1 Executive summary

Overview

1.1 The economy has grown less strongly this year than we forecast in March, primarily because higher-than-expected inflation has squeezed household incomes and consumer spending. Business and consumer surveys point to further weakness in the fourth quarter. On the assumption that the euro area struggles through its current difficulties, we expect the underlying momentum of the economy to pick up through next year, but with the headline measure of GDP broadly flat until the second half. Our central forecast is for 0.7 per cent growth in GDP in 2012, compared to the average external forecast of 1.2 per cent.

1.2 Business and consumer surveys suggest that in the third quarter of 2011 activity in the economy was running about 2.5 per cent below the potential level consistent with sustaining stable inflation in the long term. This is a smaller 'output gap' than there appears to have been a year ago despite weak economic growth in the interim. Potential output appears to have grown by only 1 per cent a year since the end of the recession. We now assume that potential output will take until the start of 2014 to return to its long-term average growth rate of around 2.3 per cent a year, as the financial sector and credit conditions take time to normalise.

1.3 These developments result in our estimate of the potential output of the economy in 2016 falling by around 3.5 per cent compared to our March forecast. This still leaves it at or above the estimates of other leading forecasters. As a consequence, we believe that there is less scope for the economy to grow at above-average rates over the next few years as spare capacity is used up. Our central forecast is for GDP to grow by 2.1 per cent in 2013, 2.7 per cent in 2014 and 3 per cent in 2015 and 2016. (The growth forecasts for the final two years would have been 2.8 per cent, but for recent methodological changes to the National Accounts).

1.4 Public sector net borrowing (PSNB) is expected to total £127 billion or 8.4 per cent of GDP this year, slightly higher than we predicted in March. The downward revisions to our growth forecasts mean that the deficit will also shrink less quickly over the coming five years. By 2015-16, we expect PSNB to have fallen to £53 billion or 2.9 per cent of GDP, compared to the £29 billion or 1.5 per cent of GDP that we forecast in March. The extra borrowing is primarily structural rather than cyclical, in other words it will not disappear as the economy recovers.

1.5 The Government's fiscal mandate requires it to balance the structural or cyclically-adjusted current budget (CACB) at the end of the five year forecasting horizon, which in this *EFO* has now rolled forward to 2016-17.

1.6 In the absence of additional policy measures in the 2011 Autumn Statement, we believe that the Government would have had a less than 50 per cent chance of achieving the mandate. Our central forecast would have shown a deficit on the CACB of £6 billion or 0.3 per cent of GDP in 2016-17.

1.7 The Government has put itself back on course to meet its targets by announcing specific policy measures that reduce the CACB by £8 billion or 0.5 per cent of GDP in 2015-16 and £15 billion or 0.8 per cent of GDP in 2016-17. The 'unchanged policy' baseline against which they are measured extends the real freeze in total spending that the Government had previously announced for 2015-16 into 2016-17. This reduces structural non-investment spending and the CACB in 2016-17 by a further £15 billion or 0.8 per cent of GDP. This gives a total discretionary cut in non-investment spending and in the CACB of £30 billion or 1.5 per cent of GDP in 2016-17, compared to a counterfactual in which structural spending grows in line with GDP.

1.8 The Government's supplementary fiscal target requires public sector net debt (PSND) to fall as a share of GDP between 2014-15 and 2015-16. In March we forecast a fall of 1.4 percent of GDP, but in the absence of policy measures we would now be forecasting an increase of 0.2 per cent of GDP. Taking the Autumn Statement policy decisions into account PSND is now forecast to fall by 0.3 per cent of GDP, meeting the target.

1.9 There is considerable uncertainty around these forecasts, as around all fiscal forecasts. Assuming that they are as accurate as past official forecasts, there is a roughly 60 per cent chance of the Government meeting the mandate in 2016-17. At the time of the March Budget, we judged that Government had set policy consistent with meeting the mandate at the then five year horizon of 2015-16. But as a result of the downward revisions to potential output we now believe that there is only a 40 per cent chance of the CACB being in surplus in that year.

1.10 We stress-test our fiscal forecasts and judgements using sensitivity and scenario analysis. The central economic and fiscal forecasts assume that the euro area finds a way through its current crisis, but a more disorderly outcome is clearly a significant downside risk. This risk cannot be quantified in a meaningful way, as there are numerous different ways in which such an outcome could unfold. Suffice to say, the probability of an outcome much worse than our central forecast is greater than the probability of an outcome much better than our central forecast.

Developments since the March 2011 forecast

1.11 Since our last forecast in March, the Office for National Statistics (ONS) has implemented methodological changes and data revisions to the National Accounts that partially rewrite recent economic history and which have an impact on our forecasts looking forward:

- the methodological changes suggest that for a given growth rate of nominal GDP – total cash spending in the economy – the official estimate of real GDP growth in any given year is now likely to be around 0.2 percentage points higher while whole economy inflation will be around 0.2 percentage points lower, other things being equal. This does not imply any actual improvement in the underlying growth performance of the economy; and
- the data revisions suggest that the economy was growing more strongly in the run-up to the financial crisis, that the recession was deeper (but slightly shorter), and that the recovery at the end of 2009 was stronger than previous figures suggested. GDP has since flattened out from the second half of 2010.

1.12 Economic growth this year has been much weaker than we expected at the time of our March forecast. Forward-looking business and consumer surveys have also weakened significantly. The intensification of the euro area sovereign debt crisis has led to significant market volatility and has doubtless helped reduce confidence. CPI inflation has been higher than forecast, largely due to rises in utility prices. The labour market has performed broadly in line with our March forecast, although it has shown signs of greater weakness recently.

1.13 These developments have prompted external forecasters to downgrade their predictions for growth in 2011 and 2012. The average forecast for CPI inflation in the final quarter of 2011 has been revised up significantly.

1.14 Our forecast in this *EFO* includes the impact of the policy announcements set out by the Chancellor in his 2011 Autumn Statement. These have little net impact on public sector net borrowing (PSNB) up to 2014-15, and then reduce it in 2015-16 and 2016-17. We have not made any material adjustments to our economy forecast on the basis of these policy announcements.

The economic outlook

1.15 Recent data suggest that the UK economy has lost momentum since the summer. Business and consumer surveys point to continued weakness in coming months and the situation in the euro area is likely to further undermine confidence and lead to tighter credit conditions for households and firms. In the near term, utility price increases are keeping inflation higher than we expected in our last forecast, reducing real household disposable income and consumption.

1.16 On the assumption that the euro area struggles through its current difficulties, we expect the economy to gain momentum gradually through next year. But the headline measure of GDP is likely to be broadly flat until the second half, partly due to various one-off factors. Consistent with this profile, we have revised down our central forecast for year-on-year GDP growth to 0.7 per cent in 2012, compared to the 1.2 per cent average forecast among external analysts.

1.17 Business and consumer surveys, and other cyclical indicators, suggest that in the third quarter of 2011 activity in the economy was running about 2.5 per cent below the potential level consistent with sustaining stable inflation in the long term. This implies that there is less spare capacity in the economy than at the end of last year, despite the weakness of economic growth in the interim.

1.18 The cyclical indicators also suggest that the potential output of the economy has been growing by only around 1 per cent a year since the recession ended. To date, this appears to reflect weak underlying productivity growth rather than rising structural unemployment. Rather than assuming that the growth of potential output snaps straight back to 2.3 per cent, our estimate of its long-run average, we now assume that it picks up gradually over the next two years as the financial sector and credit conditions normalise.

1.19 Reassessing the size of the output gap and the outlook for growth in productive potential has led us to revise down our estimate of the level of potential output in 2016 by about 3.5 per cent since March. Despite this revision, our estimate of potential output at the end of the forecast period remains in line with or above those of the European Commission, the International Monetary Fund and the Organisation for Economic Cooperation and Development.

1.20 The downward revision to productive potential reduces the scope for above-average rates of economic growth as spare capacity is taken up. We now expect the economy to grow by 2.1 per cent in 2013, 2.7 per cent in 2014, and 3.0 per cent in 2015 and 2016. The growth rates in the last two years of the forecast are higher than in March, but only because of a methodological change to the National Accounts.

1.21 Our central forecast assumes that the euro area finds a way through the current crisis and that policymakers eventually find a solution that delivers sovereign debt sustainability. A more disorderly outcome is clearly possible. This poses a significant downside risk to the central forecast, but one that cannot be quantified in a meaningful way given the numerous ways in which it might unfold. Suffice to say, even though we believe there is an equal chance that growth will come in above or below our central forecast, the probability of a much worse outcome than the central forecast is greater than the probability of a much better one.

1.22 As in our last forecast, we expect the recovery to be supported primarily by growth in business investment and net trade – although our forecasts for both have been revised down since March. Recent data revisions suggest that exports have already increased more in response to the depreciation of sterling than previously thought, suggesting that there is less of a boost still to come. We are more pessimistic about the outlook for investment partly because non-financial companies may have less cash available to invest than official statistics suggest.

1.23 Real household disposable income is forecast to have fallen by 2.3 per cent this year, a post-war record. Earnings growth is not expected to overtake inflation again until 2013 and not by a significant margin until 2014. As a result, we expect consumer spending to remain broadly flat in real terms next year before picking up as real household disposable income starts growing again.

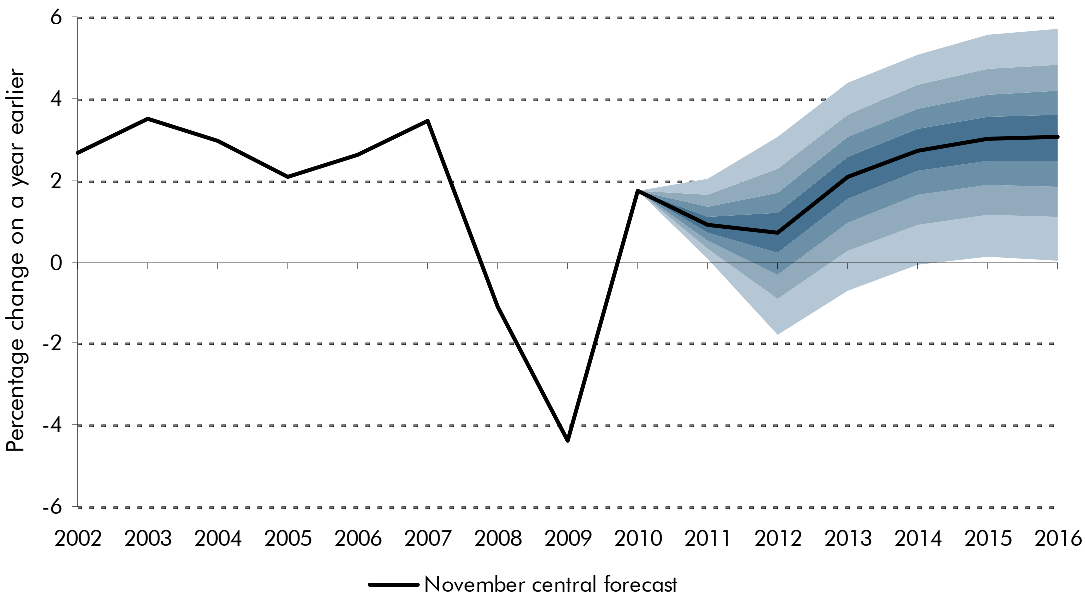
1.24 We expect the labour market to continue weakening over the coming year, reflecting the weaker outlook for economic growth. Unemployment is expected to rise from its current 8.3 per cent of the workforce to 8.7 per cent in the final quarter of 2012, before falling back again to 6.2 per cent by 2016.

1.25 We expect market sector employment to rise by around 1.7 million between the start of 2011 and the start of 2017, partly offset by a fall of around 710,000 in general government employment. General government employment is expected to fall further than we predicted in March, primarily because of the additional spending cuts pencilled in for 2015-16 and 2016-17 in the Autumn Statement. There is some evidence that public sector employers are front-loading expected job reductions.

1.26 Utility price increases have been larger than we forecast in March, which will keep inflation elevated over the near term. However, inflation is still expected to fall sharply during 2012 as past VAT rises and the upward pressure from higher energy and commodity prices fall out of the annual comparison, and as spare capacity in the economy subdues inflationary pressures. We expect CPI inflation to fall back to the Bank of England's target rate of 2 per cent in the medium term.

1.27 There is always considerable uncertainty around any central economic forecast. Chart 1.1 presents our central growth forecast with a fan chart showing the probability of different outcomes based purely on past official forecasting errors. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 10 per cent probability bands. It suggests that there is a roughly one-in-three chance that the economy will shrink between 2011 and 2012, judging from past forecasting errors.

Chart 1.1: GDP fan chart



Source: ONS, OBR

Table 1.1: Summary of central forecast and changes since March[1]

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2010	2011	2012	2013	2014	2015	2016
Output at constant market prices							
Gross domestic product (GDP)	1.8	0.9	0.7	2.1	2.7	3.0	3.0
GDP Levels (2010 =100)	100	100.9	101.6	103.7	106.6	109.8	113.1
Expenditure components of GDP at constant market prices							
Household consumption[2]	1.1	-1.1	0.2	1.2	2.2	2.7	2.9
Business investment	0.8	-0.8	7.7	8.9	9.4	12.6	12.4
General government consumption	1.5	2.2	-0.1	-1.6	-2.3	-3.2	-3.5
General government investment	2.8	-6.8	-9.4	-4.2	-0.1	-1.1	-2.3
Net trade[3]	-0.8	1.2	0.3	0.6	0.3	0.2	0.1
Inflation							
CPI	3.3	4.5	2.7	2.1	2.0	2.0	2.0
Labour market							
Employment (millions)	29.0	29.2	29.1	29.2	29.4	29.7	30.0
Average earnings[4]	2.1	0.9	2.0	3.1	4.3	4.5	4.5
ILO unemployment (% rate)	7.9	8.1	8.7	8.6	8.0	7.2	6.2
Claimant count (millions)	1.50	1.54	1.75	1.77	1.67	1.45	1.23
Output gap	-3.0	-2.7	-3.1	-2.9	-2.4	-1.7	-0.9
	Changes since March forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.5	-0.8	-1.8	-0.8	-0.1	0.2	
GDP Levels (2010 =100)	0.0	-0.8	-2.6	-3.5	-3.6	-3.4	
Expenditure components of GDP at constant market prices							
Household consumption[2]	0.3	-1.7	-1.1	-0.6	0.2	0.5	
Business investment	-1.7	-7.5	-1.2	-1.6	-0.9	4.8	
General government consumption	0.5	1.5	1.0	0.2	0.2	-1.3	
General government investment	-1.6	5.2	0.5	1.4	1.3	-3.5	
Net trade[3]	0.1	0.5	-0.6	-0.1	-0.2	-0.2	
Inflation							
CPI	0.0	0.3	0.2	0.1	0.0	0.0	
Labour market							
Employment (millions)	0.0	0.1	-0.1	-0.3	-0.3	-0.3	
Average earnings[4]	0.4	-1.1	-0.2	-0.7	0.0	0.0	
ILO unemployment (% rate)	0.0	-0.1	0.6	1.0	1.0	0.7	
Claimant count (thousands)	-1	-2	222	346	357	270	
Output gap	0.5	1.2	0.5	0.1	-0.2	-0.2	

[1] The forecast is consistent with the second estimate of GDP data for the third quarter of 2011, released by the Office for National Statistics on 24th November 2011.

[2] Includes households and non-profit institutions serving households.

[3] Contribution to GDP growth, percentage points.

[4] Wages and salaries divided by employees.

The fiscal outlook

1.28 Our central forecast is that public sector net borrowing (PSNB) will drop steadily as a share of GDP over the next five years from its post war peak in 2009-10. But we now expect it to be substantially higher across all years of the forecast than in March, largely reflecting the weaker outlook for the economy. As a result public sector net debt (PSND) is also forecast to be higher than we expected in March, but we still expect it to start falling toward the end of the forecast period.

1.29 This forecast takes into account the policy measures announced by the Chancellor in his Autumn Statement. The impact of policy measures included in the Treasury's scorecard on PSNB is broadly neutral up to 2014-15 and then reduces borrowing by £8.3 billion in 2015-16 and £15.1 billion in 2016-17.

1.30 The key elements of our fiscal forecast, including the impact of these policy measures, are presented in Table 1.2:

- PSNB falls from 11.2 per cent of GDP in 2009-10 to 1.2 per cent in 2016-17. In 2015-16, we estimate PSNB will be around £24 billion or 1.4 per cent of GDP higher than we thought in the March *EFO*;
- the cyclically-adjusted current budget (CACB) is expected to move from a deficit of 4.5 per cent of GDP in 2010-11 to a surplus of 0.5 per cent in 2016-17;
- in March we forecast that the CACB would be in surplus by 0.8 per cent of GDP or £15 billion in 2015-16, but we now expect it to be in deficit by 0.6 per cent of GDP or £11 billion; and
- public sector net debt (PSND) is forecast to peak at 78 per cent of GDP in 2014-15 before falling to 77.7 per cent in 2015-16 and 75.8 per cent in 2016-17. The peak in 2014-15 is 7.5 per cent of GDP higher than we expected in March, reflecting higher borrowing and a lower forecast for nominal GDP.

Table 1.2: Fiscal forecast overview

	Per cent of GDP							
	Outturn		Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Public sector net borrowing	11.2	9.3	8.4	7.6	6.0	4.5	2.9	1.2
Cyclically-adjusted net borrowing	9.0	7.1	6.4	5.5	4.0	2.8	1.7	0.6
Surplus on current budget	-7.7	-6.7	-6.5	-6.0	-4.7	-3.3	-1.8	-0.1
Fiscal mandate and supplementary target								
Cyclically-adjusted surplus on current budget	-5.5	-4.5	-4.6	-3.9	-2.7	-1.6	-0.6	0.5
Public sector net debt[1]	52.9	60.5	67.5	73.3	76.6	78.0	77.7	75.8
	Changes since March forecast							
Public sector net borrowing	0.0	-0.6	0.5	1.4	1.9	2.0	1.4	
Cyclically-adjusted net borrowing	0.1	-0.3	1.2	1.8	2.0	1.9	1.2	
Surplus on current budget	-0.1	0.4	-0.7	-1.5	-2.0	-2.1	-1.5	
Cyclically-adjusted surplus on current budget	-0.2	0.1	-1.4	-1.9	-2.1	-2.0	-1.4	
Public sector net debt[1]	0.2	0.2	1.4	3.6	5.7	7.5	8.6	

[1] Debt at end March; GDP centred on end March.

1.31 The deterioration in the public finances in this forecast reflects lower government receipts and higher spending as a share of national income, as shown in Table 1.3. The downward revision to public sector receipts worsens the PSNB by 0.7 per cent of GDP compared with March. The main factors are:

- lower forecast growth in the key economic drivers of tax receipts – labour income, household consumption and company profits – which feed through to lower forecasts for income tax, VAT and corporation tax;
- falls in oil prices, equity prices and interest rates compared to March, leading to lower North Sea taxes, stamp duties, and interest receipts; and
- the sharp fall in financial sector corporation tax receipts seen so far this year, which we assume not to be recovered over the forecast period.

1.32 The upward revision to total managed expenditure (TME) as a share of GDP worsens the PSNB by 0.7 per cent of GDP by 2015-16. The most significant changes here are:

- departmental spending over the spending review period is generally fixed in cash terms. Our forecast of lower nominal GDP means this is higher as a share of GDP;

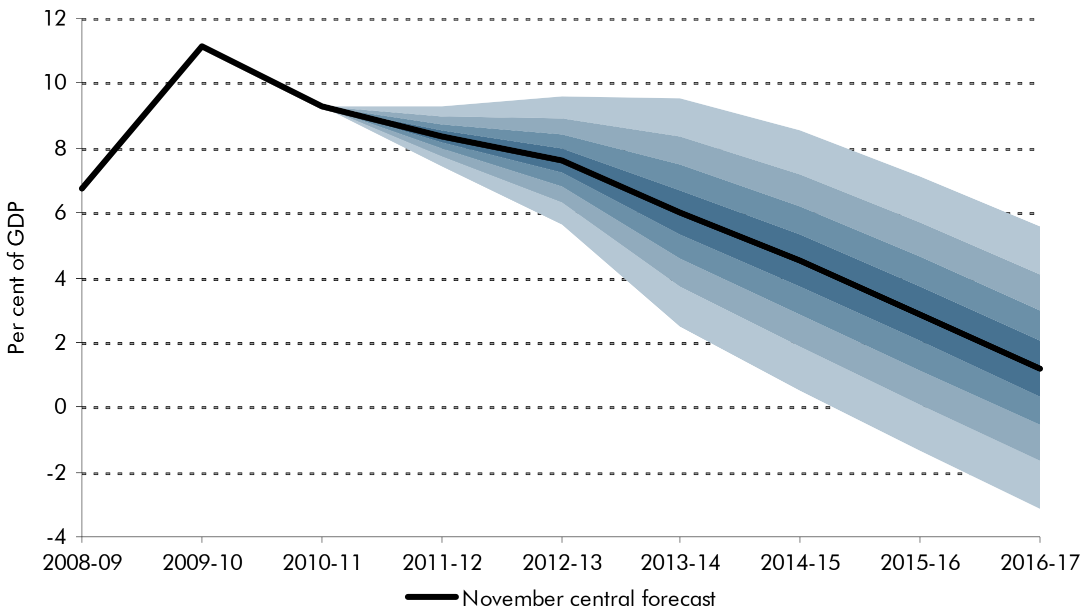
- our forecast of social security benefits and public sector pension payments has increased partly due to higher CPI and claimant count unemployment forecasts;
- this is partly offset by reduced government debt interest payments due to lower expected interest rates and lower RPI inflation; and
- in 2015-16, the Government's additional discretionary fiscal tightening reduces total expenditure as a share of GDP by 0.5 per cent.

Table 1.3: Changes to public sector net borrowing since March forecast

	Per cent of GDP				
	Outturn	Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16
PSNB March	7.9	6.2	4.1	2.5	1.5
PSNB November	8.4	7.6	6.0	4.5	2.9
Change	0.5	1.4	1.9	2.0	1.4
of which:					
Tax	-0.3	-0.5	-0.8	-0.7	-0.7
of which: policy	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Spending	0.2	1.0	1.2	1.2	0.7
of which: policy	*0.0*	*0.0*	*0.0*	*0.0*	*-0.5*

1.33 All fiscal forecasts are subject to significant uncertainties. Chart 1.2 shows our central forecast for PSNB with the probability of different outcomes, based purely on our and the Treasury's past forecasting performance, shown in a fan chart. The solid black line shows our central (median) forecast and each shaded area represents a 10 per cent probability band.

Chart 1.2: Public sector net borrowing fan chart



Source: ONS, OBR

Performance against the Government's fiscal targets

1.34 On taking office in 2010 the Coalition Government set itself a medium-term fiscal mandate and a supplementary target:

- to balance the cyclically-adjusted current budget (CACB) by the end of a rolling, five-year period, which is now 2016-17; and
- to see public sector net debt (PSND) falling in 2015-16.

1.35 In the absence of additional policy measures in the 2011 Autumn Statement, we believe that the Government would have had a less than 50 per cent chance of achieving these targets. Our central forecast would have shown a deficit on the CACB of £6 billion or 0.3 per cent of GDP in 2016-17 and an increase in PSND of 0.2 per cent of GDP between 2014-15 and 2015-16.

1.36 The Government has put itself back on course to meet its targets by announcing specific new policy measures that reduce the CACB by £8 billion or 0.5 per cent of GDP in 2015-16 and £15 billion or 0.8 per cent of GDP in 2016-17. The 'unchanged policy' baseline against which these policies are measured extends the real freeze in total spending that the Government had previously announced for 2015-16 into 2016-17. This reduces structural non-investment spending and the CACB in that year by a further £15 billion or 0.8 per cent of GDP. This gives a total discretionary cut in non-investment spending and in the CACB of £30 billion or 1.5 per cent of GDP in 2016-17, compared to a counterfactual assuming structural spending growing in line with GDP.

1.37 Taking the policy measures and the baseline tightening into account, our central forecast now shows a surplus on the CACB of over £9 billion or 0.5 per cent in 2016-17 and a fall in PSND of 0.3 per cent of GDP in 2015-16. This implies that the Government has a better than 50 per cent chance of hitting its targets. It has slightly less margin for error than it did in March, when we were forecasting the CACB would be in surplus by £15 billion or 0.8 per cent of GDP at the then five year horizon of 2015-16 and that PSND would fall by 1.4 per cent of GDP in 2015-16.

1.38 In March we estimated not only that the Government was on course to meet the mandate at the then five-year horizon of 2015-16, but that the CACB would also be in surplus a year earlier in 2014-15. In this forecast the CACB is no longer in surplus in these years, primarily because we have revised down the expected level of output by around 3.5 per cent from 2014-15 onwards, and the revision is structural rather than cyclical. This worsens the CACB by just over 2 per cent of GDP in each year thereafter. The Autumn Statement measures and baseline tightening offset about 5 per cent of this structural deterioration in 2014-15, 30 per cent in 2015-16 and 80 per cent in 2016-17. This is sufficient to keep the CACB in surplus in 2016-17, but not in the previous two years.

1.39 There is considerable uncertainty around our central forecast, as there is around all fiscal forecasts. This reflects uncertainty both about the outlook for the economy and about the performance of revenues and spending for any given state of the economy. Given these uncertainties we probe the robustness of our central judgement in three ways:

- first, by looking at past forecast errors. If our central forecasts are as accurate as official forecasts were in the past, then there is a roughly 60 per cent probability that the CACB will be in balance or surplus in 2016-17 (as the mandate requires) and a roughly 40 per cent chance a year earlier;

- second, by looking at its sensitivity to varying key features of the economic forecast. The biggest risk to the achievement of the mandate is that we again need to revise down our estimates of future potential output. If the output gap was around ¾ per cent of potential GDP narrower, or rather the level of potential output ¾ per cent lower, then in our central forecast the Government would no longer be on course to balance the cyclically-adjusted current budget in 2016-17; and

- third, by looking at alternative economic scenarios. We examine three illustrative scenarios: first, one in which banks' funding costs remain elevated and these are passed on to the wider economy; second, one in which the financial crisis had no effect on the level of potential output; and third, a scenario where structural unemployment is higher, but the productive potential of the economy remains unchanged. The first reduces the Government's chances of meeting the mandate, the second significantly increases the chances, and the third has little net impact.