National Institute Economic Review No. 242 November 2017

Prospects for the UK economy

- GDP is forecast to grow by around 1½ per cent this year and in 2018. Our forecasts have been revised lower since August.

- Annual consumer price index inflation peaks at 3.2 per cent in the final quarter of this year before easing back to the target rate of 2 per cent in the second half of 2019. The risks to that forecast are tilted to the downside.

- We expect the Bank of England to raise the policy rate by 25 basis points this month and again every six months until Bank Rate reaches 2 per cent.

The economic and political backdrop remains highly uncertain. Negotiations for the withdrawal from the EU started in June and although they are well under way, progress is slow. These are complex negotiations – the political uncertainty that has characterised the UK over the past four years has only served to widen the range of possible economic outcomes, but more worryingly it also leaves the UK vulnerable. According to the average of the three largest betting companies, there is more than a two in three chance of an early election before 2022.

The UK economy expanded by 0.4 per cent in the third quarter of this year and by 1.5 per cent compared with the corresponding quarter last year. The outturn was in line with our August forecast as well as our monthly GDP nowcast. On the assumption of a smooth withdrawal from the EU, we expect GDP growth of around 1½ per cent per year over the next five years, around ¼ percentage points lower than our previous forecast. As before, we see net trade making a substantial contribution to GDP growth.

The downward revision to our growth forecast primarily reflects a more negative view about the productivity prospects of the economy. Consistent with the new data, we now expect hourly labour productivity to average just 1 per cent over the next five years compared with 1.2 per cent previously. It is worth reminding ourselves that this period of disappointing productivity growth coincides with persistent upside surprises to the number of people employed. In other words, there is not only a productivity puzzle to explain, but also a possibly related puzzle in employment.

Inflation on the CPI measure is set to peak at 3.2 per cent in the final quarter of this year. Our forecast is broadly unchanged from August in spite of a weaker profile for GDP growth. The main reason is lower productivity and a faster rate hiking cycle by the Bank of England. We expect the MPC to raise the policy rate by 25 basis points this month, the first increase since July 2007, and then to raise every six months until the policy rate reaches 2 per cent in the middle of 2021.

In our forecast the fiscal deficit is more or less eliminated in 2022, but there are risks. Austerity fatigue has set in and the government is under pressure to raise spending across the board, in welfare, health, education, housing and salaries. Of these, perhaps the biggest risk to public finances is the cap on public sector wages. A material increase in public sector wages has the potential to spill over into the private sector and that would have consequences for both fiscal and monetary policy.

Summary of the forecast – UK economy

	Real gross national income(a)	Real GDP(a)	Unemployment(b)	CPI(c)	RPIX(d)	External current balance(e)	PSNB(f)
2017	2.1	1.6	4.3	3.2	3.9	–88.6	59.9
2018	2.2	1.7	4.3	2.2	2.9	–69.0	42.8
2019	2.7	1.7	4.3	2.0	2.6	–56.4	17.4

(a) Percentage change, year–on–year. (b) ILO definition, fourth quarter, rate. (c) Consumer prices index, percentage change, fourth quarter on fourth quarter. (d) Retail price index, excluding mortgages, percentage change, fourth quarter on fourth quarter. (e) Year, £ billion. (f) Public sector net borrowing, fiscal year, £ billion. Includes the flows from the Bank of England's Asset Purchase Facility.

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Notes for editors:

The forecast for the UK economy is published in the National Institute Economic Review no. 242 November 2017. Details of NIESR's previous UK economic forecast can be found here.

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