UNITED KINGDOM

THE OBSTACLES TO ACTIVITY ARE PILING UP

Although the United Kingdom has been penalised less severely than its European neighbours, it has not escaped the 10% tariff floor on US customs duties. The negative impact on activity will add to the pre-existing domestic brakes. The household savings rate is rising against a backdrop of high inflation. Increased defence investment in the United Kingdom and elsewhere in Europe will have a positive effect on GDP, but this will be offset by the effects of the trade war in the short term. The rise in long-term bond yields, which became more pronounced after 2 April, further complicates the budgetary equation. The Bank of England's key interest rate cut will remain gradual, given the moderate slowdown in inflation that we continue to expect in 2025.

ECONOMIC ACTIVITY: THE OBSTACLES ARE PRIMARILY DOMESTIC

The direct effect of the rising US customs duties on the United Kingdom would be contained at around 0.1 points of GDP[1]. The United Kingdom's exposure is mainly indirect, and activity will suffer from the growth shock in the European Union and the United States, the extent of which remains highly uncertain at this stage. Defence spending, which is set to rise from 2.3% of GDP in 2024 to 2.5% in 2027, will bring about increased activity, in addition to the effects of rearmament within the EU and particularly in Germany (where this effort should be pronounced). This growth surplus for the EU (+0.5 pp of GDP by 2027 - see Eurozone page) will support activity in the United Kingdom and will just offset the decline in exports to the United States[2]. The UK economy will therefore have limited room for acceleration in 2025 and 2026. The industrial recession continues, with PMI surveys even showing a plunge in new export orders in March[3]. Furthermore, the recovery in household purchasing power (+4.2% in 2024) is not fuelling consumption, but rather the savings rate, which hit a post-COVID record in Q4 2024, at 12% of gross disposable income. The high cost of constrained expenses (energy, housing) is weighing on the financial situation of some households, fuelling a rise in payment arrears.[4]

GROWTH AND INFLATION

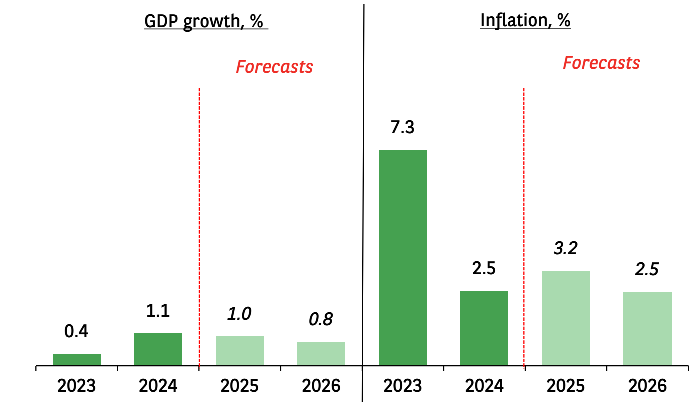

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

LABOUR MARKET: SIGNS OF STABILISATION TO BE CONFIRMED, BUT GROWING DISPARITIES

The labour market, on the other hand, is proving resilient. Payroll employment rose slightly in January-February (+0.1%), with job openings remaining at pre-COVID levels. Will April, which saw the introduction of several budgetary measures (including the increase in the national insurance contribution rate for employers, and the 6.7% rise in the National Living Wage) mark a turning point? Surveys are pointing in the wrong direction (PMI, KPMG/REC), and job losses in sectors that are already weakened and more exposed to the risk of customs tariffs (industry, retail trade) could increase. While GDP growth expected in 2025 should limit the deterioration in employment, sectoral divergences are likely.

In five years, the number of employees in UK industry has fallen by almost 4%, making it the sector that has seen the most job losses, along with trade. Less than 8% of employees now work in industry. The most affected regions, Wales, the Midlands and the North, have lost more than 5% of their industrial jobs compared to pre-Covid. Total job creation has remained more dynamic in London (+6% in five years), so the gap between the capital and the rest of the country has widened.

The UK authorities' efforts to reduce geographical imbalances (the "Levelling-up" programme launched in July 2021 is the flagship) are therefore slow to bear fruit. These imbalances are a structural brake on activity, exacerbating tensions in the capital's property market. Northern Ireland, however, is an exception. Industrial employment rose significantly during this period (+4.5%), with the region benefiting from its special post-Brexit status (Northern Ireland Treaty), giving it privileged access to the European market.

INFLATION: THE 2% TARGET OUT OF REACH IN 2025-2026

The expected rise in food, capital goods and energy inflation will keep headline inflation above 3% in 2025. Disinflation in the services sector has been slow to materialise, due to the dynamism of wages, which the slowdown in the labour market is failing to curb for the time being. The Bank of England[5] survey forecasts wage moderation in 2025 of between 3% and 4% y/y, which is insufficient to anticipate a return of inflation back towards the 2% target in 2025. According to our forecasts, this target will still be out of reach in 2026. Inflation remains structurally high due to major constraints on supply (weak productivity gains and high energy costs, imbalance in the real estate market). The de-anchoring of households' long-term inflation expectations, which has been seen in some surveys (*see chart 2*), will further limit the disinflation dynamic.

1 This result is based on the ratio of exports of goods to the United States to GDP (2.1% in 2024) and the assumption of a 3% fall in imports as a result of the 10% increase in US tariffs (import price elasticity of 0.3).
2 With UK exports to the EU amounting to 6.1% of GDP in 2024, an increase in EU GDP of 0.5 pp would support UK growth, which would be approximately 0.2-0.3 points of GDP as a high estimate.
3 The index fell by 5.7 points to 39.1 in March, its lowest level since August 2023.
4 The proportion of housing loans in arrears rose to 1.32% of total outstandings in Q4 2024 (source: Financial Conduct Authority). Average arrears on gas and electricity bills hit GBP 1,376 and GBP 1,616 respectively in Q4 2024 (source: Ofgem).
5 Bank of England, Decision Maker Panel, March 2025.

PUBLIC FINANCES: WALKING A TIGHTROPE

The rise in long-term bond yields, in a context of weak growth, will force the government to carry out more fiscal consolidation in order to restore public finances, with the risk of weighing on activity. The fiscal headroom estimated by the OBR (GBP 9.9 billion) is very small and the public body's growth forecast for 2026 (+1.9%) is significantly higher than our current estimate (0.8%). The public deficit, which stood at 5.6% of GDP in the 2023 fiscal year, should remain close to 5.5% in 2024. As the primary balance remains significantly worse than the threshold required to stabilise the debt-to-GDP ratio, the latter will remain on an upward trajectory in 2025 and 2026, approaching 105% of GDP[6].

MONETARY POLICY: FURTHER EASING

Our central scenario remains one of moderate easing in the BoE's key rates – at a rate of one cut per quarter – extending to 2026. Despite persistently high inflation, an acceleration in rate cuts in 2025 is a conceivable alternative scenario, given the risks of a slowdown in activity and the fact that monetary policy is still very restrictive. The BoE's other path of easing would be through less drastic quantitative tightening. Unlike the US Federal Reserve and the ECB, which are taking a passive approach to reducing their balance sheets, the BoE is actively selling some of the Gilts in its Asset Purchase Facility (APF) portfolio. Faced with potential shocks on the bond market, the BoE could decide to limit or halt its sales of securities as a precautionary measure, with the aim of stabilising long-term rates.

EXTERNAL POSITION: DIAMETRICALLY OPPOSED TRENDS BETWEEN GOODS AND SERVICES

The United Kingdom has a strong presence in trade in services. Despite Brexit, the country has remained really dynamic in the technology sectors, which led to a sharp rise in service exports of 7.7% in value terms in 2024 (see chart) and an increase in the trade surplus in this segment to 6.8% of GDP. Conversely, goods exports fell by 7.5% in 2024 and the trade deficit widened to 7.9% of GDP. As a result, exports of goods as a percentage of GDP plunged to 13.2% in Q4 2024, while exports of services hit a record high of 18.6%. The trade ramifications are significant: if trade tensions with the United States were to extend to services, the United Kingdom would be one of the most exposed countries.

6 Central and local government debt (as defined by Maastricht).

UNITED KINGDOM: HOUSEHOLDS MEDIAN LONG-TERM INFLATION EXPECTATIONS (5-10 YEARS)

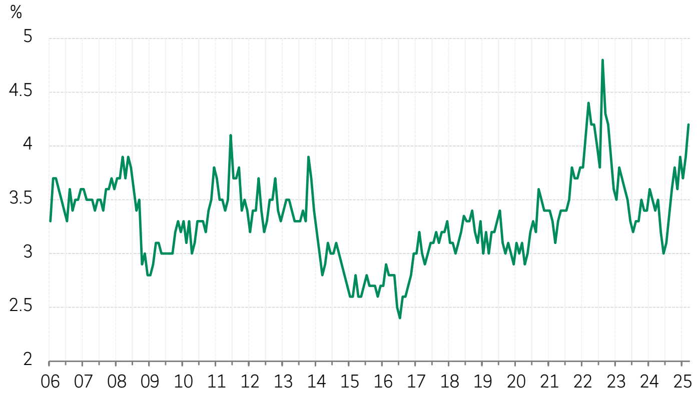

CHART 2 SOURCE: YOUGOV/CITI

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Fairly limited refinancing risks in the short term

According to our forecasts, the UK Treasury's financing needs will amount to 8.4% of GDP per year on average over the 2025-2027 period; however, this is a relatively limited level, which is due to the high average maturity of the debt (over 13 years). This means that the effects on the interest burden of refinancing at higher rates can be smoothed out considerably over time. In addition, as almost a quarter of sovereign bond outstandings are indexed to inflation, the fall in inflation was a major factor in the decline in the government's interest burden in 2024. This should remain fairly stable at around 3% of GDP in 2025-2026. The significant rise in long-term interest rates creates a significant upside risk to these forecasts. Nevertheless, by sticking with its fiscal rules, the government is able to retain the credibility it needs to contain the upward pressure on bond yields and limit the collateral effects on the property market.