

SPRING 2026 FORECAST: ANOTHER SUPPLY SHOCK HITS

KEY MESSAGES

- GDP will be flat through the middle of this year as the effects of the Middle East conflict ripple through the economy. Overall, GDP growth is expected to be 0.7% this year and 0.9% next year, as consumers and firms contend with rising energy costs, tighter financial conditions, and sustained supply chain disruption.
- It is going to be a challenging year for households. Another 250k people will become unemployed, as the jobless rate picks up by the most since the pandemic, while the direct and indirect impact of energy prices will push up inflation to around 4% by the end of the year.
- The Monetary Policy Committee will stand pat through the rest of the year, before cutting twice in the middle of next year once it has seen convincing evidence that inflation isn't sticky. Given interest rates are in restrictive territory, the 2022 playbook doesn't apply. Keeping rates unchanged will continue to weigh on economic activity, as the MPC balances building inflationary pressures and a deteriorating jobs market.
- We think that in the fullness of time the government will meet its fiscal rules. Higher inflation and pay growth will offer some support to tax revenues in the face of a weaker growth outlook, while we expect market interest rates to fall back later this year and into next.

ANOTHER SUPPLY SHOCK

The conflict in the Middle East has caused major disruption to the world economy. Beyond the Middle East, the UK is one of the countries that is most exposed to the economic consequences of the war, and it will feel the effects of another supply shock.

Reduced access to the Strait of Hormuz has dislocated supply chains, extensive damage to critical infrastructure has put upwards pressure on energy prices, while financial conditions are much tighter than they were at the start of the year. It's clear that these factors will hurt the UK's growth outlook and stoke inflation. But how big will these effects be? And what might they mean for decision makers at the Bank of England and the Treasury?

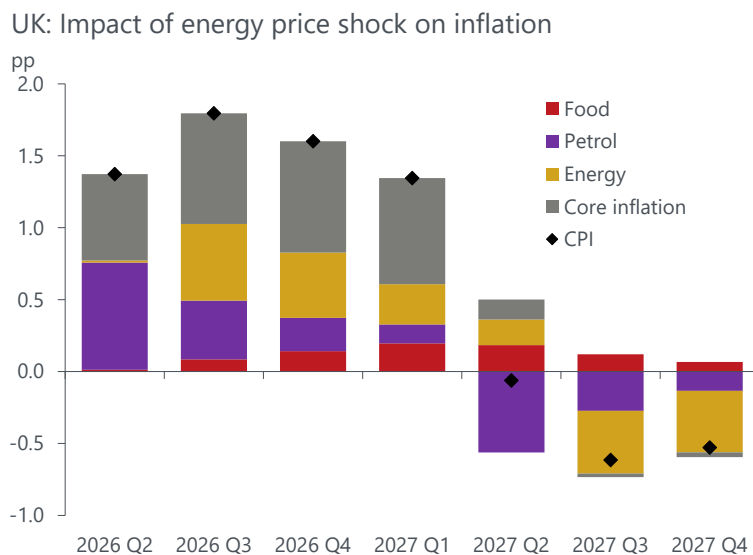
SHARP RISE IN ENERGY COSTS WILL CAUSE INFLATION TO SPIKE

It has been no secret that the disruption in the Middle East has caused energy prices to pick up significantly. Throughout February, the price of a barrel of oil was around \$69. That has since surged more than 46% to sit at around \$100, although there has been significant volatility from day-to-day. While the recent ceasefire may indicate the most significant military escalations are off the table for the time being, disruption to energy production and supply chains will persist for a sustained period. We expect oil to remain around \$100 per barrel through Q2 into Q3. The immediate effect of energy prices is already starting to show up in the price of fuels at the pump. Petrol prices have risen by close to 20% while diesel prices have picked up by more than 30%. By itself, higher pump prices will push up headline inflation by 0.5pp in April.

But it's not only the price of oil that has shot up; natural gas prices have also skyrocketed. But this does not impact consumer prices as quickly, as it will take time to be reflected in the Ofgem price cap that is used to determine households' energy bills. In July households will start to feel the pinch when the price cap is reset, jumping 13% to an annualised rate of almost £1,900 for the average household.

It's not only the direct effects of the energy price surge that will impact prices; the indirect effects will also be significant. Businesses have already reported that energy costs and a shortage of certain goods are impacting input costs. We expect these pressures to be reflected in the prices on the shelves, with goods prices inflation being around 0.4pp higher in Q3 and Q4 than a counter-factual of no energy price rises (**Chart 1**).

Chart 1: Impact of higher energy prices on inflation forecast



Sources: ITEM Club

Businesses in the services sector will also feel pressure from rising costs and cause some stickiness in services inflation. As [Bank of England analysis](#) has shown, these companies also feel the effect of rising energy prices. While earnings growth is expected to remain around 3¼% throughout the rest of this year, despite a deteriorating jobs market and the supply shock weighing on GDP growth.

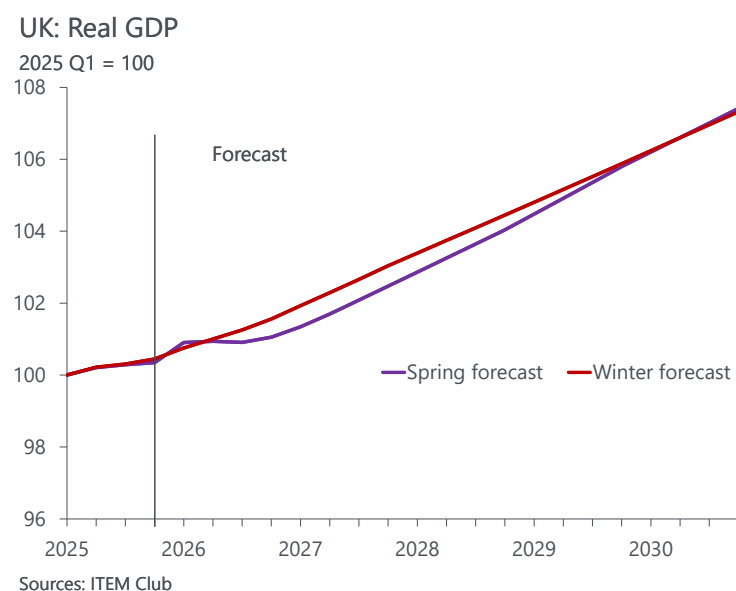
Inflation is set to pick up from Q2 and rise further in the second half of the year as the full effects of rising wholesale prices are passed through to energy bills and the prices on the shelves. We estimate inflation to have been 3.0% in Q1 and on a downwards trajectory. But we think inflation will rise to 3.4% in Q2 before heading higher to 3.9% in Q3 and 3.7% in Q4. Having averaged 3.5% through this year, we do forecast inflation to gradually fall back to 2% by the end of next year, with no significant, lasting effects from another bout of above target inflation beyond that. Inflation is predicted to be 2.3% in 2027 and 2% from there on.

VERY LITTLE GROWTH THIS YEAR

The UK looks set for another couple of years of sub-trend growth, with GDP growing by 0.7% this year and by 0.9% in 2027, compared to 1.4% in 2025.

The UK is likely to flirt with a technical recession in the middle of this year. February saw a big jump in GDP, suggesting that the economy made a strong start to the year. But this needs to be taken with a pinch of salt. Since 2022, residual seasonality within official activity estimates has led GDP to be too optimistic early in the year and too pessimistic later in the year. That's even before the effects of the conflict in the Middle East start to bite. And from the middle of the year, we expect demand to go sideways with no growth in either Q2 and Q3, as squeezed households and businesses pull back on spending. Activity is expected to improve gradually from the turn of the year, but it will take some time to get back on course and the economic effects of the conflict could still be being felt into 2027 (**Chart 2**).

Chart 2: Energy price rises will hit activity in the near-term, but activity will eventually catch up



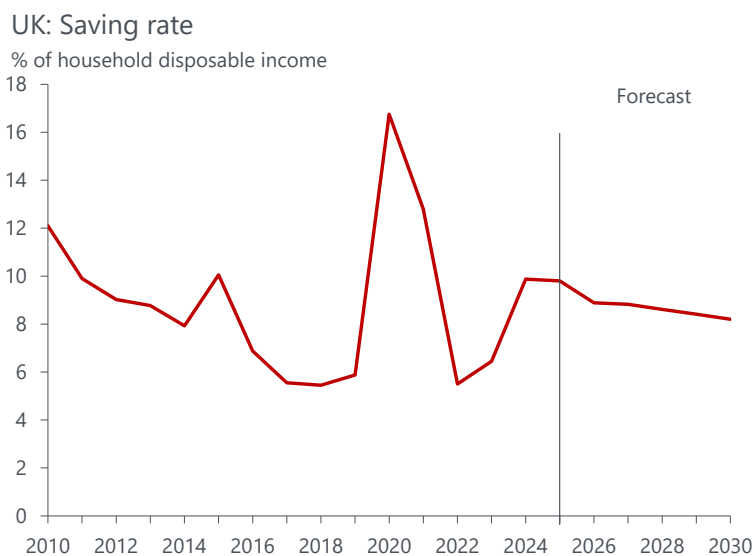
HARD TIME FOR CONSUMERS AND COMPANIES

The combination of a jump in inflation and a loosening labour market will put the brakes on households' real income growth. Having grown by 1.1% in 2025, we expect real income to fall by -0.3% in 2026 before

picking up by a modest 0.5% in 2027. Households will cushion some of the weakness in spending power by saving less, with the saving rate expected to fall from 9.8% in 2025 to 8.9% in 2026 (**Chart 3**).

Nonetheless, consumer spending growth is expected to slow from 1% in 2025 to 0.6% in 2026 and 2027.

Chart 3: The saving rate will cushion a little bit of the squeeze on real incomes



The picture is equally difficult for the corporate sector. Since the conflict, financial conditions have tightened significantly as financial markets have moved to price in interest rate hikes, while yields on government debt have risen. And at the same time as the cost of new and existing finance rising, businesses are grappling with higher input costs. With a layer of geopolitical uncertainty on top we expect firms to pull back on their capex plans this year. We forecast business investment to fall by 1.6% this year before gradually recovering to rise by 0.5% next year.

The housing market looks like it will go through a soft patch over the next couple of years. Financial markets shift to price out interest rate cuts has put upwards pressure on mortgage rates and will undo some of the improvements in affordability that we've seen in recent years. While rising inflation and a deteriorating jobs market will weigh on housing demand. We expect house prices to increase by a little over 1% this year and by 0.8% in 2027.

UNEMPLOYMENT TO RISE FURTHER

A year long soft patch will translate into rising joblessness. Consistent issues with the Labour Force Survey have made getting a clear read on the labour market difficult over the last couple of years. But, taken at face value, it points to a clear loosening in the jobs market, with the unemployment rate rising from below 4% at the end of 2023 to 5.2% at the end of last year.

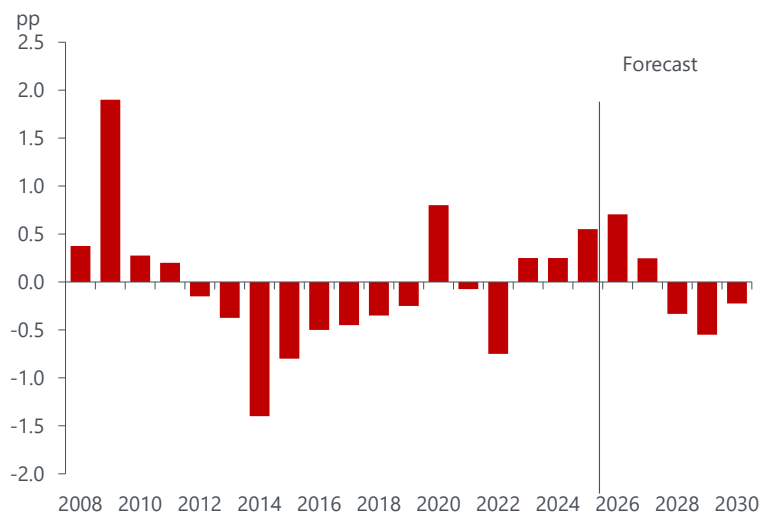
From the middle of 2026, the jobs market is likely to move into a less benign loosening phase. Over the last couple of years, the rise in the unemployment rate has reflected two factors occurring simultaneously. Businesses have reduced their hiring rate, while at the same time the number of people participating in the labour market has increased. Companies are yet to have made large scale layoffs. But we think this is about

to change. As growth flatlines, we expect the unemployment rate to rise without an accompanying rise in job market participation.

We think that the unemployment rate will peak at 5.8% in the middle of next year. To put this increase in context, it's still a lot smaller than the pickup in the Global Financial Crisis, when unemployment topped 8%. But it does mean that another 250k people could be without jobs as the unemployment rate rises at the fastest rate since the onset of the pandemic (**Chart 4**).

Chart 4: This year will see the largest rise in the unemployment rate since the pandemic

UK: Change in the unemployment rate

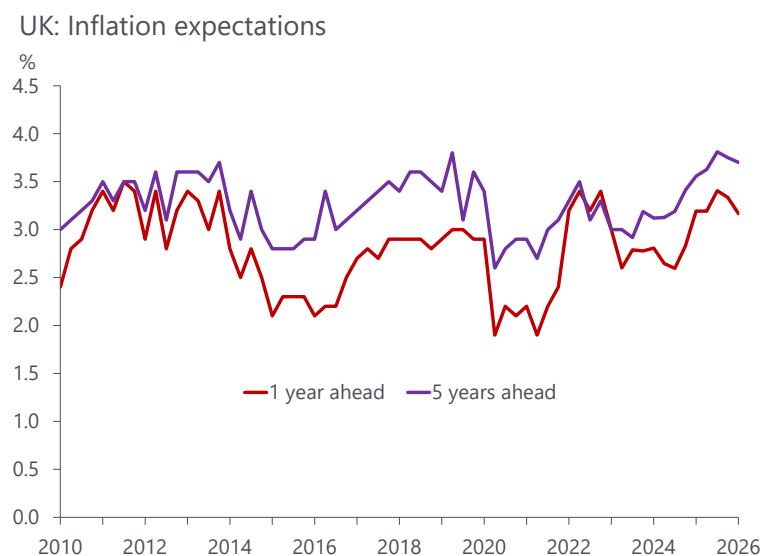


Sources: ITEM Club

BOE ON HOLD FOR THE REST OF THIS YEAR

We expect the Monetary Policy Committee to leave interest rates unchanged at 3.75% for the rest of this year and well into next.

The Committee has long been clear that it intends to set policy to balance the risks from persistent inflation and a fragile labour market, and the conflict in the Middle East has only made this dilemma more acute. Inflation is set to rise to around 4% by the end of the year and inflation expectations are already responding to higher energy prices, so it will want to make sure it squeezes out any inflation persistence before cutting interest rates (**Chart 5**). But with the unemployment rate set to peak at its highest rate in more than a decade, the Committee will want to make sure it tackles inflation in the way that does least harm to near-term growth prospects.

Chart 5: UK inflation expectations have remained high in recent years

Sources: ITEM Club, Haver Analytics

Nevertheless, we do not think that the 2022 playbook applies to this particular energy shock. Interest rates are much higher now than they were at the onset of the Russia-Ukraine conflict, when they were just above zero. Monetary policy is currently restrictive, so even by keeping interest rates unchanged the MPC is still leaning on activity. A much looser labour market means workers have less bargaining power, while a weak demand environment might limit the ability of firms to pass on higher costs.

There are some more interest rate cuts left in the pipeline. But they won't be on the agenda until the middle of next year. With inflation expected to fall back and with the unemployment rate likely to peak around levels last seen in 2014, when the UK was recovering from the effects of the Global Financial Crisis, we expect interest rates to be cut back to 3.25% in 2027.

GOVERNMENT TO MEET ITS FISCAL RULES

Based on our forecast, the government will meet its primary fiscal rule of only borrowing to invest by a similar amount to the OBR's Spring Forecast. Though we now expect weaker GDP growth, much of the impact on borrowing is offset by higher inflation, and our forecast for pay being stronger than the OBR's. We also expect bond yields to decline after this year, with the yield on a 20-year bond dropping from over 5% to 4.1% by the end of next year.

Nonetheless, if the conflict rumbles on until the Autumn then it may bring some of the tough fiscal decisions facing the government back into the spotlight. The [OBR has previously estimated](#) that a conflict in the Middle East that causes a 75% jump in wholesale oil and gas prices could increase borrowing by a little under £25bn, on average, over a five year period. We have yet to see moves in commodity prices of this magnitude, but the analysis highlights that there is the risk that the combination of a weaker real growth outlook and higher market interest rates could still lead the watchdog to take a chunk out of its estimates of the government's headroom against its fiscal rules.

If the OBR again judge there's a wafer-thin margin for error against the fiscal rules, the government would be faced with a big call. One option would be to run with a fiscal framework that would almost certainly be

viewed by financial markets as less credible. Alternatively, they could look to make further reductions to already stretched spending totals or make further tax rises. Departmental spending totals are already set out to 2028-2029, while last year's Budget assumed a sharp real terms fall in spending in 2029-2030, the target year for the fiscal rules. So, it seems the government would have to fall back on either making cuts to major spending promises – for example on healthcare spending – or break manifesto pledges around raising taxes.

The ITEM Club forecast for the UK Economy, Spring 2026

% changes on previous year except borrowing, current account and interest & 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	1.6	-0.2	1.8	1.3	2.7
2025	1.4	2.0	1.0	4.3	2.1	4.1
2026	0.7	0.5	0.6	1.3	0.7	0.1
2027	0.9	0.9	0.6	1.7	0.6	0.6
2028	1.5	1.5	1.6	1.4	1.6	1.5
2029	1.6	1.6	1.8	1.1	1.6	1.6
2030	1.6	1.6	1.8	1.5	1.6	1.6

	Net Govt Borrowing(*)	Current account (% of GDP)	Average earnings	CPI	Bank Rate	Effective exchange rate
2023	4.9	-3.6	7.1	7.3	4.7	80.5
2024	5.2	-3.0	5.4	2.5	5.1	83.6
2025	4.8	-2.5	4.4	3.4	4.3	84.7
2026	4.4	-2.4	3.2	3.5	3.8	84.2
2027	3.4	-2.1	2.9	2.3	3.6	84.1
2028	2.8	-1.7	2.8	2.0	3.3	84.1
2029	1.7	-1.6	2.9	2.0	3.3	84.1
2030	1.6	-1.5	2.9	2.0	3.3	84.1

(*) Fiscal years, as % of GDP

Source: ITEM Club