

# 1 Executive summary

## Overview

- 1.1 The economy has performed less strongly this year than we expected at the time of our last forecast in March, primarily reflecting the weakness of net exports. Looking forward, the recovery still lacks momentum. We now expect a small fall in GDP in the fourth quarter of this year, followed by a gradual pick-up next year. GDP is forecast to fall by 0.1 per cent in 2012 and then to grow by 1.2 per cent in 2013.
- 1.2 We are more pessimistic about the economy's medium term growth prospects than we were in March. We expect weak productivity to constrain nominal earnings growth for longer, with a slower fall in inflation delaying the pick-up in real incomes. The outlook for the world economy and UK exports has deteriorated and we expect the difficulties of the euro area to depress confidence and put upward pressure on bank funding costs for longer. Investment is likely to be restrained by poor credit conditions and uncertainty about demand.
- 1.3 Our central forecast is for the economy to grow by 2 per cent in 2014, 2.3 per cent in 2015, 2.7 per cent in 2016 and 2.8 per cent in 2017. This would leave real GDP 3.2 per cent lower in 2016 than we forecast in March. But most of this downward revision is assumed to be cyclical – and therefore eventually reversible – rather than structural and permanent. We have revised down our forecasts for nominal GDP slightly more than our forecasts for real GDP, as we expect whole economy inflation to be lower in the medium term than we assumed in March.
- 1.4 Public sector net borrowing (PSNB) is forecast at £108 billion or 6.9 per cent of GDP this year, excluding the transfer of the Royal Mail's historic pension deficit and associated assets into the public sector. This is £11 billion less than we forecast in March, primarily reflecting the decision to transfer balances from the Bank of England's Asset Purchase Facility (APF) to the Exchequer. Other receipts are likely to be weaker than we expected, although we assume that the Government will raise an extra £3.5 billion from the 4G spectrum auction (which will score as negative capital spending). We assume that central and local government will once again significantly underspend against their budgets.
- 1.5 PSNB is then forecast to decline to £31 billion or 1.6 per cent of GDP by 2017-18, a smaller and slower improvement than in March – mainly because the weaker outlook for the economy will reduce expected tax receipts. Receipts are

expected to remain broadly flat at around 38 per cent of GDP over the forecast, with spending falling from 43.1 per cent this year to 39.5 per cent in 2017-18.

- 1.6 Our forecast includes the impact of the policy measures announced in the Autumn Statement. Auctioning spectrum reduces borrowing this year, with 'giveaways' and 'takeaways' broadly offsetting each other through to 2016-17. Cuts in non-investment spending then extend into 2017-18 for the first time, reducing borrowing by a little over 1 per cent of GDP in that year. As regards the economy, we expect the Autumn Statement measures to deliver a small boost to growth over the next two years, partially reversed thereafter.
- 1.7 The decision to transfer surpluses and deficits generated by the APF to the Treasury means they will be reflected in the public finances on an ongoing basis. This will reduce PSNB and public sector net debt (PSND) through to 2016-17, given our assumptions for the future of quantitative easing (QE) and the way the ONS might treat these flows. But as monetary policy tightens and QE is unwound, PSNB will be higher thereafter and the reduction in PSND partially unwound. We estimate that QE will eventually result in a relatively small net reduction in the level of PSND.
- 1.8 We now expect PSND to peak at 79.9 per cent of GDP in 2015-16, compared to a peak of 76.3 per cent of GDP in 2014-15 in our March forecast. PSND is pushed higher as a share of GDP by weaker nominal GDP growth, higher net borrowing, and the reclassification of Bradford and Bingley plc and Northern Rock (Asset Management) into central government. These upward pressures are partially offset by the impact of the APF transfers and our forecast that the Debt Management Office will continue to sell gilts at a premium to nominal value.
- 1.9 The Government now appears more likely than not to miss its 'supplementary target', which requires PSND to fall as a share of GDP between 2014-15 and 2015-16. We now predict that PSND will rise by 1 per cent of GDP in 2015-16, falling by 0.8 per cent a year later. In the absence of the reclassifications and APF transfers, we estimate that PSND would be stable as a share of GDP between 2015-16 and 2016-17, and then fall in 2017-18.
- 1.10 The Government's 'fiscal mandate' requires it to balance the cyclically-adjusted current budget (CACB) at the end of a rolling five-year period, now 2017-18. Our central forecast shows the CACB in surplus by 0.9 per cent of GDP in 2017-18, implying that the Government is more likely than not to meet the mandate. This is a result of the additional year of cuts in non-investment spending. The CACB is also expected to be in surplus by 0.4 per cent of GDP in 2016-17, although this largely reflects the bank reclassifications and APF transfers.
- 1.11 There is huge uncertainty around all public finance projections, especially over this time horizon. We stress test the Government's chances of achieving its targets using sensitivity and scenario analysis. A key risk is that potential output turns out to be lower at the end of the forecast than we currently assume.

## Developments since the March 2012 forecast

- 1.12 Economic growth this year has been much weaker than we expected in our March forecast. We expected the economy to grow by 0.3 per cent in the first quarter of 2012 and to be flat in the second. Instead the latest ONS estimates show that GDP contracted in both quarters. The latest data show growth of 1 per cent in the third quarter of 2012. This was above our March forecast of 0.6 per cent, but does not fully offset the unexpected weakness in earlier quarters. Aggregate growth in the first three quarters of 2012 was 0.3 per cent, which is 0.6 percentage points lower than our March forecast. Most survey evidence suggests little pick-up in underlying activity in the coming months.
- 1.13 Given the weakness of GDP, the labour market has once again shown surprising strength. The overall level of employment rose to 29.6 million in the three months to September, against our March forecast that it would remain at 29.1 million. Around half the increase since the final quarter of 2011 was driven by a rise in self-employment and part-time employees. Nevertheless, total hours worked per week have also risen by 21.9 million since the fourth quarter of 2011, to 945 million. The unemployment rate has fallen to 7.8 per cent, against our forecast of an increase to 8.7 per cent in the three months to September.
- 1.14 Our March forecast for GDP growth in 2012 of 0.8 per cent was a little above the average outside forecast at the time. Outside forecasts have been progressively downgraded over the course of this year, and now stand at -0.2 per cent for 2012 and 1.1 per cent for 2013. In addition to the weakness in GDP growth so far this year, this likely reflects subdued forward-looking indicators and the ongoing problems in the euro area. Some of these forecasts will not have taken into account the unexpected strength of growth in the third quarter.

## The economic outlook

- 1.15 Recent data suggest less short-term momentum in the economy than we expected in March. Most survey evidence also points to continued weak underlying growth. The situation in the euro area looks likely to continue to weigh on confidence and trade in the near term and for some time to come. Inflation is also likely to be higher in the short term than we expected in March, reducing the growth of real household disposable income and consumption. As a result we have revised down our estimate of GDP growth in 2013 to 1.2 per cent. We expect a return to positive GDP growth after the fall seen in 2012, through a rebound in stock-building, a small recovery in net trade, and falling inflation supporting real household consumption.
- 1.16 Business and consumer surveys, and other cyclical indicators, would suggest an output gap of between -1.9 and -2.3 per cent in the third quarter of 2012. This

would imply that the output gap had narrowed since the end of 2011 despite actual output being roughly flat over this period and much weaker than expected in March. This in turn would imply that the weakness in output over this period was structural and that trend total factor productivity (TFP) had contracted.

- 1.17 However, wider indicators (such as the continued strength of the labour market) are difficult to square with such severe renewed structural weakness, and we do not think it is plausible that trend TFP has been negative over this period. Our central assumption therefore is that the output gap was -2.7 per cent of GDP in the third quarter of 2012, which is consistent with flat rather than negative trend TFP over 2012. This chimes with our assessment that the weakness of the economy compared to our forecast in the first half of 2012 was mostly cyclical.
- 1.18 However, our latest estimate of the output gap – combined with the recent path of actual output – continues to imply that potential output growth has been extremely depressed in the UK since the financial crisis. Rather than potential growth returning to its long-term rate by 2014, as in our March forecast, we now assume that it will still be slightly below its long-term rate at the end of our forecast. This judgement is consistent with the view that uncertainty surrounding the stability of the euro area will continue to undermine the functioning of financial markets for some time to come, and that a persistently negative output gap will also weigh down on potential GDP growth throughout the forecast.
- 1.19 Our judgements on the current output gap and future path of potential GDP shape our forecast of actual GDP growth in the medium-term. We now expect the economy to grow by 2.0 per cent in 2014, 2.3 per cent in 2015, 2.7 per cent in 2016 and 2.8 per cent in 2017. With GDP growing less quickly than potential GDP in the near term, the output gap widens to -3½ per cent by mid-2013. This cyclical deterioration reflects the effect of subdued wage growth on consumption and the relatively weak growth of UK export markets.

Table 1.1: Economic forecast overview

	Percentage change on a year earlier, unless otherwise stated						
	Outturn		Forecast <sup>1</sup>				
	2011	2012	2013	2014	2015	2016	2017
<b>Output at constant market prices</b>							
Gross domestic product (GDP)	0.9	-0.1	1.2	2.0	2.3	2.7	2.8
GDP Level (2011 = 100)	100.0	99.9	101.1	103.2	105.6	108.4	111.4
Output gap (per cent of potential output)	-2.7	-3.1	-3.5	-3.3	-3.0	-2.5	-1.9
<b>Expenditure components of GDP at constant market prices</b>							
Household consumption <sup>2</sup>	-0.9	0.5	0.9	1.6	1.8	2.4	2.9
Business investment	2.9	3.8	4.9	8.1	10.2	10.1	9.5
General government consumption	0.2	2.4	-0.7	-1.4	-1.2	-2.1	-3.0
General government investment	-20.4	-9.2	-2.5	4.8	-3.0	-2.6	0.7
Net trade <sup>3</sup>	1.2	-0.6	0.3	0.2	0.2	0.2	0.1
<b>Inflation</b>							
CPI	4.5	2.8	2.5	2.2	2.0	2.0	2.0
<b>Labour market</b>							
Employment (millions)	29.2	29.5	29.6	29.7	29.9	30.2	30.4
Average earnings <sup>4</sup>	2.2	2.7	2.2	2.8	3.7	4.0	4.0
ILO unemployment (% rate)	8.1	8.0	8.2	8.2	8.0	7.6	7.1
Claimant count (millions)	1.53	1.59	1.66	1.69	1.63	1.53	1.43
Changes since March forecast							
<b>Output at constant market prices</b>							
Gross domestic product (GDP)	0.1	-0.9	-0.8	-0.7	-0.7	-0.4	
GDP Level (2011 = 100)	0.0	-0.9	-1.7	-2.4	-3.2	-3.7	
Output gap (per cent of potential output)	0.0	-0.4	-0.9	-1.2	-1.7	-2.0	
<b>Expenditure components of GDP at constant market prices</b>							
Household consumption <sup>2</sup>	0.0	0.0	-0.5	-0.8	-1.2	-0.6	
Business investment	2.7	3.1	-1.5	-0.7	-0.1	0.0	
General government consumption	-0.1	1.8	0.4	0.7	1.6	0.5	
General government investment	-7.3	-4.2	1.1	4.7	-3.3	-1.2	
Net trade <sup>3</sup>	0.0	-1.1	-0.2	-0.2	-0.1	0.0	
<b>Inflation</b>							
CPI	0.0	0.0	0.6	0.2	0.0	0.0	
<b>Labour market</b>							
Employment (millions)	0.0	0.4	0.4	0.3	0.2	0.2	
Average earnings <sup>4</sup>	1.0	0.1	-0.9	-1.6	-0.7	-0.6	
ILO unemployment (% rate)	0.0	-0.7	-0.4	0.2	0.8	1.3	
Claimant count (thousands)	2	-62	22	166	275	340	

<sup>1</sup> The forecast is consistent with the second estimate of GDP data for the third quarter of 2012, released by the Office for National Statistics on 27th November 2012.

<sup>2</sup> Includes households and non-profit institutions serving households.

<sup>3</sup> Contribution to GDP growth, percentage points.

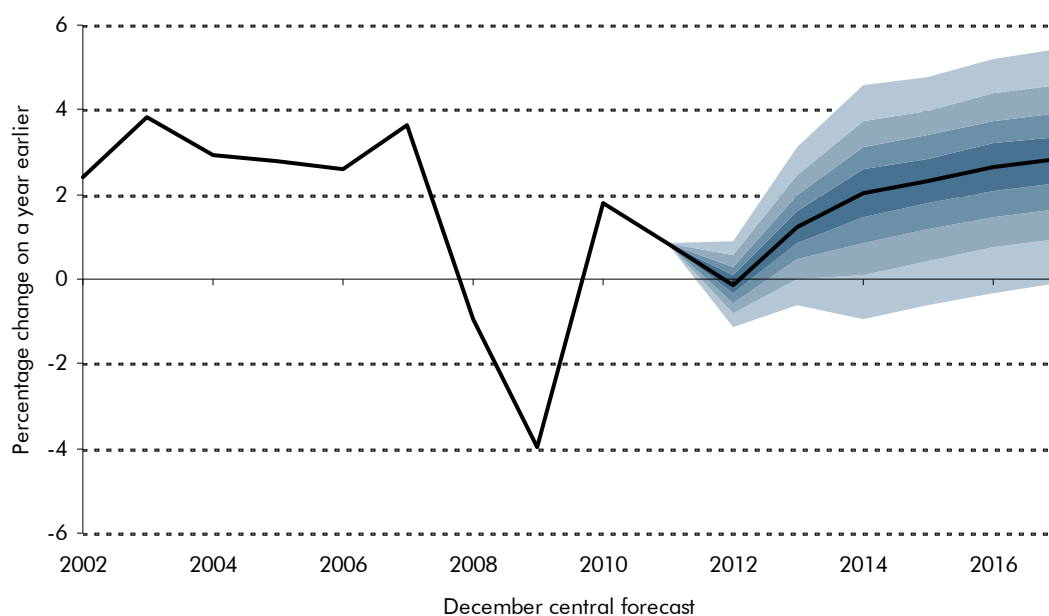
<sup>4</sup> Wages and salaries divided by employees.

- 1.20 Growth is not forecast to return to firmly above-trend rates until 2015 as credit conditions begin to normalise and financial markets return to a more stable position. The increase in real disposable incomes resulting from higher productivity growth and lower price inflation is expected to support the growth of consumption over the medium term, allowing GDP growth to move to above-trend rates.
- 1.21 Nevertheless, the output gap is assumed to close only gradually, which means that we now expect a significant margin of spare capacity to remain at the end of the forecast. This reflects the significant constraints on growth over the period – in particular, slow growth of productivity and real incomes, continued problems in the euro area and financial markets, and the generally weak outlook for the global economy. Our forecast assumes that these factors limit the extent to which the economy will grow and eliminate the output gap over the forecast period.
- 1.22 The situation in the euro area remains a major risk to our forecast. Policy action during the summer, including the ECB's new bond purchase facility, appears to have reduced some of the immediate pressures in euro area financial markets. However, the underlying situation remains very fragile and the feed through to the euro area real economy looks to have been more significant than we assumed in March. The difficulties of the euro area will not be resolved quickly and our central assumption is that they are likely to constrain UK growth for several years to come. A more disorderly outcome remains a clear possibility.
- 1.23 We expect the recovery in UK GDP growth in our forecast to be supported by contributions from private consumption, business investment and net trade:
- the contribution from private consumption is relatively small over the near term, before rising subsequently as wage growth recovers and inflation falls;
  - business investment is forecast to make a relatively significant contribution to the recovery in growth in the medium term. We have revised down our near-term forecast for business investment growth since March, reflecting the ongoing uncertainty in the euro area and a tighter outlook for credit conditions. But the starting level for real business investment is significantly higher than we expected in March following upward data revisions;
  - there is a small positive contribution from net trade over the forecast period, though weaker expected growth in UK export markets means that this contribution is smaller than we forecast in March; and
  - government consumption makes a negative contribution to growth, though we have become less pessimistic on this score since March, reflecting the

pattern over the past two years of real government consumption holding up relatively well relative to nominal spending growth.

- 1.24 Our forecast for real household disposable income growth is weaker than in March, reflecting a weaker outlook for nominal wage growth and somewhat higher price inflation. We expect real disposable income growth to be weaker than in 2012 and only slightly positive in 2013 and 2014, before picking up from 2015 as productivity and nominal wage growth recover and inflation falls.
- 1.25 The unemployment rate is lower now than we expected in March. Reflecting the weaker growth outlook, we expect the unemployment rate to increase slightly over the coming year – peaking at 8.3 per cent at the end of 2013 – before recovering gradually from 2014 and reaching 6.9 per cent at the end of 2017.
- 1.26 Between the start of 2011 and the start of 2018 we expect total market sector employment to increase by around 2.4 million, more than offsetting a total reduction in general government employment of around 1.1 million. General government employment is expected to fall further than we expected in March, mainly reflecting the additional year of spending cuts pencilled in for 2017-18.
- 1.27 We expect CPI inflation to fall gradually over the next few years, but to be higher in 2013 and 2014 than we expected in March, largely due to a bigger-than-expected contribution from tuition fee increases and the announced rises in domestic energy prices. In the medium term we expect CPI inflation to fall back to target, remaining close to 2 per cent from 2015 onwards. We expect downward pressure on prices from the negative output gap over the forecast period to be offset to some extent by upward pressure from above-trend growth rates and falling unemployment in the later years.
- 1.28 We have also reassessed our estimate of the medium-term GDP deflator. Our medium-term assumption for the growth of the GDP deflator is now 2.0 per cent, compared to 2.5 per cent in March. The level of nominal GDP in 2016 is 5.1 per cent lower than in our March forecast. Of this, 3.2 percentage points is accounted for by the downward adjustment to our forecast for real GDP growth, with the remainder due to lower GDP deflator growth.
- 1.29 There is always considerable uncertainty around any economic forecast. Chart 1.1 presents our central growth forecast with a fan showing the range of possible different outcomes based purely on past official forecasting errors. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 20 per cent probability bands. It suggests that there is a roughly 20 per cent chance that the economy will shrink again in 2013, judging from past forecasting errors.

Chart 1.1: GDP fan chart



Source: ONS, OBR

## The fiscal outlook

- 1.30 We now forecast that public sector net borrowing (PSNB) will total £80 billion or 5.1 per cent of GDP this year. Excluding the transfer of Royal Mail pension assets to the public sector, which distorts the figures this year, PSNB would be £108 billion or 6.9 per cent of GDP. This is £13 billion lower than in 2011-12.
- 1.31 The latest forecast for 2012-13 is £11 billion lower than the estimate we made in March. Policy decisions by the Government and reclassifications have reduced PSNB this year by £16 billion – in particular the auction of spectrum (which is expected to raise £3.5 billion) and the transfer of proceeds from the Asset Purchase Facility (which reduces PSNB this year by £11.5 billion).
- 1.32 These effects more than offset other forecast changes, which overall have pushed borrowing in 2012-13 up by £4 billion compared to our March forecast. Other receipts are likely to be weaker than we expected, but we also expect central and local government to once again underspend significantly against their budgets.
- 1.33 On the basis of this forecast PSNB will have fallen by 4.3 per cent of GDP, excluding the Royal Mail transfer, since its post-war peak in 2009-10. Our central forecast shows it continuing to fall to 1.6 per cent of GDP in 2017-18. This is driven by falling public sector expenditure – largely as a result of lower



departmental spending under the Government's fiscal consolidation plan – with public sector receipts expected to be broadly flat as a share of GDP.

Table 1.2: Fiscal forecast overview

	Per cent of GDP						
	Outturn			Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Public sector net borrowing	7.9	5.1	6.1	5.2	4.2	2.6	1.6
Cyclically-adjusted net borrowing	6.0	3.0	3.8	2.9	2.0	0.9	0.3
Surplus on current budget	-6.2	-5.7	-4.6	-3.7	-2.9	-1.4	-0.4
<b>Fiscal mandate and supplementary target</b>							
Cyclically-adjusted surplus on current budget	-4.3	-3.6	-2.2	-1.4	-0.8	0.4	0.9
Public sector net debt <sup>1</sup>	66.4	74.7	76.8	79.0	79.9	79.2	77.3
<b>Changes since March forecast</b>							
Public sector net borrowing	-0.3	-0.7	0.2	0.9	1.3	1.6	-
Cyclically-adjusted net borrowing	-0.4	-1.0	-0.4	0.0	0.1	0.2	-
Surplus on current budget	0.3	0.4	-0.1	-0.7	-1.2	-1.5	-
Cyclically-adjusted surplus on current budget	0.3	0.6	0.5	0.2	-0.1	-0.1	-
Public sector net debt <sup>1</sup>	-0.9	2.8	1.8	2.6	3.9	4.9	-
Memo: PSNB excluding Royal Mail transfer	7.9	6.9	6.1	5.2	4.2	2.6	1.6

<sup>1</sup> Debt at end March; GDP centred on end March.

1.34 Compared to our March forecast PSNB is considerably higher in each year from 2013-14, with the difference reaching £28 billion in 2016-17. Table 1.3 shows that this is driven by the following factors:

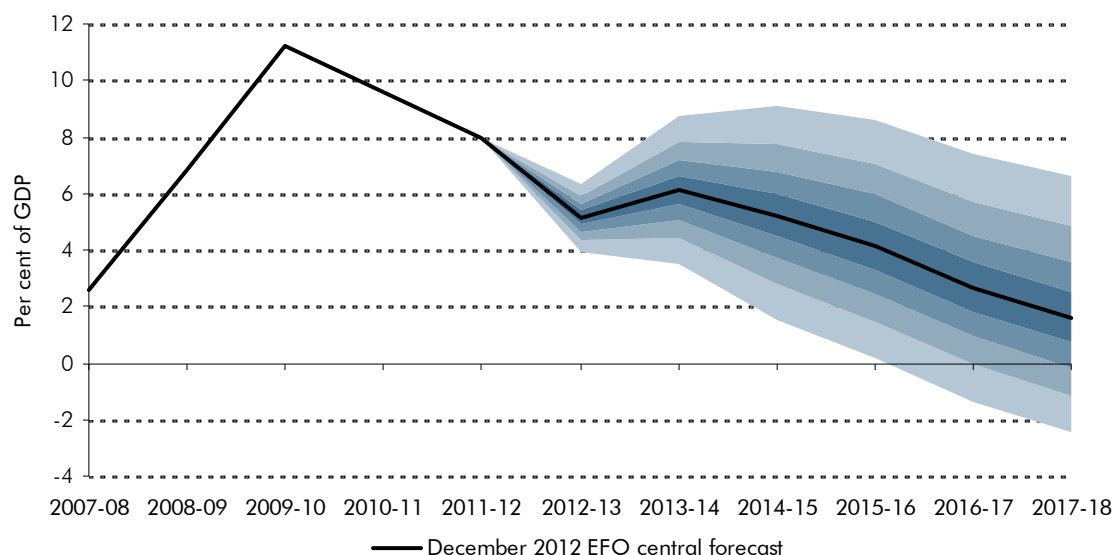
- policy measures on the Treasury's Autumn Statement policy decisions table increase PSNB slightly from 2013-14 to 2015-16, and are broadly neutral in 2016-17;
- the decision to change the treatment of the proceeds of the Asset Purchase Facility reduces PSNB significantly – by £7 billion in 2016-17. This decision will lead to higher borrowing in 2017-18 and the years beyond our forecast horizon;
- the reclassification of Bradford & Bingley plc (B&B) and Northern Rock (Asset Management) (NRAM) reduces borrowing by around £1 billion by 2016-17; and
- other forecasting changes increase borrowing by £36 billion in 2016-17. This is primarily driven by lower expected receipts, due to our weaker economic forecast.

Table 1.3: Change in public sector net borrowing

	£ billion					
	Outturn		Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
March forecast	126.0	91.9	98	75	52	21
December forecast	121.4	80.5	99	88	73	49
Change	-4.6	-11.4	1.8	12.9	21.3	27.9
<i>of which:</i>						
Forecast changes	-4.6	4.4	13.6	23.0	29.1	36.0
Policy measures	0.0	-4.0	0.9	0.9	0.9	-0.3
APF transfers	0.0	-11.5	-12.3	-10.6	-8.0	-6.6
B&B/NRAM classification	-	-0.4	-0.5	-0.4	-0.8	-1.1
Memo: March EFO PSNB ex Royal Mail	126.0	119.9	97.5	75.0	52.0	21.1
Memo: PSNB excluding Royal Mail	121.4	108.5	99.3	87.9	73.3	49.0
Memo: PSNB ex Royal Mail and APF	121.4	119.9	111.6	98.6	81.2	55.6
Memo: PSNB ex RM, B&B, NRAM and APF	-	120.3	112.1	99.0	82.0	56.7

- 1.35 The current budget is forecast to move from a deficit of £89 billion, or 5.7 per cent of GDP, this year to a deficit of £8 billion, or 0.4 per cent of GDP in 2017-18. Compared to our March forecast, the deterioration in the current budget is of a similar magnitude to the deterioration in PSNB, as changes to investment spending are relatively minor.
- 1.36 The cyclically-adjusted current budget (CACB) moves from a deficit of 3.6 per cent of GDP in 2012-13 to a surplus of 0.9 per cent of GDP in 2017-18. The medium-term forecast for the CACB is only slightly worse than in March, with a difference of 0.1 per cent of GDP in 2016-17. While the headline current budget has deteriorated by 1.5 per cent of GDP in 2016-17 since March, we expect the output gap in that year to be 2.0 per cent of GDP wider, which means that the deterioration in the CACB is much smaller. This reflects our judgement that most of the additional weakness in the economy compared to our March forecast is cyclical rather than structural. We have also reduced our forecast of potential output compared to March which, other things equal, would lead to a widening in the CACB. However, this has been offset in this forecast by the positive effect of the additional receipts from the APF and other fiscal forecast changes.
- 1.37 All fiscal forecasts are subject to significant uncertainty. Chart 1.2 shows our median (central) forecast for PSNB with successive pairs of shaded areas around it representing 20 per cent probability bands. The bands show the probability of different outcomes if past official forecasting errors are a reasonable guide to likely future forecasting errors.

Chart 1.2: PSNB fan chart



**1.38** In our latest forecast, PSND rises as a share of GDP in each year up to and including 2015-16, peaking at 79.9 per cent of GDP, before falling to 79.2 per cent of GDP in 2016-17 and then 77.3 per cent of GDP in 2017-18. PSND in 2016-17 is now expected to be around 4.9 per cent of GDP higher than we forecast in March. Table 1.4 breaks down this change as follows:

- the level of nominal GDP over the past year has been slightly lower than we forecast in March, and we expect lower nominal GDP growth in the future. By reducing the denominator we use when calculating PSND as a share of GDP, this increases PSND by 3.9 per cent of GDP in 2016-17;
- our forecast for PSND in cash terms is also higher than in March, by 1.0 per cent of GDP in 2016-17. This is the result of a number of offsetting factors shown in the bottom half of Table 1.4:
  - the reclassification of B&B and NRAM raises the current stock of debt by £68 billion. As these banks wind down their mortgage books the stock of liabilities falls, so the total addition to PSND by 2016-17 is lower at £42 billion;
  - the transfers from the APF reduce PSND over this forecast period – by £71 billion in 2016-17. Beyond the forecast horizon we would expect transfers to flow from the Exchequer to the APF, and consequently the size of the reduction in PSND to diminish;

- other forecasting changes increase PSND by £105 billion by 2016-17. This is largely the consequence of the weaker economic forecast increasing net borrowing;
- for the purposes of calculating net debt, gilts are valued at their nominal value rather than their market value. In the past, gilts have typically been sold by the Debt Management Office (DMO) at close to their nominal value, but with gilt rates expected to remain low, we assume that the DMO will continue to issue gilts at a premium, though we expect this effect to diminish over time as gilt rates rise. This reduces our forecast of PSND by £39 billion by 2016-17; and
- finally, changes to our financial transactions forecasts, and a lower starting level of debt, lead to a fall in PSND of £17 billion by 2016-17.

Table 1.4: Change in public sector net debt

	Per cent of GDP					
	Outturn		Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
March forecast	67.3	71.9	75.0	76.3	76.0	74.3
December forecast	66.4	74.7	76.8	79.0	79.9	79.2
<b>Change</b>	<b>-0.9</b>	<b>2.8</b>	<b>1.8</b>	<b>2.6</b>	<b>3.9</b>	<b>4.9</b>
<i>of which:</i>						
Change in nominal GDP <sup>1</sup>	0.0	1.1	1.9	2.8	3.6	3.9
Change in cash level of net debt	-0.9	1.7	-0.1	-0.2	0.3	1.0
	£ billion					
March forecast	1039	1159	1272	1365	1437	1479
December forecast	1025	1186	1270	1362	1442	1498
<b>Change in cash level of net debt</b>	<b>-13</b>	<b>27</b>	<b>-2</b>	<b>-3</b>	<b>5</b>	<b>19</b>
<i>of which:</i>						
Reclassification of B&B and NRAM		68	62	56	50	42
Inclusion of APF transfers		-11	-43	-55	-63	-71
Other changes in net borrowing	-5	-4	11	36	67	105
Auction price effects		-12	-20	-28	-34	-39
Financial transactions and other	-9	-14	-11	-12	-14	-17

<sup>1</sup> Non-seasonally-adjusted GDP centred end-March.

## Asset purchase facility

1.39 On 9 November the Chancellor announced that the excess cash held in the Bank of England's Asset Purchase Facility (APF) will be transferred to the Exchequer. This decision means that the cash surpluses and deficits generated by the Bank of England's quantitative easing (QE) facility will be reflected in the public finances on an ongoing basis, rather than as a one-off profit or loss to the Exchequer when QE has been fully unwound and the facility closed.

- 1.40 Capturing the impact quarter by quarter, rather than at some indeterminate date in the future, is more transparent than the current approach. The decision will not have a significant impact on the eventual net profit or loss to the Exchequer from QE, but it will mean that net borrowing will be lower than it otherwise would have been in the near term and then higher when monetary policy tightens.
- 1.41 To quantify the impact of this decision on the public finances we need to make a set of assumptions about the way it will be treated in the official statistics (which the ONS will decide next month) and how and when QE is unwound.
- 1.42 Our central forecast assumes that the Bank makes gilt sales of £10 billion per quarter from the middle of 2016, when the market expects Bank Rate to have returned to 1 per cent. This implies that QE would be unwound by late 2022, thanks to roughly £250 billion of gilt sales and £125 billion of redemptions. In this event PSNB, the current budget deficit and PSND will be lower in each year until 2016-17 than they otherwise would have been, as the Treasury receives the stock of cash currently in the APF and the future flow of coupon payments on the gilts held by the APF (minus the interest that the APF has to pay the Bank for the loan that allowed it to purchase them).
- 1.43 As monetary policy tightens and QE is unwound, the stream of regular payments to the Treasury will shrink and the APF will face capital losses. Consequently, the Treasury will need to make net payments into the APF between 2017-18 and 2022-23. This will increase PSNB and reverse some of the reduction in PSND. It will have no impact on the current budget deficit if the ONS treats the payments as capital grants, but will increase it if the ONS treats them as subsidies.
- 1.44 The overall transfer to the Exchequer is expected to be positive but modest under our central assumption, leaving PSND around 2.2 per cent of GDP lower after QE has been fully unwound in 2022-23 than it otherwise would have been. The net flow to the Exchequer will be smaller if gilt yields end up higher than the markets currently expect. If gilt yields were to jump by 200 basis points when the unwinding of QE began this would reduce the overall reduction in PSND to 0.7 per cent of GDP in 2022-23.
- 1.45 The eventual impact of QE on net debt is unlikely to be significantly different as a result of the Government's decision to transfer the surpluses and deficits. (In the absence of this decision there would be a one-off adjustment to net debt when the APF was closed). The decision does mean that the Government is likely to issue fewer gilts in the near term and more in the longer term than it otherwise would have done. As gilt rates are expected to rise, debt interest payments will be higher beyond the horizon presented in this projection than they otherwise would have been, possibly outweighing lower costs in the preceding years.

## Performance against the fiscal targets

- 1.46 In the June 2010 Budget the Coalition Government set itself a medium-term fiscal mandate and a supplementary target:
- to balance the cyclically-adjusted current budget (CACB) by the end of a rolling, five-year period, which is now 2017-18; and
  - to see public sector net debt (PSND) falling as a share of GDP in 2015-16.
- 1.47 Our latest forecasts suggest that the Government has a greater than 50 per cent chance of hitting the fiscal mandate. The CACB is forecast to be in surplus by 0.9 per cent of GDP in 2017-18, thanks to the Government's decision to continue cutting non-investment spending as a share of GDP into that year now that the forecast has been rolled forward. The CACB is also forecast to be in surplus in 2016-17 by 0.4 per cent of GDP, slightly less than we forecast in March.
- 1.48 The Government's supplementary target is more likely than not to be missed in our latest forecast. PSND rises as a share of GDP by 1.0 per cent of GDP between 2014-15 and 2015-16. In our March forecast we expected PSND to fall by 0.3 per cent of GDP between these two years. We now forecast that PSND will fall by 0.8 per cent of GDP between 2015-16 and 2016-17.
- 1.49 The proceeds from the Asset Purchase Facility do not materially affect our assessment of the chances of meeting the fiscal mandate in 2017-18. We forecast small payments from the Exchequer to cover capital losses in this year, but we currently assume these would be classified as capital transfers and would not therefore affect the CACB. In 2016-17, the CACB would be marginally in deficit without the reclassification of B&B and NRAM, and the proceeds from the Asset Purchase Facility.
- 1.50 We forecast that PSND will increase by 1.0 per cent of GDP in 2015-16 compared to 2014-15, and that the increase would be 1.8 per cent of GDP without the reclassification of B&B and NRAM and the proceeds from the Asset Purchase Facility. PSND then falls by 0.8 per cent of GDP between 2016-17 and 2017-18. PSND would be flat between these two years in the absence of these two factors. These differences are small in comparison to the overall uncertainty around the forecast of PSND at this time horizon.
- 1.51 There is considerable uncertainty around our central forecast, as there is around all fiscal forecasts. This reflects uncertainty both about the outlook for the economy and about the performance of revenues and spending for any given state of the economy. Given these uncertainties we probe the robustness of our central judgement in three ways:

- first, by looking at past forecast errors. If our central forecasts are as accurate as official forecasts were in the past, then there is a roughly 70 per cent probability that the CACB will be in balance or surplus in 2017-18 (as the mandate requires) and a roughly 60 per cent chance a year earlier;
- second, by looking at its sensitivity to varying key features of the economic forecast. The biggest risk to the achievement of the mandate is that we again need to revise down our estimates of future potential output. If the output gap was around 1¼ per cent of potential GDP narrower, or rather the level of potential output 1¼ per cent lower, than in our central forecast then the Government would no longer be on course to balance the CACB in 2017-18; and
- third, by looking at alternative economic scenarios. We examine the implications of two illustrative scenarios where the output gap closes within our five-year forecast horizon: first, a 'weaker supply' scenario where the output gap closes due to a slower rate of trend growth; and second, a 'stronger demand' scenario where the output gap closes due to stronger private investment. Under the weaker supply scenario the fiscal mandate and the supplementary target would both be breached. Under the stronger demand scenario the fiscal mandate would be met (although with less margin for error than in the central forecast) and the supplementary target would be achieved rather than breached.