

EMBARGO 00.01 hours 3 August 2011

Prospects for the UK economy

- The economy will grow by 1.3 per cent this year and 2 per cent in 2012.
- Consumer price inflation will fall back from 4.2 per cent this year to 1.9 per cent in 2012.
- Household finances remain vulnerable to a modest interest rate rise.
- The unemployment rate will rise from 7.9 per cent in 2011 to 8.3 per cent in 2012.
- Britain's productivity performance will continue to disappoint, rising by 1 per cent, on average, over the next few years.

The UK economy has been largely stagnant over the past nine months. GDP growth will pick up in the second half of this year, but this will be flattered by the negative 'one-off' effects of the second quarter. Subdued domestic demand will hinder any meaningful recovery this year. GDP growth will rely on the external sector this year and next. The economy will expand by 1.3 per cent this year, accelerating to 2 per cent per annum in 2012. The CPI inflation rate will fall from 4.2 per cent per annum this year to 1.9 per cent in 2012.

Household incomes continue to fall in real terms. Wage growth has failed to keep up with an elevated rate of inflation and tax increases. This strain on real incomes will translate into a fall in consumer spending of 0.8 per cent this year. Household finances are still vulnerable to an interest rate rise. Just a 50 basis points rise in interest rates would knock 1/3 percentage point off real income growth next year.

Over the course of the recession employment did not fall as sharply as the experience of previous recessions might have suggested. Remarkably, even though economic growth, to date, has been lacklustre, employment has increased. Even so, the unemployment rate will rise to 8.3 per cent in 2012. Falling real wages have allowed firms to 'hoard' labour, resulting in a fall in the level of productivity that has yet to be recovered. If unit labour costs are not kept in check then a further significant rise in unemployment could occur even as the economy continues to expand.

Risks to growth are dominated by external factors, in particular the ongoing sovereign debt crisis in the Euro Area. Any resulting deterioration in the economies of the UK's major trading partners would depress an already weak period of growth further; in such circumstances a domestic policy response would be required.

The public finances will not improve as quickly as the OBR expects. Weaker growth, and in particular weak consumer spending, in the short term, are behind this. Public sector borrowing will shrink by only 1 per cent of GDP in 2011–12. The Chancellor will miss his primary target of balancing the cyclically adjusted current budget by 2015–16 by around 1 per cent of GDP. The Chancellor has time to address this and further consolidation should not be introduced now. Indeed, it remains our view that in the short term fiscal policy is too tight, and a modest loosening would improve prospects for output and employment with little or no negative effect on fiscal credibility.

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Notes:

The forecast for the UK economy is published in the National Institute Economic Review, no. 217, July 2011

For a full copy of the UK Economy forecast, please contact the NIESR Press Office: Pat Shaw on 020 7654 1905/ p.shaw@niesr.ac.uk.

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