

# UK in Focus

## Economics United Kingdom

### Fiscal challenges still in the spotlight

- ◆ Fiscal spotlight continues to shine bright amid policy changes
- ◆ Inflation and labour market data are on track to help deliver a BoE rate cut in August
- ◆ Businesses and households are under considerable pressure

#### One year on

The government has been in office for one year and while a lot has changed for the global and UK economies, the intense spotlight on UK public finances has not. The 12 June Spending Review highlighted the difficult trade-offs required against a backdrop of limited fiscal wriggle room. In order to keep commitments to boost funding for the NHS and raise defence spending to 2.6% of GDP by 2027, other departments are set to see real-term cuts from 2026-27.

However, since then, spending commitments have continued to be announced. Alongside NATO allies, the UK has committed to raise defence spending to 5.0% of GDP by 2035. Within that, core defence expenditure has a 3.5% of GDP target at a cost of an additional GBP30bn a year by 2035 (chart 1), a headache for the next government. While 1.5% on “security and resilience” by 2027 would suggest that that funding will come from departmental budgets already set out at the Spending Review, rather than additional funds. Elsewhere, partial policy U-turns on welfare spending cuts and winter-fuel payments erode the small fiscal headroom ahead of the next Autumn Budget.

#### UK economy muddles through

At the latest Bank of England policy meeting in June, the committee voted to leave rates unchanged at 4.25%. The meeting minutes pointed to the need to see further progress in the disinflationary process for rate cuts to continue. Indeed, despite the recent acceleration in headline CPI to 3.4% y-o-y, it was in line with expectations and underlying inflationary pressures appear to have eased. Services inflation slowed, wage growth in April was slower than expected and labour markets continue to loosen. The rate of unemployment rose to a near four-year high in April, to 4.6%.

On the activity side GDP tumbled in April following a robust Q1 that was supported by unsustainable factors. For Q2, business surveys point to a muddling through in the face of a plethora of uncertainties, subdued demand and rising input costs. For services firms, the PMIs reported the greatest margin squeeze in over two years in June (chart 2). Similarly, renewed cost pressures on household budgets see reports of cutbacks, notably in food where price growth is reaccelerating. Meanwhile, the housing market, a bellwether of consumer sentiment, is yet to find any momentum after the hike in stamp duty, prolonged recovery in household budgets, and still restrictive interest rates. House price growth slowed to 2.1% y-o-y in June from 3.5% (chart 3).

#### KEY UK DATA

► **0.7%**

GDP growth in 3M to April

▼ **3.4%**

Consumer Price Inflation, May y-o-y

▲ **4.6%**

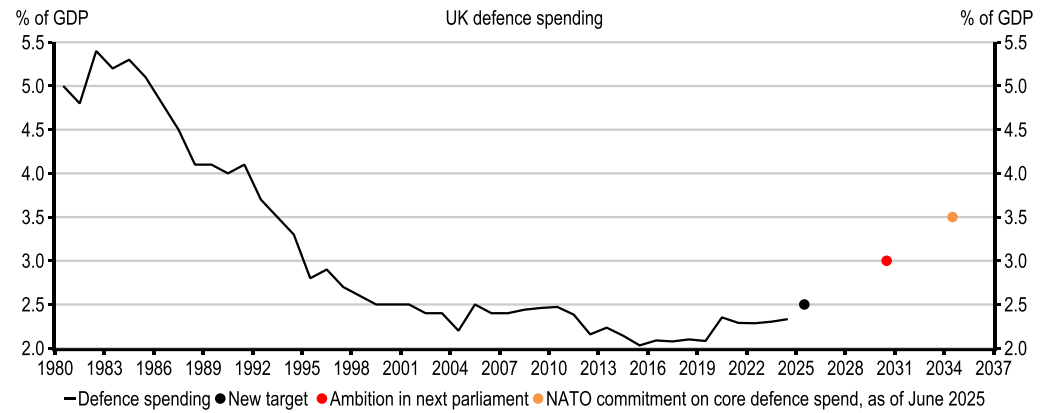
Unemployment rate, April

► **4.25%**

Bank of England Base Rate

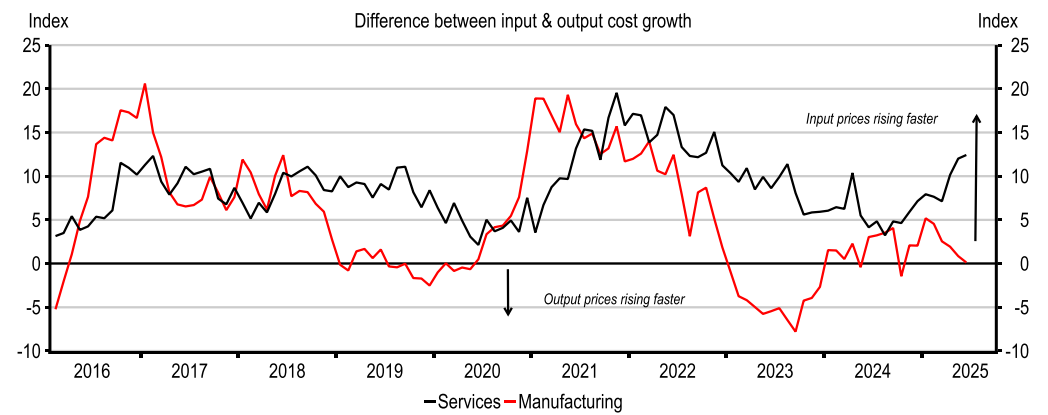
Source: HSBC

### 1. Defence spending target increased again, a headache for the next government



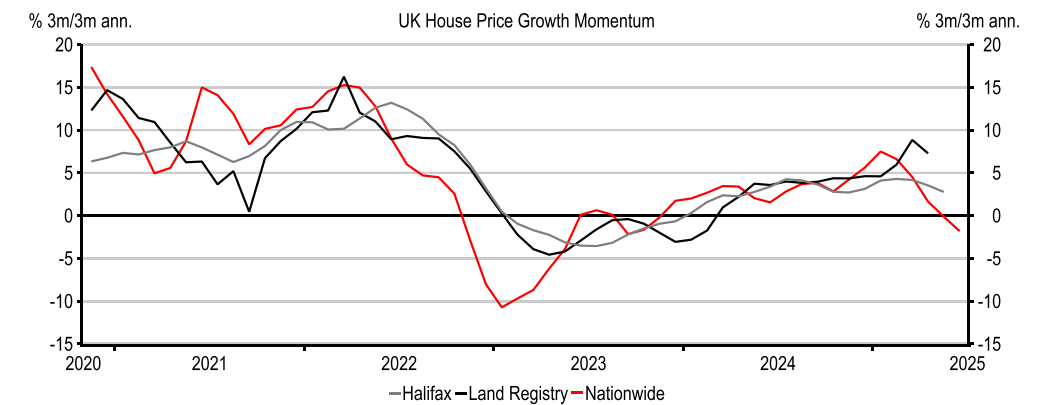
Source: Macrobond, NATO, HSBC

### 2. Margin squeeze has re-intensified for services sector firms



Source: Macrobond, S&P Global PMI, HSBC

### 3. House price momentum has slowed considerably



Source: Nationwide, Halifax, ONS, HSBC

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