UNITED KINGDOM

RECOVERY EXPECTED, BUT THE ROAD TO MONETARY NORMALISATION WILL BE LONG

The UK's policy mix (a combination of fiscal and monetary policies) is expected to be more accommodative in 2025. Its positive effects will be limited, however, given the very gradual fall in interest rates and the introduction of more restrictive budgetary rules. After GDP growth in the third quarter of 2024 fell short of expectations (+0.1% q/q), activity is expected to strengthen in Q4 (+0.3% q/q) before stabilising around this level in 2025 (between 0.3% and 0.4% q/q). The United Kingdom, which has a trade balance almost in equilibrium with the United States and exports mainly services to the US, also seems to be in a better position than its European neighbours to avoid the rise in US tariffs.

ECONOMIC ACTIVITY: IN RECOVERY PHASE

Faced with the threat of US protectionism, the UK is in a unique position. Unlike the major industrial countries in the eurozone (Germany, Italy) and China, it has a very small trade surplus with the United States (less than GBP 2 billion in October 2024)[1], which could facilitate the terms of a future trade agreement between London and Washington. For the UK, which exports more services than goods to the US, the main shock would come from a more marked slowdown in activity within the European Union, its principal market. On the domestic front, consumer spending will continue to be held back by the scale of the past inflationary shock and by the process of refinancing households at higher rates, which is not yet complete. Indeed, the Bank of England (BoE) estimates that almost half of all mortgages will see an increase in interest payments by Q4 2027[2]. GDP growth is expected to rise next year to 1.4%, with an estimated carryover for 2024 of 0.4%. Activity will slow again in 2026, as a result of a more restrictive fiscal policy and domestic constraints (structurally high inflation, transmission of the rise in interest rates to households, and weak productivity gains) and external constraints (economic slowdown in the United States).

GROWTH AND INFLATION

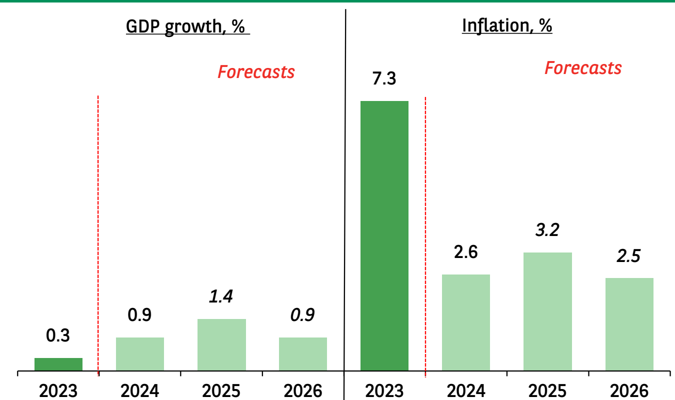

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

LABOUR MARKET: SO FAR SO GOOD

Although there are more indications of a cooling in the labour market, there is no sign of a real downturn at this stage. The number of employees fell by 0.1% q/q in the third quarter, after rising by 0.1% over the first two quarters of 2024[3]. The composite PMI for employment was below the expansion territory in November (48.9), but it is not falling as much as in the eurozone. This autumn, the number of job vacancies has just returned to the levels seen in 2019, a level consistent with a labour market that is still under pressure. Nevertheless, this deceleration should be enough to bring about a gradual slowdown in wages, which were still rising at an annual rate of almost 5% in October.

INFLATION: RENTS DRIVE INFLATION IN SERVICES

Since April, inflation has stabilised around the 2% target, thanks to deflation in energy and manufactured goods. On the other hand, the fall in inflation in services remains very limited, and a number of measures included in the Autumn Budget, which will take effect next April (6.7% increase in the minimum wage, rise in private school fees, and an increase in the rate of employer national insurance contributions), will be inflationary in nature. The rise in rents is also fuelling inflation in services and, given the upturn in property activity (*see box*), there is no guarantee that prices will decelerate rapidly in 2025 - on the contrary. Since the health crisis, the pace of increase in rents has strengthened steadily, hitting 7.3% y/y in October, the biggest rise in 31 years. While this inflation item is unlikely to be a crucial decision-making variable for the BoE, it is nonetheless a further brake on monetary easing. Excluding rents, inflation stood at 3.8% y/y in October, a level which, while not satisfactory, can be seen as moderate.

MONETARY POLICY: NO INTEREST RATE LANDING BEFORE 2026?

The Bank of England therefore has relatively little room for manoeuvre, given the situation on the inflation front. The members of the Monetary Policy Committee (MPC) are likely to opt for the status quo at their meeting on 19 December, before embarking on a new cycle of rate cuts in 2025, albeit a very gradual one, more gradual than in the eurozone, at a rate of one cut per quarter. Interest rates would not stabilise at 3.5% until 2026. Monetary policy would therefore remain restrictive next year, albeit gradually less so. However, its effects would be counterbalanced by a more accommodative fiscal policy.

FISCAL POLICY: DEFICIT STABLE IN 2025, CONSOLIDATION TRAJECTORY INTACT

UK fiscal policy will be expansionary in 2025, with the OBR estimating additional budget spending of GBP 70 bn over the next five years (around 2% of UK GDP). Against this backdrop, the OBR forecasts that the public deficit will stabilise at around 4.5% of GDP in 2024 and 2025[4], before falling further to 3% by 2027. The government has also set new, more stringent budgetary rules[5] that make this consolidation more cre-

1 Cumulative over twelve months.
2 Bank of England Financial Stability Report, November 2024, page 46.
3 Administrative data published by the ONS.
4 Fiscal years.
5 In particular, the rule that previously required public debt to be reduced within five years has been reduced to three years.

dible. The debt target has been changed from a measure known as 'net debt' to 'net financial liabilities'. The latter measure incorporates a broader set of assets which, on a net basis, reduces the debt ratio by almost 14 points of GDP compared with the net debt measure (83.7% of GDP in October 2024).

STRUCTURAL CHALLENGES: MITIGATING THE EFFECTS OF DEINDUSTRIALISATION

The decline in activity and job losses in the industrial sector – extractive and manufacturing industries – have increased sharply since the health crisis. In particular, industry's share of value added hit a new low of 10.4% in Q3 2024. This is fuelling a number of drags on the UK economy, such as falling goods exports and a widening trade deficit, as well as social and territorial inequalities. Accelerating house building and improving public services will be two other areas where the government will be expected to deliver results in 2025.

EXTERNAL POSITION: A TRADE DEFICIT PARTLY OFFSET BY SERVICES

The UK's current account remained in deficit at 2.2% of GDP in Q2 2024, year-to-date, but has more or less stabilised at this level over the last two years. On the other hand, the UK has a very large trade deficit (equivalent to 7.0% of GDP), particularly with the EU, which has widened post-Brexit and affects all the major categories of goods. The largest deficits in relation to the rest of the world are in food products, energy, and machinery and equipment. However, a large part of this deficit is offset by the substantial surplus in services (6.1% of GDP), which reflects the country's continuing strengths in high value-added services (finance and information and communication services).

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UK BILATERAL TRADE BALANCES (12-MONTH MOVING TOTAL)

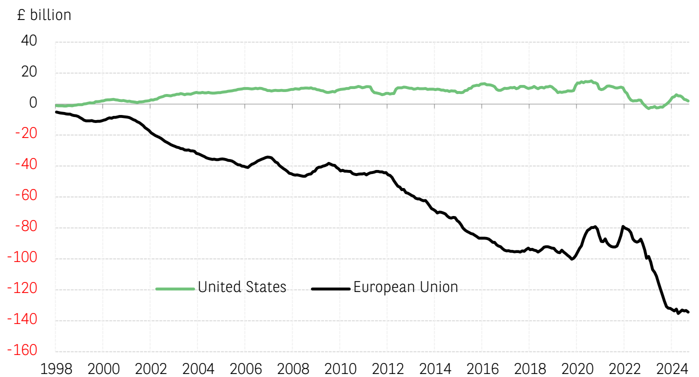

CHART 2 SOURCE: ONS, BNP PARIBAS CALCULATIONS

RICS SURVEY, SALES EXPECTATIONS IN THE UNITED KINGDOM

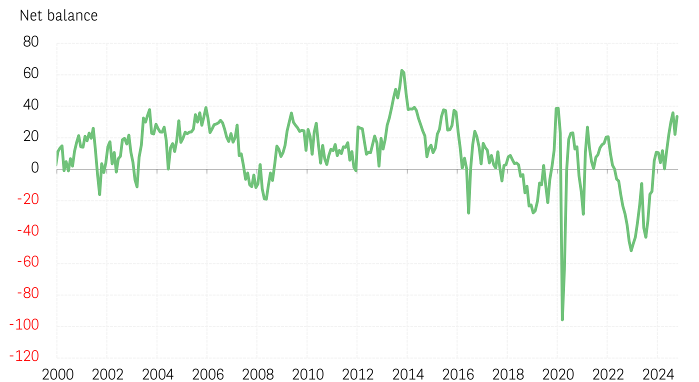

CHART 3 SOURCE: RICS, BNP PARIBAS

THE UPTURN IN THE PROPERTY MARKET, A SUPPORT AND A BRAKE ON ACTIVITY

The first interest rate cuts provided a further boost to the UK property market, which was already in a recovery phase even before monetary tightening was complete. The first signs of stabilisation came at the very end of 2022, with the beginning of a recovery according to the RICS survey[1], followed by a rebound in the volume of home loans. With 68,303 new loans (excluding renegotiations) granted in October 2024, the average for 2019 (65,784) has been exceeded. The rebound in house prices has also gathered pace, with the Nationwide and Halifax indices indicating a year-on-year rise in prices of around 4% in October-November.

The continued fall in interest rates and the increase in stamp duty announced in the Autumn Budget, which will take effect in April 2025, will strengthen this recovery in the coming months, against a backdrop of strong supply pressures. This will have the additional consequence of maintaining upward pressure on rents, and therefore on inflation. The upturn in property activity will increase pressure on the government, which has set itself the task of generating a construction shock, with the aim of building 300,000 new homes a year by the end of the government's term in 2029.[2]

1 The balance of opinion regarding sales forecasts hit a low of -51.8 in December 2022.
2 See BNP Paribas Chart of the Week, United Kingdom: the housing shortage, a major challenge for the Labour Party, 25 July 2024.