# <u>December 2013 *Economic and Fiscal Outlook* Briefing</u>

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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 *Economic and Fiscal Outlook*.

I am going to take you through some of 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 policy measures announced by the Chancellor today.

The views expressed in the EFO are the responsibility of the three members of the Budget Responsibility Committee. But we have relied enormously on the hard work of the OBR's staff and on the help of officials in numerous departments and agencies. Our thanks to them all.

As usual, the forecast went through a number of iterations to reflect new judgements, new data and proposed policy measures. We met the Chancellor to discuss a reasonably advanced draft forecast on 14 November and provided him with the final forecast on 29 November. We have come under no pressure to change any of our conclusions.

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

First, the economic forecast.

The economy has picked up more strongly so far this year than we expected in March and we expect the same to be true in the fourth quarter. We expect the pace of growth to slacken somewhat into 2014 and then to pick up again when the long-awaited improvement in productivity growth boosts earnings. The level of GDP is higher throughout the forecast than in March – and we judge that this is a cyclical improvement, reducing the amount of spare capacity in the economy, rather than a sign of stronger underlying growth potential.

Second, the fiscal forecast.

Public Sector Net Borrowing - the gap between what the Government spends and raises in revenue – is lower in every year of the forecast than in March, and by a total of £73 billion between 2013-14 and 2017-18. This largely reflects higher receipts, thanks mostly to stronger profits and the housing market. As with the economy, the improvement is judged cyclical rather than structural. Our forecast puts the Government on course to meet its fiscal mandate in the new target year of 2018-19, but we still expect it to miss its debt-to-GDP target in 2015-16.

Third, the fiscal consolidation.

In the Autumn Statement, the Government has chosen to extend its squeeze on public spending into 2018-19. This should help bring the budget back to balance for the first time in 18 years, excluding transfers to the Asset Purchase Facility. The ongoing fiscal consolidation is increasingly dominated by planned cuts in the day-to-day running costs of public services and administration, which on one measure now look set to fall to their lowest share of national income since comparable data were first available in 1948. The policy measures flagged by the Treasury in the Autumn Statement have a neutral impact on the deficit over the five years of the forecast, but they modestly increase spending pressures in future Spending Reviews and reduce tax revenues beyond 2018-19.

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

[SLIDE] Recent data show that the economy has been performing more strongly than we expected in March. Real GDP has grown by 1.8 per cent over the first three quarters of the year, compared to the 0.5 per cent we predicted in March. Private consumption and housing investment have outperformed, while business investment and net trade continue to disappoint. Hours worked in the economy have exceeded our March forecast by even more than GDP, which means that productivity growth has once again come in below expectations. Consumer price inflation has been lower than we expected, helped by lower oil prices.

[SLIDE] Judging from surveys and other short term indicators, growth looks likely to exceed our March forecast in the fourth quarter as well. But we assume that the recovery will then slow into 2014, returning to the quarterly rates we predicted in March. Consumer confidence, credit conditions and the housing market all look more positive for growth, and there may be less of a drag from the fiscal consolidation. We are also conscious that forecasts tend to lag when the economy is at turning points. But productivity, real incomes and export growth are all still weak. We judge that the pace of growth we have seen in the last two quarters would be hard to sustain while this remains the case.

[SLIDE] So how does this look in terms of numbers?

The table shows that we now expect growth this year to come in at 1.4 per cent, up from 0.6 per cent in March. And although we have not revised up the quarterly growth rates we expect to see during 2014, the growth rate for the year as a whole rises from 1.8 to 2.4 per cent, simply because the year begins with GDP at a higher level. We have revised the growth rates we expect thereafter fractionally lower, reflecting a weaker outlook for exports. But the level of GDP is higher throughout the forecast than in March. By early 2018, our forecast revisions leave real GDP 1.4 per cent higher than in March, while nominal GDP – the total cash size of the economy, which matters more for the public finances – rises by 1 per cent. Add in the upward revisions to the past level of nominal GDP that the ONS has made since March, and the overall upward revision to nominal GDP is 2.7 per cent.

[SLIDE] This slide shows the level of GDP that we expected in March, with the level in 2010 equal to 100. [SLIDE] And this slide shows today's upward revision. [SLIDE] As you can see here, the forecast is broadly in line with the outside average through to 2016, and a little stronger thereafter. We are slightly more pessimistic than the Bank of England's latest modal forecast – in part because they factor in expected revisions to past data. But the differences between the forecasts are very small in comparison to the uncertainties around any of them.

[SLIDE] The recent performance of measured GDP has been stronger than we expected, but we have not changed our estimate of potential GDP in response – that is the level of economic activity consistent with keeping inflation stable in the long term. Estimates of potential GDP are always highly uncertain – and you can never verify if they were correct even after the event. But given the continued weakness of productivity - and the relatively low levels of spare capacity reported in business surveys – we have assumed that the recent growth surprise is cyclical rather than an indicator of greater underlying growth potential.

This means that the upward revision to our growth forecast eats into our estimate of spare capacity in the economy. This chart shows our forecasts for real GDP and potential GDP in March. The so-called 'output gap' between the two lines is a measure of spare capacity. [SLIDE] The revision to real GDP in this forecast narrows the output gap and we now forecast that the spare capacity in the economy will be fully absorbed at the end of the forecast in early 2019. Our forecasts for potential GDP lie within a wide range of outside forecasts.

[SLIDE] With a smaller output gap, you might expect less downward pressure on inflation from spare capacity. But in this forecast that effect is offset by the rise in sterling since March, which pushes down import costs. As you can see in this chart, the starting level of CPI inflation is lower than we expected in March. Inflation remains above the Bank of England's 2 per cent target in the near term, partly as a result of recently announced utility price increases, but slowly falls back to target over 2015 and 2016. The Government's energy bills announcement wasn't available for our forecast. Had it been, our inflation forecast over the coming year might have been a fraction lower. But the precise effect will be determined by the true extent of pass-through from the energy companies. Both this inflation forecast and our growth forecast assume that interest rates follow market expectations, with the first rise in base rates in mid-2015.

Now let me turn to some of the developments in different sectors of the economy.

[SLIDE] In the household sector, the pick-up in consumer spending this year appears to have been driven more by lower saving than by a pick-up in incomes. This isn't sustainable forever and we expect consumer spending growth to slow next year until productivity growth revives and helps lift earnings. Wages have been weak in recent years, relative to the cost of the things consumers spend their money on – hence the concern across the political spectrum about the cost of living. But wages perhaps still remain a little high relative to the price at which firms can sell their output, given the fall in productivity. The difference is explained by higher import prices and VAT, which have raised consumer prices but not the revenues of employers. This underlines the fact that – although the link is not necessarily one-for-one – productivity growth is the only sustainable source of real income growth in the long term.

[SLIDE] Turning to the housing market, we have revised up our near-term forecasts for house price inflation, reflecting recent buoyant outturn data and the improvement in mortgage financing conditions. We expect house prices to rise by 5 per cent next year and 7 per cent in 2015, with the level of house prices 10 per cent higher than we expected in March by 2017-18. Prices are rising as demand increases, while the supply of new housing remains inelastic. We believe that house prices are being driven more by fundamentals, which are of course affected by policy, than by a 'bubble' in which people are buying simply because they expect further rises in prices. Help to buy contributes to higher demand, raising prices in the short term and helping to encourage some increase in the stock of housing over the longer term.

[SLIDE] Turning to the corporate sector, like all forecasters we are wrestling with the challenge of working out what is going on with business investment. Since our March forecast, the ONS has implemented significant methodological changes to the measurement of business investment that have left the series much more volatile and on average weaker since the end of the recession. The investment deflator has also been revised and is now noticeably more volatile than equivalent data series in other G7 countries. Looking forward, survey data send mixed messages. The Bank of England's agents report a rise in investment intentions over the past year, while the CBI industrial trends survey suggests little change.

We presume that business investment has been weaker than we expected because of sustained uncertainty about demand, lack of internal finance for those firms that rely on it, and lower expectations of future profitability. [SLIDE] As demand and productivity growth pick up, we expect business investment to gather pace, growing by an average of 8.5 per cent a year between 2015 and 2018. This would still leave it lower as a share of GDP than after the 1990s recession.

[SLIDE] Trade is another example of where the data are telling a different story from March. Back then there appeared to have been a big drop in export volumes in 2012, notably for financial services. But these estimates have now been revised higher, while recent data has been erratic and weaker than we expected in March. Reflecting this, we have revised down our near term export forecast. We have also revised down our medium term forecasts for export market growth, as well as assuming the trend decline in our market share persists. Taking imports into account as well, we expect net trade to make a weaker contribution to growth than in March – indeed very little contribution over the forecast horizon. But the current account deficit should narrow a little.

[SLIDE] While we believe that it is important to set out our central forecast transparently and in detail, we always emphasise the risks and uncertainties that lie around this and any other forecast.

In this EFO we highlight four:

- First, that euro area economies and banking systems have yet to fully adjust and so instability could return.

- Second, we have already seen that the prospect of monetary policy become less stimulative in the US and globally can be disruptive;

- Third, that productivity growth could disappoint again, delaying a return to real income growth, and;

- Fourth, that household finances are in deficit and gross debt rising. This is to be expected given the stance of policy and the pick up in the housing market, but it could pose risks further out.

So now let me turn to the public finances.

[SLIDE] As in March, our ability to compare the public finances from one year to another - and from one forecast to another - has been complicated by the Royal Mail and Asset Purchase Facility transfers. To keep things as simple as possible, I'm going to focus on an underlying measure of public sector net borrowing that excludes these two effects.

I should warn you that there are a series of potential methodological revisions to the public finances data coming up over the next few months that are likely to make life even more complicated – and could in particular have a significant impact on the measured level of public sector net debt. We describe these potential changes in the EFO.

[SLIDE] Our new estimate for the underlying deficit this year is £111.2 billion, £8.6 billion lower than we forecast in March and £3.8 billion lower than the latest estimate for the previous year. Adjusting for some switches between spending and receipts that are neutral for borrowing, tax receipts look set to be about £5.7 billion higher this year than we expected – with VAT, onshore corporation tax and stamp duty each contributing more than a billion. This is partly offset by the proceeds from the UK-Swiss tax agreement, which are likely be around £2.3 billion lower than we forecast in March. On the spending side, central government departments look likely to underspend their Treasury limits by £7 billion this year rather than the £3.5 billion we forecast in March, and the Treasury describes £2 billion of this as a policy change. Other spending looks likely to come in £1.7 billion lower than we expected, partly because we now expect local authorities to put a bit more money into their reserves than we expected, rather than spending it.

[SLIDE] This table shows that we expect the deficit to be lower in every year of the forecast than in March, with the difference rising to over £19 billion by 2017-18. Higher revenues are by far the biggest explanation, with onshore corporation tax being boosted by a higher level of profits and stamp duty by higher expected house prices and transactions. Departmental spending is lower towards the end of the forecast because the Government is assuming a tighter squeeze in future spending reviews. And, excluding fiscally neutral switches, annually managed expenditure is slightly lower, with falls in local authority spending and public sector pension payments more than offsetting modest increases in debt interest and payments to the EU. By 2018-19 we expect the budget to be back in modest surplus for the first time in 18 years, excluding the small transfers to the Bank's Asset Purchase Facility.

As you can see, the policy measures that the Treasury has included in its policy decisions table have little cumulative impact on borrowing over the forecast. [SLIDE] The £2 billion cut in the spending limits and reserve for central government departments this year offsets a £1.4 billion cumulative tax cut through to 2018-19 and a £600 million cumulative increase in spending in 2014-15 and 2015-16 – the last two years for which detailed departmental spending plans have been set. (This increase in spending in turn comprises £5.5 billion of specifically identified increases in departmental spending, offset by £2.2 billion of implied cuts in other departmental spending and a £2.7 billion cut in social security and other annually managed expenditure.)

But it is worth noting that the specific increases in departmental spending announced in the Autumn Statement, such as the extension of free school meals and the lifting of the cap on student numbers, will continue to cost money beyond 2015-16 and will therefore leave less money for departments to spend on other things when plans for those years are set out in future Spending Reviews. The cost of the net tax cuts in the policy table will also continue to accumulate beyond 2018-19.

I mentioned earlier that our forecast assumes that the positive surprise to economic growth since our last forecast is cyclical rather than structural, reducing the amount of spare capacity in the economy rather than raising our estimate of potential output. Correspondingly, the cuts in our forecasts for borrowing since March are also cyclical rather than structural: they reduce the headline deficit but not the structural deficit, the borrowing that will still be left when the economy has recovered back to its potential.

[SLIDE] This chart shows our forecasts for the total deficit and for the structural deficit in March. [SLIDE] And this chart shows the latest forecasts – the total deficit has fallen noticeably, but the structural deficit is little changed. This is important for the Government's fiscal mandate, which is defined in structural terms.

So 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, which in this forecast moves forward from 2017-18 to 2018-19. 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 1.6 per cent of GDP in 2018-19, which means we think the Government does have a better than 50 per cent chance of meeting the mandate on current policy. Indeed the Government has twice the margin that we thought it had in March – this is because it has extended the spending squeeze for a further year, reducing implied departmental spending by a further 1.0 per cent of GDP, more than offsetting a 0.2 per cent of GDP structural increase in other spending – mostly debt interest. The Government remains on course for a surplus on the current budget in 2017-18, with fractionally less margin for error than in March.

[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 roughly 80 per cent chance of meeting the mandate in 2018-19 and a 65 per cent chance of a surplus in the previous year.

[SLIDE] Now let me turn to the supplementary target, which requires net debt to be falling as a share of GDP in 2015-16. In March we predicted that the target would be missed, with net debt rising in 2015-16 and again in 2016-17. We still expect it to rise in 2015-16, breaching the target, but it now falls by a fiscally and statistically insignificant amount in 2016-17. Our debt forecast is lower in every year than in March, both because of the downward revisions to our forecasts for the budget deficit and because the ONS has revised up the level of nominal GDP.

[SLIDE] As the table shows, we now expect net debt to rise by 1.7 per cent of GDP in 2015-16 and to fall by 0.1 per cent in 2016-17. In March we predicted that it would rise by 2.4 per cent in 2015-16 and by a further 0.5 per cent in 2016-17. In both cases the improvement reflects our lower forecasts for net borrowing.

Now let me conclude by saying a little about how these forecasts have changed the picture we have of the fiscal consolidation.

[SLIDE] This chart shows total receipts and total spending as a share of GDP. The Royal Mail and APF transfers have been removed. The gap between them is underlying public sector net borrowing. As you can see, we now expect the budget to reach balance in 2018-19, with the deficit having shrunk from its post war peak of 11.0 per cent in 2009-10. Tax receipts return broadly to their pre-crisis level while spending falls sufficiently both to reverse the increase seen during the recession and to remove the budget deficit that we were running prior to the crisis.

[SLIDE] This chart shows how the deficit is being eliminated. The total improvement is 11 per cent of GDP, but with debt interest increasing by almost 2 per cent of GDP, the gross improvement is even bigger than that. Higher tax receipts deliver about the 20 per cent of the net improvement, most of which has already happened thanks to the increases in the standard rate of VAT. Spending delivers about 80 per cent of the improvement, with most of the contribution from cuts in capital spending now banked – the Government wants to hold this broadly constant as a share of GDP. By far the largest contribution, especially in terms of what still needs to be done – is what appears here as 'PSCE in RDEL', which is in effect current spending on public services and administration. This falls by almost 8 per cent of GDP.

[SLIDE] We don't have comparable data for this category of spending back very far. But if we look at a proxy for current spending on public services from the National Accounts – the government's consumption of goods and services – you can see that this is now set to fall to its lowest share of GDP since comparable data were first available in 1948.

[SLIDE] We can see why public services spending is being squeezed so tightly from this table, which compares our forecasts for borrowing, receipts and spending in 2018-19 with the position immediately prior to the crisis in 2007-08. We can see that the Government is planning to eliminate the deficit of 2.7 per cent of GDP we were running prior to the crisis, but expects to have to pay 1.7 per cent of GDP more in debt interest and 1.7 per cent of GDP more in pensions and welfare payments. Receipts are being increased by only 0.4 per cent, which means that other spending – mostly on public services – has to fall by 5.7 per cent of GDP.

On that challenging note, let me stop and we will take your questions.