changes the dynamics are sound. With housing demand traditionally important to wider consumer spending, the near-term outlook continues to be supported by lower swap rates.

A notable revision to the UK forecast relative to our year-end assumptions is to wage growth and inflation. Rises in food prices, a larger upward reset in the OFGEM energy price cap and changes to other regulated prices such as water charges and bus fares will soon force inflation back above 3%. Wage growth is also proving stubbornly strong. A rise in inflation expectations and survey evidence all convince us of a feedback loop between inflation and wage growth. According to the latest Decision Makers Panel survey wage inflation over the next year is expected to be 3.9% which remains too high to achieve the 2% inflation target. Businesses are also likely to pass on a significant amount of the increase in employer NICs via higher prices. The result is an upward revision in the inflation outlook that persists even after the near-term upward inflation influences subside, with CPI averaging 2.3% in the longer term. The corollary is that to achieve a meaningful and quick reduction in wage growth consistent with the inflation target, a significant rise in unemployment would be required.

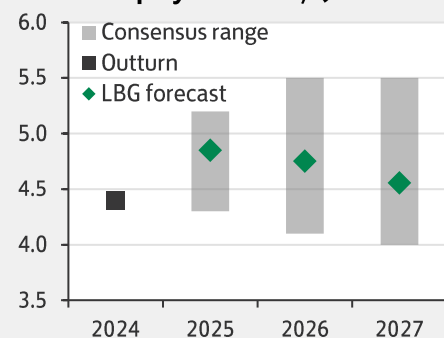
Forecast comparison

UK GDP annual percentage change



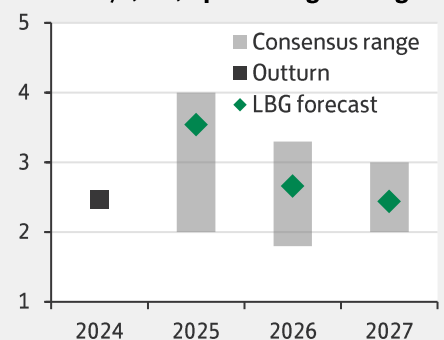
Source: HM Treasury / ONS / LBG Group Economics

UK unemployment rate, Q4



Source: HM Treasury / ONS / LBG Group Economics

UK CPI, Q4/Q4 percentage change



Source: HM Treasury / ONS / LBG Group Economics



Fiscal and monetary policy

How will the Bank of England react to the worsened inflation outlook? Prior to April's tariff announcements, we did not detect any strong preference to halt easing amongst MPC members, suggesting collectively an emphasis on protecting growth rather than bringing inflation more forcefully down to the target. Our expectation was therefore that the BoE would maintain a gradual pace of easing, with two further cuts in the course of 2025, before rates eventually settled at a 'neutral' rate of 3.5% over the longer term. With this assumption we judged that inflation would stay above the 2% target throughout the forecast. Such an outcome would be consistent with a creep towards policies that help to reduce the real value of the public debt burden.

Developments since April – including so far the absence of the UK tariff retaliation we had assumed in response to the US measures, the increased policy uncertainty and the volatility in financial markets – for the UK together represent a demand shock that adds to the case for a quicker monetary policy easing. Recent market-implied expectations bear out a view that monetary easing may happen more quickly (Chart 2). By contrast the policy question for the Federal Reserve, facing a supply shock that will raise inflation as well as damaging growth, is far more complicated in the short term – although both we and the markets expect it to be ultimately resolved by looser policy.

A separate UK policy quandary is how will the Chancellor continue to stay within her self-imposed fiscal rules. The Chancellor's Spring Statement restored a historically-slender margin of fiscal headroom of c.£10bn (Chart 3) through gradual and back-loaded spending cuts plus a reallocation between current and capital spend categories, achieved with higher defence spending paid for by cutting foreign aid. This thin margin is very limited protection against the risk of a further deterioration of the public finances.

Having navigated the fiscal test of the Spring Statement, fundamental problems nevertheless face the economy. Growth is stuck in low gear, and a weakening of the external backdrop may expose the fragility of the fiscal outlook. Additional long-term structural economic reforms are expected to be announced with the government's Industrial Strategy and Spending Review, close to 11 months after the new government took office. Whether these will improve the prospects of less prosperous regions and socio-economic groups will be an important challenge. Momentum matters, and the delay is a concern given the urgency and magnitude of changes required to address the growth challenges.

At the next Budget in the Autumn the Office for Budget Responsibility may see an opportunity to reconsider its long-held optimism about the growth potential of the UK economy, which for some time has been at the upper end of the range of forecasters. Any meaningful downgrade to the medium-term growth outlook would deplete fiscal headroom to an extent that could not be restored with modest tweaks to future spending growth leaving the Chancellor some more politically difficult policy choices.

Chart 1: US policy uncertainty

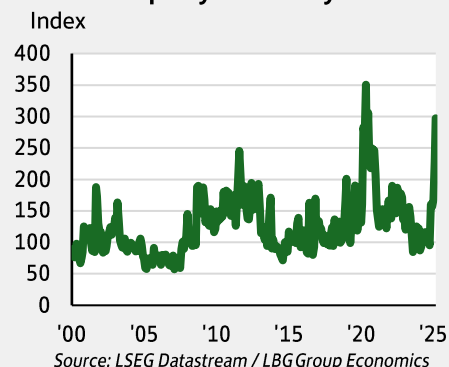


Chart 2: Bank Rate path

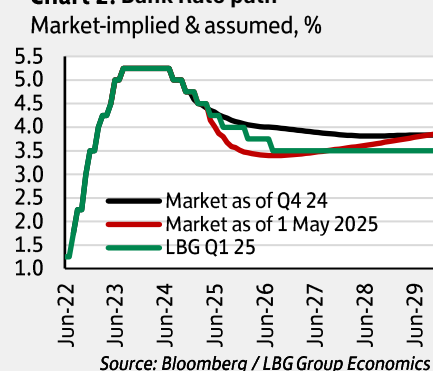
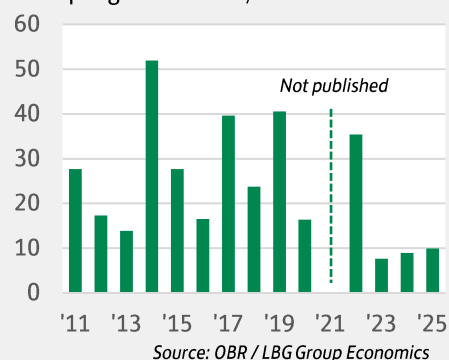


Chart 3: Fiscal 'headroom'

At Spring fiscal events, £bn



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