Bank of England

# Monetary Policy Report

**Monetary Policy Committee**
August 2025

# Monetary policy at the Bank of England

## The objectives of monetary policy

The Bank's Monetary Policy Committee (MPC) sets monetary policy to keep inflation low and stable, which supports growth and jobs. Subject to maintaining price stability, the MPC is also required to support the Government's economic policy.

The Government has set the MPC a target for the 12-month increase in the Consumer Prices Index of 2%.

The 2% inflation target is symmetric and applies at all times.

The MPC's **remit** recognises, however, that the actual inflation rate will depart from its target as a result of shocks and disturbances, and that attempts to keep inflation at target in these circumstances may cause undesirable volatility in output. In exceptional circumstances, the appropriate horizon for returning inflation to target can vary. The MPC will communicate how and when it intends to return inflation to the target.

## The instruments of monetary policy

The MPC currently uses two main monetary policy tools. First, we set the interest rate that banks and building societies earn on deposits, or 'reserves', placed with the Bank of England – this is Bank Rate. Second, we can buy government and corporate bonds, financed by the issuance of central bank reserves – this is asset purchases or quantitative easing.

## The Monetary Policy Report

The MPC is committed to clear, transparent communication. The Monetary Policy Report (MPR) is a key part of that. It allows the MPC to share its thinking and explain the reasons for its decisions.

The Report is produced quarterly by Bank staff under the guidance of the members of the MPC.

This Report has been prepared and published by the Bank of England in accordance with section 18 of the Bank of England Act 1998.

## The Monetary Policy Committee

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- Sarah Breeden
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- Megan Greene
- Clare Lombardelli
- Catherine L Mann
- Huw Pill
- Dave Ramsden
- Alan Taylor

PowerPoint™ versions of the Monetary Policy Report charts and Excel spreadsheets of the data underlying most of them are available at **http://www.bankofengland.co.uk/monetary-policy-report/2025/august-2025**.



ISSN 2633-7819

## Contents

# Monetary Policy Summary

The Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. The MPC adopts a medium-term and forward-looking approach to determine the monetary stance required to achieve the inflation target sustainably.

At its meeting ending on 6 August 2025, the MPC voted by a majority of 5–4 to reduce Bank Rate by 0.25 percentage points, to 4%, rather than maintaining it at 4.25%.

There has been substantial disinflation over the past two and a half years, following previous external shocks, supported by the restrictive stance of monetary policy. That progress has allowed for reductions in Bank Rate over the past year. The Committee remains focused on squeezing out any existing or emerging persistent inflationary pressures, to return inflation sustainably to its 2% target in the medium term.

The path of disinflation in underlying domestic price and wage pressures has generally continued, albeit to different degrees. Twelve-month CPI inflation increased to 3.5% in 2025 Q2, owing to developments in energy, food and administered prices. Pay growth remains elevated, but has declined further recently, and is still expected to slow significantly over the rest of the year. Services consumer price inflation has been broadly flat over recent months. The Committee continues to be vigilant about the extent to which easing pay pressures will feed through to consumer price inflation.

CPI inflation is forecast to increase slightly further to peak at 4.0% in September. Inflation is expected to fall back thereafter towards the 2% target, although the Committee remains alert to the risk that this temporary increase in inflation could put additional upward pressure on the wage and price-setting process. Overall, the MPC judges that the upside risks around medium-term inflationary pressures have moved slightly higher since May.

Underlying UK GDP growth has remained subdued, consistent with a continued, gradual loosening in the labour market. A margin of slack is judged to have emerged in the economy. Downside domestic and geopolitical risks around economic activity remain, although trade policy uncertainty has diminished somewhat.

At this meeting, the Committee voted to reduce Bank Rate to 4%. A gradual and careful approach to the further withdrawal of monetary policy restraint remains appropriate. The restrictiveness of monetary policy has fallen as Bank Rate has been reduced. The timing and

pace of future reductions in the restrictiveness of policy will depend on the extent to which underlying disinflationary pressures continue to ease. Monetary policy is not on a pre-set path, and the Committee will remain responsive to the accumulation of evidence.

# 1: The economic outlook

The path of disinflation in underlying domestic price and wage pressures has generally continued, albeit to different degrees (Key judgement 1). Wage growth has declined further recently, to around 5% in May, although services consumer price inflation has remained at 4.7% in recent months. Twelve-month CPI inflation averaged 3.5% in 2025 Q2, 0.1 percentage points higher than expected in the May Report and an increase from 2.8% in Q1. Around half of this rise was accounted for by an expected reduction in the extent to which energy prices have been dragging on headline inflation. The contribution of administered prices to inflation has increased, while food price inflation has also picked up by more than anticipated. While headline inflation is projected to rise slightly further in the near term, to around 3¾% over the second half of this year, the baseline projection assumes that this will not lead to additional second-round effects on domestic inflationary pressures.

Four-quarter GDP growth is projected to remain close to its recent average level, of around 1¼%, before picking up in the second half of the forecast period. This remains dependent on a sustained fall in the household saving ratio. A margin of spare capacity is estimated to have opened up in the UK economy and the labour market is continuing to loosen gradually. This margin of excess supply is expected to build a little further, before narrowing from the end of next year onwards (Key judgement 2). A range of factors are expected to reduce spare capacity further out, including the impact on demand of the gradual loosening in the stance of monetary policy embodied in the market path of interest rates. Monetary policy still weighs on the level of demand across the forecast period, however, such that it continues to contribute to the disinflationary process.

The margin of spare capacity in the economy is expected to act against some continuing persistence in domestic prices and wages in order for CPI inflation to fall back to around the 2% target in the medium term (Key judgement 3). The August CPI projection is somewhat higher than the profile in May during the first and second years of the forecast period, and broadly similar in the medium term. There remains considerable uncertainty around the calibration of the Committee’s judgement on the path of second-round effects in domestic prices and wages. Overall, the MPC judges that the upside risks around medium-term inflationary pressures have moved slightly

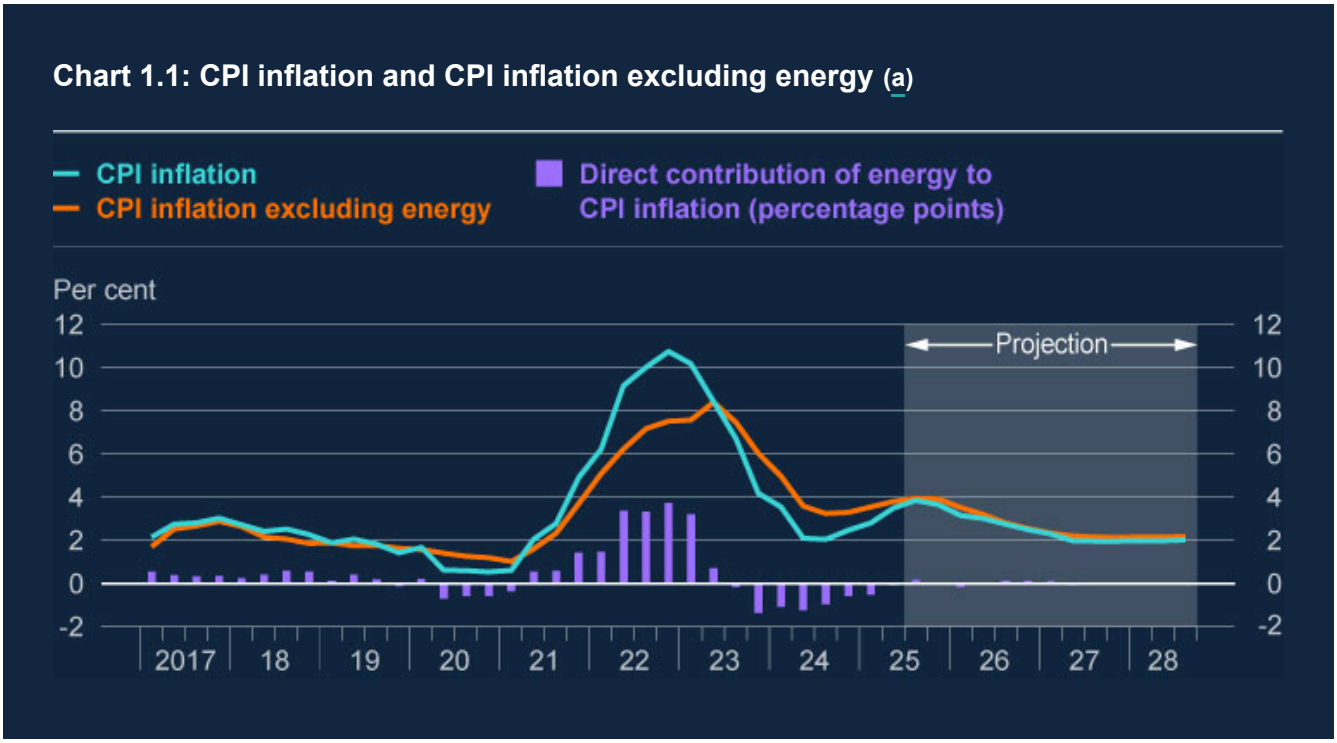
higher since May. This is in part due to the risk of inflation expectations impacting price-setting as illustrated in the inflation persistence scenario set out in the May Report.

### Table 1.A: Baseline forecast summary (a) (b)

| | 2025 Q3 | 2026 Q3 | 2027 Q3 | 2028 Q3 |
|---|---|---|---|---|
| GDP (c) | 1.2 (1.1) | 1.3 (1.3) | 1.5 (1.6) | 1.7 |
| CPI inflation (d) | 3.8 (3.5) | 2.7 (2.4) | 2 (1.9) | 2 |
| Unemployment rate (e) | 4.8 (4.6) | 4.9 (4.9) | 4.8 (5) | 4.8 |
| Excess supply/**Excess demand** (f) | -½ (-½) | -¾ (-¾) | -¼ (-¾) | 0 |
| Bank Rate (g) | 4.1 (4) | 3.5 (3.5) | 3.6 (3.6) | 3.7 |

(a) Figures in parentheses show the corresponding projections in the May 2025 Monetary Policy Report.
(b) The numbers shown in this table are conditioned on the assumptions described in Section 1.1.
(c) Four-quarter growth in real GDP.
(d) Four-quarter inflation rate.
(e) International Labour Organization (ILO) definition of unemployment. Although LFS unemployment data have been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D of the **May 2024 Monetary Policy Report**).
(f) Per cent of potential GDP. A negative figure implies output is below potential and a positive that it is above.
(g) Per cent. The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.

**Chart 1.1: CPI inflation and CPI inflation excluding energy (a)**




Sources: Bloomberg Finance L.P., ONS and Bank calculations.

(a) Energy prices include fuels and lubricants, electricity, gas and other fuels.

## 1.1: The conditioning assumptions underlying the MPC's baseline projections

As set out in Table 1.B, the MPC's August baseline projections are conditioned on:

- The paths for policy rates in advanced economies implied by financial markets, as captured in the 15 working day averages of forward interest rates to 29 July (Chart 2.3). The market-implied path for Bank Rate underpinning the August projections declines to 3½% by 2026 Q2, similar to the profile at the time of the May Report.
- A path for the sterling effective exchange rate index that is around ¾% higher compared with the May Report. The exchange rate depreciates slightly over the forecast period, reflecting the role of expected interest rate differentials in the Committee's conditioning assumption.
- Wholesale energy prices that follow their respective futures curves over the forecast period. Oil and gas prices have ended the period since May slightly higher than their levels at the time of the previous Report (Section 2.1). Significant uncertainty remains around the outlook for wholesale energy prices (Box D).
- UK household energy prices that move in line with Bank staff estimates of the Ofgem price cap implied by the paths of wholesale gas and electricity prices (Section 2.5).

- UK fiscal policy that evolves in line with government policies to date, as announced in Spring Statement 2025.
- Global and UK trade policies in place as of 29 July, which are consistent with a somewhat lower US effective tariff rate than at the time of the May Report (Section 2.1). These policies are assumed to continue throughout the forecast period. There has been a range of announced policy changes that are yet to be implemented and so have not been included in the baseline projections. These include the agreement between the US and EU announced on 27 July. And, on 1 August, the US announced increases in tariffs on a number of countries, excluding the UK, due to take effect on 8 August.
- The growth in the size and composition of the 16+ population implied by the ONS's 2022-based migration category variant national population projections, which is weaker than the previous assumption incorporated in the May Report that was based on the principal version of those projections. These population projections do not include the England and Wales mid-year population estimates published on 30 July.

### Table 1.B: Conditioning assumptions (a) (b)

| | Average 1998–2007 | Average 2010–19 | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|---|---|
| Bank Rate (c) | 5.0 | 0.5 | 5.3 (5.3) | 4.9 (4.9) | 3.8 (3.7) | 3.5 (3.6) | 3.6 (3.6) |
| Sterling effective exchange rate (d) | 100 | 82 | 81 (81) | 85 (85) | 85 (84) | 84 (84) | 84 (83) |
| Oil prices (e) | 39 | 77 | 84 (84) | 75 (75) | 68 (64) | 67 (64) | 67 (65) |
| Gas prices (f) | 29 | 52 | 101 (101) | 107 (107) | 91 (94) | 89 (86) | 80 (78) |
| Nominal government expenditure (g) | 7¼ | 2¼ | 7¾ (7¾) | 6½ (6½) | 6½ (8¼) | 3 (3) | 3¼ (3¼) |

Sources: Bank of England, Bloomberg Finance L.P., LSEG Workspace, Office for Budget Responsibility (OBR), ONS and Bank calculations.

(a) The table shows the projections for financial market prices, wholesale energy prices and government spending projections that are used as conditioning assumptions for the MPC's projections for CPI inflation, GDP growth and the unemployment rate. Figures in parentheses show the corresponding projections in the May 2025 Monetary Policy Report.
(b) Financial market data are based on averages in the 15 working days to 29 July 2025. Figures show the average level in Q4 of each year, unless otherwise stated.
(c) Per cent. The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.
(d) Index: January 2005 = 100. The convention is that the sterling exchange rate follows a path that is halfway between the starting level of the sterling ERI and a path implied by interest rate differentials.
(e) Dollars per barrel. Projection based on monthly Brent futures prices.
(f) Pence per therm. Projection based on monthly natural gas futures prices.
(g) Annual average growth rate. Nominal general government consumption and investment. Projections are based on the OBR's March 2025 Economic and Fiscal Outlook. Historical data based on NMRP+D7QK.

## 1.2: Key judgements and risks

## 1.2: Key judgement 1

**The path of disinflation in underlying domestic price and wage pressures has generally continued, albeit to different degrees. While headline inflation is projected to rise slightly further in the near term, to around 3¾% over the second half of this year, the baseline projection assumes that this will not lead to additional second-round effects on domestic inflationary pressures.**

There has been substantial disinflation over the past two and a half years, following previous external shocks, supported by the restrictive stance of monetary policy. That progress has allowed for reductions in Bank Rate over the past year. The Committee remains focused on

squeezing out any existing or emerging persistent inflationary pressures.

Twelve-month CPI inflation averaged 3.5% in 2025 Q2. This was 0.1 percentage points above expectations at the time of the May Report and an increase from 2.8% in Q1 (Section 2.5). Around half of this rise in the second quarter was accounted for by an expected reduction in the extent to which energy prices have been dragging on headline inflation. The contribution of administered prices to inflation has increased, while food price inflation has also picked up by more than anticipated (Box E).

The latest accumulation of evidence suggests disinflation in underlying domestic price and wage pressures has generally continued, although with greater signs of progress in declining pay growth than in developments in services price inflation. CPI inflation excluding energy picked up slightly to around 3¾% in Q2 (Chart 1.1).

Services consumer price inflation has remained at around 4.7% over recent months, slightly higher than expected at the time of the May Report. The still-elevated rate of services inflation reflects past strength in wage growth as well as temporary upward pressure from one-off increases in administered prices and the increase in employer NICs. Underlying services price inflation has continued to moderate across a range of measures, although progress in recent months has been slower than last year according to a measure excluding indexed and volatile components, rents and foreign holidays (Chart 2.20). Even after accounting for respective administered price changes recently, UK services inflation has remained significantly higher than services inflation in the euro area (Section 2.5), suggesting that price-setting in the UK has not yet fully normalised to a target-consistent path.

Wage growth has declined further recently, to around 5%. Annual private sector regular average weekly earnings growth fell to 4.9% in the three months to May, weaker than expected in the May Report. This is now broadly in line with Bank staff's estimate of the underlying rate of pay growth. Nevertheless, pay growth has remained higher than can be explained by its usual economic determinants.

Private sector regular pay growth is expected to slow further by the end of 2025, to 3¾%. In contrast, annual services inflation is projected to rise slightly over the remainder of the year, in part reflecting continued upward pressure from non-wage labour costs, before falling back in 2026.

There is uncertainty around the path of services inflation over coming quarters, including the extent to which weaker pay growth will over time feed through to lower services inflation, and the extent to which services inflation may continue to be boosted by other factors such as administered prices. There is little evidence so far that the empirical relationship between services inflation and wages has broken down, or that aggregate measures of profit margins are increasing. However, consumer-facing services businesses responding to the Decision

Maker Panel (DMP) Survey continue to expect some increase in price inflation over the year ahead. And DMP firms' own-price expectations have remained more sensitive to changes in aggregate CPI inflation than prior to 2022. The near-term rise in headline inflation could therefore affect price-setting behaviour, even while a weaker labour market means wage-setting is unaffected.

In the August Report baseline projection, CPI inflation is projected to rise slightly further, to around 3¾% over the second half of this year, with a peak of 4.0% in September, which is a slightly higher profile than in the May Report. This pickup reflects some near-term upward pressure on inflation from energy, food and services prices, offset by a slight decline in projected core goods inflation.

The near-term strength in CPI inflation is still expected to be temporary. This in part reflects the Committee's continuing judgement in the baseline forecast that recent developments are assumed not to lead to additional second-round effects on underlying domestic inflationary pressures, beyond those that would typically be expected to occur and in contrast to the more persistent dynamics in the inflation generating process that occurred following the very large shocks in 2021–22. In this forecast, the Committee has also maintained its judgement on the speed with which overall excess domestic inflationary pressures are expected to dissipate in the medium term (Key judgement 3). There remains significant uncertainty around these judgements, however, and the MPC judges that the upside risks around medium-term inflationary pressures have moved slightly higher since May.

## 1.2: Key judgement 2

**A margin of spare capacity is estimated to have opened up in the UK economy and the labour market is continuing to loosen gradually. This margin of excess supply is expected to build a little further, before narrowing from the end of next year onwards.**

UK quarterly GDP growth is estimated to have been 0.1% in 2025 Q2, on both a headline and underlying basis (Section 2.3). Growth is expected to pick up a little in the near term, reflecting a modest improvement in survey indicators of output.

Underlying employment growth has been around zero over recent quarters, somewhat weaker than implied by past developments in underlying GDP growth (Chart 2.11). This is in part likely to have reflected recent increases in firms' total labour costs, which may have affected employment to a slightly greater degree than previously anticipated. Survey indicators of employment intentions have remained weak.

Consistent with the weakness of employment growth, the labour market has continued to loosen gradually (Section 2.4). The LFS unemployment rate rose to 4.7% in the three months to May. The ratio of vacancies to unemployment has fallen further and is judged to be

somewhat below its equilibrium level. In addition, surveys of capacity utilisation suggest growing spare capacity within firms.

Bank staff have reassessed the extent to which weakness in productivity growth in 2023 and 2024 has been matched by lower potential productivity growth. As outlined in Box E of the February Report, potential productivity had appeared to be notably weaker last year than could be explained by factors such as the impacts of past events, notably Brexit and the pandemic. Based on new analysis that adjusts measured productivity growth for erratic and volatile components of GDP, measurement error in hours worked and variations in capacity utilisation, potential productivity growth is now judged to have been somewhat less weak over recent years, and potential labour supply growth somewhat lower. Taken together, this pushes up on past supply growth and is consistent with a margin of spare capacity having opened up slightly earlier than in the May projection.

Overall, a small margin of spare capacity is now estimated to have opened up in the economy from the start of 2024, reaching around ½% of potential GDP by the middle of 2025. The MPC continues to recognise the significant uncertainty around estimates of the current degree of slack in the economy. For example, developments in the labour market and in capacity utilisation would suggest a wider margin of excess supply, whereas models of the output gap based on nominal dynamics could suggest that the economy has a margin of excess demand currently. This highlights a tension between the possibility of greater spare capacity and the persistently high rate of domestic inflation.

> **The medium-term outlook for UK activity will be determined by both global and domestic factors.**

As set out in Box C of the May Report, recent global trade policy developments are likely to reduce UK GDP growth relative to the trade policies in place prior to this year. However, the trade policies in place on 29 July, which are assumed in the August Report projections to continue over the forecast period, are consistent with a somewhat lower US effective tariff rate than at the time of the May Report. Global trade policy uncertainty has also fallen back over recent months, though at a similar pace to the assumption underpinning the May Report projections prior to the most recent trade policy developments. Since May, volatility in financial markets has declined and global equity prices have risen.

Reflecting these developments, UK-weighted world GDP growth is expected to weaken by slightly less in the near term in the August baseline forecast than in the May forecast. Four-quarter world growth falls back to around 1¾% this year and next, before rising to 2¼% in 2027. Conditioned on trade policies as of 29 July, near-term growth is projected to be stronger in the United States and China than in the May Report. The outlook for euro-area GDP growth is broadly unchanged from May.

Box A sets out the Committee's latest assessment of the restrictiveness of the UK monetary policy stance. Reflecting the usual lags of policy, past restrictiveness is estimated to be weighing on the current level of demand, which will contribute to the disinflationary process. A range of more forward-looking estimates, based on real interest rate gaps, suggest that the degree of restrictiveness has fallen to some extent over the past 18 months. Based on the market curve conditioning assumption, restrictiveness is judged likely to wane to some extent over the forecast period.

The August baseline forecast includes a small near-term boost to activity from recent changes in mortgage market regulation, including **changes to the implementation of the FPC's loan to income (LTI) flow limit** to allow individual lenders to increase their share of lending at high LTIs while aiming to ensure the aggregate flow remained consistent with the limit of 15%.

Based on the Government's plans set out in Spring Statement 2025, the overall stance of fiscal policy is tightening materially over the MPC's forecast period. All else equal, this pulls down on the baseline GDP growth and output gap projections, particularly over the next year.

Four-quarter potential supply growth is projected to weaken slightly in the middle of the forecast period, before recovering to around 1½% in the medium term. This is slightly weaker beyond the near term than in the May Report, reflecting the lower assumed path of population growth (Section 1.1).

In the August baseline projection, four-quarter GDP growth is projected to remain close to its recent average level, of around 1¼%, before picking up in the second half of the forecast period (Chart 1.2). This forecast remains dependent on a sustained fall in the household saving ratio to under 8% in the medium term from over 10% currently. As a result, beyond the near term, consumption growth is projected to pick up to a greater degree than GDP growth, to around 2¼% on an annual basis by the end of the forecast period. There remains considerable uncertainty over this projection, as discussed below, and previous projections of material declines in the saving ratio have so far largely failed to materialise.

Reflecting the paths of GDP and potential supply, the margin of spare capacity in the baseline forecast is expected to widen slightly further over the next year, to just under ¾% of potential GDP in the middle of 2026, before narrowing to close to zero by the end of the forecast period. The impact on demand of the tightening in the stance of fiscal policy, based on the plans set out in the Spring Statement, is the main factor increasing excess supply in the near term. A range of factors is expected to reduce excess supply further out, including the impact on demand of the gradual loosening in the stance of monetary policy embodied in the market path of interest rates. Monetary policy still weighs on the level of demand across the forecast period, however, such that it continues to contribute to the disinflationary process.

Relative to the May baseline projection, there is expected to be a slightly smaller margin of spare capacity throughout most of the forecast period, in part reflecting the Committee's judgement that the lower assumed path of population growth will put slightly more downward pressure on supply than on demand over coming years.

The unemployment rate is projected to rise gradually to just under 5% by the middle of 2026 (Chart 1.3), above its assumed medium-term equilibrium rate of just over 4½%. Unemployment is slightly lower than in the May Report in the medium term, consistent with the narrower margin of excess supply in the baseline projection.

> **The Committee judges that the risks around the UK GDP growth projection are somewhat to the downside.**

There are risks around the future path of activity, spare capacity and hence inflationary pressures in the medium term (Key judgement 3), reflecting both global and domestic factors.

Box D discusses global uncertainties and their implications for the UK economy, including the risks from potential, but impossible to anticipate, future increases in energy prices, and around global trade policies. There also remain uncertainties around the paths of fiscal policy in Germany, the United States and elsewhere. Overall, there are judged to be downside risks to global activity, which would pass through to UK growth and inflation were they to occur. The scale of the immediate downside risks has diminished since May, however, reflecting the most recent developments in trade policy.

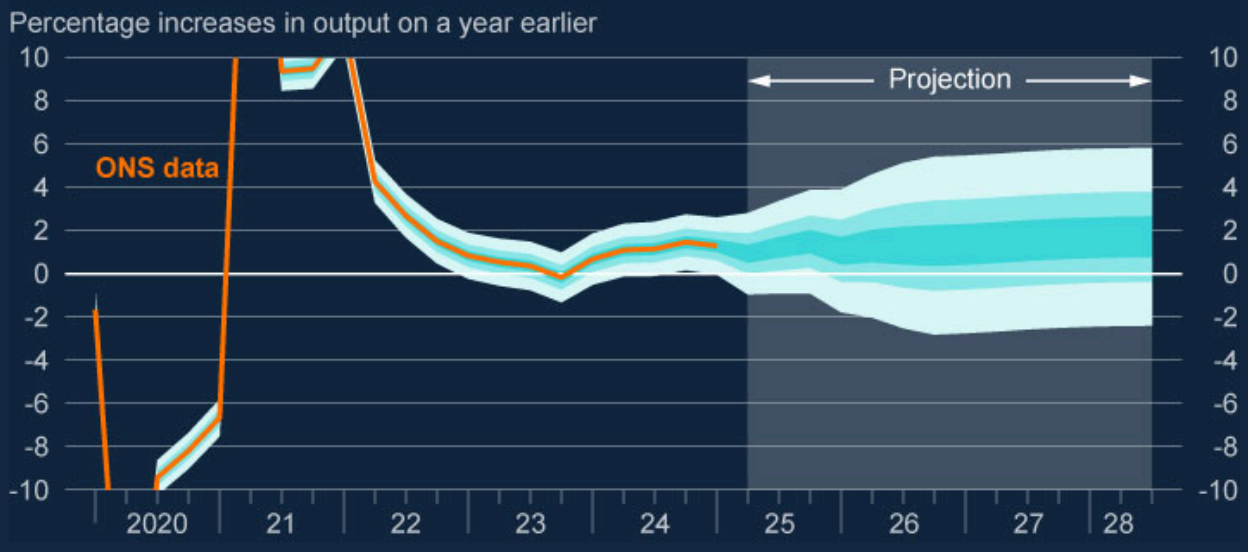
Box A of the May Report set out an alternative scenario in which UK demand is substantially weaker than in the baseline projection. This was based on an additional UK-specific increase in uncertainty, which drags on consumption and investment to a greater extent than the indirect impact on UK growth of elevated global trade policy uncertainty that has already been included in the baseline projection. Although both global and domestic uncertainty appears to have fallen back somewhat since May, there remains a risk that UK domestic demand could be weaker, and the margin of spare capacity wider, than in the baseline projection.

In particular, the MPC continues to see downside risks around consumption growth and upside risks around the path of the saving ratio over the forecast period. These could relate to the continuation of past structural factors, such as the desire for households to build up their savings following the pandemic, that have already pushed up saving by more than expected. Or it could reflect greater precautionary saving behaviour by households than has so far appeared to be occurring. The latter could be triggered by broader downside risks to activity and particularly the risk of more sudden adverse developments in the labour market. This includes the possibility that the impact of the higher labour costs facing companies has a greater impact on their employment decisions. That said, analysis of previous cycles suggests

that rapid shake-outs in the labour market have tended to be associated with larger shocks to the economy than have occurred recently, and with a greater pickup in redundancies than has so far appeared to be in train.

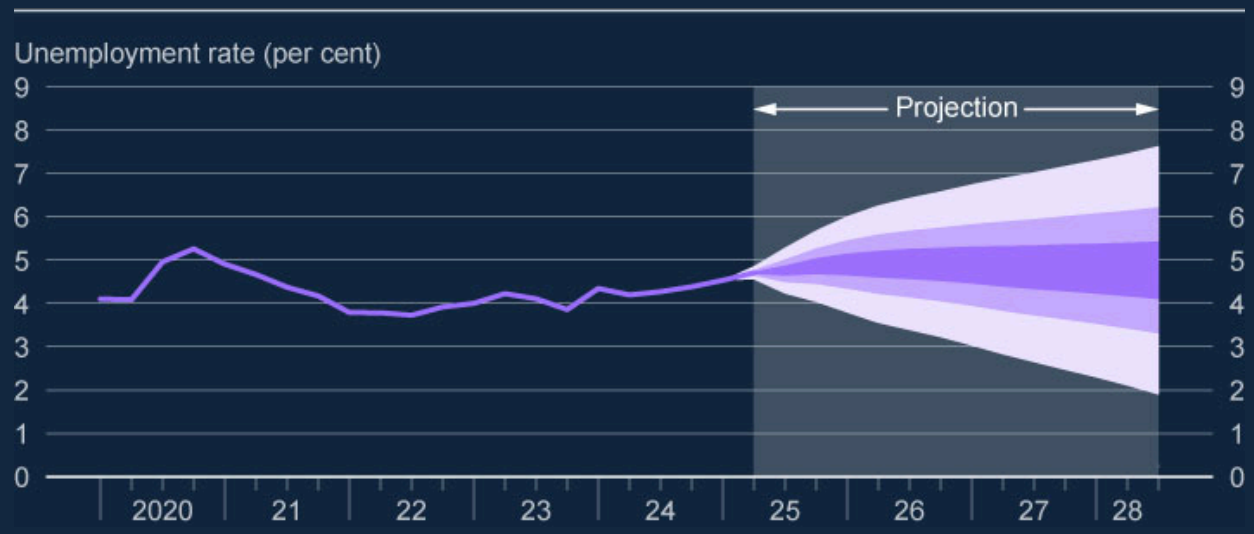
Overall, the Committee judges that the risks around the UK GDP growth projection, particularly from domestic factors, are somewhat to the downside. This is also judged to lead to a risk of a greater margin of spare capacity over the forecast period than in the baseline.

**Chart 1.2: GDP growth projection based on market interest rate expectations, other policy measures as announced**




The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on Bank Rate following a path implied by market yields, but allows the Committee's judgement on the risks around the other conditioning assumptions set out in Section 1.1, including wholesale energy prices, to affect the calibration of the fan chart skew. To the left of the shaded area, the distribution reflects uncertainty around revisions to the data over the past. To the right of the shaded area, the distribution reflects uncertainty over the evolution of GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's judgement is that the mature estimate of GDP growth would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns are also expected to lie within each pair of the lighter aqua areas on 30 occasions. In any particular quarter of the forecast period, GDP growth is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions GDP growth can fall anywhere outside the aqua area of the fan chart. Over the forecast period, this has been depicted by the grey background. The Box on page 39 of the **November 2007 Inflation Report** provides a fuller description of the fan chart and what it represents. The y-axis of the chart has been truncated to illustrate more clearly the current uncertainty around the path of GDP growth, as otherwise this would be obscured by the volatility of GDP growth during the pandemic.

**Chart 1.3: Unemployment rate projection based on market interest rate expectations, other policy measures as announced**




The fan chart depicts the probability of various future outcomes for the ILO definition of unemployment and begins in 2025 Q2. Although LFS unemployment data have recently been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D of the **May 2024 Monetary Policy Report**). The fan chart has been conditioned on Bank Rate following a path implied by market yields, but allows the Committee's judgement on the risks around the other conditioning assumptions set out in Section 1.1, including wholesale energy prices, to affect the calibration of the fan chart skew. The coloured bands have the same interpretation as in Chart 1.2 and portray 90% of the probability distribution. A significant proportion of this distribution lies below Bank staff's current estimate of the long-term equilibrium unemployment rate. There is therefore uncertainty about the precise calibration of this fan chart.

## 1.2: Key judgement 3

**Conditioned on the market path of interest rates, the margin of spare capacity in the economy is expected to act against some continuing persistence in domestic prices and wages in order for CPI inflation to fall back to around the 2% target in the medium term.**

Domestically, the August forecast for CPI inflation continues to incorporate the effects of a period of economic slack (Key judgement 2), which is required in order for price-setting dynamics to normalise fully. The Committee has not changed its judgement on the speed with which excess domestic inflationary pressures are expected to dissipate in the baseline projection. The continuing second-round effects in the baseline relate in large part to the unwind of the succession of very large external cost shocks in 2021–22, rather than additional second-round effects from the near-term pickup in headline inflation (Key judgement 1).

In terms of global factors affecting the UK, the Committee continues to judge that the overall impact of recent trade policy developments is, on balance, more likely to be disinflationary than inflationary, although the effects incorporated into the August baseline forecast are not large. UK-weighted world export price inflation, excluding the direct effect of oil prices, is expected to turn negative in the near term before recovering into slightly positive territory in the middle of the forecast period. This profile is broadly similar to the path of world prices in the May forecast, though slightly higher reflecting the constellation of trade policies as of 29 July. For that reason and reflecting recent data outturns, UK non-energy import price inflation is projected to be higher in the near term, compared with May. The direct contribution of energy prices to CPI inflation is around zero throughout the forecast period.

In the baseline projection conditioned on the market-implied path of interest rates in the 15 working days to 29 July, CPI inflation falls back gradually to 2.7% in 2026 Q3, and to around the 2% target by 2027 Q2, remaining there in the medium term (Chart 1.4 and Table 1.C). The August CPI projection is somewhat higher than the profile in May during the second year of the forecast period and broadly similar in the medium term. Private sector regular AWE growth is expected to fall to around 3% in the medium term.

> **The MPC judges that the upside risks around medium-term inflationary pressures have moved slightly higher since May.**

There remains considerable uncertainty around the calibration of the Committee's judgement on the path of second-round effects in domestic prices and wages.

Box A of the May Report set out a scenario in which inflation persistence is greater than assumed in the baseline, in part as the current strength in headline inflation could result in additional second-round effects in domestic wage and price-setting. The scenario also set out how domestic inflationary pressures could be greater if potential productivity growth was materially weaker than in the baseline, and that weakness was not reflected in lower wages. Both of these mechanisms remain relevant for the Committee's views on the risks to medium-term inflation.

As part of this continuing assessment of these risks, the MPC is monitoring a range of indicators to judge whether inflation expectations remain consistent with meeting the 2% inflation target sustainably in the medium term. Households' near-term inflation expectations have fallen back slightly recently, although medium-term household measures have continued to increase and are now materially above their historical averages. Businesses' medium-term CPI inflation expectations have increased slightly since the start of the year, while market-based inflation compensation measures are broadly unchanged.

The Committee is placing particular weight on the extent to which higher CPI inflation, including developments in salient items such as food prices, could affect inflation expectations and add to the persistence of inflationary pressures (Box E). Bank staff analysis based on a

machine learning approach suggests that, after falling towards historical averages earlier this year, a measure of the inertial component of inflation reflecting more backward-looking expectations has begun to rise again. Staff analysis also suggests that second-round effects in domestic price and wage-setting, owing to the response of inflation expectations to realised inflation, have historically become stronger when inflation has exceeded a threshold of 3½ to 4%, which is relevant given the near-term path of headline inflation (Key judgement 1).

Conversely, it is possible that the role of household inflation expectations in the wage-setting process could become weaker as the labour market loosens further.

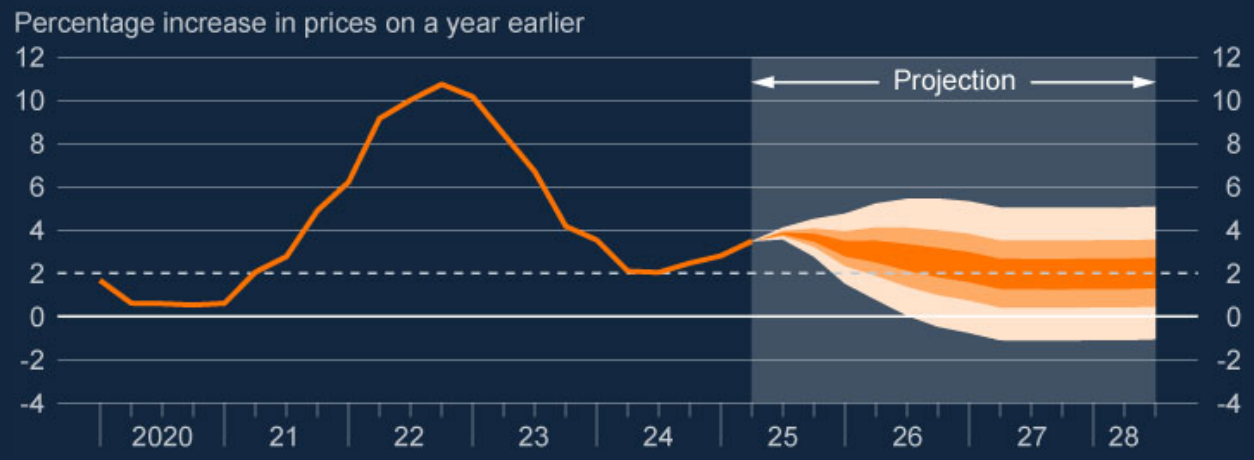
There may still be downside risks to the path of potential productivity over the forecast period, and hence upside risks to wage growth and inflation. But, this risk may have diminished since May, as Bank staff's assessment of recent potential productivity growth has been revised up, which means that potential productivity is now more explicable by the shocks that have previously affected the economy (Key judgement 2) and there is slightly less of a step change up in expected productivity growth over the forecast period.

In addition, there remains a risk that the economy has been subject to lasting changes in wage and price-setting behaviour following the major supply shocks experienced over previous years, as set out in Box A in the November 2024 Report. The recent and future path for the medium-term equilibrium rate of unemployment could be higher than assumed in the baseline forecast in this case, or because of recent increases in the wedge between wages and total labour costs. These risks would be consistent with greater persistence in inflation.

Box D discusses global uncertainties and their implications for the UK economy, including the risks to UK inflation from potential, but impossible to anticipate, future increases in energy prices, and around global trade policies. There are two-sided risks around the impact of global prices on UK inflation. These relate both to the possibility of new shocks and uncertainties around the impact of existing shocks, such as the extent of the shift in global trade patterns already under way and how this may come to affect external pressures on UK inflation.

Overall, the MPC judges that the upside risks around medium-term inflationary pressures have moved slightly higher since May. This is in part due to the risk of inflation expectations impacting price-setting as illustrated in the inflation persistence scenario set out in the May Report.

**Chart 1.4: CPI inflation projection based on market interest rate expectations, other policy measures as announced**




The fan chart depicts the probability of various future outcomes for CPI inflation and begins in 2025 Q3. It has been conditioned on Bank Rate following a path implied by market yields, but allows the Committee's judgement on the risks around the other conditioning assumptions set out in Section 1.1, including wholesale energy prices, to affect the calibration of the fan chart skew. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's judgement is that inflation in any particular quarter would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter orange areas on 30 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fans on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the orange area of the fan chart. Over the forecast period, this has been depicted by the grey background. The Box on pages 48–49 of the **May 2002 Inflation Report** provides a fuller description of the fan chart and what it represents.

## Table 1.C: The quarterly baseline projection for CPI inflation based on market rate expectations (a)

| | 2025 Q3 | 2025 Q4 | 2026 Q1 | 2026 Q2 | |
|---|---|---|---|---|---|
| CPI inflation | 3.8 | 3.6 | 3.1 | 3.0 | |
| | **2026 Q3** | **2026 Q4** | **2027 Q1** | **2027 Q2** | |
| CPI inflation | 2.7 | 2.5 | 2.3 | 2.0 | |
| | **2027 Q3** | **2027 Q4** | **2028 Q1** | **2028 Q2** | **2028 Q3** |
| CPI inflation | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |

(a) Four-quarter inflation rate.

## Table 1.D: Indicative projections consistent with the MPC's baseline forecast (a) (b)

| | Average 1998–2007 | Average 2010–19 | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|---|---|
| **World GDP (UK-weighted)** (c) | **3** | **2½** | **2 (2)** | **2 (2)** | **1¾ (1½)** | **1¾ (1½)** | **2¼ (2¼)** |
| World GDP (PPP-weighted) (d) | 4 | 3¾ | 3½ (3¼) | 3¼ (3¼) | 3 (2½) | 2¾ (2¾) | 3¼ (3¼) |
| Euro-area GDP (e) | 2½ | 1½ | ¾ (½) | 1 (¾) | 1 (¾) | 1 (1) | 1¾ (1¾) |
| US GDP (f) | 3 | 2½ | 3 (3) | 2¾ (2¾) | 1¾ (1¼) | 1¾ (1¼) | 2 (1¾) |
| Emerging market GDP (PPP-weighted) (g) | 5½ | 5 | 4½ (4½) | 4¼ (4¼) | 4 (3½) | 3¾ (3¾) | 4¼ (4¼) |
| of which, China GDP (h) | 10 | 7¾ | 5½ (5½) | 5 (5) | 4¾ (4) | 4 (4¼) | 4½ (4¼) |
| **UK GDP** (i) | **2¾** | **2** | **½ (½)** | **1 (1)** | **1¼ (1)** | **1¼ (1¼)** | **1½ (1½)** |
| Household consumption (j) | 3¼ | 2 | ½ (½) | ¾ (¾) | 1 (1¼) | 1½ (1¾) | 2 (1¾) |
| Business investment (k) | 3 | 4¼ | 4½ (4½) | 2 (2) | 3¼ (1½) | 1¼ (1) | 1½ (1¼) |
| Housing investment (l) | 3¼ | 4 | -7 (-7) | ¾ (¾) | ¼ (0) | 4½ (5) | 6 (6) |
| Exports (m) | 4½ | 3½ | -½ (-½) | -1¼ (-1¼) | 2¼ (½) | 2¼ (0) | 1¾ (2) |
| Imports (n) | 6 | 4 | -1¼ (-1¼) | 2¾ (2¾) | 5 (1½) | 1¼ (2) | 2¾ (2¾) |
| Contribution of net trade to GDP (o) | -¼ | -¼ | ¼ (¼) | -1¼ (-1¼) | -1 (-½) | ¼ (-¾) | -½ (-½) |
| Real post-tax labour income (p) | 3¼ | 1½ | 1 (1) | 4¼ (4¼) | 1½ (1½) | 0 (½) | ½ (½) |
| Household saving ratio (q) | 7¼ | 7¾ | 7¼ (7¼) | 10 (10) | 10¼ (10½) | 9¼ (9¾) | 8¼ (9) |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Credit spreads (r) | ¾ | 2½ | 1 (1) | 1 (1) | 1¼ (1½) | 1½ (1½) | 1½ (1½) |
| Excess supply/**Excess demand** (s) | 0 | -1¾ | **¾ (¾)** | -¼ (0) | -½ (-½) | -½ (-¾) | -½ (-¾) |
| Labour productivity (output per worker) (t) | 1¾ | ¾ | -¾ (-¾) | ¼ (¼) | 0 (-¼) | 1¼ (¾) | 1 (¾) |
| Employment (u) | 1 | 1¼ | ¾ (¾) | 1½ (1½) | ¾ (¾) | ¼ (½) | ¾ (¾) |
| Working-age (16+) population (v) | ¾ | ¾ | 1¼ (1¼) | 1¼ (1¼) | 1 (1) | ¾ (1) | ¾ (1) |
| Unemployment rate (w) | 5¼ | 6 | 3¾ (3¾) | 4½ (4½) | 4¾ (4¾) | 5 (5) | 4¾ (5) |
| Participation rate (x) | 63 | 63½ | 62¾ (62¾) | 63¼ (63¼) | 63½ (63¼) | 63¼ (63) | 63 (63) |
| **CPI inflation** (y) | **1½** | **2¼** | **4¼ (4¼)** | **2½ (2½)** | **3¾ (3¼)** | **2½ (2)** | **2 (1¾)** |
| UK import prices (z) | -¼ | 1¼ | 1 (1) | -1¼ (-1¼) | 1¼ (-¼) | 0 (¼) | ½ (½) |
| Energy prices – direct contribution to CPI inflation (aa) | ¼ | ¼ | -1¼ (-1¼) | -½ (-½) | 0 (-¼) | 0 (0) | 0 (0) |
| Private sector regular average weekly earnings (ab) | 4 | 2¼ | 6¼ (6¼) | 6¼ (6¼) | 3¾ (3¾) | 3¼ (2¾) | 3 (2¾) |
| Private sector regular pay-based unit wage costs (ac) | 2 | 1¾ | 7¼ (7¼) | 6½ (6½) | 2½ (2¾) | 2 (1¾) | 2 (1¾) |

Sources: Bank of England, Bloomberg Finance L.P., Department for Energy Security and Net Zero, Eurostat, IMF World Economic Outlook, National Bureau of Statistics of China, ONS, US Bureau of Economic Analysis and Bank calculations.

(a) The profiles in this table should be viewed as broadly consistent with the MPC's baseline projections for GDP growth, CPI inflation and unemployment (as presented in the fan charts).
(b) Figures show annual average growth rates unless otherwise stated. Figures in parentheses show the corresponding projections in the May 2025 Monetary Policy Report. Calculations for back data based on ONS data are shown using ONS series identifiers.
(c) Chained-volume measure. Constructed using real GDP growth rates of 188 countries weighted according to their shares in UK exports.
(d) Chained-volume measure. Constructed using real GDP growth rates of 189 countries weighted according to their shares in world GDP using the IMF's purchasing power parity (PPP) weights.

(e) Chained-volume measure. The forecast was finalised before the release of the preliminary flash estimate of euro-area GDP for Q2, so that has not been incorporated.
(f) Chained-volume measure. The forecast was finalised before the release of the advance estimate of US GDP for Q2, so that has not been incorporated.
(g) Chained-volume measure. Constructed using real GDP growth rates of 154 emerging market economies, weighted according to their relative shares in world GDP using the IMF's PPP weights.
(h) Chained-volume measure.
(i) Chained-volume measure.
(j) Chained-volume measure. Includes non-profit institutions serving households. Based on ABJR+HAYO.
(k) Chained-volume measure. Based on GAN8.
(l) Chained-volume measure. Whole-economy measure. Includes new dwellings, improvements and spending on services associated with the sale and purchase of property. Based on DFEG+L635+L637.
(m) Chained-volume measure. The historical data exclude the impact of missing trader intra-community (MTIC) fraud. Since 1998 based on IKBK-OFNN/(BOKH/BQKO). Prior to 1998 based on IKBK.
(n) Chained-volume measure. The historical data exclude the impact of MTIC fraud. Since 1998 based on IKBL-OFNN/(BOKH/BQKO). Prior to 1998 based on IKBL.
(o) Chained-volume measure. Exports less imports.
(p) Wages and salaries plus mixed income and general government benefits less income taxes and employees' National Insurance contributions, deflated by the consumer expenditure deflator. Based on [ROYJ+ROYH-(RPHS+AIIV-CUCT)+GZVX]/[(ABJQ+HAYE)/(ABJR+HAYO)]. The backdata for this series are available at **Monetary Policy Report – Download chart slides and data – August 2025**.
(q) Annual average. Percentage of total available household resources. Based on NRJS.
(r) Level in Q4. Percentage point spread over reference rates. Based on a weighted average of household and corporate loan and deposit spreads over appropriate risk-free rates. Indexed to equal zero in 2007 Q3.
(s) Annual average. Per cent of potential GDP. A negative figure implies output is below potential and a positive figure that it is above.
(t) Real GDP (ABMI) divided by total 16+ employment (MGRZ). Although LFS employment data have been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D of the **May 2024 Monetary Policy Report**).
(u) Four-quarter growth in the ILO definition of employment in Q4 (MGRZ). Although LFS employment data have been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D of the May 2024 Monetary Policy Report).
(v) Four-quarter growth in Q4. LFS household population, all aged 16 and over (MGSL). Growth rates are interpolated between the LFS and ONS National population projections: 2022-based interim within the forecast period.
(w) ILO definition of unemployment rate in Q4 (MGSX). Although LFS unemployment data have been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D of the May 2024 Monetary Policy Report).
(x) ILO definition of labour force participation in Q4 as a percentage of the 16+ population (MGWG). Although LFS participation data have been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D of the May 2024 Monetary Policy Report).
(y) Four-quarter inflation rate in Q4.
(z) Four-quarter inflation rate in Q4 excluding fuel and the impact of MTIC fraud.
(aa) Contribution of fuels and lubricants and gas and electricity prices to four-quarter CPI inflation in Q4.
(ab) Four-quarter growth in Q4. Private sector AWE excluding bonuses and arrears of pay (KAJ2).
(ac) Four-quarter growth in private sector regular pay-based unit wage costs in Q4. Private sector wage costs divided by private sector output at constant prices. Private sector wage costs are AWE (excluding bonuses) multiplied by private sector employment.

## Box A: Assessing the restrictiveness of the monetary policy stance

The MPC increased Bank Rate significantly between December 2021 and August 2023, from 0.1% to 5.25%, before starting to reduce Bank Rate in August 2024. This box sets out a range of measures that the MPC has used to assess the restrictiveness of monetary policy. The first part of the box presents evidence on the degree to which past increases in Bank Rate continue to weigh on the level of demand. The second explores the extent to which the current monetary policy stance, taken as a whole, remains restrictive and will hence weigh on demand in the future.

### Real and nominal interest rates are elevated relative to end-2021.

Both real and nominal interest rates play an important role in influencing demand and inflation (**Burr and Willems (2024)**). But real interest rates, defined as nominal interest rates adjusted for expected inflation, are usually judged to be more important when assessing the stance of monetary policy. That is because, when making spending and saving decisions, firms and households tend to factor in their expectations about future inflation (Box C of the **February 2024 Monetary Policy Report**).

Yields on UK government bonds are significantly higher than in late 2021 (Chart A). Nominal gilt yields rose notably over 2022–23, consistent with increases in Bank Rate over this period. Real yields, obtained from inflation-linked UK government bonds, also rose significantly. Both real and nominal government bond yields are lower than their peaks in 2023 but have been relatively stable over recent quarters. That partly reflects the impact of international developments, which can have a large influence on UK government bond yields (**Cesa-Bianchi et al (2021)** and **Mann (2022)**).

**Chart A: Real and nominal yields remain elevated relative to end-2021**

Bank Rate and select real and nominal government bond yields (a)


Sources: Bloomberg Finance L.P., Tradeweb FTSE Gilt Closing Data and Bank calculations.

(a) Real yields are inflation-linked UK government bond yields. The final data points shown are for 29 July 2025.

**Past increases in Bank Rate are estimated to be weighing on the current level of demand, although this impact is around its peak.**

The MPC raised Bank Rate between late 2021 and mid-2023 to curb the sharp rise in inflation over that period (Chart A). As described in Box C of the **August 2024 Monetary Policy Report**, those increases in Bank Rate have weighed on demand and contributed towards the sharp rise in the household saving ratio over recent years (Section 2.3), as well as the more recent loosening in the labour market (Section 2.4).

The impact of interest rates on demand, estimated using models that feed into the MPC's baseline projections, is shown by the aqua bars in Chart B. Higher interest rates are estimated to have been weighing on the level of demand since late 2022. Before that, a period of lower interest rates, which had been required to stimulate the economy, had been boosting demand.

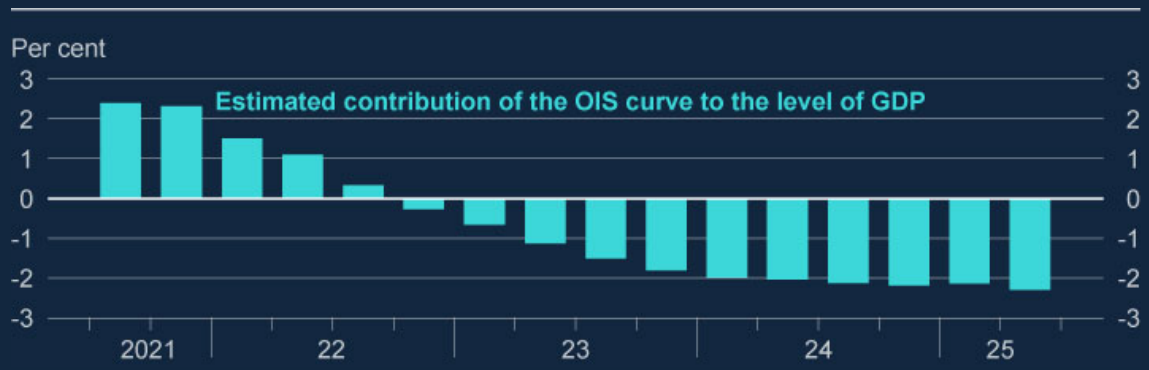
Because monetary policy affects demand and inflation with a lag (**Burr and Willems (2024)**), Bank staff estimate that past increases in Bank Rate and the market-implied path for future interest rates continue to weigh on the level of demand. The impact of past increases in interest rates on demand is now estimated to be around its peak, however.

Once that peak has passed, monetary policy will start to contribute positively to GDP growth, as its effect on demand starts to fade. Nevertheless, past increases in Bank Rate will still weigh on the level of demand, such that they will continue to support the disinflationary process over the coming years.

There are large uncertainties around the size and timing of the estimates in Chart B. The relationship between Bank Rate and the real economy can vary over time (Box C of the **August 2024 Monetary Policy Report).** In addition, these estimates capture the effects on demand of changes in Bank Rate and the market-implied path for future interest rates. This may not reflect a change in restrictiveness, which is also dependent on movements in the equilibrium interest rate, the level of interest rates that neither stimulates nor depresses the level of GDP (further details below).

**Chart B: Past increases in interest rates are estimated still to be weighing on demand**

Estimated contribution of the overnight indexed swap (OIS) curve to the level of GDP (a)




Sources: Bank of England, ONS and Bank calculations.

(a) The estimates for the contribution of the OIS curve to the level of UK GDP are the sum of the impacts on consumption, business investment, housing investment and the net imports offset in the MPC's baseline projections. The net imports offset component reflects that part of the reduction in consumption from higher interest rates will arise from lower spending on imported goods, which mechanically pushes up GDP. These estimates are based on the standard treatment of the impact of changes in Bank Rate and the OIS curve in the Bank's forecasting models. Bank staff estimate the impact of changes in the OIS curve between each Monetary Policy Report on the level of GDP, and these are then summed to obtain estimates of the total contributions. The estimates incorporate an impact from changes in the OIS curve on the level of GDP that persists over several years. The level of the aqua bars in the first data point in 2021 Q3 therefore reflects the estimated impact on demand of changes in the OIS curve from several years prior to that date. The effects of the estimated impact of changes in the OIS curve on sterling exchange rates have been excluded. The final data are for 2025 Q2.

> **Evidence from several channels of monetary policy transmission is consistent with the impact of past increases in Bank Rate on the level of GDP being around its peak.**

One of the clearest indications that higher interest rates have weighed on demand has been the rise in the household saving ratio (Chart 2.10), which stood at 10.6% in 2025 Q1, up from 4.6% in 2022 Q2. Higher interest rates have incentivised additional

household saving and lower borrowing over recent years. However, there are some tentative signs that the impact of higher interest rates on household saving may have peaked. Evidence from the March 2025 Bank of England/NMG survey suggests that fewer households across most income quintiles are increasing saving due to higher interest rates, relative to the peaks observed over 2023–24 (Chart C, left panel). And the saving ratio fell in 2025 Q1, although this largely reflected a reduction in real household incomes (Section 2.3).

Net secured lending to households has picked up in recent quarters, notwithstanding some recent volatility associated with changes in Stamp Duty Land Tax (SDLT). That is consistent with a rise in demand for borrowing due to the reduction in household interest rates since mid-2024 (Section 2.2), and has been associated with a pick-up in aggregate broad money growth (Box D of the **May 2025 Monetary Policy Report**). Lenders responding to the Credit Conditions Survey have noted an increase in demand for house purchases over the past few quarters, although that may have also reflected increased activity ahead of the changes to SDLT.

Evidence is also consistent with the impact of higher interest rates on house price inflation having peaked. House prices have fallen relative to household income over recent years, consistent with a drag from restrictive monetary policy (Box C of the **August 2024 Monetary Policy Report**). But house price inflation picked up in 2024, and estimates by Bank staff suggest that the drag on house price inflation from higher interest rates has fallen back a little over recent quarters.

Higher interest rates have also weighed on some components of housing investment, but there have been signs of recovery over recent quarters. Investment in new dwellings was weak over 2022–23, consistent with lower house prices having reduced the real returns on building new homes. And a lower volume of housing transactions has weighed on the transfer costs component of housing investment, which includes costs related to moving home, such as legal fees. But the recovery in house price inflation over recent quarters, and growing demand for house purchases, suggests that the monetary policy impact on the level of housing investment may be around its peak. Consistent with that, annual growth in private new housing construction output turned positive in late 2024, having been negative since early 2023. Despite this recent pick-up, intelligence from the Bank's Agents suggests that growth in housing investment is likely to remain subdued, relative to historical norms, over the coming year.

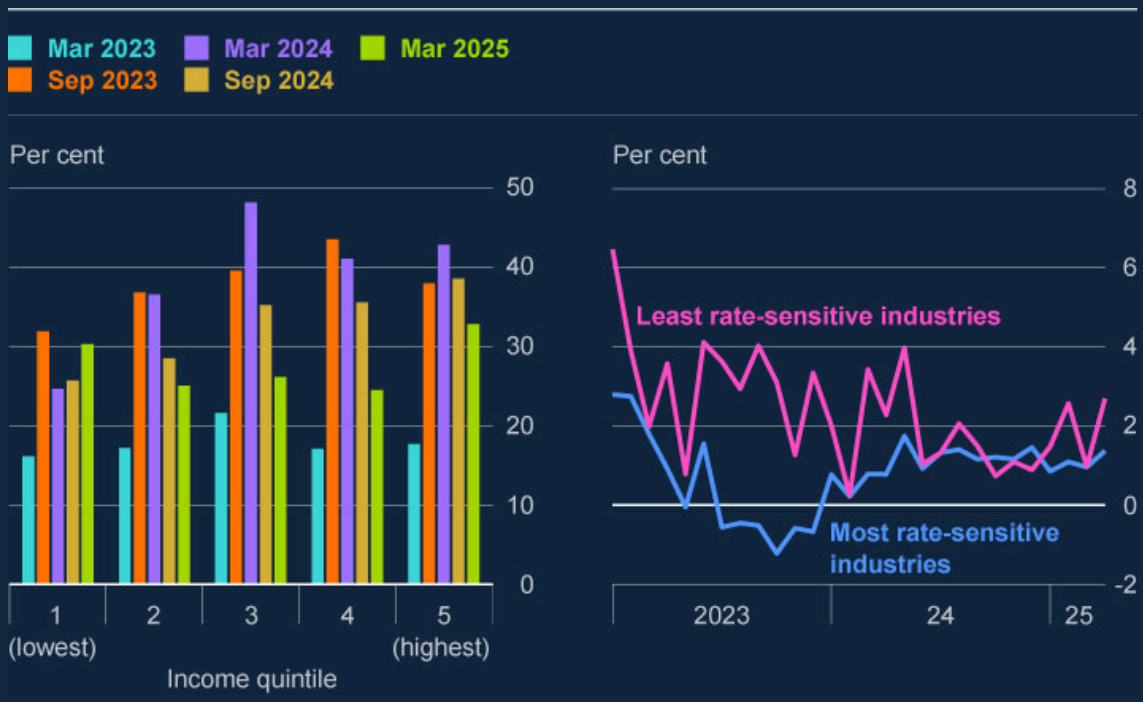
Business investment is particularly sensitive to changes in interest rates, making this channel an important aspect of monetary policy transmission (**Shah et al (2024)**). Responses to the DMP Survey indicate that higher interest rates have suppressed firms' capital expenditure growth since Bank Rate started to rise in late 2021. But this

effect now appears to have peaked, with the proportion of firms stating that the cost of finance would constrain their capital expenditure over the next year falling from 46% to 38% between January 2024 and January 2025. There has been a gradual pick-up in net lending to corporates over recent quarters (Section 2.2 and Box D of the **May 2025 Monetary Policy Report**).

Analysis of growth in businesses' gross value added (GVA), the total output of goods and services less the value of inputs used in production, also suggests that the impact of higher interest rates may have peaked. Bank staff analysis based on responses to the DMP Survey suggests that, between end-2022 and mid-2024, growth in GVA for the most interest rate-sensitive industries, including the utilities and construction sectors, was notably weaker than for other industries. But since mid-2024, GVA growth has converged across sectors with different estimated interest rate sensitivities, suggesting that the impact of higher interest rates may have peaked (Chart C, right panel). That said, past increases in Bank Rate continue to depress the level of demand for goods and services in the most interest rate-sensitive sectors. The most and least interest rate-sensitive sectors are difficult to identify accurately, and so this analysis should be treated with caution.

**Chart C: Indicators of demand suggest that the impact of tighter monetary policy may be around its peak**

Percentage of NMG survey respondents saving more than usual due to higher interest rates; annual GVA growth for industries that are most and least sensitive to higher rates (a) (b)




Sources: Bank of England/NMG survey, DMP Survey, ONS and Bank calculations.

(a) The data are from NMG surveys between March 2023 and March 2025. The data show the percentage of households in the NMG survey that reported that they had saved more than usual over the last 12 months and that higher interest rates on savings had been one of the main reasons for this increase. Households that responded 'prefer not to state' have been excluded from the calculation.
(b) The latest data are for April 2025. The most and least interest rate-sensitive industries were identified from responses to the DMP Survey, using firms' estimates of how much higher interest rates had reduced their sales. The most and least rate-sensitive industries are those in the upper and lower quartiles respectively of estimated interest rate sensitivity.

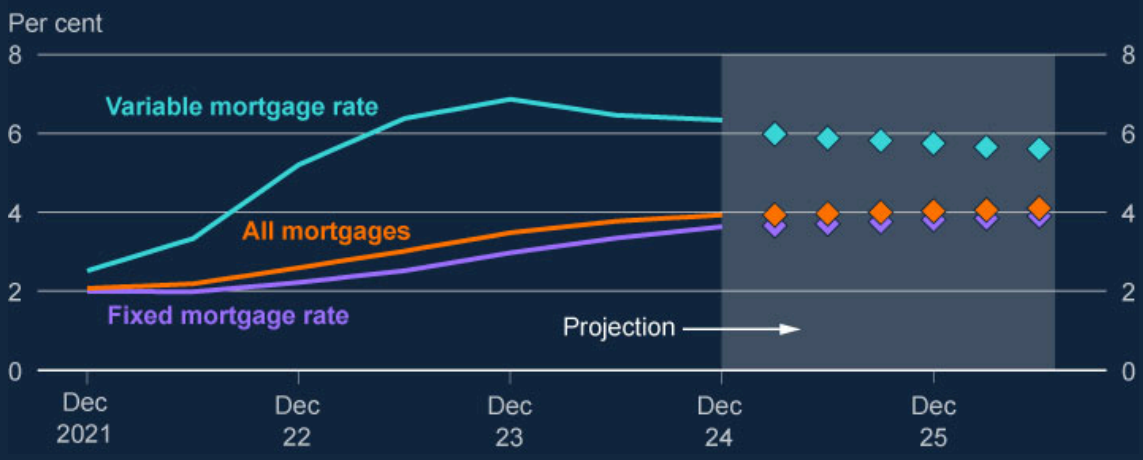
### But the impact of higher interest rates on demand via the cost of existing borrowing continues to build.

While the effects of many channels of monetary policy transmission appear to be around their peaks, the household cash-flow channel continues to build. This channel captures the effects on consumption of increases in interest rates paid by existing borrowers and those received by savers. All else equal, increases in effective mortgage rates, relative to rates paid on household deposits, tends to weigh on household consumption.

The effective interest rate on the stock of UK mortgages is expected to rise a little further over the next year. Most borrowers hold their mortgage on a fixed-rate basis over a period of between two and five years. So, while the effective rate on the stock of UK mortgages has risen from around 2% to 4% since early 2022, the long lags in mortgage refinancing mean that the effective mortgage rate is expected to continue to rise (Chart D). Meanwhile, effective deposit rates have been falling since mid-2024, as reductions in Bank Rate have passed through to household saving rates. Overall, past rises in interest rates are expected to weigh further on consumption via the cash-flow channel over coming quarters.

**Chart D: The effective interest rate on the stock of mortgages is expected to rise further over coming quarters**

Effective interest rates on the stock of UK mortgages (a)




Sources: Bank of England, Financial Conduct Authority Product Sales Data (PSD) and Bank calculations.

(a) The data from March 2025 to June 2026 are quarterly projections consistent with the MPC's August 2025 baseline forecast. The latest historical data are from the December 2024 PSD. The projections are informed by the Bank's quoted mortgage rate data and assume that fixed-rate mortgagors re-fix at a new rate, the average of projected two and five-year fixed mortgage rates, once their incentive period ends. Variable-rate mortgagors are assumed to remain on variable-rate contracts.

### Measures of the current monetary policy stance suggest that the degree of restrictiveness has fallen to some extent over the past 18 months.

While indicators of economic activity can be used to assess the extent to which past rises in Bank Rate continue to weigh on demand, they are less informative as to whether the current stance of monetary policy remains restrictive. Forward-looking estimates of the real-rate gap measure the difference between the current and future

expected real policy rate, r, and the equilibrium real interest rate, r*. The latter is the time-varying real interest rate that, if the economy started from a position of no output gap and inflation at target, would sustain output at potential and inflation at target (Box C of the **February 2024 Monetary Policy Report**). A positive real-rate gap indicates that the current monetary policy stance will weigh on demand, once lags in the transmission process are accounted for, and is hence restrictive.

Bank staff monitor a range of indicators of the real-rate gap (Chart E). The degree of policy restrictiveness implied by each of these measures is highly dependent on the level of r* embodied within them. The equilibrium real interest rate cannot be observed directly, and its definition varies between the approaches used. Estimates encompassing a higher r* will, all else equal, signal a lower degree of restrictiveness.

Real-rate gap indicators are also sensitive to the measure of inflation expectations used in their estimation. Nominal measures of the interest-rate gap, which do not account for inflation expectations, can therefore provide a useful cross-check on the degree of restrictiveness.

**Chart E: Forward-looking measures of the real-rate gap suggest that the degree of restrictiveness has fallen**

Average real-rate gaps in February 2024 and August 2025 (a)


Sources: Bank of England, Bank of England/Ipsos Inflation Attitudes Survey, Bank of England Market Participants Survey (MaPS), Bloomberg Finance L.P., Consensus Economics, **Davis et al (2024)**, ONS, TradeWeb FTSE Gilt Closing Data and Bank calculations.

(a) The February 2024 estimates for the macroeconomic models are for 2023 Q4. Corresponding estimates for the macrofinancial model are for 2024 Q1, and the estimates for financial markets and the MaPS are for February 2024. The August 2025 estimates for the macroeconomic models are for 2025 Q2. Corresponding estimates for the macrofinancial model are for 2025 Q3, and the estimates for financial markets and the MaPS are for August 2025. The macroeconomic models ranges are produced using estimates from two models. The first is a dynamic semi-structural IS curve model that relates the current output gap to past and expected future output gaps and the real-rate gap. It is estimated with data from 1988 Q3 to 2025 Q2. Average real-rate gaps over a three-year horizon are attained from a model using the Kalman filter, with associated ranges inferred from a dynamic factor model. The second set of macroeconomic model estimates are generated from one of the main models underlying the baseline projections in this Report (**Albuquerque et al (2025)**). Estimates from this model are also average implied real-rate gaps over a three-year horizon. The real policy rates used in both macroeconomic models are produced using the same model that underlies most of the baseline projections in this Report. The macrofinancial model ranges are estimated using the state-space model from **Davis et al (2024)**, with a 95% confidence interval applied around the central estimates of r*. The real policy rates used in the macrofinancial model ranges are ex-post real rates, as described in **Taylor (2025)**. The financial market ranges use estimates of the nominal neutral rate derived from three term premia models: the benchmark models in **Malik and Meldrum (2016)**, **Vlieghe (2016)** and **Meldrum and Roberts-Sklar (2015)**. These estimates are adjusted by average six-year to ten-year inflation expectations from half-year Consensus surveys to obtain real neutral rate estimates. The real policy rates in the financial markets ranges are calculated as the average instantaneous forward OIS curves over three-year horizons, deflated by annual Consensus survey inflation expectations over this period. These inflation expectations are linearly interpolated over the three-year horizon. The instantaneous forward OIS curves are estimated using the average paths for interest rates in the 15 UK working days to 23 January 2024 and 29 July 2025, on which the baseline projections for the February 2024 and August 2025 Monetary Policy Reports are conditioned, respectively. The ranges for the MaPS show the 10th–90th percentile of perceptions of the average implied real-rate gaps over a three-year horizon. The implied real-rate gaps are calculated as the difference between each MaPS respondent's weighted mean nominal Bank Rate expectation, adjusted by their expectations for CPI inflation over the same period, relative to their perception of r*. The r* component is calculated from nominal equilibrium rate perceptions

from the MaPS, applying two alternative assumptions around the deflator: the 2% inflation target or three-year CPI expectations from the MaPS. All measures of the real-rate gap presented in this chart show the implied degree of monetary policy restrictiveness over a three-year horizon. But to the extent that monetary policy can impact expectations of interest rates over longer horizons, changes to the monetary policy stance beyond the three-year point are not captured within the estimates on this chart.

Bank staff use macroeconomic models to estimate the degree of monetary policy restrictiveness. These estimates are based on dynamic structural and semi-structural models, which are underpinned by an inverse relationship between the output gap and the real-rate gap described by the investment-saving (IS) curve (Box C of the **February 2024 Monetary Policy Report**). These models estimate the current degree of monetary policy restrictiveness based on the average real-rate gap over the next three years. There is uncertainty around the results from these models, given that the estimation of the output gap itself is uncertain.

Estimates from these macroeconomic models suggest that monetary policy remains moderately restrictive (Chart E, aqua bar in right panel), but the degree of restrictiveness has fallen relative to its peak in early 2024. Reductions in Bank Rate have contributed towards a narrower real-rate gap, and hence lower restrictiveness, over that period. Meanwhile, the estimated level of spare capacity over the forecast period is currently smaller than was projected at the time of the **February 2024 Monetary Policy Report**, which has pushed up the implied level of r*. The rise in inflation expectations over recent quarters (Section 2.5) has also contributed to the fall in the estimated real-rate gap.

Bank staff also use data from financial markets and the MaPS to monitor investors' perceptions of monetary policy restrictiveness (Box C of the **February 2024 Monetary Policy Report**). In line with the result from macroeconomic models, MaPS-implied estimates of the real-rate gap suggest that the restrictiveness of monetary policy has fallen since February 2024 (Chart E, gold bars). The market-implied range of the real-rate gap has widened over the same period (Chart E, purple bars). While both market and MaPS-implied estimates of the nominal interest-rate gap remain positive, estimates of the real-rate gap are now closer to zero or negative in some cases, suggesting that market participants judge that the monetary policy stance may no longer be restrictive.

There are caveats to these measures, however. Similar to other indicators, financial market and MaPS-implied measures of the real-rate gap are highly dependent on the measure of inflation expectations used. Moreover, financial market measures may provide more of a signal about deviations of the real policy rate from the long-run real equilibrium interest rate, R*, rather than the shorter-run concept of r* (Box C of the **February 2024 Monetary Policy Report**). That is because they incorporate

expectations about future rates over long horizons. Estimates of R* derived from financial markets have risen by more than corresponding estimates from macroeconomic models over recent years (Box A of the **February 2025 Monetary Policy Report**).

The real-rate gap can also be estimated using macrofinancial models, which combine higher-frequency information from asset prices with lower-frequency trends in growth and inflation to derive estimates of r*. The real-rate gap is then calculated as the real policy rate less this estimate of r*. Estimates of the real-rate gap obtained using the macrofinancial model described in **Davis et al (2024)** suggest that the degree of monetary policy restrictiveness has fallen slightly relative to early 2024 (Chart E, orange bars). But monetary policy is estimated to remain restrictive based on this measure. And macrofinancial estimates of the nominal interest-rate gap, which do not adjust for inflation expectations, remain clearly positive.

> **Overall, while monetary policy continues to weigh on demand because of lags in transmission, the degree of policy restrictiveness has fallen.**

Past rises in Bank Rate have contributed towards the disinflationary process by weighing materially on demand. Given lags in transmission, those past rises in Bank Rate are estimated still to be weighing on demand and will continue to do so over the forecast period, such that they contribute towards the ongoing disinflationary process. As the disinflationary process has continued and Bank Rate has been reduced, forward-looking measures of restrictiveness based on the real-rate gap indicate that the degree of restrictiveness has fallen.

## Box B: Reviewing the process of quantitative tightening

Since February 2022, the MPC has been reducing the stock of assets held in the Bank of England's Asset Purchase Facility (APF) for monetary policy purposes, a process known as quantitative tightening (QT). In line with the commitment made by the MPC in the minutes of its August 2022 meeting, this box sets out the MPC's annual assessment of QT over the past year.

> **The Bank's balance sheet grew after the financial crisis and the pandemic, as the MPC used quantitative easing (QE) to meet its 2% inflation target and to support the economy.**

Following the 2008 global financial crisis, Bank Rate was reduced to close to zero to support economic activity and inflation. To further stimulate the economy when interest rates were at this level, the MPC began a programme of asset purchases known as QE (Chart A). QE works largely by reducing longer-term interest rates in the economy, ultimately boosting demand (**Busetto et al (2022)**).

Further QE programmes were conducted after the EU referendum and during the Covid pandemic. The size of the stock of assets held in the APF for monetary policy purposes peaked at £895 billion at the turn of 2022.

**Chart A: The Bank's APF holdings grew markedly through QE but have shrunk since 2022**

Stock of gilts held for monetary policy purposes in the APF (a)


(a) Gilt value is measured as the 'initial purchase proceeds' value.

**Since 2022, the stock of purchased assets has been reduced and will reach £558 billion by September 2025.**

In December 2021, the MPC started to increase Bank Rate in order to return CPI inflation sustainably to the 2% target. In 2022, once Bank Rate had been raised to a level that provided scope to reduce it as may be required, the Bank started to unwind its holdings of assets previously purchased as part of QE, a process known as QT.

From February 2022, the Bank stopped reinvesting maturing assets in the APF. Sales of gilts commenced in November 2022.

Reducing the size of the APF has the benefit of reducing the risk of a ratchet upwards in the size of the Bank's balance sheet as a consequence of repeated asset purchases over time, were the economy to return to needing support if Bank Rate were to be at the effective lower bound. QT therefore increases the headroom and flexibility available to the Bank to use its balance sheet in the future if needed.

QT has comprised a mix of sales of gilts, maturing gilts and sales of corporate bonds. The size of each of these has varied from year to year (Chart B). Between October 2022 and September 2023, £20 billion of corporate bonds were sold. Gilt maturities have varied between £35 billion and £87 billion per year, reflecting the maturity profile

of assets held by the APF. The balance of QT in 2024–25 was particularly skewed to maturities rather than sales, and the quantity of maturities will fall back in coming years. The size of the APF will fall to £558 billion by September 2025.

**Chart B: The QT process has reflected a mix of sales and maturing assets**

Initial purchase proceeds value of APF maturities and sales and maturities in future gilt stock reduction periods (a)


(a) Each year shows maturities in the period between October and September of the following year (ie a yearly QT review cycle). For October 2022–September 2023 to October 2024–September 2025 these bars show the target gilt stock reduction voted for by the MPC, including both maturities and active sales, as well as sales of assets purchased under the Corporate Bond Purchase Scheme. In periods from October 2025–September 2026 onwards only the path of expected maturities is shown, as the Committee is yet to vote on the target gilt stock reduction for these periods.

### The MPC's QT process has been guided by three key principles…

The MPC has previously set out key principles under which QT should be conducted.

First, the MPC has used Bank Rate as its active policy tool when adjusting the stance of monetary policy.

Second, sales have been conducted so as not to disrupt the functioning of financial markets, and only in appropriate market conditions.

Third, to help achieve that, sales have been conducted in a relatively gradual and predictable manner over a period of time.

### …which have helped to reduce the impact of QT on financial conditions.

The main way through which QT affects financial conditions is through the so-called portfolio rebalancing channel. This is because market demand for assets is not perfectly elastic, so the price of gilts, and other similar maturity assets, falls as the available supply increases. QT increases the supply of gilts to the market relative to a counterfactual where these gilts remain in the APF, although QT represents a relatively low share of the overall gilt market. Lower longer-duration asset prices mean long-term rates are higher than they would otherwise be. Long-term rates are affected by a wide range of factors, of which QT is only one, and movements in these rates have tended to be dominated by global factors over the past year.

The principles under which QT has been conducted help to limit financial market impacts outside this direct channel. Conceptually, QT could also affect gilt rates by changing market expectations for the future path of Bank Rate. This would be the case if market participants believed news about QT contained information about the future stance of monetary policy. As the MPC has been using Bank Rate as the active tool of monetary policy, this should not be the case. And market intelligence suggests that market participants' Bank Rate expectations have not been affected by QT announcements. QT could, in principle, also have effects on gilt market liquidity and thus affect liquidity risk premia. However, as sales have been gradual, predictable and only conducted in appropriate market conditions, there has been no marked effect on market liquidity.

> **Estimates of the impact of QT on term premia suggest a modest increase in long-term interest rates of between 15–25 basis points since QT started.**

Bank staff have updated their analysis of the effects of QT on gilt yields and the wider macroeconomy. While difficult to measure precisely, Bank staff continue to judge that the impact of QT on gilt yields has been modest.

Longer-term gilt rates are the sum of short-term rate expectations and a term premium, the additional interest return that investors require to hold long-term assets compared with purchasing equivalent short-term assets in sequence over the life of the long-term bond. Given that QT has been conducted in a way that does not communicate any changes to future Bank Rate, any impact of QT on gilt rates should come through higher term premia.

Between QT commencing in February 2022 and the end of June 2025, 10-year gilt rates rose by 325 basis points. Term structure model estimates indicate that around 150 basis points of this increase was driven by term premia, with the remaining rise accounted for by higher expected rates. Higher term premia have been driven by a

wide range of factors including a structural reduction in future domestic demand for long-term government debt, for example due to a decline in demand from defined benefit pension schemes.

Since the 2024 QT review, government bond yields have risen across countries, particularly long-term rates. Over the past year, 10-year gilt yields have risen by around 55 basis points and 30-year gilt yields have risen by around 95 basis points in the UK. Similar, albeit somewhat smaller, moves have been seen across countries. For example, in the US 10-year yields rose a little over 20 basis points and 30-year yields rose 60 basis points. In Japan, 10-year and 30-year yields rose by around 50 basis points and 100 basis points respectively. And in the euro area, 10-year and 30-year yields have risen by around 25 basis points and 60 basis points respectively.

Market intelligence and term structure models point to higher term premia having more than accounted for higher yields in the UK and internationally, with models estimating that the total term premium for 10-year gilts over the last year has increased by around 70 basis points in the UK. Isolating the specific effect of QT is not simple because term premia are influenced by a wide range of domestic and international factors, and these factors change over time. One way to estimate the specific effect is to look at movements in term premia in short periods directly around announcements of QT policies, such as when the amount of QT planned for the forthcoming year is announced, or around the time of QT auctions, where bonds are sold to the market. This helps to identify the impact of QT because gilt market pricing tends to adjust quickly in response to market news, and the short window helps to limit the influence of other factors on the estimates.

It is challenging to identify the causal impact of QT policy announcements because there have been relatively few of them and so the sample size is limited. And, as QT is being operated in a predictable manner, QT announcements and auctions should contain little news for the market.

Notwithstanding the challenges in estimating these impacts, new analysis by Bank staff points to an estimated total increase in 10-year gilt rates from cumulative QT to date of 15–25 basis points. This estimate is based on modelling the change in the 10-year gilt rate term premium on the day of QT policy announcements, combined with the effects on the day of QT auctions. Given the overall increase in term premium for 10-year gilt yields, this suggests QT has driven between a tenth and a fifth of that total.

Bank staff's most recent estimate of the impact of QT on term premia is slightly higher than in the 2024 QT review (Box A of the **August 2024 Report**), when the estimated range was 10–20 basis points. This is likely to reflect a small impact on term premia

from the additional QT since September 2024. The estimated rise in term premia due to this additional QT is much smaller than the overall rise in term premia over this period.

There is uncertainty over these estimates of the impact of QT. One drawback of event study estimates is that they cannot identify effects of QT that fall outside of the short window used for the estimation. For example, Bank staff analysis of past auction sales suggests that rate impacts have tended to be short lived and reverse over subsequent days and so the component of the estimates that reflects impacts on auction days could be overstated. In contrast, were the impact of QT to only build up slowly over time, or only operate with a lag after policy announcements or auctions, the total impact of QT on gilt rates could be underestimated.

Long-term gilt yields, such as those for 30-year gilts, have risen by more than 10-year gilt yields. Bank staff analysis suggests that the larger increase in longer-term rates has been driven primarily by global factors, rather than being attributable to QT. Furthermore, analysis of changes in term premia for 30-year gilts, based on the same model used for the estimated range above, suggests that QT impacts have been similar to those for 10-year gilts. Lower market liquidity for these assets means that the model-based estimates are more uncertain for this maturity.

Besides its impact on long-term interest rates through the portfolio rebalancing channel, staff analysis and external research suggests that QT could affect bank lending, especially as central bank reserves become less abundant in the system (**Altavilla et al (2024)**). The process of QT reduces reserves in the banking system which, among other purposes, are used by banks to insure against liquidity risk. As reserves are risk-free and the most liquid form of asset, fewer available reserves could weigh on bank lending growth. The Bank is currently transitioning to a repo-led demand-driven framework for supplying reserves, which will ensure that banks can meet their demand for reserves through use of the Bank's repo facilities (**Bank of England (2024)**). This framework should mitigate risks to bank lending from QT through this channel.

**QT auctions have had little impact on market functioning.**

There is little evidence of a material impact of QT auctions on broader market conditions. For example, the average range over which gilt rates vary on days with QT auctions is less than one basis point higher than the average range observed on days without QT auctions. Were auctions to affect market liquidity negatively, we would expect to see larger variation in rates at those times. The small impact on market liquidity will partly reflect the fact that market participants are able to adjust for the effects of QT auctions in advance, since they are announced well ahead of time. In line

with the principle that QT should be conducted in appropriate market conditions, in April 2025 the Bank **amended the schedule** of gilt sales by delaying sales of long maturity bonds following a period of international market volatility.

**External estimates of the impact of QT on rates are broadly consistent with Bank staff's analysis, but comparing with estimates for other countries is difficult due to differences in the implementation of QT programmes.**

External research on the impact of QT programmes is broadly consistent with Bank staff's analysis. For example, **Du et al (2024)** find that QT programmes in various countries have had limited impact on government bond yields, market functioning and liquidity. External estimates of the impact of QT rely heavily on event study estimates. That means they have similar limitations to the Bank staff analysis outlined above. This is particularly important for the UK given the gradual and predictable approach taken for QT (**Lu and Valcarcel (2024)**, **D'Amico and Seida (2024)**).

More generally, differences in the implementation of QT between the UK and other jurisdictions make it difficult to compare estimates of the impact of QT internationally. For instance, the Federal Reserve has indicated that shrinking its balance sheet through QT is an active monetary policy tool (**December 2021 FOMC minutes**), in contrast to the MPC's principles outlined above.

**When the MPC sets Bank Rate, it takes account of financial market conditions that reflect the effects of announced and expected APF reductions.**

The small rise in market interest rates driven by QT will have a slight contractionary effect on GDP and will slightly reduce inflation. There are large uncertainties around these estimates, but Bank staff analysis based on the UK's experience of QE suggests that the impact of a 10 basis point increase in yields would be associated with a negative impact on GDP and inflation of less than 0.2% and 0.1 percentage points respectively. To the extent that asset prices at the time of the Committee's policy assessments incorporate the impacts of announced and expected APF reductions, the MPC takes account of these impacts when taking its decisions on Bank Rate. The MPC will adjust Bank Rate such that overall financial conditions are appropriate to bring inflation back to the 2% target. It retains the ability to set the monetary stance to meet the 2% inflation target at all times.

**The effect of QT may vary over time and estimates of its impact are uncertain.**

Global economic policy uncertainty, high issuance of government bonds across countries and structural changes within the domestic bond market which have reduced demand for long-term government debt, have all pushed up on bond term premia.

These same shifts in the gilt market could pose a risk that QT has a greater impact on market functioning than previously. In an environment with lower demand for long-term assets, for example, QT could have a larger impact on market liquidity.

Measures of gilt market functioning suggest that the market has generally continued to function in an orderly manner. However, reflecting changes in the profile of underlying demand for gilts and long-term cost and risk factors, the Debt Management Office (DMO) amended its 2025–26 financing remit by reducing sales of long-term bonds and increasing short-term financing. The DMO also increased the proportion of issuance for which an issuance method has yet to be decided, in order to provide additional flexibility to respond to evolving demand and market conditions during the financial year.

The MPC will continue to monitor the impact of QT. The analysis summarised in this box will support the MPC's decision over the appropriate pace of gilt stock reduction over the year ahead.

At its September meeting the MPC will vote on the target for the reduction in the stock of UK government bonds held for monetary policy purposes over the 12-month period from October 2025 to September 2026. Bank Rate remains the MPC's active tool of monetary policy and will be set to meet the 2% inflation target sustainably in the medium term.

## Box C: Monetary policy since the May 2025 Report

At its meeting ending on 18 June 2025, the MPC voted by a majority of 6–3 to maintain Bank Rate at 4.25%. Three members preferred to reduce Bank Rate by 0.25 percentage points, to 4%.

There had been substantial disinflation over the past two years, as previous external shocks had receded, and as the restrictive stance of monetary policy had curbed second-round effects and stabilised longer-term inflation expectations. This had allowed the MPC to withdraw gradually some degree of policy restraint, while maintaining Bank Rate in restrictive territory so as to continue to squeeze out existing or emerging persistent inflationary pressures.

Underlying UK GDP growth appeared to have remained weak and the labour market had continued to loosen, leading to clearer signs that a margin of slack had opened up over time. Measures of pay growth had continued to moderate and, as in May, the Committee expected a significant slowing over the rest of the year. The Committee remained vigilant about the extent to which easing pay pressures would feed through to consumer price inflation.

Twelve-month CPI inflation had increased to 3.4% in May from 2.6% in March, in line with expectations in the May Monetary Policy Report. The rise had been largely due to a range of regulated prices and previous increases in energy prices. Consumer price inflation was expected to remain broadly at current rates throughout the remainder of the year before falling back towards target next year.

Furthermore, global uncertainty remained elevated. Energy prices had risen owing to an escalation of the conflict in the Middle East. The Committee would remain sensitive to heightened unpredictability in the economic and geopolitical environment, and would continue to update its assessment of risks to the economy.

# 2: Current economic conditions

CPI inflation was 3.6% in June, 0.2 percentage points higher than expected in the May Report. Mainly reflecting unexpected strength in food prices, CPI inflation is now projected to peak at 4.0% in September before falling back to 3.6% by the end of the year.

Services consumer price inflation remains elevated. While underlying disinflation in services prices seems on balance to be continuing, any progress is being masked temporarily by upward pressure from administered prices and the impact on some prices of the increase in employer NICs. Indicators of households' inflation expectations remain elevated, while inflation expectations of firms have been more stable.

Pay growth continues to ease from elevated rates and is projected to slow to around 3¾% by the end of this year from around 5% currently.

Developments in the labour market are consistent with a continued gradual loosening. Underlying employment growth has been around zero in recent months and the degree of slack in the labour market appears to have widened. Spare capacity within firms has also increased.

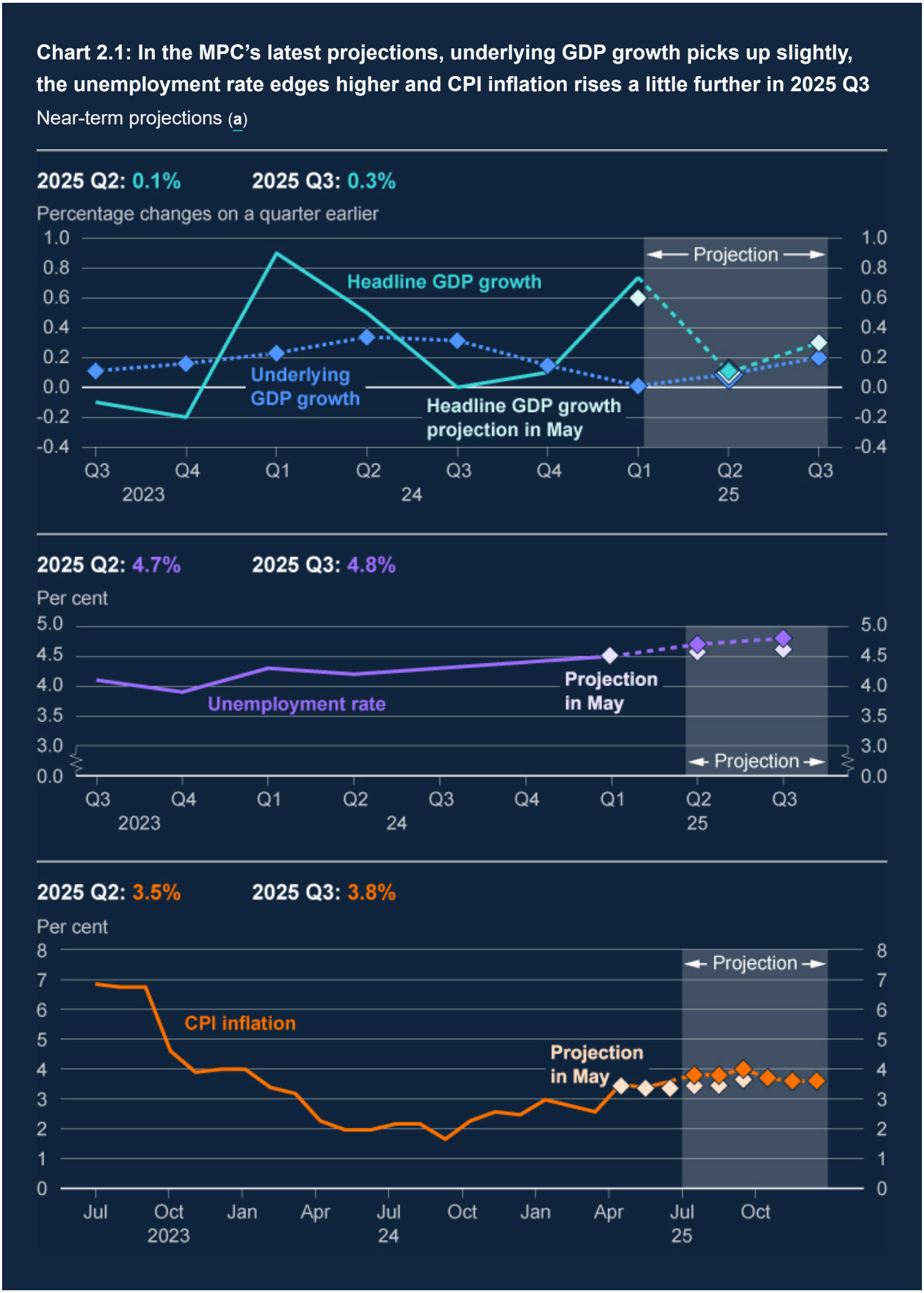
Underlying momentum in UK GDP has been subdued but is expected to pick up a little in the near term. The household saving ratio remains elevated relative to its pre-Covid pandemic average.

Developments in trade policy in the US and elsewhere continue to be a key influence on global GDP growth. The future constellation of policies remains difficult to predict, but US tariffs are currently expected to be lower on average than was assumed at the time of the May Report.

Sterling had appreciated slightly in the period leading up the August Report, compared with three months earlier. Over the same period, risky asset prices had risen and the market-implied paths for policy rates in the UK, US and euro area had been little changed.

**Chart 2.1: In the MPC's latest projections, underlying GDP growth picks up slightly, the unemployment rate edges higher and CPI inflation rises a little further in 2025 Q3**

Near-term projections (a)




Sources: BCC, CBI, Lloyds Business Barometer, ONS, S&P Global and Bank calculations.

(a) The lighter diamonds show Bank staff's projections at the time of the May Report. The darker diamonds show Bank staff's current projections. The azure diamonds in the top panel are Bank staff's estimates of underlying quarterly GDP growth. Underlying GDP data from 2023 Q3 to 2025 Q1 show in-sample fitted values of a business survey indicator model estimated by Bank staff, and data for 2025 Q2 and 2025 Q3 show out-of-sample projections. The projections for headline GDP growth and the unemployment rate are quarterly and show 2025 Q2 and 2025 Q3 (May projections show 2025 Q1 to 2025 Q3). The projections for CPI inflation are monthly and show July to December 2025 (May projections show April to September 2025). The GDP growth and unemployment rate projections for 2025 Q2 are based on official data to May 2025, while the CPI inflation figures over the same quarter are outturns. Although LFS unemployment data have been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from low response rates, which can introduce volatility and potentially non-response bias (Box D of the **May 2024 Monetary Policy Report**).

## 2.1: Global economy and financial markets

> **Trade policy announcements in the US and elsewhere are affecting global GDP growth.**

Since March, the US Government has announced a series of tariff policy changes for various countries and products.

The baseline projections in this Report are conditioned on the tariff rates implemented as of 29 July, which for the US means an estimated effective tariff rate of around 14%. This is down from the 23% estimate based on trade policies that had been implemented at the time of the May Report, but up from the 2% estimate prior to the policy changes. Tariff rates fell after the May Report as there was a de-escalation of tensions between some countries, particularly the US and China, and trade agreements between others, initially the US and the UK. After that agreement, the estimated effective US tariff rate on the UK fell from 11% estimated at the time of the May Report to 8%–9% now.

There has been a range of announced policy changes that had not been implemented as of 29 July and so were not included in the baseline projections. These include the agreement between the US and EU announced on 27 July. And on 1 August, the US administration announced increases in tariffs on a number of countries, excluding the UK, due to take effect on 7 August. Based on these recent policy announcements, the expected future US effective tariff rate is likely to rise from the level implied by tariffs implemented as of 29 July to around 17%, though remain below the rate at the time of the May Report. Although measures of trade policy uncertainty have fallen back, there remains uncertainty over future trade policies across countries. Box D discusses the sensitivity of the economic outlook to a higher level of global tariffs and to different assumptions around the impact of higher tariffs.

Changes in global trade policy have driven most of the dynamics in global GDP so far this year. Four-quarter UK-weighted global GDP growth fell from 2.2% in 2024 Q4 to 2.1% in 2025 Q1 (Chart 2.2), owing primarily to a 0.1% contraction in US GDP in Q1. Higher frequency trade data suggest that there was greater than anticipated front-loading of imports ahead of US tariff announcements in April (Box C of the **May 2025 Monetary Policy Report**).

The advance estimate of quarterly growth in US GDP picked up to 0.7% in 2025 Q2, as net trade partially recovered from this front-loading effect, with monthly US goods imports falling back by almost $70 billion in April. Growth in final private domestic demand, which abstracts from some of the volatility from trade policy, slowed in Q2, growing by 0.3%, down from 0.5% in Q1.

Euro-area GDP grew by 0.1% in 2025 Q2, lower than the projection in the May Report. This was driven by an unwinding of a greater-than-expected front-loading of exports in 2025 Q1.

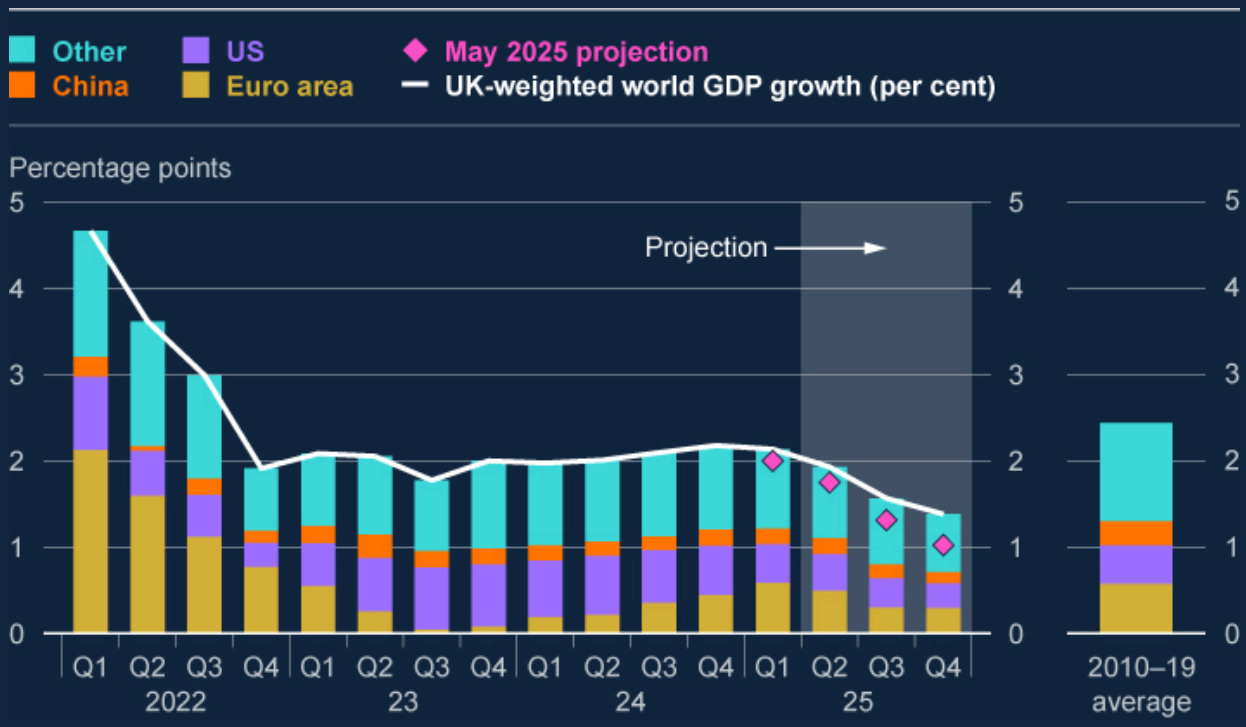
> **Lower trade barriers than at the time of the May Report, US fiscal stimulus and more accommodative financial conditions in some countries are expected to boost UK-weighted global GDP growth in 2025 H2 compared with the baseline projection in the May Report.**

Four-quarter UK-weighted global GDP growth is projected to be 1.6% in 2025 Q3 and 1.4% in 2025 Q4. While this represents a slowing in growth, the projection for 2025 Q3 and Q4 is 0.3 and 0.4 percentage points respectively above the projection at the time of the May Report.

A range of factors, including US trade and fiscal policy and financial conditions in the euro area, account for the upward revision to the near-term global GDP projection. Trade barriers are lower than assumed in the May Report projections. And a recent US bill has introduced a range of tax cuts, which are only partially offset by spending cuts and smaller tax increases. More accommodative financial conditions in the euro area are also expected to raise global growth in the near term. Continued strength in Chinese exports and strong activity in China, supported by domestic policies such as the consumer trade-in programme, are expected to increase global growth in the near term.

**Chart 2.2: Global GDP growth is projected to remain below historical norms**

Four-quarter UK-weighted global GDP growth with contributions by region (a)




Sources: LSEG Workspace and Bank calculations.

(a) Refer to footnote (c) of Table 1.D for definition. The figures for 2025 Q2 to 2025 Q4 are Bank staff projections. These projections do not include the advance estimate of US GDP in 2025 Q2 or the preliminary flash estimate of euro-area GDP for the same quarter, as the data were published after the cut-off for incorporation into the forecast. The pink diamonds are the corresponding projections from the May Report.

**Despite rises in oil and gas prices following further conflict in the Middle East, current energy prices are now closer to their levels ahead of the May Report.**

Military action between Iran and Israel (later joined by the US) in June, led to a rise in spot oil prices, peaking at a little under $80 a barrel, up from a little over $60 at the time of the May Report. Since then, tensions have eased, and spot oil prices have fallen back and averaged a little under $70 a barrel over the 15 working days to 29 July. Oil prices are currently below levels seen at the start of the year reflecting a combination of increased supply from OPEC countries and the expectation of weaker global demand. Liquified natural gas prices similarly increased in June but subsequently fell back. Oil and gas prices have ended the period since May slightly higher than their levels at the time of the previous Report.

**The easing in trade restrictions has fed through to stronger global commodity prices and broader financial market conditions.**

Reflecting the partial easing in global trade tensions, particularly between the US and China, global non-oil export prices are now expected to be around 1% higher over the forecast period (Section 1). That is primarily because lower tariff rates are expected to raise demand for global exports, particularly as lower tariffs encourage more exports from China to the US, pushing up their prices. Higher global prices are expected to pass through to somewhat higher UK import prices and eventually to consumer goods prices.

Measures of market volatility, including the VIX and MOVE, rose ahead of the May Report, driven by global trade policy announcements in April. But they have since fallen back to their average levels since 2002 (Chart 1.1 of the **July 2025 Financial Stability Report**). Specific measures of trade policy uncertainty remain elevated but have fallen back markedly from their peaks.

Equity markets have strengthened. The US S&P 500 index has risen by just under 20% since the period leading up to the May Report and the UK FTSE 100 index has also risen over this period, by around 10%. European equities prices have also risen. These rises more than reverse the large falls seen in March and April following the changes in US economic policy. Both the US and UK indices are close to all-time highs.

Corporate bond spreads have tightened in the UK and other countries and are now tighter than their average between 1998 and 2025 across asset classes, reflecting resilient corporate balance sheets (**July 2025 Financial Stability Report**).

Following the May Report, 10-year gilt yields in the UK are little changed, up by 5 basis points in the 15 working day average to 29 July compared with the 15 working day average to 29 April. There has been a more persistent change in very long-term yields over this period. The spread between 30-year and 10-year government bond yields has risen across countries since January, by around 35 basis points in the UK, 40 basis points in the US and over 50 basis points in Japan. Market intelligence suggests that the key drivers of these moves have been concerns over the long-term sustainability of fiscal policy across advanced economies and declining structural demand for long maturity bonds. Between the 29 July and 5 August, government bond yields fell back a little, driven partly by market reaction to weak US labour market data.

> **The market-implied paths for future policy rates have changed relatively little since the May Report although they have varied more in the near-term for the US.**

The European Central Bank (ECB) Governing Council maintained its deposit facility rate at 2% at its July meeting. Meanwhile, the Federal Reserve's Federal Open Market Committee maintained the target range for the federal funds rate at 4.25%–4.5% at its July meeting.

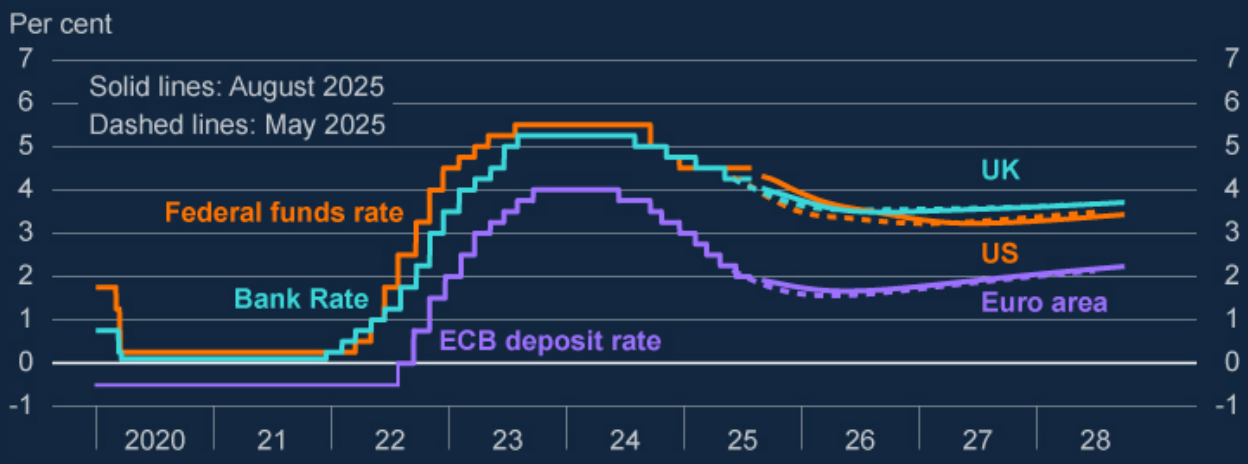
After the US announcement of higher tariffs in April, the market-implied paths for future policy rates in advanced economies fell, offsetting some of the expected drag to UK growth and inflation from the greater restrictions on trade. Despite the delay or reduction in US tariff rates after that, and the recovery in risky asset prices, the market-implied paths for future policy rates have changed little since then.

The market-implied path for the UK policy rate is, on average, little changed since the period leading up to the May Report over the next three years. Based on the 15 working day average to 29 July 2025, the market-implied path for Bank Rate fell to around 3.5% by 2026 Q2, before subsequently rising slightly to 3.7% by 2028 Q2 (Chart 2.3). The market-implied path of future ECB policy rates over the same period had risen by a little under 10 basis points on average over the next three years.

The market-implied path for US policy rates, based on the 15 working day average to 29 July, was around 45 basis points higher over the remainder of 2025 than the 15 working day average to 29 April. This, in part, reflected market expectations that the Federal Reserve would keep the federal funds rate higher in the near term to counteract the expected increase in inflationary pressures from fiscal stimulus, trade restrictions and a deprecation in the dollar. However, as of 5 August, the market-implied path for US policy rates had fallen materially from the 15 working day average to 29 July, in part driven by reaction to weak US labour market data.

**Chart 2.3: The market-implied paths for policy rates have changed relatively little since the May Report, although near-term US rate expectations have risen somewhat**

Policy rates and instantaneous forward curves for the UK, US and euro area (a)




Sources: Bloomberg Finance L.P. and Bank calculations.

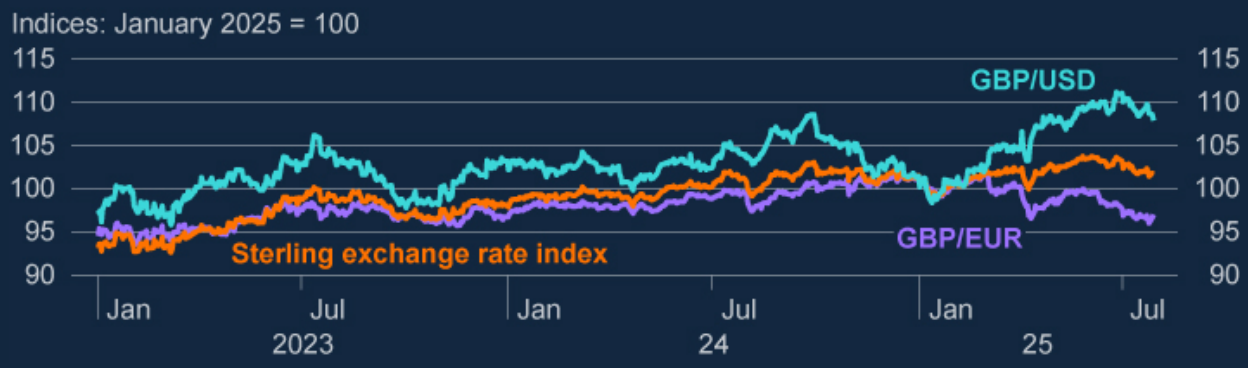
(a) All data are as of 29 July 2025. The May 2025 curves are estimated based on the 15 UK working days to 29 April 2025. The August 2025 curves are estimated using the 15 UK working days to 29 July 2025. The federal funds rate is the upper bound of the announced target range. The market-implied path for US policy rates is the expected effective federal funds rate. The ECB deposit rate is based on the date from which changes in policy rates are effective. The final data points are forward rates for September 2028.

**Sterling had appreciated very slightly in the run-up to the August Report, compared with three months earlier.**

Sterling had appreciated slightly since the period leading up to the May Report, with the average sterling exchange rate index over the 15 working days to 29 July being 0.3% higher than the 15 working days up to 29 April (Chart 2.4). The pound weakened by 1% over this period against the euro, but strengthened by around 2% against the dollar. As of 5 August, sterling had depreciated slightly compared to the 15 working day average to 29 July, to a little below the levels leading up to the May Report.

**Chart 2.4: The appreciation in sterling since early 2025 has been driven in part by weakness in the US dollar**

Sterling exchange rates (a)




Sources: Bloomberg Finance L.P., LSEG Workspace and Bank calculations.

(a) Data are indexed to the average level in January 2025 for each series. Final data are to 29 July.

## 2.2: Domestic credit conditions

**Spreads on wholesale bank debt have fallen back from their levels in April.**

UK banks' wholesale funding costs have fallen back since the May Report, having risen in April in response to growing concerns around the impact of higher tariffs on global economic activity (Section 2.2 of the **May 2025 Monetary Policy Report**).

**Many quoted household interest rates have fallen over recent months, along with effective rates on new corporate lending.**

The primary driver of changes in household and corporate interest rates over recent months has continued to be movements in their relevant reference rates. The average effective interest rate on new corporate lending, for which Bank Rate is the main reference rate, has continued to evolve broadly in line with the experience from previous Bank Rate cycles, and is now 125 basis points lower than in May 2024 (Chart 2.5, right panel).

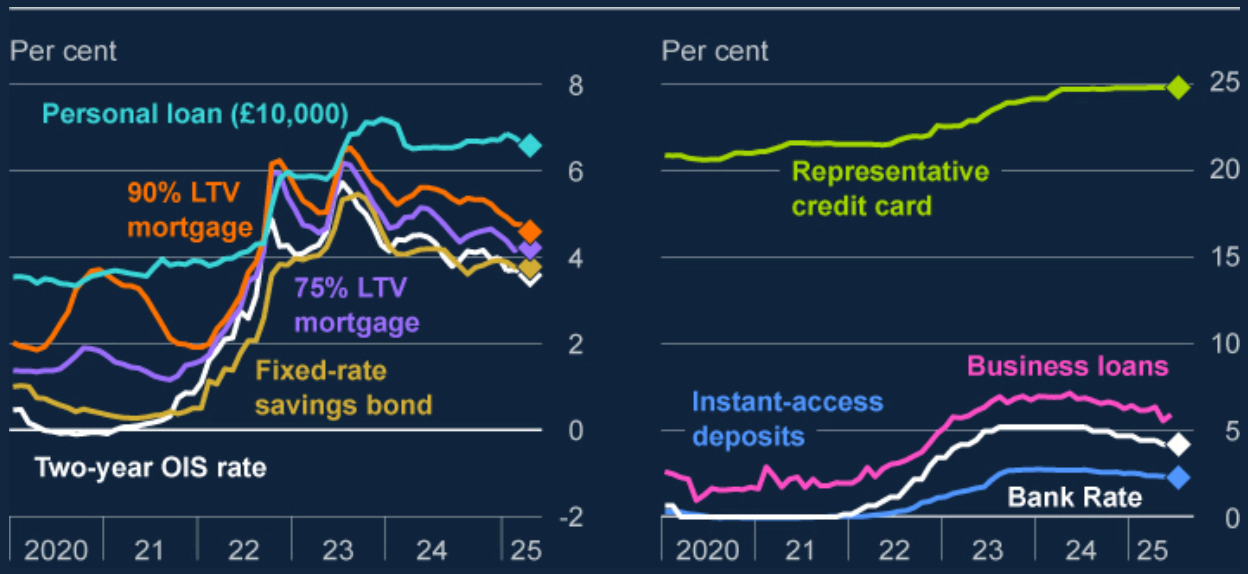
The pass-through of reductions in Bank Rate to instant-access household deposit rates has continued to be low over recent months. The average quoted instant-access deposit rate is currently around 45 basis points lower than in July 2024, much less than the reduction in Bank Rate over this period. That low degree of pass-through is partly a consequence of low pass-through during the most recent Bank Rate tightening cycle, along with increasingly strong competition for deposits between banks. Meanwhile, quoted interest rates on

representative credit card lending to households tend to respond to changes in Bank Rate very slowly and have remained around the same level since the start of the current cutting cycle.

Medium-term overnight indexed swap (OIS) rates are the key reference rates for interest rates on fixed-rate mortgages, fixed-rate savings bonds, and personal loans. Two and five-year spot OIS rates are little changed overall since the May Report. But despite some volatility, interest rates have generally fallen across relevant household products over this period, reflecting the lagged pass-through of previous falls in OIS rates (Chart 2.5, left panel). The average quoted rates on two-year fixed-rate mortgages with loan to value (LTV) ratios of 75% and 90% have fallen by around 15 basis points and 35 basis points, respectively, since April 2025. Quoted rates on fixed-rate savings bonds and personal loans have also fallen broadly as expected.

**Chart 2.5: Pass-through of changes in reference rates has continued to operate broadly as expected over recent months**

Household and corporate interest rates and their corresponding reference rates (a)




Sources: Bank of England, Bloomberg Finance L.P. and Bank calculations.

(a) Household loan and deposit rates are based on average quoted rates and business loan rates are based on average effective rates on new lending. The Bank's quoted rates series are weighted monthly average rates advertised by all UK banks and building societies with products meeting the specific criteria. **Introduction of new Quoted Rates data** provides more information. The 75% and 90% LTV mortgage rates are for two-year fixed-rate products. The reference rate for these, and for personal loans and fixed-rate savings bonds, is the two-year OIS rate. The two-year OIS rate shows monthly averages, while Bank Rate shows month-end numbers. The provisional July 2025 data are shown in diamonds. For quoted rate series and the two-year OIS rate, these are based on average values to 29 July 2025. The provisional data point for Bank Rate is based on the rate as of 29 July 2025. The final business loan rate data are for June 2025.

**Bank lending to households and corporates has generally picked up over recent quarters but there has been some volatility in recent data. Aggregate broad money growth has been relatively stable.**

Household net secured lending growth was weak over 2023, largely reflecting the impact of restrictive monetary policy on demand for borrowing. But there has been a gradual pick-up since 2024 as monetary policy has become less restrictive (Box A and Chart 2.6, left panel).

More recently, net secured lending flows have been volatile, largely due to changes in Stamp Duty Land Tax (SDLT). Net secured lending to households recovered in May and June, following the weakest monthly flow since January 2024 in April. That recent volatility is consistent with households having brought forward house purchases ahead of the rise in SDLT in April.

Recent developments in mortgage regulation are judged to be supporting mortgage approvals, which should feed through to higher lending volumes over the coming months. Lenders have already started to use lower stress test rates in borrower affordability tests following the March statement from the Financial Conduct Authority (FCA) on its mortgage rules (**July 2025 Financial Stability Report**). This is expected to lead to a larger share of lending at a loan to income (LTI) ratio of greater than or equal to 4.5 over coming quarters. Meanwhile, the FPC recommended the Prudential Regulation Authority and the FCA amend implementation of its LTI flow limit to allow individual lenders to increase their share of lending at high LTIs, while aiming to ensure the aggregate flow remained consistent with the 15% limit (**July 2025 Financial Policy Committee Record**). This is also likely to increase the availability of credit for some households over coming quarters.

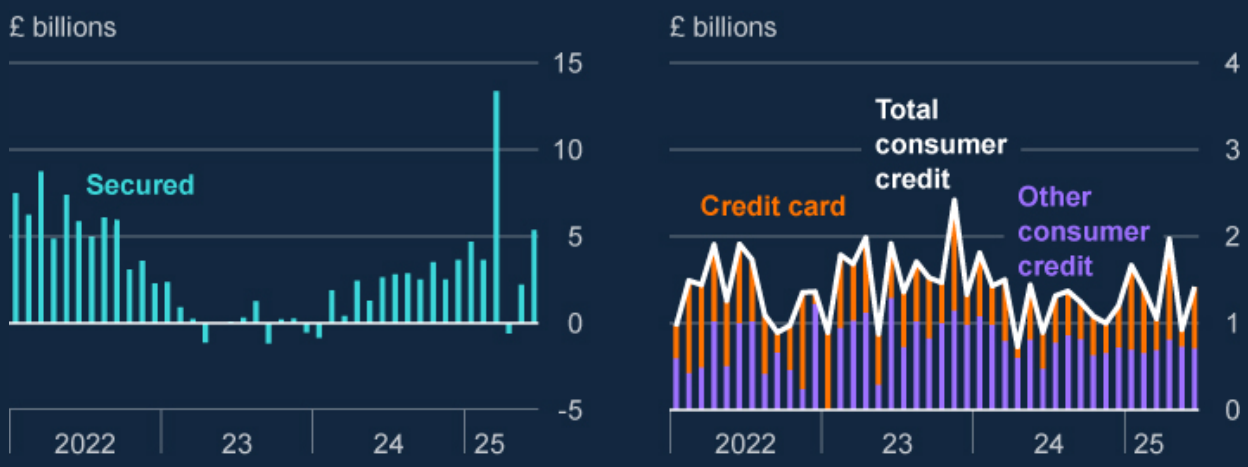
Real unsecured credit volumes have been relatively stable since the Covid pandemic, with the flows in June in line with their average level over the previous six months (Chart 2.6, right panel).

Net lending to non-financial private corporations has risen over recent months. That follows weakness between 2023 and mid-2024, driven by the effects of higher interest rates on the demand for credit and businesses repaying pandemic-era loans (Box D of the **May 2025 Monetary Policy Report**). Intelligence from the Bank's Agents suggests that credit demand from corporates remains weak in an absolute sense, but rising enquiries suggest some recovery over 2025 H2 (Box F). That is consistent with responses to the **2025 Q2 Credit Conditions Survey**, which suggest that businesses' demand for credit is expected to pick up slightly for both small and large businesses over 2025 Q3.

The annual growth rate in aggregate broad money picked up a little to 4.1% in June, while the ratio of aggregate broad money to nominal GDP remains below its pre-pandemic trend (Box D of the **May 2025 Monetary Policy Report**).

**Chart 2.6: Flows of net secured lending to households have been volatile over recent months, while net consumer credit volumes have been more stable**

Real flows of net secured and net unsecured lending to households (a)




Sources: Bank of England, ONS and Bank calculations.

(a) All flows are deflated with the CPI index and are shown in June 2025 prices. The latest data are to June 2025.

## 2.3: Domestic activity

**Temporary factors pushed up headline GDP growth at the turn of the year.**

Having flatlined in 2024 H2, GDP growth picked up sharply at the start of the year, to 0.7% in 2025 Q1, 0.1 percentage points stronger than expected in the May Report. But Bank staff judge that this recent strength largely reflects temporary factors that provide little signal for underlying momentum in GDP. Some of the strength in headline GDP was driven by growth in net trade, largely reflecting higher goods exports to the US as firms sought to front-load exports ahead of higher expected tariffs in 2025 Q2. Consistent with this, there was strength in the activity of tariff-sensitive industries, such as manufacturing and wholesale services. There was also evidence of front-loading in activity ahead of higher domestic taxation. Motor trades output rose notably ahead of higher vehicle excise duty in April and there was strength in housing sensitive sectors ahead of the April rise in Stamp Duty Land Tax (Section 2.2).

**Underlying GDP growth is expected to pick up a little in the near term.**

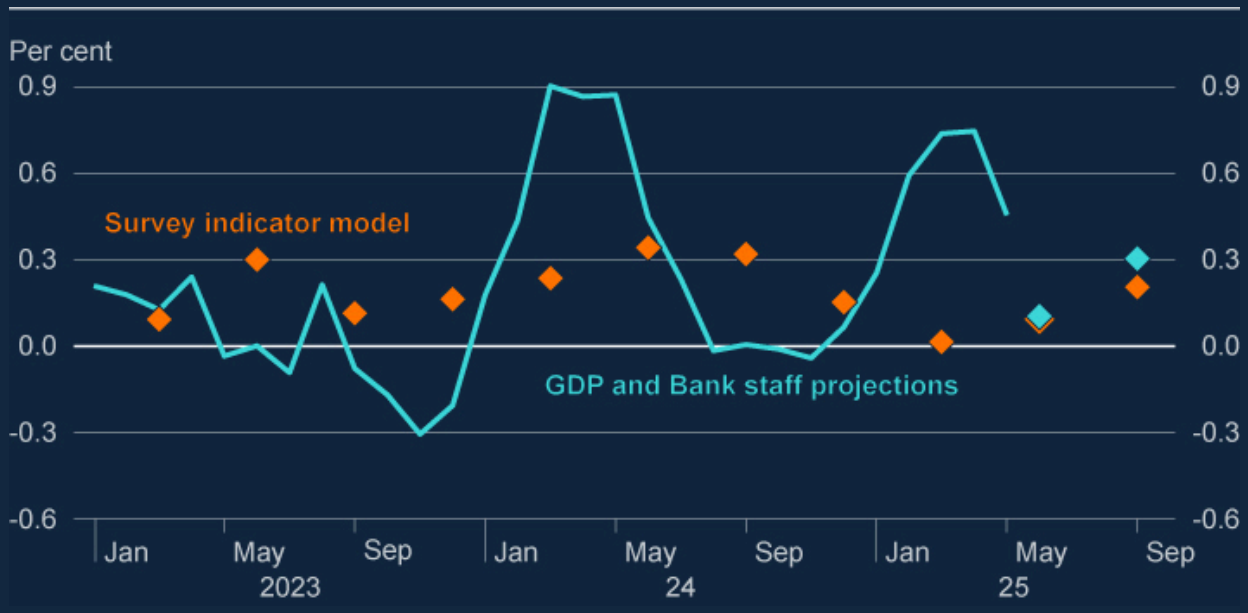
The collective steer from business surveys suggests that underlying momentum in GDP picked up from 0% in 2025 Q1 to 0.1% in 2025 Q2 (Chart 2.7). The most recent monthly output data have been weak, falling by 0.3% in April and 0.1% in May, unwinding some of the

strength in Q1 and leaving the level of GDP unchanged since February. Based on the available monthly GDP data and survey indicators, headline GDP is expected to have grown by 0.1% in Q2.

Underlying GDP growth is expected to pick up a little further to 0.2% in 2025 Q3. As of July, the final S&P Global composite UK PMI future output index had risen by over one standard deviation from its April trough, while the output index had also risen but by less. Both indices remain a little below their pre-pandemic averages. Headline GDP is expected to grow by 0.3%, a little stronger than growth in underlying GDP. That in part reflects a modest expected recovery in export volumes as part of the recently announced **UK-US Economic Prosperity Deal**, resulting in reduced automotive and aerospace tariffs for the UK.

**Chart 2.7: Underlying GDP growth is expected to pick up slightly**

Three-month on three-month growth in GDP and quarterly GDP growth implied by business surveys (a)




Sources: Bank of England Agents, BCC, CBI, Lloyds Business Barometer, ONS, S&P Global and Bank calculations.

(a) The final data point for three-month on three-month GDP growth is for the three months to May 2025. The aqua diamonds show Bank staff projections for headline GDP. The survey indicator model is based on a Staggered Combination MIDAS approach (**Moreira (2025)**). The orange diamonds to 2025 Q1 show in-sample fitted values of the survey indicator model and diamonds for 2025 Q2 and Q3 show out of sample projections.

> **Firms have reported that a mixture of global and domestic factors has weighed on output.**

Indicators of output and export orders have been below their historical averages recently (Chart 2.8), owing to a mixture of global and domestic factors. On the domestic side, firms have pointed to higher employer NICs, and uncertainty about its impact, as having weighed on growth. In the 2025 Q2 BCC Quarterly Economic Survey, 56% of firms reported that taxes were a greater concern than three months ago. On the global side, some firms reported that tariff announcements and the associated weakness in global demand were contributing to weakness in output growth. In the June S&P Global UK Manufacturing PMI survey, manufacturers reported that tariff uncertainty had resulted in lower export orders amid reports of weak global demand. And according to intelligence from the Bank's Agents, uncertainty about the global and domestic outlook remains elevated, although global uncertainty has slightly declined since the May Report. Elevated uncertainty is contributing to low business confidence and subdued investment intentions.

The impact of these global and domestic factors appears to have waned somewhat in recent months, however. Consistent with that, the Composite S&P Global UK output and new export indices have risen from their April troughs (Chart 2.8).

**Chart 2.8: Survey measures of output and export growth have picked up somewhat from recent lows**

Survey indicators of UK output and export growth (a)


Sources: S&P Global and Bank calculations.

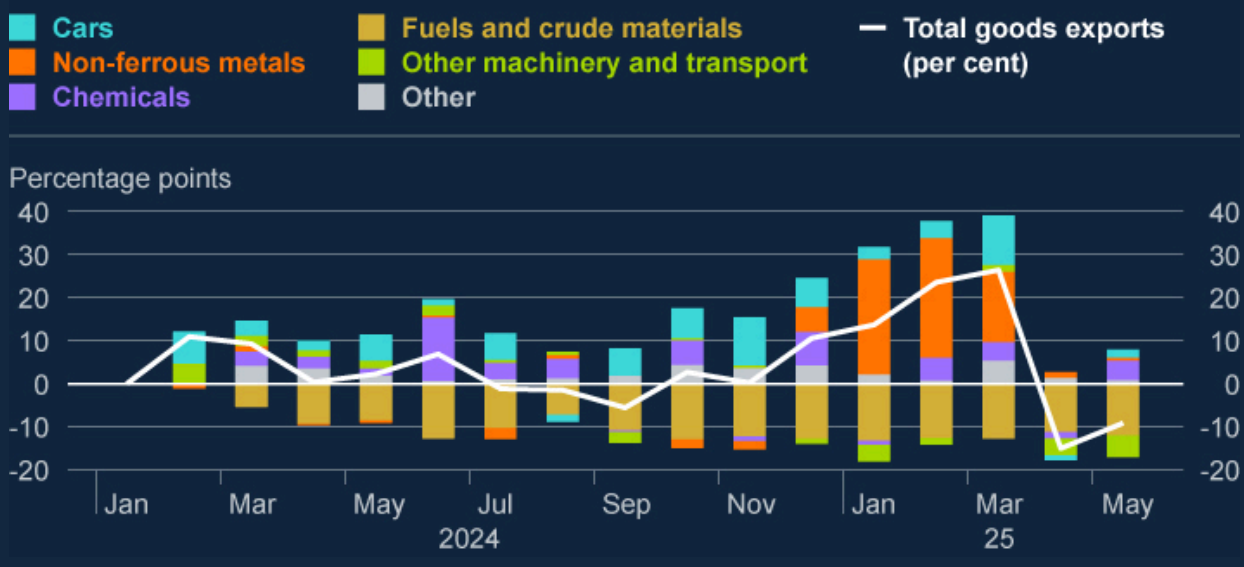
(a) A reading of above 50 in the S&P Global PMI index indicates an increase on the previous month while a reading below 50 indicates a fall. The dashed lines represent the series averages, calculated from January 1998 to December 2019 for the composite output series and September 2014 to December 2019 for the new export orders series. The latest data are flash estimates for July 2025.

**Higher global tariffs weighed on UK export growth in Q2, largely due to the unwind of front-loading.**

UK goods exports have fallen sharply in recent months. While these data can be volatile and prone to large revisions, Bank staff judge that the falls largely reflect an unwind of previous front-loading ahead of rises in global tariffs. Since March, the value of goods exports to non-EU countries has fallen by nearly 12%, which mostly reflects a 28% fall in exports to the US. These declines were predominantly driven by goods that were likely to be affected by particularly high tariffs, namely cars and non-ferrous metals, though exports of other goods were also affected (Chart 2.9). Bank staff judge that there is some additional weakness in UK export growth beyond the effects of front-loading, however. That is particularly the case for car exports, the value of which to the US had fallen by around 24% on an annual basis in May. The Society of Motor Manufacturers and Traders reported that UK vehicle production had fallen for five consecutive months in May, in part due to the impact of US tariffs, though it had picked up a touch in June.

**Chart 2.9: UK goods exports to the US have fallen sharply since March**

Contributions to percentage change in nominal UK goods exports to the US since January 2024 (a)




Sources: ONS and Bank calculations.

(a) The data are current price measures, are non-seasonally adjusted and include trade in unspecified goods. Data are shown to May 2025.

**The household saving ratio remains elevated.**

Household consumption grew by 0.3% in 2025 Q1, 0.1 percentage points lower than expected in the May Report. Consumption growth has been weaker than growth in real household incomes, such that the household saving ratio had risen to 11.6% by the end of last year. Much of that recent rise in the saving ratio reflects the restrictive stance of monetary policy (Box A). The saving ratio fell by 1 percentage point in 2025 Q1 (Chart 2.10), reflecting a decline in real household income of 0.8% as the rate of inflation outpaced the increase in nominal incomes. Despite this fall, the saving ratio remains notably above its pre-pandemic level, although these data can be heavily revised. Results from the spring Bank of England/NMG survey suggested that one of the key drivers of elevated saving, besides higher interest rates, was saving for emergencies, potentially reflecting precautionary behaviour. And in the July GfK Consumer Confidence Barometer, the savings index, which tracks people's desire to save, rose to its highest level since November 2007. But few respondents to the NMG survey said that concerns about job loss were inducing them to save more.

Indicators of household spending suggest that consumption will grow by 0.2% over Q2 and Q3. Retail sales volumes rose by 0.2% over 2025 Q2, in part reflecting weakness in food sales. And the GfK consumer confidence index remains below its historical average, largely driven by weakness in the general economic situation sub-indices. Further out, consumption growth is expected to pick up somewhat, supported by a reduced drag from past rises in interest rates. This is consistent with a gradual decline in the saving ratio (Section 1).

**Chart 2.10: The household saving ratio fell for the first time in two years in 2025 Q1, but remains elevated**

Household saving ratio (a)


Sources: ONS and Bank calculations.

(a) The ratio is calculated as saving as a percentage of total available household resources. The ONS series is NRJS. The final data point shown is for 2025 Q1.

## 2.4: The labour market and supply

**Underlying employment growth has continued to stagnate.**

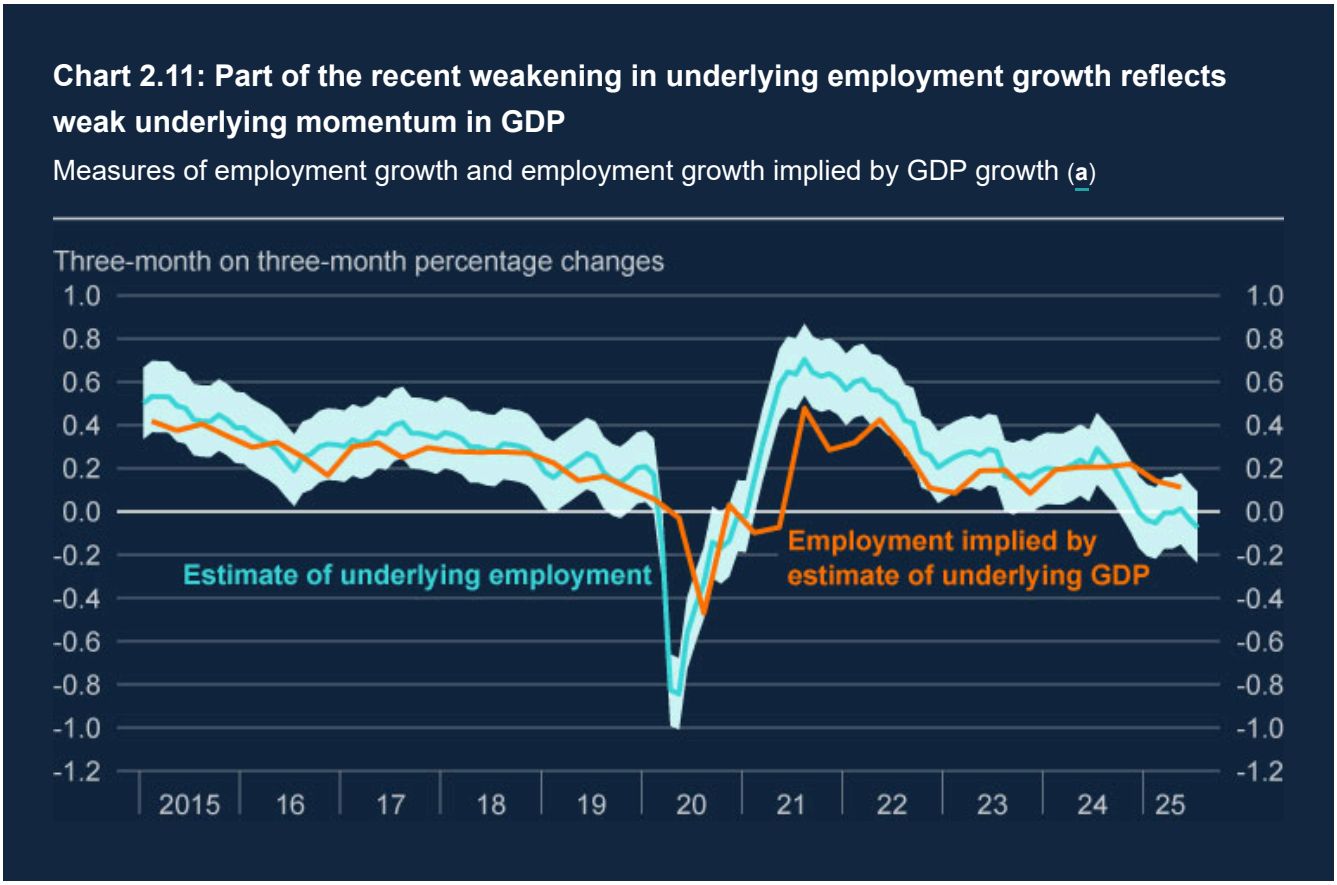
Bank staff judge that underlying employment growth, based on the signal from a range of measures, has been around zero since the end of last year (Chart 2.11, aqua line). Part of the weakness in employment reflects the weak underlying momentum in GDP. The orange line in Chart 2.11, which plots the estimated path of employment growth consistent with growth in underlying GDP, has fallen in recent quarters. And firms reported that subdued demand conditions were a constraint on staff recruitment in the June S&P Global Flash PMI survey. Weakness in GDP cannot fully explain the current weakness in underlying employment growth, however. Bank staff judge that some of that additional weakness reflects increases in employment costs. Contacts of the Bank's Agents have pointed to the rise in employer NICs and, to a lesser extent, increases in the NLW, as contributors to the weakness in employment growth. Alongside employment, firms are expected to continue to use several margins of adjustment in response to higher employer NICs (Section 2.5).

While indicators, on balance, suggest that underlying employment growth has been around zero, there is a high degree of dispersion among various measures. HMRC payroll data have been particularly weak, falling by 0.3% in the three months to June. Around half of this fall represents fewer jobs in the retail and hospitality sectors, both of which are quite labour intensive and are therefore exposed to the recent rise in labour costs. But early estimates of these data are prone to large revisions, so some of this weakness could be revised away. In addition, these data only cover employees, and it could be the case that some of the weakness reflects workers switching to self-employment.

Bank staff project employment growth to remain weak in the near term. Timely indicators of employment growth, such as the REC permanent staff placements index, are below historical averages and broadly consistent with employment growth of around zero. And employment intentions remain subdued, according to Agency intelligence. Contacts of the Bank's Agents suggest that considerable adjustment to NICs through employment has already taken place, however.

**Chart 2.11: Part of the recent weakening in underlying employment growth reflects weak underlying momentum in GDP**

Measures of employment growth and employment growth implied by GDP growth (a)




Sources: Bank of England Agents, DMP Survey, HMRC, KPMG/REC UK Report on Jobs, Lloyds Business Barometer, ONS, S&P Global and Bank calculations.

(a) Bank staff's indicator-based measure of underlying employment growth is constructed using a dynamic factor model following the approach of **Doz et al (2011)**. The model extracts a common component from monthly survey indicators, capturing comovements across series. The common component is scaled to align with LFS employment growth between 2000–19. The shaded areas represent 95% confidence intervals. The employment growth estimate implied by underlying GDP is based on a simple regression of underlying employment on six lags of underlying momentum in GDP based on Chart 2.7. The latest data are for 2025 Q2 for the GDP implied estimate of employment and July 2025 for the estimate of underlying employment based on survey data.

The ONS LFS estimate of employment has been significantly stronger than Bank staff's underlying measure, increasing by 0.4% in the three months to May. Achieved sample sizes in the LFS have improved recently, from 50% below 2019 levels in 2023, to around 17% below those levels in the latest data. But sample sizes remain low overall and therefore sampling variability is elevated. As such, the MPC continues to place less weight on the LFS relative to alternative measures of employment growth.

### The unemployment rate has edged up recently.

The latest LFS data suggest that the unemployment rate rose to 4.7% in the three months to May, up from 4.4% at the end of 2024 and 0.2 percentage points higher than expected in the May Report. Relative to employment, there are fewer indicators beyond the LFS when gauging developments in unemployment (**Broadbent (2023)**). But the combined signal from

the available indicators, such as the REC and Agents' scores for recruitment difficulties, suggest a similar increase. The rise in the unemployment rate from its recent trough in 2022 Q3 has occurred alongside a rise in labour force participation.

The recently reinstated LFS flows data are consistent with a gradual loosening in the labour market. Job-to-job flows, which track the proportion of people moving between jobs, have fallen below their historical average in recent quarters (Chart 2.12, left panel) and are consistent with the recent rise in the unemployment rate (**Gomes (2012)**). And while a broader labour market downturn would, based on past historical relationships, be accompanied by a sharp rise in the job separation rate, the current data have been broadly stable (Chart 2.12, right panel). These data should be interpreted with a degree of caution, however, given low sample sizes.

Looking ahead, Bank staff project the unemployment rate to rise slightly further, to around 4.8% by 2025 Q3. This is broadly consistent with softening employment intentions and relatively stable redundancy rates. LFS redundancies remain low, while advanced notifications of potential redundancies among larger firms, known as HR1s, are also subdued. Meanwhile, company insolvencies remain below their long-term average levels (**July 2025 Financial Stability Report**). Taken together, these data are broadly consistent with the expected continued gradual loosening in the labour market. Set against that, Google searches for redundancies, which track official redundancies fairly well, have edged up recently. And redundancies were cited as a driver of higher overall staff availability in the KPMG/REC survey. These data could point to an upside risk to the near-term projection for unemployment.

**Chart 2.12: Job-to-job flows have recently fallen below past averages, while job separation rates have been broadly stable**

Flows as a percentage of people in employment (a)


Sources: ONS and Bank calculations.

(a) These data are two-quarter flows, based on total employment of people aged 16–69 for job-to-job flows and 16–64 for the separation rate. Job-to-job flows refer to those who were employed in both quarters, but who in the latter quarter reported being with their current employer for less than three months, indicating a change of job between the quarters. The separation rate captures those who were unemployed in the latter quarter, having been classified as employed or economically inactive in the previous quarter. Refer to **ONS (2010)** for more details. The dashed lines are averages from 2002–19.

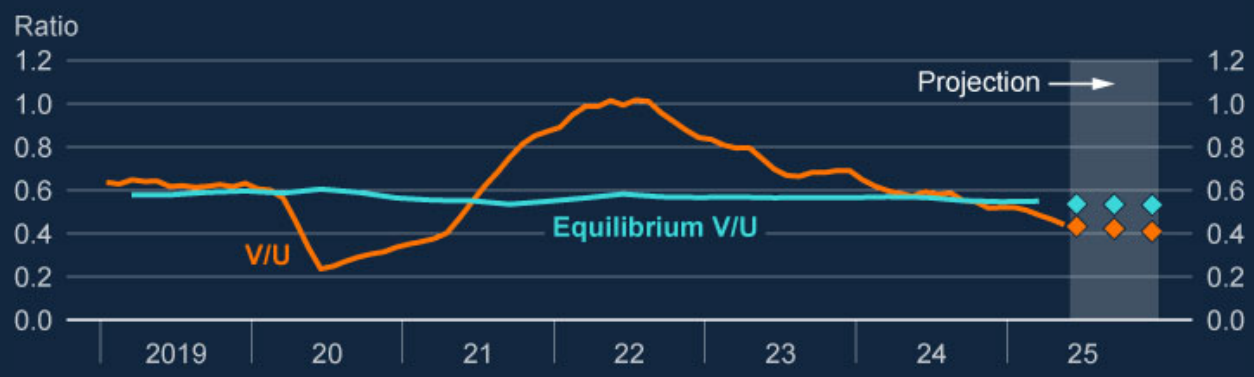
**Labour market slack is continuing to build as expected and survey indicators point to a further gradual loosening in the near term.**

Labour demand appears to have fallen further in recent months. ONS job vacancies, a measure of labour demand, have fallen by around 10% since the start of the year and Bank staff project job vacancies to fall a little further in the near term. Some firms responding to the ONS Vacancy Survey reported that they are not recruiting new workers or replacing workers who have left. Agency intelligence shows a similar picture, with many contacts reporting recruitment freezes and more intense scrutiny of hiring decisions, reflecting a mixture of higher labour costs and demand uncertainty.

Alongside higher unemployment, the fall in job vacancies has led to a further fall in the ratio of vacancies to unemployment, known as the V/U ratio (Chart 2.13). This ratio is judged to be somewhat below its equilibrium level (**Stelmach et al (2025)**) and is projected to fall a little further in the near term. Other indicators are also consistent with a growing margin of labour market slack. The net additional hours desired by workers, as a percentage of average hours worked, has continued to rise, and contacts of the Bank's Agents report that recruitment difficulties are normalising from previously elevated levels.

**Chart 2.13: The V/U ratio has fallen further below its equilibrium level**

Vacancies to unemployment ratio and its estimated equilibrium value (a)




Sources: Advertising association/World Advertising Research Centre Expenditure Report, ONS and Bank calculations.

(a) The final data point shown for the V/U ratio data is for the three months to May 2025. The equilibrium V/U ratio is estimated using an error-correction model over the period 1982–2024. The real cost of vacancy posting and hourly labour productivity are included as long-run determinants for the level of vacancies. The model also includes controls for short-term movements in these variables (**Stelmach et al (2025)**). The final data point for the equilibrium V/U ratio is 2025 Q1. The diamonds represent Bank staff projections for the V/U ratio and equilibrium V/U ratio for 2025 Q2 to 2025 Q4.

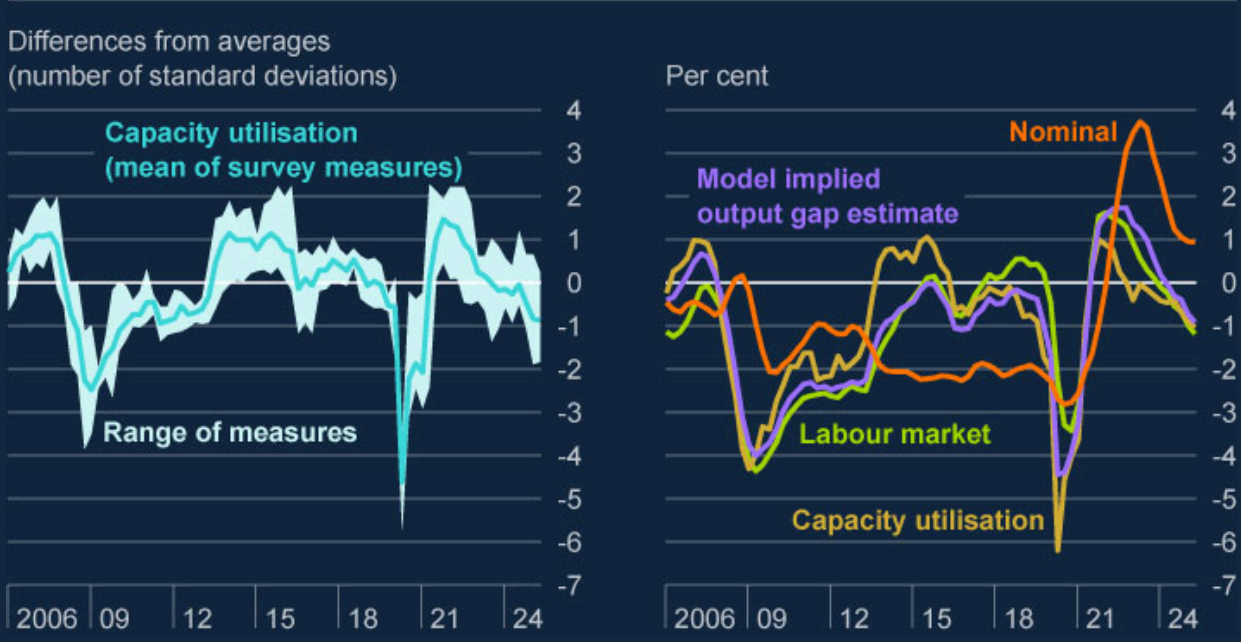
### A margin of spare capacity has opened up in the economy.

In addition to evidence of a growing margin of labour market slack, surveys of capacity utilisation suggest a growing degree of spare capacity within firms (Chart 2.14, left panel). Consistent with this, contacts of the Bank's Agents report that spare capacity is opening up across sectors, particularly in production industries, reflecting subdued demand. Top-down estimates of the output gap based on statistical techniques imply a modest widening recently, although there are large uncertainties around the precise level of the output gap. While capacity utilisation and labour market data suggest a growing margin of slack, the signal from nominal indicators remains consistent with a margin of excess demand (Chart 2.14, right panel).

Taken together, the MPC judges that the economy is operating with a degree of spare capacity. The margin of spare capacity is projected to widen a little further over the next few quarters (Section 1).

**Chart 2.14: Capacity utilisation and labour market data are consistent with growing slack**

Survey indicators of capacity utilisation (a) and model-based estimates of the output gap (b)




Sources: Bank of England Agents, BCC, CBI, KPMG/REC UK Report on Jobs, ONS, S&P Global and Bank calculations.

(a) Standard deviations from averages between 2000–19. The measures included in the swathe are from the Bank's Agents, the BCC (non-services and services), the CBI (manufacturing (capacity); and financial services, business/consumer/professional services and distributive trade (business relative to normal)) and S&P Global (manufacturing (backlogs) and services (outstanding business)). Sectors are weighted using their shares in gross value added. The BCC data are not seasonally adjusted. The data are shown to 2025 Q2.
(b) The model is estimated over 2000–2025 Q2 using the two-step estimator from **Doz et al (2011)**, obtained from running the data through a Kalman filter and smoother once. The first factor of the dynamic factor model is interpreted as a measure of slack. The factor is then mean-variance adjusted to the MPC's baseline output gap estimate over 2000–2025 Q2. The labour market block is estimated using survey indicators of slack and the vacancy gap estimate from Chart 2.13. The capacity utilisation block includes a range of surveys of capacity utilisation also used in the left panel of this chart. The nominal block contains measures of pay and underlying inflation, such as those in Charts 2.17 and 2.20. The data are shown to 2025 Q2.

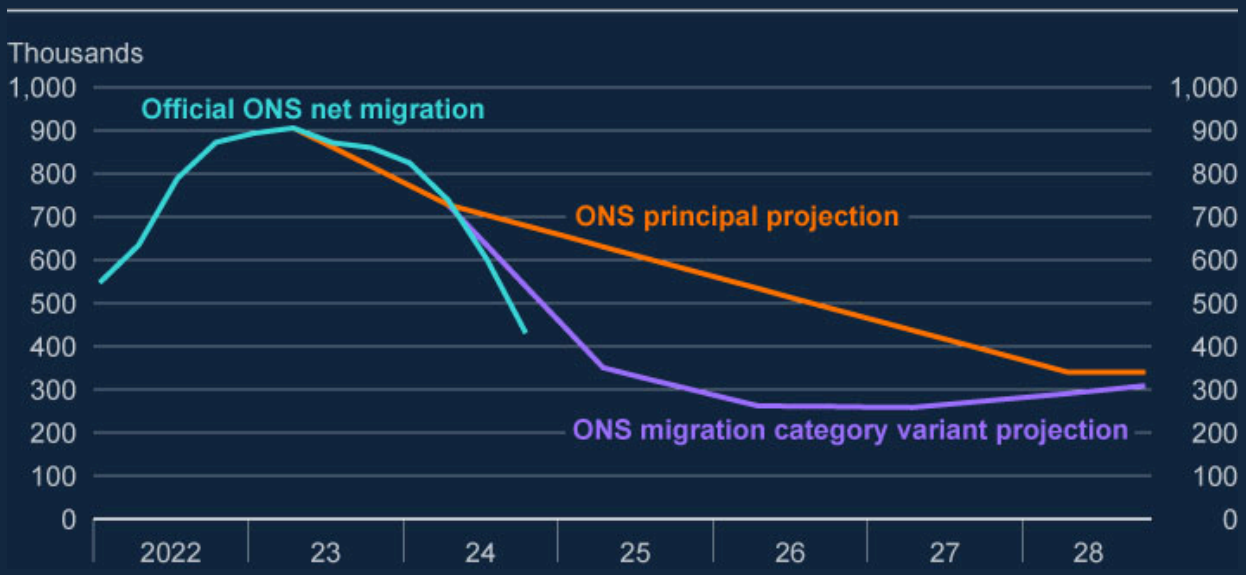
**Potential supply growth over the forecast period is expected to be weaker than projected in the May Report, reflecting lower net migration.**

Net migration fell to 431,000 in the year ending December 2024, down from 860,000 in the previous year (Chart 2.15, aqua line). That largely reflects fewer visas issued over the last year, as well as an increased number of students returning abroad. The fall in migration has been far greater than expected based on the ONS principal projection (Chart 2.15, orange line), which itself is based on 2022 population data. Based on the new migration data, the **ONS has recommended** using a lower path for future net migration, known as the migration

category variant projection (Chart 2.15, purple line). Based on that lower projected path for net migration, Bank staff have revised down their estimate for annual potential supply growth by an average of 0.2 percentage points per year over the forecast period (Section 1).

**Chart 2.15: Net migration has fallen more quickly than expected**

Estimates of net migration and ONS projections (a)




Sources: ONS and Bank calculations.

(a) The official ONS net migration data are estimated using administrative data, supported by surveys and statistical modelling. The **Provisional long-term international migration estimates: technical user guide** provides further details. These data refer to 12-month reference periods. For example, year-end December 2023 covers international migration to and from the UK from 1 January 2023 to 31 December 2023. The final official ONS net migration data are for year-end December 2024. The ONS principal and migrant category population projections are from the 2022-based national population projections. The latest data points are for year-end September 2028.

### Labour productivity growth remains weak, although the headline data may overstate some of the most recent weakness.

Measures of labour productivity growth continue to be weak relative to past averages. In the four quarters to 2025 Q1, output per hour based on headline data fell by 0.2%, while output per worker fell by 0.6% on the same basis (solid lines in Chart 2.16). That compares with average four-quarter growth of around 0.6% in these measures in the five years ahead of the Covid pandemic. But Bank staff judge that erratic factors have meant that some of the weakness in the headline data has been overstated. Underlying output per worker, based on the measures of underlying momentum in GDP and employment shown in Charts 2.7 and 2.11, grew by 0.4% in the four quarters to 2025 Q1 (Chart 2.16, dashed aqua line).

**Chart 2.16: Labour productivity growth remains subdued**

Measures of annual labour productivity growth (a)


Sources: ONS and Bank calculations.

(a) Four-quarter growth in output per worker and output per hour. Underlying output per worker is constructed using underlying momentum of GDP and employment, based on the indicator-based models from Charts 2.7 and 2.11 for GDP and employment respectively. The final data points are for 2025 Q1.

## 2.5: Wages and inflation

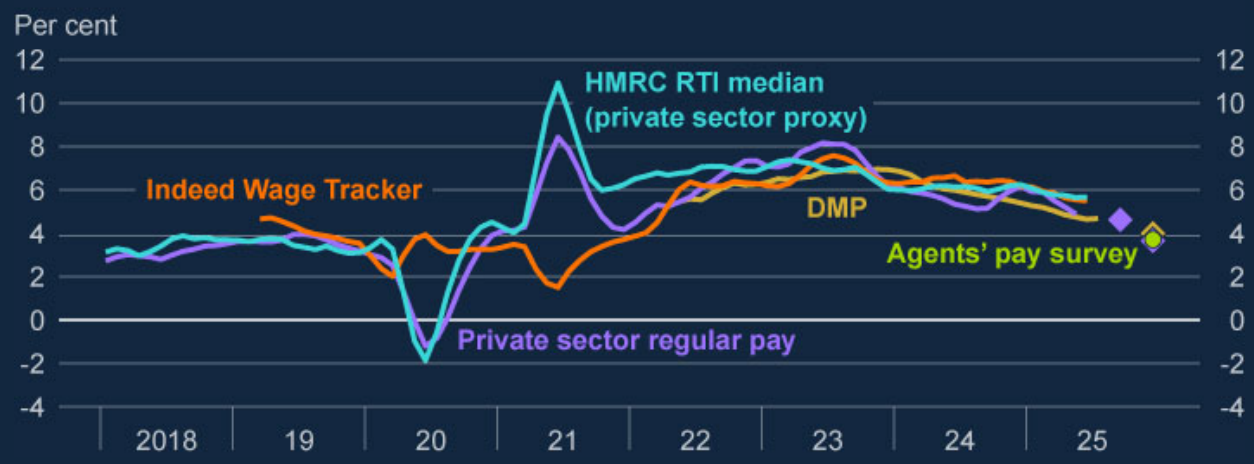
**Pay growth across a range of measures continues to fall back but remains elevated.**

Wage growth has continued to slow, to around 5%. Annual private sector regular AWE growth was 4.9% in the three months to May, compared with 5.9% in the three months to February and below the May Report projection of 5.4%. Part of the recent drop in AWE growth reflects a reversal of compositional effects and the fading of base effects that had pushed up pay growth at the start of the year, as anticipated in the May Report. But there has also been some additional downside news in private sector regular AWE growth.

The recent falls have brought AWE growth back in line with the signal of a gradual slowing in pay growth from a range of other indicators (Chart 2.17). The DMP Survey, the Indeed Wage Tracker and a proxy based on HMRC RTI data all suggest that annual pay growth has fallen modestly since the beginning of the year, albeit to a still elevated level.

**Chart 2.17: Wage growth has declined across various measures and is expected to fall to around 3¾% by the end of the year**

Measures of private sector wage growth (a)




Sources: Bank of England Agents, DMP Survey, HMRC, Indeed, ONS and Bank calculations.

(a) Private sector regular pay growth shows the ONS measure of private sector regular average weekly earnings growth (three-month average on same three-month average a year ago). DMP shows three-month average realised pay growth from the DMP Survey (three-month average on same three-month average a year ago). HMRC Real-Time Information (RTI) shows median of private sector employee pay growth. Indeed Wage Tracker shows annual average job title matched pay growth for UK job vacancies. Latest data points are for the three months to May 2025 for private sector regular pay, June 2025 for Indeed and HMRC RTI, and July 2025 for the DMP Survey. The Agents' pay survey circle shows respondents' expected average pay settlements in 2025, weighted by employment and sector. The DMP diamond shows average expected pay growth one year ahead from the December 2024 DMP Survey. Private sector regular pay growth projections are for 2025 Q3 and 2025 Q4.

### Wage growth is expected to moderate significantly further in the second half of 2025.

Private sector regular pay growth is expected to ease further over the second half of the year. That is partly due to an expected drag from base effects because of unusually strong wage growth at the end of 2024. Statistical analysis by Bank staff suggests that, even absent any further slowing in the trend of monthly pay growth rates, AWE growth should drop to around 4.5% by the end of the year. A range of indicators suggests that AWE growth will be lower than this by the end of 2025, however. Intelligence from the Bank's Agents points to average pay rises for 2025 of between 3.5% and 4%, and respondents to the DMP Survey expected pay growth to be just under 4% by the end of the year (Chart 2.17).

Meanwhile, recent pay settlements data from Brightmine, CIPD and the Bank's own settlements database continue to suggest that pay awards have been around 3%–4% since the end of last year. Within the Bank's settlements database, a normalisation in the

distribution of pay awards is evident. In particular, the share of awards above 5¼% has fallen from over 50% to below 20% over the past year, while the share of awards in the 2½% to 3¾% range has increased from around 6% to 36%.

Pay settlements in the 3%–4% range are broadly consistent with headline pay growth towards the top of this range by the end of the year. That is partly because pay settlements typically cover the period 12 months from when they are made, and hence provide a leading signal of pay growth, whereas AWE growth refers to the previous 12 months. It is also because pay settlements only capture increases in basic pay. Measures of aggregate pay growth will often depart from this due to people moving jobs to get a higher salary, in-role promotions, or discretionary pay increases outside the usual settlement period. These effects are also known as pay drift. Historically, pay drift has tended to be higher in periods of labour market tightness. As the labour market is now loosening (Section 2.4), Bank staff expect aggregate pay drift to fall back from its level of around 1 percentage point in 2024.

Overall, annual private sector regular AWE growth is projected to slow to 3.7% by the end of 2025, as the easing in the labour market and past falls in inflation expectations feed through to lower wage growth. Wage growth is expected to moderate further to a little below 3½% by 2026 Q2, broadly consistent with expected pay growth in the latest DMP Survey and early intelligence from the Bank's Agents.

**The rise in the National Living Wage is putting modest upward pressure on pay, partly offset by a drag from higher employer NICs.**

The 6.7% rise in the National Living Wage (NLW) in April was expected to push up annual pay growth by around 0.2 percentage points from 2025 Q2 in the May Report. In line with that, pay growth in the retail and hospitality sectors, which have a large share of employees at or close to the NLW, was elevated at 7.1% in the latest data. Contacts of the Bank's Agents continue to cite the NLW as the largest factor exerting upward pressure on pay in 2025.

Partly offsetting the impact of a higher NLW, the increase in the rate of employer NICs is likely to weigh on wage growth as firms try to contain the rise in overall employment costs (Box D of the **February 2025 Monetary Policy Report**). In line with this, intelligence from the Bank's Agents suggests that firms are using a range of measures to mitigate the impact of higher NICs on total labour costs, including reducing pay awards for staff paid above the NLW, as well as raising prices.

**Headline CPI inflation was 3.6% in June, above the MPC's 2% target.**

Twelve-month CPI inflation was 3.6% in June, up from 2.6% in March and slightly above the expectation at the time of the May Report. Since its recent trough in September 2024, headline inflation has picked up. This reflects a smaller drag from energy prices (Chart 1.1), a larger contribution from core goods, and, more recently, stronger-than-expected food price

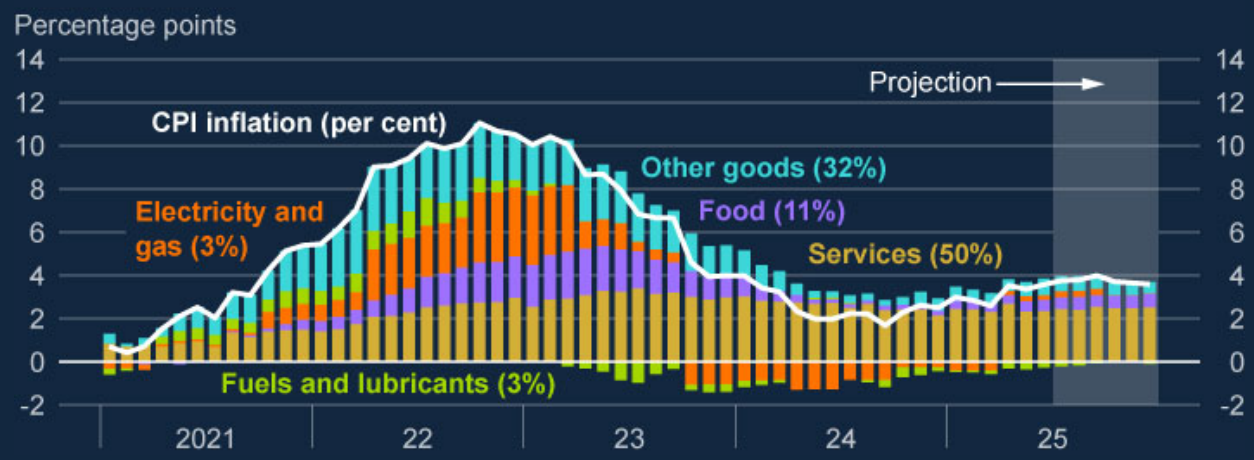
inflation. Meanwhile, core inflation has remained elevated, mainly because services inflation continues to be high at 4.7%. This reflects past strength in wage growth as well as temporary upward pressures from one-off increases in administered prices and the increase in employer NICs.

**Energy prices drove much of the rise in CPI inflation over the past year but are expected to have little impact on inflation going forward.**

The largest driver of the rise in headline inflation over the past year has been the waning drag from household energy bills. The contribution of household energy bills to headline inflation has been positive since April of this year, following 18 months in which household energy bills reduced headline inflation (Chart 2.18). The Ofgem energy price cap for the typical household is £1,720 for July until September 2025, almost 10% higher than for the same period last year, and is expected to remain at around that level for October to December 2025. Household energy bills are expected to boost inflation slightly over the next few months, partly offset by a small drag from fuels and lubricants.

**Chart 2.18: CPI inflation rose to 3.6% in June**

Contributions to CPI inflation (a)




Sources: Bloomberg Finance L.P., Department for Energy Security and Net Zero, ONS and Bank calculations.

(a) Figures in parentheses are CPI basket weights in 2025, which do not sum to 100% due to rounding. Data are shown to June 2025. Component-level Bank staff projections are shown from July to December 2025. The food component is defined as food and non-alcoholic beverages. Fuels and lubricants estimates use Department for Energy Security and Net Zero petrol price data for July 2025 and are then projected based on the sterling oil futures curve.

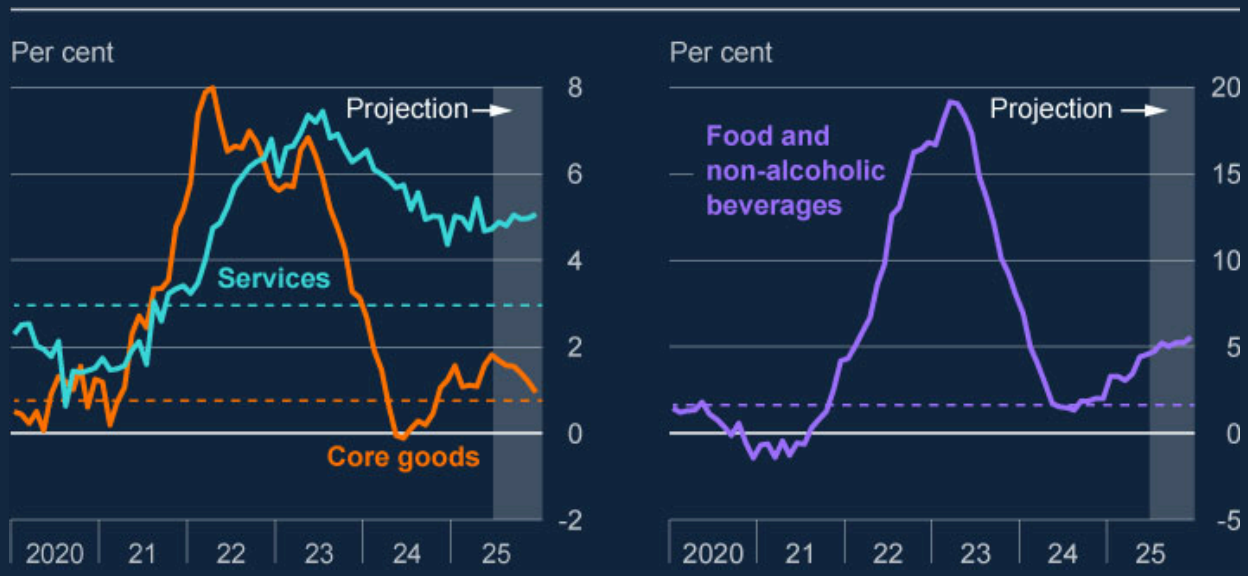
**Core goods price inflation is projected to moderate, while food price inflation is expected to rise further.**

Core goods and food price inflation fell materially over 2023 and early 2024, following declines in the prices of key inputs such as energy and other raw materials, but both have increased in recent months (Chart 2.19). Annual core goods and food price inflation were 1.8% and 4.5% in June respectively, above pre-Covid average rates.

Intelligence from the Bank's Agents suggests that the increase in core goods price inflation in recent months has mainly reflected higher labour costs. Indicators of non-labour cost pressures had increased at the beginning of the year but have fallen back somewhat since April. Annual core goods price inflation is expected to moderate in coming months, driven mainly by base effects due to strong increases in core goods prices in the second half of last year. Monthly annualised core goods price inflation rates are projected to remain slightly above their pre-Covid average in the second half of the year.

**Chart 2.19: Core goods price inflation is expected to moderate in coming months, while services and food price inflation are projected to remain elevated**

Annual inflation rates for components of CPI (a)




Sources: ONS and Bank calculations.

(a) The core goods component is defined as goods excluding food and non-alcoholic beverages (FNAB), alcohol, tobacco and energy. Data are to June 2025. Bank staff projections from July to December 2025. Dashed lines represent the 2010–19 averages, which are 3.0%, 1.6% and 0.8% for services, FNAB and core goods respectively.

There are uncertainties around the outlook for core goods price inflation due to data quality issues. In March, the ONS paused the publication of its producer price inflation data following the identification of a problem in its production (**ONS (2025)**). The ONS is expected to resume full publication of these data in October. However, **indicative producer prices** published in

July suggest that input price pressures had remained muted as of April. That is broadly in line with the PMI manufacturing input price balance, which has picked up since late 2023 but has fallen again in recent months and remains around its long-run average.

Meanwhile, food price inflation is projected to be around 5% in 2025 Q3, 1½ percentage points higher than expected in the May Report, before rising further to 5½% by the end of this year. This accounts for most of the upward revision to the projected path for CPI inflation over the next few months. High expected food price inflation is driven partly by higher global commodity prices, but also by labour costs and the Extended Producer Responsibility regulations that come into effect from October of this year (Box E).

> **Underlying services inflation has continued to moderate, but at a slower pace than last year based on some measures.**

Services inflation remained at 4.7% in June, unchanged from March and slightly above the expectation in the May Report. Underlying services price inflation has continued to moderate somewhat across a broad range of measures, including those based on exclusionary, trimming or reweighting approaches (Chart 2.20). However, all of these measures suggest that underlying services inflation remains elevated, and disinflationary progress in recent months has been slower than last year according to some measures.

**Chart 2.20: Underlying services inflation remains elevated**

Measures of three-month average monthly annualised services price inflation (a)


Sources: ONS and Bank calculations.

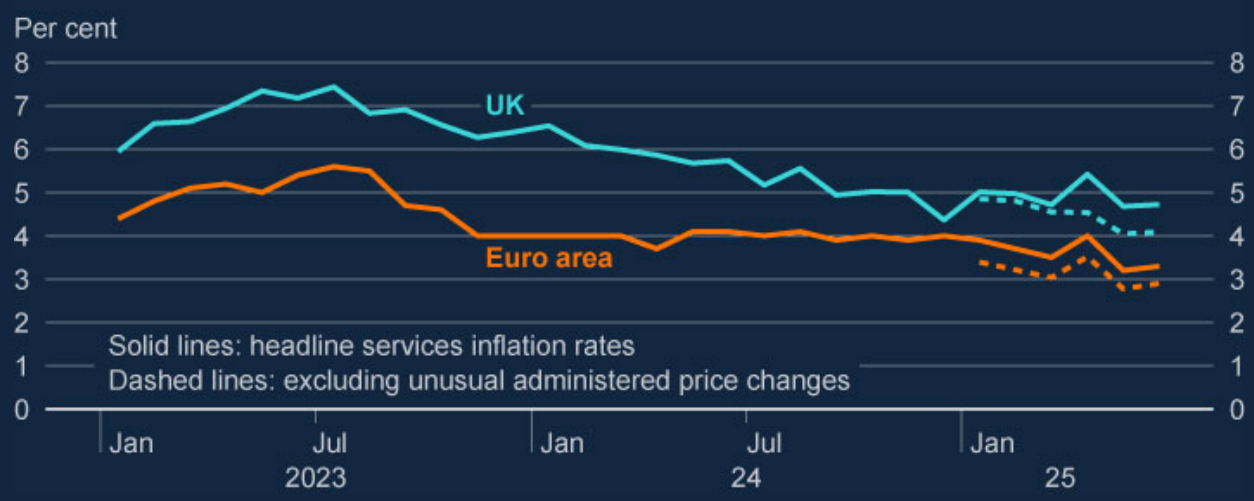
(a) Measures shown are three-month averages of seasonally adjusted monthly annualised inflation. The low variance measure is calculated by weighting each component of services inflation by the inverse variance of the change in 12-month inflation of that component from 12 months previously. The maximum adjusted weight is capped at twice its original value. Details on the components which have been included/excluded from the Services excluding indexed and volatile components, rents and foreign holidays measure are included in the accompanying spreadsheet published online. The trimmed mean measure excludes the 10% largest and 10% smallest price changes. The latest data points shown refer to June 2025.

**Elevated services inflation reflects unusually large increases in some administered prices, as well as high wage growth.**

Unusually large increases in several administered prices such as vehicle excise duty have contributed to high services inflation since April. Bank staff estimate that these are currently adding around 0.6 percentage points to UK services inflation (Chart 2.21), masking some of the disinflationary progress in the first half of this year.

**Chart 2.21: Administered price increases have contributed just over half a per cent to UK services inflation**

Measures of annual services inflation (a)




Sources: Eurostat, ONS and Bank calculations.

(a) The data shown in the solid lines are UK CPI services inflation and euro-area HICP services inflation. The dashed lines show Bank staff's estimates of the unusual contribution from administered prices to services inflation in 2025. For the UK, this captures the estimated excess impact of changes in sewerage charges, bus fares, vehicle excise duty and VAT on private school fees. For the euro area, staff have estimated the excess contribution of HICP services subcomponents judged to contain significant amounts of administered prices, relative to a pre-Covid baseline. The euro area estimate is likely to be an upper bound of the true excess contribution from administered prices in 2025. The latest data points shown refer to June 2025.

Administered price increases are also estimated to be adding to services inflation in the euro area, although to a lesser extent than in the UK (Chart 2.21). After accounting for these effects, UK services inflation remains materially higher than euro-area services inflation. That appears to primarily reflect a higher level of UK wage growth over the recent past. Four-quarter private sector wage growth in the UK was 6.2% in 2024 Q4, compared with a 4.1% increase in compensation per employee in the euro area. Since wages tend to affect services prices with a lag of several quarters, past strength in UK wage growth can account for much of the strength in UK services inflation in the first half of 2025.

**The increase in employer NICs is likely to delay further declines in services inflation.**

The Bank's Agents' company visit scores suggest that following the October 2024 budget, a wedge has opened up between firms' expected pay growth and expected total labour costs, probably reflecting higher employer NICs (Chart 2.22). Responses to the DMP Survey similarly indicate that there has been a larger slowdown in wage increases than there has been in overall unit costs in the consumer services sector. Contacts of the Bank's Agents

report that the rise in unit costs has put further downward pressure on margins, which are viewed as compressed (Box F). Firms may seek to recover margins by raising prices over coming months, depending on the strength in demand.

**Chart 2.22: A wedge has opened up between expectations for total labour costs and pay expectations**

Bank of England Agents' company visit scores (a)


Source: Bank of England Agents.

(a) After visiting companies, Agents assign company visit scores based on information gathered during the meeting. A score of +5 indicates a rapidly rising level, 0 indicates an unchanged level and -5 a rapidly falling level. Details on the scores can be found in **Relleen et al (2013)**. The latest data points are for June 2025.

### Services inflation is expected to rise in the near term before falling back next year.

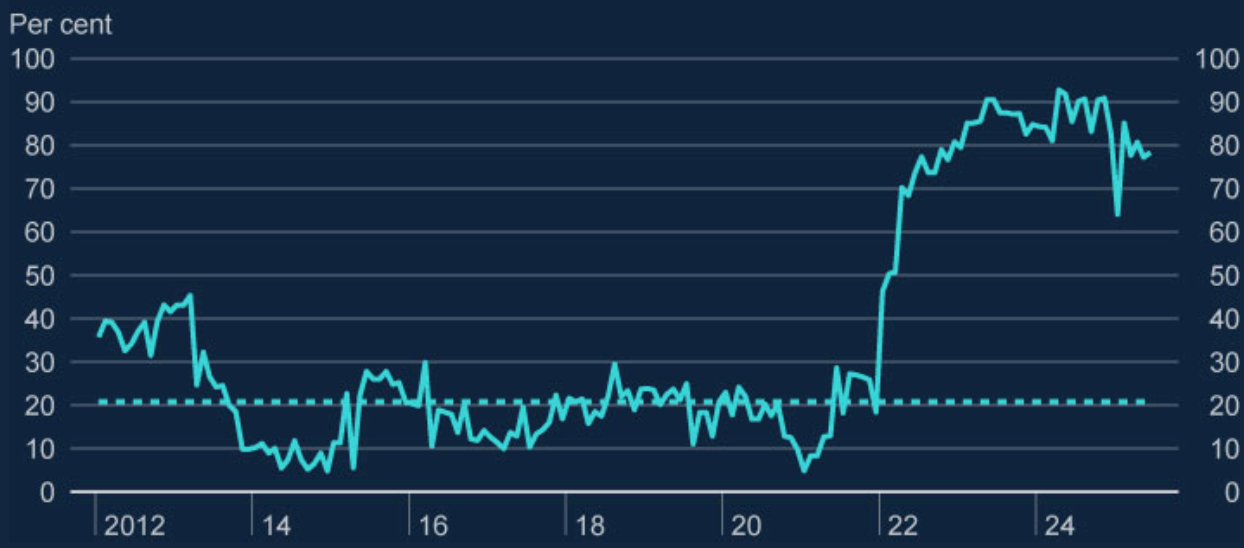
Services inflation is expected to rise from 4.7% in June to around 5.1% in December (Chart 2.19). This rise is driven by base effects due to a large drop in services inflation in the second half of last year. Annualised monthly rates of services inflation are projected to decline in the second half of the year as lower wage growth continues to feed through, although that decline is relatively slow.

The slow expected pace of decline in services inflation partly reflects the fact that lower wage growth is expected to be partly offset by increases in other labour costs, including employer NICs, in the near term. It is also due to pay growth having recently slowed by less in sectors with large direct contributions to the services CPI basket. This is driven in part by the effects of the NLW increase on the retail and hospitality sector, and could limit reductions in inflationary pressures in these sectors in the near term.

Further ahead, services inflation is expected to fall back in the first half of 2026, as lower wage growth continues to drag and upward pressure from higher employer NICs begins to fade. As inflation rates remain elevated across a large share of the services CPI basket (Chart 2.23), the expected slowing in inflation will require a broad-based change in price setting across the whole services sector.

**Chart 2.23: Inflation remains elevated across most subcomponents of the services CPI basket**

Weighted share of services subcomponents with inflation rates over 1 percentage point above their 2012–19 averages (a)




Sources: ONS and Bank calculations.

(a) The chart shows the weighted share of items in the services CPI basket at the 85-item level with monthly inflation rates over 1 percentage point above their respective 2012–19 average inflation rates. Over this period, headline inflation averaged 1.8%, while services inflation averaged 2.7%. The dashed line shows the 2012–19 average weighted share of items with inflation rates over 1 percentage point above their respective 2012–19 average inflation rates. The final data point is for June 2025.

**Headline CPI inflation is projected to remain around its current rate throughout the rest of the year, peaking at 4.0% in September.**

Headline CPI inflation is expected to rise slightly to a peak of 4.0% in September before falling back to 3.6% by the end of the year. This is higher than the 3.7% peak expected in the May Report, accounted for mainly by higher expected food price inflation (Box E). In the baseline projection, a further expected slowing in pay growth means that inflation is projected to fall back gradually next year (Section 1).

**Household inflation expectations remain elevated, though near-term expectations have fallen back slightly since the May Report.**

Inflation expectations can influence CPI inflation through their impact on wage and price-setting behaviour. The MPC monitors a range of indicators, including surveys of households and companies as well as those derived from financial market prices, to assess whether inflation expectations remain consistent with meeting the 2% inflation target in the medium term.

Survey measures of short-term household inflation expectations had risen ahead of the May Report, likely reflecting increases in headline inflation and in particular rising food price inflation (Box E). More recently, households' near-term expectations were slightly lower in July than in April according to the Citi/YouGov measure (Chart 2.24, left panel), and also fell back a little in the Bank of England/Ipsos Inflation Attitudes Survey for 2025 Q2. Meanwhile, the Citi/YouGov measure of medium-term household inflation expectations has remained materially above its historical average.

**Chart 2.24: Household inflation expectations are elevated, while businesses' expectations have risen only slightly this year**

Survey-based measures of household and business inflation expectations (a) (b)


Sources: Citigroup, DMP Survey, YouGov and Bank calculations.

(a) Data shown are from the Citi/YouGov survey and are based on responses to the questions: 'How do you expect consumer prices of goods and services will develop in the next 12 months?', and 'And what do you think will happen to the prices of goods and services, on average, over the longer term - say five to ten years?'. Dashed lines represent the series averages over 2010–19. The latest data points are for July 2025.
(b) Data shown are from the DMP Survey and are based on three-month averages of responses to the question: 'What do you think the annual CPI inflation rate will be in the UK, one year from now and three years from now?'. The latest data points are for July 2025. The DMP Survey data have a short back-run, so no historical averages are shown.

**Businesses' medium-term CPI inflation expectations have increased only slightly since the start of the year.**

One-year ahead CPI expectations of firms responding to the DMP Survey have increased slightly this year to just over 3% in July, while three-year ahead expectations have been stable at around 2.8% (Chart 2.24, right panel). The average expectation for firms' own price growth one-year ahead was 3.7%, a little lower than at the time of the May Report. Meanwhile, the Deloitte CFO survey measure of two-year ahead CPI expectations was 2.5% in Q2, down slightly from 2.6% in Q1.

**Financial market participants' expectations for near-term inflation are broadly unchanged, while medium-term market-based inflation compensation measures have risen slightly.**

Financial market participants' near-term inflation expectations are broadly unchanged since the May Report. The median respondent to the latest Market Participants Survey expected CPI inflation of 2.4% one year ahead, up marginally from 2.3% in the May survey. The median expectation for CPI inflation two years ahead was a little lower at 2.1%. Medium-term inflation expectations derived from financial markets, such as the RPI-reform adjusted measure of five-year, five-year forward inflation compensation, have risen slightly since the May Report and remain a little above pre-Covid averages.

**The MPC will continue to monitor closely developments in inflation expectations.**

CPI inflation has risen by a little more than expected in recent months and household inflation expectations remain elevated. With inflation likely to reach 4% briefly in the second half of this year and salient items such as food prices expected to increase further (Box E), there is a risk that elevated inflation expectations could become a more material influence on wage bargaining or price setting elsewhere in the economy and add to the persistence of inflationary pressures. That said, it is also possible that the role of household inflation expectations in the wage-setting process could become weaker as the labour market loosens. The MPC will continue to monitor closely developments in inflation expectations measures, including any risks they may pose to the ongoing disinflation process.

## Box D: Global uncertainties and their implications for the UK economy

The MPC's baseline projections have been produced conditional on various external assumptions, including international energy prices developing in line with market futures pricing and global tariff rates remaining at their levels as of 29 July. However, both energy prices and trade policy announcements have varied significantly since the publication of the May Report.

The first part of this box investigates the sensitivity of the MPC's baseline projections to an unanticipated rise in global energy prices. The second part investigates the sensitivity of the baseline projections to both a higher level of global tariffs and to different assumptions around the impact of higher tariffs, including via higher trade policy uncertainty and a greater impact of trade restrictions on world export prices. The higher tariff assumption amplifies the economic impact of different modelling assumptions and therefore demonstrates their relative significance.

### 1: Higher energy prices

> **Conflict in the Middle East led to rises in energy prices in June. While energy prices have fallen since then, market pricing suggests upside risks to prices remain.**

Military action between Iran and Israel, later joined by the US, in June 2025, led to a peak increase in dollar Brent crude spot oil prices of around 20%. This was a large rise, though not outside of the normal range of historical oil price changes (Chart A). Spot natural gas prices rose a little further, by around 25%.

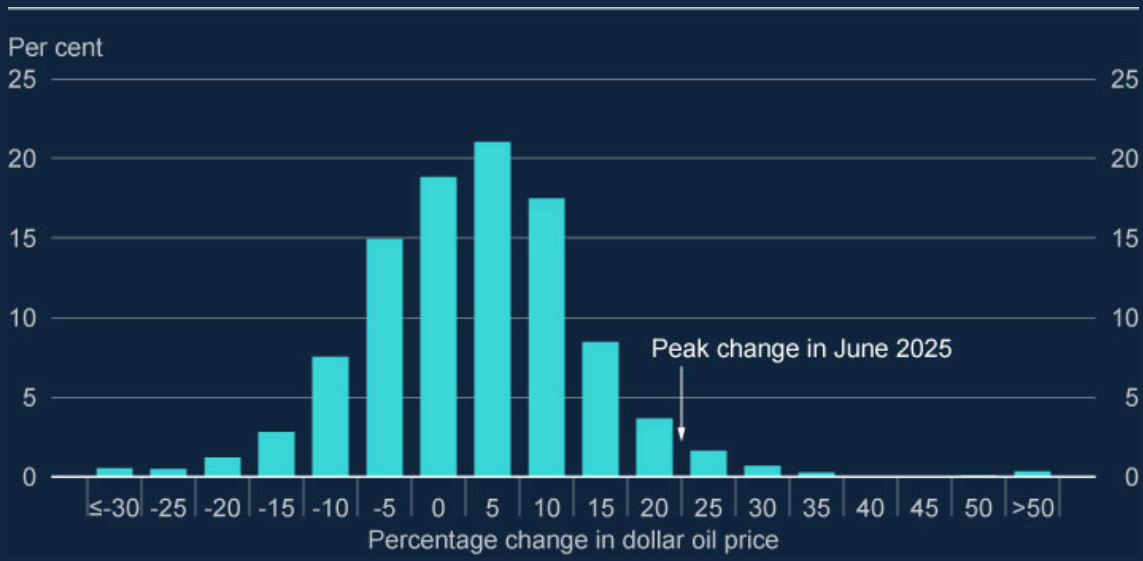
A ceasefire came into effect, and energy prices have fallen back. Brent crude spot oil prices are around $70 per barrel. However, geopolitical tensions remain. Option pricing for oil futures, which can be used to calculate a market-implied estimate of the probability of oil reaching a given price in the future, is consistent with there being a risk that renewed conflict pushes oil prices up again.

Wider conflict that affects both Iran and the Strait of Hormuz could have large effects, as this is a key route through which oil and natural gas are exported from other major energy producing countries. Supplies through the Strait of Hormuz were not disrupted during the conflict in June and the risk of disruption appears to be low, but a range of

external estimates of the impact of widespread disruption or the cessation of oil exports through this route suggests global oil prices could rise to between $100–$130 per barrel in this case. Liquified natural gas prices would also be materially affected.

**Chart A: The oil price increase in June 2025 was large, but even larger oil price increases have occurred before**

Frequency distribution of historical four-week US dollar oil price changes (a)




Sources: Bloomberg Finance L.P. and Bank calculations.

(a) Data cover June 1987 to 29 July 2025. Oil prices are dollar Brent crude. Changes are calculated for each business day compared to 20 business days earlier. The bars represent oil price changes in 5 percentage point buckets, the number shown represents the upper bound of that bucket with the exception of the rightmost bar.

> **Higher energy prices would push up UK CPI inflation through direct effects on fuel and utility prices, as well as indirect effects through higher production costs for firms.**

As part of its recent discussions, the MPC considered the sensitivity of its baseline projections to an unanticipated future rise in energy prices. In doing so, the Committee drew on experience from the rise in energy prices following Russia's invasion of Ukraine in 2022. Higher energy prices would push up consumer price inflation and reduce GDP.

Energy prices have a direct effect on CPI inflation through petrol and diesel prices, and utility bills. Motor fuel pump prices make up 2.8% of the consumer price inflation basket of goods and services. And gas and electricity make up a further 3.4%. Changes in oil prices tend to be passed through quickly and in full to pump prices.

Wholesale gas prices feed through directly, albeit with a lag, to household electricity and gas bills. This is because the Ofgem energy price cap is set quarterly with reference to previous wholesale prices. The impact on utility bills would be expected to take around three quarters to fully take effect.

Energy prices also have an indirect effect on CPI inflation through the use of oil and gas as inputs for other goods and services. Higher energy prices push up production costs, which would be expected to be passed through to consumer prices over time. For example, higher gas prices raise UK electricity costs, but since most businesses have fixed-term contracts, it will take time for these to affect businesses' costs.

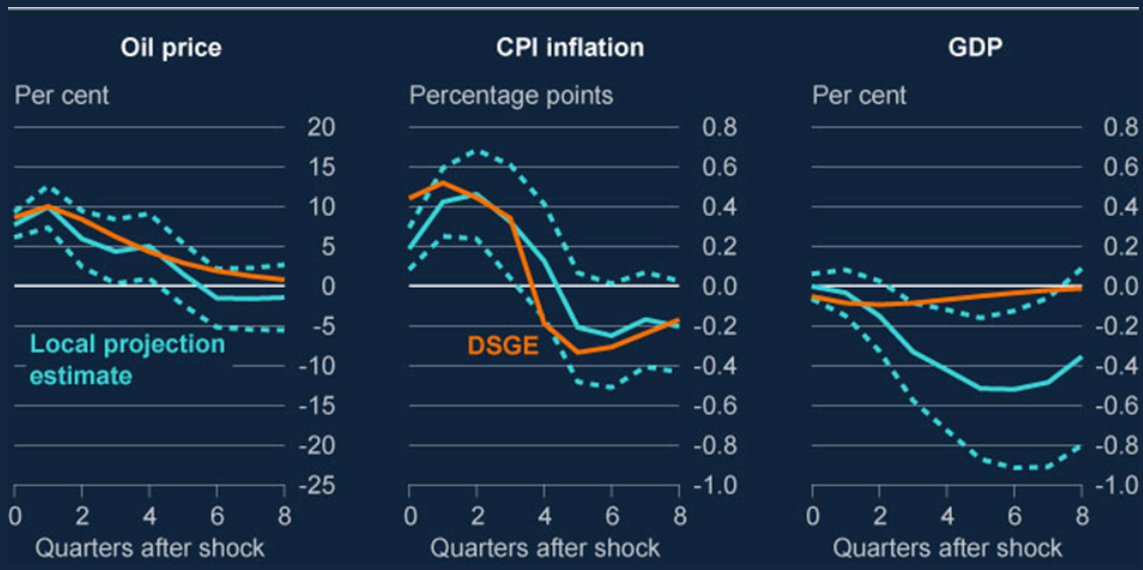
The shorter-term impacts of a hypothetical 10% rise in oil prices on CPI inflation and GDP, through both the direct and indirect channels outlined above, are depicted in Chart B. The middle panel shows the modelled response of UK CPI inflation to a global oil price shock from one of the key models that feeds into the baseline projections outlined in this Report, alongside empirical estimates from a local projections specification (**Albuquerque et al (2025)**).

In this estimation, a 10% peak increase in oil prices (Chart B, left panel) is associated with a peak increase in CPI inflation of 0.5%. That rise in CPI inflation occurs swiftly after the rise in oil prices. These results assume that the oil price shock evolves in line with historical patterns, which show that oil price shocks tend to be temporary, with prices falling back after peaking.

The estimates in Chart B show the impact of a rise in oil prices. Additional gas price rises would exacerbate any subsequent increase in CPI inflation. Previous Bank staff analysis shows that the importance of gas prices for CPI inflation and GDP has grown relative to oil prices over time.

**Chart B: Oil price shocks are estimated to raise UK CPI inflation and reduce GDP**

Impulse responses to a global oil price shock (a)




Sources: **Albuquerque et al (2025)** and Bank calculations.

(a) DSGE refers to the estimates taken from one of the main models which underlies the baseline projections in this Report. The local projections estimates are based on a sequence of regressions where the response of economic outcomes, including GDP and CPI inflation, is estimated conditional on energy price shocks. The dashed lines are 90% confidence bands around the local projection estimates. The results show impulse responses to a 10% global oil price increase. Estimates are based on data from 1987–2023.

> **The impact of higher energy prices on inflation could be exacerbated by second-round effects on domestic wages and prices, for example if inflation expectations were to rise.**

The impact of energy price changes on CPI inflation will depend on broader economic conditions, including the behaviour of inflation expectations and the level of spare capacity in the economy.

Some evidence suggests that inflation expectations may be particularly sensitive to rises in energy costs. Bank staff analysis finds evidence of asymmetrical formation of inflation expectations, with rises in prices shifting expectations more than falls in prices. A high inflation environment can mean households pay more attention to news about inflation. And evidence shows that the prices of some products, including petrol, are particularly important for households when they form their inflation expectations (Chart C in Box E).

If inflation expectations were to rise in response to an energy cost increase by more than was typical in the past, this could lead to additional inflation persistence, prolonging the period of higher inflation. Higher inflation expectations for households could lead to upward pressure on aggregate wage growth, which would in turn raise businesses' costs and potentially lead to further price rises. And higher inflation expectations for firms could be internalised into their own price-setting where anticipated future cost increases are reflected in current prices. Higher inflation expectations at a time of tight labour markets were a significant factor in the greater inflation persistence that followed the 2022 energy price shock.

The estimates in Chart B account for the average response of CPI inflation to higher energy prices over the past, and so implicitly capture the average impact of energy prices on inflation expectations and subsequent feedthrough to wage and price-setting. Any additional sensitivity of inflation expectations in the current economic environment would lead to more inflation persistence, to which monetary policymakers would respond appropriately.

In an environment where demand is weak relative to potential supply, however, firms may be more likely to absorb additional energy costs into their margins than if there is little spare capacity. As noted in Section 2.4, there is growing evidence of spare capacity within the economy. This could act against any additional inflation persistence from the interaction between higher inflation expectations and firms' price-setting behaviour.

> **Higher energy prices also reduce GDP and can generate a trade-off for monetary policy between returning inflation to the target and supporting GDP growth and employment.**

Alongside their effect on inflation, higher energy prices would also reduce UK GDP. Chart B (right panel) shows the response of UK GDP using the same baseline projection model and empirical estimates.

Following a swift hypothetical rise in energy prices, GDP falls in the subsequent quarters before recovering. There is a large degree of uncertainty over the magnitude of the GDP impact. In the DSGE estimates, the impact on GDP is relatively muted, with a temporary rise in energy prices of 10% reducing GDP by around 0.1%. That muted response reflects the fact that firms and households are assumed to substitute quickly towards non-energy inputs and goods as energy becomes more expensive. The local projections estimates indicate much larger declines in GDP, consistent with historical correlations.

As the experience of the 2022 energy price shock demonstrated, one of the challenges in understanding the impact of energy price rises is assessing how they are transmitted through the economy. The extent to which firms and households can substitute away from using energy is important and might change over time. As most UK homes rely on natural gas for heating their home, one simple example of this issue is the temperature experienced during winter. Cold weather could reduce households' ability to reduce their gas usage.

Lower GDP from higher energy prices reflects both weaker supply and demand. Demand would be expected to fall by more than supply, however, such that the degree of spare capacity widens. The model underlying the baseline projections suggests that supply is reduced by around a fifth of the overall reduction in GDP. Combined with higher inflation, this creates a trade-off for monetary policy between returning inflation to the target and supporting GDP growth and employment.

There is uncertainty over the size of any impact of higher energy prices on supply, however, and hence spare capacity. The impact on supply could be greater than implied by this model if the energy shock is very large and results in supply chains needing to be reorganised to account for higher energy prices.

The appropriate monetary policy response to an energy price shock will depend on the size and timing of the impact on CPI inflation, as well as on the level of the output gap. To the extent that CPI inflation rises while the output gap widens, the shock will create a trade-off for monetary policy makers. If the shock is short-lived, as in the example above, monetary policy may not need to respond. But if the shock is larger and more persistent, as occurred after the 2022 Russian invasion of Ukraine, a higher level of Bank Rate could be required to meet the inflation target.

## 2: Greater global trade restrictions

**There remains significant uncertainty over future global trade policy.**

Since March 2025, the US government has announced a range of new tariffs for countries and products. The US effective tariff rate at the time the baseline projection was produced was estimated at around 14%, 12 percentage points higher than in January, but 8 percentage points lower than at the time of the May Report (Chart C).

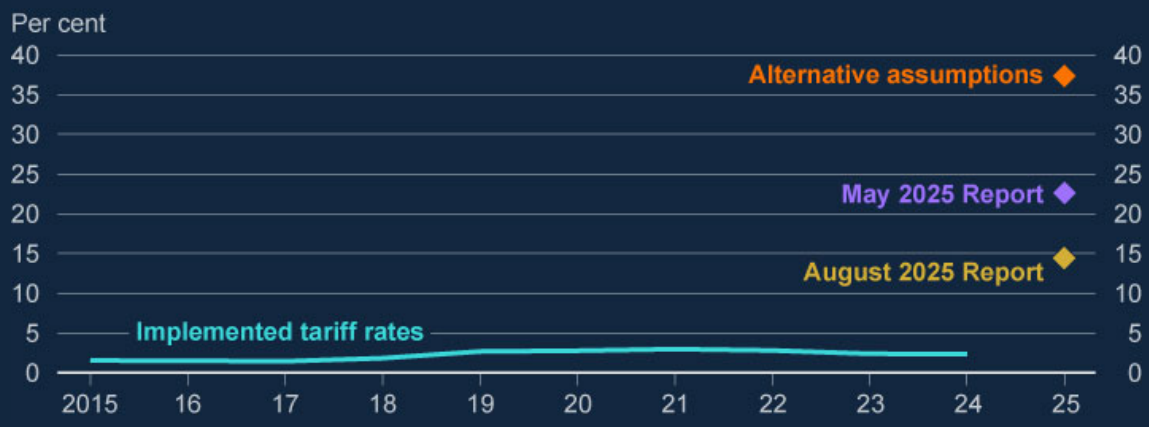
As part of its recent discussions, the MPC considered the sensitivities in the baseline projections to both higher global tariffs and to different assumptions around the impact of higher tariffs, including via higher trade policy uncertainty and a greater impact of trade restrictions on world export prices. For the purposes of these sensitivities, the US

effective tariff rate was assumed to climb to over 35% (Chart C). Other countries were assumed to respond to higher US tariffs, with significant retaliation from China and a more limited retaliation from other countries.

This exercise was not intended to model a particular likely outcome for global tariff rates. Indeed, some of the assumptions outlined in the footnote to Chart C are different to those that have been announced, including the US-EU deal on 27 July. That deal would lead to US tariff rates on goods from the EU at 15% rather than 30%, although its impact on the sensitivities below would be small. Nevertheless, the analysis remains valuable for exploring both the impact of a higher set of tariffs and the accompanying model sensitivities.

**Chart C: US tariff rates have increased since the start of this year**

Estimated US effective tariff rates (a)




Sources: US Bureau of Economic Analysis, US International Trade Commission, White House and Bank calculations.

(a) The alternative assumptions diamond was calculated as the combination of the US tariff letters sent in the first half of July, which would have raised the US effective tariff rate by around 4 percentage points, as well as US product-specific tariffs, such as pharmaceuticals, and a re-escalation of trade tensions with China. The May 2025 Report diamond is the tariff level assumed for the May Report baseline projections. And the August 2025 Report diamond is the same for this Report and is based on tariff rates implemented as of 29 July.

### There are uncertainties in how any given set of global trade policies will impact UK GDP…

As set out in Box C of the **May 2025 Monetary Policy Report**, higher bilateral global tariffs between the US and other countries would be expected to reduce global demand for UK exports and UK GDP. This reflects: a direct reduction in US imports

from the UK due to higher tariffs; a decline in real incomes in affected countries that reduces demand for imports more broadly; and estimates for shifts in global trade patterns such as countries selling their goods into new markets.

Estimates of the relationship between trade restrictions and GDP from different economic models vary. Using the same estimated relationships that underlie the baseline projections, the higher global tariffs set out above would reduce UK GDP by a little over an additional 0.2% over the next three years. Around two thirds of that impact would be expected to materialise over the course of the next year, with the remaining impact appearing evenly over the following two years. There are also likely to be longer-run impacts on global and domestic productivity growth.

There are important uncertainties around these estimates, including over the relative importance of different mechanisms through which higher tariffs impact the economy as well as around model estimates of their impact.

One area that continues to make economic impacts difficult to estimate is the extent to which uncertainty over future trade policy reduces GDP. In an environment where trade policies are uncertain, businesses may be less willing to invest in new production capacity and there could be a wider impact on business and household sentiment. Measures of policy uncertainty have fallen back from their peaks in April but could rise or fall in the future. If measured global trade policy uncertainty were to rise back to the peak earlier in the year and gradually decline over the next year and a half, estimates suggest that would reduce UK GDP by around 0.1%.

**…as well as prices.**

Within the models used for this analysis, the quantitatively largest channel through which trade restrictions affect UK prices is their effect on world export prices. Weaker global demand for exports puts downward pressure on world prices which then passes through into UK import prices. Based on the higher tariff levels discussed above, world export prices could fall by an additional 2% over the next three years, which would cause a peak reduction in UK CPI inflation of around 0.1 percentage points.

Another channel through which global trade restrictions affect domestic prices is the impact of weaker global demand on spare capacity in the UK. By raising prices of imports, higher tariffs reduce real incomes in those countries where they have been increased, which will weigh on demand for UK exports. All else equal this will lead to additional spare capacity in the UK. Higher tariff levels discussed above could reduce annual inflation by a little under 0.1 percentage points through this channel.

One uncertainty regarding the future path of world export prices relates to a possible change in the pattern of trade flows due to new trade restrictions. Specifically, the impact of lower global export prices on UK inflation could be compounded if countries formerly exporting goods to a third country attempt to shift some of this trade to the UK. This may necessitate a fall in the prices of these goods. This effect could be amplified if other countries respond to this additional competition by also reducing their export prices to the UK.

The extent to which export flows shift to the UK in response to US and retaliatory tariffs is difficult to project. Bank staff analysis of the impact of tariff increases on trade flows during previous US administrations suggests limited evidence for significant shifts in export flows to the UK in previous episodes of higher tariffs. This suggests that there may be limited impacts on UK import prices beyond the effects on global export prices mentioned above. However, as announced tariff increases have been larger than those previous examples, there could be larger effects in the current period. Monitoring high-frequency trade flows data is important for understanding how these effects may materialise in the current economic environment.

One way to assess the potential importance of this channel is to adjust the assumed import price elasticities underlying the baseline projections. It is possible the lost US demand could lead to bigger reductions in exporters' prices if demand from the rest of the world proves less responsive to price cuts. Assuming a non-US import price elasticity near the bottom of the range of empirical estimates, combined with spillovers from shifting trade patterns leading to a greater increase in global price competition, would be enough to further reduce UK CPI inflation from the assumed higher tariff level above by around 0.1 percentage points in 2027.

> **The extent to which financial market responses amplify or offset higher global trade restrictions is also uncertain.**

The sensitivities above are also dependent on the financial market reaction to changes in trade restrictions. In particular, the assumed trade policy retaliation of other countries to higher US tariffs is important for the estimated financial market effects of higher tariffs.

One important financial market channel for the impact of global trade restrictions on UK GDP and inflation is how much exchange rates move in response to those restrictions. It is difficult to predict movements in the sterling exchange rate in response to future tariff developments, however, and any movements will depend on the extent of retaliation as well as broader market risk sentiment.

Broader financial market moves could plausibly amplify the negative impact of higher global trade restrictions on UK GDP and inflation. A combination of higher uncertainty and weaker global growth would be expected to reduce risky asset prices, for example equity prices. These changes in risky asset prices would also drive a reduction in GDP. Plausible estimates of this channel, based on the higher tariffs in Chart C, suggest a further reduction in GDP of around 0.2% after three years and a small reduction in CPI inflation. These estimates were derived from the ECB-Global semi-structural model and the Bank's main forecasting model.

> **The MPC continues to monitor the effects of changing global trade restrictions and the associated impact on the UK.**

Significant uncertainty remains over future global trade policies, as well as the extent to which changing trade policies affect the UK inflation outlook. The MPC continues to monitor the effects of trade restrictions as they materialise in the UK. This includes the extent to which the economic impacts appear to be in line with model-based estimates and are materialising through the expected channels outlined in this box. The MPC will learn more about the true impacts over time, as some effects are likely to emerge relatively slowly.

## Box E: The outlook for food price inflation

Food consumer price inflation rose to 4.5% in June, materially higher than expected at the time of the May Report. While food price inflation remains much lower than the double-digit rates seen in 2022 and 2023, it is well above its pre-Covid average of around 1½%. Food accounts for about 11% of the overall consumption basket of UK households, and there is evidence that food prices can have an outsized effect on households' inflation perceptions and expectations (**Anesti et al (2025)** and **Bonciani et al (2024)**).

This box discusses the current drivers of food price inflation, including global agricultural commodity prices as well as domestic factors such as rising labour costs and regulatory changes. The box then sets out an outlook for food price inflation, informed by conversations with the Bank's Agents' contacts in the food industry, before discussing the link between food price inflation and household inflation expectations.

> **Some agricultural commodity prices have increased sharply this year, pushing up food price inflation.**

UK food price inflation is materially affected by movements in global agricultural commodity prices. That is because many food items are globally traded goods, with their prices largely determined in international markets. For instance, the UK imports large amounts of agricultural products that cannot be produced domestically, such as cocoa and coffee beans. But there is also significant trade in agricultural goods that are domestically produced. For example, the UK imported around 240 thousand tonnes of beef in 2024, mainly from Ireland, while exporting 130 of the 900 thousand tonnes of beef produced domestically, mainly to continental Europe.

The S&P Global GSCI global agricultural price index has increased by around 8% over the past year. That is materially above the average annual increase of 2.8% since 1995, but well below the increase of over 60% observed in 2021.

Within this, cattle prices have risen by almost 20%. Several contacts noted that dry weather conditions are pushing up the production costs of beef and some dairy products in the UK and elsewhere, as cows must be fed silage earlier in the year due to less grass growth.

There have also been large increases in the wholesale prices of coffee beans and cocoa over the past two years. Droughts in major coffee-producing regions like Brazil have led to reduced crop yields, while heavier than usual rainfall and the outbreak of

plant diseases have contributed to smaller cocoa harvests in West Africa. At the same time, there is evidence that growing demand for coffee in emerging markets such as China has contributed to the rise in global coffee bean prices.

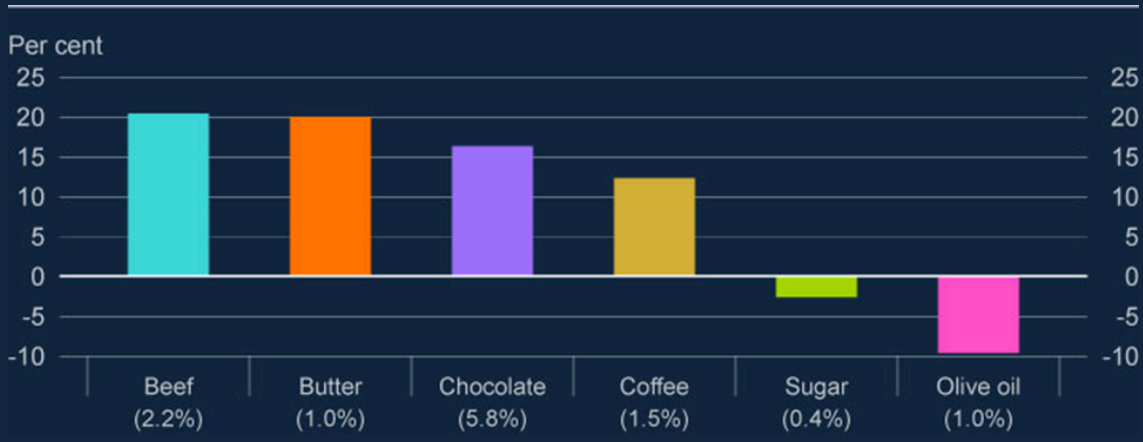
In contrast, the wholesale prices for sugar and olive oil have fallen materially. The latter is driven mainly by more favourable weather conditions in Spain, which produces almost half of the world's olive oil, with production recovering after droughts in recent years.

Changes in wholesale prices are passed through to retail prices with a lag, in part reflecting delivery contracts that are made a year in advance. That said, pass-through for perishable goods such as food has historically tended to be faster than for durable consumption goods (Box D of the **November 2024 Monetary Policy Report**). The pace of wholesale price increases has slowed in recent months, which is expected to reduce pressures on retail food price inflation in 2026 if sustained.

Movements in global agricultural prices have been important drivers of recent food consumer price inflation in the UK. In June, UK CPI subcomponent inflation rates for beef, butter, chocolate and coffee were elevated, while the inflation rates of olive oil and sugar were negative (Chart A), broadly consistent with recent movements in global wholesale prices.

**Chart A: Inflation rates for some common food items have reflected movements in global prices**

Annual inflation rates for selected food subcomponents (a)




Sources: ONS and Bank calculations.

(a) The chart shows annual inflation rates for selected subclasses (COICOP 5) of the CPI basket in June 2025. The labels include the subclass weights within food and non-alcoholic beverages.

To the extent that food prices are driven by global agricultural prices, they should tend to move in the same direction across countries. As Chart B illustrates, UK and euro-area CPI food price inflation rates have moved closely together in recent years. Staff analysis also finds that in recent months, the retail prices of individual food items in the UK and euro area have moved in the same direction, pointing to underlying commodity prices being a common driver.

**Chart B: Food price inflation has recently picked up by more in the UK than in the euro area**

Annual food price inflation (a)


Sources: Eurostat, ONS and Bank calculations.

(a) The food price inflation rates shown here include non-alcoholic beverages. The final data points are for June 2025.

Nevertheless, food price inflation is currently over 1½ percentage points higher in the UK than in the euro area. Compositional differences between the UK and euro-area CPI food baskets could in principle explain some of that difference. But reweighting euro-area food inflation with UK item weights suggests that this effect is currently small. There are instead several UK-specific factors that could account for the difference, namely higher increases in labour costs and the forthcoming introduction of the framework for the Extended Producer Responsibility (EPR) for packaging discussed below.

### Higher labour costs are contributing to food price inflation in the UK.

In addition to global agricultural commodity prices, domestic labour costs are currently an important driver of food price inflation. UK wage growth has moderated but remains significantly higher than in the euro area (Section 2.5). And annual regular pay growth has been particularly strong in the food manufacturing sector (7.0%) and in the retail

sector (7.6%), compared with 4.9% for aggregate private sector regular AWE growth in the three months to May. That is in part because a relatively high proportion of staff in these sectors are paid at or close to the National Living Wage (NLW), which increased by 6.7% in April. Furthermore, overall labour costs of supermarkets are likely to have been disproportionately affected by the lower threshold at which employers start paying NICs, in part because a relatively high proportion of supermarket staff is employed part-time.

These material increases in labour costs are likely to have pushed up food prices. According to the Bank's Agents' contacts, most of the labour cost increases associated with the NLW, but only some of the costs associated with the employer NICs increase, have so far been passed on to consumers, which has added around 1%–2% to food prices.

Labour costs are expected to continue to push up food prices in the second half of the year, although firms may not achieve full pass-through. Contacts noted that consumers were already responding to high food price inflation by trading down, limiting retailers' ability to increase prices. For example, sales of own-label items had increased at the expense of branded products. Customers were also increasingly purchasing cheaper cuts of meat and buying food staples in larger value packs. To reduce the need for higher prices, many firms along the supply chain were trying to mitigate cost increases, including through reductions in headcount. Many contacts also noted that cost pressures were putting further pressure on profit margins, which were already compressed.

> **A new framework to reduce packaging waste is expected to push up food price inflation further in the second half of the year.**

The Environment Act 2021 introduced the EPR framework for packaging to help the UK achieve its environmental goals. This framework transfers the costs of packaging waste management from local government to the businesses that produce the packaging. By placing these costs on producers, the policy is intended to incentivise reductions in the use of packaging materials and encourage recycling. The UK government announced the final details of the scheme in June, and affected firms are due to receive their first EPR invoices in October. A similar packaging waste regulation has been introduced in the EU and will come into force in August 2026, which may push up euro-area food price inflation somewhat next year.

Because packaging costs represent a higher share of food and drinks costs compared with many other goods, the packaging levy is expected to affect CPI inflation mostly via food prices. Bank staff estimate that the scheme could add a little over ½% to the level of food prices if these costs were fully passed through to consumers.

The Bank's Agents' contacts report that some suppliers started passing on the expected costs of EPR in the first half of the year, ahead of the scheme's implementation. This may be because some UK grocers are increasingly operating on longer-term contracts with major UK food suppliers, which is leading suppliers to be more forward-looking in their pricing strategies. That said, most of the pass-through is still likely to occur towards the end of the year, which will push up somewhat on food price inflation.

**Food price inflation is expected to rise to around 5.5% by the end of the year, before falling back gradually in 2026.**

Bank staff expect food price inflation to be around 5% in 2025 Q3, 1½ percentage points higher than expected in the May Report, before rising further to 5½% by the end of this year (Chart 2.19). Food price inflation is projected to account for about 0.5 percentage points of the expected deviation in CPI inflation from the 2% target in H2. Bank staff expect food price inflation to fall back gradually next year as pressures from labour cost increases fade and global wholesale food price inflation returns to historical averages. This is broadly in line with intelligence from the Banks' Agents, who report that most contacts expect food inflation to approach 5%–5.5% in the second half of the year before falling back to around 2%–3% in 2026.

There are material uncertainties around this projection. Consumers could continue switching to lower cost items to a greater degree than expected, which would put additional pressure on retailers to limit price increases. Acting in the opposite direction, global agricultural commodity prices could increase further, for instance if higher energy prices were materially to raise key input costs, or extreme weather events due to climate change were to negatively impact food production (**Parker (2025)**). Several contacts also noted that consumers had become more conscious of the environmental and animal welfare implications of their food consumption. This change in consumer preferences was already contributing to higher price pressures and was likely to continue to do so in the future. Higher-welfare animal products are more expensive to produce, and the necessary changes to supply chains can take several years and require substantial investment.

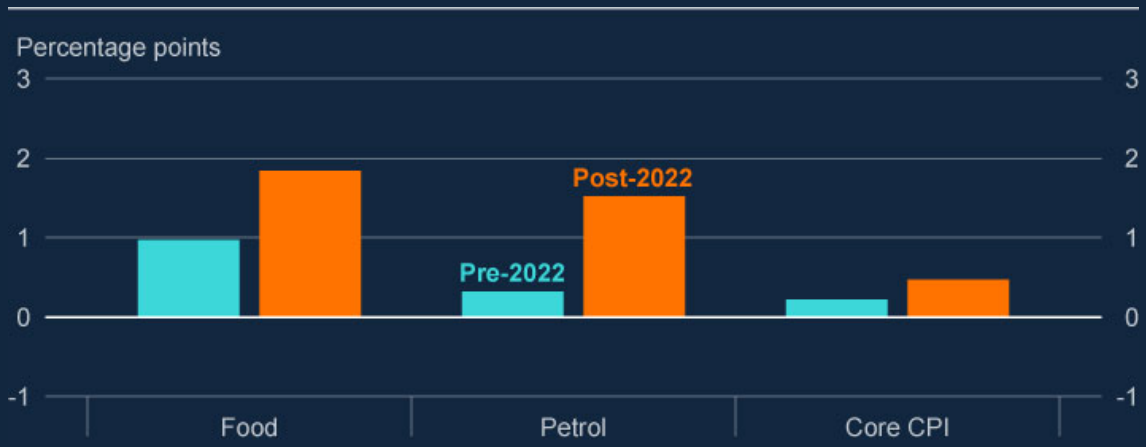
**Households' inflation expectations can be strongly influenced by developments in food prices.**

The MPC monitors food prices closely, in part because they can have an outsized influence on inflation expectations. Household expectations for future inflation comove closely with perceptions of current inflation, which in turn are sensitive to price changes observed in people's daily lives, and particularly to changes in salient items such as food (**D'Acunto et al (2021)** and **Anesti et al (2025)**).

The currently elevated level of households' near-term inflation expectations (Section 2.5) is likely to have been driven in part by high food price inflation. Recent Bank staff analysis extending **Anesti et al (2025)** shows that a 1 percentage point increase in the contribution of food prices to CPI inflation was historically associated with a roughly 1 percentage point increase in the Citi/YouGov measure of one year ahead household inflation expectations. However, since 2022 this effect has increased to 1.8 percentage points. That is consistent with previous Bank staff work, which suggested that households' inflation expectations had become more sensitive to aggregate price changes since the most recent period of very high inflation (Section 2.5 of the **May 2025 Monetary Policy Report**). Household inflation expectations have also become more sensitive to petrol prices but remain relatively less sensitive to broader core inflation (Chart C).

**Chart C: Households' near-term inflation expectations have been particularly sensitive to developments in food price inflation**

Estimated average response of household inflation expectations to changes in selected CPI components (a)




Sources: Citigroup, ONS, YouGov and Bank calculations.

(a) The chart shows the estimated coefficients from regressions of changes in Citi/YouGov one year ahead household inflation expectations on changes in the contributions of food price inflation, energy price inflation and core CPI inflation to headline CPI inflation. The pre-2022 estimation period runs from 2005 Q1 to 2021 Q4, while the post-2022 estimation period runs from 2022 Q1 to 2025 Q2.

> **The MPC will continue to monitor food price inflation, including potential effects on inflation expectations and any resulting risks to the disinflation process.**

CPI inflation has risen in recent months, driven in part by higher food price inflation. While households' near-term inflation expectations have fallen back slightly in the latest data, they remain elevated. That is likely to be due, in part, to the rise in food price inflation combined with households' attentiveness to food prices.

The expected further increases in food price inflation, against a backdrop of elevated headline inflation, means that inflation expectations could remain elevated or even increase further in the second half of the year. This could raise the risk that economic mechanisms such as those outlined in the higher inflation persistence scenario in Box A of the **May 2025 Monetary Policy Report** could begin to operate. The MPC will monitor closely developments in inflation expectations measures, including any risks they could pose to the ongoing disinflation process. The MPC will respond appropriately to ensure that inflation expectations remain anchored, and inflation returns to the 2% target in the medium term.

## Box F: Agents' update on business conditions

This box presents a summary of the Agents' intelligence gathered in the six weeks to early July that was considered by the MPC at its August meeting.

Sentiment remains subdued across retail, manufacturing, construction and business services, unchanged from the update given in the **Agents' summary of business conditions – 2025 Q2**. Weak demand is expected to continue for the rest of 2025. Uncertainty continues to weigh on export expectations, even though the impact of US tariffs has so far been milder than feared.

Agents report a slightly looser labour market, both in terms of employment intentions and easing recruitment difficulties. Intelligence on pay settlements for 2025 continues to remain broadly in line with the Agents' January pay survey at 3.7%. Contacts note that lower inflation and a looser labour market than over the past few years are driving lower settlements.

Food price inflation is now expected to peak at 5.0%–5.5% in the autumn. And consumer goods inflation is rising as retailers pass on their supply chain and own cost increases. Consumer services inflation remains elevated and stable.

> **Demand for consumer goods and services remains weak. Contacts expect this to continue for the rest of 2025, citing low consumer confidence.**

Supermarkets say turnover growth is being driven by price rises, with sales volumes at best up only marginally on last year. Contacts continue to report strong sales of premium ready meals, as customers switch from eating out. Retailers report that higher footfall is generally being offset by lower spend per customer. Heightened consumer caution continues to inhibit sales of more expensive durable goods.

Restaurants report flat volumes, although some pub chains report relatively strong growth supported by good weather. Fast food retailers see continued evidence of trading down as they gain higher-income customers but lose those on lower incomes with volumes falling overall. Home delivery volumes continue to grow strongly. The experience of hotels and visitor attractions is mixed but suggests a relatively flat market. Airports, ports, rail, and tour operators now report low growth in volumes and expect a further slowing.

> **Investment intentions remain subdued though regular replacement and update investment continues.**

Uncertainty related to weak demand, tax, regulation and wider government policy (for example, inheritance tax, business assets relief, Employment Rights Bill, Extended Producer Responsibility (EPR) regulation), as well as geopolitical instability continues to cause contacts to hold back or delay investment. Concerns about soft demand and growth prospects mean contacts generally do not need to expand capacity and are tending to stretch out the replacement cycle for machinery and vehicles. Contacts are reluctant to take on new borrowing even though they also tend not to have much financial headroom to fund investment.

The cost of labour and desire to grow without increasing headcount means that investment in software solutions, AI and low-cost automation is quite widespread and, because it can generally be financed incrementally, it is treated more like operational expenditure than capital spending. Although mention of AI is prevalent its use tends to be more experimental rather than a wholesale implementation.

> **Manufactured goods exports volumes weakened slightly further on last year owing to US tariffs. Services export values growth has held up.**

Contacts report that the pace of decline in exports to the EU continues to ease, although recovery remains constrained by post-Brexit trade frictions and weak demand. Growth in exports to the US is weaker, with softer demand linked to higher tariffs. Demand from China and the Middle East is slightly softer. Defence and aerospace exports continue to grow strongly as do exports of advisory services. Tourism from Asia remains subdued, and the number of US visitors has declined further.

The direct impact of US tariffs is milder than feared but more general tariff-related uncertainty still weighs on sentiment, though less so recently. Some contacts paused exports in April but have since resumed them. Some report increased Chinese supply into Europe, mainly in finished goods, but few observe this as putting downward pressure on price inflation. Goods exporters to the US are increasingly prioritising supply chain resilience and face some pressure to cut prices. Contacts welcomed new UK trade deals with the US and India, and Common Understanding with the EU.

> **Business services volumes growth remains weak. Contacts are still cautious about the outlook, expecting only a modest pickup in volume growth into 2026.**

Demand for audit, advisory and tax services remains strong. There are some tentative signs of merger and acquisition activity recovering, which is expected to continue should domestic uncertainty subside and the cost of finance fall. Restructuring and insolvency activity continue to edge up on the same period last year. Demand for IT services is still mixed. Although clients are cautious about spending on larger projects, there is strong growth in AI and cybersecurity. Growth in corporate hospitality and

marketing remains weak, as businesses limit discretionary spend. Logistics and wholesaling contacts report broadly stable volumes on last year. Recruitment activity remains down on last year, but there are some signs of stabilisation as businesses address pockets of skill shortages or seek advice on reducing their workforce.

> **The annual rate of decline in manufacturing volumes eased owing to the slight lessening in trade uncertainty. Despite this, the weak domestic market and subdued new orders mean confidence remains weak. Some expected improvement in weaker subsectors should lead to modest overall manufacturing output growth in 2026.**

While supply chains have normalised from the high stock levels built up after the pandemic, reducing stock and delaying orders are common themes as companies seek to manage costs.

Contacts report that US tariffs and electric vehicle competition from overseas producers is dampening automotive sector output. A few construction suppliers to house builders are seeing modest order growth, but other output is flat or falling as projects, for example in the renewables sector, continue to be delayed. Output of consumer goods and food and drink remains subdued as consumers limit discretionary spend. Manufacturers supplying energy infrastructure projects are more positive. The aviation sector has good order books, but lack of availability of components and related phasing of delivery has constrained the pace of growth. Strong demand persists in the defence sector.

> **The annual pace of decline in construction output is slightly worse, mainly due to a further softening in commercial activity. While the medium-term outlook is positive, some remain cautious about the extent of recovery in 2026.**

Commercial construction projects continue to be delayed or shelved, alongside a more general slowing in commercial activity. Contacts reported delays to public sector projects ahead of the Spending Review. While the review has increased clarity around government and infrastructure projects, some remain concerned that these delays will persist. House builders now mostly report growth in new build rates, despite frequent mention of planning delays. High-rise development is hampered by new planning regulations and higher costs. Housing association spending remains focused on repair and maintenance. Outside of the High Speed 2 rail network and the Hinkley Point power station, infrastructure spending remains subdued for the most part.

> **Employment intentions are slightly weaker than in previous rounds owing largely to higher labour costs, related to higher National Insurance contributions (NICs). However, indications are that considerable adjustment**

**has taken place already with many firms having reduced headcount over the last year.**

Larger firms and those in consumer-facing sectors have been the most active in reducing headcount. While recruitment freezes are the most common means, Agents are starting to hear more mentions of redundancies, though mainly voluntary. Contacts also report that new employment rights legislation may dampen labour demand further.

Many contacts view automation, AI, or the offshoring of some roles as a solution to increased labour costs, or a way to grow output without increasing headcount. Some manufacturers see production overseas as better value.

Agents see further evidence of recruitment difficulties easing. Many contacts observe that the balance of power in the labour market has shifted more towards employers, and that recruitment conditions are now normal for less skilled occupations. Even in specialist roles where skills shortages remain, contacts report some improvement in their ability to recruit.

**Intelligence on pay settlements for 2025 continues to remain broadly in line with the Agents' January pay survey at 3.7%.**

Contacts note that lower inflation and a looser labour market than over the past few years are driving lower settlements, with some freezing pay or delaying pay rises, although total labour costs are growing owing to NICs. Most contacts are not yet able to give a figure for 2026, but some report that they see pressures easing further and are budgeting for settlements in the 2%–4% range with a rough average of 3%–3.5%. Potential upside risks to this include the impact of the current period of above-target CPIU inflation, unions bargaining for higher increases, and next year's increase in the National Living Wage (NLW).

Higher prices, lower margins, lower pay settlements and reduced labour input are the most commonly cited channels to mitigate NICs and NLW cost pressures. Some firms facing lower margins this year will potentially take further action on prices, pay, and headcount into 2026.

Contacts are reporting some increase in spare capacity, particularly in manufacturing industries where demand is weak. For some, automation and investment are providing additional capacity.

**The combination of higher labour costs and EPR has put pressure on firms to recover their margins via price increases, although many are not able to recover as much as they would like. Consequently, pressures to restore margins will persist.**

Weak demand is making it difficult for firms to increase prices to the extent they would like in the face of these higher costs. This is leading many contacts to try to reduce other costs. This strategy may rebuild their margins, but it could take several quarters.

Materials' cost inflation is modestly positive as is inflation of imported finished goods, reflecting a pickup in the cost of energy, labour, freight and some commodities. The 90-day pause on tariffs has made it difficult to gauge the impact tariffs will have on supply chains but the effects to date have been modest. Most contacts find themselves in a holding pattern waiting for a response. Until tariffs are fully enacted, there remains significant uncertainty around their impact on costs and how firms will respond.

Manufacturers' domestic prices are increasing as they pass on some of their higher input and labour costs, where demand allows. Business-to-business price inflation is easing gradually, but the pace of decline is mixed across sectors.

Consumer goods inflation is rising as retailers pass on their supply chain and own cost increases. This is most evident in food price inflation which is now expected to peak between 5.0%–5.5% in the autumn. Although higher NLW and NIC costs are already being reflected in higher food prices, the majority of EPR costs are still to be felt. There are limited signs yet of competition in the grocery sector taking the edge off this expected peak in food price inflation. Non-food goods price inflation remains modest, reflecting soft input costs and weak demand.

Consumer services inflation remains elevated and stable. The moderation in services inflation has paused as companies have passed on higher labour and other input costs to the extent demand allows.

> **Corporate credit availability remains close to normal in aggregate, with increased competition for the more creditworthy. Credit demand remains weak, but there are signs of some recovery.**

Bank lending appetite is positive but targeted. Competition for safer lending is intensifying, with profitable firms able to refinance or increase borrowing at better spreads. However, credit remains tight for those sectors struggling financially. Alternative finance is accessible, but at higher rates. Early-stage finance is tighter than usual.

Credit demand remains weak. Contacts are cautious around the timing of market refinancing, due to high market volatility and lower liquidity. Higher capital gains tax has dampened transactional demand since April, but rising enquiries suggest some recovery in 2025 H2. Demand for working capital and asset finance is holding up.

**Demand is weaker in the housing market now that the temporary increase in activity ahead of stamp duty changes in England has fallen away.**

Secondary market demand is subdued, while supply is picking up. Demand is strongest at the cheaper end, while expensive homes are selling more slowly. Estate agents have mixed views, but most expect prices to remain flat over 2025.

Demand for rental properties continues to outstrip supply as more buy-to-let landlords exit the sector adding to the supply of homes for sale. This supply squeeze is supporting rent inflation. Some landlords are concerned arrears might rise once the Renters Reform Bill becomes enacted in law.

# Annex: Other forecasters' expectations

This annex reports the results of the Bank's most recent survey of external forecasters. Responses were submitted in the two weeks to 25 July and are summarised in Chart A. These are compared with the MPC's baseline projections, which are conditioned on a range of assumptions (Section 1.1) that may differ from those made by external forecasters.

On average, external forecasters expected GDP to rise by 1.1% over the four quarters to 2026 Q3, with four-quarter growth of 1.3% in 2027 Q3 and 1.4% in 2028 Q3 (Chart A, left panel). The average external forecast is a little below the MPC's baseline projection for 2026 Q3 of 1.3%, and further below the MPC's 2027 Q3 and 2028 Q3 projections of 1.5% and 1.7%, respectively.

The average of external forecasters' expectations for the unemployment rate was 4.9% in 2026 Q3, in line with the MPC's baseline projection (Chart A, middle panel). External forecasters expected the unemployment rate to fall to 4.7% in 2027 Q3 and to 4.6% in 2028 Q3. The MPC's baseline projection falls to and remains 4.8% in 2027 Q3 and 2028 Q3.

CPI inflation was expected to be 2.3% in 2026 Q3, below the MPC's projection of 2.7% (Chart A, right panel). The average external forecast was 2.1% for 2027 Q3 and 2.0% for 2028 Q3. The MPC's baseline projection is 2.0% in 2027 Q3 and in 2028 Q3. The range of external forecasts for CPI inflation in 2028 Q3 was very narrow.

**Chart A: At the three-year horizon, external forecasters expected four-quarter GDP growth to be 1.4%, the unemployment rate to be 4.6%, and CPI inflation to be 2.0%**

Projections for GDP, the unemployment rate and CPI inflation

# Glossary and other information

## Glossary of selected data and instruments

AWE – average weekly earnings.

CPI – consumer prices index.

CPI inflation – inflation measured by the consumer prices index.

DMP – Decision Maker Panel.

ERI – exchange rate index.

GDP – gross domestic product.

GSCI – Goldman Sachs Commodity Index.

HICP – harmonised index of consumer prices.

LFS – Labour Force Survey.

MaPS – Market Participants Survey.

OIS – overnight index swap.

PMI – purchasing managers' index.

RPI – retail prices index.

## Abbreviations

AI – artificial intelligence.

APF – Asset Purchase Facility.

BCC – British Chambers of Commerce.

CBI – Confederation of British Industry.

CFO – chief financial officer.

CIPD – Chartered Institute of Personnel and Development.

COICOP – Classification of Individual Consumption by Purpose.

DMO – Debt Management Office.

ECB – European Central Bank.

EPR – Extended Producer Responsibility.

EU – European Union.

FCA – Financial Conduct Authority.

FNAB – food and non-alcoholic beverages.

FPC – Financial Policy Committee.

FTSE – Financial Times Stock Exchange.

GfK – Gesellschaft für Konsumforschung, Great Britain Ltd.

GVA – gross value added.

HMRC – His Majesty's Revenue and Customs.

IAS – Inflation Attitudes Survey.

ILO – International Labour Organization.

IMF – International Monetary Fund.

IS – investment saving.

LTI – loan to income.

LTV – loan to value.

MIDAS – mixed-data sampling.

MPC – Monetary Policy Committee.

MTIC – missing trader intra-community.

NICs – National Insurance contributions.

NLW – National Living Wage.

OBR – Office for Budget Responsibility.

Ofgem – Office of Gas and Electricity Markets.

ONS – Office for National Statistics.

OPEC – Organization of the Petroleum Exporting Countries.

PMI – purchasing managers' index.

PPP – purchasing power parity.

PSD – Product Sales Data.

QE – quantitative easing.

QT – quantitative tightening.

REC – Recruitment and Employment Confederation.

RTI – Real-Time Information.

S&P – Standard & Poor's.

SDLT – Stamp Duty Land Tax.

VAT – Value Added Tax.

V/U – vacancies to unemployment.

## Symbols and conventions

Except where otherwise stated, the source of the data used in charts and tables is the Bank of England or the Office for National Statistics (ONS) and all data, apart from financial markets data and results from the Decision Maker Panel (DMP) Survey, are seasonally adjusted.

n.a. = not available.

Because of rounding, the sum of the separate items may sometimes differ from the total shown.

On the horizontal axes of graphs, larger ticks denote the first observation within the relevant period, eg data for the first quarter of the year.