March 2013 *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 *Economic and Fiscal Outlook*. We are very grateful to the IfG for hosting us once again.

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 in the Budget today.

The views expressed in the EFO are the responsibility of the three members of the Budget Responsibility Committee. But we have relied on the work of the OBR's permanent staff and on the help of officials in numerous departments and agencies. And we are grateful 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 28 February and we closed the forecast to the impact of everything other than policy measures on 7 March. Happily we have come under no political or official pressure to change any of our conclusions.

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

First, the economic forecast.

Real GDP growth in 2012 was slightly stronger than we expected in December, but we have revised our forecasts down slightly for 2013 and 2014. This reflects a somewhat weaker outlook for consumption, business investment and exports. We have also revised down our forecasts for nominal GDP, reflecting the revision to real GDP and a weaker outlook for government inflation. We have revised CPI inflation slightly higher and unemployment slightly lower. We estimate that the economy will be running about 3½ per cent below its full potential next year and that it will still have some spare capacity in five years' time.

Second, the fiscal forecast.

Public Sector Net Borrowing - the headline measure of the gap between what the Government spends and raises in revenue – will have fallen sharply this year. But this comparison is flattered by policy decisions that have a temporary effect on the headline deficit – notably the decisions to bring the Royal Mail's historic pension fund assets into the public sector and to transfer the cash balances in the Bank of England's Asset Purchase Facility (the APF) to the Exchequer on a regular basis.

Public sector net borrowing fell by a quarter between 2009-10 and 2011-12, but excluding the impact of these two decisions that decline has now stalled. We expect the underlying deficit to be stable at around £120 billion last year, this year and next year, only to fall again in 2014-15.

Borrowing is higher throughout the forecast than in December, with an increase of around £12 billion by 2017-18. Tax receipts have been reduced by the weaker outlook for the economy, while our forecasts for public spending are little changed. Tax receipts this year look likely to come in around £5 billion lower than we anticipated in December. But the Government has chosen to offset most of the increase in borrowing that would result by squeezing central government spending tighter and pushing some into future years. That is why this measure of the deficit does not increase between last year and this year.

As regards the Government's fiscal targets, the position is the same as in December. We think that the Government remains on course to achieve the fiscal mandate, with roughly the same margin for error. But we still think that it is more likely than not the Government will miss its

supplementary target of reducing public sector net debt in 2015-16. We expect net debt to peak in 2016-17 at around 85 per cent of GDP.

Needless to say, there is considerable uncertainty around all these projections and we apply our usual sensitivity and scenario analysis to illustrate this, as well as showing comparisons with other forecasts.

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

[SLIDE] Data revisions mean that growth in 2012 as a whole now looks a little stronger than it did three months ago. But the fourth quarter was weaker than we expected, thanks to disrupted production in the North Sea. Meanwhile, outside growth forecasts have been moving down.

With recent data pointing to a weaker near-term outlook for exports, for earnings growth and for business investment, we have revised down our growth forecasts from 1.2 per cent to 0.6 per cent for 2013 and from 2 per cent to 1.8 per cent in 2014. They are unchanged thereafter. This means that the level of real GDP in 2017-18 is 0.6 per cent lower than we forecast in December. We have also revised down our forecasts for the government consumption deflator and thus for whole economy inflation. Add this to the real GDP revision and that leaves nominal or cash GDP 2.6 per cent lower in 2017-18 than we forecast in December.

[SLIDE] Viewed in levels, you can see that we are slightly more pessimistic about the path of real GDP than the outside average forecast and the Bank of England's modal forecast out to 2015, and then slightly more optimistic than the outside average thereafter. But as you can see from the chart, the differences between the forecasts are very small in comparison to the uncertainties around any of them.

Now let me turn to some of the main components of GDP. The tables will show how much each component contributes to total GDP growth each year and how this has changed since our December forecast.

[SLIDE] The biggest component of demand in the economy is consumer spending. We have revised this down a little in the near term, 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 data have been revised higher since December and we assume that this will limit somewhat the scope for growth going forward. We have business investment rising more slowly than it did in the recovery of the 1990s, but still rising as a share of GDP.

[SLIDE] Net exports were the biggest drag on GDP growth over the past year and performed worse than we would have expected given the behaviour of export markets and sterling. Looking forward we expect a weaker contribution to GDP growth from exports than we did in December, reflecting weaker demand overseas and falling market share. This outweighs the impact of weaker domestic demand on imports.

[SLIDE] The main upward revision to our forecast comes from government consumption and investment, which did more to boost GDP last year than we expected and which we now forecast to be less of a drag looking forward. Once again, this reflects evidence that the measured output of goods and services from the government sector has been much less affected by the cuts in cash spending than we expected.

[SLIDE] You can see that from this slide. In cash terms the growth of government consumption has slowed very sharply from an average of 5 per cent a year before 2010 to around 1 per cent a year subsequently. But in real terms government consumption growth has slowed only from 1.8 per cent a year to 1.2 per cent. This largely reflects the fact that a lot of government output is measured directly, using variables such as pupil numbers that don't change much when cash budgets are squeezed. So the direct impact of austerity has been showing up more as lower measured government inflation than as lower measured government output.

[SLIDE] Despite the ongoing weakness of GDP growth, the labour market has continued to perform more strongly than we expected, with employment and hours rising. Reflecting the recent data, we have revised employment higher and now assume that unemployment will peak at 8 per cent of the labour force. Strong employment growth and weak GDP data imply continued weakness in productivity. This, and recent weakness in outturn data, has led us to revise down our forecast for nominal earnings growth.

We have also revised down our forecast for real earnings growth, as CPI inflation has been revised up to reflect recent outturn data, higher oil prices and the likely impact of a weaker pound on import prices. But we have revised down our forecasts for whole economy inflation to reflect the weakness of government inflation that I mentioned just now.

[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 necessary but difficult 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.

As in December, business surveys suggest that spare capacity was probably flat or falling at the end of the year, even as the economy shrank. Over the year this would imply a significant fall in trend total factor productivity, the efficiency with which the economy can combine inputs to produce output. A significant fall in TFP seemed plausible during the depths of the financial crisis, but it seems less so now.

So, just as we did in December, we have adjusted our estimate of the output gap so that it is consistent with flat rather than falling TFP over recent quarters. As a result, we estimate that the economy was running about 2.7 per cent below full capacity on average in 2012 and that the gap will widen to about 3.6 per cent this year. [SLIDE] This gives us a slightly smaller output gap than the average of outside forecasters in 2012 [SLIDE] and a slightly bigger one than the average in 2013. In both cases we are towards the middle of a wide range.

[SLIDE] Looking further ahead, we expect growth in potential output to pick up gradually, but still to be below its long-term rate at the end of the forecast. With actual GDP growing only slightly faster than potential GDP, we still have a negative output gap and spare capacity in the economy at the end of the forecast. Indeed by 2017 we expect potential output to be almost 15 per cent below the level implied by its pre-crisis trend, but with actual output still 2 per cent below that.

As we discuss in the report, a persistent negative output gap is not a feature you would expect to see in an economic forecast in normal times. But in current circumstances we think it is more plausible than the alternatives. As you can see here, [SLIDE] our medium term forecast for potential output lies towards the middle of a wide range of outside forecasts. Needless to say, this is a very uncertain judgement and we show how sensitive our assessment of the Government's performance against the fiscal mandate is to different estimates for potential GDP.

So let me turn now to the public finances.

[SLIDE] As I mentioned earlier, 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. Since December the Office for National Statistics has also announced some statistical reclassifications that affect the public finance measures, as well as deciding how it will treat the Asset Purchase Facility decision.

To keep things as simple as possible, I'm going to focus on an underlying measure of public sector net borrowing that excludes the Royal Mail and APF transfers, but which takes on board the classification decisions.

[SLIDE] This chart shows that underlying deficit. As you can see it fell by roughly a quarter from its post war peak of nearly £160 billion in 2009-10 to just over £120 billion in 2011-12, thanks largely to the tax increases and spending cuts announced by the current and previous governments. But we now expect this measure of the deficit to remain around £120 billion this year and next, dropping again from 2014-15 onwards. As a share of national income, the deficit does continue to fall this year and next, but more slowly than we expected in December.

[SLIDE] Our estimate for the underlying deficit this year is £120.9 billion, £1 billion higher than we forecast in December and £0.1 billion lower than in the previous year. Needless to say, that difference is fiscally and statistically insignificant. Adjusting for statistical reclassifications, tax receipts are forecast to be about £5 billion lower than we expected in December. Almost £4 billion of this shortfall comes from income tax, where recent outturn data have been unexpectedly weak. Receipts from the 4G auction also came in £1.2 billion below expectations, although these score as negative capital spending.

The revenue and 4G shortfalls are partly offset by lower spending in some areas of Annually Managed Expenditure, but other things being equal we would have seen a modest rise in this measure of borrowing this year. However, the Government has chosen to offset most of the remaining upward pressure on the deficit by encouraging central government departments to spend less. This reduces total expenditure by almost £3.5 billion this year relative to our forecast in December.

[SLIDE] Departments normally spend less than the Treasury budgets at the beginning of the fiscal year, but this year's underspend is unusually large. We estimate that departments will spend almost £11 billion less than the limits set out for them by the Treasury in July last year.

The very sharp-eyed among you will have seen the evidence pointing in this direction when the Spring Supplementary Estimates were presented to Parliament early in the year. The 'Spring Supps' already showed an unusually large £5 billion underspend against last July's plans, which included £4 billion that departments had surrendered to the Treasury to spend in future years under its Budget Exchange programme.

Departments' unpublished February forecasts then showed a further £5 billion underspend, partly resulting from fresh agreements with the Treasury to halt spending or push it into future years. Departments normally underspend even against these final forecasts and we assume that this will be true again this year – but to a much smaller degree than usual, given the scale of the squeeze that departments have faced.

The use of Budget Exchange and other carry-forward agreements obviously puts upward pressure on spending in subsequent years. The Chancellor has chosen to limit the impact of this by 'top-slicing' most departmental spending limits by 1 per cent over the next two years. We assume that departments will still underspend against these lower limits, but to a much smaller degree than they are likely to this year.

Given the unusual scale of the underspend this year – and the fact that the Government is relying upon it to ensure that our forecast for the underlying deficit does not rise – we made it clear to the Treasury that we would need to publish much more detail than usual of the within-year spending forecasts for departments, so as to satisfy ourselves and

others that this forecast is central, albeit one around which there inevitably remains uncertainty. And so this EFO spells out for the first time the scale of Budget Exchange, the size of the other carry-forward agreements, the departmental breakdown of the February forecasts and the scale of the spending pressures created for future years. These new details may not excite much comment down at the Dog and Duck, but they are another important step forward for the transparency of the public finances. And we will expect to maintain it in future years.

[SLIDE] So now let us look in a little more detail at the underlying borrowing forecasts over the rest of the forecast horizon.

As you can see, the underlying deficit is higher each year in this forecast than in December, and by about £12 billion at the end of the forecast.

The main reason is the weaker outlook for receipts. Income tax is down thanks to weak receipts this year and a weaker outlook for average earnings. Onshore corporation tax is down because of weaker expected profits. Offshore corporation tax is down because we expect capital and operating expenditure to be higher. VAT is down because of weak receipts this year and a weaker outlook for nominal consumer spending. In the other direction, capital taxes are higher thanks to equity prices.

Our medium term spending forecasts are little changed in cash terms. Higher RPI inflation and interest rates push up debt interest costs. Lower unemployment reduces social security costs. The EU budget deal reduces our net EU contribution, partly offset by our exchange rate forecast. And our downward revision to whole economy inflation implies lower cash spending on public services beyond the current spending review period.

Turning to policy, the decision to push some central government spending forward from this year, and the measures on the Budget ‘scorecard’, both have a relatively small impact.

[SLIDE] As regards the Budget scorecard, there are modest net ‘takeaways’ and ‘giveaways’ in each year and they cancel each other out over the forecast horizon as a whole. There is a £3 billion switch from current to capital spending that helps the fiscal mandate, although this does not take effect until 2015-16. Not surprisingly, as this is a neutral

Budget package overall, it has no significant impact on our GDP forecast at the end of the five year horizon. The fuel and beer measures modestly reduce near-term inflation and the housing measures are likely to underpin the pick-up we expect in transactions.

[SLIDE] So, viewed in nominal terms, the deficit is higher because of lower receipts. Viewed as a share of GDP, the deficit is higher because of higher spending – lower nominal GDP leaves the average tax rate little changed, but it pushes up cash spending as a share of GDP.

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 means 2017-18. 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 0.8 per cent of GDP in 2017-18, which means we think the Government does have a better than 50 per cent chance of meeting the mandate on current policy. As you can see from the table, our judgement on potential output, and our underlying forecasts for revenues and spending would have reduced the surplus to 0.4 per cent of GDP. But this reduction has been largely offset by higher transfers from the APF and the Budget measures. These include the switch from current to capital spending, which improves the current balance.

Our central forecast also shows that the Government remains on course to achieve a surplus in 2016-17. But this would not have been the case without the Budget measures.

[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 70 per cent chance of meeting the mandate in 2017-18 and a 50 per cent chance of 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. In December we

predicted that the target would be missed, as net debt would rise in 2015-16. We now expect it to rise for a further year, peaking at 85.6 per cent of GDP in 2016-17 rather than at 79.9 per cent in 2015-16, as we said in December. You can also see in this chart that the debt ratio has been revised up over the past as well as into the future – this is because the ONS has now implemented the decision it announced last autumn to classify Bradford & Bingley and Northern Rock (Asset Management) as central government bodies, bringing their debts onto the balance sheet.

[SLIDE] As the table shows, we now expect net debt to rise by 2.4 per cent of GDP in 2015-16 and by a further 0.5 per cent in 2016-17. The debt path – and the change in the debt ratio from year to year - has been pushed higher by the additional borrowing, by the downward revision to nominal GDP, and by other assumptions in our forecast – such as the price at which the Debt Management Office will sell gilts relative to their nominal value. 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.

In the absence of the Royal Mail and APF transfers, and the Bradford & Bingley / NRAM reclassifications, our core judgements on the Government's progress against the targets would be unaffected. The Government would still be on course to meet the mandate, but with slightly less margin for error. And it would still be on course to miss the supplementary target, but by a slightly wider margin.

So those are the highlights of the EFO. We are now very happy to take your questions.