



EY ITEM Club Spring Forecast

Tariffs delay the recovery

April 2025

■ ■ ■
The better the question. The better the answer.
The better the world works.



Shape the future
with confidence

Ernst & Young LLP (EY UK) is the sole sponsor of the ITEM Club, the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

Contents

Foreword	3
Highlights	4
1. Introduction	5
2. US tariffs will hurt global growth	6
3. New tariffs hold back UK growth	13
4. Fiscal reset on the cards at the Autumn Budget	20
Forecast in charts	24

Foreword



Anna Anthony
UK&I Regional
Managing Partner
Ernst & Young LLP (UK)
[LinkedIn](#)



Peter Arnold
UK Chief Economist
Ernst & Young LLP (UK)
[LinkedIn](#)

The debate over whether economics is an art or a science is a perennial one, and the current global circumstances highlight that at times it's a bit of both. The latest GDP data for the UK economy suggested (another) Q1 rebound in 2025 – with GDP growing by 0.6% three-month-on-three-month in February, roughly double what was expected back in the EY ITEM Club winter forecast. In the normal turn of events, this would have likely led the EY ITEM Club to revise up its growth forecast for 2025.

However, the waves of uncertainty unleashed on the global economy stemming from the various tariff announcements made by the US Government this month, have reverberated through financial markets. In the short-term, this uncertainty will impact sentiment and hence business investment and consumer spending decisions. In the medium-term the imposition of tariffs will impact global growth, while in the longer term (if they remain in place) we will likely see some significant shifts in the nature and location of economic activity, as supply chains reconfigure, and policy calibrates.

Taking all of this together, the EY ITEM Club has cut its outlook for 2025 UK GDP growth from 1.0% to 0.8%, and from 1.6% to 0.9% for 2026, before predicting a return to a 'normal' level of growth of c1.5% by 2027. There is a significant uncertainty attached to this forecast; based on the sensitivities modelled by the OBR in its analysis published as part of the Spring Statement; there is (at least) a range of uncertainty of c+/- 0.4% to these forecasts!

The UK does look less exposed compared to others; it has broadly balanced trade with the US so is 'only' subject to the baseline 10% tariff on goods, and as a services-orientated economy is less directly exposed than more manufacturing orientated EU economies (Germany in particular), and of course China. However, certain sectors – automotive most obviously, and potentially pharmaceuticals – do trade heavily with the US and hence look vulnerable. The UK will also certainly be caught up in a general global economic slowdown, particularly if growth in the EU stalls.

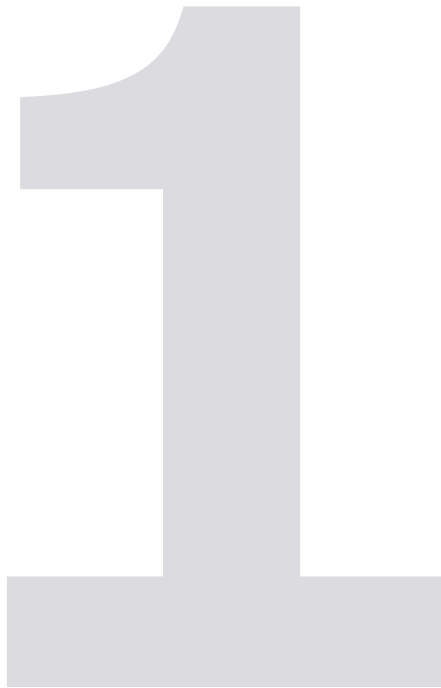
The current situation has a number of significant implications for policymakers, not least for the Chancellor who is already facing some tough decisions on government spending and will be closely watching gilt yields, tax receipts and growth. Whilst the Budget may be six months away, we should expect further recalibration of the public finances post the Spending Review in June

The Bank of England (BoE) will also need to think through its response; on balance the imposition of tariffs could be deflationary for the UK due to a combination of a weaker global economy, trade diversion and falls in commodity prices. A strengthening pound vs the dollar could also help the fight against inflation – opening the path to more aggressive interest rate cuts. However, the BoE will be keeping one eye on domestic inflationary pressures, and may act with caution unless clear signs emerge of a weakening economy (e.g., such as a spike in unemployment).

For businesses there is a definite need for scenario planning, and to carefully consider responses based on exposure to direct impacts (e.g., managing tariff liability), as well as indirect impacts from weaker global demand and volatility in financial, commodity and currency markets.

Highlights

- Despite the pick-up in momentum at the start of this year, US tariffs pose a significant risk to the global and UK economies, and we expect growth to slow sharply into Q2. Despite a weaker growth picture from the middle of this year, a strong Q1 means we only slightly downgrade our 2025 growth forecast to 0.8% from 1.0%. But with some of the weakness rolling through into next year, we have made a much larger downgrade to our 2026 growth forecast, which we now expect to be 0.9%, down from 1.6%. We still expect growth to settle around 1.5%, but we don't think this will be reached until 2027.
 - US tariffs will make access to one of the UK's key export markets more difficult, weakening goods demand. Global growth will also be softer as a result. Economic uncertainty will also weigh on consumers and businesses as they delay major spending decisions. More uncertainty combined with weakening real income growth paints a picture of modest household spending, while firms will be cautious with their capex given the lack of clarity around the business environment.
 - Even though the UK is a service-led economy and so less exposed to changes in tariffs than some others, it nonetheless remains sensitive to large changes in international trade policy. More protectionism and the uncertainty that comes with it are undoubtedly bad for UK growth prospects, but its near-term inflation consequences are more uncertain. Although, on balance, we expect it to weigh on inflation. Lower wholesale energy prices and the prospect of cheaper Chinese imports will, we think, outweigh the effect of potential supply chain disruption on consumer prices.
 - Nevertheless, inflation will be heading in the wrong direction through 2025 as the progress made last year is lost. Increases in regulated prices look set to push up inflation above 3% from April, where it will remain for nearly all of this year. The genuine progress on sticky inflation has been slow and will take considerably longer, as domestic labour costs are likely to remain high this year.
- Slow growth will see the unemployment rate rise, but the labour market will continue to function smoothly and pay growth will remain high as staff push for pay rises. Any slowing in earnings growth will be offset by the additional cost of higher National Insurance contributions (NICs).
- We suspect that the Bank of England will continue to remain cautious about the economic outlook given the heightened uncertainty. We think it will continue to cut once per quarter until at least August as it monitors how the changes in tariffs, National Insurance contributions and the National Living Wage feed through to the economy. After that, we forecast it will carry on lowering Bank Rate at every other meeting until it hits 3.5% in February 2026 as it tries to balance weak growth and sticky inflation. However, with the MPC perhaps becoming more concerned that tariffs and uncertainty will damage demand, we think that risks continue to skew towards more rate cuts this year.
 - A fiscal reset in the autumn is increasingly possible with tax rises and changes in the fiscal rules on the table. The Government's tax and spending plans continue to build in little margin for error, and the impact of tariffs will have already eliminated most of it. While the Spring Statement left a lot of the big questions around how the Government might finance future defence commitments or deliver some public services unanswered. With the growth outlook now looking weaker, there's scope for a broader change in policy, with the possibility of further tax rises or changes in fiscal rules up for debate. However, the UK's high debt and weak growth dynamics still require fiscal policy to be kept tight for some time if the public finances are to remain on a sustainable footing.



Introduction

Since our winter forecast, the UK has performed better than we expected – albeit this may have been distorted by ongoing data issues (e.g., changes in seasonal activity patterns) with official growth estimates. However, the US Government’s proposed increases in tariffs presents a clear and obvious risk to the global and UK economic outlooks that will delay the UK’s return to its cruising speed until 2027.¹

Our latest forecast report begins by discussing recent US tariff announcements and their potential economic impact before we look at what they might mean for the UK’s growth and inflation outlook. Given that some of the big questions around UK fiscal policy went unanswered at the Spring Statement, we will also examine what US tariffs might mean for the Government’s tax and spending plans when it comes to the Budget later this year.

A hand holding a smartphone displaying a financial chart, with a large number 2 in the background.

2

US tariffs will hurt global growth

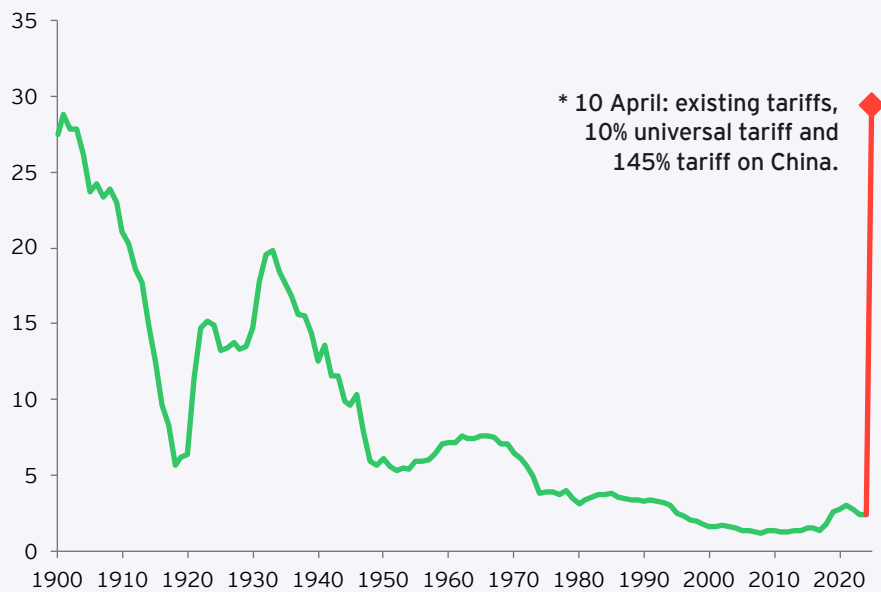
The US has increased tariffs all around the world

On 2 April, the US announced sweeping changes to its trade policy, establishing a 'baseline' tariff of 10% on all imports from countries other than Canada and Mexico. It has paused plans to hit countries that run large goods trade surpluses with the US with an additional tariff for 90 days. China was heavily penalised with new levies that increased its tariff rate to 145%.

Some exemptions were made on certain goods, but tariffs may follow here, too. Steel, aluminium and cars were excluded from reciprocal tariffs, but the 25% tariffs implemented earlier this year were confirmed. However, speculation remains around changes to auto tariffs. Some electrical items, such as smartphones, including those from China, have been granted a temporary exemption from both the baseline and reciprocal tariff. In addition, pharmaceuticals and essential minerals will not be covered by these tariffs but could be subject to tariffs later.

US: Effective tariff rate*

%



Source: US International Trade Commission/EY-Parthenon/EY ITEM Club

US tariffs will hurt global growth prospects

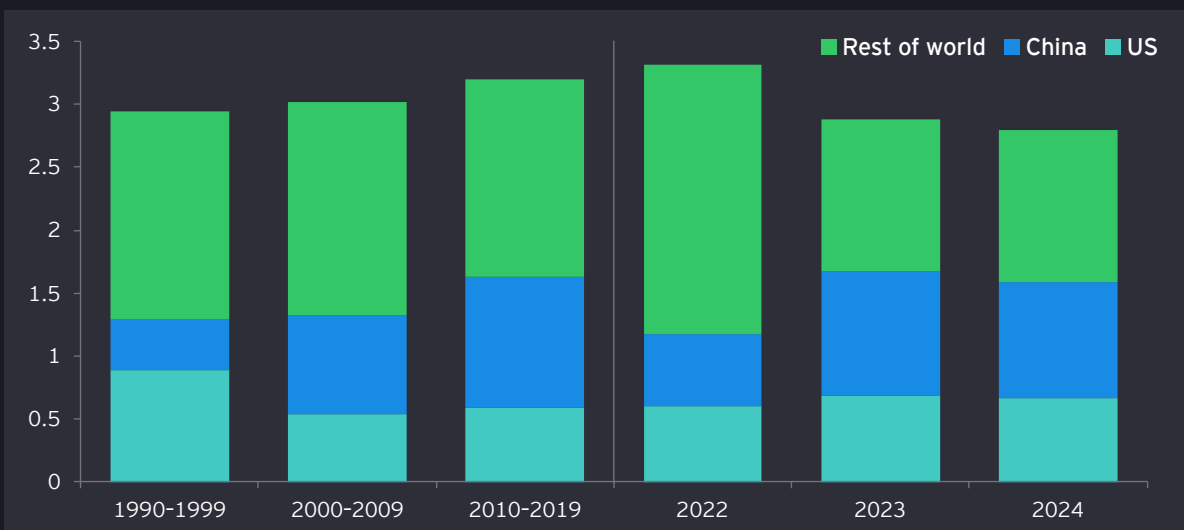
The imposition of tariffs will see growth slow sharply in the global economy's two growth engines: the US and China. Since the 2000s, the US and China have been responsible for about half of the world's GDP growth. As the world returned to normal following the pandemic, this trend re-emerged. However, with the US effective tariff rate rising by possibly more than 20 percentage points (pp), US inflation could increase by close to 2pp.² With the US consumer feeling the pinch, growth in the US could slow by more than 1pp in 2025.³ Meanwhile, the increase in US tariffs will have a much more significant impact on China's export sector, given its greater reliance on the US as a destination for its goods than vice versa.

However, the effects of the imposition of tariffs will not be felt by the US and China alone. With a baseline tariff of 10% likely to remain in place, many advanced economies still face a material increase in the effective tariff rate when exporting to the US, while the effects of uncertainty and supply chain disruption will both hamper activity. To some extent, the overall growth picture will be determined by how countries respond through trade deals or retaliatory measures. Nonetheless, one of the global economy's growth engines – China – has been hit particularly hard and responding with retaliatory measures, it looks likely that global growth will slow to around 2%. That would be only around 1pp above global population growth and one of the weakest performances since the Global Financial Crisis.

Global: GDP growth

% year

Source: National Sources/
EY ITEM Club



Tariffs will hold back UK GDP growth through the turn of the year

For the UK, the announcement to delay the introduction of reciprocal tariffs by 90 days will do little to alter the broad effect of US tariffs, which will be a marked hit to growth. The temporary postponement of US reciprocal tariffs for most countries was largely offset by the additional increase in the US tariff on Chinese imports, with the effective tariff rate remaining above 20%, albeit more concentrated on Chinese goods. Our forecast assumes that the US's effective tariff rate remains above 20% for the next five years.

Although the UK economy is service-led economy, and faces only a relatively small increase in its effective tariff rate, the US shift towards protectionism will drag UK growth. There is a direct effect as it has become more difficult for the UK to access its single largest goods export market. As we set out in our previous report, 16% of UK goods exports go to the US. So, a more than 10pp rise in the effective tariff rate will directly impact UK growth. The ITEM model estimates that a 10% rise in the price of goods exports lowers their demand by around 7%.

This translates to a direct impact on total goods exports of slightly more than 1%, representing a direct hit to GDP of around 0.2%. However, of more considerable consequence for UK exports will be the indirect impacts of US tariffs through a weaker global economic backdrop. However, some of this weakness will be compensated for by weaker UK demand for imports.

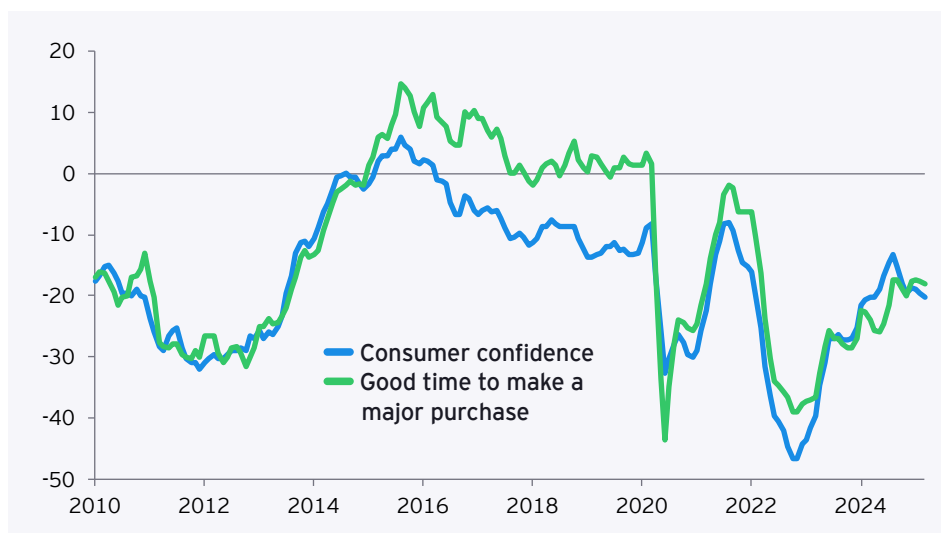
On top of the trade effects, uncertainty will weigh on household and corporate spending decisions.

Consumer sentiment, having picked up through the latter half of 2023, has not made much headway through 2024 and into 2025. Despite real incomes having risen by more than 4% last year, there is still little sign that households are looking to spend more on big-ticket purchases, with the saving rate rising to 12% in Q4 2024, far more than its long-term average. With households already in a cautious mood, the uncertainty from that changing US policy will have further impact. This will likely cause them to continue putting some spending decisions on hold.

UK: Consumer confidence

Balance statistic

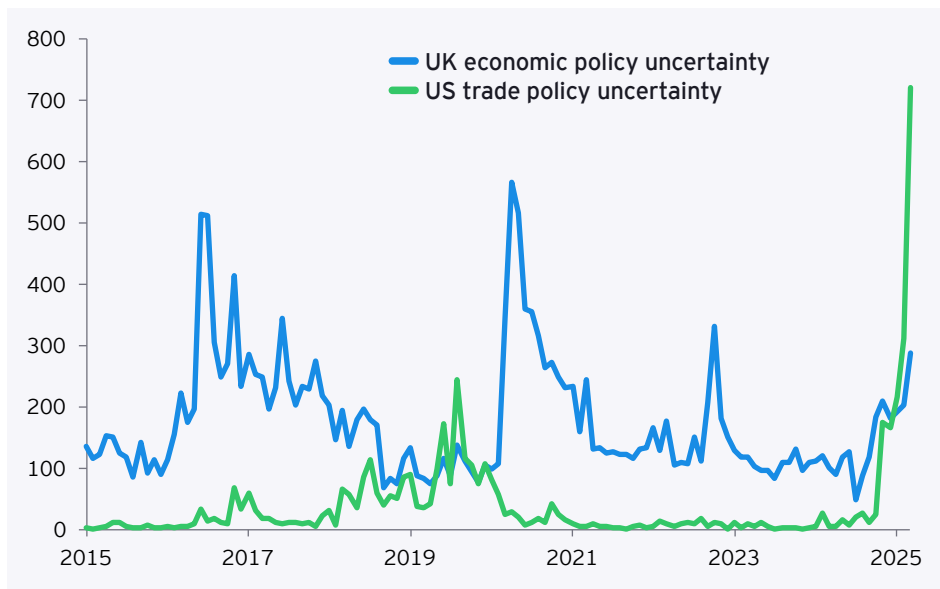
Source: Haver Analytics/
EY ITEM Club



UK: Economic uncertainty

2019 = 100

Source: Economic Uncertainty Policy Index/ EY ITEM Club



Uncertainty can be particularly harmful to businesses' capex intentions. The recent uncertainty around US trade policy has translated into uncertainty around the outlook for the UK economy. Coupled with heightened market uncertainty, we think it will weigh on firms' spending decisions as they also grapple with the increase in cost pressures coming from the rise in the National Living Wage and NICs. We now expect business investment to be soft over the course of the rest of 2025 and into 2026. But as time passes, we expect further falls in interest rates to support capex growth.

The net effect of weaker export demand from both the US and wider global economy combined with more caution amongst consumers and businesses is that we now expect GDP to end 2026 0.6% below the level in our winter forecast. That's broadly consistent with the scenario analysis provided by the OBR alongside the Spring Statement, which saw the US effective tariff increased by 20pp.⁴ However, the final landing point on tariffs remains uncertain and any changes to our baseline could impact our GDP forecast. Based on the same scenario analysis, in the unlikely event that the baseline tariff was removed and the situation with China was de-escalated, the level of GDP could be 0.4% higher than we expect. But on the downside, if there was widespread retaliation to US tariffs, the OBR's analysis suggests GDP could be 0.4% lower than our central case.

Even if there is not universal retaliation, the UK could still feel the effects of a further escalation of tensions between the US and China, if it were to further weigh on international trade. In our central forecast, the introduction of tariffs lowers global trade by around 5-6%. If further trade disruption were to cause an additional 1% decline in world trade, UK exports would fall by a similar amount.

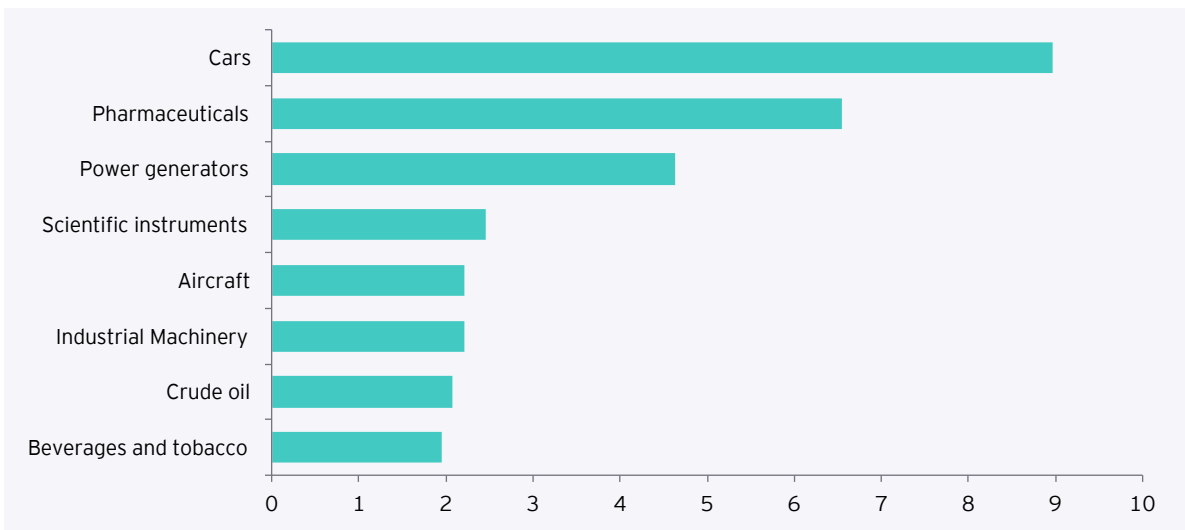
While the whole of the economy will feel the effects of tariffs, some sectors will feel them more acutely than others. As the largest importer of UK goods, reduced access to the US market will impact many of the UK's major goods exporting sectors. Of the large goods exporters, the car making and pharmaceutical industries are particularly reliant on US demand and will almost certainly face a large rise in the tariff applied to their products. The auto industry will be subject to a 25% levy. Pharmaceuticals have been exempt from higher tariffs so far but could still face increased levies at some point.

However, the broader implication of weaker world trade and a softer global economy is that other export-led sectors will also feel the squeeze. In 2024, just under half of non-US goods exports were accounted for by 10 sectors. Of these, cars, power generators and pharmaceuticals are exposed to both the direct and indirect effects of US tariffs. However, other sectors including the beverage and tobacco industry, and the scientific equipment production sector will also feel the effects of slower global growth acutely. The Bank of England estimates that UK exports worth £20bn have their final destination in the US.⁵



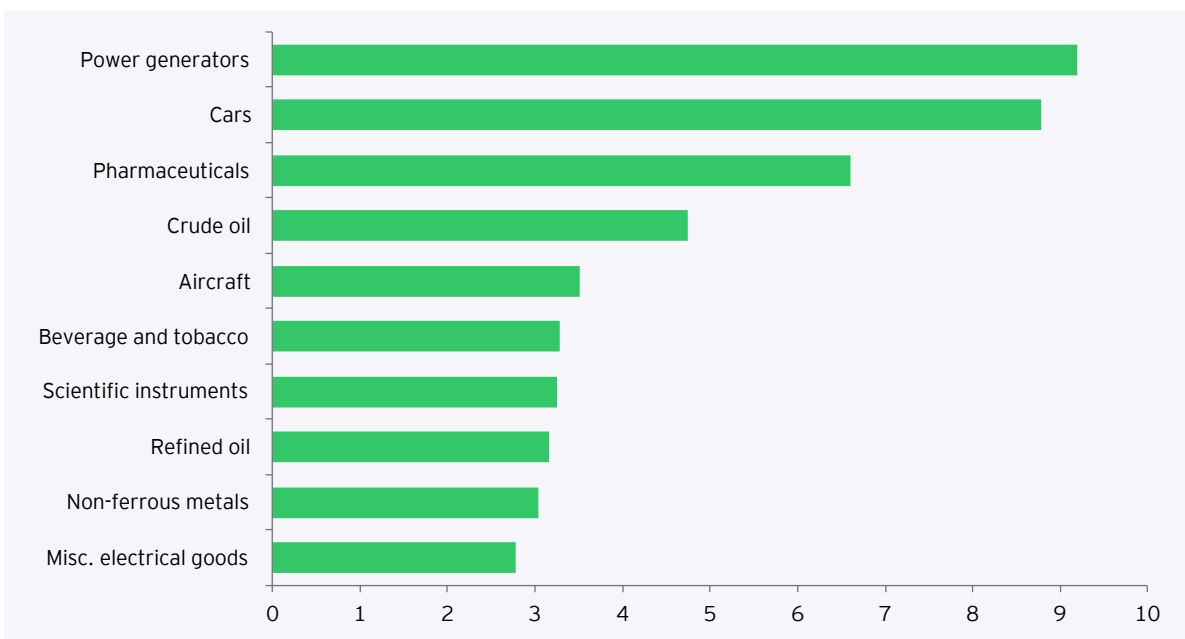
UK: Goods exports to the US £bn

Source: ONS/EY ITEM Club



UK: Share of non-US goods exports % of non-US goods exports

Source: ONS/EY ITEM Club

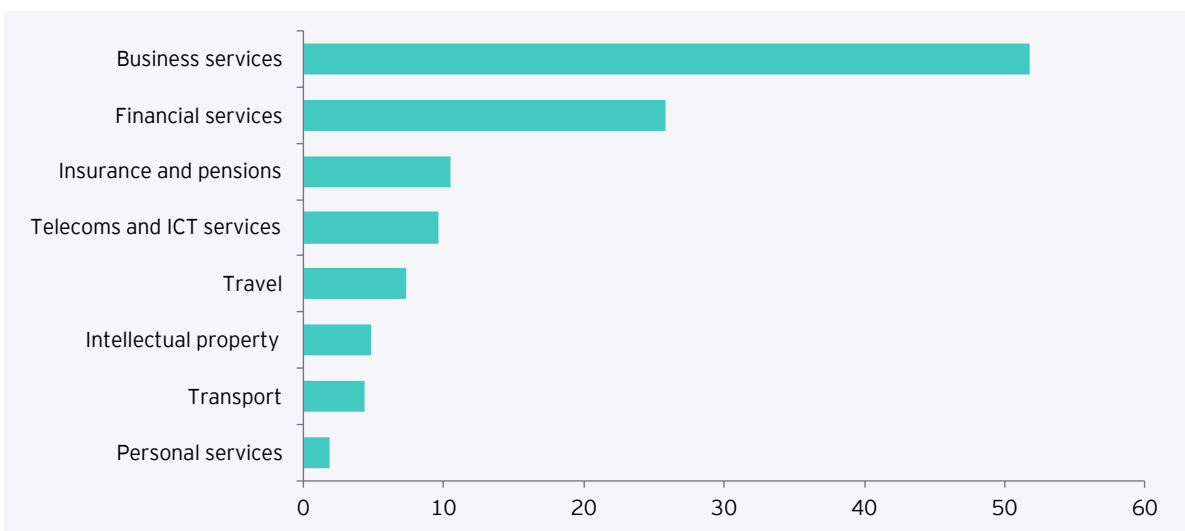


The US is also an important export market for UK services providers, particularly those that offer sophisticated professional services. In fact, in 2023, at £119bn, the UK exported almost twice as many services to the US as it did goods.⁶

Professional services were the largest source of exports by value, and while not directly impacted by tariffs, the weaker UK economy will likely mean demand from the US for these services will also be weaker.

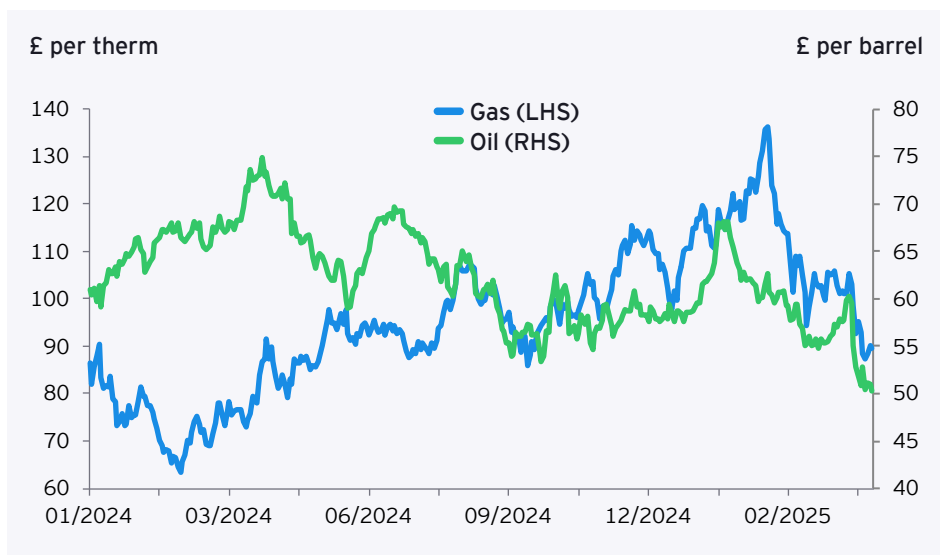
UK: Services exports to the US £bn

Source: ONS/EY ITEM Club



UK: Wholesale energy prices

Source: Haver Analytics/
EY ITEM Club



The inflation impact is less clear, but tariffs may be disinflationary in the near-term

While the directional impact of US tariffs on UK growth is clear, the response of UK inflation to US tariffs is less so. On balance, as the Government looks unlikely to retaliate with tariffs of its own, instead looking to seek a trade deal that will enhance the UK's access to the US market even if tariff rates are not adjusted, we think it more likely tariffs will be disinflationary in the near-term.

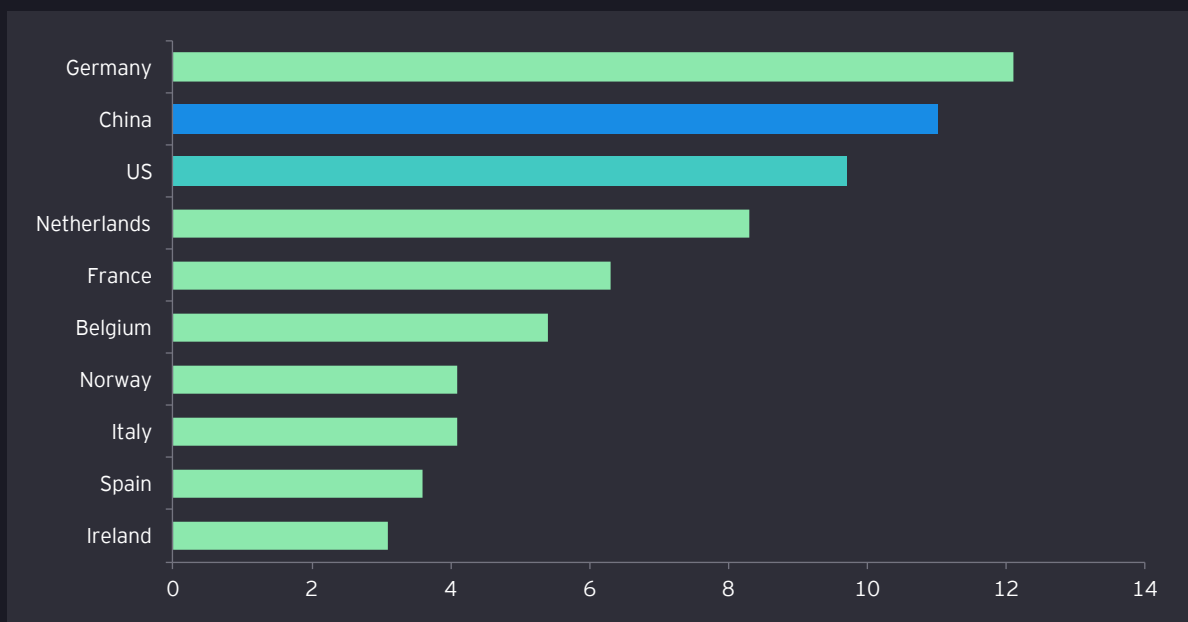
The largest downward impact comes via energy prices, which on the wholesale market have fallen sharply since the announcement of US tariffs as the market has moved to price a weaker global growth outlook. If sustained, falling oil prices will pass through relatively quickly to prices at the pump. However, lower natural gas prices will take more time to show up in consumer prices and will only be partially reflected in the July update of the Ofgem price cap.

In addition, there is the possibility that the UK could see reduced import price pressures, particularly from China. As the UK's Chinese imports are unlikely to be re-exports from the US, they won't be directly impacted by the tariffs China is applying to US goods. With tariffs making the US market more expensive, Chinese exporters may turn towards other markets to find buyers for their goods. With established trading links and similar product demand to the US, it seems likely that some Chinese producers would try to increase their UK sales, which, in turn, would put downward pressure on import price inflation.

UK: Source of UK goods imports

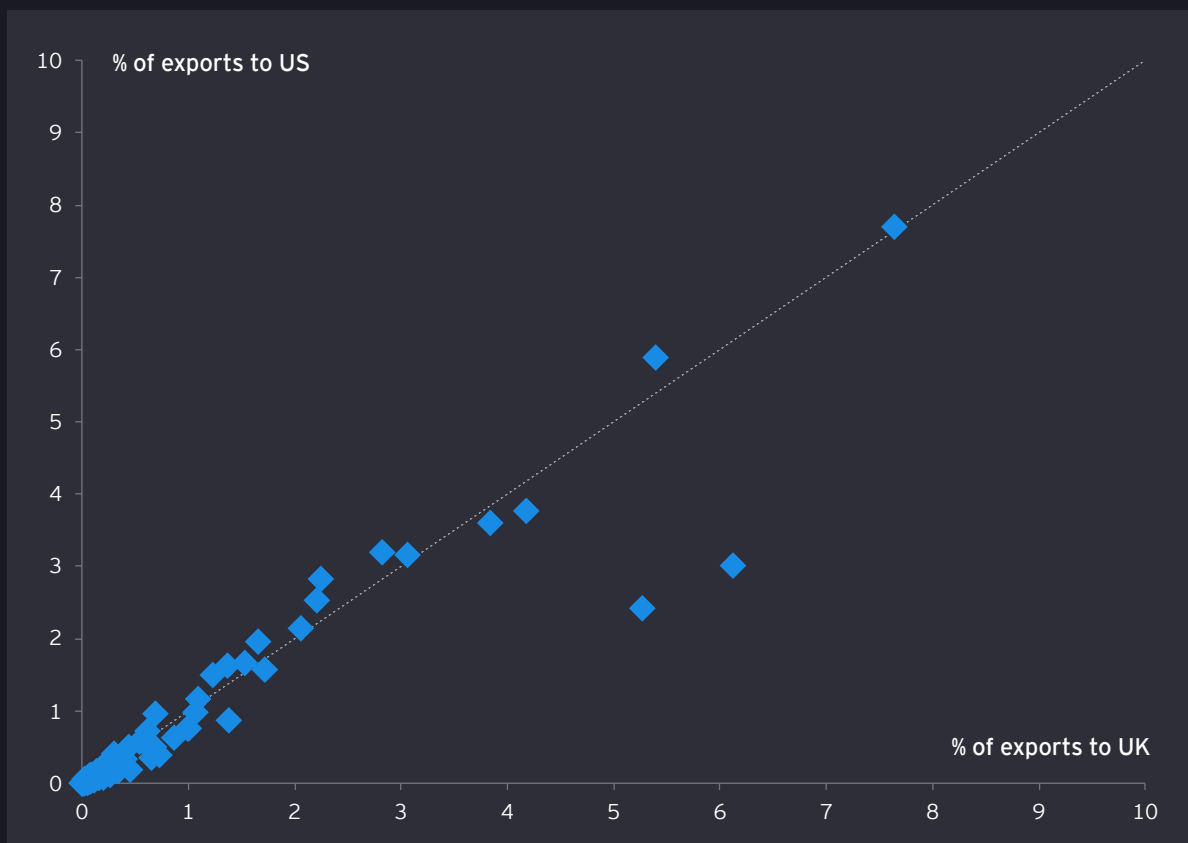
% of goods imports

Source: ONS/EY ITEM Club



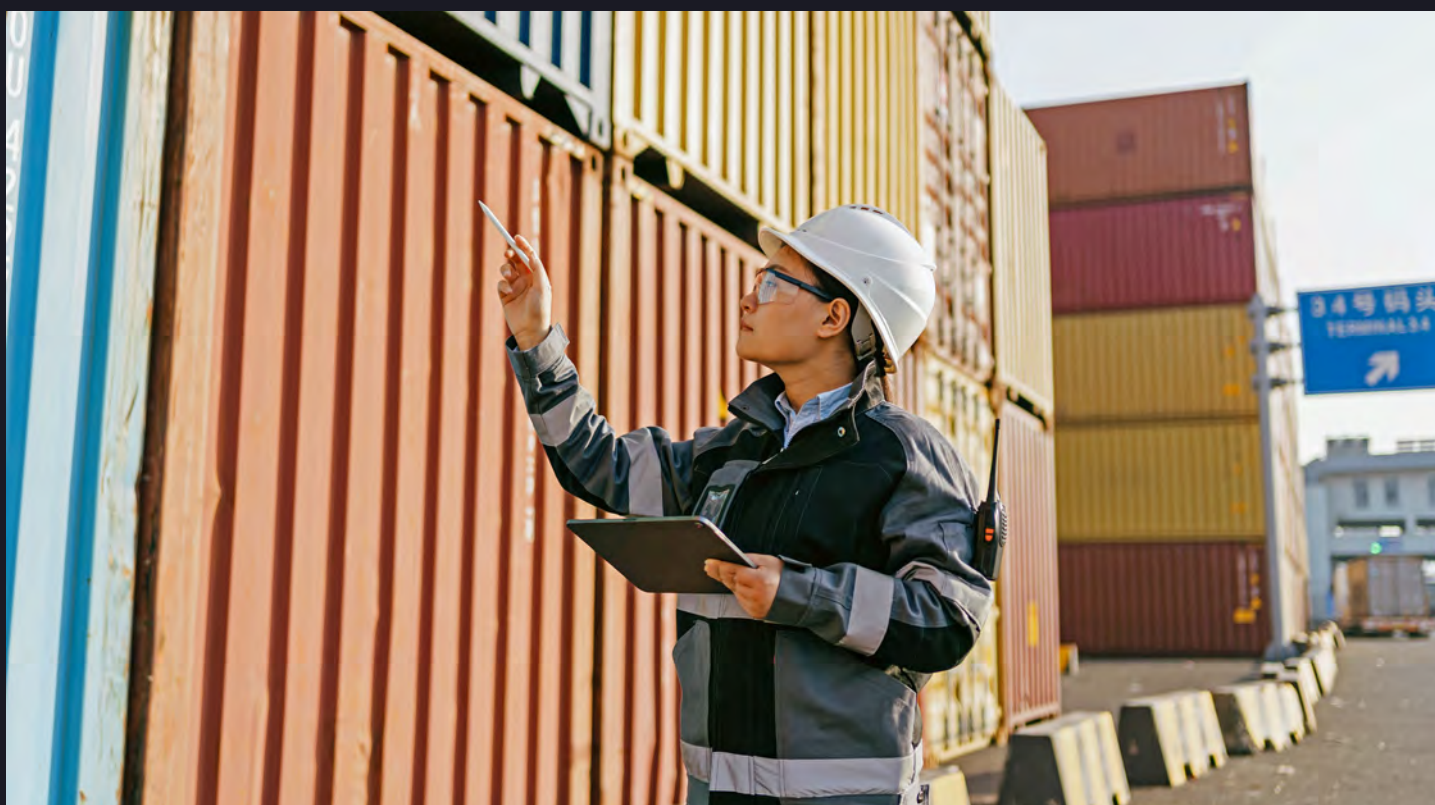
China: Goods exports to the UK and the US

Source: Haver Analytics/
EY ITEM Club



Nonetheless, one of the lessons from the pandemic is that disruption to cross-border supply chains can have a powerful effect on inflation. Sharp rises in used car prices in the US and Europe over 2022 and 2023 resulted from a shortage of semiconductors from South Korea and Taiwan, limiting the production of new cars. With the tariffs eventually levied on some Asian economies,

potentially at the larger end of the spectrum, there is the possibility that this type of disruption ripples through supply chains and puts upward pressure on goods prices in the UK and other developed market economies. Importantly, some of these ripple effects are hard to identify in advance and can have surprisingly large inflationary consequences.





3

New tariffs will hold back UK growth

The big change in the international trading environment and continued geopolitical uncertainty will see the economy lose momentum through 2025 and into 2026. On the back of a bumper Q1 2025 reading, we have only marked down our growth projection marginally to 0.8% from 1.0%. The immediate risk tariffs pose to growth can be more clearly seen in weaker quarterly growth rates from Q2, which has led to a bigger change in our forecast for next year. We now forecast 0.9% growth in 2026, down from 1.6% in our January report.

Q1's growth rebound won't last as tariffs hit the economy from Q2

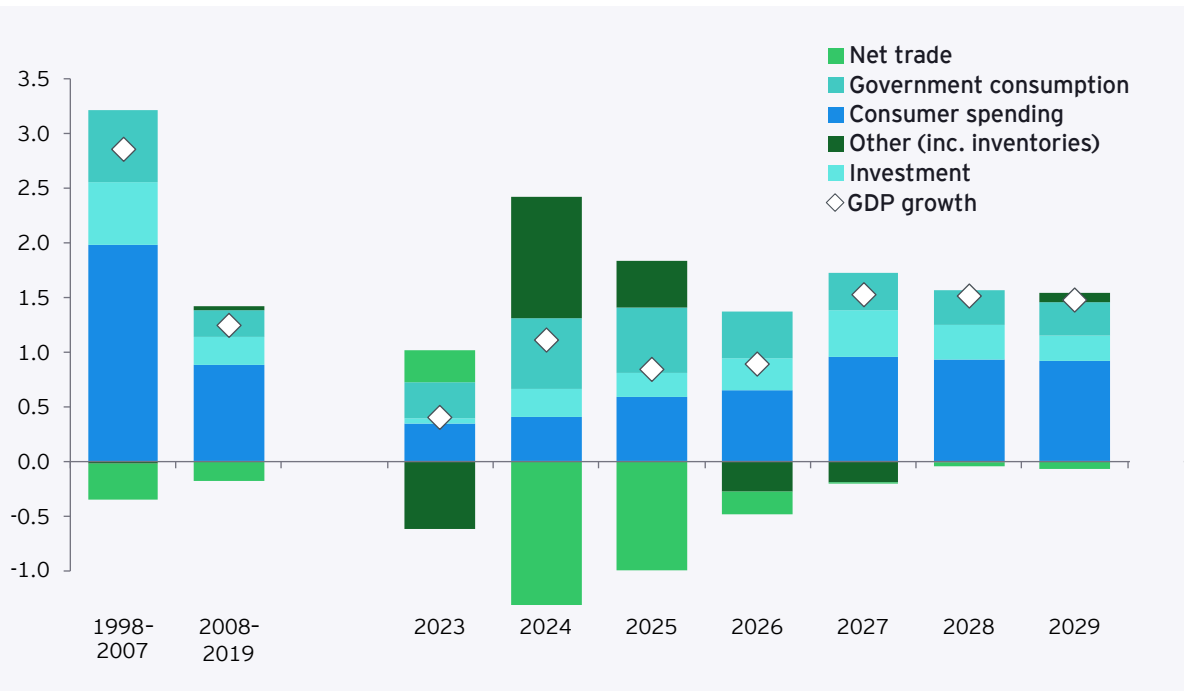
Having slowed to 0 in Q3, the Office for National Statistics (ONS) estimates that GDP growth edged up to 0.1% in Q4. However, monthly output data up to February pointed to a much more marked acceleration in growth than we pencilled into our winter forecast. Across the three months to February, activity has increased by 0.6% and looks to be running well ahead of the 0.3% rise we had expected in Q1. However, we think that the pick-up in growth is overstating the economy's true performance over the last few months. The GDP data is probably heavily affected by residual seasonality, which leads to growth estimates early

in the year being too optimistic. The flip side is that estimates in the latter half of the year are then too pessimistic. In each of the past three years, GDP growth has slowed sharply into the second half (H2) before picking up again at the start of the next year.

With official estimates indicating that 2025 has made a strong start, we expect GDP growth to lose momentum across the course of this year as the effects of tariffs start to bite. Having grown at 0.6% in Q1, we expect quarterly GDP growth to slow to 0.1%-0.2% over the course of 2025 and into 2026.

UK: Contributions to GDP growth

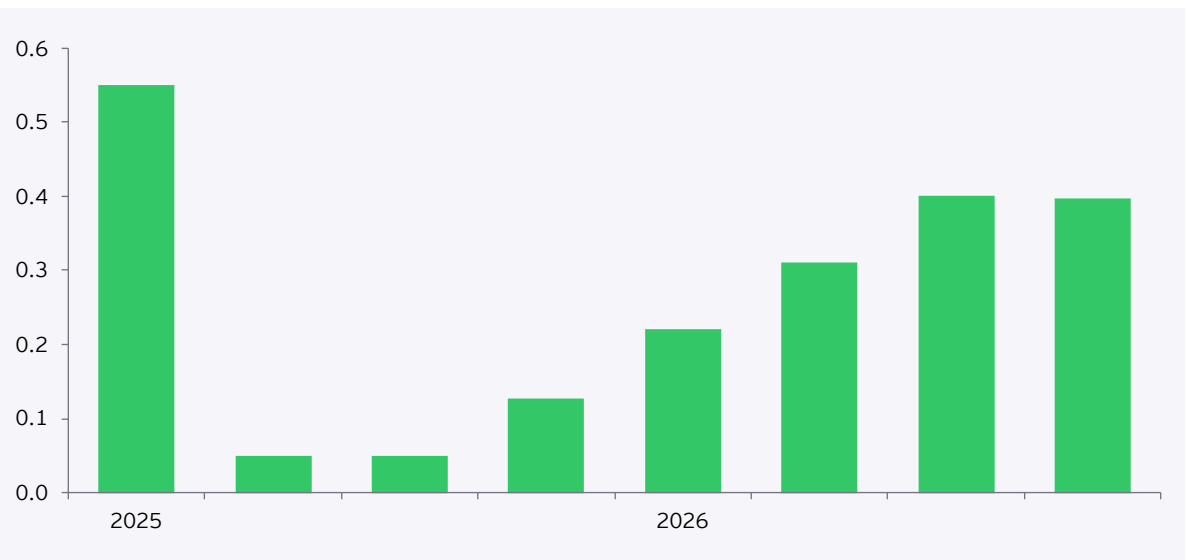
% pts



Source: EY ITEM Club

UK: Quarterly GDP growth

% quarter



Source: Haver Analytics/
EY ITEM Club

The labour market will loosen, but cost growth will remain high

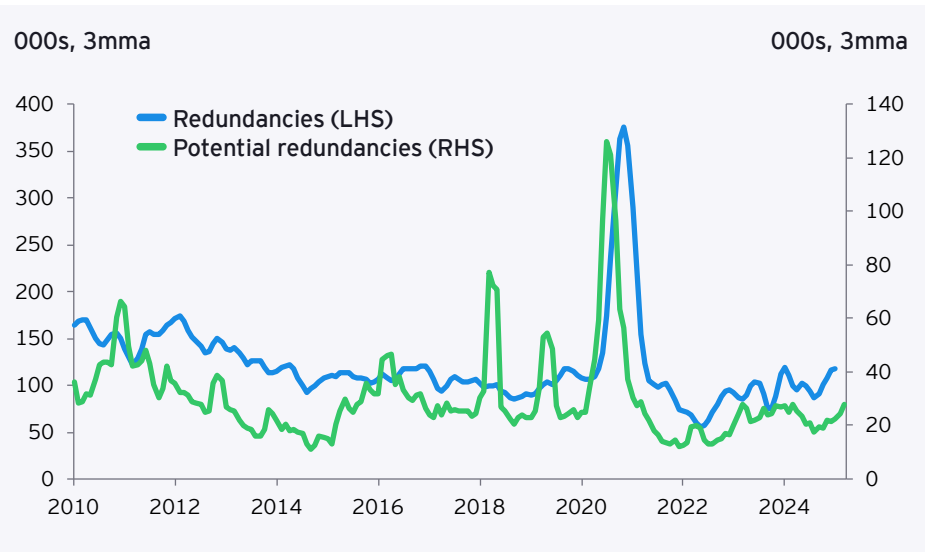
As the economy has moved sideways over the last few years, the labour market has loosened, but it remains orderly. Vacancies have fallen back to a little below pre-pandemic levels, but there are no signs of large layoffs. As momentum slows over 2025, we think the labour market will loosen further, and unemployment will rise. However, in a broader context, this will be a modest change in the job market. With no recession in the forecast, the unemployment rate should rise 0.5pp to close at 5% by the end of this year before settling around 4.5% in mid-2027.

A feature of recent years has been elevated pay growth despite the normalisation of the jobs market. We expect this to continue over the coming year, with earnings growth forecast to only ease back gradually. Both households and firms still expect inflation to remain sticky. So, with the labour market forecast to remain in pretty decent health, we think that private sector pay growth will slow from close

to 6% at the end of last year to just under 4% by the end of this year as firms absorb some of the increase in NICs in lower headcount and smaller pay rises. We project pay growth to remain above the rates consistent with inflation returning to the 2% inflation target throughout this year, with earnings returning to around 3% next year.

As we pointed out in our winter forecast, April's rise in employers' NICs will offset any slowdown in earnings growth this year. With wages growing between 2% and 4%, the tax rise will mean that businesses still face labour cost growth of around 4% and 7% for most employees, comparable to last year. Cost rises will be most marked for those businesses that rely heavily on lower-paid staff, with the National Living Wage also having risen by 6.7%. Many of these firms operate on thin margins and have faced tricky operating conditions since the pandemic, so the risk of elevated job losses in areas such as retail and hospitality remains.

UK: Redundancies



Source: Haver Analytics/
EY ITEM Club



Upcoming changes in regulated prices will push inflation higher with underlying pressures sticky

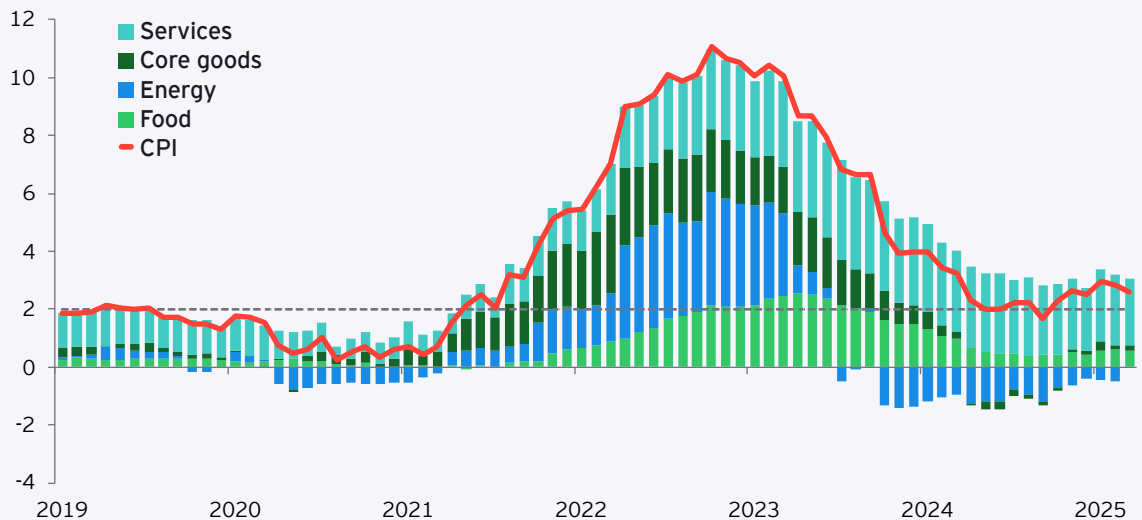
The quick wins we saw on inflation at the end of last year have all but faded, and inflation looks set to rise above 3% in April, remaining there throughout most of this year, even as the recent falls in commodity prices filter through to consumer prices. While part of this pick-up can be explained by a rise in regulated prices, there is no getting away from the fact that domestic inflationary pressures remain sticky. We expect inflation to fall back to close to the 2% target towards the end of next year.

Households will face a sharp rise in energy and water bills in April. The spike in wholesale energy prices at the end of January eventually filtered through to a 6.4% increase in gas and electricity prices in April, while water bills have risen by an eye-watering 26% for the year.⁷ Other unregulated prices that are often set each April and tied to past inflation, such

as telecoms and broadband contracts, have also increased. With many of these prices only set once per year, a large rise in April will push up the annual rate of inflation until March next year. However, if sustained, the recent falls in wholesale prices will see households' energy bills fall back in July.

In the end, there will be a gradual slowdown in services inflation, which is most closely linked to labour costs, and inflation will head back to and stick at the Bank of England's target. But this will take time. Although it has fallen from over 7% in 2023 to 4.7% in March, there has been little progress over the last few months, while pay growth has remained high. From here, we expect services inflation to edge back only gradually as labour cost growth is not expected to slow much as April's increase in employers' NICs kicks in.

UK: Contributions to CPI inflation
% year



Source: Haver Analytics/
EY ITEM Club

Forecast for the UK economy, spring 2025

% changes on previous year except borrowing, current account and interest and exchange rates

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2022	4.8	5.1	7.4	5.1	12.6	13.0
2023	0.4	0.0	0.5	0.3	-0.4	-1.2
2024	1.1	2.4	0.6	1.5	-1.2	2.7
2025	0.8	1.8	0.9	1.2	-0.5	2.3
2026	0.9	1.1	1.0	1.6	-0.4	0.2
2027	1.5	1.5	1.5	2.4	1.3	1.2
2028	1.5	1.5	1.5	1.7	1.6	1.5
2029	1.5	1.5	1.5	1.3	1.6	1.6
	Net govt. borrowing (*)	Current account (% of GDP)	Average earnings	CPI	Bank Rate	Effective exchange rate
2022	4.9	-2.2	6.4	9.1	1.5	79.7
2023	4.8	-3.5	6.9	7.3	4.7	80.5
2024	4.7	-2.7	5.3	2.5	5.1	83.6
2025	4.0	-2.7	4.5	3.0	4.2	83.9
2026	3.2	-2.8	3.3	2.4	3.5	83.8
2027	2.6	-2.7	2.9	2.0	3.5	83.8
2028	2.4	-2.6	2.8	2.0	3.5	83.8
2029	2.3	-2.5	2.9	2.0	3.5	83.8

(*) Fiscal years, as % of GDP

Source: EY ITEM Club

The impact of tariffs will be felt more widely than just exports

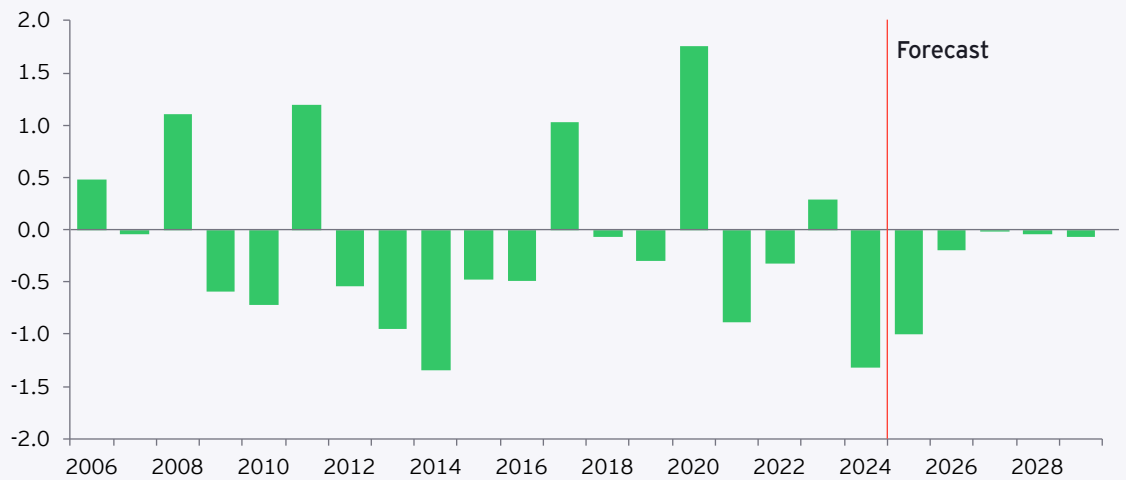
As we set out in Section 2, the key change since our previous report is the announcement of the US's tariff schedule. However, the effects go beyond the direct impact on access to the UK's largest single goods export market. Slower growth in trade partners worldwide and continued uncertainty will weigh heavily on UK demand.

Overall, we expect exports to fall by 0.5% this year. Given that the Government has not moved to retaliate against the US tariffs, we do not expect a direct impact on imports from any UK tariffs. However, weaker demand and some trade disruption will see some slowdown in import growth, too.

Rising inflation and slowing wage growth will see individuals' real pay growth slow down. Rising unemployment and fiscal drag will see real household income growth start to slow from approximately 4% in 2024 to less than 2% in 2025. With this in mind, we think that after a decent start to 2025, consumption will lose momentum over the course of the year, and the saving rate will only drift down slowly. This marks a change from our recent forecasts. We now expect a less marked decline in consumer caution, with the saving rate still falling back but settling above historical averages. This means that the shortfall in spending on durable goods could continue for some time as the consumer remains wary about making big-ticket purchases.

UK: Contribution of net exports to GDP growth

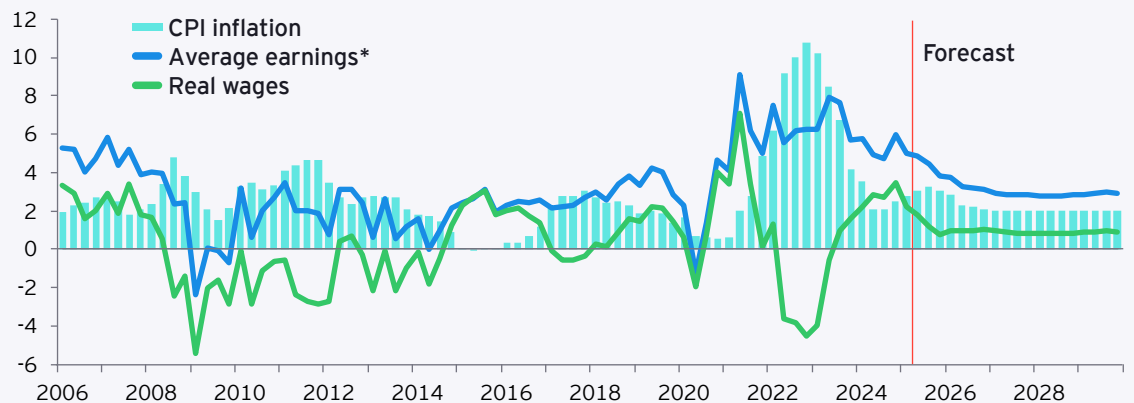
% year



Source: EY ITEM Club

UK: Average earnings and inflation

% year

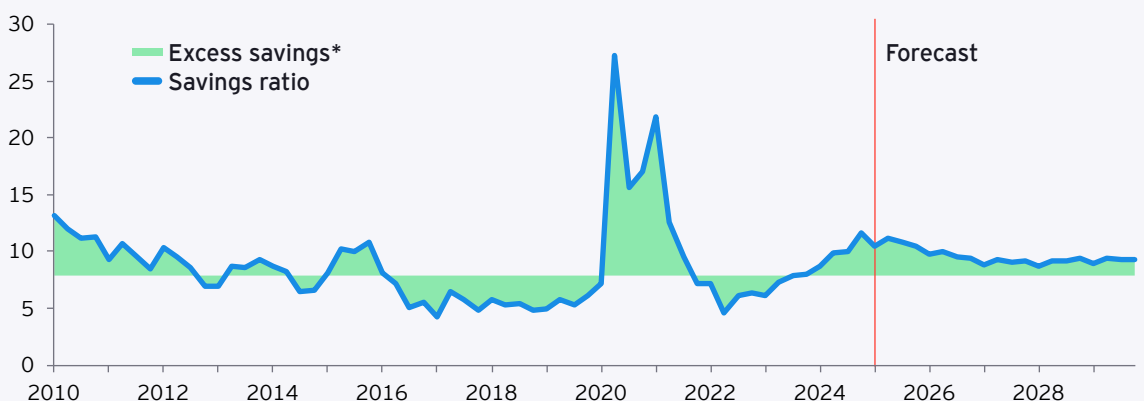


* National Accounts measure.

Source: EY ITEM Club

UK: Household saving ratio

% of disposable income



* Relative to 2010-2019 average.

Source: Haver Analytics/
EY ITEM Club

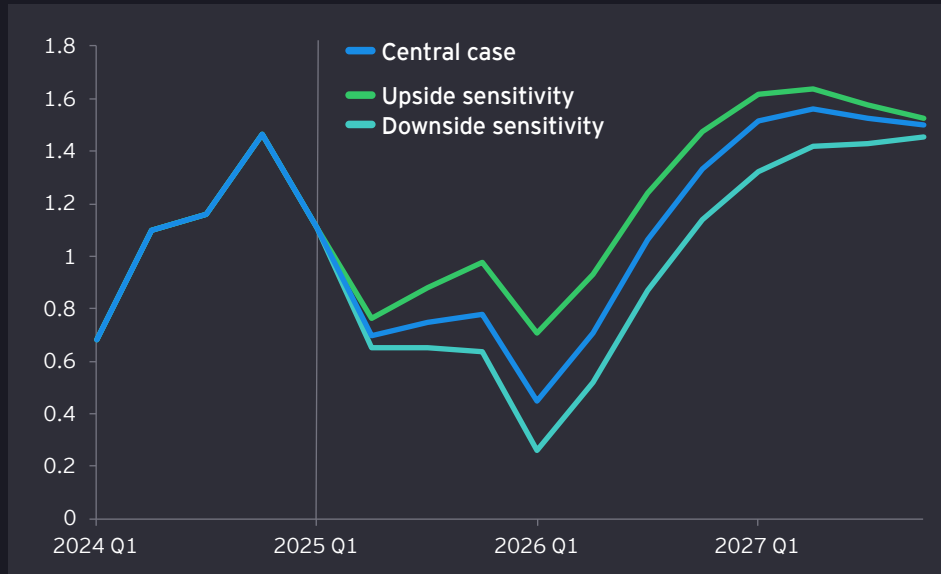
The growth outlook will remain sensitive to the eventual outcome on tariffs

As we set out in section 2, our central forecast assumes that the US imposes a baseline 10% tariff on all countries, with higher tariffs on some specific items such as autos and a 145% tariff on China, lifting the average effective US tariff rate above 20%.

But a lot of uncertainty remains around the final tariff schedule. On the one hand, in the unlikely event that the US Government decides to remove

the baseline 10% tariff and de-escalate with China, GDP would be stronger than we expect and could see 2026 growth increase to 1.1%. This would lift 2026 growth to 1.1%. But, on the other hand, if there are retaliatory tariffs from other trading partners, the negative impact from shifting global trade policy would be larger and could see the 2026 growth projection drop to 0.7%.

UK: GDP growth sensitivity analysis
% year



Source: EY ITEM Club

The Bank of England will still take a gradual approach to cutting rates

Since our last report, the Bank of England has lowered Bank Rate by 25 basis points (bp), as we expected, to 4.5%. However, the Monetary Policy Committee (MPC) has provided little steer on where it expects interest rates to go over the remainder of this year. Even before any tariff announcements, its communications suggested that it had little conviction on how the economy would pan out, given the uncertainty around how changes in the National Living Wage and employers' NICs would impact the labour market, wages and pay.

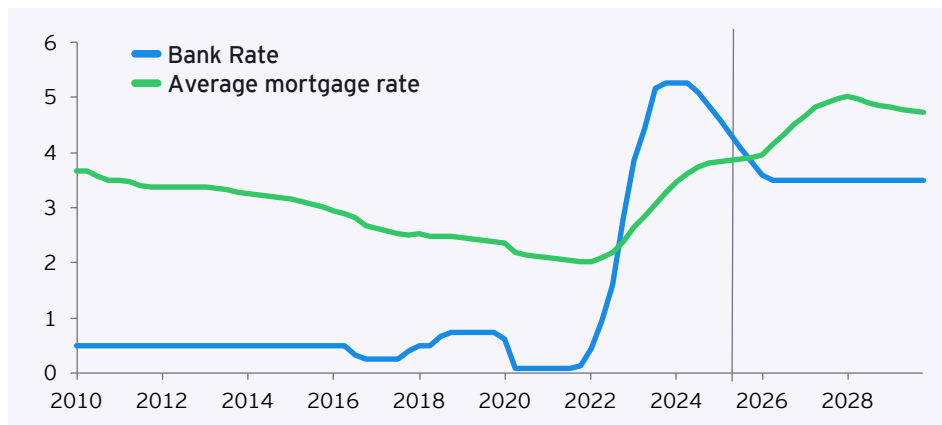
Without a sharp contraction in activity and a labour market that is unlikely to result in significant job losses, we expect the MPC to stick to its careful tempo of a 25bp cut at every other meeting as it continues to monitor how the impacts of domestic and international policy changes ripple through to the broader economy. We think the MPC will cut Bank Rate to 4.25% at its May meeting and to 3.75% by the end of the year. We expect Bank Rate to settle at 3.50% in February 2026.

The initial reaction of financial markets to the introduction of tariffs was that the Bank of England would have to cut more than they previously expected, with Sterling Overnight Index Average (SONIA) swaps moving to price four rather than three 25bp cuts this year. Although this moves financial markets to be more in line with our view, we think that recent developments are, on balance, slightly dovish. Despite tariffs potentially damaging global supply chains, we think the MPC could be more concerned that sustained economic uncertainty will generate some economic slack. So, we see the risks skewed towards quicker interest rate cuts than we incorporate into our central case.

Despite interest rates falling, we expect some drag from past rises to remain. The Bank of England's assessment of the housing market indicates that a significant minority of households still have to refix their mortgages to a higher rate.⁸ Given the large number of five-year fixed deals taken out when interest rates were low in 2021 and the housing market reopened, we expect the average mortgage rate to continue to rise in 2025 and 2026.

UK: Bank Rate and average mortgage rate

%



Source: EY ITEM Club

Having started the year well, the housing market could slow down for the rest of the year

The housing market got off to a strong start this year despite mortgage rates increasing as financial markets processed the implications of the US election and the Autumn Budget. This demand appears to have been temporary as home buyers looked to bring forward transactions ahead of stamp duty thresholds returning to normal in Q2 2025. With housing market indicators slowing into March as this effect waned, it looks likely that the housing market could go through a near-term soft patch, exacerbated by heightened economic uncertainty.

With interest rates on new mortgages likely to slowly fall as the Bank of England gradually cuts interest rates, we do expect there to be some demand for housing during the remainder of this year. However, with affordability stretched, a small rise in unemployment and ongoing uncertainty around the outlook, we think that some potential buyers might postpone major spending decisions until they have more clarity on the economy's path. Altogether, we think this will lead to modest housing market performance over the course of this year, with house prices expected to grow by 3.3%.

Fiscal policy is set to continue to tighten over the coming years

As we go into more detail in the next section, the Spring Statement was a stopgap ahead of the Autumn Budget, where the recent tariff announcements make a fiscal reset a real possibility.

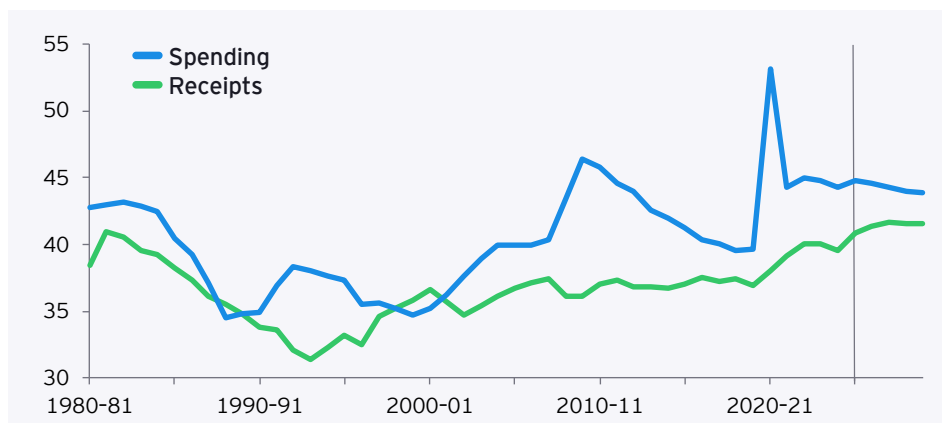
The UK continues to struggle with challenging fiscal dynamics. High debt, high interest rates and weak growth have seen the UK fiscal outlook deteriorate, and the Government will have to continue to tighten fiscal policy in response. The Spring Statement did little to change the fact that tax revenues will increase much more quickly this year and next year

than spending, the net effect of which is a break on growth.

A key part of the Government's strategy for delivering public services within tight departmental budgets is widespread efficiency gains. This will probably imply a reduction in public sector headcount. Given that over the last few years, the public sector has significantly supported the labour market, there is the risk that it will loosen more quickly than we expect if the Government pursues more efficiency gains than we currently assume.

UK: Public spending and tax revenue

% of GDP



Source: EY ITEM Club



Fiscal reset on the cards at the Autumn Budget

Despite her pledge to deliver only one fiscal policy-making event every year, the Spring Statement saw the Chancellor make some changes to government spending plans. However, these were merely tweaks around the edges to ensure the Government continued meeting the fiscal rules set out in the Autumn Budget. It did very little to answer the big fiscal questions and left open the prospect of a larger rethink around fiscal policy in this year's Spending Review and Autumn Budget. The imposition of US tariffs has only increased the chances of a fiscal reset towards the end of the year.

The Government will continue to operate with a thin margin for error

Having announced a significant increase in spending at her first Budget in October, the Chancellor trimmed back these spending plans a little at the Spring Statement. By changing the eligibility criteria around some out-of-work benefits, the Government is estimated to have lowered the welfare bill by around £5bn. Simultaneously, it reduced its budget for day-to-day spending by around £5bn.

Given the uncertainty around the global economic outlook, these changes do not represent a broad shift in fiscal policy or the Government building up a buffer. Instead, they are the result of the gamble that the Government took at its first Budget when it only left a small margin for error against its fiscal rules.

To keep the public finances on a sustainable footing, at the last Autumn Budget, the Government pledged that by 2029-30 it would only borrow to

invest and that its net financial liabilities would be declining relative to national output. But it set its tax and spending plans, so the first of these rules was only met by a wafer-thin margin of £9.9bn, comparable to the previous government, but significantly below the roughly £30bn that governments have typically left themselves.

Over the six months since the Budget, growth was weaker than the Office for Budget Responsibility (OBR) expected, and market interest rates were higher. As a result, when the OBR updated its forecast at the Spring Statement, the Government was no longer expected to meet its fiscal rules. Therefore, to make sure it remained compliant, the Government cut back its previous spending plans. However, the changes were only sufficient to rebuild the buffer against its rule of only borrowing to invest and do not offer any more headroom.

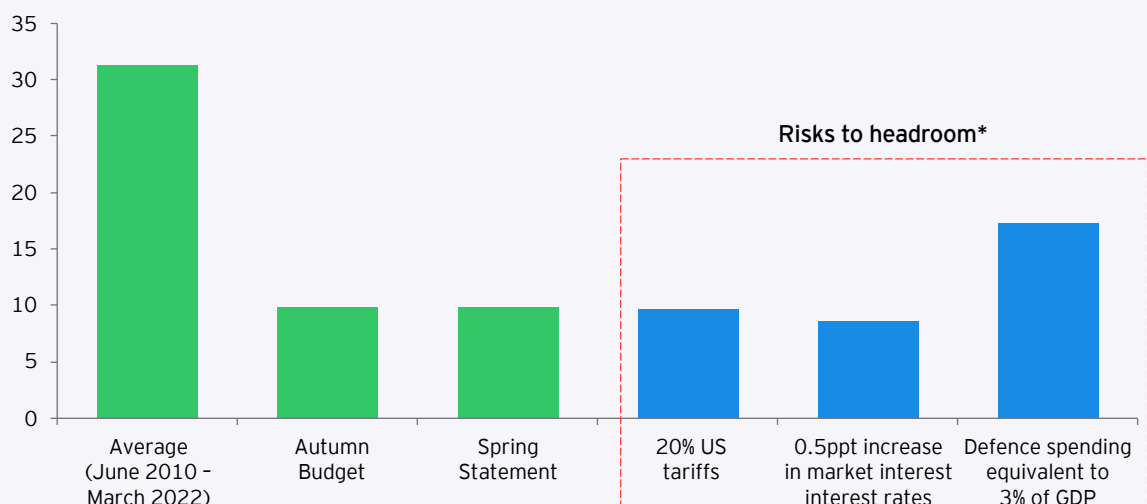
There is plenty of scope for the Government to be blown off course again

By not building in more headroom, the Government continued to run the risk that its fiscal policy could be knocked off course by relatively normal swings in economic or financial market performance. However, the shift in US trade policy marks a much larger change in the global economy that will have a material impact on the UK's public finances.

In our view, the recent tariff announcements will have significantly reduced the Government's headroom relative to the OBR's Spring Statement assessment, which did not include any tariffs on UK exports to the US. If our forecast comes to pass, we do expect the Government to just meet its rule of only borrowing for investment, but with less headroom than in the Spring Statement. This suggests that at a minimum, the Chancellor would have to build back some breathing space at the Autumn Budget.

Given the high level of government debt and the relatively long average maturity of the UK's borrowing, its fiscal position is susceptible to shifts in market interest rates. Between its Autumn Budget and Spring Statement forecasts, bond yields rose sharply, with the 10-year yield increasing by 60bp. This drove an upward revision to the forecast for interest payments of £9.4bn. These types of shifts are common in financial markets, particularly given the uncertainty currently hanging over the global economy. Even when the Spring Statement was published, bond yields had risen relative to the assumption underpinning the projections, eliminating around one-third of the headroom. Since then, fixed-income markets have been very volatile as they have responded to US tariffs.

UK: Fiscal headroom £bn

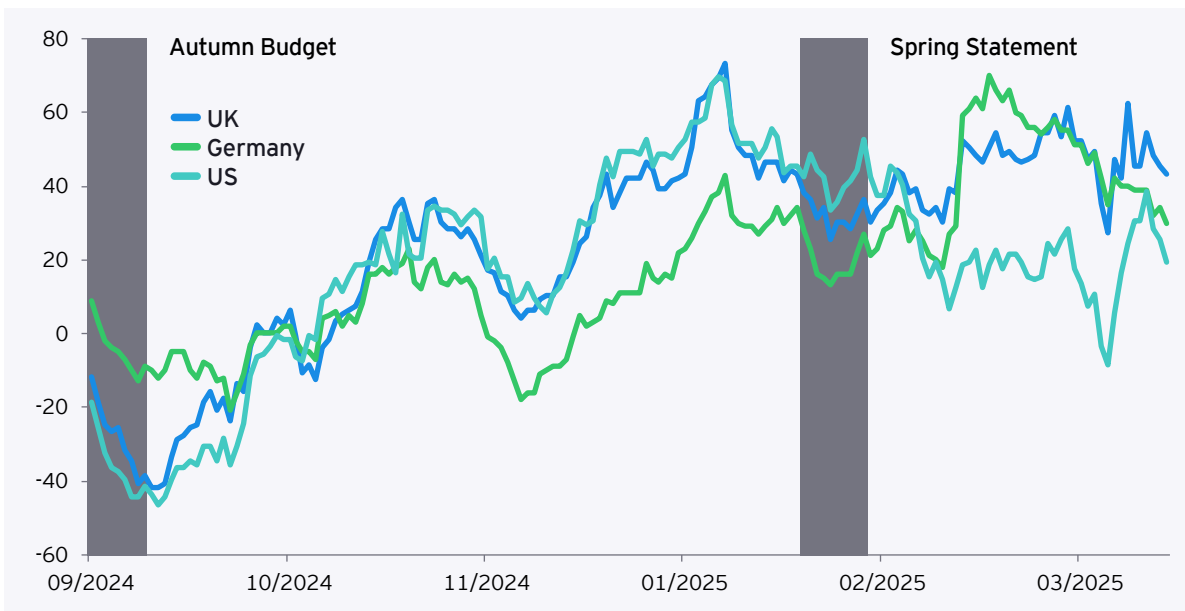


* OBR estimates.

Source: Office for Budget Responsibility/EY ITEM Club

Global: 10-year government bond yields

bp change since October, shaded areas are OBR interest rate assumptions



Source: Haver Analytics/
EY ITEM Club

The big questions were left unanswered

While the Spring Statement made some small adjustments, it left the big questions surrounding UK fiscal policy unanswered. With the already limited fiscal space being further reduced by tariff changes, it remains to be seen how the Government will fund the possibility of another rise in defence spending or how some unprotected government departments will deliver some day-to-day services with already tight budgets.

In this summer's spending review, the Government will set out departmental day-to-day spending totals for 2026-27 to 2028-29. The Government has committed to increase defence spending to 2.5% of GDP by 2027. However, although this would lift the UK's defence spending above NATO's current spending target, it might have to rise further. NATO Secretary General Mark Rutte has said that members will have to boost their defence spending by "considerably more than 3%".¹⁰ With a NATO summit this summer, there is the chance that the target will be revised up to at least 3%.

Of course, defence spending is more capital-intensive than other parts of public expenditure, which means a more significant chunk of it will not be considered against the Government's rule of only borrowing to invest. Looking at total department budgets, around two-thirds of total defence spending is expected to go on day-to-day activities compared with around 80% for the rest of the Government. Nearly all the additional defence spending in the Spring Statement was considered an investment. However, it seems likely that if an extra £17bn of defence spending were to occur, at least some would go on day-to-day expenditure.

With the aid budget, which was used to fund the new defence spending announced at the Spring Statement, already reduced to 0.3% of GDP, there is a good chance that more defence spending will use up some of the existing headroom.

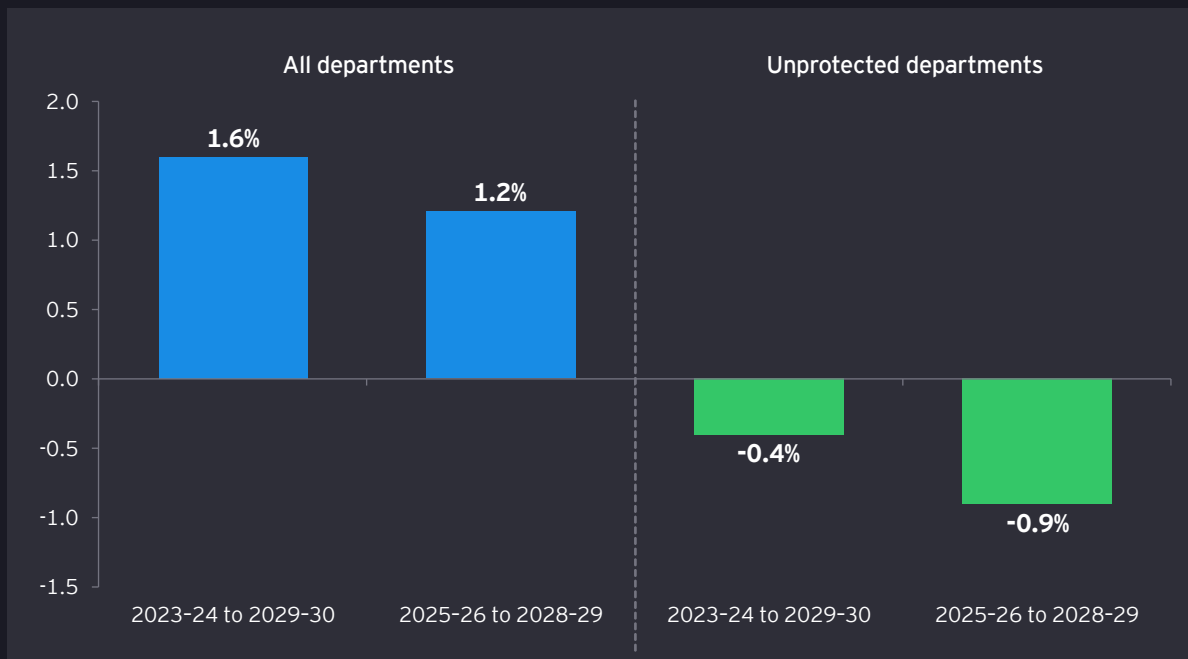
Even without further increases in defence spending, questions continue to swirl around how the Government will deliver some public services. At the Spring Statement, it pulled forward some day-to-day spending before reducing it in the final year of the forecast horizon. By pushing some savings into the year that is not covered by this year's Spending Review, it has delayed saying how it will deliver some functions at a time when budgets are most stretched. While the Government's spending totals are still much more significant than those it inherited from the previous government, it only has limited space to push savings into the outer years of the forecast before they risk looking less realistic.

Within the next few years, covered by this summer's Spending Review, some government departments will likely face real-terms cuts. Over that period, total day-to-day spending is expected to increase by 1.2% each year in real terms. However, with some departments enjoying protections around their budgets, such as health and defence, unprotected departments are expected to see their budgets cut by 0.9% each year in real terms. With these departments facing challenging spending totals, the Government relies heavily on efficiency savings to continue delivering some public services. The extent and efficacy of efficiency gains are inherently uncertain: analysis from the Institute of Fiscal Studies suggests that the Government may also be relying on too optimistic a reduction in administration costs.¹¹

UK: Real growth in day-to-day public spending

%

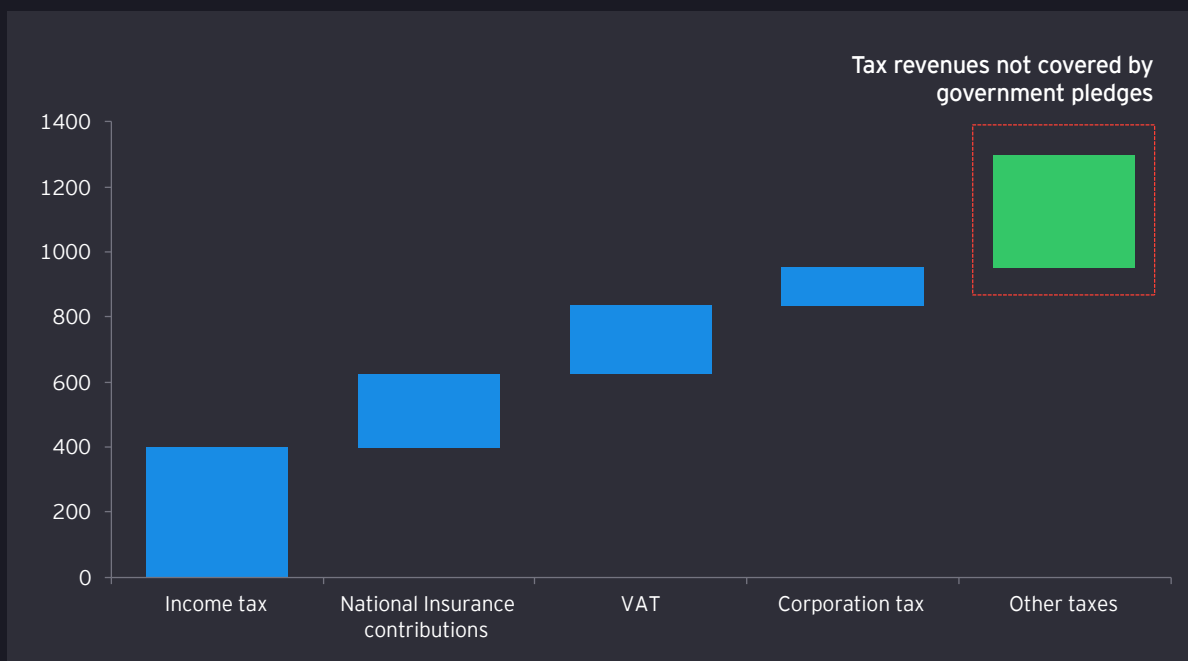
Source: Institute for Fiscal Studies/EY ITEM Club



UK: Tax revenues in 2029-2030

£bn

Source: Office for Budget Responsibility/EY ITEM Club



A fiscal rethink may be on the agenda

With these big question marks still hanging over the UK's fiscal outlook, the Spring Statement will likely be a short-term stopgap ahead of a more comprehensive rethink of fiscal policy in the Autumn Budget. To give its fiscal framework some more durability, the Government might look to build up some more headroom. But this will be difficult given the changes to US trade policy and the OBR's already rosy medium-term growth projections, which see GDP growth settle around 0.25pp above our projections.

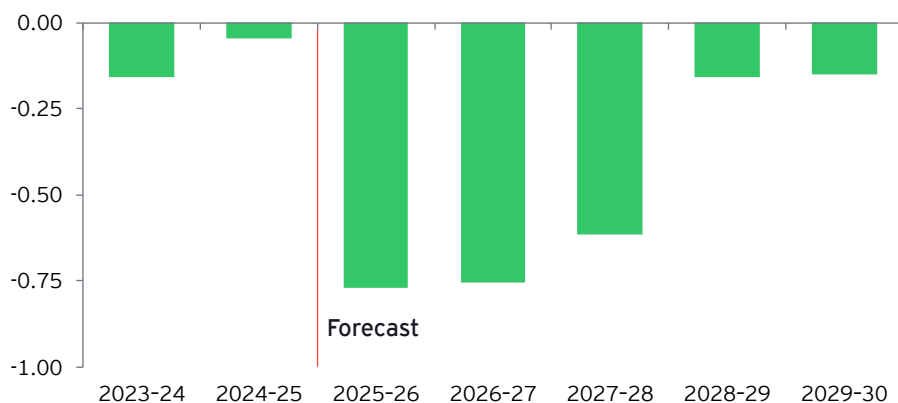
Labour's pledge not to raise income tax, employee NICs, VAT or corporate tax rates limits the options for additional tax revenue. These taxes make up more than half of the tax base, so if left untouched, it would require the effective tax rate on the rest of the tax base to be increased by around 6pp to raise an extra £20bn more revenue. Given the world has changed a lot since last summer's general election, if faced with the need to raise more revenues, the Government may raise some of the tax rates it had pledged to leave untouched or consider changing its fiscal rules once again.

Forecast in charts

Fiscal policy

- Even before the shift in US trade policy, the Spring Statement was a stopgap before the possibility of a wider fiscal rethink at the Autumn Budget.
- The UK's challenging fiscal dynamics mean tax revenues will have to rise more quickly than spending to keep the public finances on a sustainable footing.
- We expect the Government to just meet its existing rules, but it will be a close-run thing. If the Government persists with this framework, it will have to build back some headroom while trying to overcome the challenge of funding additional spending in areas like defence.

UK: Change in public sector borrowing
% ppt of GDP

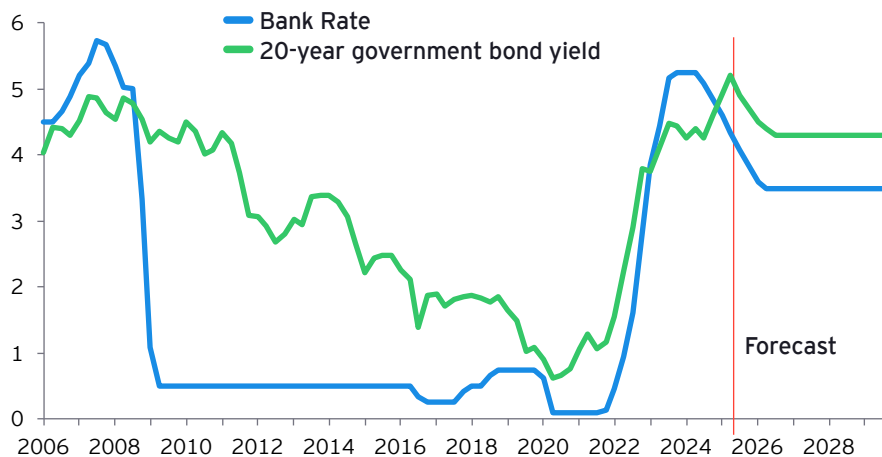


Source: EY ITEM Club

Monetary policy

- The MPC has continued to cut interest rates at a pace of once per quarter, lowering Bank Rate to 4.5%. We expect Bank Rate to be cut to 4.25% in May.
- We suspect the MPC has little conviction in the current economic outlook, so we expect it to continue lowering Bank Rate at its cut-hold tempo until at least the summer as it sees how tariffs and the change in employer NICs and the National Living Wage play out.
- We see risks as skewed towards more rather than fewer interest cuts this year as uncertainty, and weaker global growth may open some additional economic slack.

UK: Bank Rate and 20-year bond yield
% year

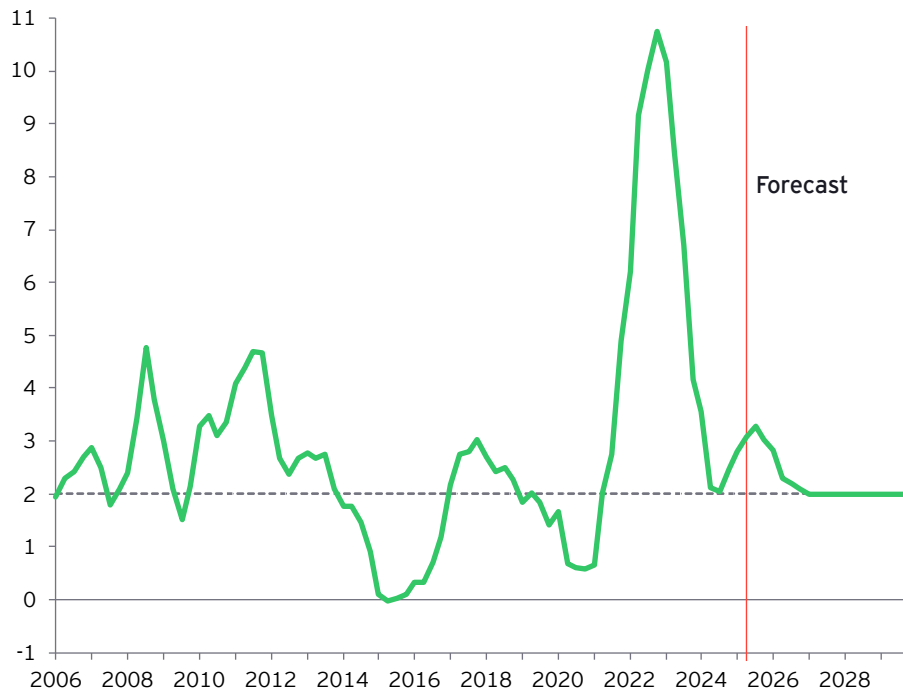


Source: EY ITEM Club

Prices

- Having fallen below the 2% target last autumn, inflation has increased over the last six months as the impact of past energy price falls has faded.
- Inflation looks set to rise further in April as large rises in regulated prices, such as water and energy bills, come into force, pushing inflation above 3% for the rest of this year.
- Domestic inflationary pressures will be sticky even as the labour market loosens a little. On balance, we expect the impact of tariffs will be to soften inflation as lower import and energy prices feed through to the prices on the shelves. Inflation is forecast to fall back to 2% around the end of 2026.

UK: CPI inflation
% year

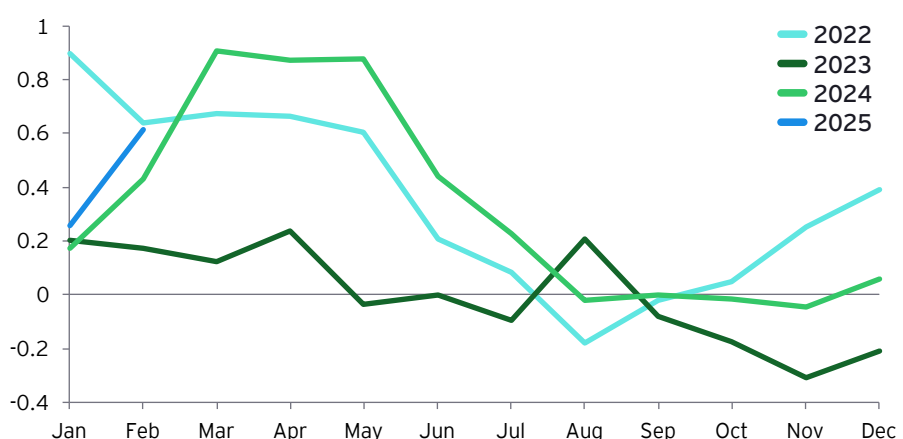


Source: EY ITEM Club

Activity

- GDP growth looks likely to have picked up sharply into Q1. We think some issues with the official estimates are probably overstating growth at the start of this year.
- With US tariffs disrupting trade and weakening the global economy, we expect demand for UK exports to slow. Consumer and business caution will hold back domestic demand.
- The US tariffs will slow the growth recovery, and we now forecast subdued growth in 2026, with output only returning to around trend growth in 2027.

UK: Monthly GDP
%, 3m/3m

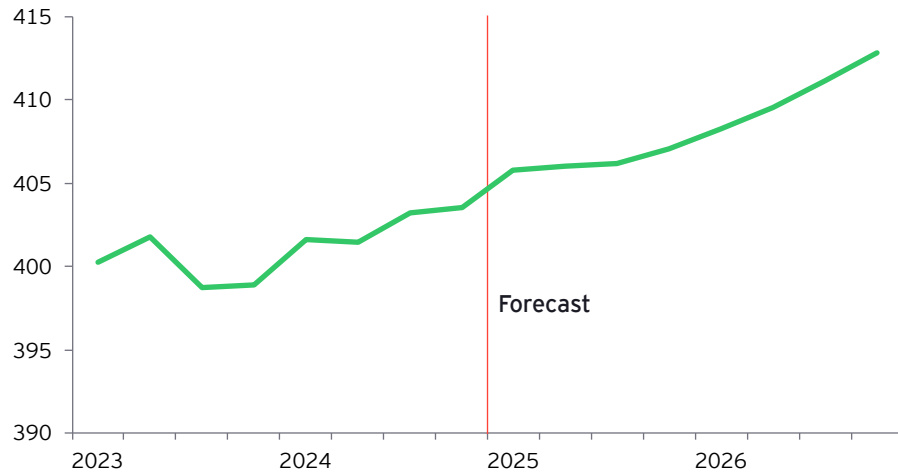


Source: Haver Analytics/
EY ITEM Club

Consumer demand

- As the economy slowed towards the end of last year, so did consumer spending, with the saving ratio picking up sharply. There are some signs spending picked up in Q1, but these may be short-lived.
- As real wage growth is squeezed, fiscal policy drags and some job losses are felt, real household income growth will slow.
- Uncertainty around the outlook will see households remain cautious through 2025 and into 2026. Consumption growth will be modest, with households' saving rates settling a little higher than average.

UK: Consumer spending
£bn, 2022 prices

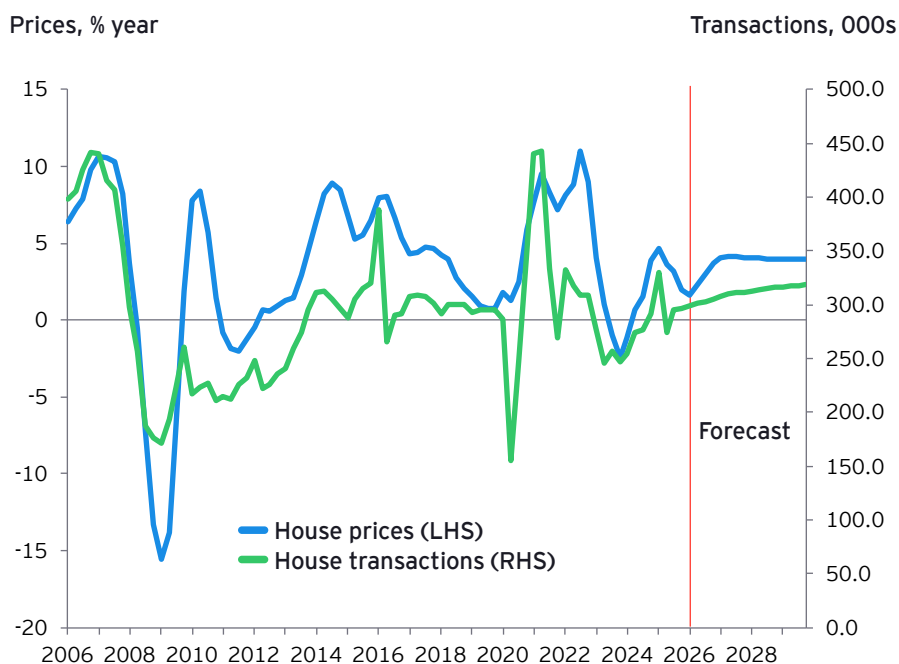


Source: EY ITEM Club

Housing market

- The UK housing market made a strong start to the year even as new mortgage rates drifted upwards as home movers tried to complete their transactions before stamp duty thresholds changed.
- In the near term, the market will likely take a pause for breath as some house purchases will have been brought forward from the middle of the year.
- Toward the end of 2025, we expect relatively modest housing market performance as economic uncertainty lingers, valuations remain stretched and interest rates only fall gradually.

UK: House prices and transactions

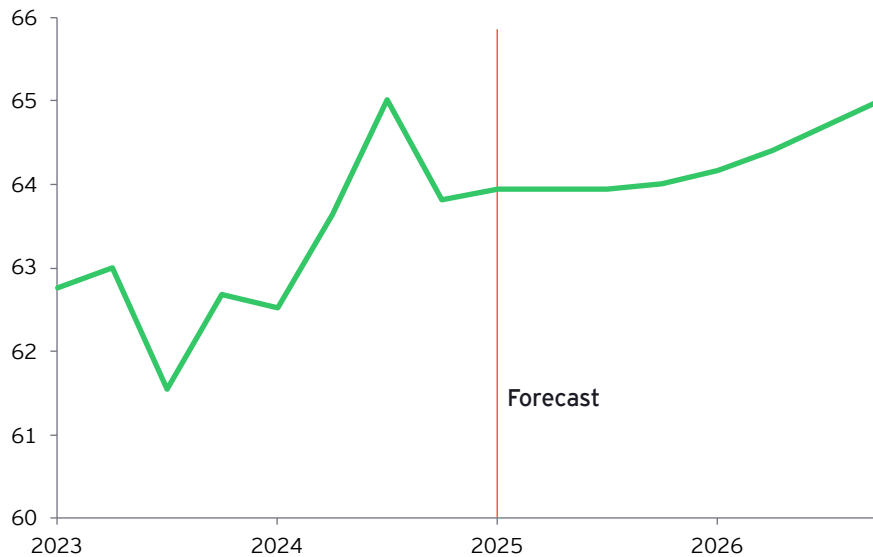


Source: EY ITEM Club

Company sector

- Business investment fell sharply in the final quarter of last year, although the data is volatile, and we take the drop with a pinch of salt.
- The heightened uncertainty around international trading arrangements and the global economic outlook will lead firms to postpone some large capital projects, weighing down investment.
- With around 80% of corporate liabilities financed with floating interest rates, businesses respond much more quickly to falling interest rates. We expect investment growth to improve in 2026 and 2027 as debt service costs reduce, new finance becomes less expensive and uncertainty falls.

UK: Business investment
£bn, 2022 prices

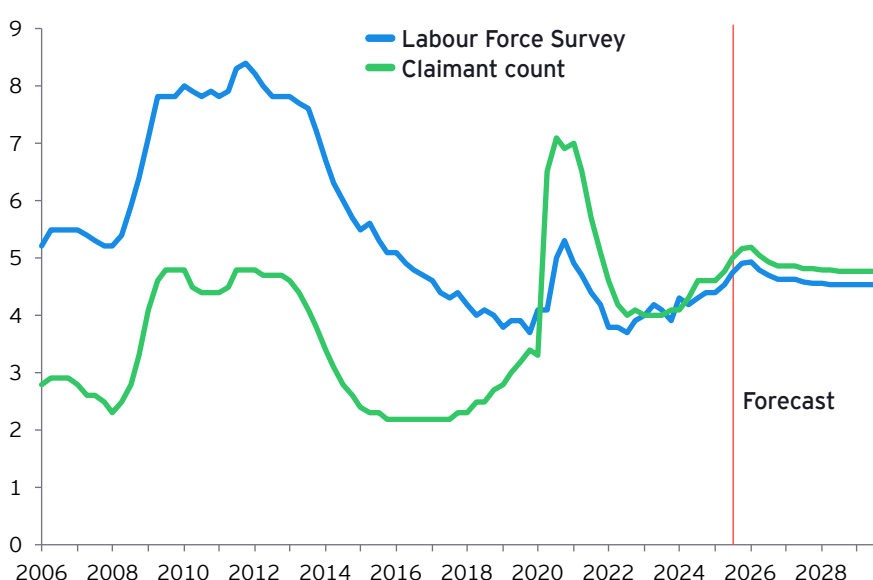


Source: EY ITEM Club

Labour market and wages

- Having been very tight after the pandemic, the labour market has normalised over the last year or so. Job openings have fallen back, but large-scale lay-offs have not occurred.
- With growth set to slow through this year and into next, we do expect to see some job losses and the unemployment rate rise. This will be relatively small, with the jobless rate only expected to rise to around 5%.
- Although the labour market looks set to weaken, the recent experience of high inflation looks like it will push workers to ask for decent pay gains this year.

UK: Unemployment rate
%

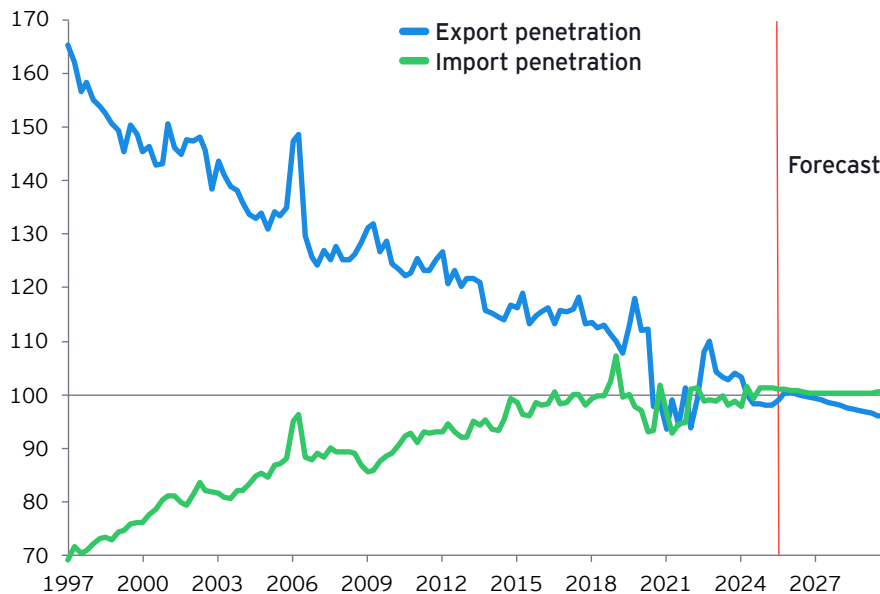


Source: EY ITEM Club

Trade and the balance of payments

- The imposition of tariffs will make direct access to the US, a key UK export market, more expensive. On top of that, a weaker global economy will see export demand fall sharply.
- Growth in the export of both UK goods and services is expected to slow as a result, with exports forecast to fall in 2025 and 2026.
- Although we do not expect a direct response from the UK Government in the form of tariffs, slower world trade and weaker domestic demand will also cause import growth to slow over the next couple of years.

UK: Export and import penetration 2024 = 100



Source: Haver Analytics/
EY ITEM Club

Endnotes

1. EY ITEM Club (2025) "UK economic growth downgraded after weaker-than-expected end to 2024"
2. EY (2025) "Trade Compass – April 2025"
3. Daco (2025) "Reciprocal tariffs will reshape the global trade landscape"
4. Office for Budget Responsibility (2025) "Economic and fiscal outlook – March 2025"
See box 2.2 for more detail. Although it should be noted that the distribution of the tariffs was universally 20% across countries rather the 10% baseline tariff and 145% tariff on China.
5. Bank of England (2025) "Monetary Policy Report – February 2025"
6. Jozepa *et al* (2025) "House of Commons Library Research Briefing – US trade tariffs"
7. Water UK (2025) "Annual average bill changes in 2025-2026"
8. Bank of England (2024) "Financial Stability Report – November 2024"
9. BBC (2025) "Reeves confirms 15% cut to Civil Service Running Costs"
10. Politico (2025) "Rutte: NATO spending will be 'considerably more than 3 percent'"
11. Boileau (2025) "Public service spending: small changes, big challenges"

EY | Building a better working world

EY is building a better working world by creating new value for clients, people, society and the planet, while building trust in capital markets.

Enabled by data, AI and advanced technology, EY teams help clients shape the future with confidence and develop answers for the most pressing issues of today and tomorrow.

EY teams work across a full spectrum of services in assurance, consulting, tax, strategy and transactions. Fueled by sector insights, a globally connected, multi-disciplinary network and diverse ecosystem partners, EY teams can provide services in more than 150 countries and territories.

All in to shape the future with confidence.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

About EY ITEM Club

EY ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. EY ITEM Club's use of the model enables it to explore the implications and unpublished assumptions behind government forecasts and policy measures.

Uniquely, EY ITEM Club can test whether government claims are consistent and can assess which forecasts are credible and which are not. Its forecasts are independent of any political, economic or business bias.

© 2025 EYGM Limited.

All Rights Reserved.

EYSCORE 003305-25-UK

ED None

All views expressed in the EY ITEM Club Winter Forecast are those of ITEM Club Limited and may or may not be those of Ernst & Young LLP. Information in this publication is intended to provide only a general outline of the subjects covered. It should neither be regarded as comprehensive or sufficient for making decisions, nor should it be used in place of professional advice. Neither the ITEM Club Limited, Ernst & Young LLP, nor the EY ITEM Club accepts any responsibility for any loss arising from any action taken or not taken by anyone using this material. If you wish to discuss any aspect of the content of this newsletter, please talk to your usual EY contact.

This document may not be disclosed to any third party without Ernst & Young LLP's prior written consent.

Reproduced with permission from ITEM Club Limited.

ey.com/uk/item