UNITED KINGDOM

GROWTH REMAINS RESILIENT IN THE FACE OF SHOCKS

UK growth remains comfortably above 1% despite successive shocks, and this favourable momentum is set to continue into 2027 (growth forecast at 1.3% after 1.2% in 2026). The development of artificial intelligence is supporting economic activity, as is industry, with the impact tending to strengthen. The anticipated acceleration in inflation towards the end of the year should trigger a rate rise by the Bank of England, tightening monetary policy and weighing on domestic demand, while the contribution from foreign trade would remain neutral. This slowdown is then expected to give way, from 2027 onwards, to a gradual recovery in economic activity as monetary conditions normalise. The main area of vulnerability lies in the sustainability of debt servicing: despite an average maturity of 13 years, sensitivity to long-term interest rates and high exposure to inflation (23% of the debt is index-linked) are likely to increase the financial burden, and could even jeopardise the timetable for stabilising public debt, which is scheduled for 2027.

GROWTH: UNEXPECTED VIGOUR

UK growth remains steady, despite a series of shocks, registering +0.6% q/q in Q1, +0.4 % q/q in Q2, and a further +0.4 % m/m in July. It already appears certain that growth will exceed 1% this year. This performance is underpinned by private consumption that has proved resilient in the face of inflation, thanks to a fall in the savings rate (9.4% of GDP in Q1 2026, down from 10.1% in 2025), and by a rebound in business investment (+1.2% q/q in Q2 compared with +0.4% in Q1), driven by machinery and equipment, non-residential construction and the rise of AI. At the same time, the positive impact of public investment on growth was offset by a fall in public consumption, whilst the contribution from foreign trade remained neutral. For the time being, the shock of the war in Iran is reflected mainly in prices (costs) rather than volumes, whilst the UK remains heavily dependent on energy imports[1]. Finally, one-off effects—early stockpiling and the 'World Cup' effect on the one hand, and the impact of the heatwave on the other—have largely cancelled each other out.

Whilst growth is expected to stall in the second half of the year (0.2% q/q), driven by rising inflation and fiscal uncertainty ahead of the October deadline, followed by a Bank of England rate rise, the medium-term outlook stays favourable. After 1.2% in 2026, growth is expected to edge up to 1.3% in 2027, as monetary conditions normalise – broadly in line with the Eurozone averages (1.1% and 1.5% respectively).

INDUSTRIAL OUTPUT IS REBOUNDING, FUELLED BY RISING DEMAND IN SERVICES

British industry continues to account for a modest share of the economy (13% of GDP in early 2026, of which 9% is excluding energy). The sector faces persistent structural constraints, amplified by Brexit related frictions, volatile energy prices and competition from China. The oil and gas sub sector is further pressured by falling North Sea production and the accelerating energy transition.

Despite these challenges, British industry can draw on its strengths in high-tech segments, which complement high value-added services (the UK invests nearly 5% of its GDP in intellectual property products, the highest level amongst the major European countries). The growth of artificial intelligence, the healthcare and pharmaceutical sectors (driven by an ageing population), defence (stimulated by European investment and support for Ukraine[2]), and the electrification of networks as part of the energy transition are all key drivers of development.

Growth and inflation

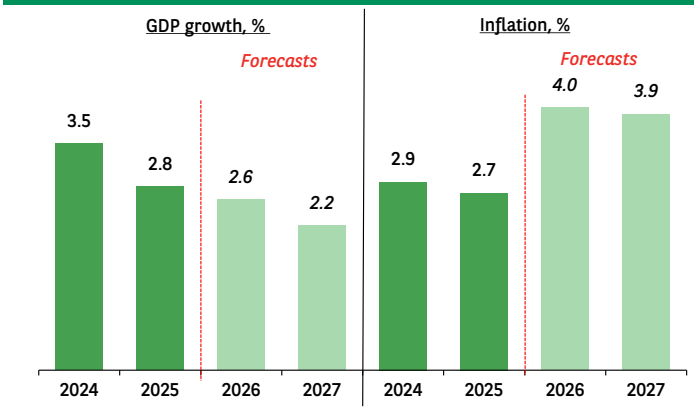


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Manufacturing output rebounds, driven by the acceleration of the AI cycle

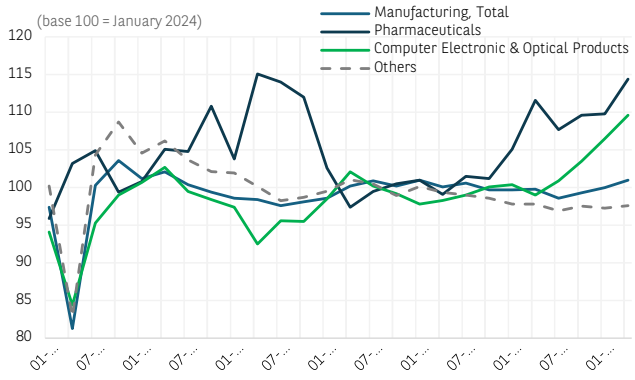


CHART 2 SOURCE: ONS, BNP PARIBAS

These trends are reflected in the industrial production index, which returned to growth as early as 2025 (*see Chart 2*).

1 Faced with declining oil production in the North Sea and the closure of several refineries, the United Kingdom now imports 43% of its primary energy consumption (DUKES 2025, 48% IEA 2024). The country therefore finds itself in a situation of increased vulnerability, exporting 90% of its crude oil only to re-import refined products – a risk exacerbated by limited storage capacity.
2 Although the UK has not secured full participation, its third-country status under the SAFE programme (€150 billion in EU defence loans) allows its suppliers to secure up to 35% of the value of European defence contracts. At the same time, thanks to the agreement signed last July, the country is expected to benefit from the EU's Ukraine Support Loan (which includes €60 billion in defence procurement) without any derogation (and therefore without needing to prove that the equipment is not available within the EU in sufficient quantities or within a reasonable timeframe).

In Q2 2026, activity expanded in eight of the thirteen sub-sectors, with a 2.6 % y/y rise in July. Whilst this momentum was underpinned by a restocking of inventories in response to geopolitical tensions in the Middle East, the latest business surveys (July–August PMIs and CBI) appear to point to a sustained recovery: new orders – especially export orders – are increasing, and recruitment has hit its highest level in more than two years.

FOREIGN TRADE: VULNERABLE TO SHOCKS

The balance of goods and services remains structurally in deficit (-2.8% of GDP in Q2 2026). Goods exports are being held back by the decline of two historic drivers: the automotive sector (-18% y/y), hampered by competition from Asia and reshoring policies (Europe/USA), and the pharmaceuticals sector (-8%), mainly affected by inventory cycles. Conversely, growth prospects are emerging for mechanical generators, up 10% y/y, driven by the aerospace sector and energy demand from data centres. Trade with the United States (which accounts for 17% of total trade) remains characterised by high tariff volatility, whilst the scope of the May 2025 Economic Prosperity Agreement is proving limited by its non-binding nature and tensions surrounding the Digital Services Tax (a 2% tax applied to the digital revenues of very large platforms, including US platforms). At the same time, while negotiations with the EU (which accounts for 46% of trade) have slowed after the change of government, the rapprochement remains a political and strategic priority.

In contrast, services exports continue to grow strongly, driven by finance, consultancy and the digital sector in markets outside Europe. Telecoms and IT are showing strong momentum (+16%), driven by cloud computing and AI. However, the services surplus only partially offsets the goods deficit.

LABOUR MARKET: A FRAGILE STABILISATION

The stabilisation of the unemployment rate at 4.9% in Q2 2026 masks a weakening in demand: job vacancies fell to 707,000 over the May–July period, reaching their lowest level since 2014 (excluding the COVID-19 period). Signs of recovery are emerging in some leading indicators (S&P/KPMG), but the underlying trend remains characterised by sluggish demand and high costs (energy, inputs and labour). To protect their margins, companies are prioritising staff retention over hiring entry-level candidates.

The unemployment rate is expected to rise slightly, peaking at 5.1% in Q4 2026. This should help ease wage pressures (growth in regular pay stood at 3.5% y/y in the three months to June 2026, compared with 4.8% a year earlier), and should limit the risk of a wage-price spiral. However, while initial forecasts for 2027 suggest wage agreements may be similar to, or even lower than, those in 2026 (BoE Agents' Summary, September), the risk of inflation expectations becoming unanchored persists and could reignite wage pressure dynamics.

INFLATION AND THE BASE RATE : RISING IN THE SHORT TERM, FALLING IN THE MEDIUM TERM

The rise in energy prices has so far had varying effects on different economic agents. Businesses felt the rise in energy input costs quickly, before a brief lull in June when market prices fell. Households were initially protected by Ofgem's energy-price cap, but the 13% cap increase in July triggered a rebound in inflation, which stood at 3.1% y/y in August. Core inflation has been stable at 2.6% for several months, but is now expected to rise again: goods inflation climbed to 2.7% in August (from 2.2% in July), while services inflation remains stable for the time being (at 3.5%).

Public debt is expected to stabilise from 2027 onward

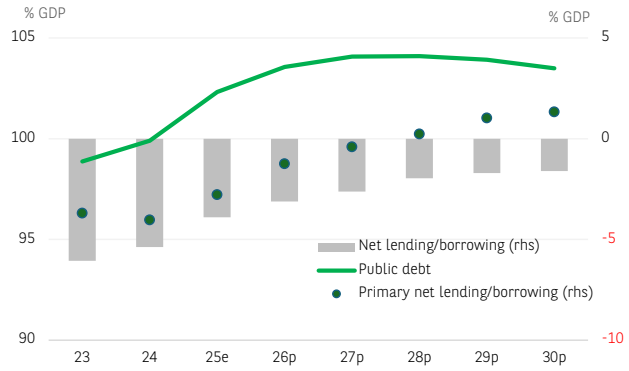


CHART 3

SOURCE: IMF, MACROBOND, BNP PARIBAS

Consequently, inflation is projected to peak at 4.1% in Q1 2027—50 bps higher than the average peak observed in the Eurozone, due to its already higher starting point. The Bank of England (BoE) is therefore expected to raise its key interest rate by 25 bps by the end of 2026, to 4%, tightening its monetary policy relative to our estimate of the neutral rate (2.25–3.25%). However, the expected moderation in wage pressures should help to ease inflationary pressures thereafter, allowing for monetary easing of 50 bps in the second half of 2027 according to our forecasts.

The exchange rate is expected to be supported by solid fundamentals, underpinned by resilient growth and the government's fiscal discipline.

THE NEW GOVERNMENT'S ROOM FOR MANOEUVRE TO CONTINUE FISCAL CONSOLIDATION IS LIMITED

Fiscal consolidation is underway: following a primary deficit of 4% of GDP in 2024 and 2.8% in 2025, the IMF forecasts a further reduction to 1.2% of GDP in 2026. Prime Minister A. Burnham has reaffirmed its commitment to fiscal rules, which will be essential for stabilising long-term interest rates, but which will limit room for manoeuvre to fund its policy priorities (decentralisation, public services, purchasing power, defence and the energy transition). The rise in UK bond yields (+120 bps on 1- and 10-year maturities as at 15 September) is one of the sharpest among advanced economies. This rise partly reflects the financial markets' increased sensitivity to macroeconomic uncertainties and monetary policy expectations. The high proportion of inflation-linked Gilts (23% in Q2 2026) also automatically increases debt service (despite an average maturity of 13 years), which is expected to rise from 2.6% of GDP in 2025 to 2.8% in 2026. The monetary easing we anticipate by the end of 2027 should ease the pressure on long-term rates, although these will remain slightly above the levels seen before the outbreak of the conflict in Iran. Furthermore, the BoE will now pursue a policy of quantitative tightening at a reduced annual pace, whilst halting the issuance of 30-year Gilts, which should flatten the yield curve at its long end. The stabilisation of public debt, expected in 2027, will require a return to a primary deficit of -0.8% of GDP, followed by a primary surplus by 2030; gross debt is therefore expected to peak at around 104.4% of GDP in 2027 (104% in 2026) before stabilising.

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