United Kingdom

Growth steady despite external pressures

Growth in the UK economy was better than expected in 2026 despite headwinds from geopolitical events. However, the labour market has loosened, and inflation, having fallen in the early part of the year, has risen again as higher energy costs feed through. Looking forward, fiscal constraints are likely to remain, given the level of government debt, while monetary policy will be constrained by higher inflation, raising the possibility of rate increases.

Frances Haque
Giles Andrews

Economic growth was positive for the first half of 2026, growing by 0.6% in Q1 and 0.4% in Q2 despite the headwinds from the Middle East conflict, with households supporting growth by using savings, as seen in chart one. However, the outlook is for weaker growth, with higher energy and food prices squeezing household consumption again. The resolution of the conflict in the Middle East will have a large impact on this outlook — particularly inflation — with the possibility of second-round effects increasing the longer the conflict continues. That is not to mention its impact on interest rates, growth, etc.

The labour market continued to loosen in 2026 and appears to be having some effect on reducing private sector wage growth, which at the end of Q2 was 2.8% — a level that the Bank of England would consider in line with its inflation target. Unemployment fluctuated and the ongoing issues with the Office for National Statistics (ONS) Labour Force Survey continue, but the unemployment rate and other data such as vacancies, His Majesty's Revenue & Customs (HMRC) payroll data and the results of other surveys suggest that the labour market could be stabilising in H2 2026. The unemployment rate at the end of Q2 was 4.9%. However, risks around increasing costs for businesses either through higher taxation, higher energy prices or other higher input prices could mean further consolidation of the workforce. The use of artificial intelligence (AI) may also have an impact on areas of the labour market looking forward.

Inflation had been falling in the first half of 2026, but with household energy bills rising in July, inflation returned to 2.9% at the start of Q3. Headline inflation is set to increase over the rest of the year, peaking at 4%. It is also considered likely that the energy price cap will increase again in October and January, meaning that inflation will be higher in 2027 than previously thought. At present, growth in output producer price inflation is lower than input producer price inflation, as shown in chart two. This suggests that firms are not passing on all cost rises at present. However, this may change if costs to businesses continue to rise.

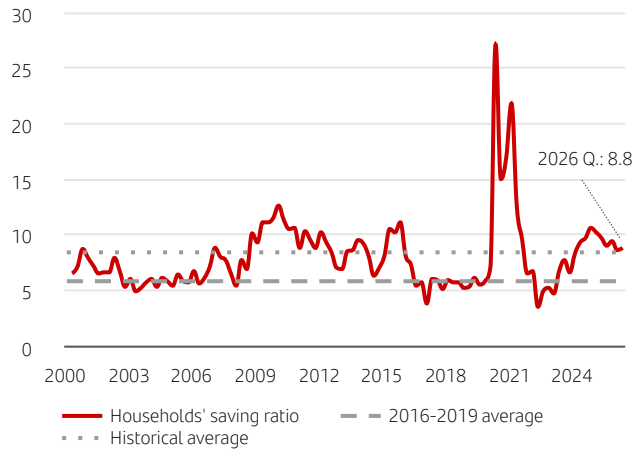
United Kingdom

Inflation is forecast to rise over the rest of 2026 and into 2027. It is now expected that the Monetary Policy Committee (MPC) will raise Bank Rate further. However, this is heavily dependent on the cessation of the conflict in the Middle East. Inflation expectations, which can be key to second-round effects, have increased recently given the continuation of the conflict. However, with a weaker labour market than in 2023, the probability of strong second-round effects is lower. That said, rising inflation into 2027 could alter the outlook.

The fiscal constraints facing the UK are similar to those of other countries, although UK government bond yields seem to be more volatile, bringing up borrowing costs and continuing to pose problems for the government. The constraints for the government remain the same, but with taxes at an all-time high and many of the largest tax-raising measures ruled out, large increases in taxes will be challenging. With extra borrowing difficult, cuts in spending would also be needed to help the country move towards a more sustainable fiscal position.

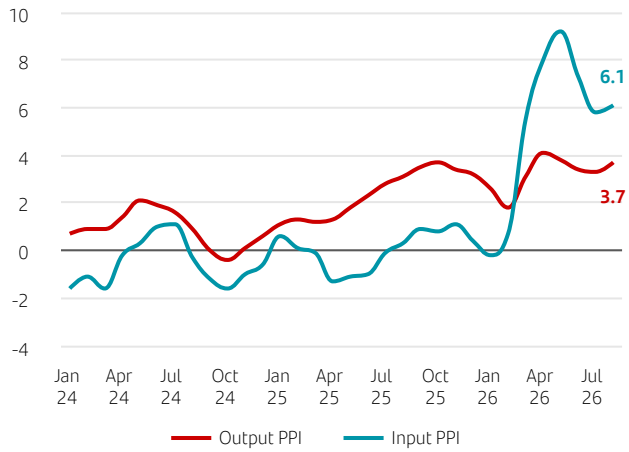
Key risks to the outlook include: an energy shock from the ongoing Iran conflict; a potential fiscal crisis due to the level of government debt; lower real disposable income; and higher business costs. However, on the positive side, AI could drive productivity and growth.

UK: Households' saving ratio
(%)



Source: Macrobond.

UK: Producer price inflation
(%, y/y)



Source: Macrobond.

Macroeconomic forecasts

	2026e	2027e	2028e
GDP growth (%)	1.3	0.9	1.4
Unemployment rate	5.4	5.4	5.2
CPI inflation	3.1	3.3	2.1

Source: Santander Research. Annual average.



United Kingdom In focus

Are there signs of a productivity revival in the UK?



UK productivity appears to be improving after years of weak growth, but the signal is uncertain because it depends on the employment data used. The key question is whether this reflects a genuine structural gain in efficiency or a temporary labour market effect. The answer will be crucial for judging the UK's medium-term growth outlook.

UK productivity growth has slowed markedly since the financial crisis

Productivity is a measure of how efficiently inputs are converted into outputs and is one of the most important factors in determining living standards and prosperity in the long run. Before the 2008 financial crisis, UK productivity typically grew by around 2% per year. However, the country has experienced a significant slowdown in productivity growth, to around 0.6% between 2010 and 2019 and 0.4% between 2020 and 2024.

Labour productivity is the most common way to measure productivity, with output per hour worked the preferred metric in the UK because it accounts for changes in working hours. Data published by the Office for National Statistics (ONS) suggest output per hour worked fell by 1.2% q/q in Q2 2026, with output per worker estimated to have increased by 0.2% q/q in Q2 2026.

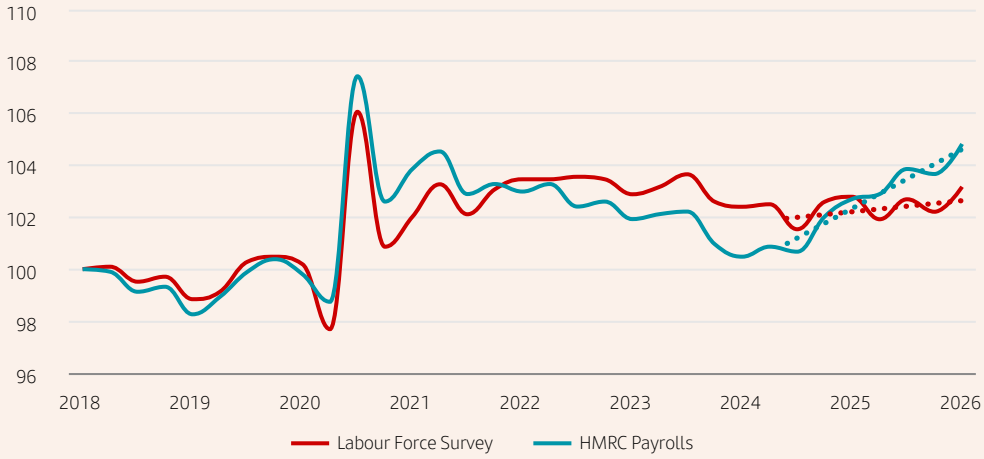
Measurement issues cloud the UK's recent productivity performance

However, the accuracy of productivity data depends on which measure of employment is used, with different sources showing that productivity has either soared or broadly flatlined since 2024.

For years, the ONS' sole measure of labour productivity was calculated by dividing UK gross value added (GVA) by the number of hours worked in the economy, based on figures from the Labour Force Survey (LFS). However, the LFS has suffered from a spate of major challenges since the pandemic, which has made the sample less representative of the UK population and increased volatility and statistical uncertainty in the series. The problems with the LFS have led policymakers and economists to place more weight on alternative data sources for the labour market, such as payroll numbers from HMRC and the ONS' workforce jobs (WFJ) data. When looking at measures of employment across different sources, it is clear that the LFS has diverged from the other two. The LFS has been far more optimistic on the level of employment in the economy in recent years. Since the end of 2019, the LFS suggests employment has risen by 6.4% compared to 4.5-5% for WFJ and payroll data. As the chart below shows, using the weaker alternative sources of employment data to calculate output per hour

implies the UK has experienced a sharper rise in productivity than the official data suggests.

UK: Output per hour (Q1'18=100)



Sources: ONS and Santander Research.

Given the above, we would place more weight on these alternative sources (as they align with other surveys, such as the Purchasing Manager's Index (PMI) employment balance) and employment measures in the Bank of England's Decision Maker Panel (DMP) survey, which suggest a gradual loosening of the labour market.

More in hope than expectation

An improvement in productivity growth would of course be welcome, and it looks as if this could be greater than the ONS data suggest. If sustained, it would partly offset some of the expected strain on the public finances. However, it is also important to understand why productivity may have improved. It may be due to the increasing use of artificial intelligence (AI)[1], seeing as the UK is relatively well placed to benefit from new technology given the strength of our services sector. However, it could also have been driven by the large minimum wage increases and higher employer National Insurance contributions, pushing low-paid and younger workers out of jobs, and thereby increasing output of the remaining workers temporarily.

Conclusion

Productivity has risen, but why is less clear. Both points of view set out above have merits, but for current productivity levels to be sustained and benefit the UK's medium-term growth prospects, improvements need to be focused on those sectors best placed to take advantage of new technologies.

[1] Van Reenen, J. (2026), 'Productivity, innovation and the future of growth', keynote speech, Royal Economic Society Annual Conference, 20 August.