

**EMBARGO 00.01 hours 1 February 2011**

## **Prospects for the UK economy**

- The economy will grow by only 1.5 per cent in 2011 and 1.8 per cent in 2012.
- Consumer price inflation will be 3.8 per cent this year but fall to 1.8 per cent in 2012.
- The sharp rise in oil prices will raise inflation by over ½ percentage point in 2011.
- Growth over the next two years will come mainly from net trade.
- Real disposable income will fall for the second successive year, by 0.8 per cent in 2011.
- There is a case for delaying some of the austerity programme but accelerating planned increases in the state pension age.

Growth in 2011 will be lacklustre. The economy will expand by 1.5 per cent, barely higher than the 1.4 per cent expansion in 2010. Some of the output lost to the exceptionally poor weather in late 2010, when GDP fell by 0.5 per cent, will be regained in early 2011, but the average rate of growth across the two quarters will be just 0.1 per cent. With the recovery so subdued, this year's surge in inflation will peter out and CPI inflation will fall to 1.8 per cent in 2012.

What growth there is this year will come mainly from net trade, as exports rise by 6.4 per cent while imports increase by only 2.1 per cent. That impetus will continue in 2012, when net trade will contribute 1.4 percentage points out of total growth of 1.8 per cent. This reflects a belated response by exporters to a more competitive pound and the opportunities of faster-growing foreign markets. Corresponding to this, the manufacturing sector, which accounts for about half of all exports, has been performing strongly and expanded by 1.4 per cent in the final quarter of 2010.

Imports will be subdued partly because domestic producers have become competitive but mainly because domestic demand will grow by just 0.4 per cent a year in both 2011 and 2012. Government spending will fall while personal consumption will decline by 0.1 per cent this year. Real disposable income, which fell by 1 per cent last year, will decline further in 2011, by 0.8 per cent.

Oil price increases will reduce real incomes by 1 per cent and boost inflationary pressures. Interest rates may well have to rise in the Spring to hold back these pressures. The case for further Quantitative Easing is evaporating.

Working out the right balance of macroeconomic policy in this environment involves making a judgement about the size of the output gap. We estimate that the economy is currently operating around 4 per cent below its potential. Given that margin of spare capacity, there is a case for promoting the recovery by postponing at least some of the austerity programme. The cost of delay would be acceptable because borrowing costs are currently low. In the longer term, however, the government should set itself a more ambitious target of running sustained surpluses to prepare for the cost of population ageing. As an alternative to swift consolidation, it could raise the state pension age faster so that it reaches 68 rather than 66 by 2020.

**ENDS**

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**Notes:**

The forecast for the UK economy is published in the National Institute Economic Review, no. 215, January 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](mailto:p.shaw@niesr.ac.uk) or  
Goran Stankov on 020 7654 1931/ [g.stankov@niesr.ac.uk](mailto:g.stankov@niesr.ac.uk).

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**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](mailto:s.kirby@niesr.ac.uk)) on +44(0)20 7654 1916

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