

December 2012 Economic and Fiscal Outlook Briefing

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Good afternoon ladies and gentlemen.

My name is Robert Chote, Chairman of the OBR, and I would like to welcome you to this briefing on our latest *EFO*. We are very grateful to the Institute for Government for hosting us once again.

I am going to take you through the highlights of the report and then we will be very happy to take your questions. The slides and my speaking notes will be available after we finish.

[SLIDE] The usual background first.

The EFO contains our latest five-year forecasts for the economy and the public finances and an assessment of the Government's progress against the two fiscal targets that it has set itself. All these incorporate the impact of the measures announced in the Autumn Statement.

The views expressed in the EFO are the responsibility of the three members of the Budget Responsibility Committee – myself, Graham Parker and Steve Nickell. But we have relied enormously on the work of the OBR's permanent staff and on the time and expertise of officials in numerous departments and agencies. And we are very grateful to them.

As usual, the forecast went through a number of iterations to reflect new judgements, new data and the proposed policy changes. And we met the Chancellor to discuss a reasonably advanced draft forecast on 23 November. I am pleased to report that we have come under no political or official pressure to change any of our conclusions.

[SLIDE] Now let me describe briefly what we are going to cover today.

First, the economic forecast. We have revised down our projections for real and nominal GDP growth throughout the forecast horizon, despite

the Autumn Statement measures providing a modest boost over the next couple of years. In contrast to last autumn's EFO, we treat most of this downward revision as cyclical (and therefore potentially reversible) rather than as a wholly structural hit to the potential of the economy.

Second, the fiscal forecast. The first point to make is that comparisons from one year to the next and between the March forecast and this one are complicated by a number of special factors: the Royal Mail pension transfer that was included in the March forecast; the Government's recent decision to transfer the balances in the Asset Purchase Facility to the Treasury, and; the ONS's decision in September to reclassify Bradford & Bingley and Northern Rock Asset Management as central government bodies. These affect most of the fiscal aggregates we are interested in and we do our best to disentangle their impact for you.

Abstracting from these special factors, the basic story is that our downward revisions to most categories of income and expenditure in the economic forecast reduce tax future revenues, but have relatively little impact on government spending (in part because of the resilience of the labour market). So the budget deficit shrinks more slowly than in March.

By extending its non-investment spending cuts into 2017-18, the Government is on course to achieve its fiscal mandate, which has rolled forward into that year. But higher net borrowing and a lower forecast for nominal GDP mean that we think the Government is no longer on course to achieve its supplementary target of reducing net debt in 2015-16, despite some help from these special factors. Needless to say, there is considerable uncertainty around all these projections and we apply our usual sensitivity and scenario analysis to illustrate this.

So let me give you a little more detail of the economic forecast.

Our forecasts for economic growth are noticeably lower throughout the forecast period – mirroring what we have seen in the Bank of England's and other outside forecasts since the spring.

[SLIDE] GDP growth over the past year has been much weaker than we expected last November, which is more than explained by the weakness of net exports. Growth in the third quarter was boosted by special

factors and the recovery still lacks momentum. We expect a small fall in GDP in the fourth quarter and a gradual pick-up thereafter.

[SLIDE] This suggests that growth will be slightly negative in 2012 as a whole, rather than plus 0.8 per cent as we predicted in March. As you can see, we have also revised down the expected growth rates for subsequent years. We expect weak productivity growth to constrain nominal earnings growth for longer, with a slower fall in inflation delaying the pick-up in real household incomes. The outlook for the world economy and UK exports has deteriorated. And events in the eurozone are likely to depress confidence and elevate bank funding costs for longer. Investment is likely to be constrained by poor credit conditions and uncertainty about domestic and foreign demand.

[SLIDE] Viewed in terms of levels, this means that we now expect real GDP to be about 3.2 per cent lower in 2016 than we expected in March. This is slightly more optimistic than the current average of outside forecasts and a little less optimistic than the Bank's latest modal forecast. It is worth pointing out that the differences between these lines are dwarfed by the uncertainties around any of them.

Now let me turn to some of the main components of GDP.

[SLIDE] The biggest component of demand in the economy is consumer spending. We have revised this down, reflecting a weaker outlook for nominal earnings as productivity remains subdued, and the impact of a slower fall in inflation on real household incomes.

[SLIDE] Business investment has grown slightly less strongly this year than we expected and we have revised down the growth rates looking forward to reflect the impact of the euro-zone's problems on credit conditions and confidence, and a weaker outlook for domestic demand.

[SLIDE] That said, we should bear in mind that the starting point for this business investment forecast is significantly stronger than we expected in March, following ONS data revisions. Business investment is now estimated to have risen by 7 per cent since the trough of the recession, rather than falling by 1 per cent as the data and our forecast suggested in March. The performance of business investment now looks much

more similar to the 1990s recovery than it did, although we think it will perform less strongly over the next couple of years.

[SLIDE] Looking briefly at the other main components of demand:

- We have also revised down the expected contribution to growth from net trade, although it remains positive. Disappointing net trade was a key contributor to the double dip recession, reflecting both weaker export markets and falling market share.
- Conversely, we have revised up our estimate of the contribution that government consumption makes to growth. This is in recognition of the fact that over the past two years the output of goods and services from the government sector as recorded by the ONS has been affected much less by the ongoing cuts in cash spending than we assumed would be the case in our previous forecasts.

[SLIDE] Despite the weakness of the GDP growth, the labour market has continued to perform more strongly than we expected, with employment rising and also total hours worked. We expect some rise in unemployment over the coming year, given our lower growth forecast, and a slower improvement thereafter than in March. Additional spending cuts in 2017-18 imply a bigger fall in government employment.

Inflation is likely to be higher over the next couple of years than we expected in March, thanks to tuition fees, energy costs and agricultural prices. But we have revised down our medium-term estimate of whole economy inflation, as the consumer spending deflator seems likely to stick closer to CPI inflation than we had previously thought.

[SLIDE] Assessing the potential level of economic activity – the amount of goods and services that the economy could produce while keeping inflation stable in the long term – is a key judgement in all our forecasts. It determines how much growth the economy can sustain and how much of the budget deficit is structural rather than a temporary consequence of the state of the economic cycle. The difference between actual output and potential output – the so-called ‘output gap’ – is a measure of spare capacity in the economy.

Our usual methods of combining business surveys and labour market data suggest that spare capacity in the economy shrank during the double dip, even though output was falling. This would imply a significant fall in trend total factor productivity, the efficiency with which the economy combines different inputs to produce a unit of output.

A significant fall in trend TFP seemed quite plausible during the depths of the financial crisis, but it seems to us less plausible now. So we have adjusted our estimate of the output gap so that it is consistent with flat rather than falling trend TFP over recent quarters. As a result, we estimate that the economy is running about 3 per cent below full capacity in 2012, [SLIDE] fractionally more than the average of outside forecasters.

This judgement, on its own, would make the Chancellor's life easier by reducing the structural component of the budget deficit. [SLIDE] But the impact of this decision is more than offset by an additional assumption that the growth of potential GDP – which has remained very weak – will take longer to return to its long-run rate than we assumed in March. Taken with recent data, these judgements mean that potential GDP is expected to be about 1.3 per cent lower than in our March forecast by 2016.

[SLIDE] Compared to outside estimates, this means that we are somewhat more optimistic about the economy's medium term supply potential than the IMF, the OECD and the European Commission, but somewhat less optimistic than some domestic analysts, such as Oxford Economics. Needless to say, this is a very uncertain judgement and we show how sensitive our assessment of the Government's performance against its fiscal targets is to different estimates for potential GDP.

[SLIDE] One consequence of our forecasts for actual and potential GDP growth is that the economy is still assumed to be running significantly below full capacity at the end of the forecast. The output gap is minus 1.7 per cent in 2017-18. Most forecasters who look out this far are in a similar position, but it is clearly not a feature that you would expect in a forecast in normal times. To reflect this, the EFO includes two alternative scenarios in which the output gap does close by 2017-18, either because demand ends up stronger or supply weaker than in our central forecast.

So let me turn now to the public finances.

[SLIDE] As I mentioned earlier, our ability to compare the public finances in one year to another – or this forecast to the March forecast – is complicated in this EFO by three special factors. So let me describe their impact briefly before looking at the forecast itself.

[SLIDE] The Government's decision to take the Royal Mail's historic pension fund deficit and associated assets into the public sector was announced and included in the March forecast. As you will recall, it reduces net borrowing by £28 billion this year and net debt by about £23 billion from next year.

[SLIDE] In September the ONS also announced that it would treat Bradford & Bingley and Northern Rock Asset Management as part of central government, which means that their balance sheets and financial flows are now included in the fiscal aggregates that we forecast and the Government targets. This will result in a small ongoing reduction in net borrowing and the current budget deficit. But, more significantly, it will also increase net debt by 4.3 per cent of GDP this year, falling steadily to 1.7 per cent of GDP in 2017-18 as their mortgage books run down.

[SLIDE] The third 'special factor' is the Government's recently announced decision to transfer the surpluses and deficits in the Bank of England's Asset Purchase Facility to the Treasury quarter by quarter. We think this paints a more transparent picture than the current approach, but only if you look at the impact over the whole lifetime of QE.

To quantify the fiscal implications of this decision we have to predict how the Office for National Statistics is likely to treat the various flows when it makes a formal decision on this next month. And we also have to make an illustrative assumption about when and how the Bank of England will choose to unwind QE. In our central projection, we assume that the Bank begins to unwind QE in mid-2016 – when the market expects bank base rate to have returned to 1 per cent – and that it finishes the job in 2022. But we look at other variants as well. And I should emphasise that this is an illustrative projection and not an informed prediction of the how the Bank is actually likely to behave.

Under this scenario, net borrowing and net debt are lower in the near term as the Treasury receives the coupon payments on the gilts bought by the APF. But net borrowing will be higher when monetary policy tightens and QE is unwound, as these coupon flows diminish and the APF faces capital losses that the Treasury has to cover. And this will partially reverse the earlier reduction in net debt.

The eventual net profit or loss to the Exchequer is unlikely to be significantly affected by the Treasury's decision, or indeed if QE was be unwound earlier or later or more or less quickly. But it will be affected by what happens to gilt yields over this period. In our central projection we assume that our main scenario for the unwinding of QE is priced into the market and that gilt yields do not respond. But we also examine what happens if gilt yields were increase by 200 basis points when the unwinding gets under way, perhaps as an announcement effect.

[SLIDE] Let's have a look at this in pictures. This chart shows the impact of the APF decision on net borrowing in our central scenario. Borrowing is lower by about three quarters of a percent of GDP to begin with. The gain then gradually diminishes and net borrowing is higher than it otherwise would have been from 2017-18 until QE is fully unwound.

[SLIDE] If gilt yields were to jump when the unwinding begins, the hit to net borrowing from 2017-18 would be bigger than our the central scenario but still only about half a percent of GDP a year.

[SLIDE] This chart shows the impact on net debt. Under the central scenario, the peak effect is to reduce net debt by around 4 per cent of GDP, with the eventual impact being a reduction of around 2.2 per cent of GDP. [SLIDE] With the jump in gilt yields, the eventual reduction falls to 0.7 per cent of GDP. Needless to say, both figures are dwarfed by the uncertainty surrounding any net debt projection over this time horizon.

The APF decision does mean that the Government will be issuing fewer gilts in the near term and more in the longer term than it would otherwise have done. Other things being equal this will produce some debt interest savings over this horizon, which are not included in this comparison (but are included in our main debt interest forecast). But interest bills are likely to be higher further out and it is not clear what

the overall saving or cost would be. Once again, it is likely to be modest compared to the other uncertainties surrounding the outlook.

[SLIDE] So now let me turn to the public finance forecast itself, and begin with borrowing this year:

- Excluding the impact of Royal Mail, we expected net borrowing to come in at £120 billion in March. We now expect the figure to be £108 billion. This reflects a number of factors.
- First, judging from developments over the year to date, tax revenues this year are likely to be lower than we expected in March, pushing up borrowing by about £10 billion.
- But spending is also likely to be lower, saving about £6 billion. Central and local government once again appear to be spending less than they budgeted for on public services and administration.
- The newly announced 4G spectrum auction is expected to raise around £3.5 billion this year, with some small further reduction in borrowing from the other Autumn Statement measures.
- And then finally the APF transfer brings in £11.5 billion, with a small further contribution from the bank reclassifications.

This leaves net borrowing at 6.9 per cent of GDP, measured on this basis, down from 7.6 per cent of GDP in our March forecast.

[SLIDE] Looking forward, we expect the deficit to decline steadily as a share of GDP, but more slowly than in March. As you can see, the APF transfer and the bank reclassifications reduce the size of the upward revision to the borrowing numbers since March, but they also slightly reduce the fall in the deficit between this year and 2016-17.

[SLIDE] The reduction in the deficit results from public spending falling as a share of GDP while tax revenues remain broadly constant.

[SLIDE] By 2016-17 receipts are expected to be almost £30 billion lower than we expected in March, while spending is only £1.2 billion lower.

On the receipts side, most tax streams are lower as a result of weaker incomes and weaker spending in the economic forecast. And, as we saw, this is partly offset by the APF transfers and bank reclassifications, which are still contributing almost £7 billion to receipts in that year.

On the spending side, lower inflation and lower interest rates push the forecast down, while higher unemployment and higher debt interest push it up. The net effect is to produce little change since March.

[SLIDE] The tax and spending measures in the Treasury's Autumn Statement scorecard have little net impact over the first four years of the forecast, with the takeaways and giveaways broadly offsetting each other. With our forecast extending to 2017-18 for the first time, the Chancellor has chosen to extend his non-investment spending cuts into that year. This reduces borrowing by a little over 1 per cent of GDP in that year, compared to the position if spending was held flat as a share of GDP.

On the economy side, the Autumn Statement measures – notably the temporary rise in capital spending – nudge up GDP growth a little in 2013 and 2014, with the effect partially unwinding thereafter. The fuel duty cut lowers inflation a little and various measures are likely to boost housing market transactions.

Now let me turn to the Government's fiscal targets.

[SLIDE] The fiscal mandate requires the government to have the cyclically adjusted current budget in balance or surplus five years ahead, with the target date moving out to 2017-18 in this forecast. That means raising enough money to pay for non-investment spending, adjusting for the impact of any remaining spare capacity in the economy.

Our central forecast shows the cyclically adjusted current budget in surplus by 0.9 per cent of GDP in 2017-18, which means that we think the Government has a better than 50 per cent chance of meeting the mandate. As you can see from the table, that surplus is more than accounted for by the Chancellor's decision to extend his cuts in public spending as a share of GDP into 2017-18. The APF transfers and the bank reclassifications do not have a significant impact on the Government's chances of meeting the mandate at this time horizon.

Our central forecast also shows that the Government remains on course to achieve a surplus in 2016-17, the previous mandate year. But that would not be so without the APF transfers and bank reclassifications, which make more of a contribution in that year.

[SLIDE] As always, there is significant uncertainty around the central forecast. The flamethrower of uncertainty shows the probability of different outcomes based on past official forecasting errors. It suggests that there is a 70 per cent chance of meeting the mandate in 2017-18 and a 60 per cent chance of there being a surplus in the previous year.

[SLIDE] Now let me turn finally to the supplementary target, which requires debt to be falling as a share of GDP in 2015-16. As this chart shows, we now expect debt to rise in that year, to a peak of just under 80 per cent of GDP, and then to start falling in 2016-17. So we believe that it is more likely than not that the Government will miss the supplementary target. Again there is considerable uncertainty around the central forecast, but we cannot quantify the probability of different outcomes in the same way that we can for the mandate.

[SLIDE] This chart shows how our forecasts for the change in debt in 2015-16 – and also in 2016-17 – have moved since the March EFO.

In March we forecast that debt would fall by 0.3 per cent of GDP in the target year. Our forecasts for nominal GDP and higher public sector borrowing would have turned this into an increase of 2 per cent of GDP, other things being equal. The APF transfers and the bank reclassifications both reduce net debt in 2015-16, relative to the previous year, but not by enough to rescue the target.

As the next column of the table shows, the APF transfers and the bank reclassifications do help to ensure that debt falls in the following year. Without them we would have expected net debt to be broadly flat between 2015-16 and 2016-17 and to start falling only in 2017-18.

To conclude, I should remind you that our job is simply to assess the Government's progress against its targets and to report on that as transparently as we can. Parliament has instructed us not to comment on whether the targets are the right ones or whether the Government

should do what would be necessary to stick to them in circumstances like these. With that caveat, we are very happy to take your questions.