Background

• The IMF said in 2016 that “summary reporting of specific risks is a weakness that should be addressed”

• The Government then legislated for us to produce an FRR every two years, to which it is obliged to respond

• We published our first FRR in July 2017 and the Treasury responded with Managing fiscal risks in July 2018

• Several other countries produce risk reports, but usually by their finance ministries or cabinet offices
Our approach

• The IMF defines fiscal risks as
  – “the possibility of deviations of fiscal outcomes from what was expected at the time of the Budget or other forecast”

• In this report we focus on risks
  – To our latest (March 2019) forecast over the medium term
  – To fiscal sustainability over the longer term

• We are interested in
  – Probability and potential impact: any change over last two years?
  – What the government is doing: response in MFR and policy

• But taking on fiscal risk not necessarily a bad thing
Chapters and special themes

- **Macroeconomic risks:** output gap mismeasurement
- **Financial sector risks:** shadow banking
- **Revenue risks:** tax relief and digital economy
- **Primary spending risks:** NHS & free TV licences for over 75s
- **Balance sheet risks:** fiscal illusions & intangible assets
- **Debt interest risks:** ‘R-G’ and debt dynamics
- **Fiscal policy risks:** looser fiscal rule?
- **Climate change:** introduction to future work
- **A fiscal stress test:** IMF no-deal Brexit scenario
Big picture

• Most fiscal risks we identified in 2017 remain
• Some significant government action
  – Monitoring, management and transparency
  – Deficit lower and debt starting to fall as %GDP
• But significant medium-term policy risks
  – ‘Balanced budget’ objective being downplayed
  – Big spending increases off-timetable (NHS)
  – Potential PMs have big shopping lists
  – Possibility of disruptive no-deal Brexit
• Health costs and ageing remain big long-term risks
Macroeconomic risks

- Risks to potential output growth
- Risks of a cyclical downturn
- Sectoral balances
- GDP composition risks
Productivity growth

![Graph showing productivity growth from 1972 to 2036, with per cent output per hour and period average as axes. The graph includes a March 2019 forecast and FSR 2018 projection.]
The economic cycle

Output gap

Per cent

March 2019 forecast

Monthly/quarterly GDP growth

- Monthly GDP growth
- Monthly growth implied by PMIs
- Quarterly GDP growth

Per cent

Q1 2016, Q2 2016, Q3 2016, Q4 2016, Q1 2017, Q2 2017, Q3 2017, Q4 2017, Q1 2018, Q2 2018, Q3 2018, Q4 2018, Q1 2019, Q2 2019, Q1 2020, Q2 2020
Structural and cyclical borrowing

Cyclical deficit
Structural deficit
Public sector net borrowing

Per cent of GDP

Forecast

Structural deficit: original and now

Per cent of nominal GDP

Latest estimate
Real-time estimate

1995 1997 1999 2001 2003 2005 2007 2009 2011 2013 2015 2017
Fiscal policy and spare capacity

CAPSNB (per cent of nominal GDP)

Output gap (per cent of potential output)

Spare capacity, Expansionary fiscal policy

Spare capacity, Contractionary fiscal policy

Above potential, Expansionary fiscal policy

Above potential, Contractionary fiscal policy
Fiscal policy and spare capacity

CAPSNB (per cent of nominal GDP)

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Above potential, Contractionary fiscal policy
Financial sector risks

• Last time: financial crises and long-term trends

• HMT: better regulation of the banking sector has made crises less likely and potentially costly

• But what if risks are simply pushed elsewhere?

• More oversight and regulation of ‘shadow banks’, but is this sufficient?

• Potential bail-out costs and possible contagion
Shadow banking in the UK

Assets (USD trillion)

- Collective investment vehicles
- Loans with short-term funding
- Intermediation from secured funding
- Credit creation
- Securitisation-based credit intermediation
- Unallocated

Revenue risks: forecasts
Tax rises less certain than tax cuts
Tax reliefs

- Tax reliefs and expenditures help define the tax base
- Some are structural and some policy-motivated
- HMRC has identified 1,171
- Sum of reliefs estimated at 21% of GDP, but this reflects interactions. Not the gain from abolition
Why might tax reliefs pose a risk?

• Overall cost not clear and data poor
• Cost of policy-motivated reliefs high and rising
• Less effective scrutiny than equivalent pots of spending
• Lack of transparency and HMRC commentary
• No systematic evaluation of effectiveness
• Add to complexity and encourages avoidance
Tax reliefs

Per cent of GDP
Why might tax reliefs pose a risk?

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Digitalisation

• Risks in both directions

• Poses challenges in terms of what economic activity can be taxed and where

• More and better data could aid administration

• Multilateral action to address downside risks?
Non-interest spending: forecasts

Per cent of GDP

2000-01 2005-06 2010-11 2015-16 2020-21

Treasury forecasts
OBR forecasts
Outturn

Office for Budget Responsibility
Spending risks

• Medium term
  – ‘Austerity fatigue’
  – Health spending (now crystallised)
  – Shrinking spending limit share
  – Local authority reserves and commercial activity
  – Welfare reform and legal challenges

• Long term
  – Non-demographic health and social care costs
  – Ageing population and triple-lock
Free TV licences for over-75s

- July 2015 Budget: BBC loses compensation for lost revenue and given decision on future policy

- Maintaining status quo would cost BBC £745m, but confining to PC recipients reduces this to £250m

- But that implies 250k rise in take-up costing £850m

- Highlights risks from hypothecation

- Will consider fully in our next forecast
Balance sheet risks

• Balance sheet risks little changed
• But better monitoring and management
• Fiscal illusions remain an issue
• Housing associations off balance sheet
• But better treatment of student loans
Debt interest and debt stock

Per cent of GDP

Net debt (LHS)
Net interest payments (RHS)

March 2019 EFO
‘R-G’ favourable in most countries

(average from 2019 to 2024)
Nominal growth and interest rates

Effective nominal interest rate (R)
Year-on-year change in nominal GDP (G)
Growth-corrected interest rate (R-G)

WWI  WWII  Post-war decades  Post-crisis

Per cent

1900-01  1925-26  1950-51  1975-76  2000-01
The distribution of ‘R-G’ since 1900

![Graph showing the distribution of the difference between effective interest rate and nominal GDP growth (percentage points) from 1900 to 2020. The graph is divided into categories: Less than -10, -10 to -7½, -7½ to 5, 5 to 2½, 2½ to 0, 0 to 2½, 2½ to 5, 5 to 7½, 7½ to 10, and More than 10. The categories are further divided into Wars, Peacetime, Total, and Post-crisis. The graph indicates the number of years within each category, with more favourable differences on the left and less favourable on the right.]

**Number of years**

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Climate change

• Scale of fiscal risk depends on temperature change

• Risks from sudden shocks (extreme weather events) and long-term pressures (adaptation and mitigation)

• If Paris targets broadly met, less costly than recessions / financial crises and healthcare cost pressures / ageing?

• But climate-related risks not well modelled or understood

• Hope to do more quantitative analysis in future, drawing on central bank analysis of financial sector risks
A no-deal Brexit stress test

• Based on the IMF’s ‘no deal, no transition’ scenario A in the April World Economic Outlook

• Not necessarily the most likely – scenario not a forecast

• Less severe than some and than our 2017 stress test

• But useful to illustrate potential channels
Stress test: real GDP

![Stress test graph showing real GDP over time from 2013 to 2023. The graph compares 'Stress test' and 'March 2019' scenarios. The 'Stress test' scenario shows a consistent increase, while the 'March 2019' scenario fluctuates slightly before rising steadily.](image-url)
Stress test: nominal GDP

Potential output
Output gap and other
Deflator
Nominal GDP

Percentage points difference from March forecast
Stress test: borrowing

-20
-10
0
10
20
30
40
50
60
2017-18 2019-20 2021-22 2023-24
£ billion difference from March forecast
Debt interest spending
Customs duties
Capital taxes
Income tax and NICs
Other
Difference
Conclusion

• Many potential shocks, pressures and risks taken on by choice are much as they were two years ago

• But ‘no deal’ Brexit risks more prominent

• ‘Austerity fatigue’ risk partly crystallised

• But still apparent in leadership shopping lists and open discussion of looser fiscal objective