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Research Report

UK economic outlook: navigating the endgame

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Institute for Fiscal Studies

IFS Report R340

Benjamin Nabarro

UK economic outlook: navigating the endgame



**Economic
and Social
Research Council**



1. UK economic outlook: navigating the endgame

Benjamin Nabarro (Citi)

Key findings

1. **The UK's economic performance over the past two decades is hard to describe as anything other than a policy failure.** Productivity growth has been dire – with per-worker growth over the past decade the weakest on average since at least 1850. The innovative engine behind the UK economy seems to have stalled. In 2014, a little under 6% of all firms in the UK (14,000) were ‘high-growth firms’ – employing at least 10 people and growing their headcount by more than 20% per annum for three years running. This has fallen to just under 4% now. Macroeconomic resilience also seems to have suffered as low growth, low investment and weak income growth have all fed back into one another.
2. **The growing global challenges surrounding ecological and geopolitical transition should add to a sense of urgency.** These imply further economic headwinds to growth in the years ahead, alongside heightened volatility. More physical investment will be required to ameliorate these effects. But this does not constitute a strategy for addressing the UK's existing growth shortfall. **High debt levels, a structural external financing gap and elevated rates volatility mean the stock of outstanding debt is a growing vulnerability.** In this sense, the UK likely finds itself in a worse position than the US or the Euro Area.
3. The UK needs to lift growth despite these growing challenges, in the context of limited policy space. Here we think the focus should be on boosting intangible and ICT investment, alongside broader efforts to improve diffusion from the technological frontier. **Both growth and resilience will need to be areas of focus.** The UK, as a small open economy, remains particularly exposed to future shocks. Efforts to bolster resilience, as well as better coordinating monetary and fiscal policy, will be crucial to navigating these shocks better in future. In our view, **without countercyclical ‘burden**

sharing' between monetary and fiscal policy, structural efforts to lift trend growth are unlikely to be successful.

4. **The cyclical outlook we present here is one of near-term 'sogginess' and medium-term optimism.** Globally, we think the near-term outlook is likely to remain somewhat weak. Supportive factors for demand – in particular, significant fiscal support – are beginning to fade. Continued structural uncertainties in China – recent stimulus notwithstanding – remain a headwind across Europe. And US growth exceptionalism does appear to be gradually fading as the impact of tighter monetary policy feeds through. **We expect global activity to fall back in the second half of this year.** This implies fading external support for UK growth as we move into 2025. External inflationary influences are also likely to continue to fade.
5. **The UK economy has surprised to the upside since the start of 2024.** We now expect real GDP growth of 1.0% this calendar year, compared with a forecast of just 0.1% back in January. **But these welcome improvements are not yet indicative of a secure economic recovery.** Instead, they primarily reflect transient improvements in capacity as energy prices have fallen back. For now, the outlook for the core domestic demand engines for the UK remains subdued. A sharp improvement in real incomes since the start of the year has not yet translated into stronger consumer spending. Firm sentiment and investment intentions have improved but remain on the defensive side. And public consumption is likely to prove constrained. **We expect growth to remain positive but weak in the near term, with real GDP increasing by 0.7% next year.**
6. A procyclical monetary policy approach risks slowing the recovery in our view. Structural changes have slowed the transmission of monetary policy into economic activity. **The effects of higher interest rates may become more material as many parts of the economy are forced to borrow once more; around half of the cumulative effect of monetary policy is still to be felt.** This will suppress demand, just as the supply side of the economy begins to recover. Better news in the latter case reflects lower energy prices, and rebalancing between labour and non-labour inputs in production. This is cause for optimism, although monetary headwinds will make it difficult to capitalise immediately. **We expect growth to accelerate markedly through 2026 and 2027 as monetary and fiscal constraints are eased.**
7. The outlook for the household sector should improve modestly in the months ahead, although household sentiment remains somewhat defensive. **Much will depend on developments in the household saving rate. The 'cash' saving rate – i.e. excluding the imputed equity of pension funds – has climbed from 3.4% just before the pandemic to around 8% now.** This has been pushed higher by a

combination of uncertainty, consumption smoothing and balance sheet impairments. In the months ahead, we think the saving rate may come down modestly as uncertainty dissipates – although we expect the rate to remain elevated as households overall are significantly less well off now than before the pandemic. **We expect private consumption to increase by only 0.6% in 2025, compared with 1.5% in the Bank of England's baseline estimate.** The outlook for firms should improve as supply growth picks up and costs decline, though any gains will come from a weak base. Business investment should recover gradually as interest rates fall.

8. Excess labour demand – present through 2022 and 2023 – has now been eliminated. We think most recent data suggest the labour market is continuing to loosen. Vacancies have continued to trend down over recent months, if perhaps at a more moderate pace than last year. Private employment dynamics also look weak, at least according to the PAYE data. **As public sector employment growth slows, we think the unemployment rate will increase to 4.9% next year and 5.3% in 2026.** The risks here seem broadly balanced, although a flattening in the Beveridge curve would, if anything, imply a faster pass-through from lower vacancies into higher unemployment from here. We expect a modest loosening of the labour market to weigh on wage growth and consumer confidence into 2025.
9. The UK's inflation process over recent years has been primarily 'conflictual' in that high wage growth and services inflation both reflect efforts to make up for large losses associated with an adverse terms-of-trade shock. This, we think, has contributed to sticky wage and services price inflation over recent months. But increasingly we think there are signs that these effects are beginning to fade, with the real income loss associated with the shock now having been more than fully absorbed. **Evidence of further 'agitation' around either inflation or nominal wage growth seems limited, and confined to a few specific quarters.** And forward expectations for both wages and prices are now broadly consistent with the inflation target. The natural decay in the UK's inflation processes primarily reflects the relatively high 'cost of conflict' rather than the demand-destructive impact of higher rates. Inflation seems to have broadly returned to target without much direct input from monetary policy. To the degree that the latter now weighs on demand and slack, **we expect to undershoot the inflation target through 2026.**
10. **The Monetary Policy Committee (MPC) remains in an inflation-averse state of mind.** Having cut rates for the first time in August, we expect the committee to ease policy only gradually over the coming months as evidence around inflation continues to accumulate. However, if the labour market does loosen through the first half of next year, we think that is likely to signal the committee should pick up the pace. **In our**

view, a continued focus on the upside risks around inflation, while understandable, is increasingly inappropriate. We expect the MPC to cut rates into accommodative territory through 2025–26 as policy refocuses on the risks around the labour market, and monetary policy is forced to correct for a procyclical monetary and fiscal stance through 2023 and 2024.

11. After two decades of stagnation, change is needed. **The outlook is for a period of near-term sogginess, followed by a more robust cyclical acceleration as supply-side improvements continue to materialise. This may provide a window of opportunity.** Already, in the past decade, the gap between what the UK economy can support, and what has societally been promised, has widened. This is combined with the potential for an intermittently binding external liquidity constraint that also poses more acute risks. In a context of growing international rates volatility, the UK does not have time to spare.

1.1 Introduction

The UK's economic performance over the past two decades can only be fairly described as a policy failure. In the wake of the financial crisis, trend productivity growth has decelerated more abruptly than elsewhere. That has been accompanied by acute fiscal policy error through the financial crisis and then the post-COVID period – both of which have added further embedded losses. The result is increasingly pronounced economic weakness, constraints on fiscal policy and a widening gap between what the UK can produce and what society demands. The outlook presents opportunities for meaningful structural reform, but also reaffirms the risks associated with continued inaction.

In the near term, the outlook is framed by underlying improvements around the supply side of the economy, but also continued sogginess on spending and demand. We expect growth to remain subdued into 2025, decelerating from 1.0% this year to 0.7% next, as policy headwinds continue to bear down on the recovery. However, we think this is likely to precede a fuller economic recovery through 2026 and 2027 as improvements in supply are realised.

Unemployment, in the meantime, will increase to around 5.2% by early 2026 as a margin of excess labour demand emerges, before falling back thereafter. We expect inflation to remain in a 2–3% range in the near term before decelerating more fully through the end of next year as stronger energy effects fade and slack bears down on domestic prices. We expect an undershoot in headline CPI through much of 2026.

Here, our outlook is framed by three themes.

First, and on the more optimistic side, we do see potential for some ‘catchup’ on the supply side after the recent shock-induced stupor. The large shocks that have buffeted the UK in recent years are either fading or reversing. Excess global manufacturing capacity seems to be increasingly feeding into lower UK import prices. Energy prices also seem likely to moderate further – recent geopolitical news notwithstanding. In the UK, these supportive headwinds are then complemented by improving productivity as input prices fall, capacity comes back online and production rebalances in a more capital-intensive direction. The net implication is that near-term supply growth is likely to be around 2% or so – stronger than the 1.4–1.5% long-term trend that is often assumed.

Second, the outlook for the demand side of the economy is, if anything, deteriorating. Over recent years, fiscal policy has stimulated in response to supply shocks. Some adjustment will be required as this procyclical fiscal stance is gradually unwound. This has also brought fiscal policy increasingly into conflict with monetary policy which has been forced to be more aggressive to offset the impact of fiscal support. The implication is that the UK will likely see concurrent fiscal and monetary headwinds into the end of 2025 as the supply shocks that have so far driven this cycle begin to fade. Demand headwinds could be compounded by balance sheet impairments accrued during the pandemic, which we continue to think will keep household saving somewhat elevated. We think a rise in unemployment may be the result.

The third factor is a lingering degree of inflationary aversion on the part of monetary policy. This is understandable given the experience of recent years, but perhaps no longer the right approach. As inflation has jumped in recent years, the scale of the monetary policy response has reflected a desire to weigh disproportionately against the risk of embedded inflation, as well as offsetting the impact of a procyclical fiscal stance. This has meant a more activist and hawkish stance. However, the balance of risks has materially shifted. Supply shocks are reversing. Fiscal policy is inflecting. Inflation is fading. And the labour market appears increasingly vulnerable. The full spectrum of risks should increasingly be incorporated into policy deliberations going forward, rather than simply those around inflation. In our view, the Monetary Policy Committee (MPC) is already too slow on the turn. This adds to the risk that policy is ultimately cut into accommodative territory in the years ahead to make up lost ground.

Together, these points suggest that good economic news is coming, but its realisation may be deferred rather than immediate. In the very near term, the UK faces the legacy of the latest round of macroeconomic policy mistakes. But, once adjustments have been worked through, a window of opportunity should emerge. It is vital policy utilises that momentum to drive a more meaningful structural improvement.

Below, we begin by discussing the structural challenges posed by the economic inheritance (Section 1.2). We then turn to the global and domestic outlook for activity (Section 1.3), before

turning to the labour market in Section 1.4, inflation in Section 1.5 and policy conclusions in Section 1.6.

1.2 The economic inheritance

On 28 February, Chancellor Rachel Reeves warned that the incoming Labour government would face ‘the worst economic situation since Second World War’.¹ We would not go that far. But Ms Reeves does take the helm after two decades of chronic economic mismanagement. If the UK’s 20th century economic experience was framed by three mistakes – return to the gold standard and austerity in the wake of the 1929 crash (Eichengreen, 1992; Gwiazdowski and Chouliarakis, 2021; Heffer, 2024); a failure to engage with Europe from a position of strength in the 1950s (May, 1998); and the conflation of serious supply reform with expedient demand stimulus in the early 1970s (Morrison, 1974) – then all three errors have been repeated to some degree in the space of a decade and a half. The result has been abject economic performance. Trend UK productivity growth has collapsed to near-record lows. And various measures of public service performance and well-being – including improvements in longevity – have stalled (Health Foundation, 2019).

This should be a call to arms. Poor performance, when sustained, becomes harder to reverse and more uncertain in its institutional consequences (Eichengreen, 2018). It is also likely that the global macroeconomic and financial environment is becoming more adverse. Lifting trend growth is likely to be essential if the UK is going to deal with the choppy waters ahead and make the economic transitions required by major ecological and geopolitical challenges.

In this section, we consider what explains the slump in productivity and what might be needed for the UK to transition to higher growth. We then turn to some key issues with the UK’s macroeconomic resilience, and to some legacy macro-financial risks which will constrain the Chancellor’s policy options.

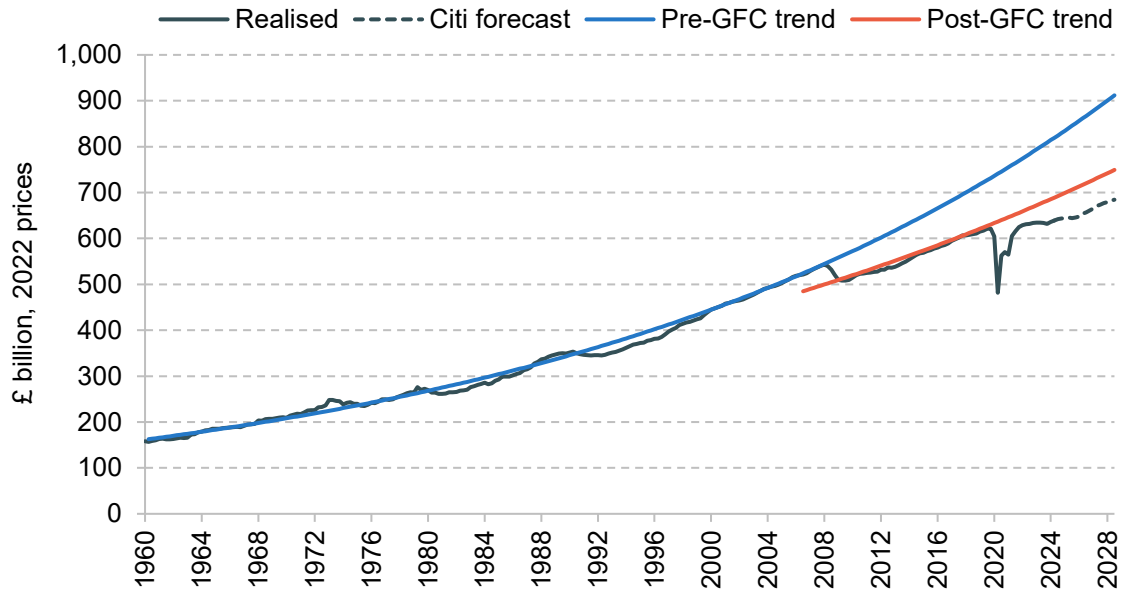
What will it take to get higher growth?

UK economic activity is 36% lower than it would be had it continued to grow in line with its 1997–2008 trend. This compares with 31% in the Euro Area and 24% in the US, comparable countries that – at least in the latter case – have faced similar shocks. While most advanced economies have experienced slower trend growth, the decline in the UK has been particularly severe. This has been compounded by a further relative deterioration in the UK’s post-COVID

¹ <https://news.sky.com/story/labour-will-inherit-worst-economic-situation-since-second-world-war-shadow-chancellor-warns-13083097>.

performance, with UK GDP now 6.1% short of its pre-pandemic (2014–19) trajectory, compared with 4.3% in the Euro Area.

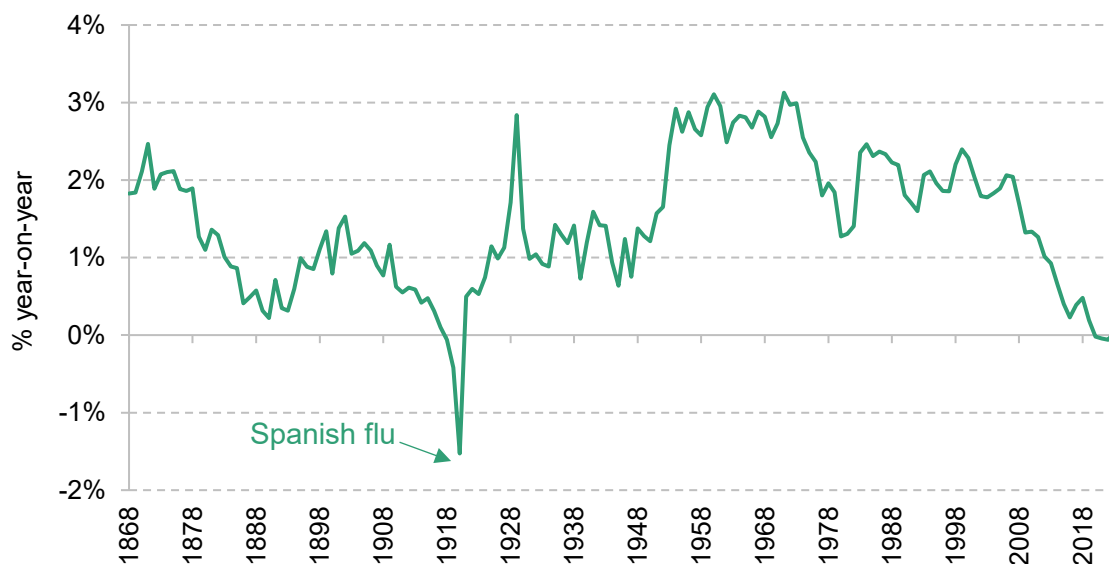
Figure 1.1. UK GDP versus historical trends



Note: Pre-GFC trend here is calculated between 1960 and 2007 and post-GFC trend is 2010–19, where GFC is Great Financial Crisis.

Source: ONS.

Figure 1.2. UK potential growth in GDP per worker (10-year moving average of year-on-year % growth)



Note: Potential GDP is measured here by taking observed GDP adjusted by an Okun rule. This is then divided by the number of workers. In more recent years, we have taken OBR estimations of potential. Average is taken over a 10-year rolling window.

Source: ONS, OBR, Thomas and Dimsdale (2016).

This slow growth in UK output is despite a material increase in labour supply. Productivity – measured by output per worker, or per hour worked – has therefore fared even worse (Van Reenen and Yang, 2024). The recent decline in potential output per worker in the UK is unprecedented since the late 19th century (see Figure 1.2). Nicholas Crafts, before his passing last year, noted that the slump in productivity growth is unprecedented in the last 250 years (Crafts and Mills, 2019).

A simple growth accounting exercise is useful here. The decline in real GDP growth in the UK – of around 1.8 percentage points (ppts) on average between 1995–2006 and 2007–19 – can be decomposed into changes in: labour supply (+0.1ppt); human capital, as measured by average years of schooling (–0.2ppt);² physical capital (–0.5ppt); and total factor productivity (–1.2ppt).³ The last is by far the largest driver. According to these data, total factor productivity (TFP) in the UK was 4.6% *lower* in 2019 than in 2007 (similar to the fall in France). Over the same period, TFP has increased by 2.2% in Germany and 5.1% in the US.

What explains this weakness? Here it is worth taking the decomposition above with a pinch of salt. TFP is measured as a residual – effectively describing those activity improvements that cannot be explained by physical capital, labour or human capital. The outcome is therefore heavily dependent on what kind of capital data are used. Using some more granular data, such as the OECD KLEMS data, suggests slower capital deepening has contributed to a more abrupt productivity slowdown here than it has in France, Germany or the US (Van Reenen and Yang, 2024). But this faster slowdown is concentrated in either digital infrastructure or intangible assets, rather than major capital projects. We think this helps explain the faster fall in simpler measures of TFP, which are likely to reflect this deceleration in intangible investment as a residual.

Decelerating digital and intangible investment fits with the pattern of UK growth after the financial crisis, with a faster slowdown in productivity in intangible-intensive sectors – many of which faced a particularly abrupt credit crunch (Goodridge and Haskel, 2022; Bailey et al., 2022). Ahn, Duval and Sever (2020) find there was a materially larger reduction in intangible investment in indebted firms than in less indebted equivalents or indeed in investment in tangible assets across OECD countries. The subsequent increase in many firms' preference for internal liquidity seems to have been persistent, with a widening gap between the cost of capital

² For details, see https://www.rug.nl/ggdc/docs/human_capital_in_pwt_90.pdf. See also Feenstra, Inklaar and Timmer (2015).

³ Decomposition of change in real GDP growth between 1995–2006 and 2007–19, assuming a Cobb–Douglas constant-returns-to-scale production function. Citi analysis based on Penn World Tables and ONS data. Compares the UK with a weighted average of France, Germany and the UK. Similar benchmark countries are used in other studies, such as Van Reenen and Yang (2024).

and the rate of return required for firms to deem projects worthwhile – their ‘hurdle rate’ (Cunliffe, 2017; Melolinna, Miller and Tatomir, 2018).

These more persistent effects have effectively strangled investment in digital and intangible assets over recent years. In fact, we think the impact has been twofold. First, these challenges have weighed heavily on investment in the first instance. Second, they have also limited firm entry and competition. For firms of a certain size, borrowing against cash flow is possible, enabling incumbents to continue to grow. But for smaller firms, the ‘tyranny of collateral’ is more obviously binding (Cecchetti and Schoenholtz, 2017 and 2018). For example, in the UK, a 2015 survey found that 90% of all lending to small and medium enterprises (SMEs) was secured against some kind of physical collateral (Haskel and Westlake, 2022). This has limited reallocation, weighing on growth. This has also enabled a degree of strategic underinvestment on the part of incumbents. In an oligopolistic market, investment becomes something of a strategic game. If other firms dial back, this can quickly be perpetuated across the sector at large.

The logic here is involved and difficult to prove. But a decline in reallocation and competition does fit the broad patterns we see in the data. We also know that the gap in firm productivity levels between sector ‘leaders’ and laggards has been widening for some time (Andrews, Criscuolo and Gal, 2015; Autor et al., 2020). While the contribution to growth of the 10% most productive firms – outside of the financial sector – has been roughly constant over time, the contribution of the ‘upper middle’ (those between the 50th and 90th percentiles of productivity) has more than halved since the financial crisis (Office for National Statistics, 2022). Given the associated concentration of the growth slowdown in more intangible-intensive sectors, it is plausible that financial constraints are weighing on both new entry and broader digital investment.

What will it take to improve this picture? We think the focus should be on institutional arrangements for investment. For example, improving the tax treatment of certain kinds of equity finance could help, and also allow a better sharing of risk and reward between firms and lenders (Hosono, Miyakawa and Takizawa, 2017). For now, the tax treatment continues to favour debt finance (Adam, Delestre and Nair, 2022). Encouraging larger firms, which can borrow against proven intangible expertise, to finance smaller equivalents could also boost investment, as well as improving the sharing of expertise.^{4,5} Much more work will be needed here to shift the balance.

⁴ Haskel and Westlake (2022) note that many larger firms are often able to borrow on the basis of cashflow covenants, but this is usually only available to larger firms. See also Lian and Ma (2021).

⁵ The literature on foreign direct investment speaks to potential productivity benefit associated with investment agreements if also associated with knowledge sharing. See Baldwin (2016).

Aside from finance, a range of other challenges have impeded reallocation. Four stand out:

- Technological issues associated with frontier firms, and associated challenges around competition policy, as incumbency advantages count for more.
- Low labour mobility, as high housing costs have disincentivised workers from moving to more productive regions. Young renters are less likely to move than in the past, and rental prices have tended to grow more quickly than wages in faster-growing areas (Judge, 2019).
- Weak transport infrastructure, particularly in large UK cities outside of London. Only 40% of the urban population can reach these city centres by public transport in 30 minutes, compared with 67% in continental Europe (Rodrigues and Breach, 2021). This has stunted ‘thick market’ effects that can otherwise boost the efficacy of local labour markets.
- Growing skills shortages, particularly in STEM subjects (Stansbury, Turner and Balls, 2023). OECD analysis marks the UK out as suffering a particularly severe mismatch between workers’ fields of study and job requirements, and a greater extent of workers ‘underqualified’ for their jobs (Deb and Li, 2024). Falling spending on adult skills, from an already low base, will not have helped.

In all cases, these effects risk inhibiting competition at the frontier, and more broadly limiting productivity growth. And their effect has been to gradually bear down on business dynamism – i.e. the rate of firm turnover. Here the fall has been significant and consistent over recent years (see Figure 1.3). This, we think, is a function of both ‘pull’ and ‘push’ factors. On ‘pull’ factors – drivers that are pulling capacity from less productive areas – a thinning in the number of growth opportunities has also meant a decline in the number of ‘high-growth’ firms.⁶ In 2014, a little over 6% of all firms in the UK (14,000) were defined as ‘high-growth’ firms. This has fallen to just under 4% now. Brexit may have played a role here, with many such firms historically utilising single market membership to boost their growth (Freeman et al., 2022).

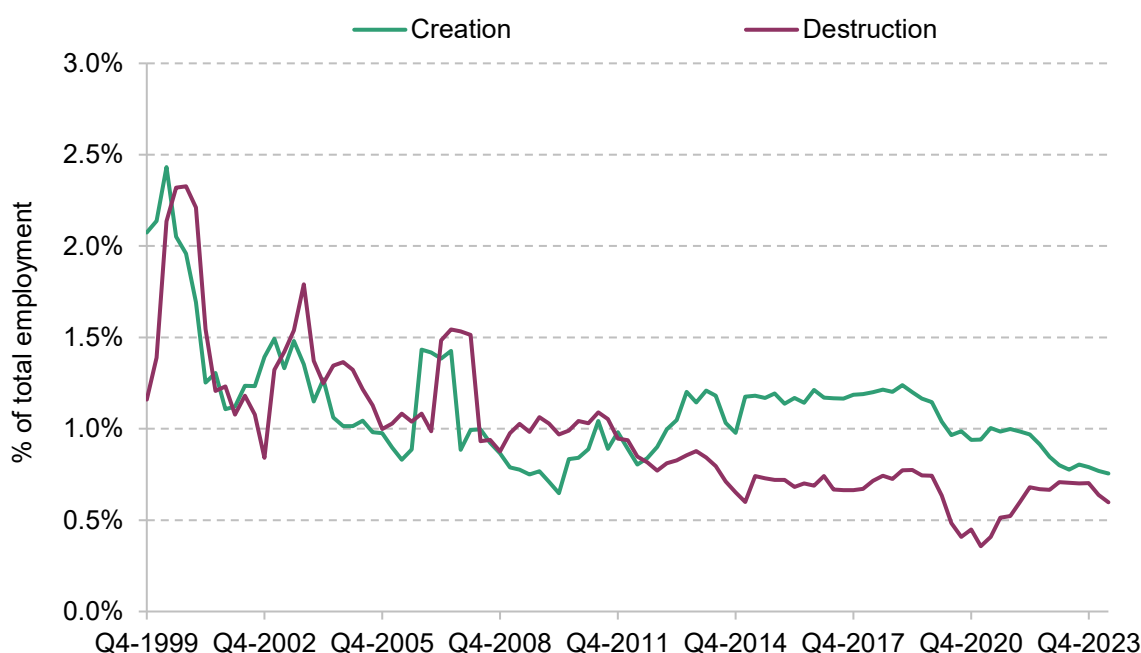
There have also been ‘push’ factors – i.e. capacity remaining ‘trapped’ in suboptimal allocations for longer. Here the most obvious cases have been in the initial period after the financial crisis and in the post-COVID period. In the former case, weak financial institutions may have played a role, with weak financial balance sheets creating an incentive not to recognise losses. But increasingly through the pandemic the same effect has operated, even as financial institutions have remained robust. In part, this may reflect the direct impact of sweeping subsidies, which allowed some firms to cling on. It may also be that in a more intangible-intensive economy,

⁶ Here we are defining these in terms of employment. ‘High-growth’ firms are defined by the OECD as firms employing at least 10 people and enjoying employment growth of more than 20% per annum for three years running.

firms have an incentive to protect sunk costs – in the form of firm-specific assets – until they become unviable from a cash-flow perspective. This can take some time.

While less ‘churn’ may sound like a good thing, a moderate rate of firm failure and creation is indicative of a healthy process of ‘creative destruction’ that supports innovation and productive reallocation. The scale of the reduction here should be a growing cause for concern.

Figure 1.3. UK job destruction and creation owing to firm turnover (% of total employment)



Note: Measure reflects the share of total employment that is reallocated owing to firm creation or destruction per quarter.

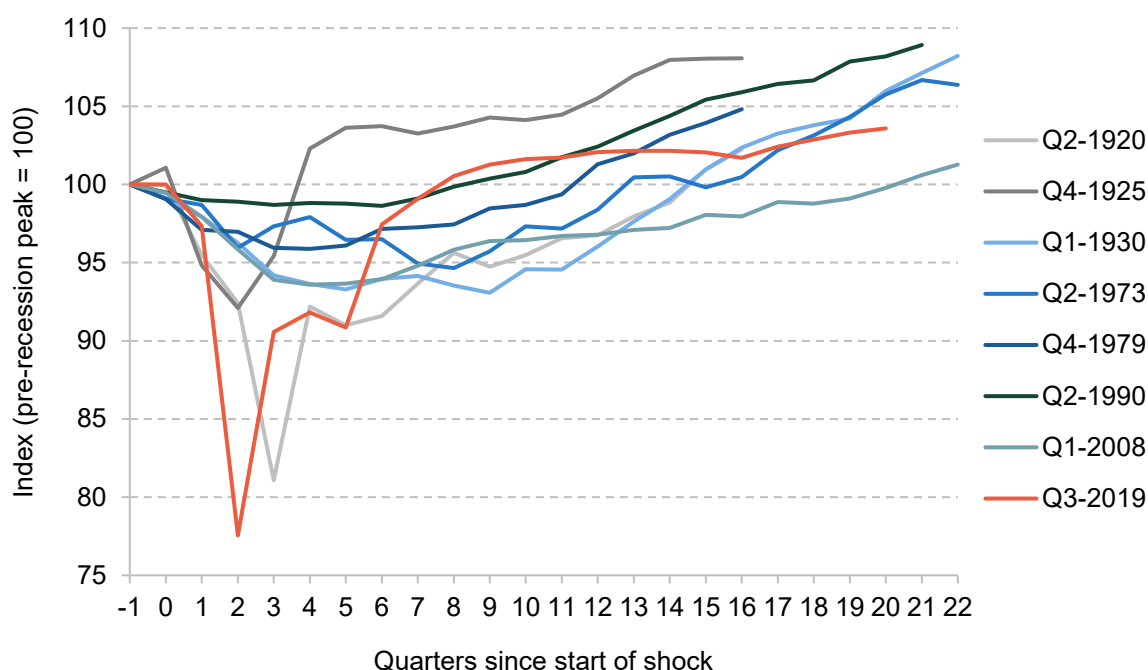
Source: ONS.

Improving macroeconomic resilience

The ability of the economy to recover from macroeconomic shocks is important. Supply shocks are – as we note below – growing more frequent. And the UK, as a small open economy, is often especially exposed. Unfortunately, the UK’s performance in this respect seems to be getting worse. Its cumulative recovery from the pandemic has been comparatively underwhelming. And as shown in Figure 1.4, the cumulative recovery in real GDP since the pandemic has been weaker than the UK’s recoveries from previous shocks, except for the Great Financial Crisis. Now, as then, we think the loss in the level of GDP is unlikely to be made up anytime soon.

While the financial crisis and the pandemic were very different shocks, we think both episodes highlight some key macroeconomic vulnerabilities that may impede future economic recovery.

Figure 1.4. Real GDP recovery from various macroeconomic shocks



Note: Figures show the cumulative GDP recovery, with the index linked to the pre-recession peak. The data for the latest cycle run to the end of 2024, with 2024 Q3 and Q4 numbers Citi nowcasts.

Source: ONS.

First, there has been a structural decline in macroeconomic flexibility. Sectoral reallocation, particularly in an acute context, seems to have slowed. The UK's recovery after the financial crisis, for example, was characterised by an unusually high dispersion of relative prices and capital returns (Broadbent, 2012). This reflected challenges reallocating resources across different economic sectors (Barnett et al., 2014). Significant shifts in relative prices are evidence of similar challenges in the post-pandemic period. In recent years, these have also been accompanied by an increase in wage dispersion. In part, this may reflect some of the skills issues above, and an associated drop in intersectoral job mobility. In 2006, 52% of all job moves were to a different industrial (SIC) sector, but this had fallen to 37% in the latest data. The gap between tasks in jobs that are being hired for, and those jobs that are being dissolved, is increasingly stark (Nabarro, 2022a).

For the UK, this is a particularly pressing issue, especially when it comes to reallocation between the tradable and non-tradable sectors. In a more volatile global supply and rates environment, one of the ways the UK can adjust to – for example – an adverse shock in global rates markets would be to devalue the currency, and reallocate more domestic production towards the tradable sector (Broadbent, 2011). If that is becoming increasingly difficult, then more of the associated loss must be absorbed by domestic demand. That is a more painful process.

Second, the UK has suffered from a lack of systematic coordination between monetary and fiscal policy. Both in the period after the financial crisis, and in the response to the terms-of-trade shock in 2021–22, monetary and fiscal policy worked against one another. In the former, fiscal consolidation arrested balance sheet repair, limiting the impact of monetary loosening. In the latter, sweeping cash support limited the effective propagation of the original price shock, and also worked against tightening monetary policy. Early evidence suggests relative success at the height of the pandemic, with monetary and fiscal policy working ‘hand in glove’ – although there is an argument this went somewhat too far with the benefit of hindsight (and the efficacy of the vaccines). At best, this is self-defeating. But at worst, the UK macroeconomic response has not just been imbalanced, but often particularly poorly selected – favouring the instrument that is least appropriate. As we note below, in recent history this has reflected the use of an instrument with a long outside lag – interest rates – to address an immediate inflationary risk, instead of an instrument with a much shorter outside lag acting in the opposite direction. That has forced monetary policy to do more in order to secure the necessary insurance. The implication is a weaker outlook now as further policy adjustment works through.

Third is an absence of strategic economic leadership. At times of great uncertainty, providing some strategic clarity can be crucial to triggering an effective investment response. In a context of reallocation, this can be relatively powerful. One way of thinking about this is the effective cost of capital in an investment decision being a function of the rate of interest, the depreciation rate and the expected change in valuation. In the event of economic reconfiguration, at least a portion of the existing asset base is likely to fall in value. But the present value of new investment should, by contrast, be elevated. Appropriate policy interventions can protect investment by separating the former and the latter (Vines and Wills, 2020). That, in turn, can help reduce scarring via capital deepening (Krugman, 2009). Unfortunately, when confronted by this in the recent past, official silence has been deafening.

Managing macro-financial risks and navigating new constraints

In the face of the chronic growth challenge, the most obvious, and indeed tempting, response may be a large debt-financed programme of public investment – a fiscal ‘throw of the dice’. We think this impulse should be resisted for two reasons. First, many of the challenges described above require reform, not only investment. That in turn requires care. And second, and perhaps more importantly, recommendations for such ‘shock therapy’ pay insufficient attention to the risks the UK increasingly faces as a large dual-deficit economy – one with both a government current budget deficit and a current account deficit. Looking forward, we think this will limit policy’s room for manoeuvre.

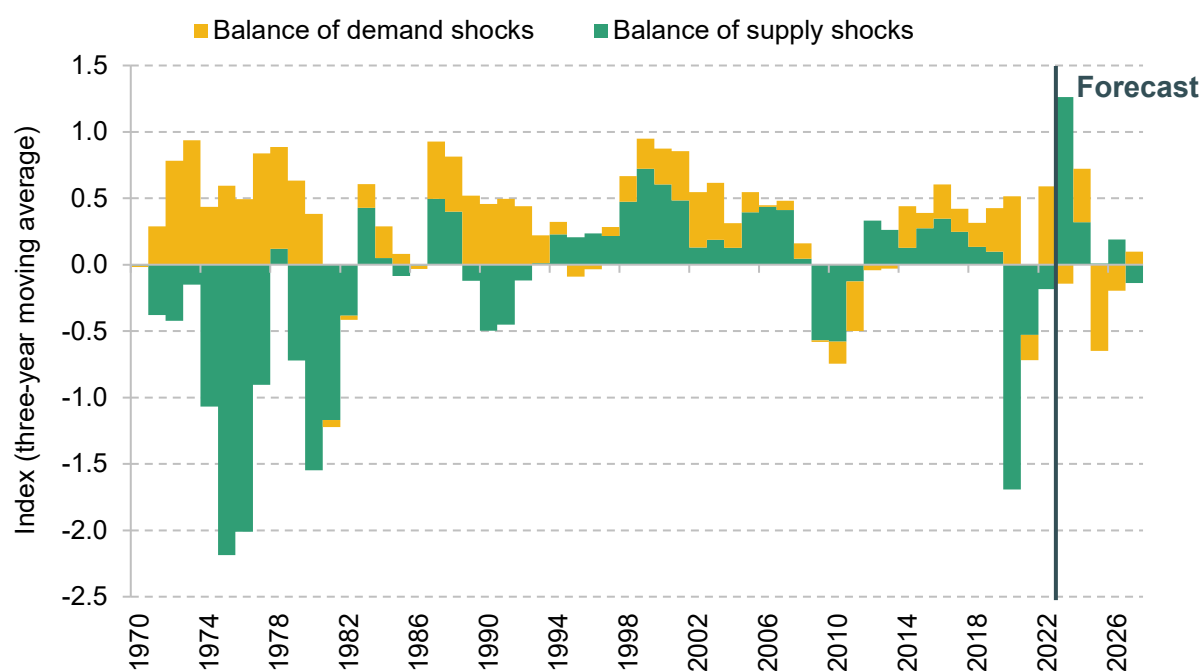
The fundamental issue here is the combination of a high debt stock, increasing volatility on the supply side of the global economy, and the continued need for the UK to attract international capital. As we have seen in recent years, the risk of adverse supply and price shocks seems to be

increasing. Figure 1.5 shows the trend over recent decades, with supply generally a benign and mildly positive economic force through the 1990s and early 2000s. Since the financial crisis, however, this has changed. And rates volatility has begun to increase.

The implication, we think, is that we now need to take the outstanding debt stock rather more seriously. The ‘risk’ scenario is as follows.

A further adverse supply shock – such as a major increase in the price of tradable goods – hits. Inflation begins to rise. Rates, globally and domestically, move (further) above nominal GDP growth. In response to a fall in growth and real incomes, the government feels compelled to offer sweeping support. As more capital is demanded, investors begin to wonder when and how the UK will move from a large primary budget deficit to a surplus sufficient to stabilise debt in the medium term – particularly in a context of higher rates. Given higher existing debt levels, investors may be less patient, and increasingly demand a premium. As yields move higher, the underlying fiscal position worsens. This dynamic begins to feed back on itself.

Figure 1.5. Decomposition of macroeconomic volatility, 1970 to 2027



Note: Supply and demand shocks are identified using an agnostic identification procedure (Uhlig, 2005). A positive demand shock is characterised as a positive shock to both output and inflation. A positive supply shock is a positive shock to output but a negative shock to inflation. A negative supply shock is characterised as a negative shock to output and a positive shock to inflation. A negative demand shock is characterised as a negative shock to both output and inflation. The bars show the net balance each year, on a three-year rolling-average basis. Figures for 2023 to 2027 are Citi forecasts.

Source: Thomas and Dimsdale (2016), Uhlig (2005), ONS, Citi Research.

To be clear, the vulnerability here is not the stock of debt per se but stems from the traded character of government bonds ('gilts') and the UK's external financing gap. The former means that buyers of UK sovereign debt can exert some market power, effectively going 'on strike' until they are happy with the level of yields. The latter means that in the event of such speculative stress, the UK cannot resort to more forceful forms of financial repression to act as a circuit breaker. As we saw in October 2022, market maker of last resort operations are viable but – as the Bank was clear at the time – can only arrest the violence of the move, and not offer an effective yield cap. Speculation could also see the currency devalued. But given the weakness of the initial response of the current account, this would do little to address the external financing need as trade values would likely not react. Specifically, as we discussed above, the response of domestic production to the exchange rate seems to have become increasingly muted. This means more adjustment is now pushed to domestic demand. At best, these dynamics can immediately demand a tightening policy response, with painful results. At worst, they could force the UK to close its external financing gap very quickly, with potentially disastrous results.

These vulnerabilities are to some extent unique to the UK. In the US, reserve currency status limits the buyer power of bondholders. In the Euro Area, as in Japan, a large current account surplus enables a greater degree of domestic control, at least hypothetically. It is plausible that these governments could find the capital to fund domestic liabilities if they could find a means to direct them. In the UK, there is no such recourse.

Structural changes in the gilt market are further adding to the vulnerability here. Domestically, traditional demand for longer-duration bonds seems to be falling as defined benefit pension schemes wind down.⁷ This leaves the overall debt servicing burden more sensitive to changes in market rates. And the UK remains dependent on foreign buyers of sovereign assets. As gilt holdings in the Bank of England's Asset Purchase Facility wind down, this dependence is only likely to increase. This should engender caution surrounding further 'goodwill' – especially as global investment inflows move away from traditional allies.

Fundamentally, alongside a solvency issue, there is a lingering liquidity issue that will stalk UK fiscal policy for some time to come. This, we think, is especially relevant to discussions around the public balance sheet. While it may be appropriate to pay greater attention to the balance sheet position in time, issuing gilts to build physical assets would still reflect an increase in fiscal risks for the UK (see Chapter 2). This needs to be both reflected and managed.

For policy, we see three implications:

⁷ <https://www.reuters.com/markets/rates-bonds/uk-debt-chief-sees-less-value-long-dated-gilt-issuance-2024-03-06/>.

- 1 *Higher and more volatile rates should mean more concern around outstanding debt, and stronger preferences for a smaller outstanding stock.* Over recent decades, such concerns have been effectively rendered moot by the trend decline in rates. That is unlikely to be as supportive going forward. This should suggest some concern about a further ‘ratchet up’ in outstanding debt, especially if supply shocks become more common.
- 2 *Creative solutions are needed to address investment demands, without accruing even more conventional debt.* Here, the underlying risk emanates from the buying power of bondholders and their ability to go ‘on strike’. Other avenues of bolstering the asset base may offer better trade-offs from a liquidity point of view. Structures such as co-investment are by no means risk free but, to the extent they enable investment without adding to the stock of liabilities that could be speculated upon, they could create a better trade-off between risk and benefit than merely funding such schemes up front.
- 3 *The macroeconomic policy balance in the event of further cost shocks probably does need to be re-appraised.* We would argue for fiscal policy to show some initial restraint in the event of shocks, and that monetary policy should be a little more passive. Fiscal expansion not only increases pressure on funding. But to the degree it forces monetary policy to be even more aggressive, this in turn can feed back into the medium-term rates profile. That can fuel speculation about the UK’s capacity for fiscal pain. Not only is a rates-driven response to such shocks ineffective or painful economically, it is also financially risky – at least if higher rates are expected to persist for some time.

Summing up: charting a better path

The UK is likely to face a series of strategic demands for resources in the years ahead – for the net zero transition, in response to geopolitical risks or for investment in public services (particularly in health and social care as the population ages). While ignoring these demands would ultimately be economically harmful, these investments are unlikely to deliver meaningful growth. In fact, they are likely to cost.

To meet these challenges, policymakers need to act urgently to boost growth and improve the UK’s ability to recover from future shocks. Transitioning to a high-growth, high-investment equilibrium will require greater policy focus on: the treatment of intangible assets, improving skills, labour mobility and business dynamism. Such efforts will likely need to be accompanied by a more thoughtful playbook in terms of managing supply shocks, particularly when it comes to the balance between monetary and fiscal instruments.

This reform agenda must now be delivered within more pronounced policy constraints, and in a context where the risks of overstepping those constraints are plausibly greater. This should temper the impulse to rely primarily on significant increases in debt-funded public investment. We are sure public investment will be part of the answer, but this will need to be funded partly

via lower consumption – i.e. some combination of higher taxes or lower day-to-day public spending – and supported by structural reform. Gains cannot come without some initial pain.

In this sense, the Chancellor does inherit some difficult challenges. If funding costs do normalise as expected and economic capacity begins to improve, it is essential that any resulting fiscal space is put to more productive use. But success will depend, first and foremost, on broader structural reform.

1.3 The economic outlook: avoiding a hard landing

After a period of subdued supply growth, we see potential for a modest degree of catchup in the years ahead. However, that supply-side optimism is checked somewhat in the near-term by lingering consumer caution, modest fiscal consolidation, and lagged effects from higher interest rates. We expect demand to remain somewhat subdued, and a margin of slack to emerge over time. Rate cuts, most likely into accommodative territory, are likely to follow.

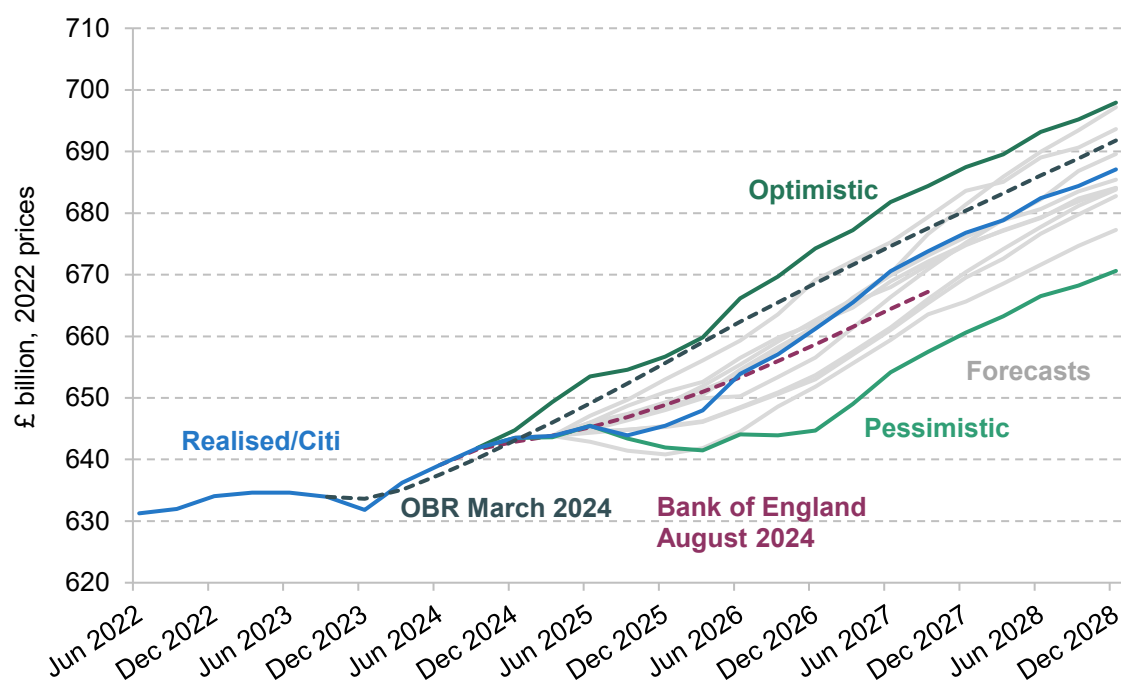
The risks remain substantial. Globally, there are some signs of labour market loosening in the US, although we anticipate only a modest slowdown, and a swift recovery in 2025. Structural uncertainties in China also remain a concern, generating we think a downside skew to the risks around external demand. The traded component of inflation looks likely to remain relatively soft, with goods prices likely easing in relative terms.

Domestically, the key question increasingly surrounds the saving rate. On the household side, real income growth is not yet feeding through into higher consumption. Firms are also still cautious. We expect some modest improvement through the remainder of this year, as uncertainty continues to fade. But still high interest rates alongside a meaningful deterioration in household balance sheets suggest a more persistent increase in household saving.

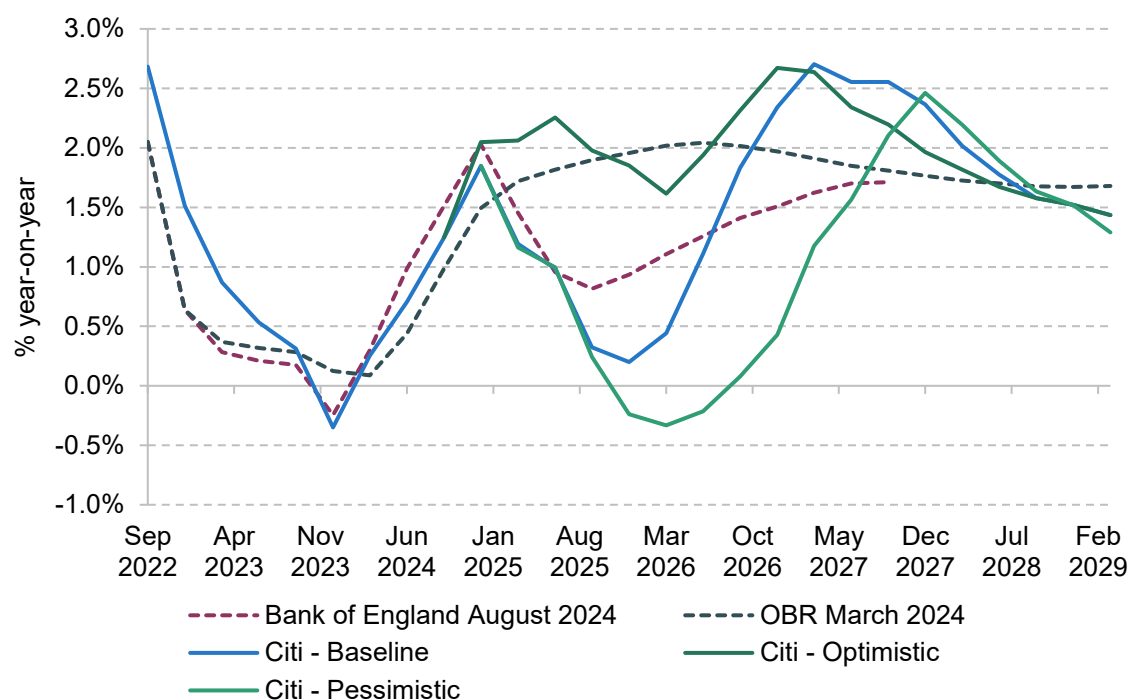
In our baseline scenario, we expect UK GDP to increase by 1.0% this year, but by only 0.7% next year, as shown in Figure 1.6. While we remain cautious into 2025, we expect growth to accelerate markedly through 2026 and 2027 as the monetary and fiscal constraints are eased back and catchup potential is subsequently realised, before normalising through the second half of the forecast horizon.

Figure 1.6. Real GDP under different scenarios

Panel A. Real GDP, chain-linked volume measure (£ billion, 2022 prices)



Panel B. Real GDP growth (% year-on-year)



Note: The graph shows our baseline forecast alongside the Bank of England's modal, market-conditioned forecast for August, and our optimistic and pessimistic scenarios. The latter are discussed in Box 1.1. The OBR forecast is taken from the March 2024 economic and fiscal outlook. Historical forecasts in Panel A are indexed back to the last realised data point at the time the forecast was made.

Source: OBR, Bank of England, ONS, Citi Research.

Given the degree of uncertainty, we also present two alternative scenarios for real GDP in Figure 1.6. In the optimistic scenario, we assume that energy commodity prices fall more quickly. In the pessimistic, we model the impact of a large procyclical fiscal stimulus in the US, which under certain assumptions may weaken the UK's economic outlook. These are intended to illustrate the potential sensitivity of our baseline estimates to different shocks, and to give a sense of what scale of shock would be required to deliver economies of different sizes by the end of the forecast period. These alternative assumptions are discussed more fully in Box 1.1 later, and their impacts on the trade-offs facing the Chancellor at the upcoming Budget are addressed in Chapter 2.

In this section, we begin with the recent UK recovery, then turn to the global economic outlook, trends on the supply side of the UK economy, the outlook for demand and for households and firms, and recent trade underperformance.

How secure is the UK's economic recovery?

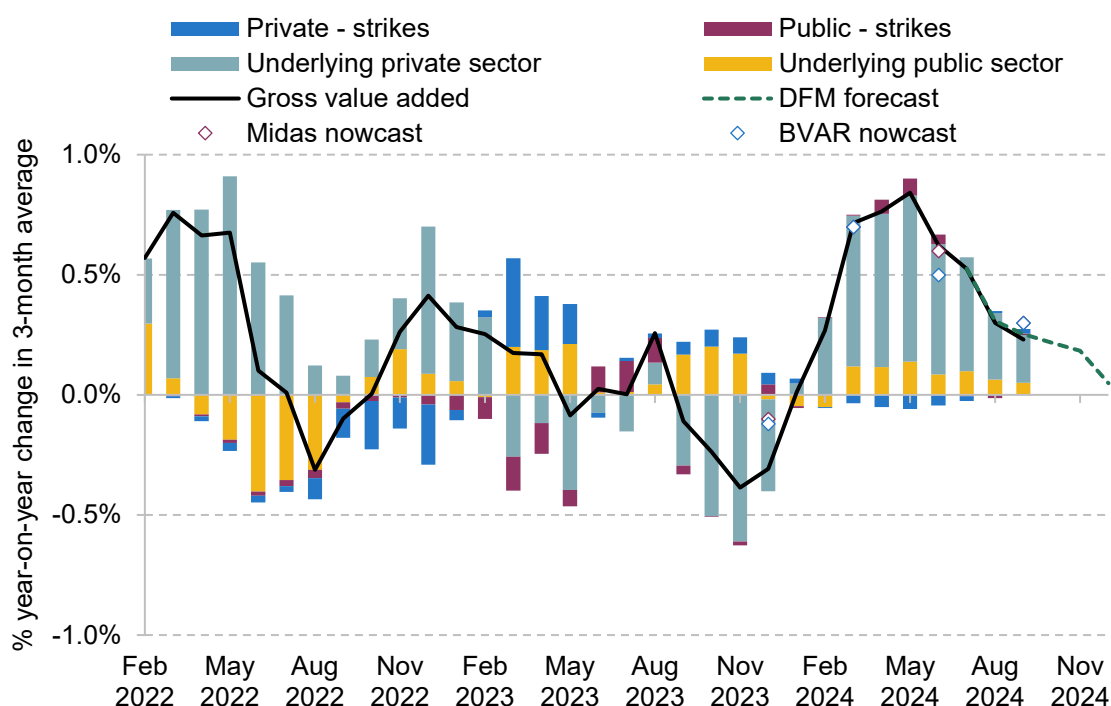
The UK economy has surprised to the upside since the start of 2024. We now expect real GDP growth of 1.0% this calendar year, compared with forecasts of just 0.1% back in January. Revisions in the forecasts of the Monetary Policy Committee of the Bank of England have been equally dramatic: from year-on-year GDP growth of 0.2% to 1.2% as of August, at least in the MPC's market-conditioned baseline (Bank of England, 2024b).

Unfortunately, while welcome, we think these improvements are not yet indicative of a secure economic recovery. This is for three reasons. First, a reasonable share of the upside surprise in the year to date only compensates for a strikingly weak end of 2023. Second, and associated, the pickup in growth that has occurred has remained sectorally narrow and has been unusual. Specifically, most of the growth has been concentrated in the non-consumer, untraded, business-to-business services sector such as 'scientific research and development'. As energy prices have fallen, we think many of these sectors have been 'turned back on'. And third, those sectors that have driven the recent improvement have generally been those to lag, rather than lead, in a cyclical upswing.

Indeed, it seems the underlying 'engines' of demand in the UK are not yet obviously motoring. In recent quarters, public consumption has been surprisingly strong, perhaps reflecting in part the overspend noted by the new Chancellor in the 29 July spending audit (HM Treasury, 2024). These effects, however, may not last. And there does not seem to be much scope for a sustained consumer-led economic recovery. The tradable sector is already contracting, with global demand likely to soften further. There is little in the data as yet that implies to us that there will be a sustained, demand-led economic upswing. We expect quarterly growth to fall slightly to 0.3% in Q3 and 0.2% in Q4 before falling further into 2025. Figure 1.7 shows a breakdown of the drivers of recent growth, as well as our nowcasts into the end of the year. A correlation-weighted

average of the soft data would suggest underlying quarterly activity growth of around 0.2 percentage points. Expectations remain a little more buoyant, although these too have softened in recent months.

Figure 1.7. Nowcast of UK gross value added



Note: BVAR and Midas nowcasts are products of a Bayesian VAR model and a mixed frequency sampling model respectively. Our main nowcast is based on a dynamic factor model (DFM) of roughly 120 survey indicators.

Source: ONS, Citi analysis.

The global outlook: subdued demand

In this subsection, we consider the economic outlook for the world's largest economic blocs – China, Europe and the US – in turn, and then what this may mean for the UK.

China

China's economic growth has slowed. We now forecast growth of 4.7% in 2024, versus 5.0% at the start of the year. Some of the softer data – such as consumer confidence – appear somewhat worse. Recent weakness is attributable to two main factors.

- 1 *Industrial misallocation.* The decentralisation of government investment decisions, coupled with central direction, seems to have led to industrial duplication in several target areas. For instance, Liu (2024) argues that China can now produce almost twice the volume of solar panels that the global market can absorb. As higher rates have curbed demand for capital

goods, a supply glut has emerged, and manufacturing PMI surveys reflect weak demand and falling prices.

- 2 *Domestic real-estate troubles.* Residential property prices have been falling for nearly a year, undermining consumer confidence and increasing precautionary saving. Consumer confidence has suffered as a result, and much of the consumption data – such as retail sales – have remained soft.

Stimulus is crucial to turning around China's woes. With CPI hovering just in inflationary territory, the longer it takes for a more forceful reaction to emerge, the greater the probability the Chinese economy finds itself caught in some kind of deflationary trap.

Recent interventions have provided some limited relief in the property market, but have thus far been predominantly monetary.⁸ To date, fiscal support to the consumer appears modest – with policymakers still seemingly minded to do 'as little as possible' rather than 'whatever it takes'. We expect growth to remain soft into 2025, and global goods inflation to remain subdued.

Europe

We expect real GDP growth in the Eurozone to average around 1%, although with a clear divide between core and peripheral economies. Spain and Greece are growing at 2–3%, driven by strong service sectors. German growth is much weaker, reflecting weaker external demand from China, and domestic competition from Chinese imports, which are increasingly competitive (rather than complementary).

Europe's trade challenges are both structural and cyclical. Structurally, European manufacturers are grappling with increasingly direct competition from China and high unit costs, especially for energy. European households pay some of the highest electricity costs globally, which is eroding market share. Unit costs in March 2023 were \$0.21 per kWh in France but \$0.52 in Germany, compared with \$0.18 in the US, \$0.08 in China and \$0.47 in the UK. Mario Draghi, former Prime Minister of Italy, has called for a significant increase in public investment to address some structural issues (Draghi, 2024), but political barriers make this unlikely.

Cyclically, the question is for how long services output can be sustained while manufacturing growth falters. This will depend primarily on the labour market. Softening in manufacturing hiring has so far been offset by public sector strength, and falling structural unemployment in the periphery. However, there is a risk the labour market will loosen further, especially as fiscal

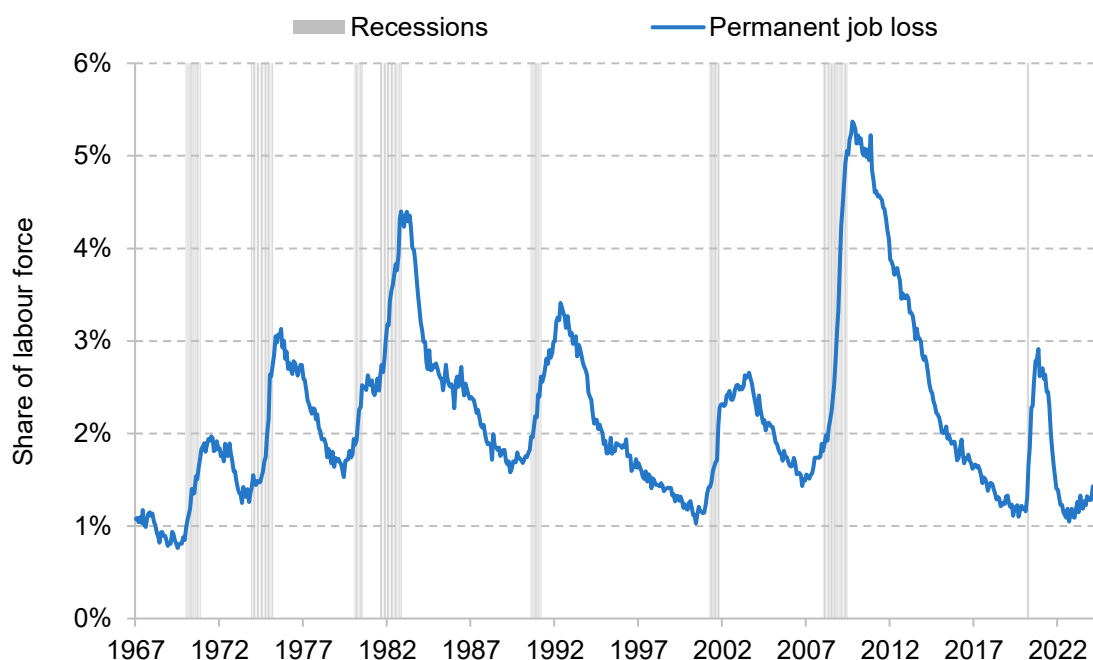
⁸ In May, multiple steps were taken to stabilise the property market. These included the removal of the mortgage rate floor, a provident fund loan rate cut and a cut to the minimum downpayment ratio. Subsequent government direction included the establishment of a local government buy-back programme, where unsold property would be converted to social housing, and a People's Bank of China relending programme for social housing. Four months on, it is clear that the intervention has had a limited impact, with recent research questioning whether it was even net stimulative (Sheets, 2024). However, more recent measures could have a larger impact.

tightening continues in the European core – a similar potential concern in the UK. This risk will be compounded by slowing growth in the US.

US

After stronger-than-expected growth in the first half of the year, the outlook for the US is finely balanced – between a ‘hard landing’ with a weakening labour market and a ‘soft landing’ where activity remains stable even as inflation eases. Historical comparisons might suggest a hard landing, with the ‘Sahm Rule’ – an early recession indicator linked to a loosening labour market – already triggered, as shown Figure 1.8. But this cycle has been anything but typical, and consumer spending has been fairly robust, countering recession fears for now.

Figure 1.8. Recessions and permanent job losses in the US since 1967



Source: BLS.

We do expect US economic growth to slow toward the end of the year. A further softening in labour demand is a key concern, if this increases the household saving rate. For now, we anticipate a modest slowdown and a swift recovery through 2025, although the outcome could be less benign.

Commodity prices and interest rates

Recent events and associated risks notwithstanding, commodity prices are expected to come down – near-term political risks notwithstanding. Oil prices have already fallen by 17% since April, in part reflecting the tepid outlook for aggregate demand. Prices have increased sharply in recent days as the geopolitical temperature has increased. Uncertainty has increased as a result.

Nonetheless, in the medium term, we expect an expansion of supply, with continued pressure from OPEC members for a lifting of production quotas and non-OPEC production continuing to outpace forecast aggregate demand growth. Citi's commodities team expects oil prices to fall to as low as \$60/bbl over 2025 as these effects feed through. We expect gas prices in Europe to remain broadly stable (barring further shocks).

We also expect shipping prices to normalise, after another period in which prices have been unusually elevated. For instance, the WCI Shanghai to Rotterdam index – an estimate of the cost of container freight – climbed sharply through 2024, peaking at four times the 2023 rate. Attacks in the Red Sea have driven a large-scale rerouteing around the Cape of Good Hope, elongating journey times and cutting capacity. But prices have begun to fall once again.

On interest rates, much will depend on the outcome of the US presidential election at the start of November, but the global picture is one of improving supply and somewhat subdued demand. All three major transatlantic central banks have now begun to ease policy. The Federal Reserve cut rates in September from 5.3% to 4.8% and pencilled in two more quarter-point rate cuts in 2024. We anticipate the Fed will seek to return to a 'neutral' policy rate fairly quickly over the coming months to minimise the risk of a further labour market deterioration. We expect the European Central Bank to seek further reassurance around wage and price setting, and to cut rates more gradually, although later rate cuts may ultimately prove larger overall.

What might this mean for the UK?

Altogether, demand tailwinds globally are beginning to fade. This reflects demand-based uncertainty in the US and structural concerns in China, and subdued manufacturing and consumer demand in Europe. Our earlier forecasts reflected an anticipated recovery in Chinese domestic output and some associated spillovers in European production. The former has proven disappointing and US 'growth exceptionalism' has become more pronounced.

As a result, we have revised down our forecasts for global growth in 2025. In our baseline assessment, global activity falls back in the second half of the year. External inflationary influences are also likely to be fading.

We now expect UK-trade-weighted global GDP growth of 1.8% this year and 1.5% next, before a gradual recovery to an annual rate of 2.0% in the medium term. This implies little external support for UK growth as we move into next year, and indeed tradable support fading somewhat.

Otherwise, our UK forecast is conditioned on the following assumptions:

- UK-trade-weighted global real GDP growth of 1.5% in 2025, 1.6% in 2026 and 1.9% in 2027, a little softer than other recent official forecasts.

- Oil prices to fall to around \$70/bbl, based on the oil futures curve. Here we see risks skewed to the downside given the views of our commodity team above.
- Gas prices to fall gradually to 73.4 pence per therm over the forecast horizon.
- UK-weighted export prices to fall by a further 2% next year, before recovering through 2026.
- Trade-weighted sterling to settle in an 82–83 range, 2.5–3.0% higher than earlier in the year.

Box 1.1. Alternative scenarios

As in previous years, we complement our baseline forecast with two alternative scenarios, in this case based primarily on differences on the conditioning assumptions.

In our **optimistic scenario**, we assume that global commodity prices fall more quickly. Global oil prices fall to a little over \$50/bbl, a further 25% decline from current levels, and compared with \$70/bbl in our baseline scenario. We assume European gas prices follow a similar profile, perhaps reflecting a more accommodative deal around the transit of gas through Ukraine. We assume that a 10% supply-driven reduction in oil and gas prices boosts medium-term capacity by 0.15–0.2% and 0.3% respectively. We also assume a modest front-loaded benefit from lower household saving as residual inflation-related uncertainties fade. In this scenario, we would expect real GDP to end up around 1.8% stronger than our baseline forecast, as shown on Figure 1.6.

Our **pessimistic scenario** focuses on the UK's external financial vulnerabilities. We model the impact of a large (5%), procyclical, permanent tax cut in the US. We have opted for a deliberately large move here to explore the risks associated with a shift in global interest rates; we are interested in this, rather than the impact of the tax cut per se. On the spillovers to the UK, we assume a 0.35 spillover from US to UK real GDP – a relatively high ‘real economic’ effect. But we then assume that the scale and procyclical nature of the stimulus mean a larger sell-off at the longer end of the US curve as inflation concerns grow, with associated spillovers into UK rates. We assume UK funding costs increase by around 1% at a five-year horizon, less than half the increase in the US. And we assume that the Federal Reserve responds to the associated stimulus, resulting in a fully offsetting rate-hiking cycle. We assume the Federal Reserve would increase Fed Funds rates by 2.5–3.0ppt, weighing on subsequent US GDP. We assume that much of the effect of the funding shock must be absorbed via domestic demand – reflecting the inelastic nature of the UK's external account. We expect that by the end of the forecast horizon, real UK GDP would be around 2.4% lower under this scenario than in our baseline.

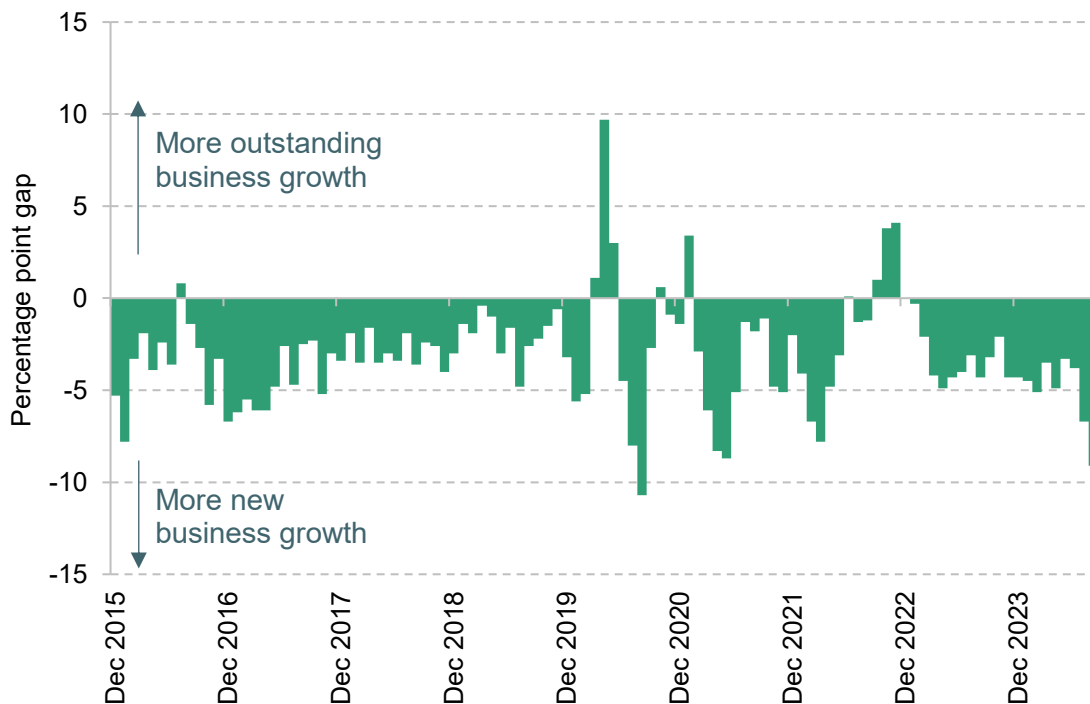
Improvements on the supply side

In the near term, we think the supply side of the UK economy will continue to recover. Three supportive trends are continuing to work though.

First, the last remnants of temporary labour matching issues have diminished. In recent years, extensive cash support for firms and the continuation of the furlough scheme through much of 2021 locked workers into existing employment, even as the shape of the economy changed. This led to a severe tightening of the labour market – especially in sectors with high churn in normal times – and a sharp deterioration in labour market matching overall (Nabarro, 2022a). This has also resulted in a period of discretionary labour hoarding as firms grew more uncertain about their ability to hire. As these effects have gradually faded, the reallocation of labour has improved, enhancing underlying capacity.

Second, there have been reductions in energy and food prices facing firms. Here, supply losses result from function-specific capital and from belated price adjustments. This can make it more challenging to adjust to sudden, large asymmetric or technology-specific shocks, such as a surge in energy prices. Take the example of a takeaway pizza shop. If gas prices suddenly double, but output prices adjust only slowly, then the firm may choose to reduce capacity temporarily in order to minimise the loss – at least until such time as output prices and input costs are in better balance. Capacity utilisation becomes a dimension of capacity adjustment. The PMI data illustrate this shift (see Figure 1.9): during the energy crisis, outstanding business grew very quickly relative to the overall volume of new orders, consistent with firms cutting back on capacity. Since then, the gap between these growth rates has widened again. With energy prices facing many parts of the commercial economy only just beginning to fall, further improvements are expected.

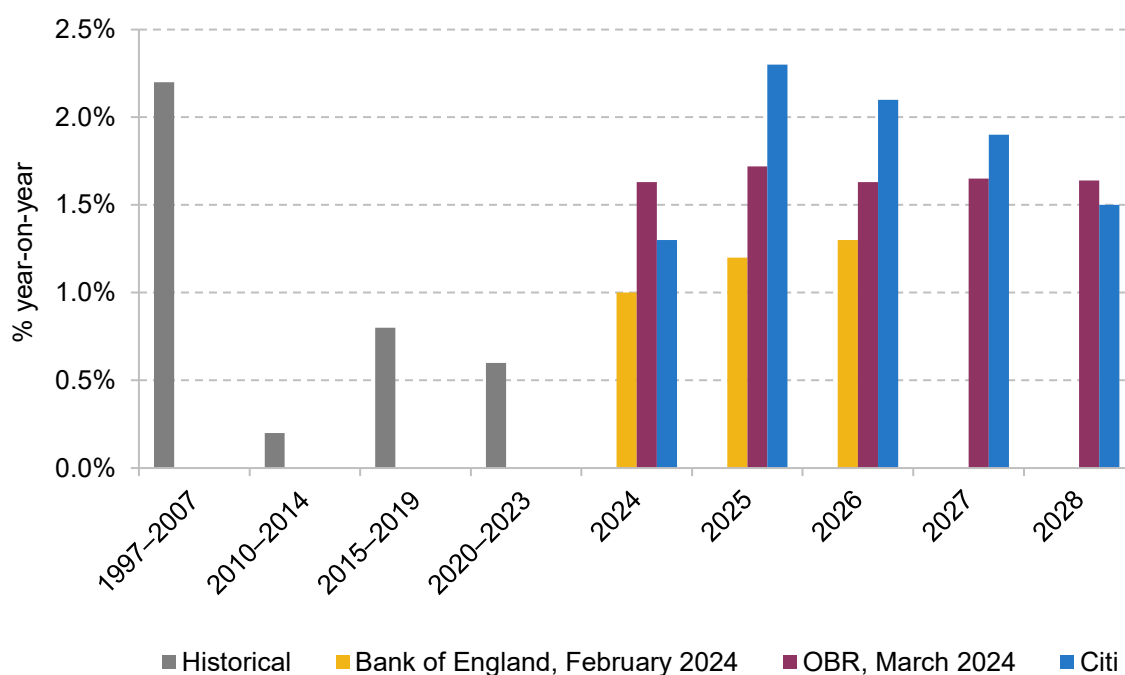
Figure 1.9. Percentage point gap between growth in outstanding business and new business



Source: IHS Markit.

Third, the relative price of labour and non-labour inputs is shifting again. In 2022, as input prices increased sharply, labour became relatively cheap. Alongside discretionary labour hoarding, this is one reason firms did not reduce staffing in 2022 despite cutting back on capacity. Such shifts are particularly important in the UK and, historically, they explain why unemployment fell less than expected after the financial crisis but by more than anticipated in the early 1990s, for example.⁹ Over the past 18 months, the relative cost of labour initially fell, incentivising labour-intensive production. This trend has since reversed as energy prices fell and wages increased. We expect the relative price of labour to continue to rise in the coming months as costs continue to fall back – at least relative to wages. This should drive productivity enhancements as production becomes more capital intensive. But this suggests aggregate demand must grow more strongly if the labour market is to be kept on an even keel. Historically, this has not been the norm.

Figure 1.10. Year-on-year growth in potential GDP, UK



Note: Grey bars cover periods of several years.

Source: ONS, Bank of England, OBR, Citi analysis.

Currently, we estimate the UK's long-term potential growth rate at around 1.4–1.5%. This is consistent with the ONS's latest population estimates, alongside our view of trend productivity growth. In the near term, however, we think capacity can grow somewhat faster than this as

⁹ The UK is a small open but also services-orientated economy. As a result, the relative price of labour can move around significantly. The production side of the economy is also relatively sensitive to associated changes as labour and capital are more easily substituted.

these supply shocks wane, as shown in Figure 1.10. Unfortunately, substantial scarring remains likely. But we think modest catchup effects are more likely than not. Compared with the Bank of England, we anticipate stronger potential growth through 2025 and 2026 as these benefits materialise.

Monetary and fiscal policy are both likely to depress demand

With the supply side improving, we expect the constraint on economic activity to shift to the demand side, primarily due to the legacy of policy during the pandemic. The current challenge is the result of two factors. First was a procyclical fiscal approach during the energy and cost shocks of 2022–23, with fiscal policy effectively offering sweeping support in response to a supply shock. Second, and associated, was the anti-inflationary insurance taken out by monetary policy over the same period. In both cases, the UK economy faces a period of adjustment ahead – with policy headwinds likely continuing to build.

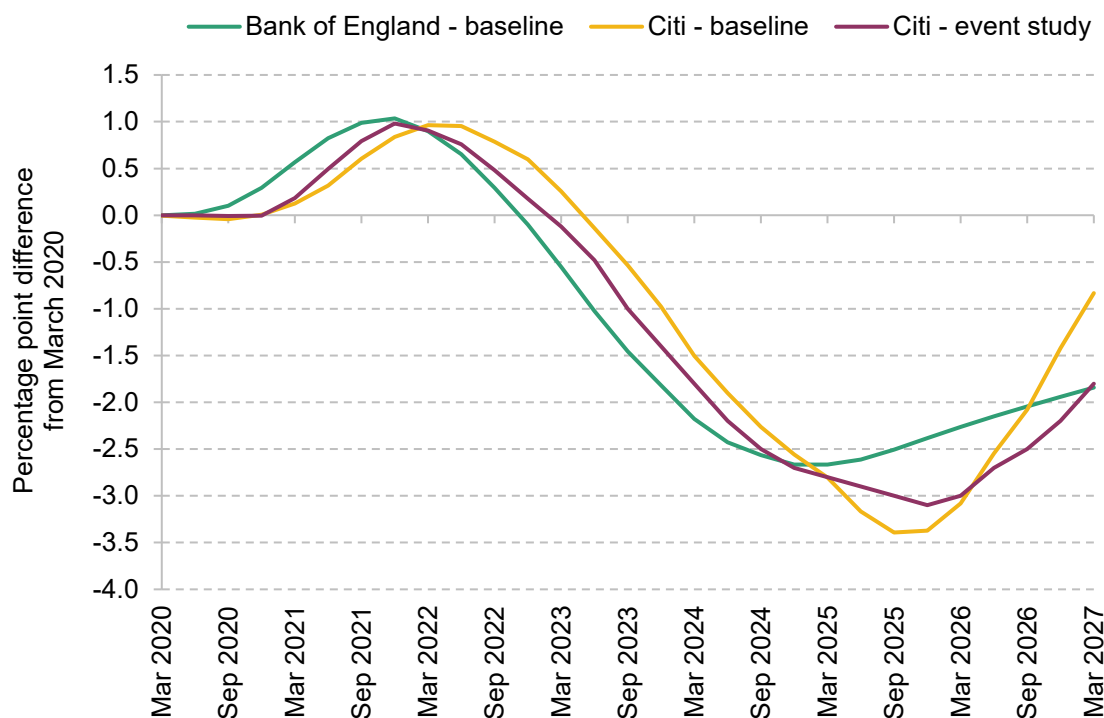
The key debate centres on the transmission of monetary policy. One view holds that the overall macroeconomic effects of the rate increases of recent years have been limited. While by no means the collective view of the MPC, Bank staff did note in August that the majority of the impact of previous rate rises on real GDP may already have been felt (Bank of England, 2024b). Others have noted the risk that rates may be even less ‘restrictive’ than the MPC had thought (Greene, 2024). While not the intention of policy 18 months ago, that would suggest that in fact policy has not been hugely powerful, with relatively little further effect to come.

While this view remains plausible, we think it sits at one (optimistic) end of a wide range of plausible outcomes. Estimates of Bank staff, for example, are based on a 2015 model (Cloyne et al., 2015) which itself is sensitive to modest specification changes (such as the period over which the model is estimated). And this is only one model among many. Other approaches over the same period – such as an event study approach (shown in purple on Figure 1.11) – would suggest a greater effect to come.

And with respect to the recent data – which show some signs of life in the housing market and a slight uptick in credit growth – these continue to be buffeted by some of the oddities of the recent cycle, in particular the large increase in monetary holdings through the early part of the pandemic. This has sheltered large swathes of the economy from higher capital costs, as households and businesses had accumulated internal liquidity between 2020 and 2022. With holdings now back at trend, credit growth is beginning to increase. But so too are effective interest rates.

Indeed, as we see it, the risk around any historical estimate of policy transmission is probably skewed towards a longer lag rather than a shorter one. Five key structural changes are notable and relevant in our view:

Figure 1.11. Modelled impact of changes in Bank Rate since 2020 on UK GDP (% of GDP)



Note: The Bank of England Baseline here is based on Cloyne et al. (2015), incorporating the changes in rates only. The purple line shows an 'event study' approach based on MPC announcements and speeches by MPC members. The series is then orthogonalised against the subsequent data themselves, as suggested by Bauer and Swanson (2022). The event study series is based on a two-hour window around these announcements. The Citi Baseline estimate is based on a five-variable SVAR model, estimated 1971–2019.

Source: ONS, Bank of England, Cloyne et al. (2015), Bauer and Swanson (2022), Citi analysis.

- 1 The proliferation of fixed-rate lending.** Fixed-rate mortgages accounted for 95% of new mortgage lending in 2019, compared with 40% in 2010. This shift has slowed the impact of higher rates on cash flow and provided greater near-term security for households, slowing transmission into the household sector.
- 2 Larger financial asset holdings.** Both households and firms are generally carrying more interest-bearing assets. Respectively, this reflects an older population and recent government-backed support for businesses. This meant households and firms enjoyed an up-front boost from stronger interest income as rates rose.
- 3 Improved household equity.** Greater equity in the housing market has provided a buffer against deteriorating credit conditions, even as house price growth has stalled. Lower household debt – and a concentration of that debt among those with more cash assets – has ameliorated any precautionary saving response.
- 4 Declining business creation.** The UK has experienced a long-term decline in business dynamism, as discussed in Section 1.2, resulting in lower net new corporate lending for the

same level of activity. This, and the fact that existing firms often have substantial cash reserves, has slowed the impact of rising borrowing costs on activity and employment.

- 5 Increased substitutability between labour and capital.** Over the past decade, the UK economy has become more specialised in sectors where the effects of rate changes on employment tend to manifest more slowly, reflecting a greater degree of substitutability between capital and labour. The initial impact of rate hikes may be to lower productivity, with impacts on employment coming later.

All of this to us implies lower, slower transmission from rates to activity. The changes here can be roughly grouped into three structural changes.

First, in an equilibrium sense, there is less probably demand for new credit at any single point in time. Historically, this has tended to be how most of the demand-destructive effects of policy materialised, and often at a relatively rapid pace (Bernanke and Gertler, 1995). We think this mechanism is less powerful now. On the firm side, that reflects the trend reduction in business dynamism we noted above, and the shift towards intangible assets that are more often financed via internal liquidity (Caggese and Pérez-Orive, 2020). On the household side, that also reflects the shift towards older age groups, who consume fewer durables and have less demand for housing credit (Guerrón-Quintana and Kuester, 2019; Wong, 2019). Among this group, there may also be more ‘target savings’ behaviour, which offsets the traditional savings boost from higher rates.

Second, the precautionary response associated with higher debt and interest rate volatility also seems truncated. This also reflects the shift towards an older population. We know that historically in the UK, indebted households have tended to have a more violent reaction to changes in debt servicing as binding liquidity constraints loom (Cloyne, Ferreira and Surico, 2020). Today, fewer households are in this position, with fewer mortgaged households and a larger offsetting base of financial assets. And similarly, corporate deleveraging over recent years and self-funding of an increasing share of investment leave investment less responsive to changes in rates.

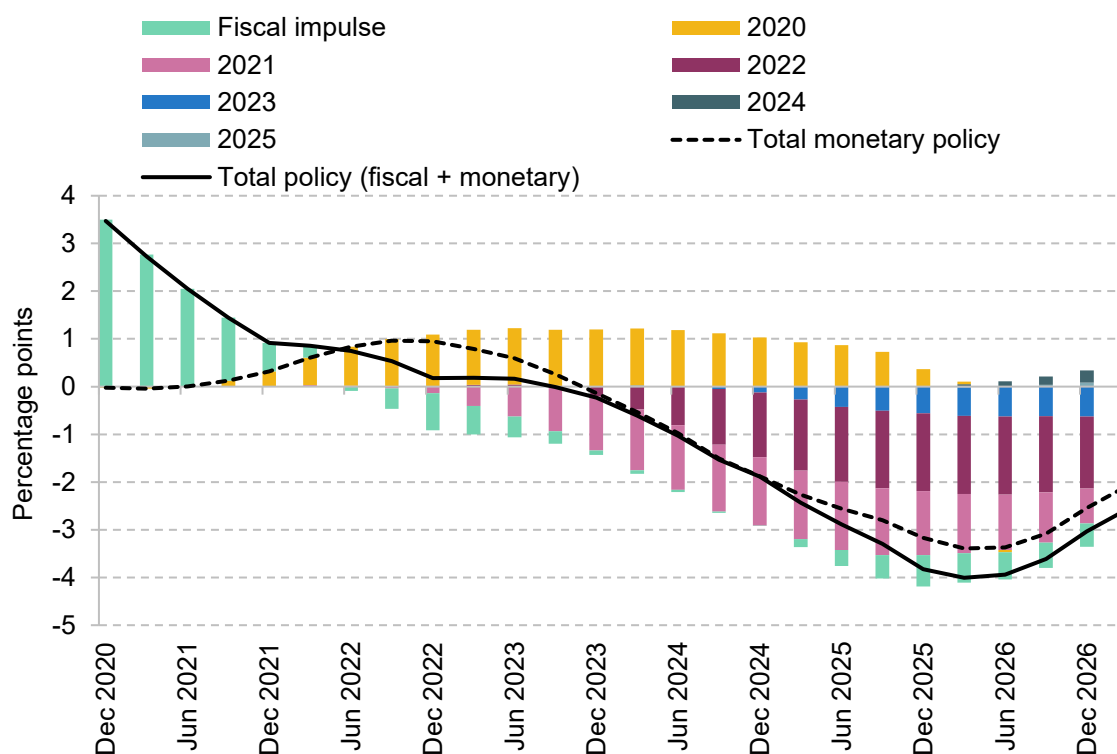
Third, just as transmission has grown more dependent on cash-flow effects, changes in mortgage structure and asset holdings have attenuated their impact. Hence initially both households and firms have enjoyed something of an income boost from higher rates as the rate of return on assets accelerated but debt servicing costs were unchanged. In more recent months, that has begun to reverse, implying a growing headwind to income growth in the months ahead.

This would suggest policy transmission overall may be a little lower, but crucially also slower. Here we think it is useful to think about policy transmission as reflecting three separate steps: the transmission from Bank Rate to financial conditions, the transmission from financial

conditions directly to activity, and then the rebalancing of activity in response to the shock to financial conditions. The second and third steps are likely to take time.

Alongside headwinds from monetary policy, fiscal policy is also likely to exert downward pressure on activity. The details will depend on what the new Chancellor does in her inaugural Budget on 30 October, but the fiscal inheritance (discussed more fully in Chapter 2) suggests some fiscal consolidation is to be expected over the coming years. The combination of fading prior support (including energy grants and similar) with a further tax increase of £15–20 billion in the autumn – even if this was focused in areas with low fiscal multipliers and was accompanied by top-ups to day-to-day spending (£5 billion) and investment (£10 billion) – would still suggest a headwind from fiscal policy into next year. The combined policy impulse is shown on Figure 1.12.

Figure 1.12. Combined impact of monetary and fiscal policy on UK GDP level (percentage point deviation from trend)



Note: Monetary policy impact here is based on the Bank and associated market rates modelled through a SVAR impulse response. This has been discounted to reflect some of the structural changes listed above. It has also been pushed back by a quarter – reflecting the arguments above. The fiscal impulse is based on the cumulative impact of all discretionary changes since the onset of the pandemic. Here we have excluded the Energy Price Guarantee and the Energy Bill Relief Scheme. Some of the public spending during the height of the pandemic has also been discounted, reflecting reported waste.

Source: ONS, Bank of England, OBR, Wolf (2020), Citi analysis.

Further headwinds to demand, as we note below, increase the risk of a rise in the unemployment rate in the months ahead. This, we think, could have been avoided with policy that was more appropriately calibrated previously and that reflected a better-balanced policy mix. As many of the MPC's more 'dovish' members noted through 2022, hiking rates in the face of recent supply shocks risked weighing on demand just as the effect began to ebb (Tenreyro, 2023).

Nonetheless, monetary policy was forced to take out an increasing degree of insurance as fiscal policy became more and more stimulative. The resulting drag speaks to the limitations of using an instrument with a long lag to address a near-imminent inflation concern – a feature that often requires monetary policy to overshoot, but also risks dragging at precisely the wrong time.

Consumption still subdued with households not dissaving yet

Household consumption remains the single most important component of UK GDP. It has also been central to the UK's post-COVID economic underperformance. Private consumption is now 8.7% below its pre-pandemic trend, well above the shortfall seen in the Euro Area, and 1.3% below its pre-pandemic level. The hope for 2024 was that falling inflation and rebounding real incomes would drive a recovery in consumption. This has yet to materialise.

Consumers seem to be shifting their spending rather than increasing it. Recent figures show a modest improvement in retail sales as goods prices fell, but offset by slowing momentum in the consumer services sector. This is supported by industry trackers such as the Coffey Peach Index, which remained subdued over the summer, with nominal growth in the low single digits.¹⁰ While business-to-business services have continued to grow, growth in consumer-facing services has stalled.

Looking ahead, we expect consumer spending to strengthen, particularly retail spending. Consumer confidence has improved, although the upward trend seen through late 2023 and early 2024 has paused as real income growth stabilised. As real income gains feed through, they should begin to boost consumption more noticeably. Some surveys, such as recent PMI data, indicate improving consumer demand – at least in the anecdotes – and we expect growth to pick up by the end of the year (S&P PMI, 2024).

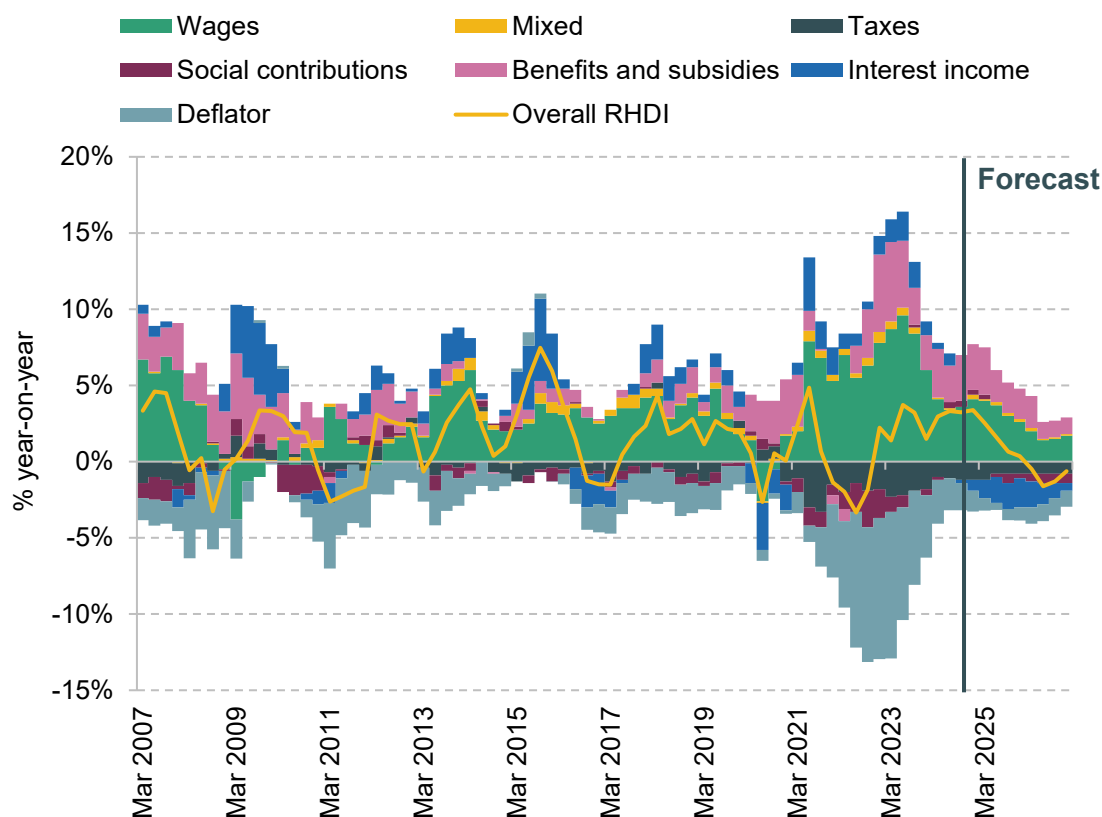
However, the scope for a sustained consumer-led economic recovery seems to be narrowing.

Most of the recovery in real incomes has already occurred. Annual growth in real household disposable income (RHDI) has hovered at around 3–4% since 2023 Q2, as faster nominal wage growth has accompanied slower price growth. We anticipate some additional momentum in the fourth quarter as public sector pay deals are finalised. Beyond that, we expect nominal wage

¹⁰ Nominal growth across hospitality establishments is estimated to have fallen from 5.2% year-on-year in March to 1.3% now, suggesting further reductions in volumes.

growth to slow and interest income to fall. As shown in Figure 1.13, growth in RHDl is expected to steadily decline through 2025 and turn negative in 2026.

Figure 1.13. Real household disposable income growth, UK (% year-on-year)



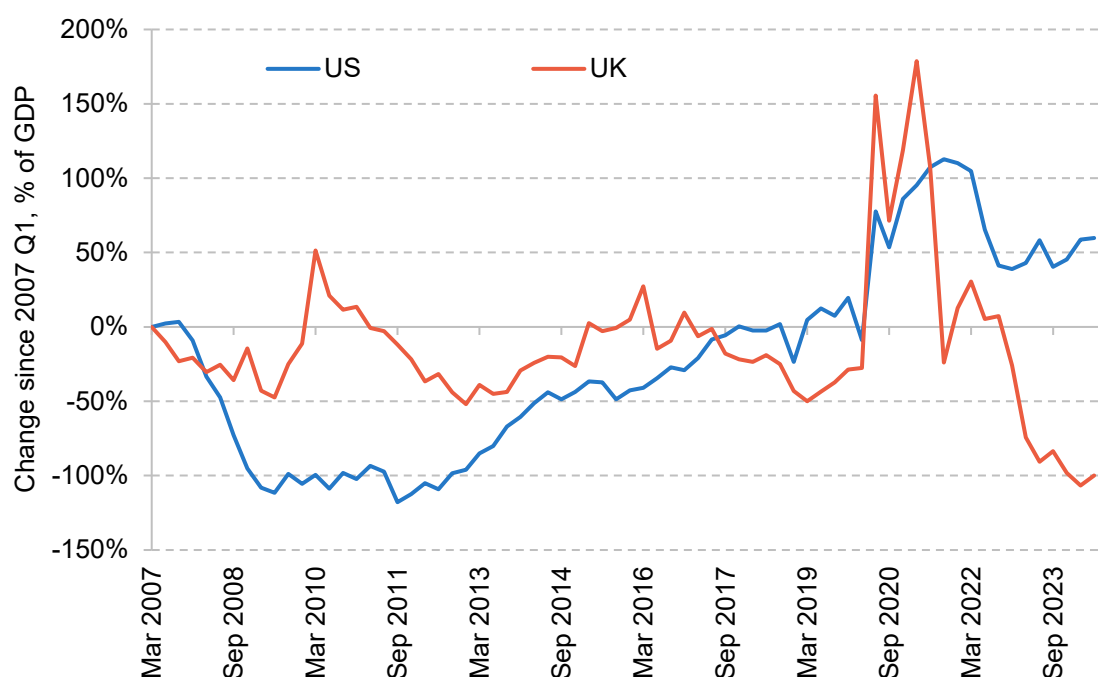
Source: ONS, Citi analysis.

As consumption has remained subdued, even as household incomes have grown, household saving rates have climbed sharply. The headline saving rate was 9.8% in Q2, compared with 6% on the eve of the pandemic. The ‘cash’ saving rate – i.e. excluding the imputed equity of pension funds, and once the adjustments in the 2024 Blue Book have been accounted for – has climbed from 2–3% before the pandemic to around 8% now. This is shown in Figure 1.15 later.

The degree of optimism about consumer spending hinges on how quickly saving rates might fall. We expect only a gradual normalisation of saving rates, driven by three factors.

- 1 **A decline in precautionary saving.** Households tend to increase savings in the face of inflation uncertainty. In particular, as inflation first surges, households may save more as they are cognisant of the erosion of nominal asset values but may overlook the reduction in nominal liabilities (Schnorpfeil, Weber and Hackethal, 2023). This was evident as consumer confidence plummeted in 2022, but this effect seems to have diminished, with consumer confidence now aligned more closely with current real wage, unemployment and inflation figures.

Figure 1.14. Net worth of the private non-financial sector: percentage point change since 2007 Q1 (% of GDP)



Note: The graph shows the change in net worth of the private non-financial sector since 2007 Q1, measured as a share of GDP. In both the US and UK cases, pension entitlements have been excluded from the calculation on grounds of relevance. In the UK's case, corporate real assets have been calculated by taking the total nominal value of the market sector and multiplying it by the GOS share of non-financial corporates. Housing wealth is calculated via the total number of privately owned dwellings, multiplied by the average house price. UK data are taken from the ONS accumulation accounts; US data are from the Federal Reserve system.

Source: BEA, Federal Reserve, ONS.

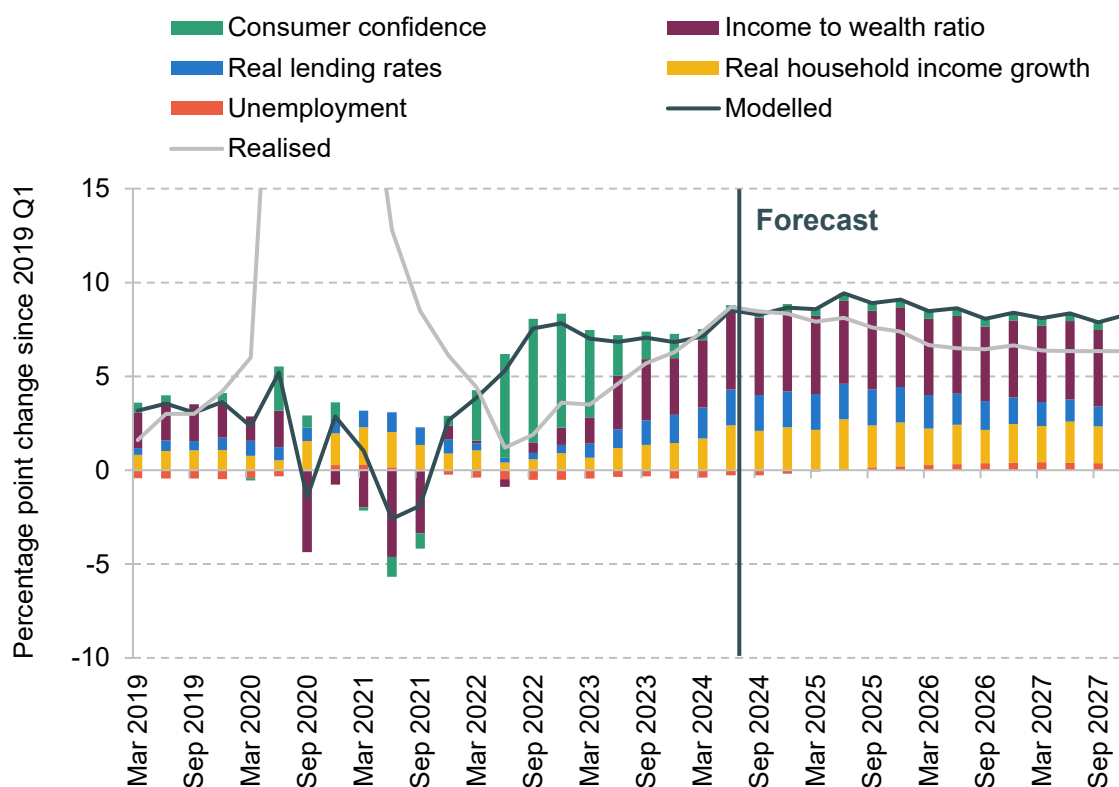
- 2 Consumption smoothing.** Households typically save during income spikes and dissave when incomes fall, so that large swings in real income growth have large but short-lived impacts on inflation. We observed this in 2022–23, as rising costs led to households dissaving, followed by an increase in saving rates in recent quarters as incomes recovered. This dynamic should stabilise as real income growth slows, pushing the saving rate down somewhat from recent highs.
- 3 Household balance sheets.** During past inflationary periods, households typically held real assets financed by nominal liabilities. An older population now holds more financial assets, often in deposits or bond-based investments, and these have performed poorly, impacting household balance sheets. Indeed, household (and firm) balance sheets appear to be weaker as we emerge from the pandemic. Figure 1.14 shows the development of net worth in the private non-financial sector (which includes both households and firms, excluding those in the financial sector), incorporating both real and financial assets and liabilities. In the UK, net worth is now nearly 90% of GDP lower than it was in 2007 – falling from 630% to

542% of GDP. This is in contrast to the experience in the US, for example, where net worth is now nearly 60% above – up from 521% to 580% of GDP.

One argument holds that as interest rates fall and income drivers shift from interest income to wages in the coming months, the household saving rate will start to come down. We agree with this to some extent. However, as shown in Figure 1.15, our modelling suggests that a sharp drop in the ratio of household net worth to real incomes explains some of the recent rise in saving rates. These effects should be somewhat more persistent. And to the degree real rates fall, we think these will remain higher than on the eve of the pandemic. We expect cash saving rates to fall modestly as real income growth slows, but remaining perhaps 5% of income above the rate in 2019.

We see the main upside risk as a significant rally in nominal house prices, which is plausible as interest rates fall. For now, most soft data suggest nominal house price growth remains at or slightly below inflation, and we expect growth to remain in the low single digits. But a stronger recovery could mean a faster consumption recovery in the months ahead.

Figure 1.15. Changes in households' cash saving rate: percentage point change since 2019 Q1



Note: Model here consists of unemployment, real household income growth, real lending rates, consumer confidence and the income to wealth ratio, and is estimated as a simple OLS model based on data from 1996 to 2019.

Source: ONS, Bank of England, GfK, Citi analysis.

The combination of falling real household disposable income growth and only a slow decline in saving rates suggests that consumption growth is likely to be weak into 2025. We expect private consumption to increase by only 0.6% in 2025, compared with 1.5% in the Bank of England's baseline estimate.

Firm profitability and the prospects for investment

The outlook for firms should improve as supply growth picks up and costs decline, though any gains will come from a weak base. Profitability and viability challenges are expected to persist.

Business investment has been underwhelming recently. After rebounding in 2022–23, it has since stagnated, with transport investment stabilising but machinery, construction and intangible investments remaining flat. The reasons for this underperformance primarily relate to uncertainty and the rising cost of capital – which, on a weighted average basis, is up about 4 percentage points since interest rate hikes began. This latter increase would historically have reduced business investment by 10–15%, all being equal. We think this has now largely passed through. Other challenges, such as higher energy prices and issues with key capital imports, may also have contributed. But these should now be beginning to fade.

As costs ease and interest rates fall, we expect business investment to recover gradually. However, rates are still high, and many firms, particularly in the CBI survey, cite the cost of capital as a major barrier to investment. And although investment intentions have risen slightly, the recovery has been weaker than anticipated, especially given the UK's historically low investment levels. While larger firms are more optimistic, smaller businesses remain cautious (Xero, 2024). Overall, sentiment remains somewhat defensive.

While the sequential picture is improving, we think such benefits will come through only gradually. This is for two reasons.

First, firms have been tapping into internal funds, limiting the pool of available capital remaining for intangible investment. To the extent that firms were using internal liquidity – often financed at lower rates – to stay afloat, they are now facing the expiration of these effective subsidies. Those relying on liquid deposits may face renewed challenges as their capital costs rise. These effects have been material. The government-backed corporate loan schemes left corporate deposits in early 2022 around £80 billion above their pre-COVID trend. These are now around £30 billion below.

Second, there continues to be pressure on profit margins. ONS data suggest private non-financial corporate profit shares are about 2–3% of GDP lower than pre-pandemic. Survey and ONS data suggest that the picture here has stopped getting worse but nonetheless the level has deteriorated. The latest business demography data suggest that roughly the same number of jobs are being lost

to firm destruction as are being created by firm formation. This is in contrast to the period prior to the pandemic, where more jobs were created, and suggests some challenges remain.

On the private residential side, we are more optimistic, expecting investment growth of 1.8% in 2025 and 6.4% in 2026. This optimism is based on stronger housing market activity and potential support from new government planning reforms. Our forecast assumes the annual construction rate of new dwellings will rise from a current run rate of around 200,000 to 300,000 by the end of the parliamentary term. While lower than Labour's manifesto pledge – which was for 1.5 million homes over the parliament – a more gradual increase seems plausible given the sector's concerns over skill shortages. Since new home construction represents 20% of sector output and 6% of GDP, this would contribute about 0.5% to overall activity over five years, accounting for offsetting increases in imports.

Overall, while the UK is expected to converge slightly with G7 investment levels, this recovery will take time, especially until interest rates fall more significantly.

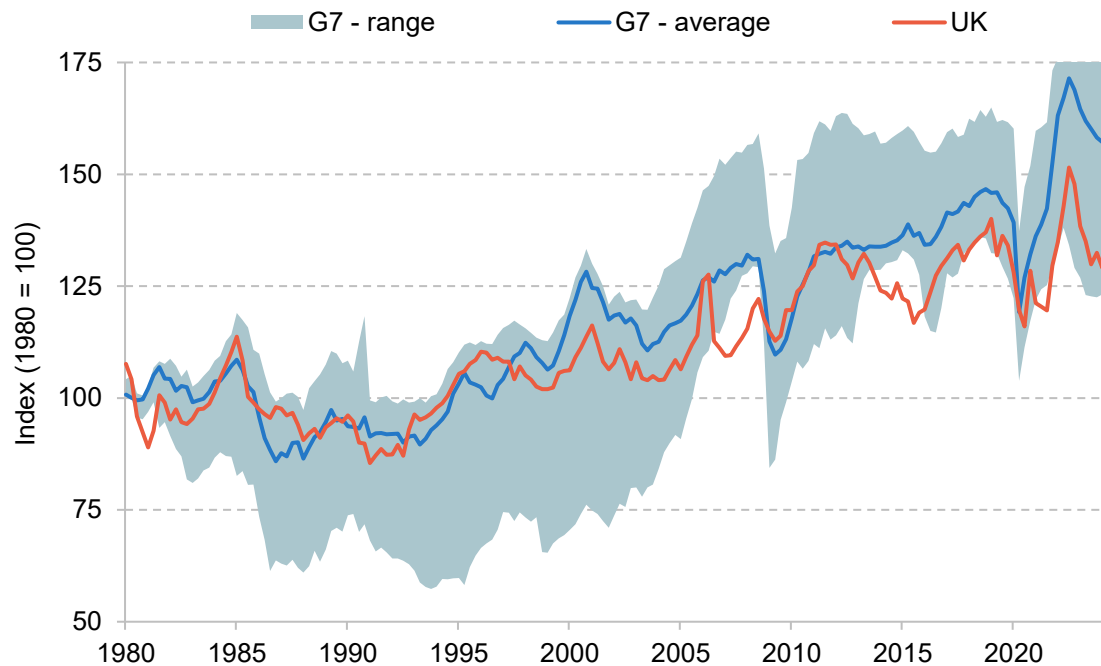
Trade underperformance

On trade, the UK continues to underperform relative to international benchmarks. Since 1980, the UK's trade intensity (imports and exports, as a share of GDP) has increased by 33%, compared with an average of 57% across other G7 countries. As shown in Figure 1.16, this gap is much wider than in 2019 and comes despite advantages such as a strong UK services trade, which has generally recovered better post-pandemic.

The UK's trade dynamics have been heavily buffeted by global developments over recent years. Goods trade, particularly to the EU, initially fared relatively well through 2021–22. This was likely due in part to global supply chain challenges associated with the end of pandemic lockdowns. In the period since, UK goods exports to both EU and non-EU countries have slumped back, particularly relative to G7 comparators, as shown in Figure 1.17. The symmetrical weakness in exports to both the EU and non-EU may reflect the importance of EU trade as a complement to UK goods exports elsewhere.

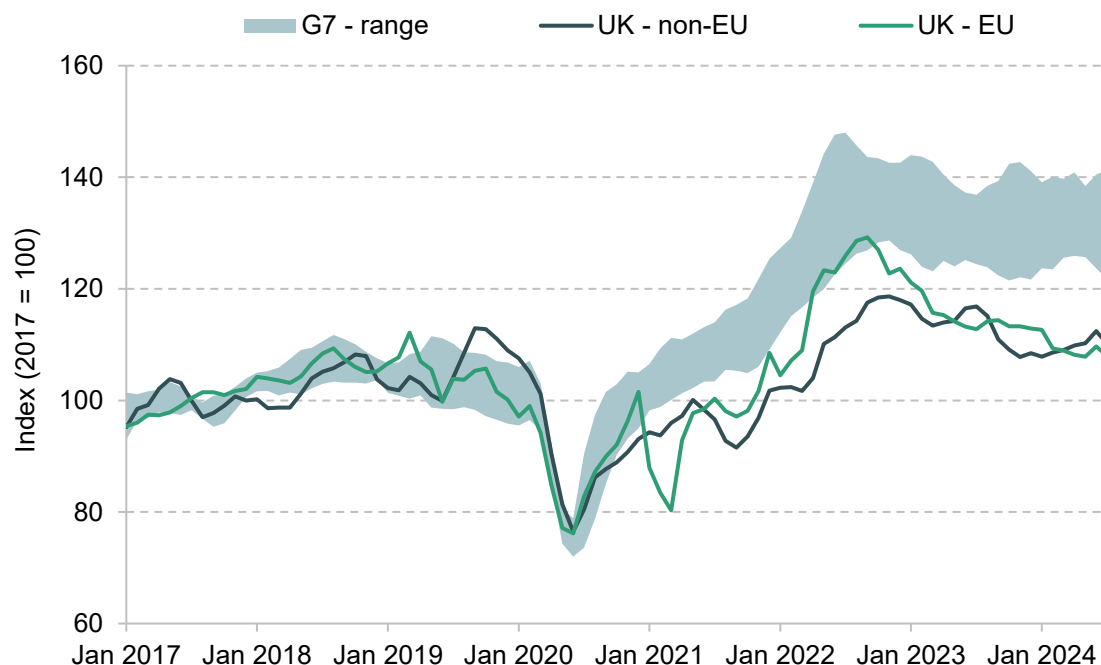
Turning to services, there have been striking differences in trends by sector – particularly when it comes to trade with the EU. Intellectual property exports to the EU have grown by 56% since 2019 Q4. Construction and travel exports to the EU have fallen while increasing strongly to non-EU destinations. Overall, services growth has been marginally stronger to non-EU destinations, but by less than expected. The exception is the financial sector, where exports to the EU have grown at a marginally faster rate than exports elsewhere.¹¹

¹¹ Here the data are somewhat complicated by firm relocations, particularly of US-headquartered entities.

Figure 1.16. Trade intensity since 1980, UK and G7

Note: Graph shows trade intensity – measured as imports and exports divided by GDP. The level is then indexed back to an average over 1980.

Source: National statistical offices.

Figure 1.17. Goods exports since 2017

Note: The graph shows four-quarter average levels. The UK series excludes erratics such as non-monetary gold.

Source: ONS, national statistical offices.

On imports, there is growing evidence that additional UK–EU trade frictions have hurt the UK consumer over recent years. The import price deflator on food from the EU has increased by almost 50% since 2019, while the equivalent for food imports from non-EU destinations has increased by around 18%. If EU food import prices had increased at the same rate as their non-EU equivalents, this would amount to a £273 reduction in the annual food bill of the average UK household, if fully passed on by retailers and producers.¹²

Altogether, the UK does seem to be struggling with international competitiveness. The tradable sector contracted 1.0% in the four quarters to 2024 Q2.¹³ The UK current account deficit has widened again to around 4%, although we expect this to shrink through 2025 due to lagging domestic demand. For now, we remain less immediately concerned about the capital account deficit than in previous years, with more currently financed via net direct investment. Although risks remain, this somewhat reduces the UK’s reliance on potentially volatile portfolio inflows.

1.4 Labour market risks

The labour market has loosened over the past two years, and labour supply and demand are now broadly in balance. However, the economic outlook suggests the labour market is likely to continue to weaken as labour demand remains subdued. That adds to the risk of a further increase in unemployment ahead.

Our concerns stem from three observations. First, as labour demand has fallen back, there are signs of something of a deterioration in labour matching as ‘thick market’ effects have dissipated. That suggests a faster transmission from further reductions in vacancies into unemployment. Second, high labour costs – at least relative to non-labour equivalents – increase the risk of a more abrupt period of labour shedding – particularly when paired with weak corporate balance sheets. And third is the continued, and prominent, role of public sector employment growth in propping up the employment aggregates. As we move into next year, we are unsure this is likely to last.

Indeed, we currently expect the unemployment rate to increase to 4.9% next year and 5.3% 2026. In this section, we look at the dynamics of labour demand and supply, changes in employment and the degree of slack, and consider the recent role of changes in the National

¹² The latest edition of the family spending bulletin from ONS (Office for National Statistics, 2024a) shows the average UK household spends £63.50 on food and non-alcoholic beverages per week. This is £3,302 on an annualised basis. Around 40% of all foodstuffs are imported. Assuming a 20.9% reduction in the price of these imports, that would suggest an 8.3% reduction in food costs overall. That equates to £273.

¹³ This figure takes the year-on-year change in tradable sector GDP for 2024 Q2. Here, the tradable sector is defined by the share of imported and exported content in the supply and use tables, a definition that is borrowed from Broadbent et al. (2019).

Living Wage. A softer labour market is neither necessary to return inflation to target, nor affordable in the context of a lacklustre recovery. For the Bank of England in particular, that suggests remaining attentive to the risks around the real side of the economy.

Further softening of labour demand

Labour demand in the UK has fluctuated in recent years. Following a near-total shutdown during COVID-19, hiring rebounded sharply in 2021–22. In the latter half of 2021, vacancies were increasing by about 280,000 per quarter, even as the furlough scheme worked against labour separation. Since then, much of the hiring backlog has been addressed, but underlying demand has also decreased.

Despite increased activity at the start of this year, there are few signs that labour demand is ticking up again. Currently, there are 857,000 open vacancies, down from 1.3 million in mid-2022. The latest three-month change shows a decrease of 39,000 job advertisements per quarter – just under half the peak rate of decline during the Great Financial Crisis. Thus, while the rate of decline may have moderated, it remains high.

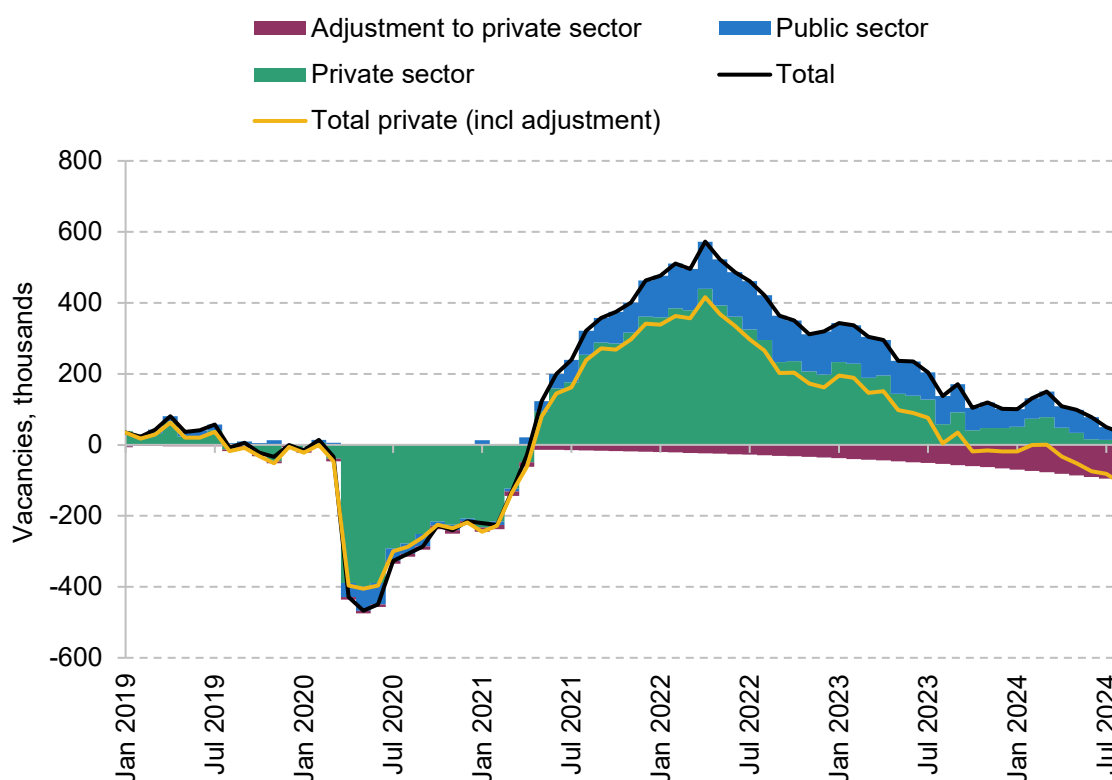
We believe the headline vacancy figure likely overstates labour market strength for two reasons.

First, there has been a trend increase in overall job postings in recent years as online recruiting has become more common, lowering advertising costs. Our structural model suggests that a 10% reduction in the cost of advertising a vacancy can lower the equilibrium ‘vacancy rate’ by 0.2–0.3 percentage points.¹⁴ Since 2018, we estimate that the expansion of online platforms has reduced the average advertising cost by around 15%, implying a 105,000 reduction in the equilibrium vacancy level. Adjusting for this, vacancies are currently below the level seen in 2019, as shown in Figure 1.18.

Second, tighter labour market conditions are now mainly a public sector phenomenon. The latest headline vacancy data (not adjusting for the trend discussed above) show 33,000 more overall vacancies than in 2019, but that includes 41,000 more vacancies in public administration, education and healthcare. Given the limited substitution between public and private sectors, this suggests the private sector labour market is already somewhat looser than in 2019.

¹⁴ This is based on the UK’s pre-COVID Beveridge curve and a structural search and matching model. See Yashiv (2007).

Figure 1.18. Adjusted vacancy measures, UK



Note: The adjusted measure reflects the impact of a 15% drop in the average cost of advertising a vacancy on the headline vacancy rate. Private sector excludes public administration, education and health.

Source: ONS.

Looking ahead, much of the soft data suggest continued declines in labour demand in the coming months. Daily vacancy data from Indeed.com have trended down recently, while Adzuna's figures have stabilised at a lower rate than the ONS headline numbers indicate. Most survey indicators of labour demand and workforce growth indicate stagnation or further reductions. Established surveys such as the KPMG–REC report show ongoing contractions in both temporary and permanent listings. The Decision Maker Panel (DMP) employment growth index has also moderated to 1.1% year-on-year, down from 1.7% at the year's start. With aggregate demand likely to remain soft, we expect labour demand to continue to weaken gradually into next year.

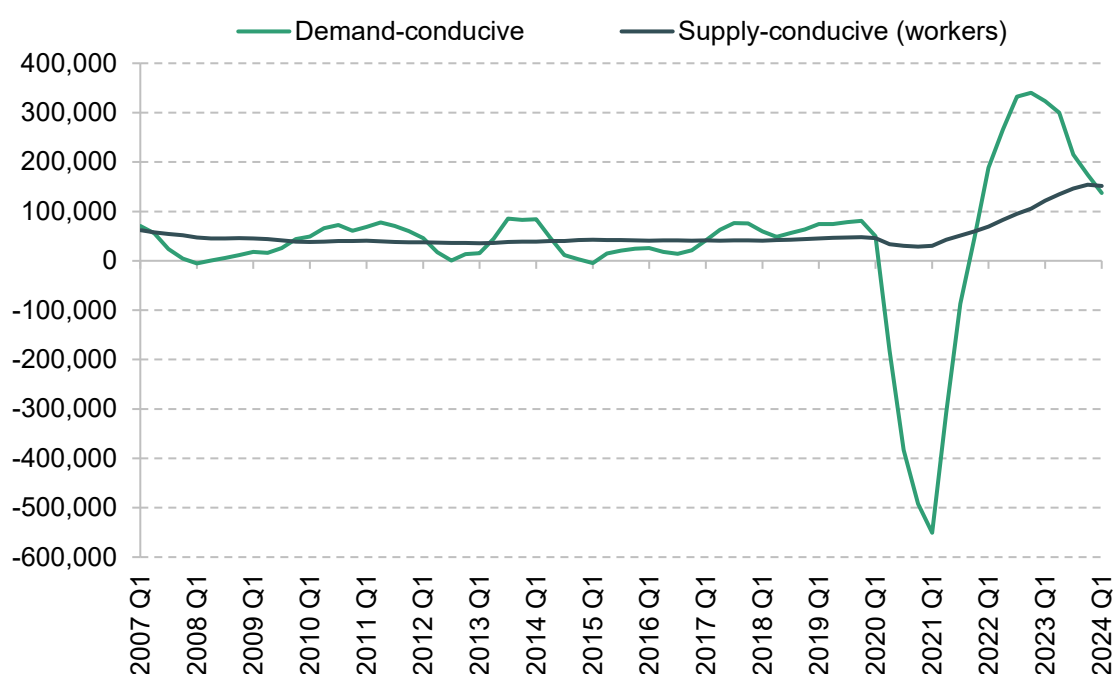
Labour supply continuing to rise

While labour demand appears to be weakening, there are signs that underlying labour supply is continuing to recover. In addition to an improvement in labour matching as post-COVID distortions have eased (as discussed in relation to supply-side improvements in Section 1.3), underlying aggregate labour supply has also continued to normalise.

There have been two main drivers.

The first has been both an increase and a shift in the composition of net immigration. Higher-than-expected overall immigration has resulted in stronger workforce growth. The latest ONS population projections suggest cumulative workforce growth of 5.2% between 2021 and 2026, for example, versus 2.6% in 2023 Q1 estimates. Immigration flows into the UK are also becoming more conducive to supply. For instance, Figure 1.19 shows the net impact of changes in visa applications through the tourist, student, dependant and worker routes – weighting each by their propensity to work. In 2021–22, a strong recovery in tourism alongside large refugee flows likely added more to demand in the first instance. Increasingly, that balance is shifting in favour of supply.

Figure 1.19. UK entry visa approvals, weighted by propensity to work



Note: Data based on numbers of entry clearance visas.

Source: HM Government.

Second, on the domestic front, the participation rate seems to have stabilised. It has declined since the onset of the pandemic, with more than 673,000 more people reported by the Labour Force Survey (LFS) as being inactive owing to ill health than in January 2020 and an increase of 311,000 in the number of economically inactive students.¹⁵ But the participation rate does seem to have stopped falling, despite some increases in those out of work owing to caring

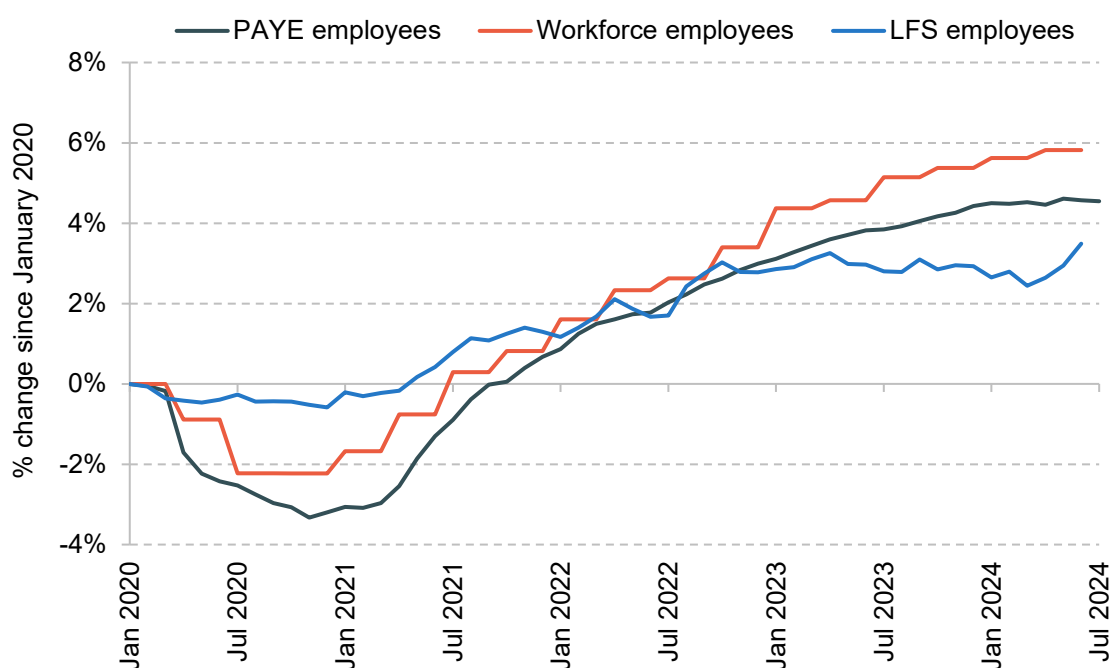
¹⁵ Note these LFS estimates are somewhat dated. The headline LFS aggregates are still based on out-of-date population estimates from late 2023.

responsibilities. With the working-age population set to continue growing, that suggests overall labour supply will pick up.

Employment levelling off

In contrast, much of the employment data suggest that growth is slowing, particularly in the private sector, although different sources conflict somewhat. The Labour Force Survey indicates that employment growth is now picking up, but only after a prolonged period of flat or falling growth. We give more weight to payroll and workforce job estimates given the sampling issues with the LFS. As shown in Figure 1.20, these suggest stronger growth in 2022 and 2023, but weaker growth more recently.

Figure 1.20. Measures of UK employee growth (% deviation since January 2020)

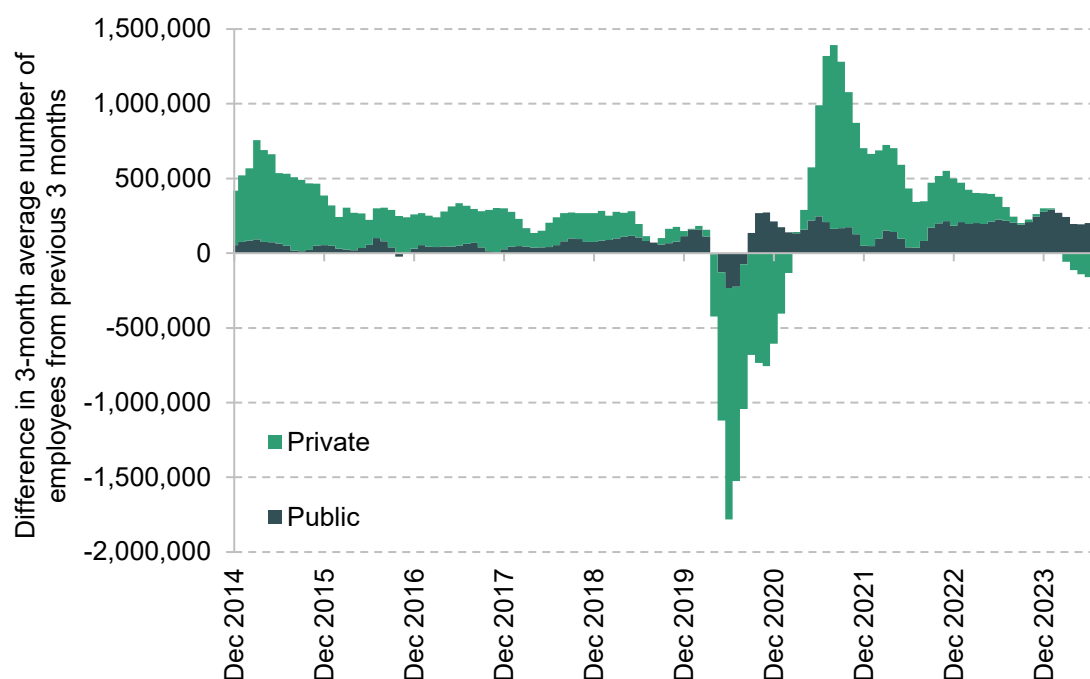


Note: In all three cases, the focus is on employee growth. The graph shows the cumulative percentage change since January 2020.

Source: ONS.

As with the vacancy data, the headline overall trends may paint a rosier picture than the detail. Both the PAYE and LFS data, once adjusted for classification changes, indicate a significant decline in private employment in recent months. As shown in Figure 1.21, the PAYE data show that the three-month rate of private employment growth has fallen to its lowest level since 2020 Q2, with 14 sectors reporting a decrease in PAYE employment – the highest number since August 2020. The adjusted LFS data also reflect this decline, showing a quarter-on-quarter drop of 190,000 in private employment – again the weakest growth since 2020, matched only during the Great Financial Crisis.

Figure 1.21. Employee growth in the UK, by public and private sector employers, from PAYE data



Note: Public sector comprises public administration, education and health.

Source: ONS.

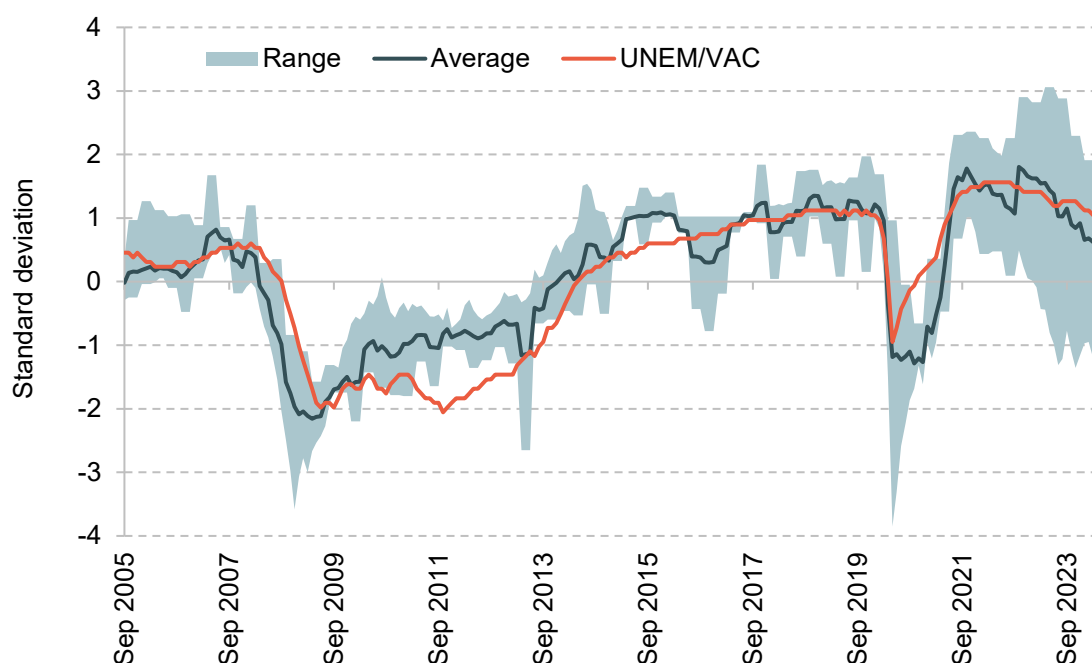
This weakness is mirrored in survey data. While some indicators, such as the Lloyds Business Barometer and the Purchasing Managers' Index (PMI) employment indicator, have held up better, others are giving a more cautious signal. For instance, the latest KPMG–REC survey reported further declines in permanent placements, and the PMI data have started to moderate recently.

Labour market becoming less tight

With aggregate labour supply increasing and headline employment stagnating, we think the labour market is loosening, as shown in Figure 1.22. Interpreting this is complicated by the absence of reliable Labour Force Survey data (Broadbent, 2023). The unemployment rate has remained somewhat volatile – increasing to 4.4% in 2024 Q1, only then to fall sharply. Nonetheless, the claimant count has continued to increase, perhaps a little faster than what would be implied by the change in eligibility alone.¹⁶ And data around hiring difficulties and slack also suggest a marginally looser labour market now than in 2019.

¹⁶ Specifically, the Office for National Statistics (2024b) estimates that changes in eligibility for universal credit should have added 180,000 to the claimant count over the six months from April 2024. The claimant count has increased by 223,000 over this period.

Figure 1.22. Measures of labour market tightness in the UK



Note: The unemployment to vacancies ratio is inverted and shown in the UNEM/VAC series. The 'Average' series shows various other indicators, the range of which is shown by the shaded area. All data here are normalised over the period 2005–19.

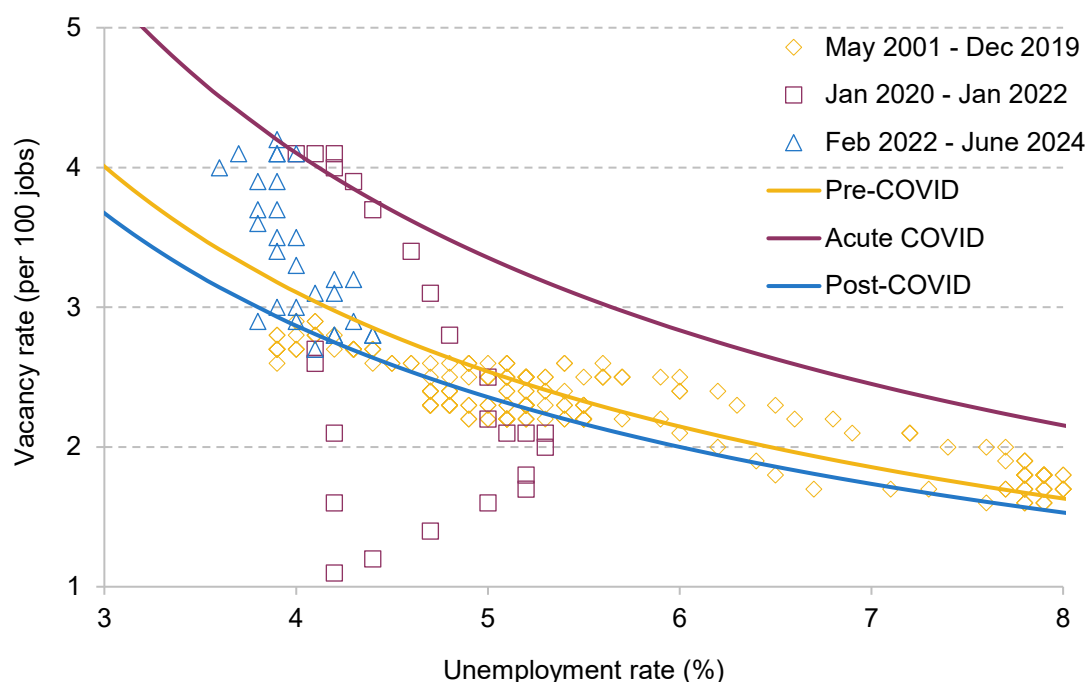
Source: ONS, CBI, Bank of England, KPMG–REC.

If labour demand softens further, as we expect it to, the pass-through into unemployment may accelerate. The fall in vacancies so far has been relatively painless, with only modest impacts on frictional unemployment. The reason is that the associated vacancies primarily reflected a temporal mismatch. As this has been worked through, workers could often move within similar sectors and to firms in the same geographic areas. Matching was very effective. As a result, the reduction in vacancies has fed through into unemployment to only a very limited extent. This is shown on Figure 1.23. In the period since January 2022 (as shown by the blue triangles), the curve has been strikingly steep.

Much of this adjustment to temporal mismatches has now taken place. And broader 'thick market' effects will also dissipate as vacancy numbers fall. These dynamics have often been a little more abrupt in the UK, reflecting a faster flattening of the Beveridge curve.¹⁷ But there are now signs of this. There is already an increasingly marked divergence in the level of vacancies across regions, and low flows of labour across sectors and regions, for example. Any fall in vacancy numbers may now translate more quickly into higher unemployment.

¹⁷ This all comes down to a variable in a search and matching model known as 'sigma' which is the rate at which the Beveridge curve flattens as vacancies fall. In the US, this value is relatively low, meaning a more robust labour market overall. In the UK, that variable seems to have been somewhat higher, at least historically. See Figura and Waller (2022).

Figure 1.23. Beveridge curve for the UK



Note: Pre-COVID covers the 2001–19 period. Acute COVID covers 2020 and 2021. Post-COVID covers the post-2021 period.

Source: ONS.

Further large increases in the National Living Wage would bring risks

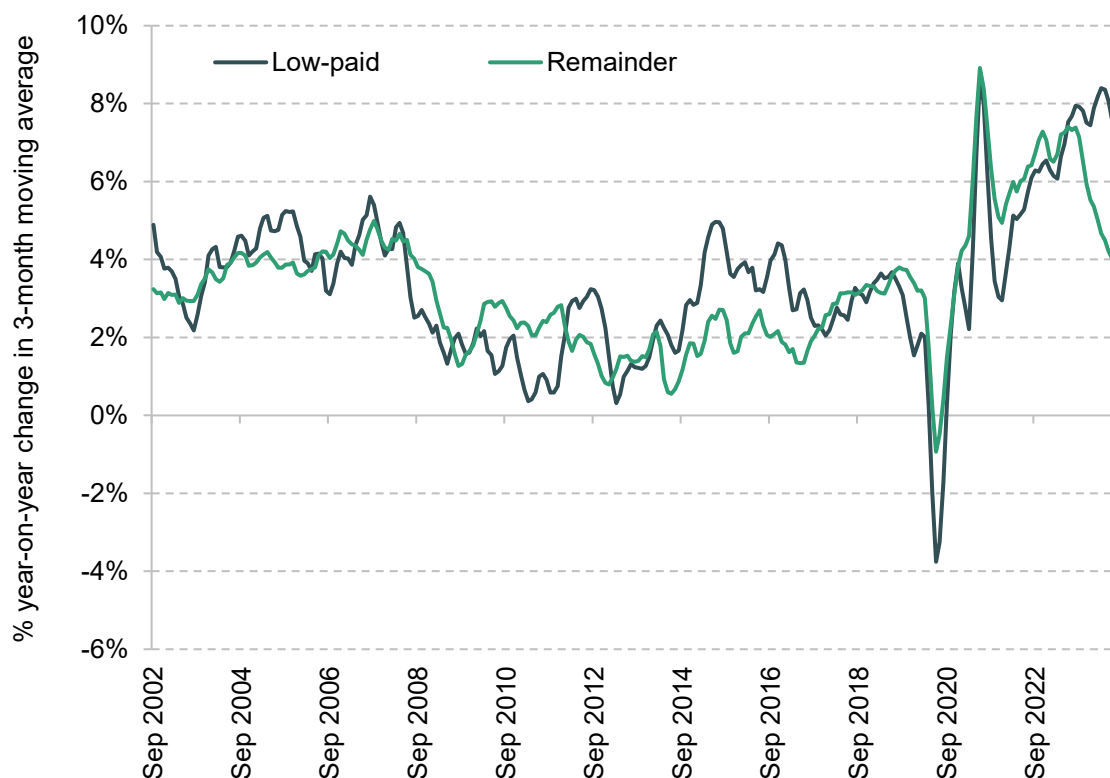
We discuss the outlook for wage growth in more detail in Section 1.5. But the final point we want to make here is that there are some modest signs that increases in the National Living Wage (NLW) are beginning to lead to some job destruction. This increases the risk if the government were to push ahead with further large increases.

Currently, private sector regular pay is growing at 4.9% year-on-year (three-month average). However, in ‘low-paid’ sectors – where over 50% of workers earn within £1 per hour of the NLW – wage growth is at 7.1%. This compares with 3.8% in non-low-paid sectors, as shown in Figure 1.24, suggesting that underlying wage growth (apart from the impact of the NLW) may be slowing.

The NLW has already been increased significantly in recent years, with a 39.3% increase in the headline hourly rate since 2019. The Low Pay Commission’s latest guidance suggests a further 5.8% increase in April would be needed to keep pace with forecast growth in median pay (Low Pay Commission, 2024). Even before the sharp increase in the NLW over the pandemic, pay growth and productivity have broadly kept pace with one another (Teichgräber and Van Reenen, 2021). This does not suggest substantial monopsony power, which has previously enabled

increases in the minimum wage to drive increases in both labour demand and pay growth. The Competition and Markets Authority has also noted that labour market concentration has remained stable or declined over recent decades, with residual issues increasingly concentrated in certain regions and sectors (CMA Microeconomics Unit, 2024).

Figure 1.24. Private sector wage growth in the UK, in high- and low-paid sectors



Note: Low-paid sectors here include agriculture, retail, transport, hospitality, administrative services, recreational services and personal services. Data exclude arrears and bonus payments. Seasonally adjusted using X-13.

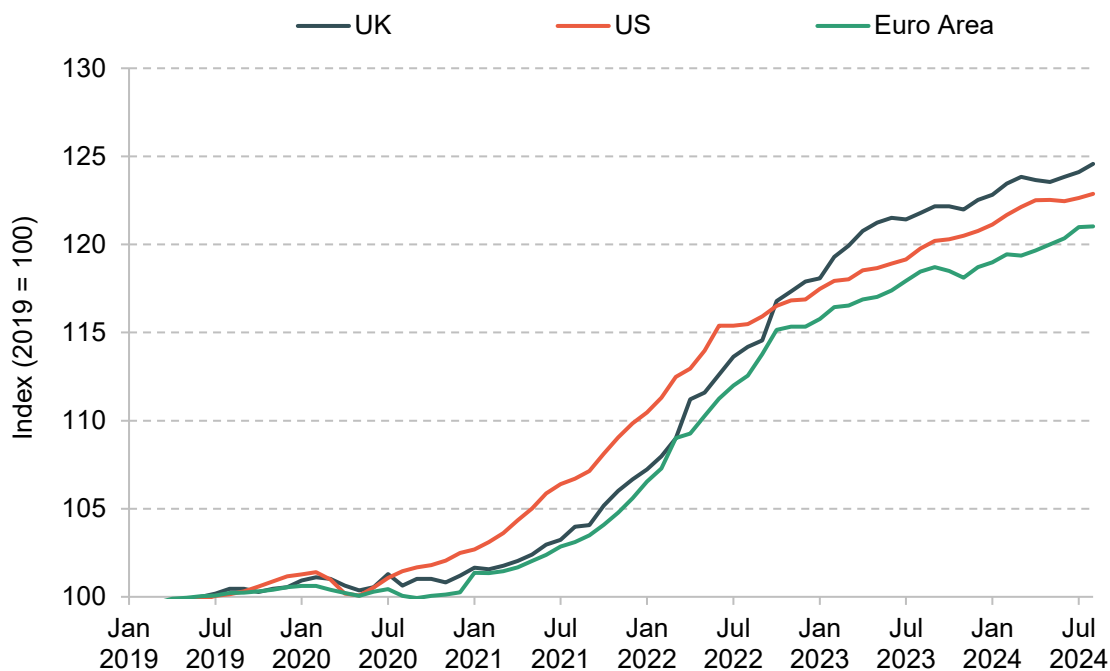
Source: ONS.

That is reason for caution. Over the past year, demand has slowed sharply in sectors more exposed to the NLW. Quarterly employment growth in sectors with 50% of workers either at or within £1 of the National Living Wage rate have now seen PAYE employment growth fall to 3.3 standard deviations below its post-2015 average. For other sectors, the drop is 2.5 standard deviations. There may of course be other drivers of this, and the NLW has been tremendously successful in boosting both employment and pay over recent decades. From here, further boosts to the incomes of lower-paid workers may require different tools.

1.5 Wages and inflation: a cessation of hostilities?

The UK has experienced a recent surge in inflation, with CPI peaking at 11% in October 2022, well above the 2% targeted by monetary policy. Cumulative growth in consumer prices since the pandemic now exceeds that in the US or the Euro Area, at 25%, as shown in Figure 1.25. Having hiked the bank rate successively from 0.1% in 2021 to 5.25%, the Bank of England cut the rate in August by 0.25 basis points, but seems determined to secure more evidence of disinflation before embarking on a more deliberate easing cycle.¹⁸

Figure 1.25. Cumulative consumer price inflation since 2019



Source: National statistical offices.

The inflation surge resulted directly from three large cost shocks: to core goods in 2021, energy prices in 2022, and then food prices. Second-round effects through wage growth and services inflation, once established, have taken time to fade as indexation and other ‘mechanical’ effects have continued. The persistence of both wage and price inflation speaks to a lingering margin of ‘conflictual inflation’ resulting from the incompatibility of real wage and firm margin demands, as well as fiscal stimulus. We think this sits at the heart of any residual concern.

¹⁸ <https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2024/august-2024>.

Increasingly, our view is that these effects are fading and doing so fully. The complete absorption of the real income shock, alongside moderating inflation and wage expectations, suggests that residual risks are increasingly limited. Looking forward, we continue to place stock in more structural analyses of UK inflation dynamics. These suggest that the UK's inflationary anchor, although battered and bruised, remains intact. In our view, the UK is on course for inflation to return broadly to target next year, and then to undershoot in 2026.

Cost shocks and conflict

The initial surge in UK inflation was predominantly supply-driven, resulting from three successive, large cost shocks:

- The surge in global traded goods prices through 2021 as the economy rebounded after the pandemic but supply chains remained under pressure. At their peak, non-energy industrial goods prices subsequently grew by nearly 8% year-on-year through early 2022 – the fastest growth since the late 1980s.
- The surge in household energy prices following the outbreak of conflict in Ukraine. Falls in inflows of Russian gas over the summer of 2022 drove a dramatic surge in wholesale gas prices, and a sharp rise in household energy prices, with total energy inflation peaking at around 60% year on year.
- Stemming partly from the energy shock, a sudden rise in food prices, which peaked at 19.6% year-on-year in early 2023, the highest since 1977.

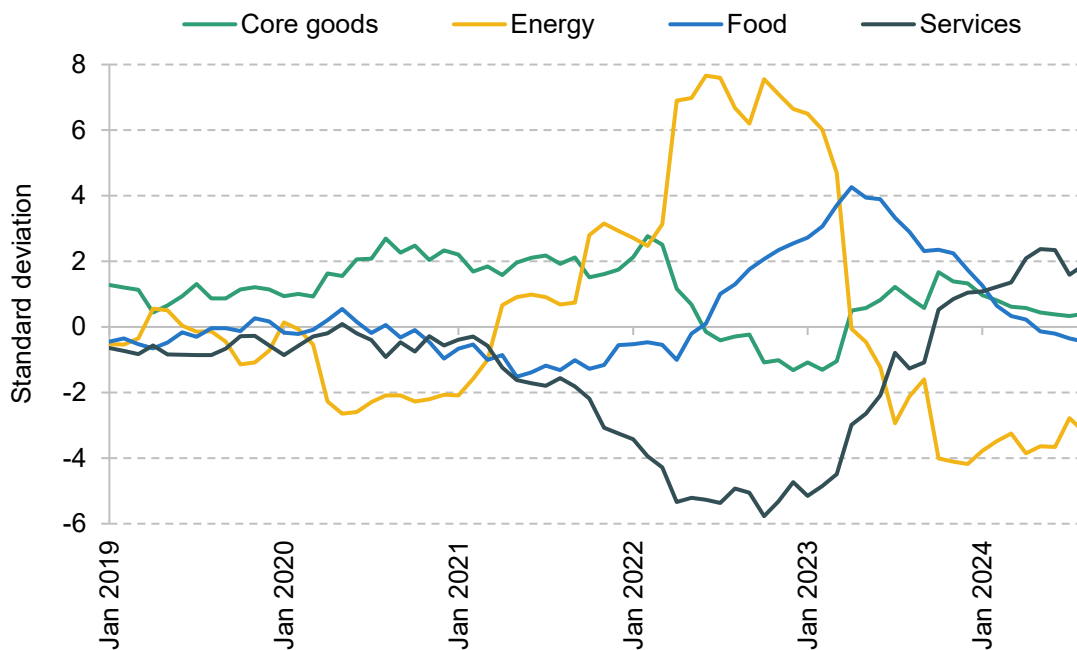
These successive shocks, shown in Figure 1.26, drove a high rate of headline inflation and – importantly – a sharp drop in the real value of domestic incomes. At its peak, before some of the offsetting fiscal interventions, the loss amounted to 5% of GDP, comparable in scale to the worst years during the oil price shock of the 1970s. Inflation became the mechanism by which the pain of this economic loss was shared.

However, the scale of the loss, and the large-scale fiscal offsets, have we think created an environment in which both workers and firms felt able to ‘contest’ the associated effect. The subsequent disparity between the real economic capacity of the UK economy, and the aspirations of workers and firms, has generated persistence in UK inflation as these struggles have gradually worked through (Pill, 2023). Most directly, this has been reflected in the incompatibility of real-wage aspirations of workers, with the margin expectations of firms (Rowthorn, 1977; Lavoie; 2022).

This we think is crucial framing for the UK's inflation process over recent years. One view holds that the domestic labour market has contributed to higher and more persistent domestic inflation. We think this is a misreading of the data. Tighter labour markets may have made it easier for workers to contest reductions in their real income. But in fact we find little evidence of a

‘multiplicative’ effect of labour market tightness onto wage growth – as this argument might imply. And overall the reduction in slack seems to have made only a modest contribution to inflation. We estimate that changes in the ratio of vacancies to unemployed workers have contributed less than 0.5 percentage points to quarterly CPI inflation over the period, and other estimates range from 0.2 to 0.4 percentage points, compared with several percentage points in the US.¹⁹

Figure 1.26. Changes in relative prices within the CPI basket



Note: Measure here shows the annual change in the relative price of given components, compared with the whole index. These effects are then normalised by each item's historical volatility over the period 1995–2019.

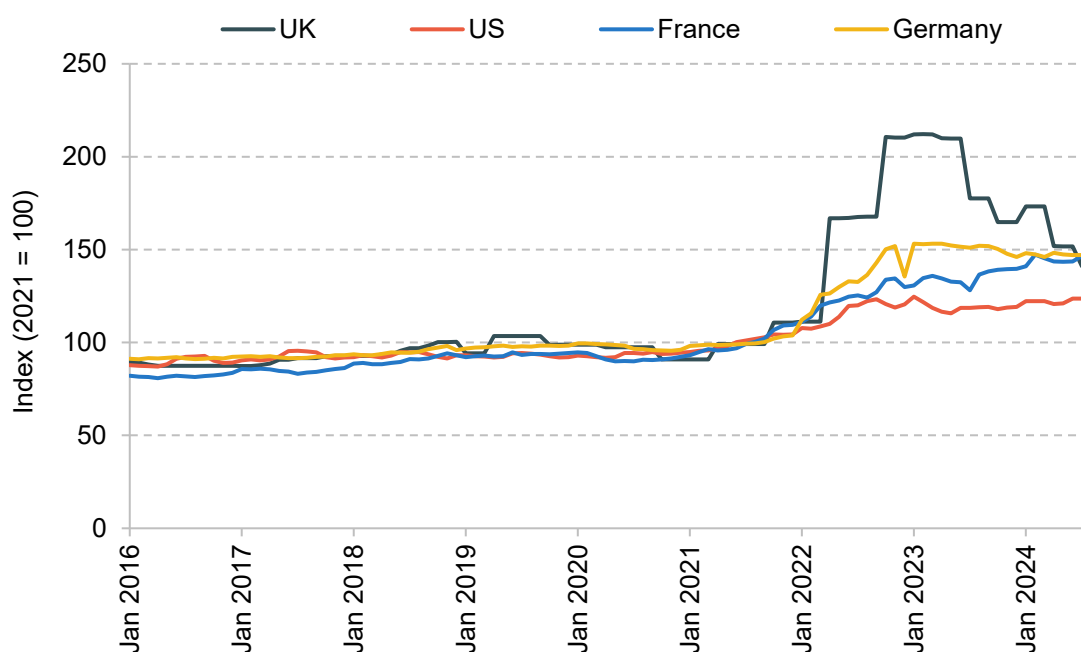
Source: ONS.

Instead, our view is that both wage growth and services inflation have reflected the same fundamental cost shock. The larger response of wage growth in the UK is more closely related to the scale of the shock and associated policy offsets than either a shift in domestic price setting or domestic tightness. Hence in the UK the household energy shock seems to have been materially larger than elsewhere in Europe, with household energy prices increasing further. This has since been compounded by increases in food inflation. The focus of these shocks within the household sector has affected the way inflation has been transmitted, with more conflictual dynamics coming via higher wage demands in the first instance.

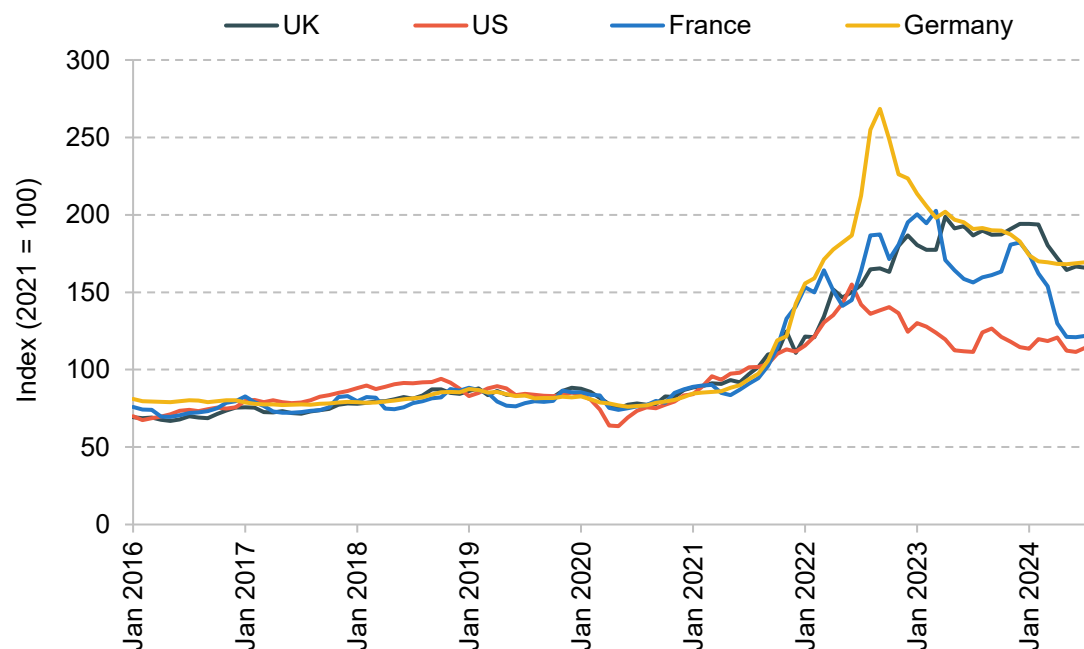
¹⁹ This uses the multi-equation framework set out by Blanchard and Bernanke (2023).

Figure 1.27. Transatlantic energy inflation

Panel A. Consumer price index energy inflation



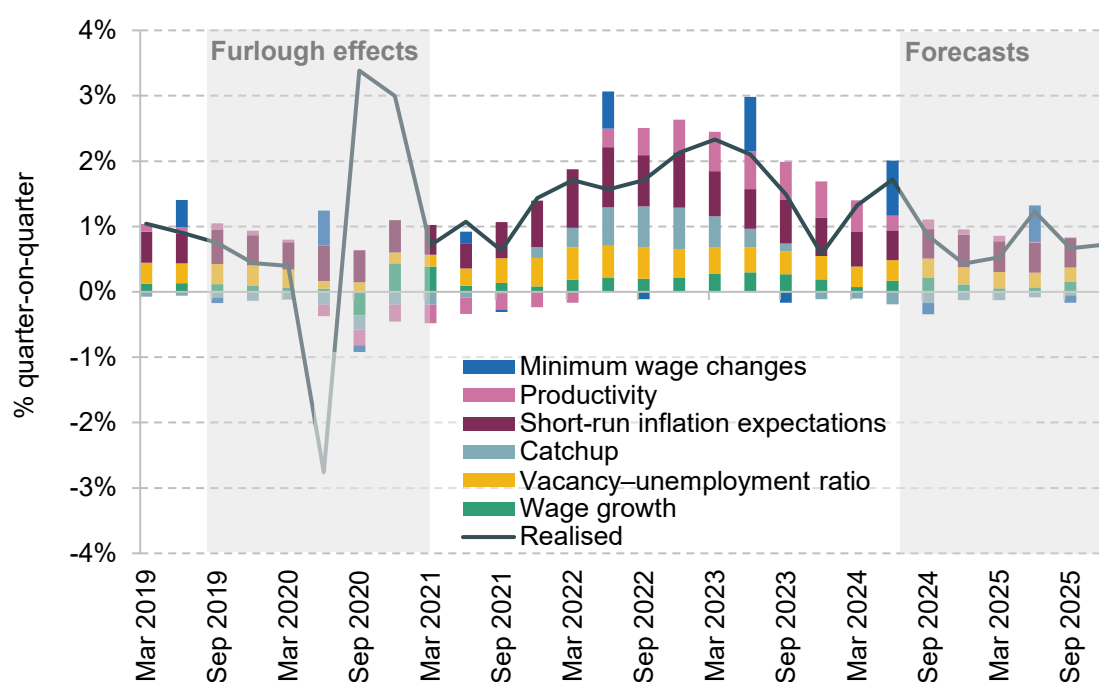
Panel B. Producer price index energy inflation



Note: Data show household energy costs only in Panel A. Panel B covers electricity and piped gas.

Source: National statistical offices.

Figure 1.28. Realised and forecast private sector regular pay growth



Note: The bars show the modelled contributions based on the period 1992–2019. The line shows the realised out-turn, and a forecast from 2024 Q3. Model equation is an auto-regressive distributed lag on the quarterly data, measured with four lags. Variables include: productivity – measured as output per worker; wage growth – using a combination of Average Weekly Earnings (private sector regular pay) and the Average Earnings Index; the vacancy to unemployment ratio; short-run inflation expectations – measured via an average of the Citi/YouGov and Bank of England / Ipsos survey for inflation 12 months ahead (pre-1997 this is measured via NIESR professional forecast expectations); minimum wage changes – measured as the quarterly change in the headline rate; and catchup – measured as the gap between realised and expected inflation 12 months prior. Model is estimated over the period 1992–2019.

Source: ONS, NIESR, Bank of England / Ipsos, YouGov, Bernanke and Blanchard (2023), Citi analysis.

Importantly, once these differences in the distribution of the initial shock are accounted for, evidence of a structural break in inflation is actually very limited. For example, Figure 1.28 shows recent UK wage growth versus a modelled estimate based on the UK's post-1992 experience.²⁰ Higher realised inflation has fed back into higher wage growth, but at a rate entirely commensurate with the behaviour of the UK economy between 1996 and 2019. In other words, there has been an especially large shock, but the impact – owing either to the scale of the shock or to coincident labour market tightness – has not been greater than linear models suggest. Indeed, in Figure 1.28, there is no obvious positive residual, which suggests that wage behaviour has remained in line with that suggested by existing labour market institutions.

How might these dynamics evolve in future? Conventional price and wage behaviour gives us some confidence that the impact of the shock to inflation should fade over time. In a modern

²⁰ The model equation is based on Blanchard and Bernanke (2023).

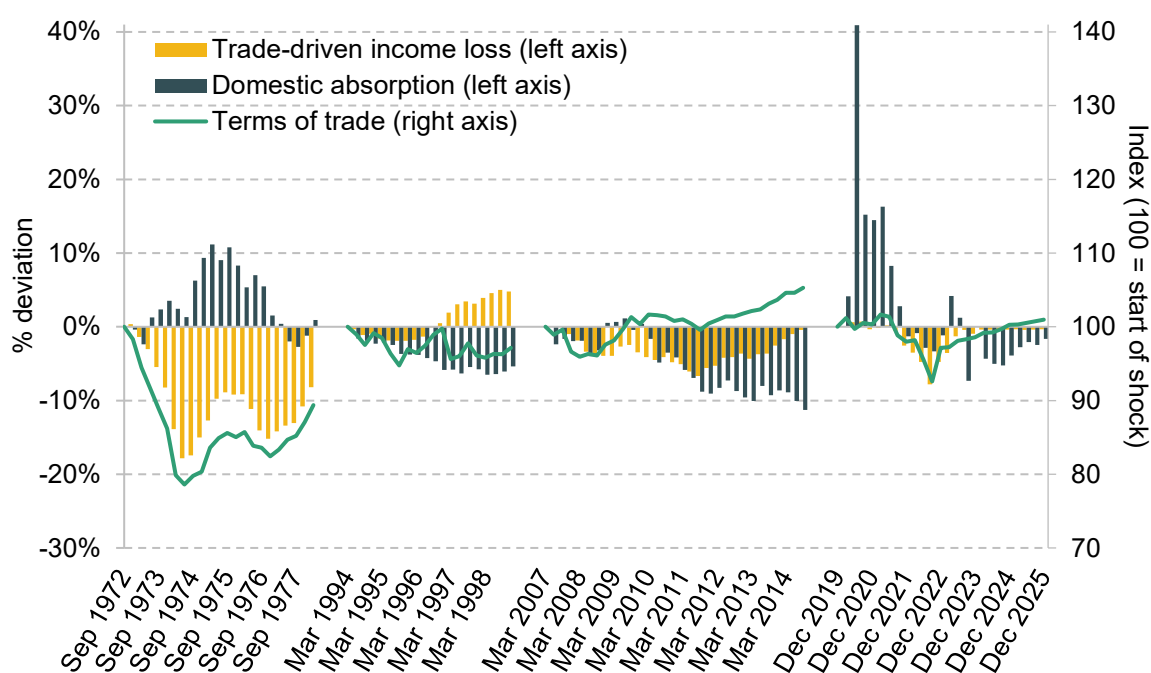
labour market, the only way workers can effectively bargain for higher wages is through frequent job moves. For firms, markets (at least consumer-facing ones) that are largely competitive penalise efforts to recover profit margins. In both cases, the data would suggest that these effects are fading. In our view, while a real loss remains for both firms and households, the relative cost of continuing to contest this distribution is an important reason why these effects should organically fade over time (Guerreiro et al., 2024). These circumstances are very different from those of the 1970s (Brittan, 1979).

We see three conditions that need to hold for a period of conflictual inflation to come to an end:

- 1 The real economic loss associated with the persistent element of the shock needs to have been fully absorbed into incomes.
- 2 Firms and households must expect that the distribution of the shock will continue – i.e. their forward wage and inflation expectations must be stable at target-consistent levels.
- 3 There must be no obvious plans for continuing to contest the distribution or making up lost ground.

All three of these conditions are increasingly being fulfilled.

Figure 1.29. ‘Loss absorption’ of UK terms-of-trade shocks



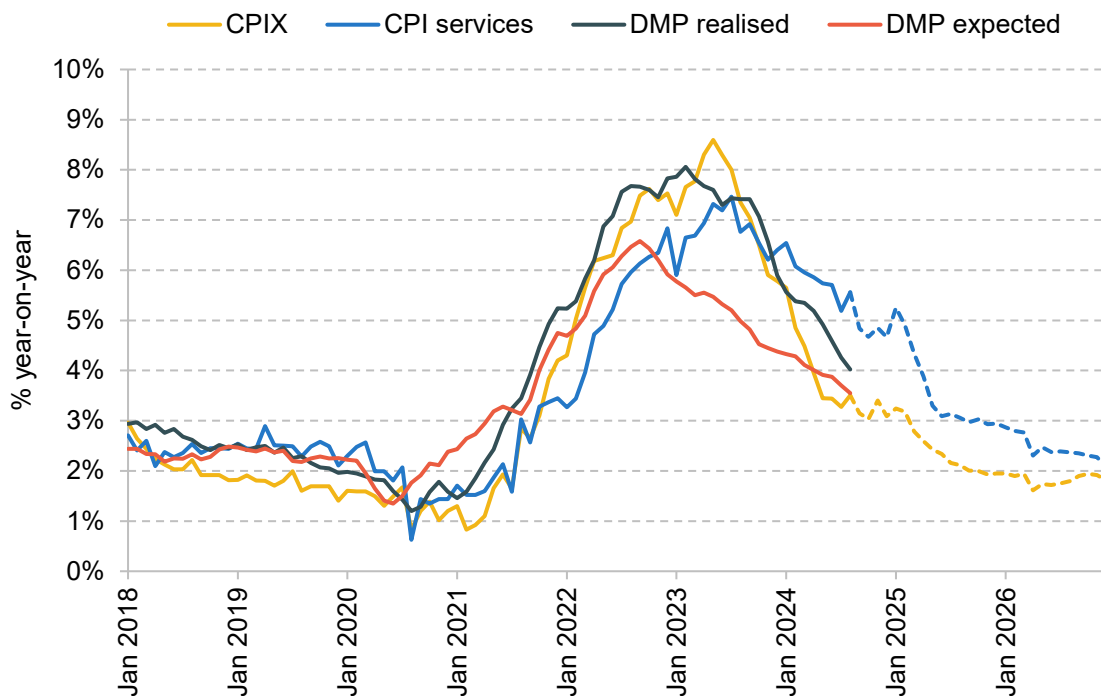
Note: The dark grey bars (domestic absorption) show post-tax income of the private sector, de-trended for labour force and productivity growth. The gold bars (trade-driven income loss) show the change in the relative cost of imports, multiplied by the import intensity.

Source: ONS, Citi analysis.

First, Figure 1.29 shows the real income losses associated with a change in import prices (the trade-driven income loss) and changes in the post-tax incomes of the private sector, detrended for productivity and labour force growth (the degree of ‘domestic absorption’ of that loss). These series must at least align for the process of ‘loss allocation’ to be complete. In the 1970s, this was never achieved, driving accelerating inflation. In every major shock since, such a process has been completed, and current experience more closely resembles these later episodes.

Second, the forward-looking wage and price expectations of both households and firms seem increasingly well-anchored. Our own survey suggests household inflation expectations have fallen back to pre-pandemic levels in recent months (Nabarro, 2024). Firms’ price expectations also seem to be normalising quickly, as shown in Figure 1.30. Other survey data for the services sector, including PMI output prices, are also continuing to trend down.

Figure 1.30. Firm price expectations, and CPIX and services CPI inflation



Note: CPIX denotes CPI excluding energy and are dashed when forecast. DMP realised and expected refer to firms’ own prices.

Source: ONS, Bank of England DMP, Citi analysis.

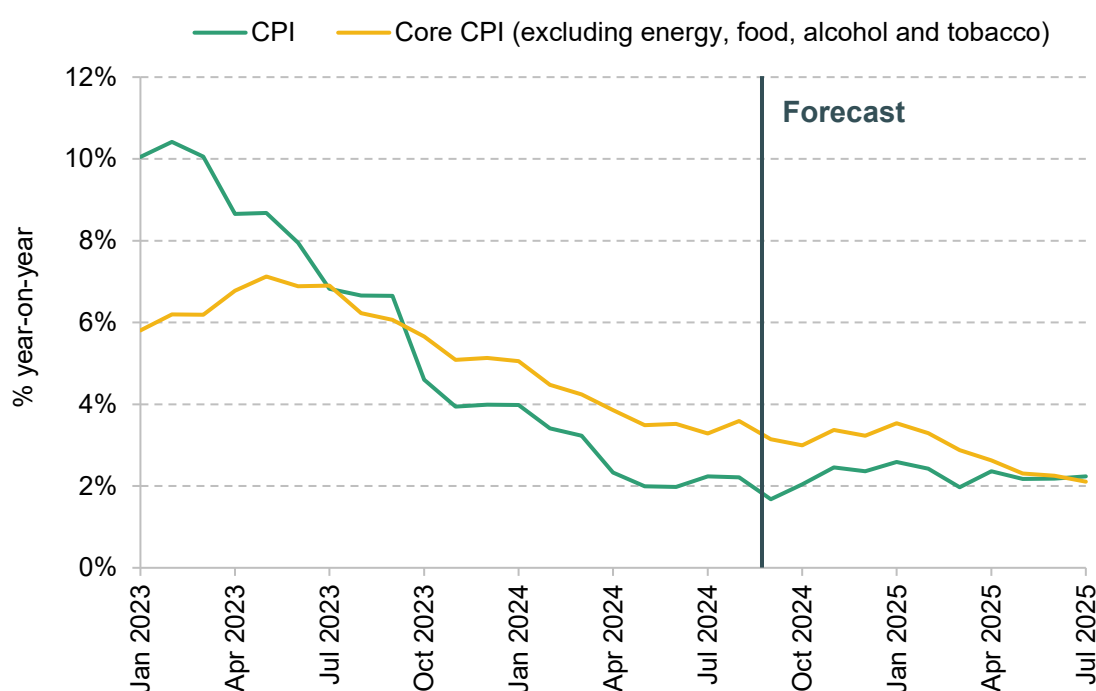
Third, there are few obvious signs that either firms or workers are agitating to shift the allocation of losses, at least in the private sector. The Decision Maker Panel data show a modest improvement in expected firm margins in the year ahead, but ones that are not demonstrably inconsistent with the 2% inflation target being met. And wage expectations – at least in the Bank

of England's latest Agents survey – are expected to be around 2–4% next year.²¹ Strike action, at least in the private sector, has also fallen back to more normal levels, having peaked at the end of 2022.

The outlook for inflation

In our view, this is all consistent with a gradual return of inflation to target. There is early evidence of this, with three-month-by-three-month underlying services inflation now at 4.2%.²² We expect this to fall further in the months ahead, with annual services inflation falling to 4.7% by year-end – materially below the MPC's latest published forecast of 5.3%.

Figure 1.31. Annual CPI inflation, UK



Source: ONS, Citi analysis.

Looking forward, we expect headline inflation to average 2.2% next year and 1.6% into 2026. This reflects the fading of domestic inflation discussed above, as well as:

- Relatively stable household energy inflation. Prices are set to increase into the turn of the year, but current futures suggest these effects should be reversed through the remainder of 2025, leaving overall household energy bills unchanged. Oil prices provide a small disinflationary impulse.

²¹ <https://www.bankofengland.co.uk/agents-summary/2024/2024-q3>.

²² As defined by the MPC in Bank of England (2024a).

- Core goods prices will remain relatively subdued. In part, this reflects weak global demand, as well as the effect of a stronger currency. The latter, all else equal, suggests a 0.3ppt downward effect on headline CPI through to the middle of next year.
- Food prices that will also remain relatively subdued. The currency should exert a downward pressure, and many of the upstream pressures are continuing to ease as lower energy prices feed through.

We think the UK is currently on course to undershoot its inflation target through 2026, particularly as the labour market becomes looser. We expect wage growth to ease to around 3.7% in Q2 next year, and then to around 2.5% through 2026. Headline CPI inflation, we think, will range from 1.5% to 2.0% through 2026.

The outlook for the Bank of England

We think this inflation outlook – alongside the widening slack in the labour market we noted in Section 1.4 – suggests there will be further reductions in Bank Rate in the months ahead. We think such cuts will proceed gradually at first, before accelerating through the first half of next year. We expect Bank Rate to ultimately be cut into modestly accommodative territory, before gradually settling in a 2.5–3.0% range.

The rate-hiking cycle since 2021 has effectively been motivated by two sets of economic factors.

- First, the sequence of adverse supply shocks rendered some kind of policy-driven demand destruction necessary. As these shocks have hit, they have had not just an additive but a multiplicative adverse impact on the supply side of the economy. That has made it difficult for demand to slow organically at the same rate. Fiscal policy has then pushed further in the opposite direction. In a shorter-run sense, that meant some margin of monetary demand destruction was required in order to keep supply and demand in balance amidst uncertainty about how persistent those cost shocks were likely to be.
- Second, with a tight labour market and a large increase in consumer prices, monetary policy has felt it increasingly necessary to lean against the risk of a shift in inflationary regime. High inflation has increased the risk of inflation expectations becoming de-anchored. Policy has felt it increasingly appropriate to lean against the associated scenario, given its possible costs. Here the key factors are high uncertainty and an asymmetry in the costs associated with reversing different policy mistakes. If inflation had become de-anchored, then policy would have faced a materially higher ‘sacrifice ratio’ between inflation and unemployment to reaffirm control.

In recent months, both sets of risks have ebbed. And the MPC chose to cut rates for the first time in four years in August. Nonetheless the tone from the committee has been decidedly cautious – noting the need to keep policy restrictive. And the MPC’s framework still reaffirms the potential

for more persistent inflation. Here the MPC has increasingly been communicating around three ‘scenarios’, including a symmetric fading of inflationary challenges, some residual stickiness (the modal case) and a structural break, implying more persistent inflation.²³ The third scenario is attributed either to an increase in the ‘NAIRU’²⁴ or to less restrictive policy. In this case, a rapid series of cuts would indeed be costly.

In our view, the continued degree of ‘inflation aversion’ reflected in this approach is becoming inappropriate. This is for two reasons.

First, on the inflation side, the risk of de-anchoring from this starting point increasingly depends on a combination of a higher NAIRU and a higher R^* ²⁵ - i.e. inflation must be more persistent for a given degree of labour market tightness, and rates less restrictive than thought. We find that combination increasingly difficult to square with data that generally show inflation to be fading in a conventional manner. It is possible R^* has shifted higher, for example, but then this would not obviously be consistent with the extent of disinflation evident in the data. This particularly costly scenario therefore strikes us as increasingly unlikely.

Second, absent this risk, it is not obvious that the costs of ‘doing too much’ from a policy perspective are now greater than the costs of doing too little. While more aggressive cuts may mean stronger inflation 18 months forward, the associated risk of de-anchoring no longer seems costlier than, for example, an unexpected increase in unemployment. This is the implication of the economy that begins with supply and demand in better balance. A disproportionate focus on inflation alone increasingly makes little sense.

With inflation converging on target and the output gap in balance, we think the MPC should already be making a dash for neutral. Given the committee’s caution, we expect it to cut only at a quarterly pace into the first half of next year, before stepping up the pace from May. This excess of inflationary caution now is likely to imply a larger cutting cycle – ultimately into accommodative territory – through 2026.

An over-reliance on monetary activism is likely to cost the UK here, as it did during the financial crisis. In this case, timing is the main issue – monetary policy can only offer effective countercyclical insurance somewhat belatedly, worsening the trade-off in terms of the risks of a shift in the inflationary regime. But there are also more inherent challenges around the kind of trade-offs monetary policy can achieve in the face of such a sector-specific cost shock. These

²³ <https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2024/september-2024>.

²⁴ The non-accelerating inflation rate of unemployment.

²⁵ The real interest rate that is neither expansionary nor contractionary when the economy is at full employment.

reflect a Phillips curve²⁶ that remains quite flat in the UK,²⁷ and margins that – unusually – appear to us to be countercyclical on a monetary policy shock.²⁸ If the aim in the event of conflictual inflation is to realign price and wage setting with a target-consistent wage Phillips curve, monetary policy is increasingly poorly placed to drive these adjustments (Van Der Ploeg and Willems, 2023). This bolsters the arguments we have made in previous editions of the Green Budget for a reappraisal of countercyclical burden sharing in the years ahead (Nabarro, 2022b and 2023).

1.6 Conclusion

The economic outlook we have outlined here combines cyclical softness with medium-term buoyancy and structural vulnerability.

The balance of risks in the UK – as elsewhere – is changing quickly. The last vestiges of ‘conflictual inflation’ seem to be fading, just as monetary policy transmission is dialling up. Having provided fiscal stimulus in response to an adverse supply shock, the UK now faces a period of coordinated monetary and fiscal retightening. This comes at a time when the output gap is effectively already closed. With supply recovering, this risks an unnecessary period of excess capacity. Some warned of this timing mismatch through the early stages of the hiking cycle. With the inflationary risk broadly contained and supply challenges fading, we think some of these warnings are beginning to come to fruition. While the MPC is beginning to shift its position, the committee is probably already somewhat ‘behind the curve’. We expect a modest increase in unemployment next year, and consecutive rate cuts into accommodative territory (below 2.5–2.75%) to follow.

Notwithstanding this cyclical softness, the underlying supply outlook for the UK is improving, and indeed doing so quite quickly. After years where productivity growth has averaged effectively zero, we see scope for catchup. In the near term, a subdued demand outlook will, in the first instance, feed into slack. But that should then enable a robust acceleration as we move into the middle of the parliament as an improving supply picture is realised. The emergence of near-term slack does add to the risk that this potential is only partially utilised, with unemployment instead risking further scarring in the years ahead. For monetary policy in particular, this again speaks to the need to take a balanced view of the risks. But it also suggests

²⁶ The Phillips curve represents the relationship between the rate of inflation and the unemployment rate.

²⁷ Notably, in contrast to the US, we have not seen evidence of a non-linearity in the Phillips curve even as the labour market reached very tight levels. We suspect that may be something to do with the transient nature of the tightness, and the associated end of the furlough scheme – see Nabarro (2024).

²⁸ Here the analysis is undertaken using a proxy-SVAR looking at the response of the labour share to monetary policy surprises. Our analysis finds the labour share falls in the event of a tightening monetary policy surprise – see Nabarro (2024).

there will be a notable window of underlying political and economic opportunity as, cyclically, things become somewhat stronger.

It is vital this space is used wisely. After two decades of effective growth ‘failure’, the UK has accrued an enormous negative ‘public equity’ position – a widening gap between what the British economy can affordably sustain, and the promises upon which firms and households are currently making economic decisions. Previously, this could have been ameliorated by lower and lower rates, although that adjustment has increasingly ebbed. With more supply disruption likely, this gap risks getting worse.

The specific challenge the UK faces is the combination of this poor underlying position with an inelastic external financing requirement. This carries acute risks. The UK faces an urgent need to raise trend growth, but probably already faces tight constraints on doing so. Sweeping public investment interventions such as the Inflation Reduction Act in the US, or even the European public investment plan mooted by Mario Draghi, would not be viable here – at least not on a purely debt-funded basis. The UK will need to be smarter. This, we think, makes it especially important that policy utilises cyclical upswings to its advantage. The middle of this parliament will present a window of opportunity that cannot be missed.

Finally, and more optimistically, we think the UK can lift trend growth over time, despite the constraints. This requires three important things:

- There needs to be a reduction in the rate of policy mistakes. The UK has made some striking, self-imposed macroeconomic policy errors since the financial crisis. Given the weakness of the starting point, these are errors that the UK cannot afford to repeat.
- The UK will need to change its playbook in the face of supply shocks. In part, this reflects the acute external financial vulnerability noted above and the risks subsequently posed by concurrent fiscal expansion and higher policy rates. It also reflects the crude economic cost of crushing investment just as the economy most requires reallocation. While supply growth is now picking up, it does so from a baseline that is more than 6% short of its pre-pandemic trajectory. We do not see that being made up anytime soon.
- The UK will need to develop a cogent strategy for boosting underlying growth. Even if the UK did have space for widespread capital investment, the changes that matter most here involve supporting reallocation, driving intangible investment, and pushing through effective retraining. This requires more than simply spending money.

We think concrete progress can be made in all three areas over the next five years, but this will be a protracted effort. Given the growing supply risks, and associated volatility, the UK economy is currently on unstable ground. The longer these efforts are delayed, the sharper will be the trade-offs that are ultimately required to restore stability.

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