March 2022 *Economic and fiscal outlook*

Office for **Budget Responsibility**

Transcript of Presentation by:

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1. Cover slide

2. Introduction

Good afternoon everyone and welcome to this online presentation of our March 2022 *Economic and fiscal outlook* (*EFO*). Thank you for joining us.

I am going to take you through the highlights from our latest forecast and we'll then go into an online question and answer session. My slides and speaking notes are now available on our website where we'll also be posting a recording of this event.

If you would like to ask a question at any point, please use the Q&A feature, and we'll try to answer as many as possible. Please give your name and institution.

3. Background

Let me begin by thanking the staff from the OBR, Treasury, and across government whose expertise, adaptability, and hard work were once again essential to putting this latest forecast together.

Let me also officially welcome David Miles who joined Andy King and me on the OBR's Budget Responsibility Committee in January and replaces Charlie Bean as our economy expert.

And I should stress that all assumptions, analysis, and conclusions presented in this latest *Economic and fiscal outlook* are our own.

This was another *EFO* prepared against the backdrop of an unfolding shock to the global economy – this time caused by the Russian invasion of Ukraine on 24 February.

The invasion happened midway through the preparation of our forecast and prompted us to keep it open longer than usual to capture new data, especially on the reaction of world energy prices.

Our forecast is based on average oil and gas prices in the five working days to 2 March, a week after the start of the invasion.

Global energy prices have been highly volatile since then:

- Initially upwards on the back of speculation about the possibility of Western sanctions on Russian exports.

- And then downwards as the scope of those sanctions became clearer and hopes were raised about the prospects for a ceasefire.

And, as of this morning, gas and oil prices were fairly close (gas a bit lower, but oil a bit higher) to the levels assumed in our central forecast.

But we illustrate in a scenario in the *EFO* what the economic and fiscal consequences would be were prices to spike back up to their post-invasion peaks.

This was also an unusual Spring Statement for the amount of policy in it:

- both to mitigate the immediate impact of higher energy costs on households; and
- to deliver permanent reductions in personal taxes.

And I'll talk about their impact on disposable incomes, the tax burden, and the Chancellor's fiscal targets in the second part of my presentation.

4. Impact of the Russian invasion of Ukraine

But let me start with the most important development since we published our last forecast in October.

The Russian invasion of Ukraine is first and foremost a human tragedy and a reminder of the terrible costs of wars and the immense and immeasurable losses for those caught up in them.

But it's also had serious repercussions for the global economy, whose recovery from the worst of the pandemic was already being buffeted by the Omicron variant, supply bottlenecks, and rising inflation.

The UK doesn't have extensive trade links with either Russia or Ukraine, so our economy's most direct exposure to the invasion is via its impact on the global price of energy.

And while around two-thirds of our gas and oil imports come from the US, Norway, and Qatar and less than 10 per cent come from Russia, we pay global prices for all of them.

And Russia *is* a major player in *global* gas and oil markets, accounting for 17 and 12 per cent of *global* production respectively.

So it is mainly via its impact on *global* gas and oil prices – and their knock-on effects for UK inflation – that the Russian invasion and international response affects *our* forecast.

But we also take account of the invasion's impact on other important economic and fiscal determinants, including:

- On global GDP growth, which we have reduced by half a percentage point this year, which matters for demand for our exports.

- On UK equity prices, which had fallen by 2 per cent following the invasion, and which matter for capital gains tax receipts.

- And on interest rates on UK government debt, which fell back modestly in the wake of the invasion.

We did *not* take explicit account of price rises in *other* commodities such as wheat, nickel, and other raw materials.

But we did augment the first effect of higher gas and oil prices on UK inflation by 25 per cent in order to take account of the wider indirect effects of higher energy prices on the cost of, and demand for, other goods and services in the economy.

5. UK exposure to gas and oil shocks

When looking at the implications of this latest energy price shock for the UK economy today, it's important to bear in mind a number of factors which make us different both from the UK economy that experienced the oil shocks of the 1970s and from other European economies faced with the same energy price shock today.

First, having been a net *exporter* of energy during the North Sea boom of the 1980s and 90s, the UK has gone back to being a net *importer* of energy over the past two decades, as you can see from the blue line in the chart on the left.

This means that rises in global energy prices are, like they were in the 1970s, a terms of trade shock which reduces our overall living standards.

But, we have also become a less *energy-intensive* economy since then. The energy intensity of UK output has fallen by two-thirds since the oil crises of the 1970s, and by over 40 per cent since the start of this century. And our now largely service-based economy is one of the least energy-intensive in Europe, as you can see from the diamonds in the chart on the right.

However, over this same period, we've actually become relatively *more* dependent on gas and oil to meet our energy needs – as rising renewable production has not been sufficient to offset declining output from coal and nuclear power. As you can also see from the chart on the right, in 2019 we relied on gas and oil to meet three-quarters of our total energy needs, compared to a European average of less than 60 per cent.

Taking these three factors into account, we can expect higher gas and oil prices to have a significant impact on the UK economy, but for this latest energy price shock to be less severe than the inflation and output shocks we experienced during the first and second oil crises of the 1970s.

6. Global energy market developments

Turning now to developments in energy markets, energy prices had already begun to rise as we finalised our previous forecast in October and spiked up toward historic highs following the invasion of Ukraine and subsequent announcements of international sanctions against Russia.

Our forecasts for gas and oil prices are based on post-invasion futures curves over the next three years and then held constant in real terms after that.

This implies that gas prices remain around £3 per therm until the start of next year before falling back to £1.20 per therm by the end of the forecast period – around twice the levels assumed in our October forecast.

Oil prices are about 40 per cent higher than our October forecast at their peak, touching $100 a barrel this year, before falling back to around $80.

A more prolonged war or more severe set of sanctions than currently priced into these futures curves would clearly represent a downside risk to our forecast while a more rapid resolution of the conflict and easing of sanctions would present an upside risk.

We examine the economic and fiscal implications of gas and oil prices returning closer to their post-invasion peaks of over £5 a therm and over $120 a barrel, respectively, in a scenario in Chapter 4 of the *EFO*.

7. Inflation

In our central forecast, these higher global energy prices feed into domestic inflation in four stages:

- directly and immediately through the impact of higher oil prices on the pump price of petrol and other fuels;
- also directly but with a lag through the impact of higher gas prices on the Ofgem energy price cap which is reset in April and October each year;
- indirectly via higher prices for goods and services that use energy in their production; and
- indirectly through their effect on aggregate demand as higher energy prices hit real incomes.

These *additional* energy-driven price pressures add to *existing* inflationary pressures from global supply bottlenecks for goods and a tightening domestic labour market here in the UK.

Taking all of these factors into account, inflation is now expected to peak at a 40-year high of 8.7 per cent in the fourth quarter of this year, its highest level since the second oil shock of the late 1970s and early 1980s.

8. Inflation

This slide looks in more detail at the contribution of different global and domestic factors to the increase in inflation over the next few years.

Inflation remains higher for longer than in our October forecast, reflecting two main causes:

- First, the effect of higher oil and gas prices, which you can see immediately push up the price of fuel, shown in yellow in this chart, and the price of domestic utilities, shown in blue, with a lag of several months.

- Second, we now expect more of a domestic wage response to the rising cost of living in the context of a tighter labour market, which pushes up the price of non-tradable services, as shown in the green bars.

- Both of these factors continue to push prices up even as pressures from supply bottlenecks in global goods markets, shown in red, begin to fade.

Inflation drops back below 2 per cent in late 2023 as energy prices fall sharply – before returning back to target by the end of 2025.

9. GDP

Turning to the implications for UK GDP, the shock of the Russian invasion hit an economy that, as you can see from the blue line on the left, had only just returned to its pre-pandemic level of activity at the start of this year, after being buffeted by the Omicron variant in December.

With higher inflation expected to weigh on real incomes and consumption, we have cut our forecast for real GDP growth this year by more than 2 percentage points compared to our October forecast, from 6 to 3.8 per cent.

Real growth then settles at around 1¾ per cent over the remaining four years of the forecast.

The *level* of real GDP by the end of the forecast period remains 2 per cent below our pre-pandemic baseline, reflecting our unchanged assumption that the pandemic reduces the level of potential output by this amount.

10. Labour market

But we *have* revised the *composition* of this 2 per cent scarring assumption, however, to reflect developments since our October forecast – and, in particular, a mixture of good and less good news coming out of the labour market.

The good news is that unemployment has continued to fall, reaching 3.9 per cent in the three months to January, rather than rising to 5.2 per cent as we assumed in October.

But *wider* labour market developments have been *less* encouraging.

In particular, we now expect the number of people participating in the labour market to be about 200,000 fewer in the medium term than in October and 400,000 fewer than assumed in our pre-pandemic baseline forecast:

- About half of this can be attributed to a smaller population, due largely to lower net migration during the pandemic.

- The other half is due to lower labour market participation rates among the resident population, especially among older workers.

This lower overall labour supply, coupled with continued strength in labour demand, results in a tighter labour market than we expected in October.

This, combined with growing pressures on the costs of living, means we also expect stronger nominal earnings growth this year of 5.3 per cent.

11. Living standards

However, even at this faster rate, earnings don't keep pace with rising inflation over the next 12 months.

And once one also takes account of all the changes in taxes and benefits coming in from April, including the additional support announced in this Spring Statement, households' real disposable incomes on a per-person basis are set to fall by 2.2 per cent over the next 12 months.

As you can see from this chart, this would be the biggest single financial-year fall in living standards since records began 66 years ago, and more than twice the roughly 1 per cent falls in living standards experienced during the oil shocks of the 1970s and early 1980s.

And, without the range of energy rebates and tax cuts announced by the Chancellor in today's Spring Statement, this fall in living standards would have been half as big again at over 3 per cent.

12. Government borrowing

Turning to the fiscal outlook, despite these economic headwinds, the public finances have continued to recover more quickly from the pandemic than we expected, with borrowing in this financial year expected to come in £55 billion below our October forecast.

This was primarily the result of tax revenues holding up much better during the pandemic than we anticipated, especially among higher-rate income taxpayers and financial companies.

But spending has been revised down too – despite higher debt interest costs – as investment projects have been hit by supply bottlenecks and local authority spending has fallen short of our forecasts.

Borrowing is then slightly *higher* than our October forecast *next* year due to higher inflation pushing up the cost of the Government's index-linked debt as well as the temporary support offered in this Spring Statement to help cushion its impact on households.

But borrowing is again lower over the final four years of the forecast, as this temporary support is withdrawn and partly recouped.

13. Government debt

Looking at what this means for the government's stock of liabilities, debt is lower than our October forecast in *every* year in both cash terms and as a share of GDP.

It now peaks at 96 per cent of GDP this year before falling back to 83 per cent by the end of the forecast period.

However, this forecast also includes a glimpse of the risks that are lurking in that stock of debt which we've highlighted in previous reports.

Specifically, both the large proportion of UK government debt that is indexed to inflation and the shortening of the effective maturity of that debt as a result of quantitative easing have made the Government's debt stock much more sensitive to changes in both inflation and interest rates.

In this forecast, both are rising much faster than we or the Chancellor expected in October and drive net interest payments to an all-time high of £83 billion in cash terms in 2022-23 and to their highest level in 27 years as a share of revenue, at 7.6 per cent in that year.

Since much of this jump is driven by the spike in inflation pushing up the accrued cost of index-linked debt, the increase in debt interest costs falls away the following year.

But interest rates on conventional debt are higher in the medium term too, so even when inflation has subsided, interest costs still remain £9 billion higher than we forecast in October, despite the stock of debt being lower in cash terms in every year.

14. Changes in borrowing since October

Looking in more detail at what drives the change in borrowing relative to our previous forecast, this chart breaks that difference down into:

- First, differences arising from underlying forecast changes (shown in blue).
- And second, changes arising from discretionary policy decisions taken by the Chancellor in this Spring Statement – and by the Government more generally since October (shown in other colours).

Starting with the blue forecast changes, the first thing you can see is that, despite GDP coming in broadly in line with our forecast, there was a significant improvement in the pre-measures fiscal position of around £15 billion in the later years of the forecast thanks to stronger tax receipts outweighing inflation-driven increases in debt interest and welfare costs.

This is *not* true, however, in 2022-23 due to the aforementioned spike in inflation which doubles interest costs and far outweighs the improvement in receipts in that year.

Turning to the *policies* announced since our last forecast and in this Spring Statement:

- The first element is an energy cost package (shown in the green bars) which costs around £12 billion in the coming year. This energy package includes:

  (a) A 5p cut in fuel duty from this evening whose £2.4 billion cost is, in theory, contained to one year by an over-indexation of the duty by RPI +5p this time next year.

(b) There is also a £200 energy bill discount this October costing £6 billion and whose cost is recouped over the next five years via a new levy on household energy bills raising £1.2 billion per year.

(c) And a there is a one-off £150 council tax rebate from this April for the 80 per cent of households in Bands A to D, costing £2.9 billion in the coming fiscal year.

- The second element of the Spring Statement policy package is a pair of personal tax cuts (shown in red) which cost £10 billion per year in the final years of the forecast and comprise:

  (a) First, an increase in the thresholds above which people start paying National Insurance this July, costing around £5 billion per year and saving around 30 million taxpayers an average of £290 a year.

  (b) Second, a 1p cut in the basic rate of income tax from 20 to 19 per cent from April 2024, costing around £6 billion per year and saving around 30 million taxpayers an average of £170 a year.

- The third and final element of the policy package is a raft of reforms to student loans (shown in yellow) which were announced last month in response to the Augar Review. These measures save nearly £6 billion a year by reducing the overall effective subsidy provided by the state to students for new loans.

Taking both forecast and policy changes since October into account, this leaves borrowing £10 billion lower in 2024-25, the target year for the Chancellor's fiscal rules.

15. Tax burden

Looking in more detail at what the changes announced in this Spring Statement imply for the overall tax burden, as shown in this chart on the left:

- the permanent cuts to National Insurance and income tax announced today – circled in red – reverse just over a quarter of the personal tax rises the Chancellor announced last year; and

- they reverse around one-sixth of *total* tax rises announced by this Chancellor since he came to office in February 2020 – which are the sum of all the dark green blocks in the shaded area in the same chart.

The most significant of these tax rises include:

- the increase in corporation tax from 19 to 25 per cent next April;

- the four-year freeze in income tax allowances and thresholds from *this* April; and

- the increase in National Insurance rates this April and the introduction of the new health and social care levy next year.

And so, as shown in the chart on the right, the tax burden is still on course to rise from 33 to over 36 per cent of GDP over the next five years, its highest level since the late 1940s.

16. Fiscal Rules

These tax rises do play an important role in enabling the Chancellor to meet his fiscal rules while paying for a state that is 2 per cent of GDP larger than before the pandemic.

And the Chancellor continues to meet both the targets he set himself in October to get debt falling and balance the current budget in three years, and even does so one year early in 2023-24.

And by not spending the entire net windfall in this Spring Statement compared to October, he has actually added to the headroom against both of these rules in the target year 2024-25 by:

- £10.3 billion against debt falling; and
- £6.5 billion against balancing the current budget.

And in our next forecast, the three-year rolling target date moves onto 2025-26, increasing his room for manoeuvre by a few more billion.

17. Risks to the outlook

Given wider developments since October, the Chancellor may well need this additional headroom, because the array of risks to the fiscal outlook are varied and growing

This slide lists just a few of the most important ones split into:

- those arising from a more challenging geopolitical and macroeconomic context; and
- those arising from the sustainability of the Government's current policy settings in that more challenging environment.

On the economy side, a key risk stems from the future course of the war in Ukraine:

- Greater disruption to energy markets as a result of the conflict, a widening of that conflict beyond Ukraine's borders, or further tightening of international sanctions could mean energy prices and inflation remain higher for longer.
- In a scenario in the *EFO* we explore the economic and fiscal implications of gas and oil prices returning to their post-invasion peaks, which could push inflation close to double digits and add around £7 billion to borrowing from next year onwards.
- A more *sustained* rise in energy prices could do more *lasting* fiscal damage since, for a net energy importer like the UK, it could weigh on the economy's productive potential – the key driver of medium-term *fiscal* prospects.

Rising Covid cases at home and abroad also remind us that the *pandemic* is not over and in another scenario in the *EFO* we explore the economic and fiscal impact of the emergence of a vaccine-

escaping variant this winter, which would lead to a sharp contraction in output and demands for further fiscal support for households and businesses.

On the policy side, the more uncertain and more inflationary environment creates risks in a host of different policy areas:

- The Chancellor's plan to raise £3.6 billion by reversing today's cut in fuel duty with RPI+5p super-indexation next year looks ambitious given no Chancellor has been able to raise fuel duty rates at all in the previous 12 years, let alone in a way that raises pump prices by 6 per cent overnight.

- On the welfare side, lags in the uprating of benefits to rising inflation means that their real value will fall by almost 5 per cent in the coming year, and they will take up to 18 months to catch up with the rising cost of living. Having them keep pace with inflation this year would cost an extra £12 billion.

- Higher inflation also erodes the real value of the three-year budgets set in last October's Spending Review by between £5 and 17 billion, depending on the measure of inflation used, and at a time when many departments are already under pressure to clear pandemic-related backlogs.

- Rising geopolitical risks are likely to also create pressure to increase defence spending above the current NATO minimum of 2 per cent of GDP with each percentage point costing around £25 billion.

And these economic and policy pressures must all be managed in a context of the heightened sensitivity of government borrowing costs to higher inflation and interest rates – as illustrated by the doubling of debt interest costs in 2022-23 relative to our October forecast and the £9 billion a year upward revisions thereafter.

18. Conclusion

So in conclusion, thanks in no small part to the Chancellor's success in protecting viable jobs and profitable business through the coronavirus pandemic, the economy and the public finances have emerged from the last crisis in better shape than we expected.

But barely two years on from the start of the pandemic, the UK and the world economy face another set of challenges which it has not had to confront for a more than a generation – that of rising geopolitical tensions, energy prices, and inflation.

The Russian invasion of Ukraine has delivered a further shock to a global economy that had only just returned to pre-pandemic levels and was already being buffeted by the Omicron variant, supply bottlenecks, and rising inflation.

While the course of the war in Ukraine and international response is highly uncertain, we expected it to knock around ½ a percentage point off global growth this year.

And these events have already driven global energy prices to historic highs which are expected to push inflation here in the UK up to a 40-year high of almost 9 per cent and reduce GDP growth from 6 to 4 per cent this year.

With inflation outpacing earnings and taxes due to rise from this April, real living standards are set to fall by more than 2 per cent over the next 12 months, their largest financial-year fall since records began in the mid-1950s.

In his Spring Statement today, the Chancellor provided £18 billion in rebates and tax cuts to help households cope with rising costs this coming year and £10 billion in personal tax cuts over the medium term.

Together, these offset around one-third of the overall fall in living standards people would otherwise have faced over the next 12 months and reverse around one-sixth of the medium-term tax rises this Chancellor has introduced since coming to office.

Despite these near- and medium-term giveaways, the Chancellor slightly increased the headroom against his two fiscal rules to around £30 billion.

But the array of global risks and domestic pressures on the public finances suggest he may need all of that, and possibly more, to get him through the next few years.

And, with that, I'll now ask David and Andy to join me to take your questions.