

EMBARGO 00.01 hours 20 October 2010

Prospects for the UK economy

- The recovery will continue but it will be sluggish, with GDP growing by 1.6 per cent a year in both 2010 and 2011.
- Consumer price inflation will remain surprisingly high in 2011 given the amount of spare capacity, averaging 2.8 per cent during the year.
- The squeeze on household budgets will cause consumer spending to stagnate in 2011.
- Public-sector net borrowing will fall less than the official forecast, reaching 3.6 per cent of GDP in 2014–15 rather than 2.1 per cent.

The economy grew at the heady rate of 1.2 per cent in the second quarter of 2010, but that was a flash in the pan. Output growth will slow to 0.5 per cent in the third and become even more subdued in the last three months of the year and through 2011 because of fiscal retrenchment. There remains a one in five chance of a fall in output in 2011 as a whole. If output were to fall it would be wise to undertake a temporary fiscal stimulus.

Households face the dismal prospect of two successive years when real disposable income falls, by 0.8 per cent in 2010 and 0.6 per cent in 2011. Consumers will manage to raise their spending by 0.8 per cent this year, but only by running down the saving ratio from 6.2 per cent of disposable income in 2009 to 4 per cent this year. With little room to manoeuvre by running it down further, consumer spending will stagnate in 2011. Meanwhile government spending will be falling, mostly because of a 19 per cent decline in fixed investment, although government consumption (current spending on public services) will also decline, by 1.1 per cent in real terms.

Despite the fiscal brake on growth, the economy will expand, though only by 1.6 per cent a year in both 2010 and 2011. The profile of the two years will differ markedly. This year stockbuilding contributes 1.2 per cent to growth while net trade subtracts 1 per cent. Next year, the contribution from inventories is just 0.2 per cent while net trade picks up the baton and adds 1.2 per cent to growth. A recovery in business investment, which generally makes up about 60 per cent of total fixed investment, will also bolster the economy especially in 2011 when it will rise by 5.9 per cent.

The fiscal deficit will fall more slowly than forecast by the Office for Budget Responsibility, to 3.6 per cent of GDP in 2014–15 rather than 2.1 per cent. The overrun arises essentially from lower taxes, for two main reasons. Growth will be slower; with the exception of 2010, we are forecasting slower growth until 2014, especially in 2011 and 2012. As a result GDP will be lower in 2014–15 than the OBR expected, reducing the tax base. Moreover, taxes will be less buoyant, recovering only modestly by 2014–15, with receipts being around 1 per cent below the 38.8 per cent of GDP expected by the OBR.

Fiscal policy may become too tight and in response monetary policy could become too loose. This might entail risks to price stability in the longer term. We suspect that spending cuts will be delayed and their scale reduced as compared to the budget plans. If the cuts were half the size and direct taxes were raised to fill the gap then output growth would be ¼ percentage higher in 2011 and 2012, and the same budget target would be reached in 2015.

ENDS

Notes:

The forecast for the UK economy is published in the National Institute Economic Review, no. 214, October 2010

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 or
Goran Stankov on 020 7654 1931/ g.stankov@niesr.ac.uk.

The National Institute Economic Review is the quarterly journal of the National Institute of Economic and Social Research (NIESR). Published in January, April, July and October, it is available from Sage Publications Ltd at subscription@sagepub.co.uk.

Further details of NIESR's activities can be seen on <http://www.niesr.ac.uk> or by contacting: enquires@niesr.ac.uk.

For further information:

National Institute of Economic and Social Research
2 Dean Trench Street
Smith Square
London, SW1P 3HE
United Kingdom

Switchboard Telephone Number: +44 (0) 207 222 7665
Switchboard Fax: +44 (0) 207 654 1900

Contact:

Simon Kirby (s.kirby@niesr.ac.uk) on +44(0)20 7654 1916

Ray Barrell (r.barrell@niesr.ac.uk) on +44(0)20 7654 1925