

UNITED KINGDOM

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THE UNITED KINGDOM FACES THE RISK OF STAGFLATION

Following a strong performance in 2025, the UK economy will suffer in 2026 as a result of its dependence on imported commodities, with little fiscal headroom to address the situation. GDP growth is expected to fall to 0.7%. Inflation is expected to remain persistently above the Bank of England's (BoE) 2% target, standing at 3.6% in 2026 and 3.3% in 2027 (though this forecast will depend on the scale and duration of the conflict). However, demand is significantly less robust than in 2022, which should limit second-round effects. Nevertheless, the BoE is expected to respond. According to our forecasts, it will raise its key interest rate by 25 basis points in Q2 and then in Q3; it is expected to lower it again in 2027. Grappling with a structural trade deficit and reappraising its 'special' trade relationship with the United States, the United Kingdom is expected to continue its strategic rapprochement with the European Union.

GROWTH: VULNERABILITY TO RISING COMMODITY PRICES

In 2025, GDP growth accelerated to 1.4% (up from 1.1% in 2024), driven by private consumption (contributing 1 percentage point) and public and private investment (in digital and new technologies) (0.8 percentage points), whilst the trade balance deteriorated. However, after a very strong start to the year, performances faltered, with growth reaching 0.1% q/q in Q4 and private investment declining, against a backdrop of high uncertainty (a factor limiting output for two thirds of firms, according to the CBI survey).

Whilst the positive results from business surveys in Q1 2026 and the first monthly growth figures may have suggested a recovery (with manufacturing and services PMIs in expansion territory), the energy shock caused by the war in Iran is expected to weigh on the economy. Input costs and supply lead times have tightened significantly. In 2026, growth is expected to be mainly supported by the increase in public spending planned in the Budget. However, the United Kingdom appears to be one of the European countries most exposed to a rise in commodity prices (notably low gas stocks). Yet, the size of the public deficit and upward pressure on long-term interest rates limit the ability of public finances to support household purchasing power. Therefore, GDP growth is expected to be affected (-0.3 pp compared to our initial scenario).

DETERIORATION OF THE LABOUR MARKET

The unemployment rate rose to 5.2% in November 2025 (+1.6 pp compared with the low point in June 2022), a level around which it is tending to stabilise. There is a significant deterioration among young people, who are seeing an unemployment rate of 16% in December 2025 (+6.3 pp since June 2022). The number of job vacancies fell to 721,000 in February 2026, a drop of around 45% since early 2022, whilst the number of unemployed people per vacancy rose to 2.6.

Recent geopolitical developments have added further uncertainty. KPMG/REC surveys report a decline in recruitment (both permanent and temporary), whilst recent PMIs indicate a slight contraction in private-sector employment.

Rising unemployment and a decline in UK competitiveness (with wages rising faster than in other European countries) have started to weigh on wages. Wage growth has slowed significantly, with weekly wages excluding bonuses rising by 3.5% year-on-year in February 2026 (3.7% including bonuses), compared with 5.7% (5.9%) a year earlier, the lowest level since the post-COVID period. This trend is expected to continue, with wage growth likely to fall back below inflation (see Chart 2).

Growth and inflation

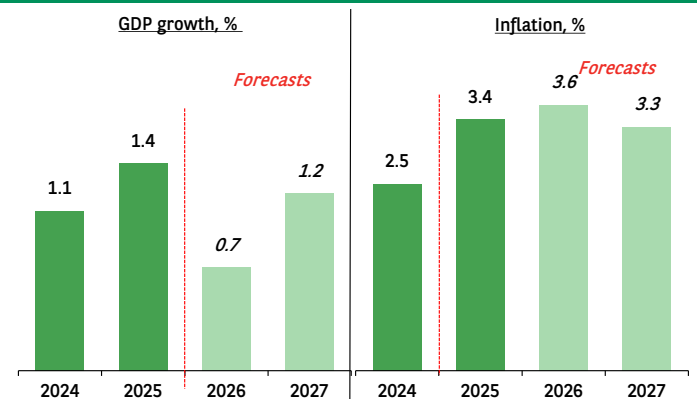


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

INFLATION: A TEMPORARY PHENOMENON?

We estimate inflation to stand at 3.3% year-on-year in March (+0.3 percentage points compared with February). According to our scenario, it will rise further, coming close to the 5% year-on-year threshold in January 2027. What's more, whilst the year-on-year change for seven out of twelve components still exceeded 3% in February 2026, core inflation is also expected to be pulled upwards and will once again exceed 4% by the end of the year, according to our forecasts. Rising energy prices have caused this rebounding inflation. Whilst fossil fuels (almost exclusively oil and gas) dominate its energy mix (nearly 76% in 2024), the country imports nearly 70% of its gas; as for oil, whilst production covers around 55% of demand, almost all (95%) of the fuels used have passed through an import stage. In addition, the country is being hampered by its low stock levels. They cover less than two days of average national consumption for gas (at the time of writing, due to its limited storage capacity), and are limited at the International Energy Agency's minimum reserve requirements for oil.

However, we expect that the peak in inflation will be more moderate than in 2022. The current environment is less conducive to second-round effects, as the post-COVID catch-up phase is behind us, the labour market has eased, financial conditions are tighter and direct fiscal support remains limited and targeted.


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MONETARY POLICY: TIGHTENING WILL BE HARD TO AVOID

There has been a complete U-turn in the monetary policy outlook, shifting from ongoing easing prior to the war in Iran to the prospect of tightening. After a brief return to the BoE's target in 2024, inflation has subsequently picked up again and is not expected to return to target in the short-to-medium term. Inflation expectations (BoE business survey) have rebounded to 3.5% over 12 months (+0.5 percentage points m/m). As a result, the BoE has adopted a more hawkish tone following its March monetary policy meeting.

Whilst the BoE is continuing its quantitative tightening, it has slowed the pace and adjusted the distribution of sales in September 2025 in order to limit pressure on the gilt market and ease pressure on the long end of the yield curve. The stock of gilts held in the Asset Purchase Facility (APF) is expected to reach GBP 488 billion by the end of September 2026 (vs GBP 895 billion in February 2022, a fall of 45%). Unlike other central banks, the BoE does not limit itself to maturing securities but actively sells its holdings on the secondary market. The annual decision on the pace of QT for the following year (October 2026–September 2027) is expected to be taken in September 2026.

NO ROOM FOR MANOEUVRE IN PUBLIC FINANCES

In its 2025 Spending Review, the government aimed to reduce the public deficit gradually, through increased tax revenue (a freeze on tax thresholds and an increase in employers' contributions: GBP 28 billion by 2029–2030) combined with controlled growth in spending. However, this trajectory could be affected by the ongoing energy crisis. For the time being, the UK government has limited itself to measures targeting the most vulnerable households and most energy-intensive businesses, at a very modest budgetary cost (less than 0.01% of GDP in 2026 and 2027). This reflects its limited room for manoeuvre, particularly as the markets are showing increased sensitivity to developments in the United Kingdom's public finances. Since the start of the war in Iran, the gilt market has been particularly turbulent, with the sharpest rise in bond yields among advanced economies to date. While the average maturity of the debt is relatively long (13.8 years), nearly 11% of the total outstanding debt is due for refinancing this year and will be directly exposed to rising interest rates. Furthermore, around 24% of the debt is inflation-linked, which automatically increases the sensitivity of the interest burden to inflation. According to our forecasts, the interest burden will increase by around 0.4 percentage points of GDP in 2026 if bond yields stabilise at their current levels (4.8% for 10-year yields, up 50 basis points in six weeks).

Taking into account the latest growth and inflation forecasts, the debt-to-GDP ratio is set to continue rising in the coming years (increasing by 2.5 percentage points to 104.8% in 2026, following 102.3% in 2025 and 99.8% in 2024). Slower fiscal consolidation and/or a sharper rise in debt servicing costs would delay its stabilisation, which we anticipate by the end of the decade ([see our analysis](#)). In its forecasts published in March, the Office for Budget Responsibility anticipated that the government would meet the targets that it had set for itself: a balanced current budget and a reduction in net public debt as a percentage of GDP by the end of the term of office (in August 2029). The greater-than-expected fiscal headroom available to the government at the start of the year (thanks to stronger tax revenues) could help it to meet the deficit target for 2026, despite the impact of slower GDP growth on public finances, but is unlikely to allow for the implementation of substantial economic support.

Nominal wage growth is slowing and approaching inflation

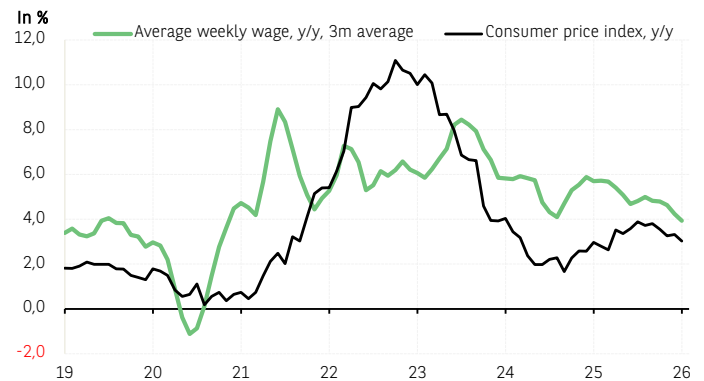


CHART 2

SOURCE: ONS, MACROBOND, BNP PARIBAS

FOREIGN TRADE: MOVING TOWARDS AN ACCELERATED RAPPROCHEMENT WITH THE EU

The United Kingdom's trade balance is still structurally in deficit (averaging GBP 37 billion since 2017, or -1.4% of GDP). The deficit in goods (primarily energy, food, vehicles and machinery), which is partially offset by the surplus in services, is expected to widen due to rising energy prices. Furthermore, the United Kingdom could lose the benefits negotiated under the bilateral trade agreement with the United States on 8 May 2025 (Economic Prosperity Deal (EPD)), whilst the United States is its largest export market (15.6% of goods), a position that has strengthened since Brexit. After the Supreme Court invalidated the measures based on the IEEPA, a blanket 10% tariff on US imports has been introduced for a period of 150 days, until 24 July. The sector-specific provisions of the EPD are being temporarily maintained pending the outcome of the ongoing renegotiations between the two countries. Closer ties with the European Union, however, open up favourable prospects for British industry, which could benefit from the EU's rearmament and reindustrialisation. The EU is still its main trading partner (41% of exports and 49% of imports), with a recurring deficit (of GBP 89 billion in 2025). Participation in the SAFE programme remains under discussion. British companies should automatically benefit from the Industrial Accelerator Act due to their status as trusted partners, provided, however, that legislative negotiations do not restrict the conditions for access. Finally, the UK government is preparing a bill to enable automatic regulatory alignment with future changes to EU rules in the areas covered by the negotiated agreements (currently limited to sanitary and phytosanitary standards, the carbon market and electricity trade). The bill, which aims to ease trade and reduce post-Brexit barriers, is expected to be presented to the UK Parliament this year.

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Marianne Mueller

marianne.mueller@bnpparibas.com
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