EY ITEM Club Autumn Forecast

Tightening the purse strings

November 2025

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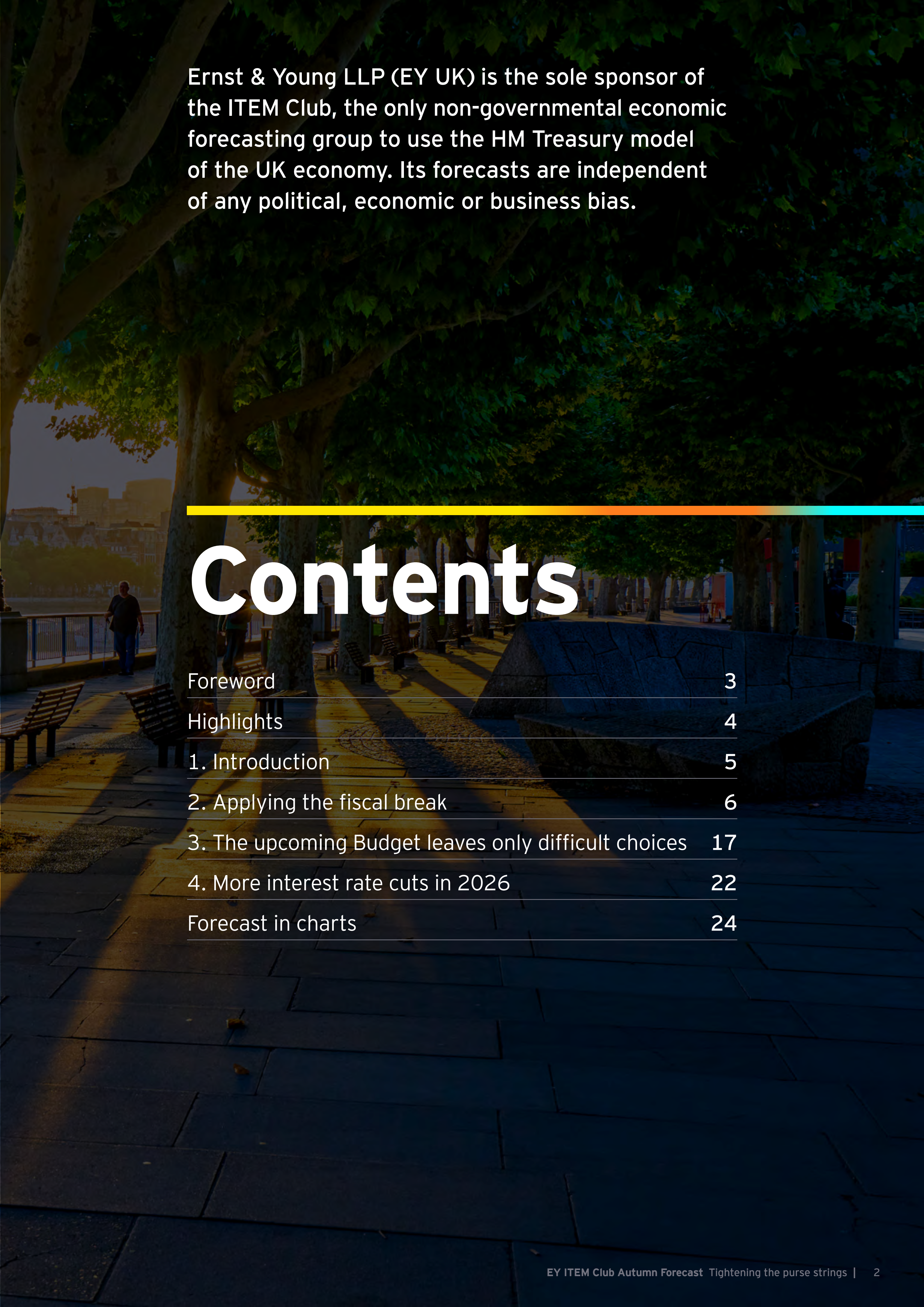

Ernst & Young LLP (EY UK) is the sole sponsor of the ITEM Club, the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

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Foreword

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The past year has seen the return of President Trump to the White House, the introduction of US tariffs, volatility in global financial markets and the continuation of conflicts in Europe and the Middle East. However, if you were only looking at the UK economy, you could be forgiven for thinking not much had changed.

Twelve months ago, the UK Government was grappling with what was expected to be the most important Budget it would deliver this parliament, in the face of challenging fiscal circumstances, with an economy that had started the year brightly but had lost momentum through the summer.

A year on, after another encouraging start, momentum has slowed once again, the fiscal position remains difficult, and the Government is poised to deliver another Budget that could shape its legacy.

Let's start with the economy – a strong start to the year saw UK GDP expand by 0.7% in Q1 and 0.3% in Q2, both above expectations. This momentum has been enough for the EY ITEM Club to upgrade its forecast for UK GDP growth in 2025 from 1.0% to 1.5%.

However, there are already signs of a slowdown in activity through the summer as the impact of tariffs and concerns around potential tax rises began to impact business and consumer confidence.

Inflation remains higher than is comfortable, reaching 3.8% in August. While the September reading of 3.8% was better than the 4.0% that had been expected, there is still enough inflationary pressure coming through in services and food prices to likely prompt the Bank of England to defer any further interest cuts to the new year. This comes despite the steady cooling in the labour market, with unemployment set to rise to 5.0% by 2026.

The key challenge for the UK economy, however, remains the state of the public finances. The Chancellor's fiscal headroom, which was tight at just £10bn, has likely disappeared in the face of rising bond yields and slower growth. While the precise amount remains uncertain, the EY ITEM Club view is that the Chancellor will need to find between £25-30bn of spending cuts or tax rises to restore headroom – if the Government is to remain within the current fiscal rules. These measures will act as another headwind for growth prospects in 2026 – with GDP growth forecast to fall to 0.9% in 2026, before recovering to 1.3% in 2027 and beyond.

Yet amidst these challenges, businesses should also look for opportunities. Real incomes have recovered to pre-energy shock levels, and there is also a fair amount of flexibility in consumer balance sheets. Companies that can effectively tap into and re-ignite consumer appetite stand to gain.

With the Budget approaching, it would not be a surprise if, alongside measures to manage the deficit, the Government announces a range of pro-growth measures targeted at accelerating investment and reducing the costs of red tape for business. This, combined with the right tone on fiscal prudence, could lead to some positive re-pricing in bond markets, which in turn would further reduce fiscal pressure.

If the right balance can be struck between fiscal prudence and measures that stimulate growth, this could well be a Budget that comes to define the Government's time in power. In light of this, businesses are adopting a cautious stance and when asked for their expectations for the Budget, many fall back on a common refrain, "wait and see."

Highlights

- Having made a strong start to the year, we expect the UK economy to see some of its recent momentum fade. Second-quarter growth was supported by government spending. We expect that to ease as the Government tightens fiscal policy and the global economy remains soft. A stronger-than-expected first half of 2025 has led us to revise up our growth projection to 1.5% for this year. But we now expect a sharper slowdown, with growth of 0.9% next year, before rising to 1.3% in 2027 and settling at 1.4% from 2028.

- The Government will face a £25bn to 30bn fiscal shortfall at the upcoming Budget. Some of the savings can be made up with policies that don't immediately bite but will start to be felt in two to three years. But to preserve its fiscal credibility, the Government will probably have to make about half of these savings up front through tax changes, which in the near-term may fall disproportionately on certain sectors of the economy, given the manifesto pledges not to raise income tax, employee National Insurance contributions (NICs), corporation tax or VAT. To soften a tough fiscal message, the Budget may promise some pro-growth offerings around regulation.

- The signs are that the job market's deterioration has almost bottomed out. Businesses have slowed hiring as they've felt the effects of April's NICs rise, but we are not seeing large-scale lay-offs, so we expect a modest rise in the unemployment rate to 5% in the first half of next year. The public sector's support for the labour market will ease with some of this year's fiscal tightening still to be felt.

- Having held at 3.8% in September, inflation has likely peaked, but it will take a year to get inflation back to target. The recent rise in inflation reflects energy, food and regulated prices. But this has topped out, and their effects on inflation are starting to fade. Nonetheless, it will be the gradual normalisation of services inflation, as the impact of recent tax changes wanes, that will eventually see inflation sustainably returned to target. With pay growth slowly easing and with the effects of April's NICs rise gradually being reflected in prices, we think that by the end of next year inflation will fall back to close to the 2% mark.

- A Monetary Policy Committee (MPC) that appears more concerned with the risks around cutting interest rates too quickly rather than too slowly will skip an interest rate cut in November. But we think that, as inflation falls back from its September peak and the jobs market continues to deteriorate, the MPC will restart interest rate cuts in February as it moves to support activity. We think that Bank Rate will fall to 3.5% by the middle of next year, where we expect it to settle.

- Less consumer caution will support household spending over the coming year. Slowing pay growth and sticky inflation will pare back real earnings growth, which, combined with rising unemployment, will lead to very weak real income growth. But with falling interest rates and the scars of the pandemic and energy price crisis fading, there's scope for consumers to save less of their pay cheques at the end of every month, supporting spending growth.

- Capex will go through a soft patch around the turn of the year. Continued uncertainty around the global economy and domestic tax policy will lead to some investment decisions being cancelled or postponed. But healthy balance sheets will see the corporate sector pick back up as the MPC start cutting interest rates again.

1

Introduction

Since our summer forecast, the UK has sustained a little more momentum than we thought. But below the surface, there are a few signs of weakness, and we think that the Budget will only see headwinds intensify. With interest rates set to be on hold until the start of next year and domestic and international uncertainty still swirling, we see growth slowing next year before a relatively modest pick up as the Government looks to backload some of the Budget's additional fiscal tightening.

Our autumn forecast sets out how the economy has developed through the summer and what it means for 2026 and beyond, before taking a closer look at the decisions facing the Government at the Budget and the Monetary Policy Committee when it comes to setting interest rates.

2

Applying the fiscal brake

We have revised our forecast for GDP growth this year upwards to 1.5% as government spending has helped to sustain a little more momentum than we anticipated. However, we expect the Government to increase taxes at the Autumn Budget as it looks to fill a £25bn to £30bn fiscal black hole with around half of the measures introduced immediately. At the same time, stickier inflation will prompt the Monetary Policy Committee to take a brief pause in its cutting cycle. Taken together, we think this will prompt quite a sharp drop in growth. We forecast 0.9% GDP growth in 2026, before picking up in the medium term, but some delayed fiscal changes suggest the increase in growth will be relatively modest, settling at around 1.4%.

Growth has slowed and will remain modest

On the face of it, although growth has slowed since its strong start to 2025, the UK has continued to perform well compared with its international peers. Having grown by 0.7% and 0.3% in Q1 and Q2 respectively, the UK has grown at an annualised rate of 1.9% in H1, far ahead of the second-fastest G7 economy – Japan – where growth has been 1.2%.

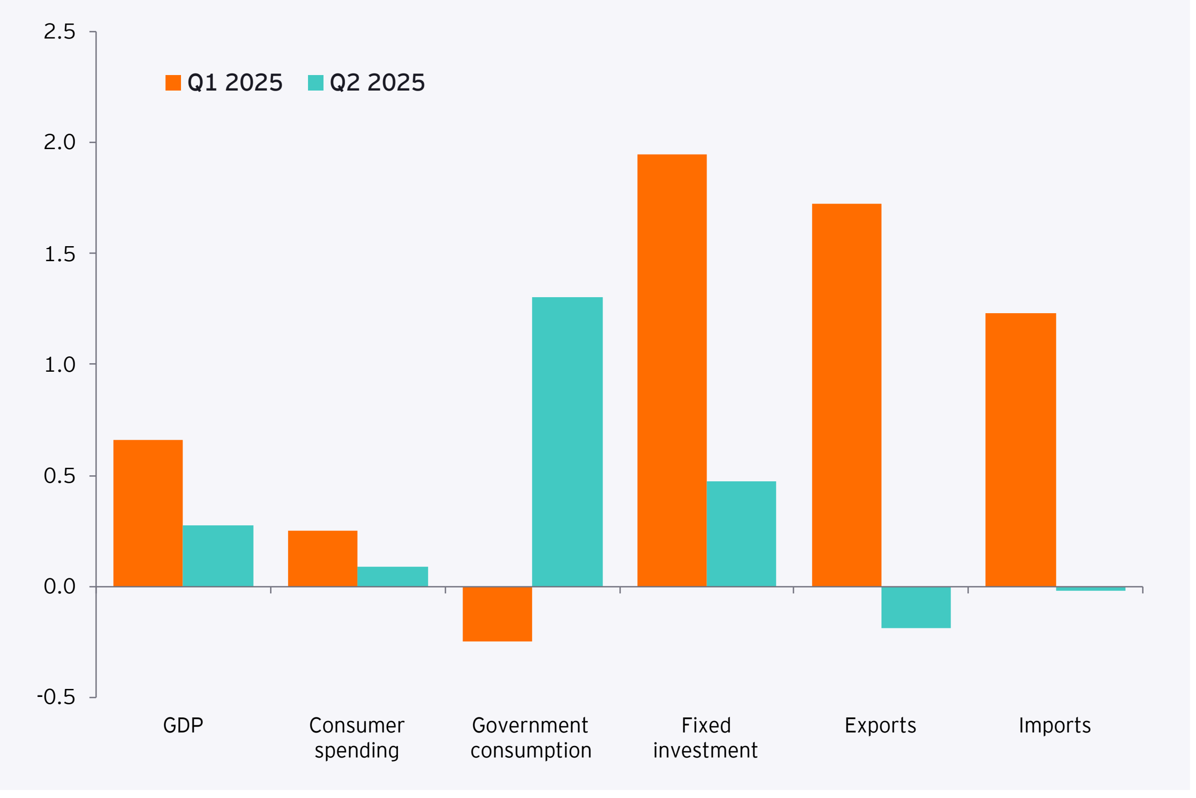
But we think the UK's performance since the start of the year is a little exaggerated. GDP growth of 0.3% in Q2 is stronger than the 0.1% we pencilled in for our summer forecast. But this upgrade largely reflects upward revisions to the April and May GDP estimates, and we do not think this necessarily reflects sustained momentum. Q2 growth was heavily reliant on government spending, with health output benefiting from a large vaccination drive. Early indications are that growth will remain at a similar rate in Q3. Over the three months to August, output increased by 0.3%, and it looks like that could dip to 0.2% when the third quarter is rounded out.

The private sector's performance was underwhelming in Q2. Consumer spending was little more than flat, while investment fell after being very strong in Q1, which had been boosted by the one-off purchase of some aircraft. However, investment has still increased over H1 as a whole. In its September GDP release, the Office for National Statistics (ONS) implemented improved methods for compiling GDP, however we still think they are impacted by residual seasonality, which is flattering the UK's recent performance, particularly compared with other countries. Residual seasonality seems to make Q1 and, to a lesser extent, Q2 GDP very strong, which is compensated for by weaker growth in the second half of the year. If we compare G7 GDP growth in H1 against the same time last year, the UK is in the middle of the pack. On the one hand, it's been a lot weaker than the US, and a little softer than Canada and Japan. But on the other hand, it has grown more than France, Germany or Italy.

Taken together, the economic environment is likely to remain challenging for business, as they will have to navigate weak external demand, tightening fiscal policy and squeezed household spending power. However, there are (currently) few recessionary warning lights flashing.

UK: GDP growth – expenditure components

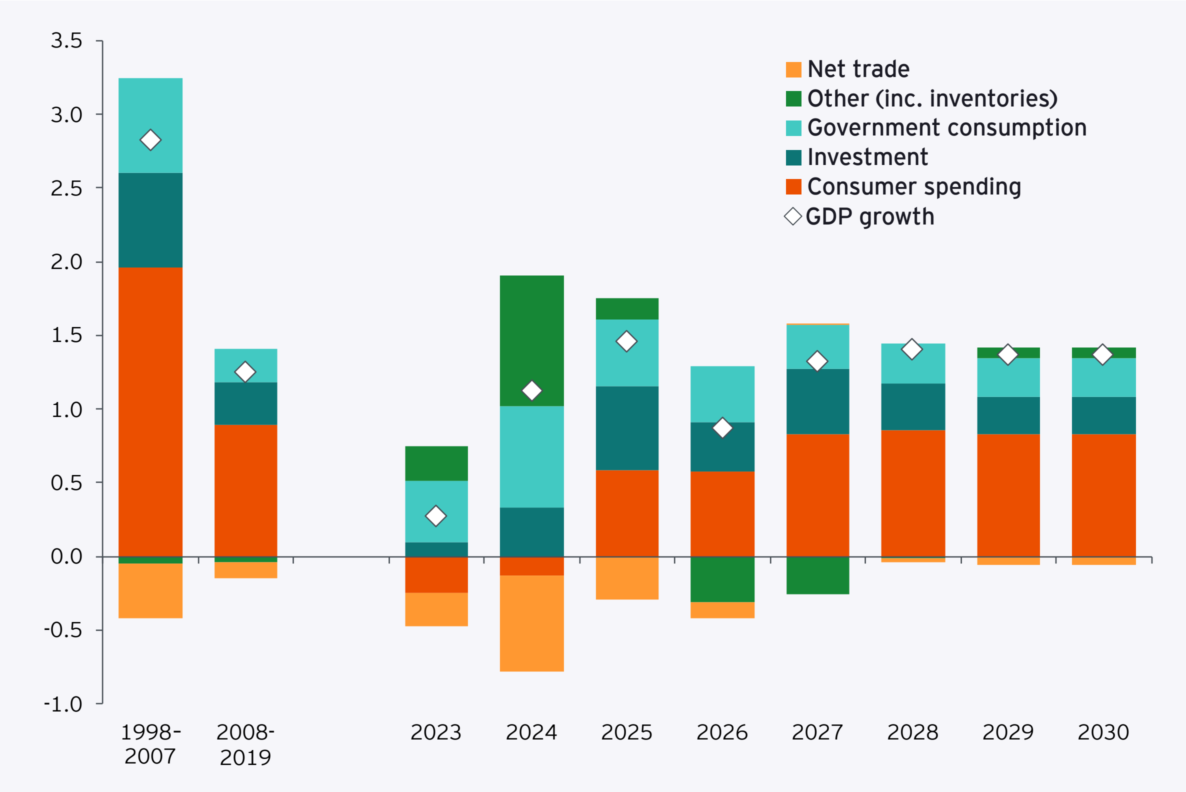
% quarter



Source: EY ITEM Club, Haver Analytics

UK: Contributions to GDP growth

% pts



Source: EY ITEM Club

Forecast for the UK Economy, Autumn 2025

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

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2023	0.3	0.4	-0.4	0.5	-2.3	-1.6
2024	1.1	1.7	-0.2	1.8	0.7	2.6
2025	1.5	1.7	1.0	3.0	2.9	3.6
2026	0.9	1.0	0.9	1.7	-0.3	0.0
2027	1.3	1.3	1.4	2.2	1.3	1.2
2028	1.4	1.4	1.4	1.6	1.6	1.6
2029	1.4	1.4	1.4	1.3	1.6	1.6
2030	1.4	1.4	1.4	1.3	1.6	1.6
	Net govt. borrowing (*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2023	4.8	-3.6	6.9	7.3	4.7	80.5
2024	5.0	-2.2	5.3	2.5	5.1	83.6
2025	4.6	-3.5	4.4	3.4	4.3	84.7
2026	3.2	-3.7	3.2	2.7	3.6	84.3
2027	2.6	-3.5	2.9	2.0	3.5	84.3
2028	2.4	-3.4	2.8	2.0	3.5	84.3
2029	2.1	-3.3	2.9	2.0	3.5	84.3
2030	2.1	-3.3	2.9	2.0	3.5	84.3

(*) Fiscal years, as % of GDP

Source: EY ITEM Club

Autumn Budget to weigh on growth

As we discuss in more detail in Section 3, the Government will face a significant fiscal black hole at the Autumn Budget. To make sure it meets its fiscal rules, our base case is that the Government will have to reduce borrowing by £25bn to £30bn, either via increasing tax revenue or cutting spending. The full effects of the savings on growth won't be felt immediately, as there's some scope for the Government to backload savings through cuts to day-to-day spending in 2029–30 and by extending the freeze on income tax thresholds beyond 2027-28. Nonetheless, some of the tax changes will have to be brought in for the coming tax year to retain the Government's fiscal credibility.

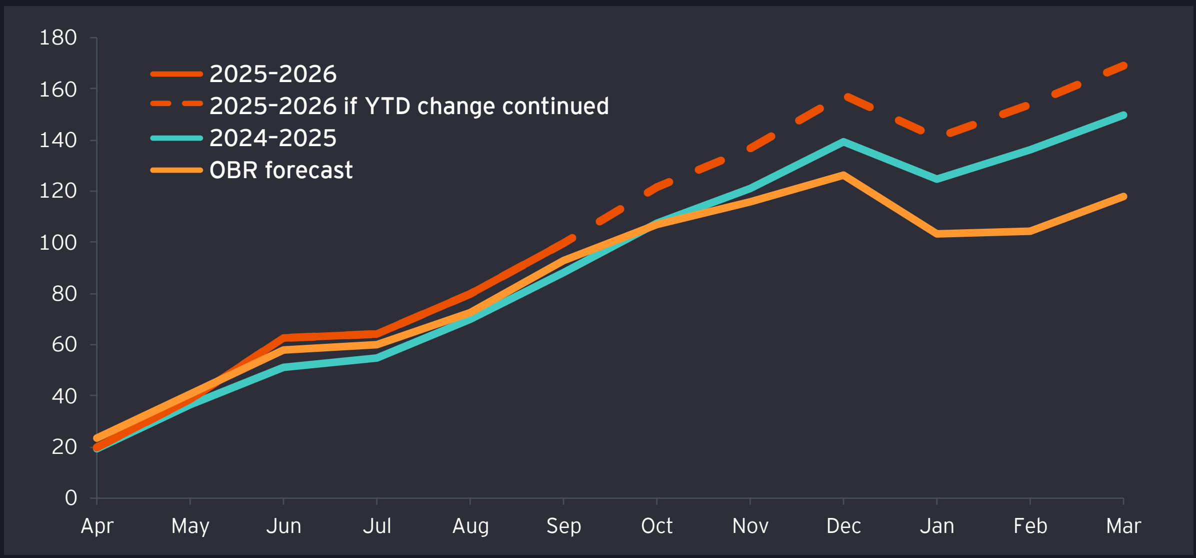
Although the Government has pencilled in a fiscal tightening since the last Budget, the economy is yet to really feel its effects. At the Spring Statement, the OBR estimated that government borrowing this year would fall to £118bn, down from £149bn in the previous fiscal year – a reduction equivalent to roughly 1% of GDP. But the OBR estimated that nearly all this saving would come between December and March as capital gains taxes come into effect. So, while the impact of the NICs change may have been seen in the labour market, the full effect of tightening fiscal policy is yet to be felt.

This has been exacerbated by the Government borrowing more than expected over the first half of the year, with the current budget deficit to September running more than £7bn ahead of schedule.

New taxes introduced at the Budget on top of an already backloaded fiscal tightening within this year are expected to slow recent momentum; however, much will depend on the specific measures announced. The Chancellor could be faced with difficult choices around maintaining manifesto commitments – particularly given Income Tax, National Insurance and VAT combined contribute more than two-thirds of the total UK tax take – along with whether existing reliefs could be restricted.

UK: Public sector net borrowing*

£bn

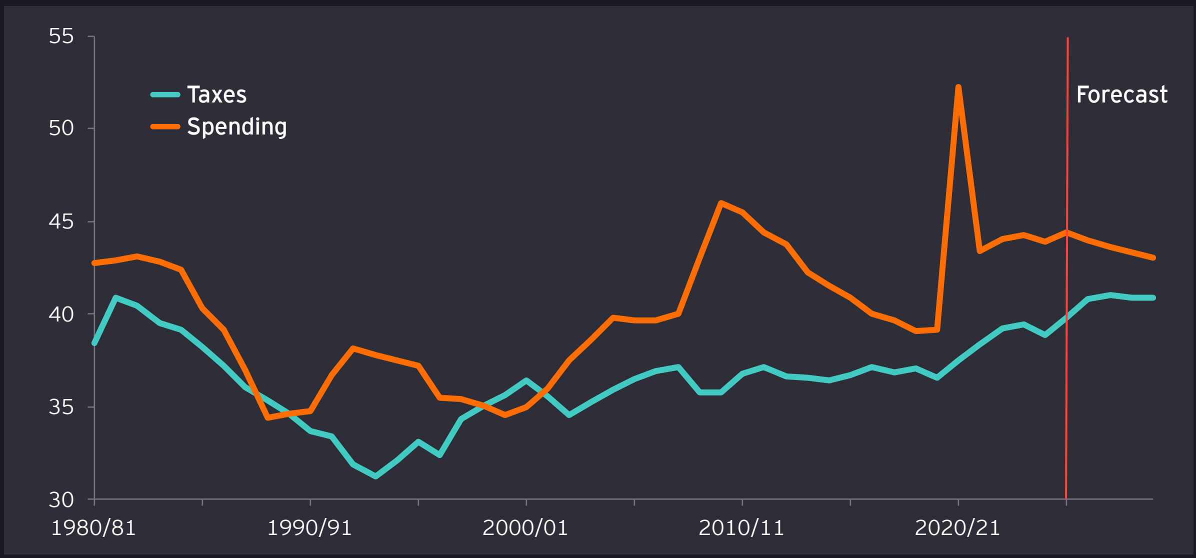


* Excluding public sector banks

Source: EY ITEM Club, Haver Analytics and OBR

UK: Tax revenue and public spending

% of GDP



Source: EY ITEM Club

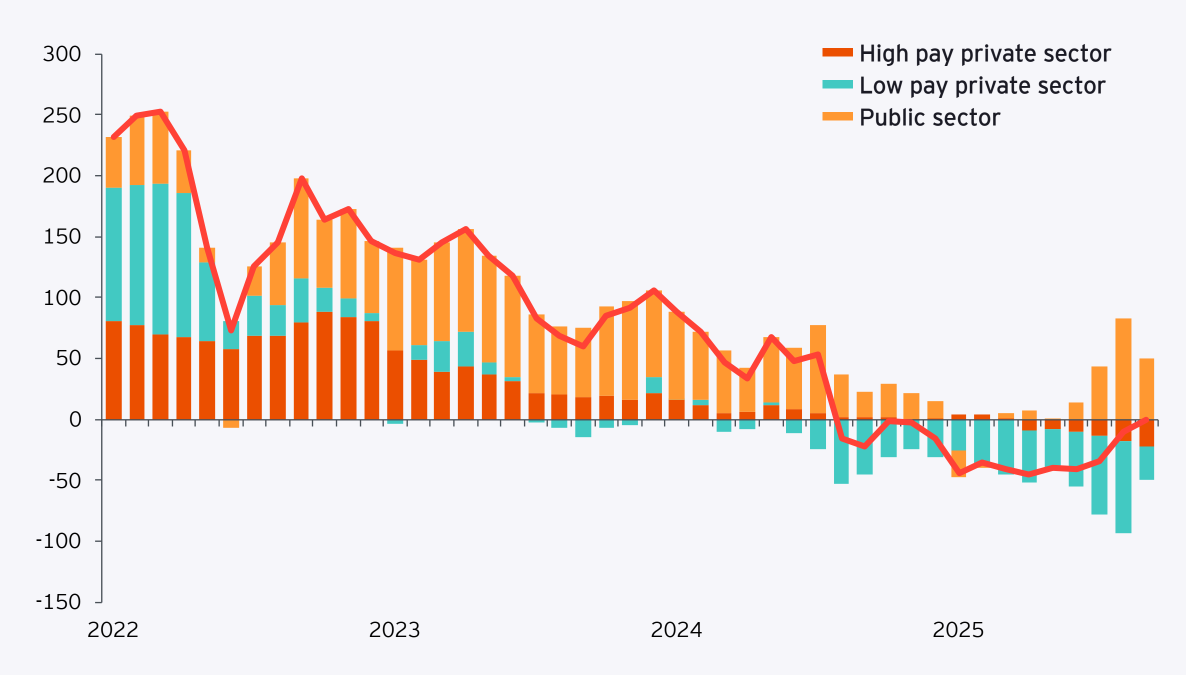
The labour market will loosen as fiscal policy tightens

Over the last few years, relatively modest growth has seen the labour market transition from being very tight to signs that some slack is appearing. In the last few months, the deterioration in the jobs market has slowed. Although we do think there is a little more labour market loosening to play out. We expect this to be marginal and orderly, with unemployment increasing to a peak of 5% in the first half of next year, before gradually falling back towards 4.7%. This is still a far cry from the jump to 8% unemployment we saw in the Global Financial Crisis (GFC), for example.

The last year has seen businesses reduce headcount amid soft demand and rising costs. Ongoing data quality issues with the Labour Force Survey mean that employment estimates based on tax records offer the best steer on overall labour market conditions. This payroll information shows that businesses began to reduce staff numbers in the latter half of last year, as a rise in employers' NICs compounded a relatively modest growth backdrop. Notably, the reduction in employment was earlier and more pronounced in low-paying industries, such as hotels and restaurants, where the change in NICs has been felt most acutely.

UK: Payroll by sector

Change over three months (000s)



Source: EY ITEM Club, Haver Analytics

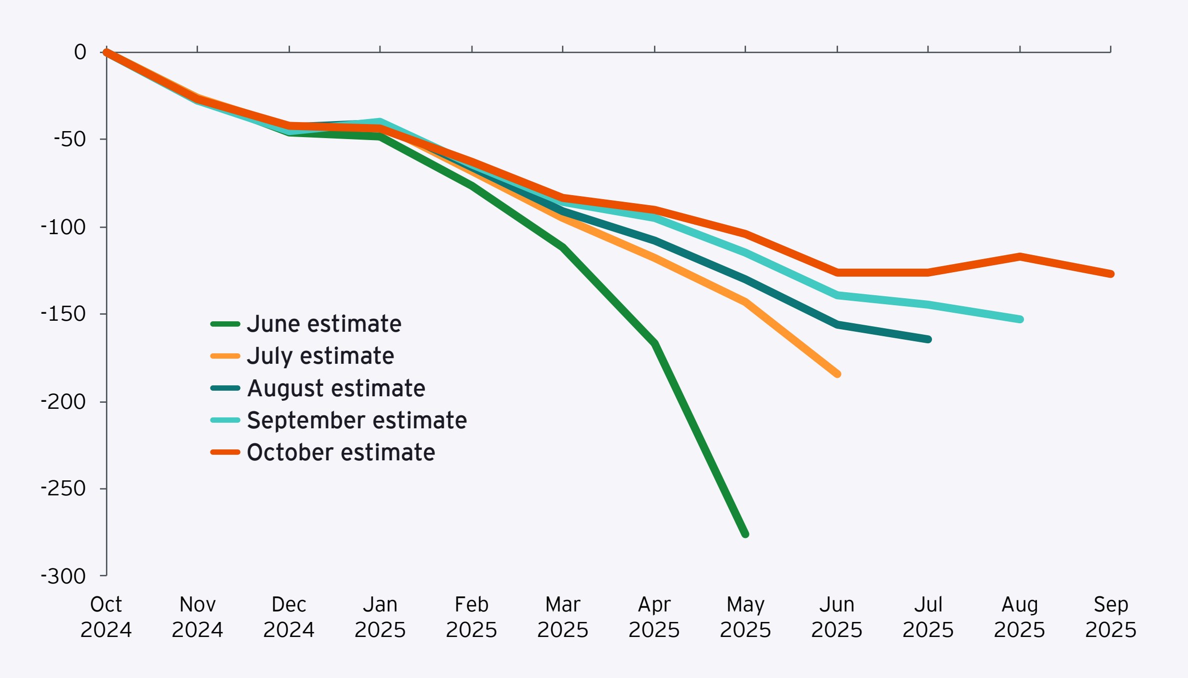
In the last couple of months, the speed of payroll declines, with almost no change in August and September, has led some commentators to suggest that the effects of the NICs change are bottoming out. But we think that the labour market loosening still has further to run. The recent resilience of employment has been driven by industries – health, education and public administration – that would typically be considered heavily reliant on public spending rather than private demand and are reimbursed for the rise in National Insurance costs. But with fiscal policy set to tighten, we suspect that this support could be relatively short-lived, and the labour market will continue to loosen over the coming quarters.

So far, the way that businesses have handled the rise in employment costs is by reducing hiring rather than increasing layoffs. And we expect this to continue through this year and into next. Tax records show that the flow of individuals into jobs has slowed, without a rise in the number of people being let go. This is matched by the vacancies and redundancies data. The number of open positions has fallen further below its pre-pandemic level, and the number of vacancies relative to people looking for jobs has risen. But there has not been a marked rise in redundancy notifications. Matching the ongoing weakness in business hiring expectations, we expect employment growth to slow further over the coming quarters, pushing the unemployment rate from 4.8% in the middle of this year to 5.0% in H1 2026, before edging back to around 4.7% over the next few years.

Pay growth has already slowed from its recent highs, and we expect it to continue to ease back. In part, this reflects an unusually strong end to last year, which is now starting to unwind. However, at 4.7% in Q2, private sector pay growth still has some way to go before it's consistent with inflation returning to the 2% target. Businesses indicate that current pay rises are around 3.5% and with more jobseekers to openings, fewer job-to-job moves, and some of April's NICs increase being passed back to employees through reduced settlements, we think that wage growth will fall back towards 3.5% by the end of this year and settle around 3% in the middle of next.

UK: Payroll estimates

Cumualtive change (000s)



Source: EY ITEM Club, ONS

At the peak, but inflation will be sticky on the way down

Inflation has risen since the last report, recording 3.8% in September, as fuel and food price inflation continued to put pressure on the headline rate. But with the base effects from fuel almost having reached its peak, inflation looks set to fall back over the coming months as negative base effects caused by last October's chunky increase in the energy price cap will reduce energy's contribution to the headline rate.

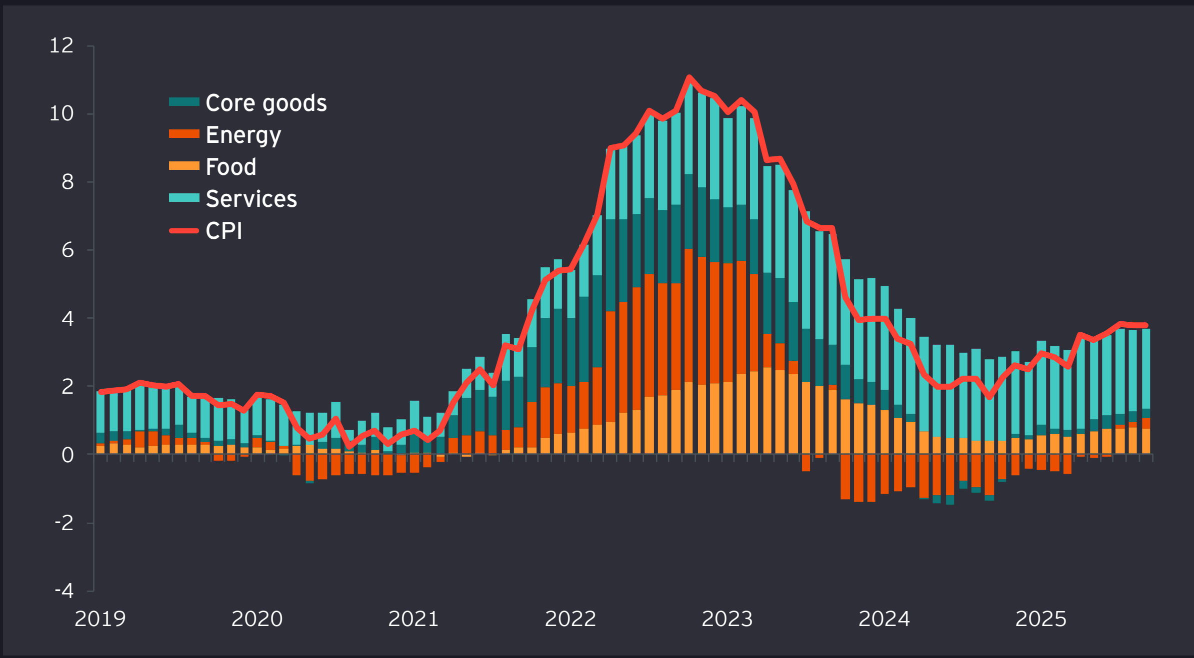
Below the surface, the progress on inflation is likely to be mixed. While it is much less pronounced than the increase in 2021, the sharp rise in food price inflation we have seen in recent months has started to unwind. September's drop, in part, reflects larger-than-normal discounting. But there are already signs that strains on domestic and international wholesale markets have eased. The UK imports cocoa and coffee, where poor harvests have put a lot of pressure on wholesale prices. Domestically, the dry summer increased the cost of producing foods based on cattle products. Given that food is perishable, changes in wholesale prices are typically reflected relatively quickly.[1] So the recent fall back in wholesale agricultural prices should start to pass through to the prices on the shelves in early 2026, supported by the strength of the pound against the dollar. But more generally, the easy progress on core goods has been made, and with international supply chains now running at much closer to normal, we expect core goods inflation to remain stable around its current level.

Ultimately, it will be services inflation that determines how quickly inflation falls back to target. At close to 5%, it remains far above the rates consistent with headline inflation returning sustainably to the 2% target. And we expect this normalisation process to be gradual over the course of next year. By the middle of next year, pay growth should be back to around levels consistent with inflation hitting the inflation target. At the same time, the effects of this year's very large increases in administered prices, with most resets in April, and the NICs changes will drop out of the annual inflation calculation. With more normal labour cost growth and a smaller rise in regulated prices, we think services inflation will fall back to more normal rates by the end of next year, and so we see inflation close to 2% target from the start of 2027, having averaged 2.7% over 2026. However, with inflation having picked up towards the end of 2025, if employees push for large pay rises through the early 2026 pay round, then the path back to 2% inflation could be much more protracted.

We expect inflation at 2% from 2027 onwards.

UK: Inflation contributions

% year



Source: EY ITEM Club, Haver Analytics

Sticky inflation keeps interest rates on hold

Having settled into a pace of a cut every quarter, the decision to cut Bank Rate to 4% in August was a close call, and we think it will be the last cut this year. Divisions have emerged amongst rate setters, but it's clear that most MPC members are more concerned about cutting too quickly rather than too slowly, as inflation has settled at 3.8% and the labour market has not cracked. Although the MPC has not changed its guidance, we think this has led the Committee to shift its default position from cutting every other meeting to temporarily keeping Bank Rate on hold. In response, financial markets have moved to reduce the odds of another cut this year, with market participants now expecting the next cut to come in February.

We don't think the UK will remain an international inflation outlier and that interest rates continue to hold back activity, so we expect the MPC to start cutting interest rates again next year, as we discuss in more detail in Section 4. But with inflation undershooting the MPC's forecast, the December meeting is live, and one more rate cut this year cannot be ruled out. On balance, we lean towards the next cut coming in February. We expect Bank Rate to settle at 3.5% in the middle of next year.

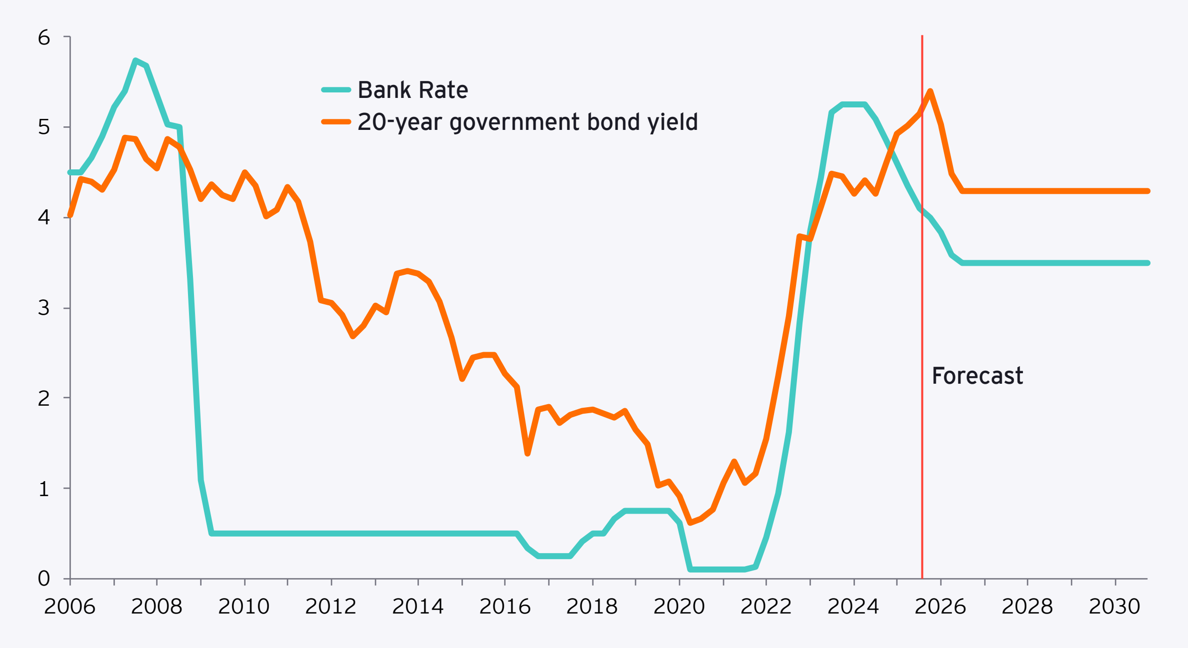
For most of the last three months, gilt yields had risen as financial markets grew more worried about the sustainability of international fiscal policy and sticky inflation. But following September's downside inflation surprise, gilt yields retraced as some inflation worries abated.

Looking at the past moves, yields had risen more at the long end than at the short end or belly of the curve. Fiscal concerns from not only the UK's position but also from other major economies such as France have led investors to demand a greater risk premium to hold long-dated government debt. But gilt yields have become more volatile as the demand from pension funds has fallen and the reliance on international investors has increased.

In response to some signs of gilt market stress appearing, the Bank of England reduced the overall size of its quantitative tightening (QT) programme for October 2025 to September 2026 to £75bn, down from £100bn over the previous twelve months. On top of that, the programme was skewed towards the short end of the yield curve, so as not to put unnecessary stress on the market. Even as the Bank of England cut interest rates, we expect bond yields to remain elevated as risk premiums linger, reflecting continued fiscal worries through most of next year, with the interest rate on a 20-year gilt expected to settle around 4.3% at the start of 2027.

UK: Bank Rate and 20-year bond yield

%



Source: EY ITEM Club

Consumption growth to remain modest

We expect modest consumption growth over the coming years. We think that consumer spending will be 0.9% in 2026, increasing to 1.4% by 2027.

We think that building consumer confidence and falling interest rates will support consumption over the coming year as households' real income growth slows. With inflation elevated and pay growth cooling, households' real earnings growth is easing, compounded by modest employment growth as the labour market continues to loosen. On the face of it, this hit to consumers' spending power would reduce household consumption. But with the household saving rate registering 10.8% in 2025 Q2, which is more than 2ppt above its long-run average, there's plenty of scope for the consumer to save a little less. This poses a challenge for businesses, particularly those directly facing consumers, of how to convince consumers to get back to spending. At the same time, the Budget should consider how it can harness households' fundamental health and encourage greater consumer activity.

On the back of the pandemic and the energy price crisis, it's hard to disentangle how much of the pickup in household saving is precautionary and how much is a response to higher interest rates.

But even with high interest rates, money is still flowing into accounts where it must remain for a fixed period to earn a return, so we do think this has a role to play in the current high saving rates. But, as we set out in the summer report, there have also been flows into current accounts as households to continue to build up rainy day funds.

On the back of a Budget that looks like it will leave the major taxes facing households unchanged over the next few years and may ease some of the burden of the recent rise in living costs, we expect the household saving rate to fall back towards more normal levels. Despite the challenges of the last few years, households' finances, in aggregate, are in a healthy position. On the back of strong income growth and high saving rates, the household debt-to-income ratio is currently low by historical standards, so there is scope for consumers to loosen the purse strings.

UK: Average earnings and inflation

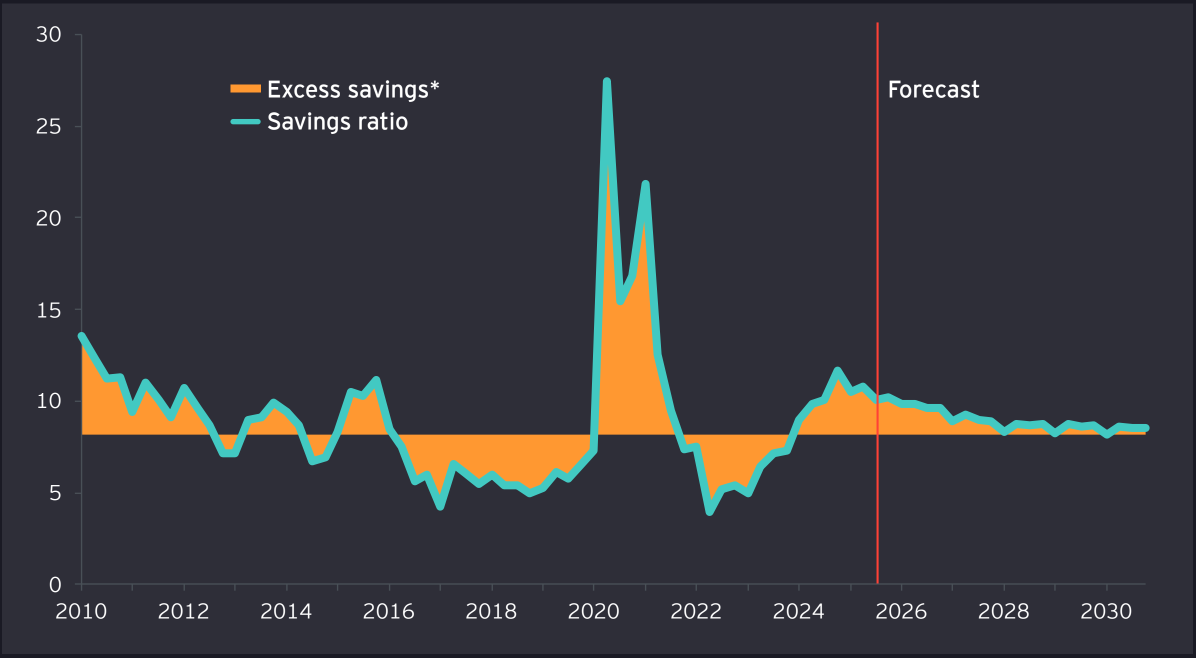
% year

* National accounts measure

Source: EY ITEM Club

UK: Household saving ratio

% of disposable income



* Relative to 2010-2019 average

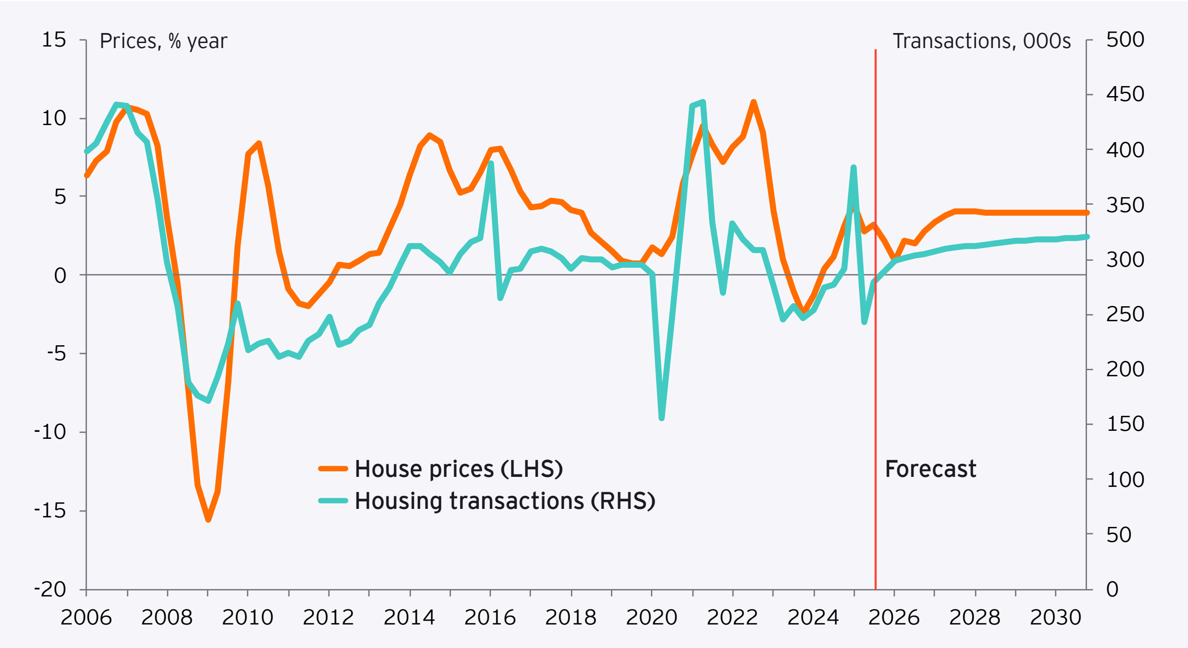
Source: EY ITEM Club, Haver Analytics

Housing market set for continued modest performance

Getting a clean read on the housing market has been made tricky by April's change in Stamp Duty thresholds. With the temporary increase in thresholds coming to an end, the first quarter saw a surge in activity and a bounce in prices as home movers rushed to complete transactions before the deadline. With some transactions brought forward, there was a sharp drop-off in transactions in April that gradually unwound across the summer. By August, transactions had moved above the level we saw last year and are around the pre-pandemic norm. In contrast, the rise in mortgage approvals and lending over the summer looks to have topped out. The possibility of property taxes in the Autumn Budget might create near-term uncertainty in the market. But, more generally, from here housing market performance will be driven by economic fundamentals.

The housing market continues to face several affordability challenges. On the one hand, a couple of years of strong pay growth and muted housing market performance have led to some improvements in affordability metrics. On the other hand, valuations remain stretched, as recent developments largely undo the big spike in unaffordability during the pandemic's race for space. Markets' reappraisal of the near-term interest rate path has pushed up the two-year and five-year swap rate, which banks use to price mortgages. So, mortgage rates look set to rise in the near term, which, coupled with slowing real income growth and a deterioration in job market prospects, suggests the housing market will continue to face challenges in the near term. With interest rate cuts set to resume next year, we still expect modest house price growth of 2% next year. Still, this would be a fall in the real house price.

UK: House prices and transactions



Source: EY ITEM Club

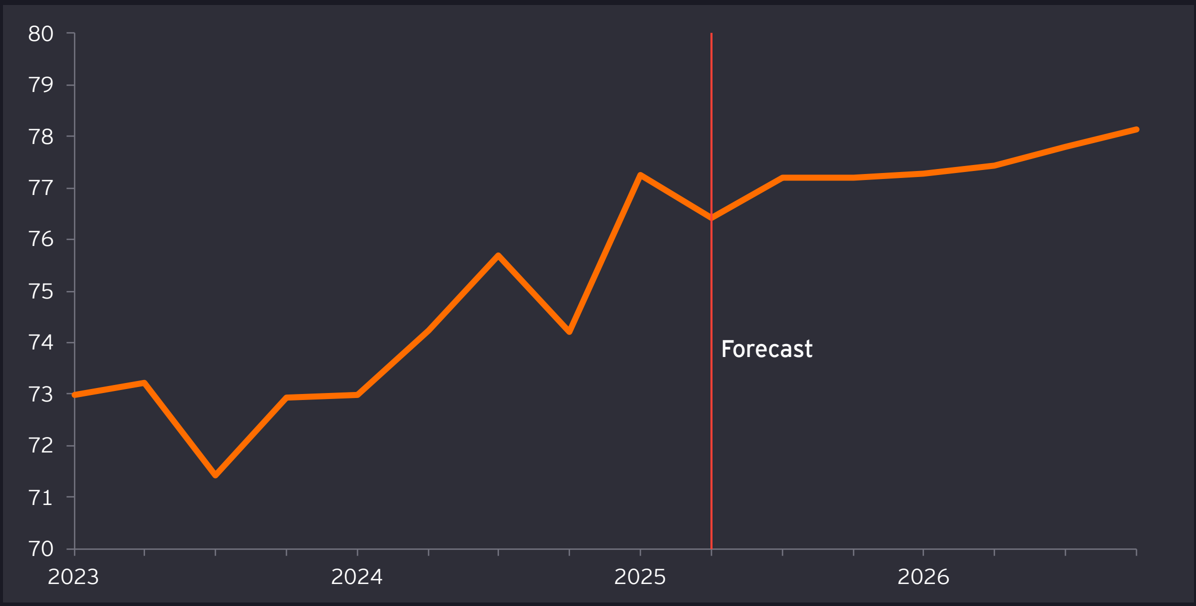
Investment to slow as interest rates and uncertainty bites

Large transactions and the imposition of US tariffs have led to significant volatility in business investment at the start of the year. Capex increased by 4.1% in the first quarter, driven by the purchase of aircraft and some large one-off projects. To some extent, this unwound in Q2 with investment falling back by -1.1%.

Businesses are more sensitive to changes in interest rates than households, with more than 80% of their borrowing on floating-rate loans. So, the upcoming pause in interest rate cuts will have a larger impact on companies' debt servicing costs as well as increasing the cost of new finance. Uncertainty at home from a government with little fiscal space, leaving open the prospect of future tax rises, and abroad from an international trading environment that can shift very quickly, will keep some businesses from advancing their investment plans.

UK: Business investment

£bn, 2023 prices



Source: EY ITEM Club

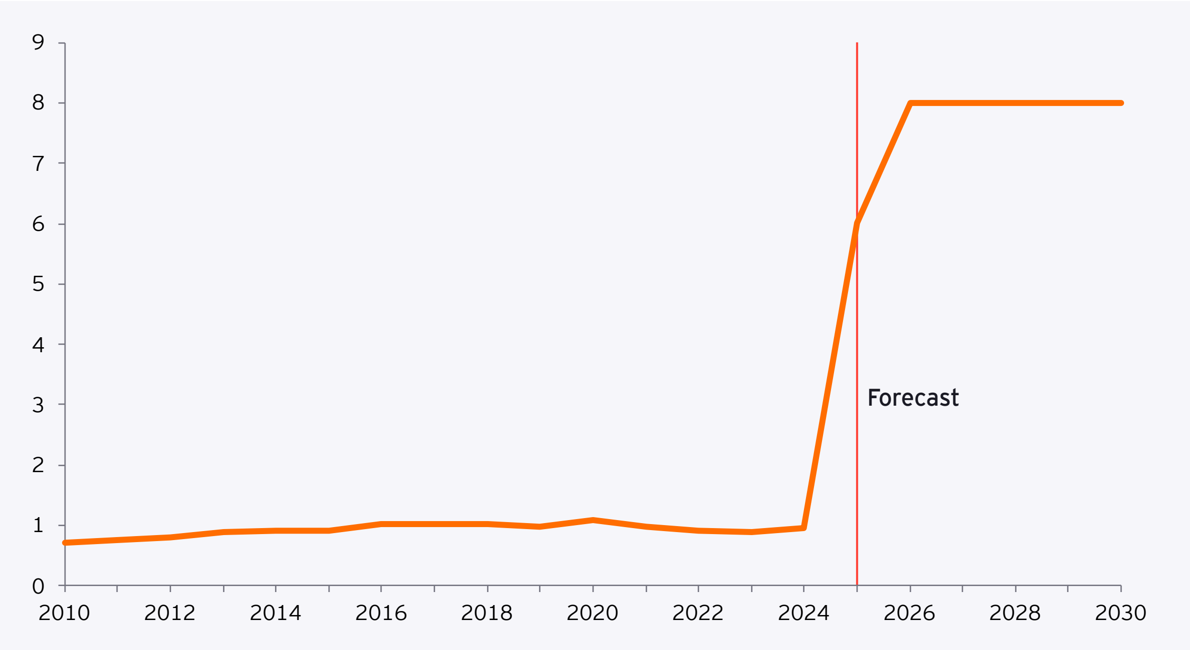
World economy continues to point to growth risks

International trade policy and geopolitical risks continue to hang over the UK outlook. As we have set out in previous reports, the US is one of the UK's major trading partners, and so it will continue to feel the effects of the increase in US tariffs. Even though the UK has seen one of the smallest increases in tariffs compared with some other countries, it still faces a sharp rise in the effective tariff rate on goods sold to the US, with the effective tariff rate expected to reach 8% from below 1%. On top of that, the UK is a large exporter of services to the US and the rest of the world. So, a further nudge down in global growth in 2026 will also weigh on external demand, leading to a slight decline in exports next year.

More generally, the geopolitical backdrop continues to present a risk to the outlook. Recent US tariff announcements on pharmaceuticals indicate how quickly international trade policy can change, and headlines around a further escalation in trade tensions between the US and China make clear risks continue to bubble just below the surface.[2] Meanwhile, ongoing conflicts in Europe and the Middle East continue to threaten international supply chains and wholesale commodity markets. Particularly given the UK's recent inflation episode, these pose upside risks to UK inflation and downside risks to UK growth.

US: Effective tariff rate on UK goods

%



Source: EY ITEM Club, US International Trade Commission

3

The upcoming Budget leaves only difficult choices

Last year, the Government's first Budget reversed the previous Conservative Government's implausible spending cuts and funded it with a tax rise. To retain its credibility, the Government set out its fiscal rules with the primary target of making sure that by 2029/30, it is only borrowing to invest. But having left itself little margin for error at subsequent fiscal events, the Budget leaves the Chancellor probably having to raise taxes to account for a weaker Office for Budget Responsibility (OBR) growth forecast and increased welfare bill. If the Chancellor does not take credible action to keep the public finances on a sustainable footing, government debt could see its price fall, and sterling could be vulnerable to a correction.

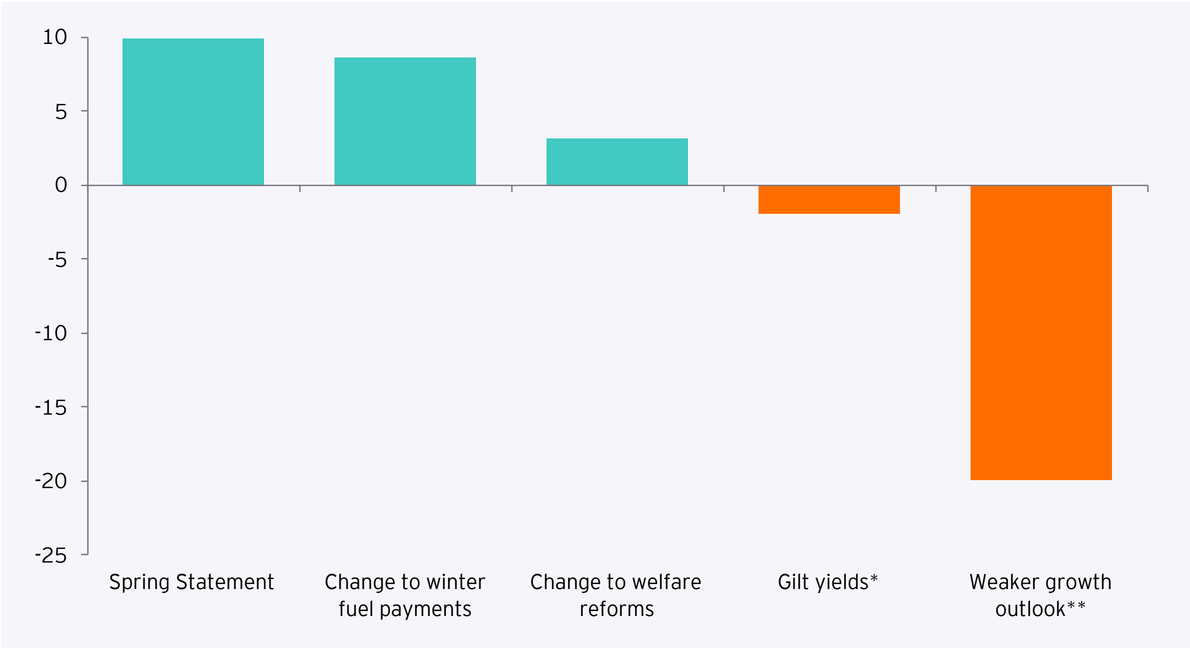
Headroom keeps disappearing

Setting fiscal policy to hit a set of targets is nothing new, but the margin for error is much narrower than usual. Since the financial crisis, governments of either stripe have committed to sticking to different fiscal rules, but all have been intended to keep the public finances on a sustainable footing. What is more unusual is not the Government's targets, but how little wiggle room it has given itself against them. Typically, governments have left around £25bn to 30bn of headroom against their targets. However, the current Government left itself around £10bn at its first Budget and the Spring Statement.

Since the Spring Statement, changes in market interest rates and policy U-turns will leave the Government having to cut spending or raise tax revenue. If it follows normal convention, the OBR will base market interest rates on the average of the ten working days ending Wednesday, 15 October. Since the Spring Statement, market interest rates have repriced higher, which reduces headroom by £5bn. Combined with the Government rowing back on the welfare reforms announced at the Spring Statement, all the margin for error against the fiscal rules is used up.

UK: Change in headroom since the Spring Statement 2025

£bn



* COB 15 October

**Productivity growth of 0.9% per year

Source: EY ITEM Club, OBR

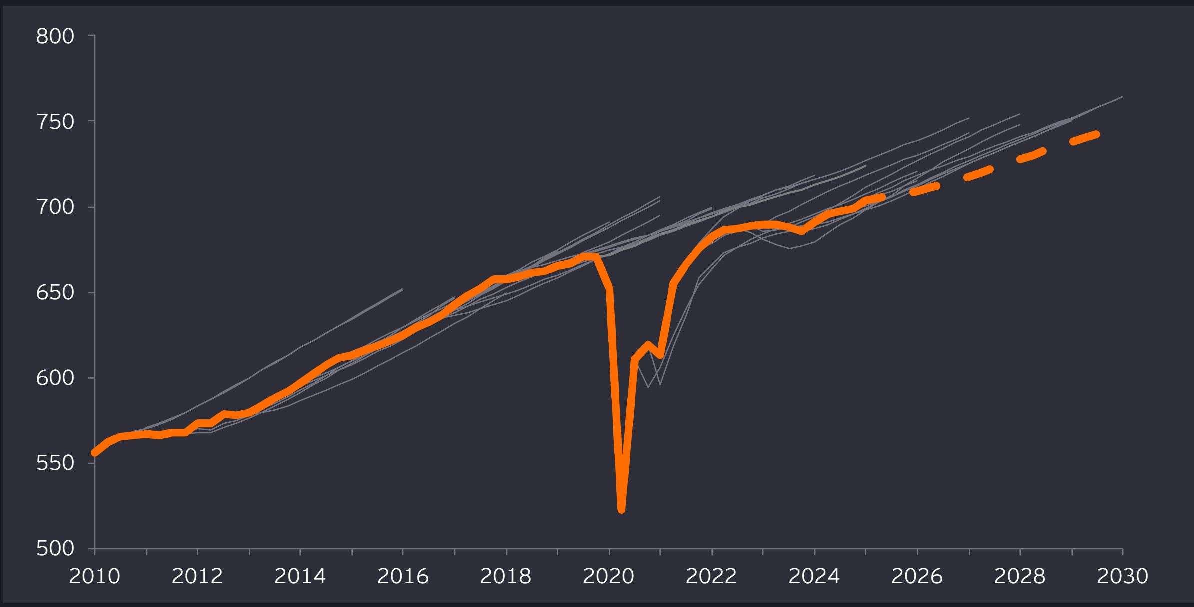
OBR to mark down its optimistic growth forecasts

The OBR has been perennially optimistic on the growth outlook, and we expect it to reduce its long-run forecast in response to continued disappointing productivity growth. At the Spring Statement, the OBR expected annual real GDP growth to settle around 1.75%, which is a quarter point higher than our forecast. This reflects an optimistic annual productivity growth forecast of around 1.25%, which is around a quarter point higher than our forecast. But the OBR has shown it has little conviction in its forecast, with the OBR's leading economist, Professor David Miles, conceding that the forecasts are an "educated guess, and maybe not even terribly educated".[3] Media briefing has already indicated that the OBR intends to reduce its forecast, but it's unclear by how much.

If growth is reduced to align with our forecast, the level of real GDP in 2029/30 – the key year for the fiscal rules – would be around 1.5% weaker. Combined with the interest rate move and welfare U-turns, current borrowing could be around £25bn to £30bn larger.

UK: Office for Budget Responsibility GDP forecasts

£bn, 2023 prices



Source: EY ITEM Club, OBR

How can the Government close the gap

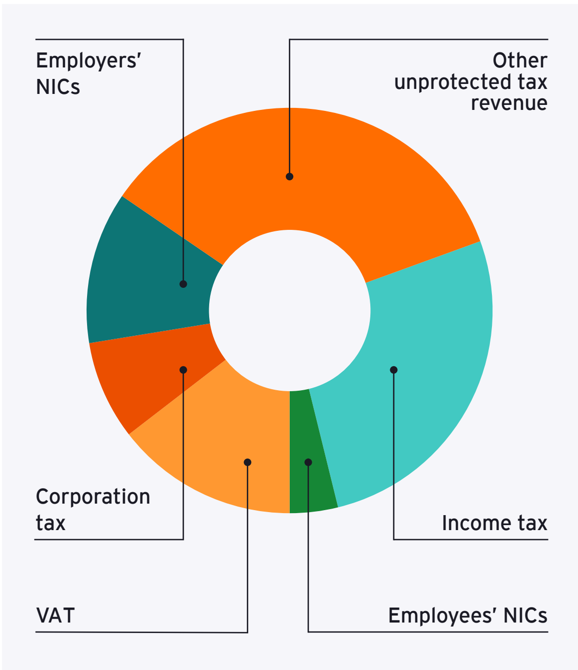
The overdue markdown to the OBR's growth forecast leaves the Government at a significant fiscal crossroad. To meet its own fiscal rules, it will have to either increase taxes or cut spending. However, that's easier said than done. Its manifesto pledge not to increase the rates of income tax, employee NICs or corporation tax means more than two-thirds of the tax base cannot be adjusted to raise revenues. Similarly, it will be difficult to make plausible spending cuts given the funding challenges already facing some government departments and the U-turn on previously proposed welfare reform. At the Spending Review, health and defence were the big winners. The counterpart is that the schools' budget looks tight, while some departments, such as Environment, Food, Rural Affairs and Culture, face outright cuts.

The levers the Government is most likely to pull will have the greatest impact towards the end of this parliament. If the Government were to extend the freeze on income and NICs thresholds from 2027/28 until the end of the parliament then that might raise around £10bn by 2029/30.[4] Meanwhile there is scope to perhaps trim day-to-day spending in the final year of the forecast as it wasn't included in the allocations made in the summer spending round.

That leaves the Government possibly having to find around £10bn to 15bn of tax rises, which, to be credible, will have to be introduced almost immediately. Given the manifesto commitments, it is likely that the Government will rely on a menu of tax changes, which are individually small but, combined, will help the Government meet its fiscal targets.

Of course, this risks putting greater strain on certain parts of the economy, if, for example, bank and gambling levies are increased sharply. Tax changes to capital gains and pensions can increase tax revenue but also create perverse incentives for individuals to save less for the future, potentially putting greater strain on public finances.

UK: Expected split of tax revenue in 2025-2026



Source: EY ITEM Club, OBR

The impact of raising taxes

The OBR estimate that tax rises have a smaller impact on growth than spending cuts.[5] Its latest fiscal multipliers show that if taxes are increased to generate revenues equivalent to 1% of GDP, then the peak effect is a reduction in activity of around 0.3%. Our base case is that the Government will introduce around half of the £25 to £30bn of tax rises immediately, with the remainder coming in the second half of the forecast. Applying the latest multiplier estimates, this would reduce the level of GDP up front by around 0.1% to 0.2%, building to 0.3% to 0.4% by the end of the forecast.

Although there may be scope for some of the effects of tax rises to be offset by pro-growth measures. If the Government were to reduce regulation in certain parts of the economy, then the OBR may build in some growth boost as they did with the planning reforms announced before the Spring Statement.[6] While there is the possibility that targeted welfare reforms may be judged to bring more people into the workforce.[7]

Given the amount of tightening required hinges on the size of the downgrade to the OBR's growth forecast, there remains uncertainty about what will happen at the Budget. On the one hand, if the Government were only needed to raise around £10bn of additional revenue then it's unlikely that there would be any significant up-front hit as the bulk could be found through extending income tax thresholds and tweaking spending in the outer years of the forecast. On the other hand, if the Government were to need to raise more revenue than our forecast anticipates, then there would be a larger near-term hit to GDP. If the Government had to find an additional £45bn, then the up-front impact on GDP maybe more like 0.2% to 0.3% of GDP, building to 0.4% to 0.5% by 2029/30.

Maintaining fiscal credibility

For most of the period since the Spring Statement, UK bond yields have been higher than when the Government last set out its fiscal plans. For the most part, that didn't reflect a positive reappraisal of the UK's economic fundamentals. Instead, it reflected greater concerns around sticky inflation pushing up short-term interest rate expectations. However, following September's inflation downside surprise, bond yields have declined as markets concerns around inflation persistence have reduced.

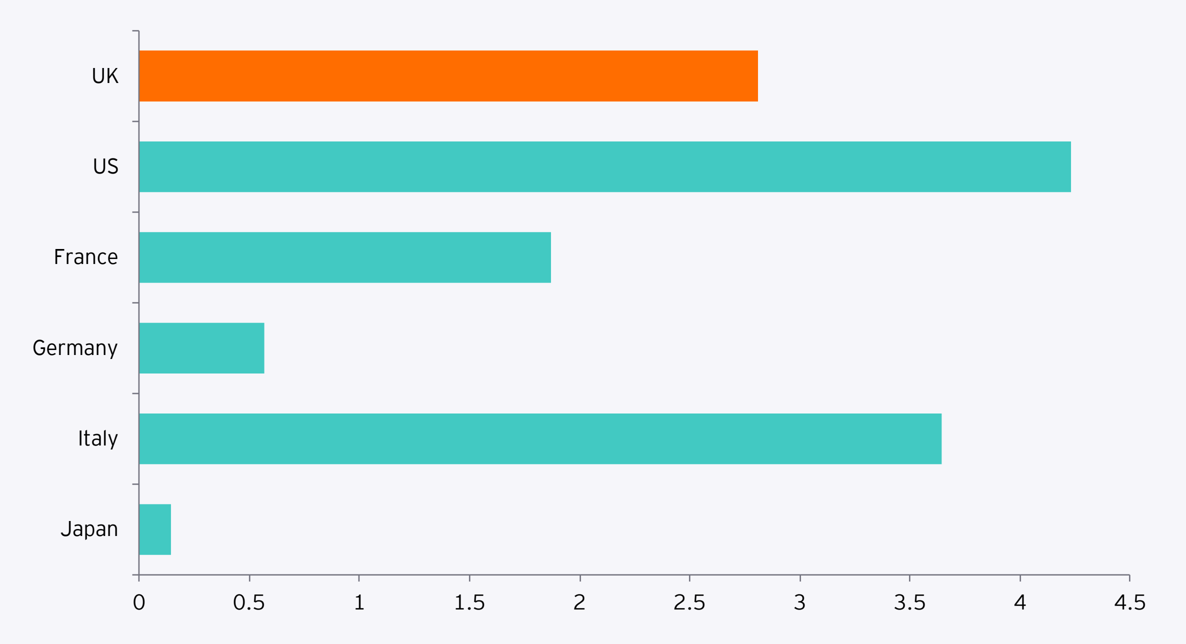
Notably, in the UK, the yield curve has steepened, with the interest rate on long-dated gilts being higher than those on short- and medium-dated gilts. This, in part, reflects changing demand for UK government bonds from pension funds. But there are still fears in the market about the UK's fiscal position, shown by, for example, yields rising after August's disappointing public finances data.

The pound's performance has been mixed. It has strengthened against the dollar but weakened a little against the euro and Nordic currencies. The improvement against the dollar is more a story of dollar weakness, following the US administration's tariff announcements rather than sterling strength. And with the pound currently trading above 1.30 against the dollar — some of the highest levels seen since Boris Johnson was Prime Minister — it leaves it vulnerable to a revaluation.

With markets still vulnerable to higher interest rates on government debt and a sterling depreciation, the UK remains at risk of a stagflationary event if the Government does not maintain its credibility at the Budget. A fall in the currency would put upward pressure on import prices and generate inflation, but the tightening in financial conditions from higher market interest rates would weigh on growth. So, the Government must make sure it presents a credible set tax rises and spending cuts, with a good chunk of those up front rather than pushed out to the end of the forecast to maintain fiscal credibility.

G7: Government interest payments in 2024

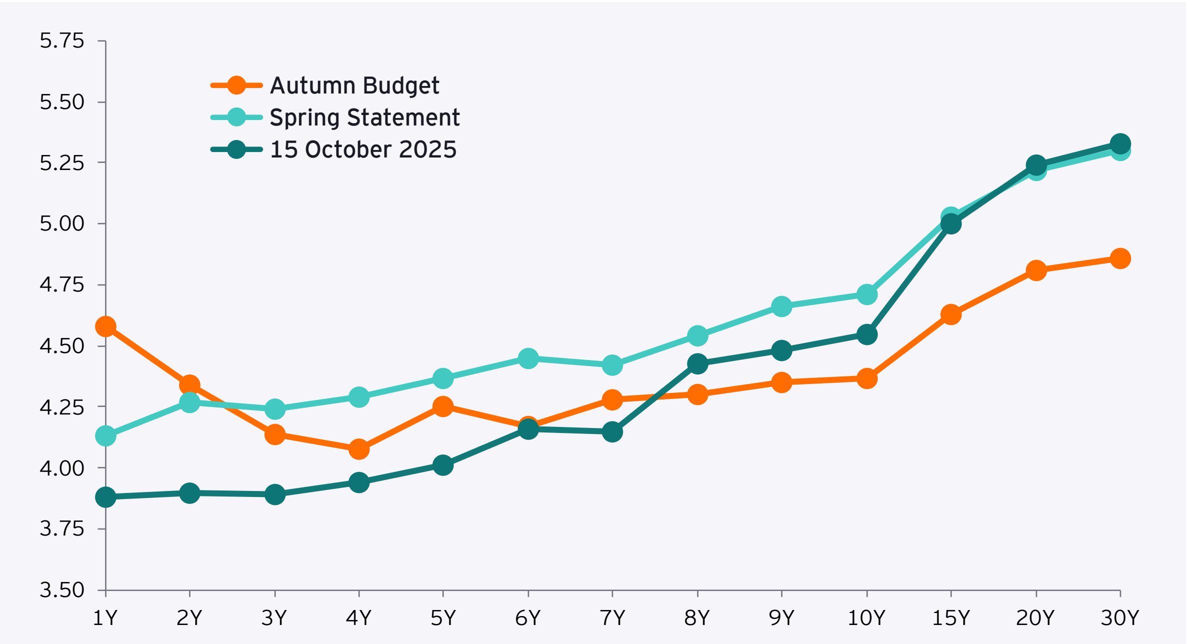
% of GDP



Source: EY ITEM Club, Haver Analytics

UK: Government bond yield curve

%



Source: EY ITEM Club, Haver Analytics

4

More interest rate cuts in 2026

At its August meeting, the Bank of England took a hawkish stance, leading financial markets to reduce their odds of another interest rate cut this year. We agree with that assessment as the Monetary Policy Committee is currently more concerned about cutting too quickly rather than too slowly. But we do think that as inflation falls back towards target and the labour market weakens, most of the Committee will once again turn their attention to gradually reducing rates.

Inflation concern grows as labour market issues cool

Since August 2024, the Bank of England has been gradually cutting interest rates as it balances above-target inflation with a weakening labour market. But in recent months it's been clear that inflation will be stickier than the MPC expected earlier in the year, while the deterioration in the jobs market has eased. Looking back at its recent forecasts, the MPC's projections had the highest inflation rate through 2026.

The recent rises in food prices have only made the MPC more anxious, with higher food inflation the big change in its near-term inflation forecast. Although September's decline in food price inflation will be welcome, it won't offer the MPC too much comfort as it may reflect greater discounting rather than a clear turning point.

Alongside energy prices, the cost of household food shopping is one of the most visible prices to people. Therefore, they have a significant influence on inflation expectations, which in turn will be central to workers' pay negotiations. With inflation reaching close to 4% — a marker where the MPC thinks that households will start to really notice prices rising — a surge in food prices has already seen households' inflation expectations pick up over the last few months.[8]

At the same time, the pace of business headcount reduction has slowed from around 20,000 in May and June to be broadly flat across August and September. Combined, this has led an MPC that was already concerned about cutting too quickly to consider pausing interest rate cuts as it waits to make sure that inflationary pressures are subsiding.

UK won't always be an inflation outlier

Compared with the US and the eurozone, inflation in the UK should give the MPC cause for concern. Inflation in the UK settled at 3.8% in September and remains far above the inflation target. By comparison, in the US inflation is around 3%, boosted in recent months by the inflationary impact of tariffs, while in the eurozone, inflation has already stabilised around the 2% mark. Notably, services inflation, which is most responsive to domestic inflationary pressures, has been much less sticky than it has in the UK. In the eurozone, where inflation is measured on a comparable basis, services price gains peaked at 5.5% in the middle of 2023. But since then, they have fallen back to 3.5%, which, although higher than the pre-pandemic average, is materially lower than in the UK. Services inflation in the UK peaked at 7.3% in July 2023 and has declined to around 4.5% to 5%.

However, we do think that some of this gap can be explained by one-off factors that will ease in the middle of next year. Part of the explanation is that a rise in regulated prices (for example, in water bills) in April 2025 is still pushing up the annual inflation rate. This effect will diminish next year as prices are reset by a smaller amount. In addition, businesses are currently passing on some of the increase in labour costs from the rise in the employer NICs. But we think this will be a one-off change, and so the effect on annual inflation will drop out in the middle of next year. In addition, the possibility of some Budget announcements could reduce inflation, for example, a reduction in VAT on energy bills.[9]

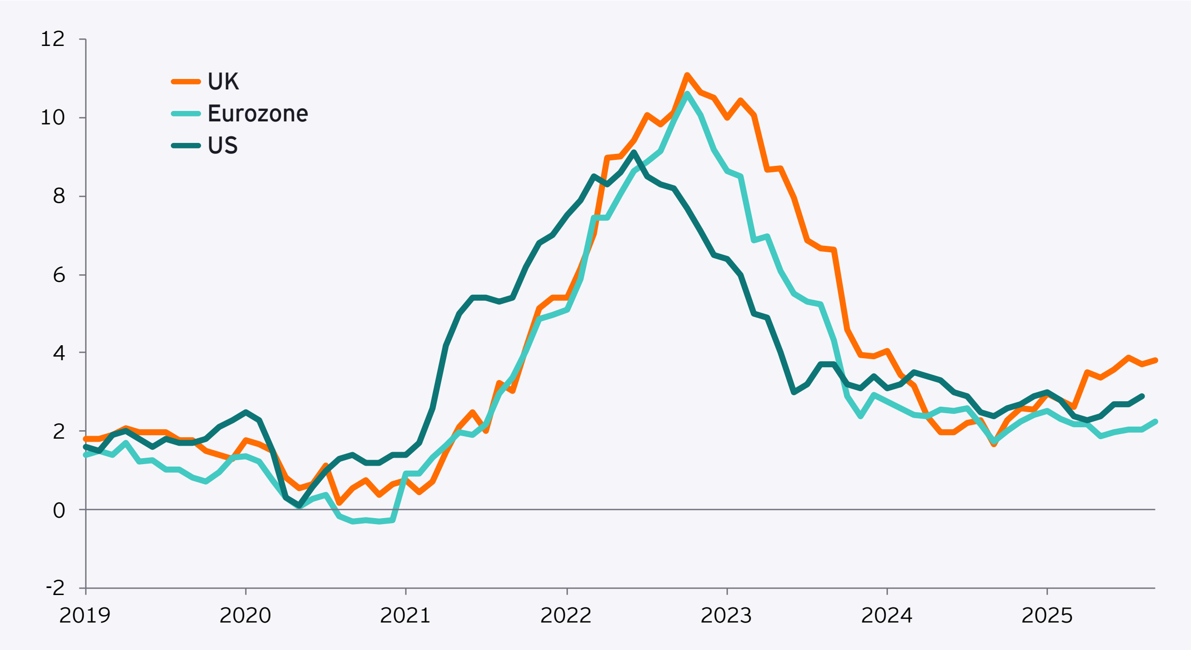
With inflation stickiness and the MPC pausing on rate cuts, its path is likely to diverge from those of the other major central banks for a little while longer. But this is not unusual. The different structures of the economies and the various objectives of the central banks – the Federal Reserve has a dual mandate to keep inflation in check and try to keep the economy at full employment – have caused the major central banks to take different paths.

As a case in point, the recent ECB and Fed cutting cycles prove that central banks can adjust policy at different rates. With inflation much closer to target, the ECB has cut much more quickly than the Bank of England, lowering interest rates at seven successive meetings to 2%, compared with 4% in the UK.

But the ECB looks like it has now returned the policy rate to a neutral stance and will make only small adjustments in the near term. Meanwhile, the Fed began cutting rates quite quickly in the latter half of 2024, but by the start of 2025 the economy was stronger than anticipated, so the loosening cycle was put on hold. But recent signs of a deteriorating jobs market led the Fed to cut in September and has opened the door to further cuts over the remainder of this year.

G3: Inflation

% year



Source: EY ITEM Club, Haver Analytics

Why will the Bank of England start cutting again?

UK interest rates are currently holding back activity, so once the MPC has confidence that inflation is back on a steady downward trajectory, we think the Bank of England will start cutting interest rates to stimulate growth.

The clearest sign that interest rates are restrictive is the labour market. Although it has slowed in recent months, businesses continue to reduce headcount, and the indications are that businesses' hiring intentions remain weak. Weak demand is holding back hiring, even allowing for the impact of higher employer NICs.

Households' saving behaviour is probably being influenced by high interest rates. Of course, to some extent, high saving rates reflect households' precautionary saving as they rebuild their real wealth holdings in the shadow of the twin shocks of the pandemic and the energy price crisis. But there is likely some yield-seeking going on, too. If high saving rates were purely a response to economic uncertainty, then we might expect the saving rate in the eurozone to have fallen back by more than in the UK, given it saw a lower peak in inflation and an earlier and more sustained return to the inflation target. But that hasn't been the case, suggesting high interest rates are playing some role in current saving patterns. So, we expect lower interest rates will help to get some households spending again.

How far can interest rates fall?

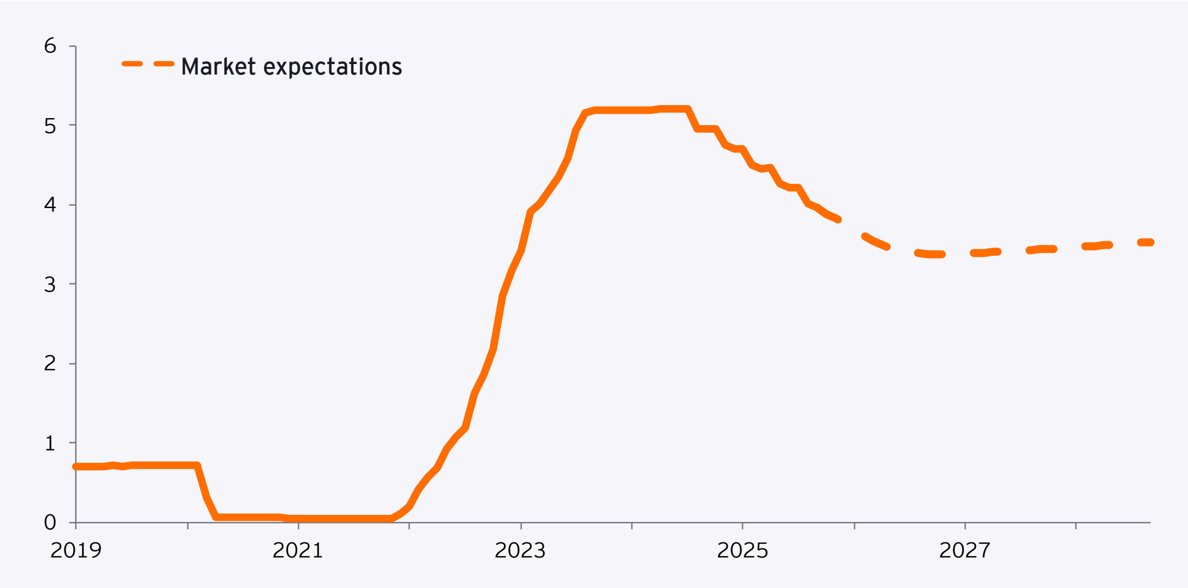
The Bank of England estimates that the interest rate that will return inflation to target in the absence of future economic shocks; the so-called neutral rate is between 2% and 4%. Financial markets largely agree with this assessment. The swaps curve expects interest rates to fall to around 3.5% over the next year or so, before rising after a few years as the market demands a greater yield to hold the contract for a longer period.

Ultimately, we expect Bank Rate to fall to 3.5% by the middle of next year with the MPC restarting its cutting cycle at its February meeting. But it's hard to have high conviction about whether the first cut will come at the Bank of England's December or February meeting and will largely reflect the precise balance of how much and quickly the labour market loosens, how quickly inflation falls back and how much tightening is included in the Budget.

We think that Bank Rate will settle at 3.5%. This is around the long run nominal GDP growth we expect. It's below the pre-GFC level of interest rates when Bank Rate averaged around 5% as weaker productivity and a shift in global demographics and risk preferences have seen more savings around the globe. But it's also above the level seen between the GFC and the pandemic, when Bank Rate remained between 0 and 1% while the Government was undergoing significant fiscal tightening alongside large corporate-sector deleveraging.

UK: Overnight interest rate

%



Source: EY ITEM Club, Haver Analytics

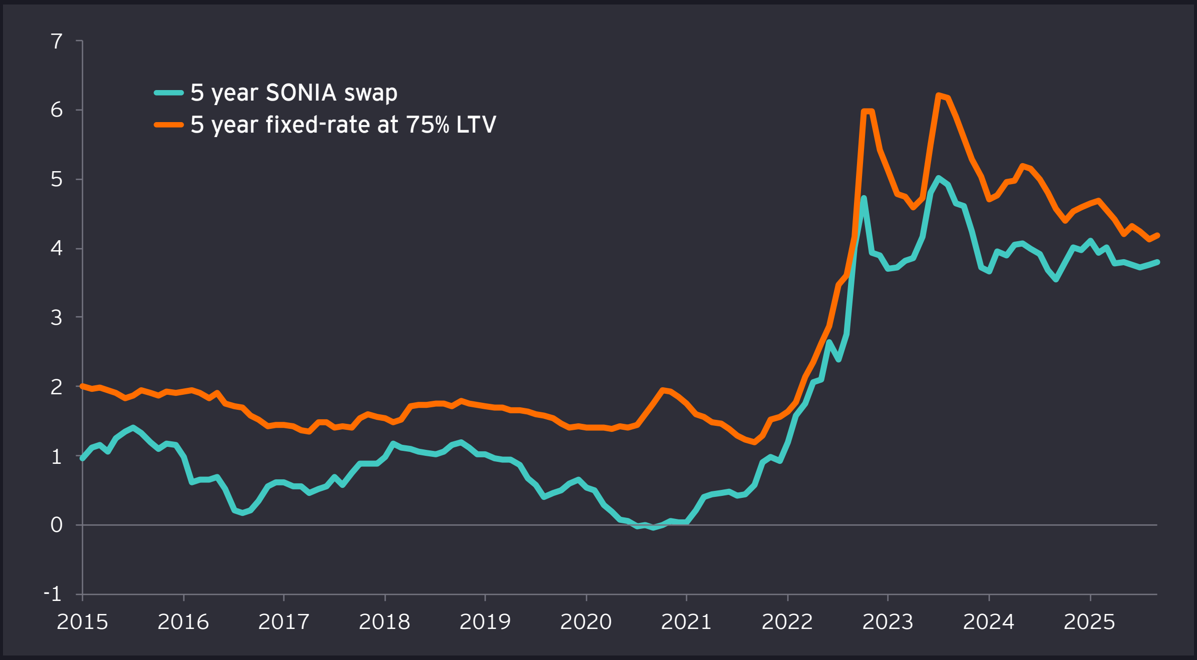
Consumers will see interest rates fall... eventually

Banks typically price mortgages based on how much it costs to access funds – whether retail or wholesale – approximated by the interest rates expected in interest rate swap markets.

With financial markets expecting a skip in interest rate cuts, new mortgage rates could be flat or even increase in the near term as the market's reappraisal feeds through to the retail price of borrowing. But as the Bank of England cuts rates, borrowing rates should fall back, particularly as banks continue to operate with a relatively tight spread as they look to win business in a quite slow-moving housing market. Nonetheless, as Bank Rate will settle far above the levels we saw during the pandemic and in early 2026, a significant minority of households will still have to refinance their mortgages at higher interest rates as their five-year fixed-rate mortgages expire. The net effect is that we think the average mortgage rate will continue to rise through next year and into 2027, before slowly falling back. For savers, the picture is much simpler. As interest rate cuts are realised, the interest rate on savings accounts will decline gradually.

UK: New mortgage and SONIA swap rates

%



Source: EY ITEM Club, Haver Analytics

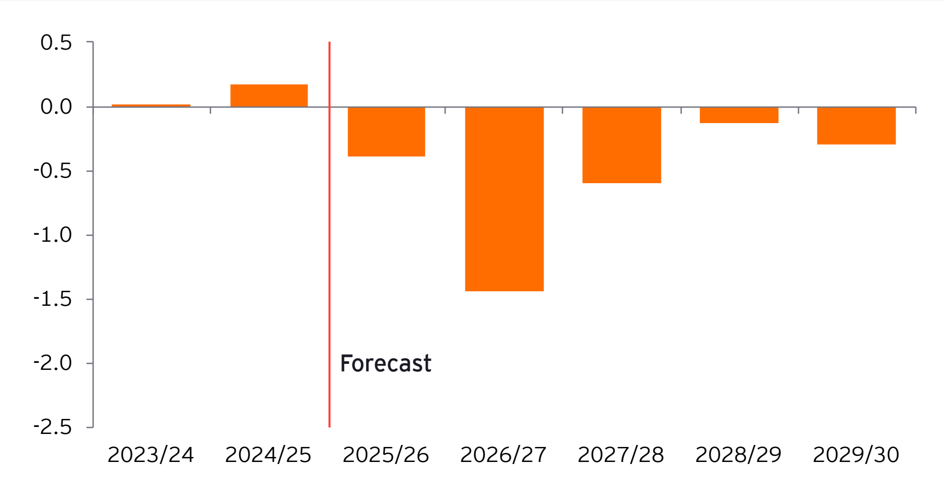
Forecast in charts

Fiscal policy

- The pandemic and the energy price shock saw unprecedented government support, resulting in a large rise in government debt and the interest rate on government borrowing.
- The Government has already announced a set of tax and spending plans designed to keep the public finances on a sustainable footing. But more needs to be done to hit its fiscal target, and the Budget will likely see more tax rises.
- The situation is made more difficult by the OBR taking a more pessimistic view on the growth outlook. We think the Government will need to tighten fiscal policy by £25bn to £30bn to meet its fiscal targets.

UK: Change in public sector borrowing

% pts of GDP



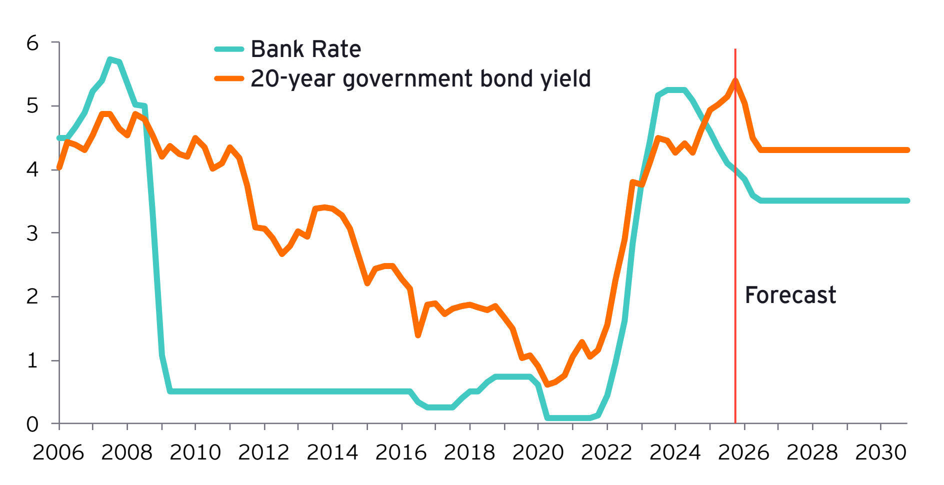
Source: EY ITEM Club

Monetary policy

- The MPC continued cutting interest rates, lowering Bank Rate to 4.00% in August. But that was a finely balanced decision, with many on the MPC preferring to keep rates on hold.
- We now think with inflation having reached close to 4% and signs that the labour market is deteriorating less quickly than previously thought that the MPC is more worried about cutting rates too quickly rather than too slowly.
- We still think that there are more interest rate cuts to come in the first half of 2026 as inflation falls back towards target and the labour market loosens. We expect interest rates to settle at 3.5%.

UK: Bank Rate and 20-year bond yield

%



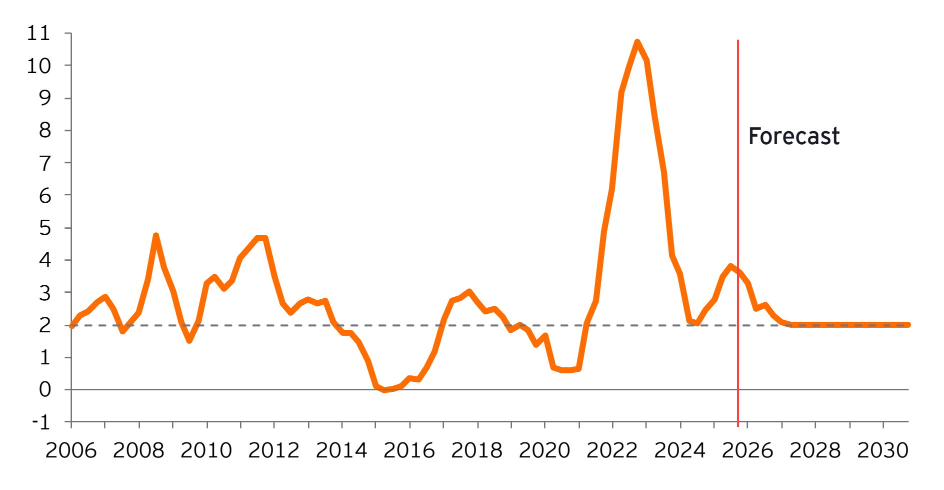
Source: EY ITEM Club

Prices

- Inflation settled at 3.8% in September as energy and food prices pushed up on the headline rate. But it looks very likely that this is the peak in inflation as energy base effects wane and softening wholesale food prices pass through to the prices on the shelves.
- Services inflation will remain sticky around the 5% level in the near term. As the National Living Wage (NLW) and NICs rise, labour costs remain elevated despite cooling pay growth.
- With pay growth falling back to target consistent rates by the middle of next year, we expect inflation to fall back to around target by the end of next year.

UK: CPI inflation

% year



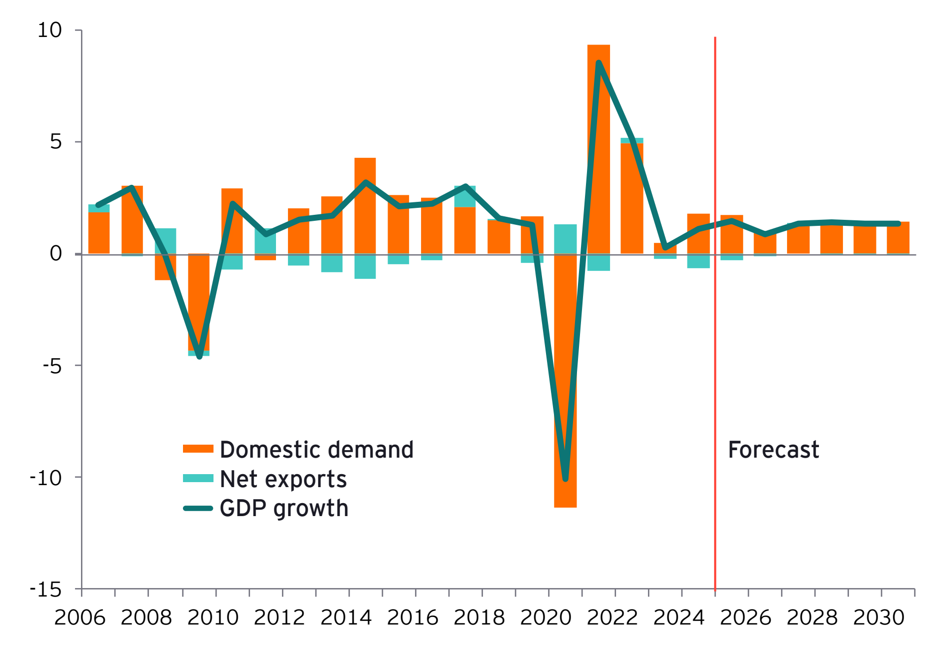
Source: EY ITEM Club

Activity

- GDP growth slowed to 0.3% in Q2 having grown by 0.7% in Q1. Although the details show that private-sector growth has been weak, government spending has driven growth.
- With more fiscal tightening likely to soon be underway, the Bank of England on hold until the new year and US tariffs leaning against the world economy, we expect growth to be soft through the turn of the year.
- We think that these headwinds will ease a little, but some backloaded fiscal tightening at the Budget will mean that the pickup in growth will be modest.

UK: Contributions to GDP growth

% year



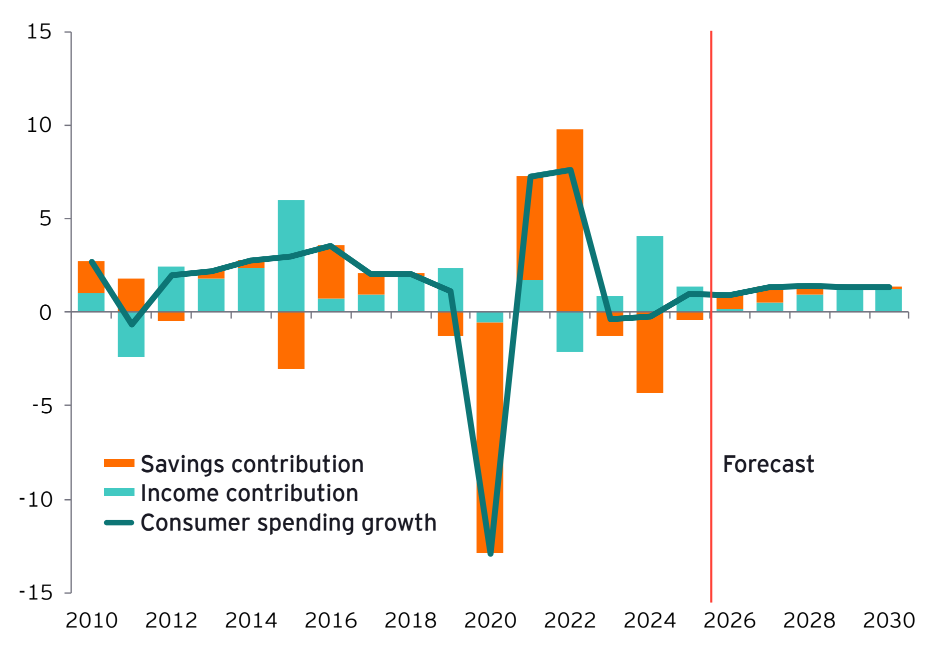
Source: EY ITEM Club

Consumer demand

- Consumers have remained cautious over the course of 2025, with consumption barely growing on the quarter in Q2. The saving rate remains high, and with a healthy balance sheet, households have scope to save a little less.
- Over the next couple of years, real income growth will slow. But we think that this will be cushioned by a fall in the saving ratio as interest rates decline and the scars of the pandemic and energy price shock fade.
- With decent fundamentals underpinning the household sector and interest rates being cut to neutral, we think that over the forecast, the saving ratio will fall back towards its long-run average.

UK: Contributions to consumer spending growth

% year



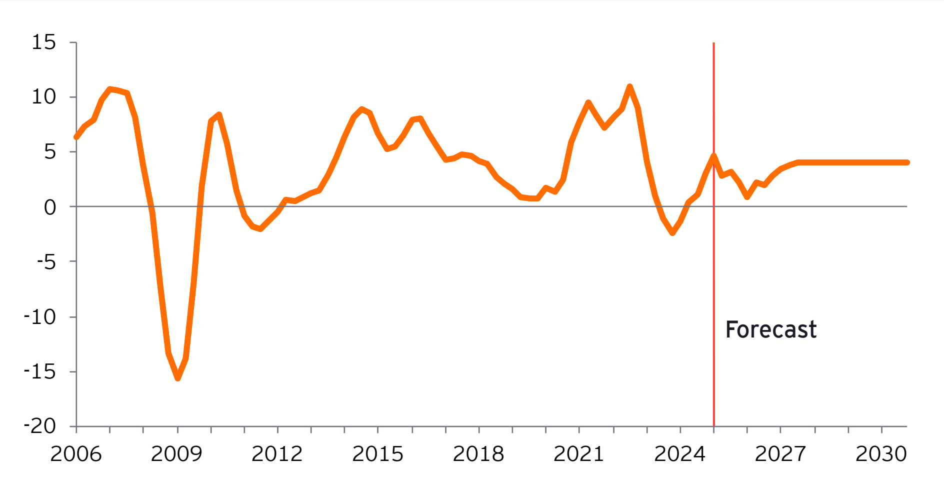
Source: EY ITEM Club

Housing market

- The housing market has been volatile as some transactions were pulled forward to beat April's change in Stamp Duty thresholds.
- But the signs are that this volatility is now in the rear-view mirror. Transactions have picked back up to levels above those seen last year and are tracking pre-pandemic trends, and the recovery in mortgage lending looks to have topped out.
- The outlook for the housing market is modest. Valuations, although slightly improved, are stretched. A pause in interest rate cuts will make the near term more difficult. But as interest rates fall, we expect the housing market to gradually pick up.

UK: House prices

% year



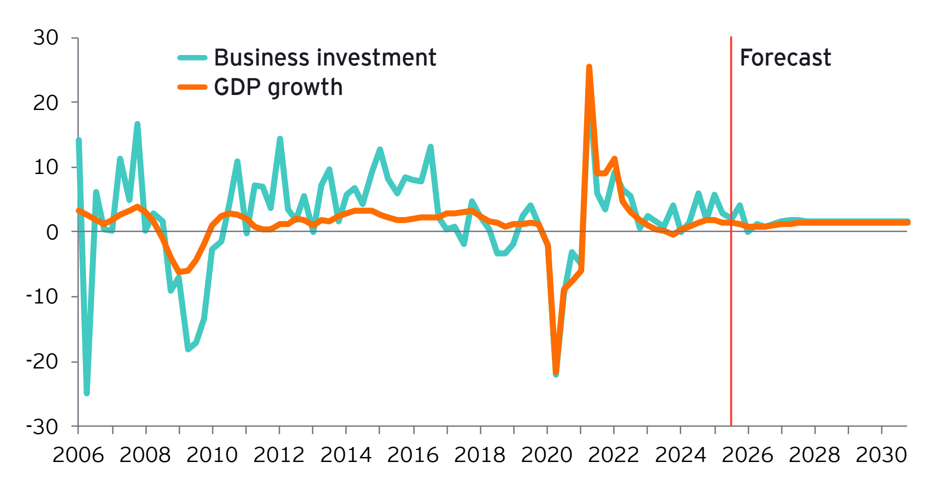
Source: EY ITEM Club

Company sector

- Having picked up markedly in Q1, investment fell back in Q2 as the effects of some one-off purchases of aircraft unwound.
- Investment will be flat through the first half of 2026 as some businesses postpone spending decisions amidst the uncertainty of tax rises and a pause in the Bank of England's cutting cycle.
- But with signs that there are still investment opportunities available to companies, we think investment will rise as interest rate cuts in early 2026 reduce corporates' debt service costs.

UK: Business investment and GDP

% year



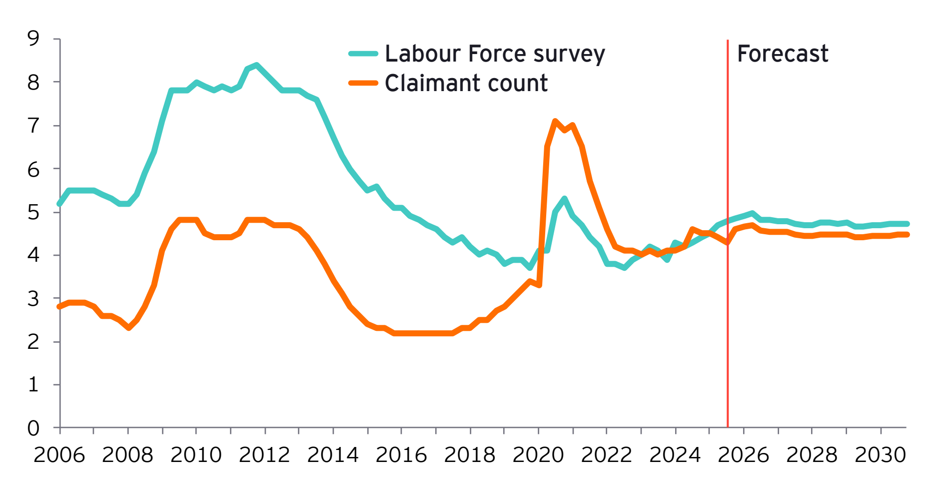
Source: EY ITEM Club

Labour market and wages

- A period of weak growth has seen the labour market loosen over the last couple of years.
- In the last six months or so, the increase in employers' NICS and the NLW added to a period of weak growth, saw businesses reduce headcount.
- According to the most recent data, it appears the jobs market deterioration has slowed. But we think there is scope for it to loosen further as the government tightens fiscal policy. We forecast the unemployment rate to rise to around 5% early next year.

UK: Unemployment rate

%



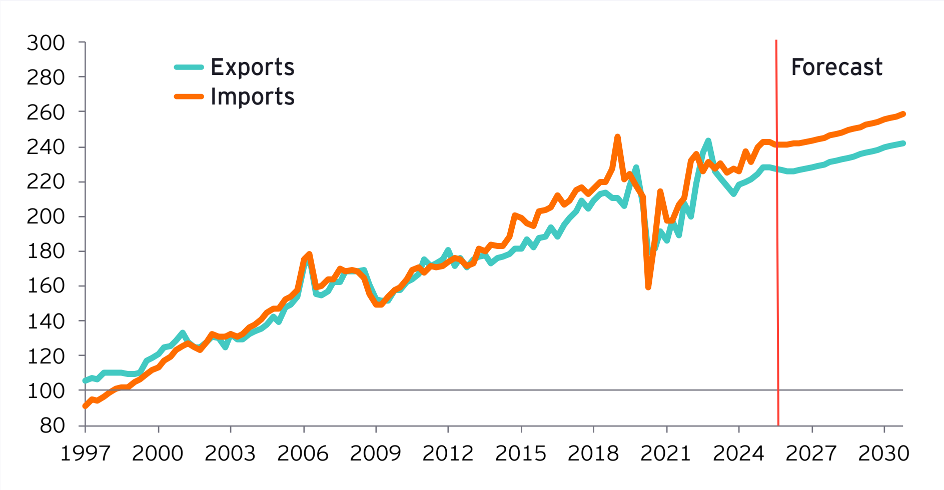
Source: EY ITEM Club

Trade and the balance of payments

- Although it has seen a smaller increase in US tariffs than other countries, the UK still faces significantly higher tariffs to export goods to its largest market.
- Having bounced in Q1 ahead of tariffs being introduced, exports fell back in Q2 and are expected to drop back more over the remainder of 2025 and into 2026 as a slowdown in world growth sees UK export demand ease.
- With no direct response from the UK to the US Government's tariffs, we do not see a big change in the UK's import share. But we do think imports will soften as domestic demand growth slows.

UK: Exports and imports

£bn, 2023 prices



Source: EY ITEM Club

Endnotes

1. Bank of England (2025) "Monetary Policy Report – August"
2. Financial Times (2025) "Donald Trump threatens extra 100% tariff as he retaliates against China"
3. House of Commons (2024) "Oral Evidence: Budget 2024, HC625"
4. HMRC (2024) "Tax ready reckoner statistics"
5. OBR (2020) "Economic and Fiscal Outlook – November 2020"
6. OBR (2025) "The supply-side impact of planning reforms – land value uplift and construction sector productivity"
7. For example, the OBR has previously estimated that reductions in employee NICs resulted in an increase in labour supply.
8. Bank of England (2025) "Monetary Policy Report – August 2025"
9. Financial Times (2025) "Minister hints at VAT cut on household energy bills"

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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.

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