4 March 2025

UK in Focus

Economics
United Kingdom

Global developments could add to UK fiscal troubles

- Global geopolitics drives economic uncertainty, adding to fiscal woes
- UK economic growth has disappointed and expectations for 2025 have been downgraded
- Despite the acceleration in inflation, interest rate cuts should continue over the next year

Global geopolitics has taken centre stage over the last month, from US tariff announcements, to the possibility of a Ukraine-Russia peace deal, a new German Chancellor, and an increase in UK defence spending. Positively, Prime Minister Starmer appeared to have a constructive meeting with President Trump, perhaps lessening the likelihood of direct tariffs on UK goods exports. That said, the UK remains exposed to broader global trade disruption, notably across Europe.

The increase in UK defence spending that brought forward plans to reach 2.5% by 2030 will be fiscally neutral due to a reallocation of overseas development aid funding (chart 1). However, further increases, such as ambitions to increase defence expenditure to 2.65% and then to 3% after the next election would, at this juncture, prove a challenge and likely require further spending trade-offs and/or accounting adjustments, such that defence spending is classified as investment spend and wouldn't fall under the Chancellor's fiscal mandate to balance current spending with revenues. Indeed, the UK may also participate in multilateral bond-financed funding programmes.

Undoubtedly, further increases in defence spending requirements would add to an already complicated fiscal landscape for the Chancellor further down the line. For the looming fiscal statement on 26 March, disappointing economic data since the October Budget and financial market volatility have raised the prospect that the fiscal 'headroom' afforded to Chancellor Reeves a few months ago may have been wholly or partially eroded. One response option would be to impose further 'efficiency savings' to unprotected departments, in addition to the 2% already announced.

Growth and inflation woes resurfaced

UK economic data has been mixed, while GDP data showed growth of 0.9% for 2024 overall, yet the private sector is reported to be in recession. Meanwhile, surveys have continued to point to a subdued start to the year, albeit appear to have stabilised. We recently revised down our UK GDP growth forecast for 2025 to 0.9% from 1.4% previously.

KEY UK DATA

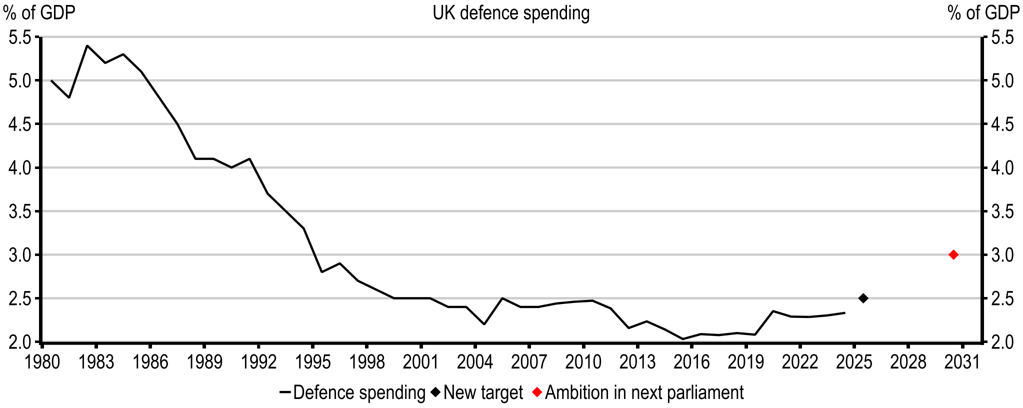
▲ 0.1%	GDP growth in 3m to December
▲ 3.0%	Consumer Price Inflation, January y-o-y
► 4.4%	Unemployment rate, November
▼ 4.50%	Bank of England Base Rate

Source: HSBC

For inflation, we have revisited our 2025 outlook and now see headline CPI peaking at 3.8% in September. However, the acceleration in price growth is largely externally driven via higher energy prices, water bills, and indexed linked services (chart 3). In contrast, services inflation – the proportion of inflation of most concern to the Bank of England (BoE) – should continue to moderate. As such the BoE continues to signal a gradual path for interest rate cuts as it looks through the “hump” in inflation.

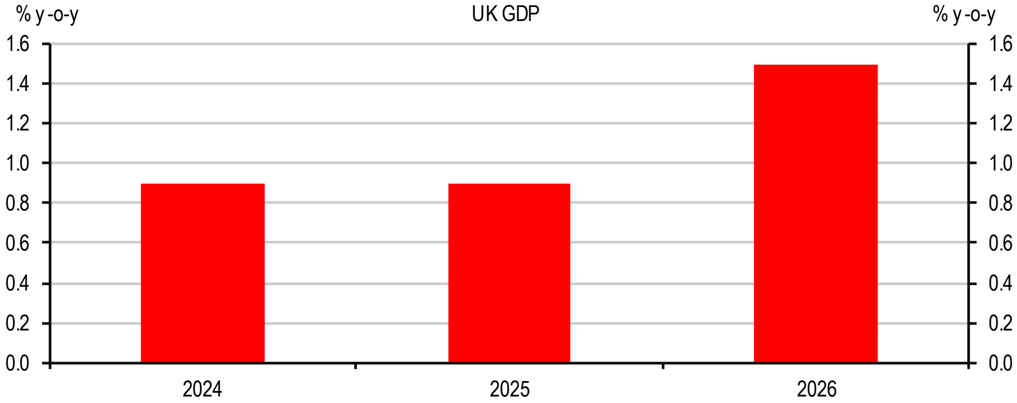
The BoE has judged that the risk of second-round inflationary effects is lower than in the last couple of years. However, uncertainty in labour market data continues to be a headache for policymakers in judging the degree to which structural factors have – and could continue to – influence domestic inflationary pressures. At the most recent monetary policy meeting (6 February 2025), the committee seemed to place greater weight on that scenario and a need to be “careful” in cutting Bank Rate. From our perspective, labour market slack is likely to continue to build over 2025, pay growth settlements should ease, while business investment and consumption growth will be modest as global uncertainty and inflationary pressures drag on activity.

1. Rise in defence spending shouldn't impact fiscal policy, for now at least



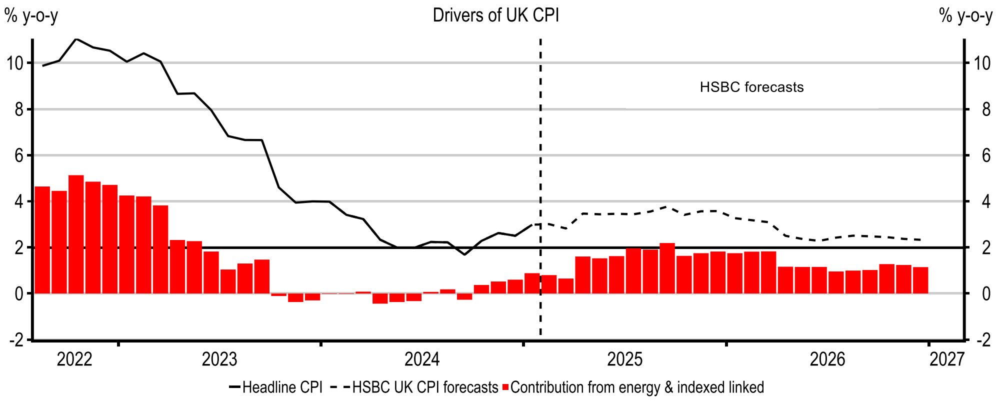
Source: Macrobond, NATO

2. GDP growth forecasts for 2025 downgraded after a weak 2024…



Source: Macrobond, ONS, HSBC forecasts

3. …and inflation forecasts raised, although almost entirely driven by external shocks



Source: Macrobond, ONS, HSBC forecasts

Disclosure appendix

Important disclosures

1 This report is dated as at 04 March 2025.

2 All market data included in this report are dated as at close 03 March 2025, unless a different date and/or a specific time of day is indicated in the report.

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