Andrew Bailey: The UK economy in an unpredictable world

Speech by Mr Andrew Bailey, Governor of the Bank of England, at the British Chamber of Commerce's Global Annual Conference, London, 26 June 2025.

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There is a lot going on in the world around us. Escalation of the conflict in the Middle East drove up energy prices in the past few weeks but in the last few days they have come back down again. Global trade policies remain unpredictable. These are things that weigh on the global economy.

Elevated global uncertainty affects UK businesses too. We have heard that clearly through the Bank's Agents – and I have heard it when I talk to business leaders from across the country. Expectations for export sales have softened, investment decisions have been delayed, and supply chains adjusted – though on investment the messages delivered by the Prime Minister from this stage a few hours ago are positive and welcome news.

While I am on the subject of world developments, I visited Kyiv last Friday at the invitation of the Ukrainian National Bank. The experience was humbling. The moral case is clear: as a nation, Ukraine has the right to determine its own future. And that is what Russia does not accept. I strongly agree with successive UK Governments that we must give our full support to Ukraine on this. The strands of history run deep here, and it is our security that is at stake too. The moral argument is unassailable.

But there is more to the story for the UK economy then global events, and for the Monetary Policy Committee's decisions on interest rates. It is the wider developments in the domestic UK economy that matter, and that is what I will focus on today.

I will start with some background of relevance for the theme of this conference, before turning to the outlook for activity, inflation and monetary policy.

That background, I'm afraid, is one of slowing potential growth in the UK economy in recent decades. By Bank staff estimates, average annual growth rates in potential supply in the UK economy was above 2½% in the years from 1990 and up to the global financial crisis. In the decade after the financial crisis, it halved to around 1¼%. This is not a very good start to the story, although of course history does not dictate what happens in the future.

Slower potential supply growth reduces the rate at which economic activity can expand without generating inflationary pressures. Monetary policy has to respect this constraint; a temptation to boost growth by stimulating demand in an environment where supply is constrained would be both ineffective and counterproductive. Achieving price stability, by contrast, creates the environment that is supportive for sustainable growth.

Raising the potential growth rate of the economy is one of the most important challenges facing us as a society today.[1] It is the only source of sustainable improvements to the standard of living. And it is key to addressing other big challenges we face – dealing with an ageing society, enhancing our defence capabilities, and responding to climate change. To do so we need to harness new technologies, invest in new skills in the labour force and build new trading relationships with the outside world.

Artificial Intelligence has the potential to be the next General Purpose Technology – like for example electricity before it – and could catalyse innovation and growth across the economy. That is an opportunity we must not miss.

Innovative and outward-looking UK businesses are essential to those efforts. After all, that is where the growth will come from. I am encouraged by the entrepreneurial spirit I meet as I travel with the Bank's Agents to visit companies and talk to business leaders. You never quite know what to expect on these visits, whether it is AI-supported street sweepers, quantum computing in space, or a business idea that appealed to me – how to get bikes onto the top of cars more easily to transport them. And it is encouraging to see business leaders from across the UK come together at this conference to seek practical, forward-looking solutions. I would like to thank you, Shevaun, and the British Chambers of Commerce for the leadership you provide.

Growth also requires strong institutions and public policies to provide a supportive environment. I welcome the Government's strong commitment to growth and its initiatives to strengthen the UK's relations to our trade partners. The Prime Minister's messages this morning were very positive and welcome news, setting out a course that can unleash further investments that will make a real difference to the UK economy.

The Bank of England has a role to play too, with our strong commitment to monetary and financial stability. These are important foundations for growth and prosperity.

So let me turn to the outlook for activity, inflation and monetary policy as we see it today.

The UK economy grew by 1.1% in 2024 when compared to 2023 overall, and by 1.5% when comparing the fourth quarter of 2024 with the fourth quarter of 2023. And while growth was weak in the second half of last year, it had a strong start to 2025 with 0.7% quarterly growth reported for the first quarter in the ONS's First Estimate. This is a bit stronger than we had expected in our May Monetary Policy Report – and by itself would raise the prospect that growth could turn out a bit stronger than we had been expecting in the second quarter too. So far so good.

But there are a couple of reasons why we think the UK economy will grow at a more moderate pace over the coming quarters.

First, the unexpected strength in the first quarter was driven by strong outcomes for volatile components of GDP in the monthly figures for March. This was possibly a result of front-loading of activity ahead of increases in Stamp Duty Land tax and Vehicle Exercise Duty, and with a temporary boost to trade ahead of the imposition of new tariffs on exports to the United States. Consistent with this, monthly GDP contracted by 0.3% in April.

Second, looking at the expenditure components of GDP, while business investment was strong in the first quarter, businesses tell us that heightened uncertainty and a weak demand outlook are weighing on investment intentions. That could point to slower investment over coming months – although how it pans out remains to be seen, and again I was encouraged by what the Prime Minister had to say earlier. And, while real household incomes have risen quite strongly, consumption has not followed suit. The household savings rate, in other words, has gone up – and to quite a high level compared to past experience. We have not seen evidence yet to indicate any decline in the saving rate, with the implications that carries for consumption.

We should not be too surprised about this. Monetary policy remains restrictive to ensure that past inflationary pressures are squeezed out, with higher interest rates incentivising saving over consumption. And households are likely to smooth through rises in their real incomes following previous increases in the cost of living. This is consistent with what respondents to our annual household survey have told us. In our most recent survey from March, 27% say that higher interest rates was a reason why they had saved more than usual over the past year, and just over one-third reported having rebuilt their buffer of savings for a rainy day.

The labour market has been very tight in the past few years. But we are now seeing signs that conditions are easing. Employment growth is subdued, and several indicators of labour demand and hiring intentions have softened. Real time data from HMRC suggest that the number of payrolled employees fell by 0.4% in the three months to May, and have now fallen in each of the last 7 months, with a contraction of more than 100,000 people on the month. These data are often revised in later vintages, but survey-based measures and intelligence from the Bank's Agents corroborate the pattern of continued loosening.

That takes me to pay. We watch this very carefully. Wage growth remains an important factor behind the remaining persistence in services price inflation in particular. A sustainable disinflation in the UK economy after the big shocks we have faced relies on a normalisation of wage growth to levels consistent with the 2% inflation target.

This process still has some way to go. Annual private sector regular average weekly earnings (AWE) growth was 5.1% in the three months to April, down from 5.9% in the three months to January, having risen in the second half of last year. That said, AWE measures are reducing much as we have been expecting, and momentum in the latest data has softened. The latest data on pay settlements and pay expectations point to a significant decline in wage growth in the year ahead. The latest intelligence from the Bank's Agents continue to suggest average pay settlements for 2025 of 3.5 to 4.0%, closer to levels consistent with the inflation target.

What we are ultimately concerned about is the extent to which easing pay pressures feed through to consumer price inflation. So let me turn to inflation.

Headline CPI inflation fell sharply through 2023 and into 2024, before reaching the 2% target towards the middle of last year. This year inflation has taken a step up again, to 3.4% in the latest data for May, and we expect it to remain around 3.5% at least into the Autumn before returning to back towards our 2% target next year.

Against the backdrop of a continued gradual easing of price pressures in the UK economy, thanks to the restrictive stance of monetary policy, this increase in CPI inflation has owed largely to increases in energy prices and other regulated and administered prices, such as water bills and Vehicle Excise Duty. Household energy prices contributed around a quarter of a percentage point to headline CPI inflation in May, and other regulated and administered prices added a little under half a percentage point.

The important point is that these price increases are not directly linked to underlying cost pressures in the UK economy – to the balance between aggregate demand and aggregate supply – in a way that would clearly require a monetary policy response. We should not expect them to persist. And we do not expect that they will rekindle domestic inflationary pressures via new second-round effects as we saw it after the big global shocks that drove inflation up to much higher levels in 2021 and 2022.

A key difference to that episode is that – as I have just described – conditions in the UK labour market are very different now compared to the very tight labour market we had then.

But we should recognise that this short-term pick-up in inflation introduces some further uncertainty into the near-term outlook for inflation. So we have to monitor very closely how this plays out. Some of the regulated and administrative prices could change again. And we have to ensure that second-round effects do not take hold.

Also on our watch list is food price inflation, which has risen materially, from 3.0% to 4.4% in May. The prices of meat, chocolate and non-alcoholic drinks have gone up the most, consistent with higher wholesale prices for beef, cocoa beans and coffee. These price increases are to an extent idiosyncratic, with reports of reductions in cattle herds and climate-related disruptions to coffee and cocoa production. But our Agency intelligence also highlights labour costs and costs related to new packaging regulation as wider factors at play. And, like energy prices, food prices are salient to consumers. We have to make sure that these increases do not feed through to second-round effects either. Although they have fallen back in the latest data, household inflation expectations have been increasing somewhat recently and remain at the upper end of the range that we would normally expect given the level of headline inflation.

As we look ahead, however, it is not least the evolution of services price inflation that will determine headline inflation – and service price inflation, more than goods price inflation, is affected by costs pressures in the UK economy, including pay. The overall picture here is that services price inflation is coming down gradually. But services price inflation remains elevated, at 4.7% in the latest data for May. We need to see disinflation continue – and that easing pay pressures feed through to consumer prices.

I will add a short remark on the increase in employer National Insurance Contributions. There are a number of ways this increase in the cost of employment could play out: it could be absorbed by firms, either in lower profit margins or through productivity improvements; it could be passed on to customers through higher prices; it could be reflected in lower wages; or it could lead firms to reduce employment. When we ask businesses, they tend to tick all the boxes. That is understandable. Firms' margins are the first to adjust. But I am beginning to hear a bit more evidence of adjustments through pay and employment.

With moderate growth and a softer labour market, a wider margin of slack in the UK economy will support continued disinflation in the domestic economy and a gradual return of headline inflation to the 2% target as we look beyond the near-term increase. In recent months, the evidence that slack is opening up has strengthened, especially in the labour market. But there remain uncertainties around the overall balance between supply and demand in the economy as well as the remaining inflation persistence in the system.

In the May Monetary Policy Report, we presented two scenarios to illustrate this. In one scenario, there could be weaker supply and more persistence in domestic wages and prices, including from second-round effects related to the near-term increase in CPI inflation and structural changes in the labour market. In another scenario, inflationary pressures could ease more quickly owing to greater or longer-lasting weakness in demand relative to supply, in part reflecting uncertainties globally and domestically. The mechanisms underlying both these scenarios remain relevant to our deliberations on the MPC, set alongside our broader assessment of risks.

And global risks are of course among them, including but not restricted to trade policy. Global uncertainty remains elevated. So while the direct impact from trade policies on world output may be smaller than we might have feared, the uncertainty associated with it nevertheless continues to have an impact on the UK economy. There have been significant moves in the oil price following the escalation of the conflict in the Middle East, although not always in the direction we may intuitively have expected. That only goes to show the unpredictability of events in the world today.

Overall, while the significant progress we have made on disinflation has allowed us to cut Bank Rate, we retain a restrictive monetary policy stance to squeeze out remaining persistence in inflationary pressures. There remain two-sided risks to inflation. Given the outlook, and continued disinflation, a gradual and careful approach to the further withdrawal of monetary policy restraint remains appropriate. Interest rates remain on a gradual downward path. But monetary policy is not on a pre-set path – and at the June meeting, there was not a strong enough case to cut Bank Rate.

As we meet for our August meeting in a few weeks' time, we will assess the situation afresh. Monetary policy needs to continue to remain restrictive for sufficiently long until the risks to inflation returning sustainably to the 2% target in the medium term has dissipated further.

In an unpredictable world, low and stable inflation matters more than ever, because that – alongside the supportive initiatives being pursued by the Government – enables businesses and households to plan ahead and invest, a key foundation for sustainable growth in the UK economy.

Low and stable inflation is the best contribution monetary policy can make to growth and prosperity in the United Kingdom.

Thank you.

I would like to thank Hassana Babangida, Sarah Breeden, Julia Giese, Karen Jude, Huw Pill, Dave Ramsden, Andrea Rosen, Victoria Saporta, Martin Seneca, Michal Stelmach, James Talbot and James Walkington for their comments and help in the preparation of these remarks.

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[1] See Growth: What does it take in today's world? - Lecture by Andrew Bailey | Bank of England