

## UK Watch

## UK mid-year up-date: entrenched inflation

**Entrenched inflation**

Our UK forecast is a story of a supply constrained economy with entrenched inflation as a result. Capacity pressures are high because the supply side of the economy has been hit by four shocks: energy, supply chain disruptions, workforce sickness and Brexit. These shocks mean weak demand bumps up against even weaker supply. Additionally, in our view inflation expectations have modestly deanchored.

**Means extended period of weak growth**

Unless none of current inflation reflects capacity pressures or deanchored expectations, bringing inflation to target sustainably will require the central bank to generate a margin of spare capacity. To do that the economy will need to grow slower than its potential, which we peg at 1% a year. We expect UK growth of 0.4% in 2023 and 0.3% in 2024.

**And extended period of restrictive interest rates**

To deliver weak growth the central bank will in our view need to keep interest rates restrictive for an extended period. With mortgage market changes meaning rate hikes transmit slower and less to demand the BoE needs to hold rates higher for longer to cut demand. We assume three more 25bp hikes to 5.25% terminal. We see upside risks.

**Inflation falls, core sticky**

Inflation drops from current elevated levels as energy, food and goods inflation follows easing wholesale costs and producer price pressure down. Inflation reaches target mid-2024 as utility price cuts drag. Core sticks above 2% for longer, however sitting at 2.8% end 2024. The BoE accordingly engineers near-zero growth for 2023 and 2024 by keeping Bank Rate at or close to terminal until end 2024. Core inflation falls towards target through 2025 as spare capacity weighs, but it is a gradual process given limited spare capacity. We see core inflation at 2.4% at end-2025.

**Easier policy, better growth, in 2025**

With inflation falling and unemployment above the inflation neutral level in second half 2024 we think the BoE can begin easing rates. We look for one rate cut in 2024, in August, then one per quarter in 2025 taking Bank Rate to 4.0% at end-2025. Growth improves as pressure on mortgage holders drops taking 2025 growth at 0.6%.

**Fiscal risks**

Fiscal policy poses one of the largest risks to our forecast, aside from how wholesale energy costs evolve. Pre-election fiscal stimulus would boost our Bank Rate calls. Post-election fiscal tightening, meanwhile, could mean quicker Bank Rate cuts.

More detail in our recent reports [UK Viewpoint: Strong housing credit quality vs entrenched inflation = higher for longer 09 June 2023](#) and [UK Viewpoint: Growing too much to fix entrenched inflation 30 May 2023](#)

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**Refer to important disclosures on page 3 to 5.**

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**Exhibit 1: UK economic forecasts**

Supply restricted economy with entrenched inflation

		2022	2023	2024	2025	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	1Q25	2Q25	3Q25	4Q25
GDP	% qoq					0.1	0.0	0.4	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.2	0.3
	% qoq ann.					0.5	0.0	1.6	0.0	0.0	0.0	0.4	0.4	0.4	0.8	0.8	1.2
	% yoy	4.1	0.4	0.3	0.6	0.2	0.2	0.7	0.5	0.4	0.4	0.1	0.2	0.3	0.5	0.6	0.8
Private Consumption	% qoq					0.1	0.3	0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.2	0.2	0.2	0.2
	% yoy	5.6	0.4	-0.2	0.4	0.3	0.3	0.7	0.4	0.2	-0.2	-0.4	-0.3	0.0	0.3	0.6	0.8
Government Consumption	% qoq					1.7	1.2	0.9	0.4	0.1	0.3	0.3	0.3	0.3	0.5	0.5	0.5
	% yoy	1.8	3.5	1.6	1.5	1.2	4.2	4.4	4.3	2.7	1.7	1.0	0.9	1.2	1.4	1.7	1.8
Investment	% qoq					1.3	-1.4	-1.3	0.1	0.0	-0.2	-0.2	0.0	0.1	0.2	0.3	0.4
	% yoy	8.6	-0.2	-1.2	0.4	0.4	1.3	-1.2	-1.3	-2.6	-1.4	-0.2	-0.4	-0.2	0.2	0.6	1.0
Final Domestic Demand <sup>1</sup>	% qoq					0.6	0.2	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.3	0.3	0.3
	% yoy	5.4	0.9	0.0	0.7	0.5	1.3	1.1	0.8	0.2	0.0	-0.1	-0.1	0.2	0.5	0.8	1.1
Net exports <sup>1</sup>	% qoq					-0.3	0.0	-0.1	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
	% yoy	-1.2	1.8	0.0	0.0	4.8	3.5	-0.7	-0.4	-0.1	-0.1	0.1	0.1	0.1	0.1	-0.1	-0.1
Stockbuilding <sup>1</sup>	% qoq					-0.2	-0.2	0.5	0.0	0.1	0.0	0.0	0.0	-0.1	0.0	-0.1	0.0
	% yoy	-0.1	-2.4	0.3	-0.1	-5.1	-4.7	0.3	0.0	0.3	0.5	0.1	0.1	0.0	0.5	-0.2	-0.1
Current Account Balance	% of GDP	-3.8	-2.6	-2.7	-2.7	-2.3	-2.7	-2.8	-2.8	-2.8	-2.7	-2.6	-2.6	-2.6	-2.6	-2.7	-2.7
Manufacturing output	% qoq					0.5	0.1	0.0	0.0	0.1	0.3	0.5	0.6	0.6	0.6	0.6	0.6
	% yoy	-3.7	-0.2	0.7	-3.7	-1.9	-0.7	1.1	0.6	0.2	0.4	0.9	1.5	2.0	2.3	2.4	2.4
Unemployment rate <sup>2</sup>	%	3.7	3.9	4.3	3.7	3.9	3.9	3.9	4.0	4.1	4.3	4.4	4.5	4.5	4.5	4.5	4.4
RPI Inflation <sup>2</sup>	% yoy	11.6	9.4	3.4	3.0	13.6	10.9	8.5	5.0	4.2	3.0	3.0	3.3	3.1	2.8	3.0	3.0
CPI Inflation (harmonised) <sup>2</sup>	% yoy	9.1	7.2	2.4	2.0	10.2	8.3	6.5	4.1	3.4	2.0	2.0	2.2	2.1	1.9	2.1	2.1
CPI (core) <sup>2</sup>	% yoy	5.9	6.3	3.7	2.5	6.1	6.8	6.5	5.8	5.2	3.7	3.0	2.8	2.7	2.5	2.5	2.4
General govt balance <sup>5</sup>	% of GDP	-5.6	-4.7	-3.2	-2.8												
General govt debt <sup>3,5</sup>	% of GDP	96.2	97.3	99.1	99.5												
General govt debt	% of GDP	102.4	101.6	102.7	103.9												
Bank Rate <sup>4</sup>	%	3.50	5.25	5.00	4.00	4.25	4.75	5.25	5.25	5.25	5.25	5.00	5.00	4.75	4.50	4.25	4.00

Notes: <sup>1</sup> Contribution to GDP growth <sup>2</sup> Period averages <sup>3</sup> Excludes Nationalised banks, and thus is not on Maastricht basis, <sup>4</sup> End period, <sup>5</sup> Fiscal years **Source:** BofA Global Research, ONS, Bank of England, Office for Budget Responsibility.

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