

November 2020 Economic and fiscal outlook – Press conference speaking notes

Slide 2: Intro

Good afternoon everyone and welcome to this online presentation of our November 2020 Economic and fiscal outlook. Thank you for joining us.

I am going to take you through the highlights from our latest forecast and then we'll go into an online question and answer session. If you would like to ask a question at any point, please use the Q&A feature, and we will try to answer as many as possible. Please give your name and institution. My slides and speaking notes will be on the website at the end of this event.

Slide 3: Background

This is my first forecast since taking over from Robert Chote as Chairman of the OBR last month. I'd like to start by thanking Robert for all that he has done to establish, build, and lead this important institution over the last decade.

I'd also like to thank my colleagues Charlie Bean and Andy King, the staff of the OBR, and numerous officials across government – including, for the first time, government scientists and public health experts – whose insights were invaluable in helping us assemble this most challenging of forecasts. But I should stress that all the assumptions, analysis, and scenarios we present today are our own.

It is now almost a year since coronavirus arrived on our shores. But the course of the pandemic remains the most important determinant of our economic and fiscal prospects.

And while we've had encouraging news about several vaccine trials in recent days, there remains considerable uncertainty about how effective those vaccines will prove to be in preventing not only infection but also transmission of the virus – and about how quickly they can be rolled out to the general population.

In light of this continued uncertainty, it would be misleading to rely upon a single, central forecast to describe the current economic and fiscal outlook. Part of the role of official forecasters like us is to find ways to communicate the **risks** around that outlook - so that the public, parliament, and policymakers can make decisions that are robust to a range of possible futures.

For this reason, as in our Fiscal Sustainability Report back in July, we continue to present several possible scenarios for the economy and public finances conditioned on different assumptions about the future course of the virus, the stringency of health restrictions, and the availability of potential vaccines.

All these scenarios assume that the UK successfully concludes a free trade agreement with the European Union prior to the end of the transition period in five weeks' time. However, because negotiations remain ongoing and may not ultimately prove fruitful, we also present an alternative scenario in which our relationship with the EU defaults to World Trade Organization terms from the 1st of January.

We estimate that such a No Deal outcome would reduce the level of UK GDP by around 2 per cent and increase borrowing by around £10 billion compared to the figures you are about to see. The details underpinning these estimates can be found in Annex B to the EFO document.

Economy Section

Given the importance of understanding what we have been through this year to projecting where we may be headed over the next five, let me start with an account of how our lives, economy, and public finances have been up-ended since we published our last Economic and Fiscal Outlook back in March.

Slide 4: Coronavirus impact on major economies I

The UK was one of the countries hit hardest by the initial wave of the pandemic – seeing the one of the highest rates of hospital admissions and third highest fatality rates in Europe, as shown in the charts on this slide.

And as cases in this country mounted, the Prime Minister announced the first national lockdown on the 23rd of March - shuttering businesses and schools across the country over the months of April, May, and June - one of the longest lockdowns in Europe during the first wave of the pandemic.

Slide 5: Coronavirus impact on major economies II

Both because of the severity of the outbreak here and because, as shown in the chart on the left, we locked down harder and for longer than most other countries, the UK has also suffered one of the largest falls in output during the first wave of the pandemic.

As shown in the chart on the right, UK GDP fell by 22 per cent in first half of this year, the sharpest contraction of any major advanced economy other than Spain.

Slide 6: Monthly GDP outturn

But as case numbers fell and public health restrictions were lifted over June and July, economic activity rebounded strongly over the summer. As you can see from this chart of monthly GDP, output recovered from being 26 per cent below its pre-virus peak in April to being just 9 per cent down by September.

This recovery from the first lockdown was faster than predicted in our July FSR, though not as fast as witnessed in some other European countries.

Throughout the first lockdown and subsequent recovery, employment, earnings, and consumption were supported by an array of government interventions unprecedented in their scale and scope in peacetime.

Slide 7: Employees supported by CJRS and SEISS

With around 9 million on the furlough scheme and another 2½ million on the self-employment scheme, about one third of the total workforce have benefitted from direct government support at some point over the past eight months.

Support for firms has also been substantial with well over a million taking out government-guaranteed loans while those in the hospitality sector have also benefitted from a 15 per cent cut in VAT and the Eat Out to Help Out Scheme in August among other things.

And while unemployment has crept up from 4 per cent at the start of the year to 5 per cent in September, these schemes have helped stave off what would have been a far bigger rise in worklessness.

And business support measures – and forbearance by creditors – has also helped employers stay liquid during this period, with the number of company insolvencies actually running a third *lower* than normal for this time of the year.

Slide 8: Realtime mobility data since March

However, a resurgence in infection rates and the reimposition of tiered health restrictions in the different nations and regions of the UK took the wind out of the recovery at the end of the summer – with the economy growing by just 1 per cent in September and real-time mobility indicators suggesting that economic activity contracted as cases rose through October.

Further tightening of health restrictions over October and the imposition of a second lockdown in England on 5 November, is expected to drive growth back into negative territory this quarter.

However, because schools remain open and many businesses have adapted their workplaces to make them Covid safe, we expect the reduction in output during the second lockdown to be only 60 per cent as severe as that experienced during the first lockdown, leaving GDP 15 per cent below its pre-virus peak this month.

Slide 9: Key epidemiological questions

From here on, the economic outlook depends crucially on the answers to three epidemiological questions:

- First, how effective will the second national lockdown be in reducing case numbers to manageable levels?
- Second, what general level of public health restrictions will be needed to control the virus after lockdown ends on the 2nd December?
- Third, how effective will the new vaccines be and when will they be available to the general population?

Different answers to these questions provide the basis for our three scenarios for the path of the economy over the next five years.

And I should emphasise that our forecast was closed before the government made its latest announcements regarding the revisions to its tiered health restrictions.

So Tier numbers mentioned in these scenarios relate to the regime as it existed before 5 November not as was announced by the Prime Minister on Monday.

Slide 10: Coronavirus scenario assumptions

Our upside scenario assumes that :

- the current lockdown substantially reduces the number of cases by the time it is lifted on the 2nd of December.
- Thereafter an effective test, trace, and isolate programme allows for a substantial loosening of public health restrictions to an average level equivalent to Tier 2 under the pre-lockdown regime.
- An effective vaccine become widely available in the spring, permitting a further easing of health restrictions and rapid return to relative normality by the end of next year.

In our central forecast,

- lockdown also ends on the 2nd of December but a higher residual infection rate and a less effective test, trace, and isolate system require a more stringent set of public health restrictions – on average equivalent to Tier 3 under the pre-lockdown regime – to remain in place until spring.
- The arrival of warmer weather then allows an easing of those restrictions until effective vaccines become widely available in the *latter* half of next year, permitting a slower return to normal life than in our upside scenario.

In our downside scenario,

- continued high infection rates at the end of the current lockdown mean that an *ineffective* test, trace and isolate regime must be augmented by a *tighter* set of public health restrictions on average than was in place prior to the 5th of November to keep the virus in check throughout the winter.
- The arrival of spring permits some easing of these restrictions but, unlike in the other scenarios, no vaccine proves to be effective in stopping the spread of the virus.
- And so subsequent waves of transmission necessitate the periodic reimposition of further national lockdowns.
- And the continued risk of infection requires more lasting changes in the conduct of our economic and social lives.

Slide 11: Real GDP forecast

This next set of slides show you what these different scenarios imply for the path of the economy over the next 5 years relative to our March and July forecasts.

Slide 12: Real GDP forecast: Upside scenario

In our upside scenario, output rebounds to pre-virus levels by end of next year – and to its pre-virus path by the end of the forecast period – with no long-run scarring of the economy

Slide 13: Real GDP forecast: Central forecast

In our central forecast, there is a more gradual return of economic activity to its pre-virus level at the end of 2022.

And the longer period of lower investment and higher levels of worklessness take their toll on long-run supply, which remains 3 per cent below our March forecast

Slide 14: Real GDP forecast: Downside scenario

In our downside scenario, economic activity does not regain its pre-virus level until the end of 2024 and remains 6 per cent below its pre-virus path, reflecting the loss of productivity from the adjustments to economic and social life necessary to keep the virus under control in the absence of an effective vaccine

Let me now turn to the implications of these different scenarios for the labour market:

Slide 15: Unemployment forecast: Upside scenario

In the upside scenario, the extended furlough scheme provides an effective bridge to a rapidly recovering economy boosted by the rollout of vaccines in the spring. The unemployment rate ticks up to just over 5 per cent in the second quarter of 2021, but falls back quickly to its pre-virus level as those looking for work are reabsorbed by an economy which can still make ready use of their skills and experience.

Slide 16: Unemployment forecast: Central forecast

In our central forecast, unemployment peaks at 7½ per cent and falls back more slowly to a slightly more elevated level by the end of the period.

This higher level of unemployment reflects the longer stretch of depressed economic activity, resulting in a greater number of firm failures, and loss of skills matches between employer and employee.

It also reflects the significant gap in time between the current deadline for the ending of the furlough scheme in March and the turnaround in economic activity which in this scenario gathers pace mid-summer.

Slide 17: Unemployment forecast: Downside scenario

In the downside scenario, unemployment reaches 11 per cent and falls back slowly to 5¼ per cent by the end of the forecast, still 1¼ percentage points above its pre-virus level.

This reflects the greater reallocation of labour between sectors necessary to adjust to a more socially distanced economy

Slide 18: Unemployment forecast vs. 1980s recession

However, in all of these scenarios, unemployment remains below the 12 per cent peak reached in the wake of the recession in the early 1980s.

Fiscal Section

So what does this all mean for the public finances?

Slide 19: Increase in government spending in 2020

In the UK, as in many other countries, coronavirus has prompted an expansion in the size of the state and extension in the scope of its activities unparalleled in peacetime.

Among the 35 advanced economies, the UK has seen the second largest increase in government spending a share of GDP – rising by 14 percentage points this year compared to an average of 8 percentage points across advanced economies.

Slide 20: Increase in government deficits in 2020

To finance this dramatic increase in spending in the face of falling tax revenues, UK government borrowing this year is forecast to rise to £394 billion in our central scenario. This is:

- 7 times higher than the £56 billion we borrowed last year
- twice what we borrowed at peak of financial crisis
- the 2nd largest increase in borrowing in the G7
- the highest recorded borrowing since the height of the second world war in 1944

And the cost of the pandemic has mounted over the course of this year as the second wave of infection has taken hold, health restrictions have tightened, and government support for workers and firms has been extended.

Slide 21: Sources of increase in borrowing in 2020

This chart shows how our latest forecast for borrowing this year compares with those we made in back March, before the pandemic arrived in full force in this country, and in July, in the wake of the first national lockdown.

It shows that:

- At the time of the March Budget, we forecast that borrowing would be £55 billion this year
- By July, our FSR projected it to reach £370 billion with about 40 per cent of the increase in borrowing due to the impact of a smaller economy and 60 per cent due to the cost of the government's policy response as it stood after the Chancellor's Summer Economic Update
- Since then, the economy and tax receipts have performed better than we forecast, and some policy measures have turned out to be less costly than we initially expected, saving around £40 billion against our July forecast for borrowing this year
- But the cost of policy measures announced since July, including in the Chancellor's Spending Review today, add a further £60 billion to government borrowing – £85 billion for their direct cost, with £25 billion coming back via the boost they provide to the economy.
- This takes the total borrowing this year to £394 billion or around one-fifth of the economy.

And unlike during the financial crisis where the consequences of the economic downturn for receipts dominated the increase in borrowing, most of the rise in the deficit this year comes from the direct costs of government policy interventions.

Slide 22: Growth in covid policy costs in 2020

And these measures have been announced in a succession of 14 policy statements over the last year, each carrying a price tag of £20bn on average and each of which would have constituted a substantial budget in its own right in normal times.

Looking at the composition of this £280 billion in government support:

- just under half has gone on directly combatting the virus through higher spending on the NHS and related public services
- one-quarter has gone on the furlough scheme and income support for the self-employed
- another quarter has gone to support businesses in the form grants, guaranteed loans, and tax reliefs
- the remaining sum has gone on things like boosting universal credit awards, taking over the railways, and topping up local authority funding

Of course, these policies have helped to avert the potentially much larger indirect costs to the public purse which would have come from letting employment and incomes go into freefall as a result of the first and second lockdowns.

With that as an account of the large, but largely temporary, near-term cost of coronavirus, what medium-term damage might the pandemic do to the fiscal position?

Using the economic scenarios I outlined earlier, the EFO also presents three scenarios for the path of the public finances over the medium-term.

Slide 23: Borrowing forecast: 3 Scenarios

In our upside scenario, borrowing falls back from a peak of 17 per cent of GDP this year to 1.7 per cent in five years' time. This is around half a per cent of GDP *below* our pre-virus forecast in March – thanks to lower interest costs and the £10 billion cut to non-covid spending totals announced in today's Spending Review.

In our central forecast, borrowing falls from 19 per cent of GDP this year back to 4 per cent by the end of the forecast period as temporary policy costs abate and the economy recovers. But borrowing five years from now is around £40 billion *higher* than in our March forecast reflecting the 3 per cent long-run loss of output and a somewhat larger hit to tax revenues in this scenario.

Finally, in our downside scenario, borrowing peaks at 22 per cent of GDP this year then falls back more slowly to 6 per cent of GDP – due in part to the additional fiscal costs of responding to a third wave of infection, but mostly to the even greater degree of economic scarring in this scenario.

Slide 24: Sources of increase in borrowing

To illustrate what drives the change in the borrowing relative our pre-virus forecast in March, this chart breaks that difference down into:

- changes arising from the economic forecast
- changes arising from discretionary policy decisions measures

You can see that that most of the increase in borrowing this year and next is due to government policy measures to combat the virus (shown in dark blue), with the impact of the recession on tax revenues (shown in red) and welfare spending (shown in yellow) making up the remainder.

The direct costs of the virus fall away from 2022-23 as covid-related spending is withdrawn, while the scarring effect of the virus on the economy and receipts remains.

This is slightly offset in each year by the Chancellor's decision in this Spending Review to take around £10 billion out of non-covid spending relative to the totals he set in March which accounts for most of the small green bar on the bottom of the chart.

Let me now turn to the specifics of the 2020 Spending Review announced by the Chancellor earlier today, the financial implications of which have been reflected in our forecast.

Slide 25: Spending Review 2020

Looking at the detail of the Spending Review outcome for different departments,

- a total of £46 billion was added to departments' budget next year, which is just over a third of the £125 billion added this year.
- Of this, £ 56 billion has been directly linked to the fight against covid across 11 out of 23 major Whitehall department.
- However, as I mentioned, these increases are partly offset by the £10 billion reduction in business as usual spending.
- While the Treasury has not stated explicitly where these savings come from, they have announced alongside them decisions to:
 - cut overseas aid from 0.7 to 0.5 per cent of national income, and
 - freeze public sector pay outside the NHS and the lowest paid

And apart from the foreign office (which now owns the overseas aid budget), all departments see real-terms growth in their resource budgets next year with the biggest winners in real growth terms being the reserve to pay for as yet unknown covid costs, DEFRA to take over the Common Agricultural Policy from Brussels, and Transport to take over the railways.

Departmental capital spending is little changed since the March Budget announced big rises in government investment over the next two years – bringing it up to a historically high 3 per cent of GDP and supporting the economic recovery shown in our forecast.

Slide 26: Spending Review 2021?

And while no detailed spending plans are provided beyond next year, we can estimate what the combination of the government's multi-year commitments in the areas of health, schools, defence, and aid imply for all other departments' budget in 2021 Spending Review.

Within the £397 billion total for which plans will need to be set in 2022-23,

- £143 billion has already been allocated to the NHS,
- £52 billion to schools,
- £32 billion to defence,
- and £7 billion would be needed to keep aid spending at 0.5 per cent of national income

This leaves £163 billion to be allocated to the remaining government departments which, as this slide shows, that would imply spending on those 'unprotected' public services being broadly frozen in real terms per capita in 2022-23 relative to the previous year.

Slide 27: Spending Review 2021?

Were the government to wish to return overseas aid back to 0.7 per cent of national income once the pandemic is over but keep total spending the same, this would

- entail a 47 per cent real-terms increase in the aid budget which in this chart is literally off the scale
- and require a 1.9 per cent real cut in per capita spending for all other government departments.

With such stark trade-offs in store for the next spending review, it's perhaps not surprising that the government's taking public expenditure planning one year at a time

Slide 28: Debt/GDP forecast: 3 Scenarios

Let me turn now to the longer-term legacy of the pandemic for the public finances.

The stock of government debt is set to rise by 20 per cent of GDP this year and to exceed 100 per cent of GDP in every year of our central forecast.

Debt stays just below the 100 per cent mark on our upside scenario thanks to a more rapid recovery in the economy and falls back more decisively at the end to 90 per cent of GDP.

In our downside scenario, debt rises above 120 per cent of GDP and stays there for the remainder of the next five years

Slide 29: Debt/GDP forecast vs. March: Central scenario

Comparing our latest central forecast for debt with our pre-virus forecast in March, of that 27 per cent of GDP increase in debt this year:

- 10 per cent of that increase is due to a weaker economy – shown in blue
- 11 per cent is due to fiscal policy measures announced since Budget – shown in red
- 6 per cent is due to the temporary effect of the Bank of England's additional QE and Term Funding Scheme - shown in yellow- whose unwinding allows headline debt to fall as a share of GDP in the last two years of the forecast.

Slide 30: Debt/GDP ex Bank of England: 3 Scenarios

However, if one excludes these temporary, balance-sheet-neutral transactions by our central bank, underlying debt rises as a share of the economy in every year in both our central forecast and downside scenarios.

Slide 31: Debt interest/revenue forecast

At the same time, despite the government's higher stock of debt, the cost of servicing that debt actually falls to new historic lows as a share of government revenue in our central forecast. This is thanks to further rounds of QE and further falls in interest rates since the start of the pandemic – reflecting the relative attractiveness of gilts as a safe-harbour asset in the midst of the covid storm.

Slide 32: Debt interest sensitivity

But while the overall cost of servicing the government's debts has fallen, the public finances have in the process become much more sensitive to future rises in interest rates. This is due to a combination of factors including:

- First, the 20 per cent of GDP increase in the total debt stock
- Second, the government's decision to shorten the maturity of its primary issuance this year
- Third, and most important, the impact of the Bank of England's expanded QE operations which swap an additional £440bn of long-dated government gilts for floating rate central bank reserves

The combined effect of these three factors has been

- To increase the share of our outstanding debt with a maturity of less than one year from one-quarter a decade ago to more than a half today
- And to double the sensitivity of debt interest costs to changes in short-term interest rates.

Slide 33: Fiscal rules

So where does this leave the Government relative to the various fiscal rules and targets it has set for itself?

The OBR has a legal obligation to assess whether the government has more than 50 per cent chance of meeting its fiscal rules based on our central forecast.

This presents a continuing challenge as the set of fiscal rules currently on the statutes book were set by Philip Hammond in his first Autumn Statement in November of 2016.

Since then, the Conservative Party included a new set of fiscal rules in their 2019 Election Manifesto but these were superseded by the review of the fiscal framework announced by the new Chancellor in March. The conclusion of this review has been postponed while the government deals with the pressures the pandemic and the Treasury has effectively stopped trying to chase any particular fiscal target until virus-related uncertainties recede.

But for the record, our latest EFO shows that

- none of the fiscal rules currently on the statute books are met
- while two of the three rules in the Conservative Party manifesto are met based on our central forecast.

Slide 34: Balancing the books

Most recently, the Chancellor in his October Party Conference Speech stated his determination to balance the books and get debt under control once the pandemic has run its course. So for completeness, we also look at the degree to which different interpretations of these goals are met over our forecast horizon.

Looking at three conventional definitions of fiscal balance, the headline deficit, the primary deficit, and the current budget deficit, none of them are achieved on our central scenario by the end of this forecast period.

Matching day-to-day spending to receipts, the loosest of the three definitions of balancing the books, would require current spending cuts or tax rises of £27 billion in the final year of the Parliament based on our central forecast.

Slide 35: Getting debt under control

Depending on the scope of liabilities and assets taken into account, the government fares better in getting debt under control by the end of this Parliament.

Headline debt falls at the end of the forecast period by 0.3 per cent, but as mentioned earlier, this is only because of the unwinding of the Bank of England's Term Funding Scheme.

Excluding the help offered by the Bank, underlying debt rises by 0.8 per cent. Getting it to fall on our central forecast by the end of the period would require spending cuts or tax rises of £21 billion on our central forecast.

However, if we look at public sector net financial liabilities, a broader measure of the balance sheet taking account of all the government's financial assets and liabilities, it would meet this goal by more than 1 per cent

Slide 36: Conclusion

So, let me conclude.

This country has already paid a heavy economic and fiscal price as a result of the coronavirus pandemic. The analysis we are publishing today lays bare these costs which are now being compounded by a second wave of infections.

But the news from recent days regarding the effectiveness of several candidate vaccines has also provided us, for the first time, with a credible basis for forecasting a more lasting economic recovery motivated by something more than just our innate hopefulness and faith in the miracles of science.

But much remains uncertain and our scenarios illustrate several possible paths for that recovery, some of which are longer, rougher, and more costly than others.

Which of those paths we take depends crucially on how effectively three elements of the government's *public health* response (lockdown, test and trace, and vaccine rollout) can work together to permit a safe and steady recovery in economic activity back toward pre-virus levels.

And the economic toll that we pay along the way will also depend on how effectively three elements of the government's *economic* policy response (support for workers, businesses, and the health service) can operate to protect jobs, firms, and lives in the meantime.

But what is clear even now is the toll this pandemic has taken on the public finances.

While the government has not struggled to borrow what it needed to fight the virus and mitigate its economic effects, it has in the course of doing so already accumulated a stock of debt three times higher than we had twenty years ago.

While the interest rates we are paying on that debt are one-sixth what they were at the turn of this century, there are no guarantees they will remain so low. Indeed, history warns the interest rates can rise much faster than debt can fall. And the shortening of the effective maturity of our debts has left the public finances more exposed to a sudden rebound in interest rates.

What future fiscal adjustment will ultimately be required to restore the nation's public finances to health – and ensure our resilience to the next crisis – depends in no small part in how well we can manage this one.

But what we can say at this stage based on our central forecast is that while the Chancellor's Spending Review has made a £10 billion downpayment on that adjustment, a further £20 to 30 billion would be needed to meet the loosest conventional definition of balancing the books and arrest the rise in the underlying debt-to-GDP ratio by the end of our five year forecast horizon.

Thank you very much for your attention, and with that, we'll now turn to your questions.