Future Fiscal Frameworks

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Much of the very rich discussion both in NIESR's new Occasional Paper and in this afternoon's seminar has been about fiscal policy and fiscal frameworks.

I wrote a fair amount on these topics in previous lives, but now head of an institution whose role is narrowly defined in legislation to producing the official economic and fiscal forecast and not providing advice on the appropriate fiscal targets or policies.

The task of producing that forecast has been hard enough over the last year without also having to advise the Chancellor on what to do in response.

So I am going to confine my remarks to three areas where I think we as economic forecasters need to learn lessons from the past decade and look to do a better job in the decade ahead.

In doing so, I'll try to echo some of the themes that have emerged from the foregoing discussion as they relate to understanding and forecasting the economy and public finances.

I should stress that my remarks concern the forecasting profession as a whole (in the UK and around the world), and not the OBR in particular who, if anything, have been at the forefront of innovation and adaptation in this area long before I arrived.

First, to oversimplify only slightly, in constructing our forecasts we have tended to think of the macroeconomy as being characterised by a fixed and stable rate of growth in supply, around which shocks emanate from the demand side of the economy (driven by the mysteries of animal spirits).

This was probably a valid way of thinking about the economy during the Great Moderation, but in just over a decade we have seen three significant shocks to three different parts of the supply side of the economy:

- the financial crisis which hit the banking sector;
- Brexit which hit the tradable goods and services sector; and
- Coronavirus which hit non-tradable services sector.

And while our current near-term fiscal prospects depend primarily on how quickly aggregate demand, and especially consumption, responds to the rollout of vaccine and lifting of public health restrictions over the next few months, our long-term economic prospects depend much more on the long-run legacy that these shocks leave behind for:

- business investment and the capital stock;
- population and labour supply; and
- the productivity of all of these sectors.

To illustrate the problem of trying to think about the macroeconomy in conventional business cycle terms, in no fiscal year since the creation of the OBR has the estimated output gap exceeded 1.6 per cent in ‘outturn’ (though we have forecast output gaps of more than twice that) and at no point over the current forecast horizon do we expect it to exceed 1 per cent (thought output fell by almost 10 percent last year).

So conventional conceptions of business cycles just aren’t relevant to a series of shocks which have impaired both the supply and demand sides of the economy, and fiscal frameworks based on these concepts alone are not likely to offer much useful long-term guidance or near-term flexibility to policymakers.

A second and related shortcoming of the forecasting profession has been a tendency to give an unduly certain and sanguine view of medium-term prospects.

This is partly as a function of the aforementioned assumption that output returns to a pre-defined long-run trend within a standard 5-year forecast horizon.

But it is also because we don’t attempt to anticipate future shocks or take account of government’s asymmetric reaction function to those shocks - in which they spend during downturns but also spend during upswings as well.

The consequence of this reluctance to catastrophise is a failure to anticipate the ratcheting upward in the level of debt that comes with each successive shock to the public finances which in the UK has seen debt climb from under 40 per cent of GDP prior to financial crisis to almost 100 per cent of GDP today.

At the same time, a third and final shortcoming of the macroeconomic forecasting profession has been the focus on the *level* of debt as the principal measure of fiscal sustainability and to the exclusion of considerations around its costs or maturity or about the other liabilities and assets that are relevant to the government’s long-run fiscal position.

This is best highlighted by two facts:

- First, that while the level of debt has more than doubled over the past decade as a share of GDP, the cost of servicing that debt, measured as the share of government revenue consumed by interest payments, has more than halved over that same period.
- Second, that the UK public sector’s total liabilities are more than 50 per cent greater than its total debt stock, once one takes account of non-debt liabilities, in particular in the form of unfunded public sector pensions.

So what are we, as the government’s official forecaster, attempting to do to learn lessons from the past, improve the way we do our jobs, and enable better fiscal planning and policymaking.

First, we are taking a harder and deeper look at how we forecast the supply side of the economy:

- We have done this in the near-term during the pandemic by building up a sector-by-sector picture of the level of economic output that it was possible to produce each month under various levels of public health restrictions.
- We are also monitoring the longer-term legacy of pandemic for the capital stock, labour supply, and productivity where there is currently a lively debate about the degree of permanent scarring that may result from the traumas the economy has experienced over the past year.

A second thing we are trying to do even more than previously is to emphasise degree of uncertainty about economic and fiscal outlook, both in the near-term but also over the long-term.

- We started doing this by publishing fan charts around our central forecast a decade ago, but the limitation of this approach was that range was based on historic forecast errors which failed to effectively communicate the radical uncertainty created by the pandemic.
- So in our November forecast, we constructed three alternative scenarios for path of the virus and public health response, which provided for the possibility of things like the failure of the test, trace, and isolate system and the emergence of new, vaccine-resistant variants of the virus.
- And we have also begun publishing a biennial Fiscal Risks Report which looks at a wider range of potential shocks that could affect the UK's economic and public finances. The third edition of this report due out this summer we will be placing particular emphasis on tail risks including:
    - The pandemic itself and the legacy it leaves for the public finances;
    - The economic and fiscal impact of climate change;
    - And risks associated with the government's elevated debt stock

A third and final thing we are trying to do, together with colleagues in the Treasury and ONS, is to begin to forecast broader measures of the government balance sheet, including public sector net worth, which capture a wider range of government assets and liabilities.

Whether this forms a formal part of the government's fiscal framework or not, we think providing more information about the evolution of the full range of government's assets and liabilities recognised in national accounts helps to improve the overall transparency of the public finances. In particular it helps to shine a light on how the government is managing its burgeoning portfolio of loans and equity investments in everything from affordable housing to satellite companies to high tech toilets.

We will be publishing a working paper about the methodology for constructing our first forecast of public sector net worth later in the summer.