National Institute of Economic and Social Research

# Press Release

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**Prospects for the UK economy: NIESR's latest forecast for the UK economy.**

- After falling this year by 4.4 per cent, GDP will grow by 1.3 and 1.5 per cent in 2010 and 2011.
- Following a drop of 3.3 per cent this year, consumer spending will fall by 0.7 and 0.1 per cent in 2010 and 2011.
- Public sector net borrowing will fall only to 7.7 per cent of GDP in 2013–14, a more pessimistic projection than the Treasury's.
- The financial crisis and recession have reduced potential output by 4 per cent of GDP.

The economy is poised to resume growth in the fourth quarter and GDP will rise by 1.3 per cent in 2010. But the recovery will be feeble since consumer spending, the usual mainstay of demand, will continue to fall, by 0.7 per cent. Indeed it will carry on falling in 2011, though only by 0.1 per cent, as households continue to save more. The saving ratio will reach 8.2 per cent of disposable income in 2011, up from 1.7 per cent in 2008. Business investment will fall again, by 6.9 per cent in 2010 after its drop of 18.2 per cent this year.

With such powerful contractionary forces still in play, the recovery will be underpinned by net trade, which will contribute 1 and 1.4 percentage points of GDP growth of 1.3 and 1.5 per cent in 2010 and 2011 respectively. Government spending will help a little next year, but the recovery will also rely heavily on the turnaround in the inventory cycle, which will contribute 1 and 0.4 percentage points of GDP growth in 2010 and 2011 respectively.

The shift in the economy away from domestic demand and towards exports is long overdue. But this rebalancing is one reason why sorting out the public finances will be particularly painful since exports, unlike consumption, are tax-poor. Whereas the Treasury is forecasting a fall in public sector net borrowing to 5.5 per cent of GDP in 2013–14, our forecast shows borrowing at 7.7 per cent in that year.

The UK faces a structural budget deficit of 6 per cent of GDP, and the build-up of government debt, which may reach 93 per cent of GDP by 2015, will leave a burden for our descendants. Fiscal consolidation will be expensive, but the faster it happens the lower the rise in debt. Raising the standard rate of income tax by 7p or widening the VAT base by 10 per cent of spending would both raise 2 per cent of GDP revenue, as would a 5-year public sector pay freeze, or a 10 per cent cut in services. All are costly and consumption would be higher and debts lower if the retirement age is increased more rapidly than planned. There is a case for extending working lives by three years in order to reduce the structural deficit by 3 per cent of GDP.

The financial crisis and recession will permanently reduce potential output by 4 per cent of GDP, rather higher than the 3 per cent average for European countries. Of this loss of capacity, three-quarters arises from higher real interest rates on investment and one quarter from the effects of higher return migration on the labour supply.

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