Office for
Budget
Responsibility

Fiscal sustainability report 2020

The live event will begin at 11am

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Fiscal sustainability report 2020

Robert Chote
Chairman

London
14 July 2020

Background

- **Most FSRs**
  - Run long term public finance projections off the latest medium-term Budget forecast
  - Discuss the National Accounts and Whole of Government Account balance sheet

- **Because of the coronavirus and delay to the WGA, this FSR**
  - Sets out three scenarios for the economy and the public finances
  - Runs simplified long-term public finance projections off them
  - Discusses changes in fiscal risks

- **Last week's HMT statement finalised too late to include in the numbers**
  - So we discuss its impact in more general terms

- **Thanks to staff and stakeholders for amazing job in current circumstances**

The three scenarios

- **Starting point: GDP fell by 25% between February and April. Now recovering**
- **Pace of recovery and long-term 'scarring' depend on**
  - Course of pandemic and development of effective vaccines and treatments
  - Speed and consistency with which Government lifts health restrictions
  - Response of individuals and businesses as it does so
  - Effectiveness of policy in protecting viable businesses and sustaining employment
- **Three scenarios**
  - Upside: GDP down 10.6% this year; pre-virus peak by 21Q1; no long-term scarring
  - Central: GDP down 12.4% this year; pre-virus peak by 22Q4; GDP down 3% at horizon
  - Downside: GDP down 14.3% this year; pre-virus peak by 24Q3; GDP down 6% at horizon
- **These are only three illustrative possibilities of many**

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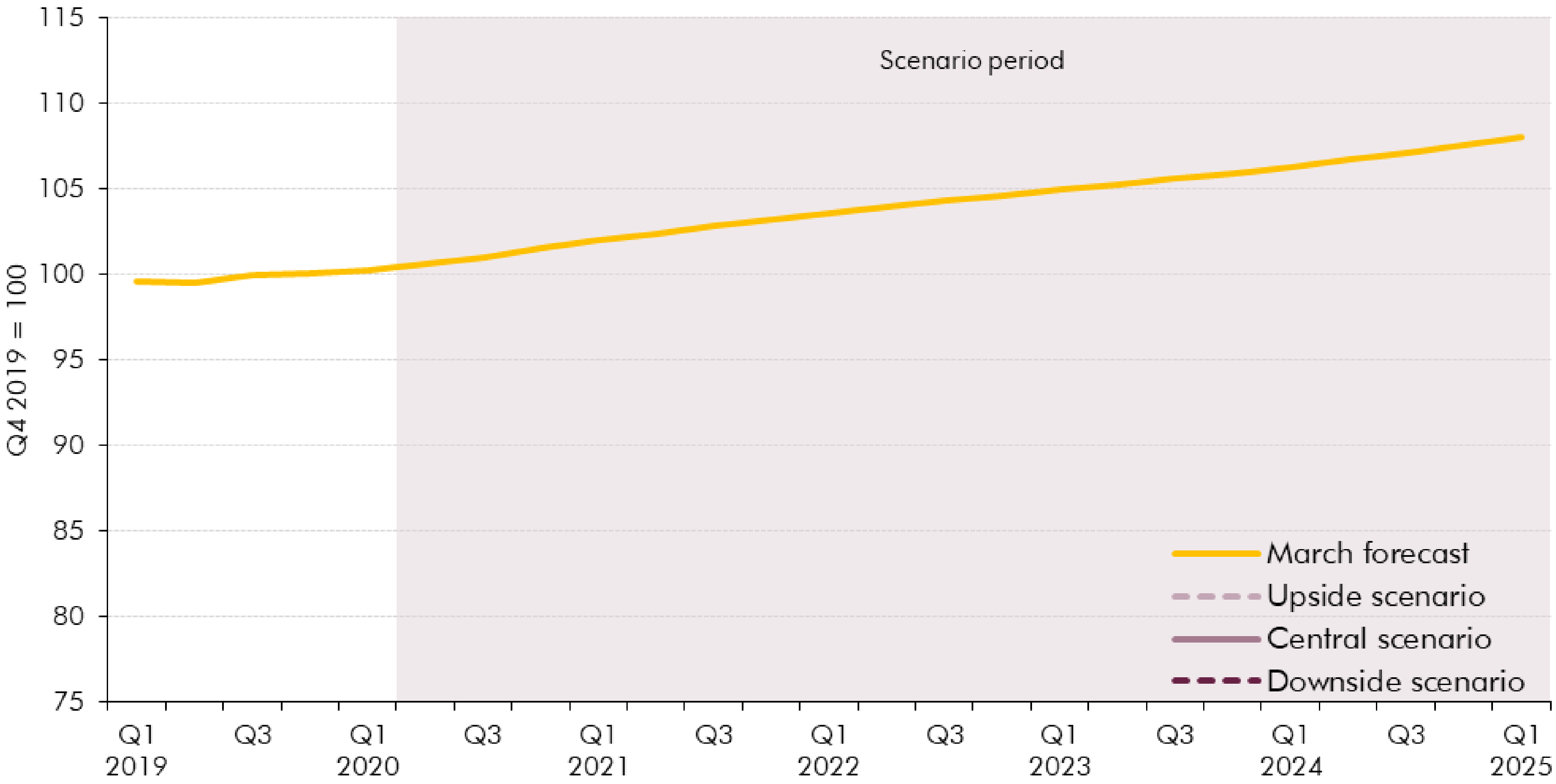
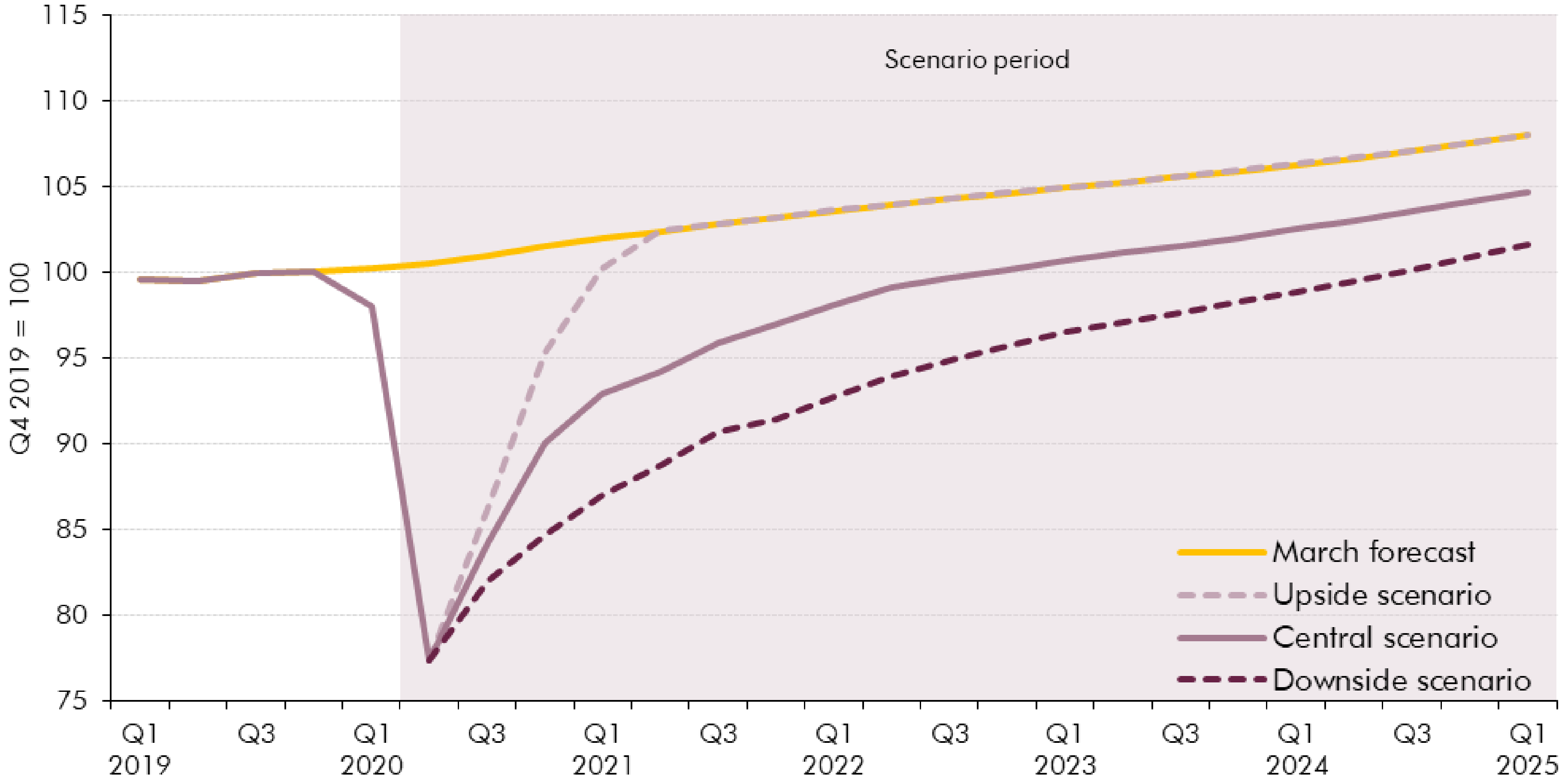
Real GDP versus March forecast



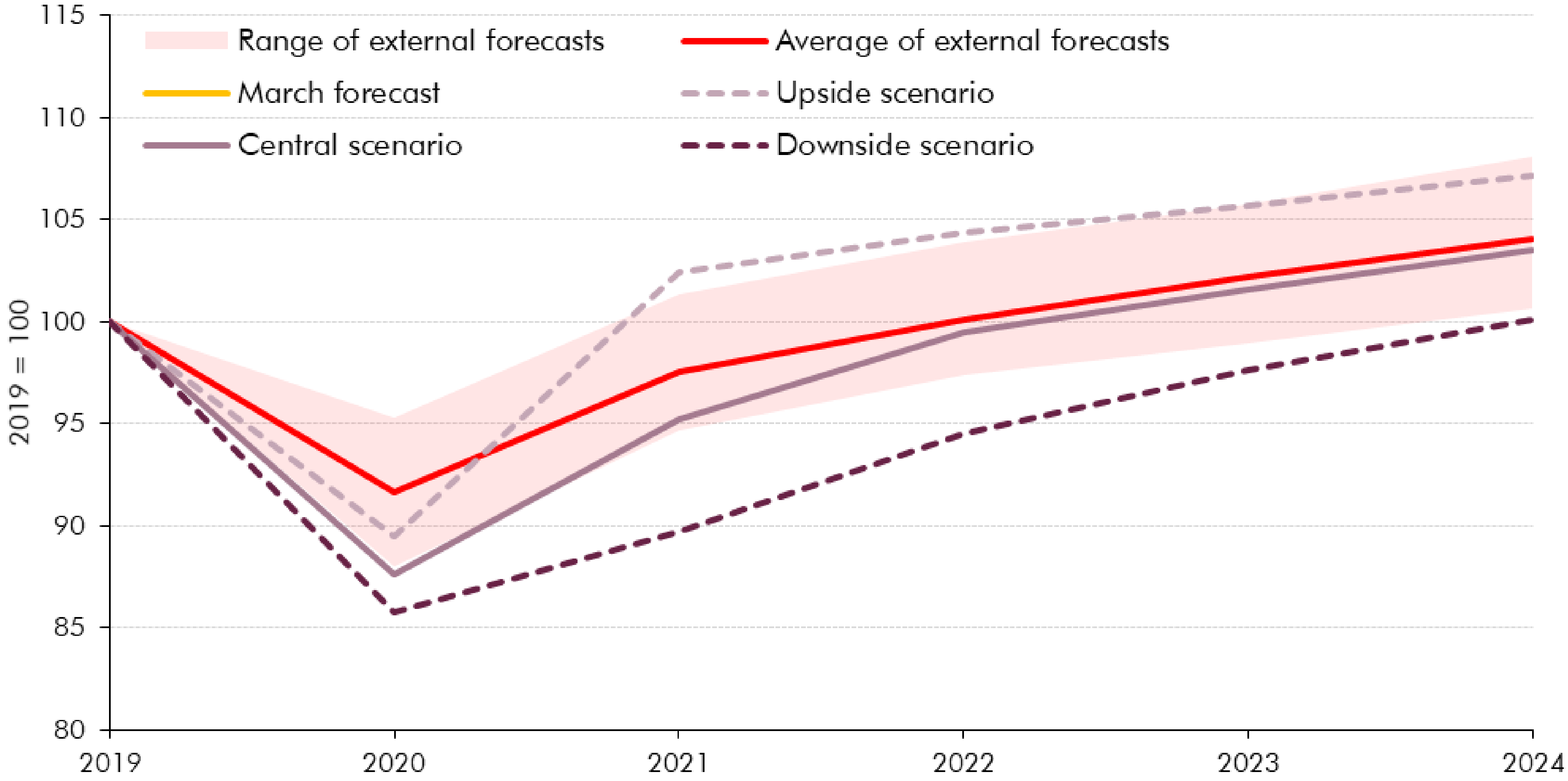
Source: ONS, OBR

Real GDP versus March forecast



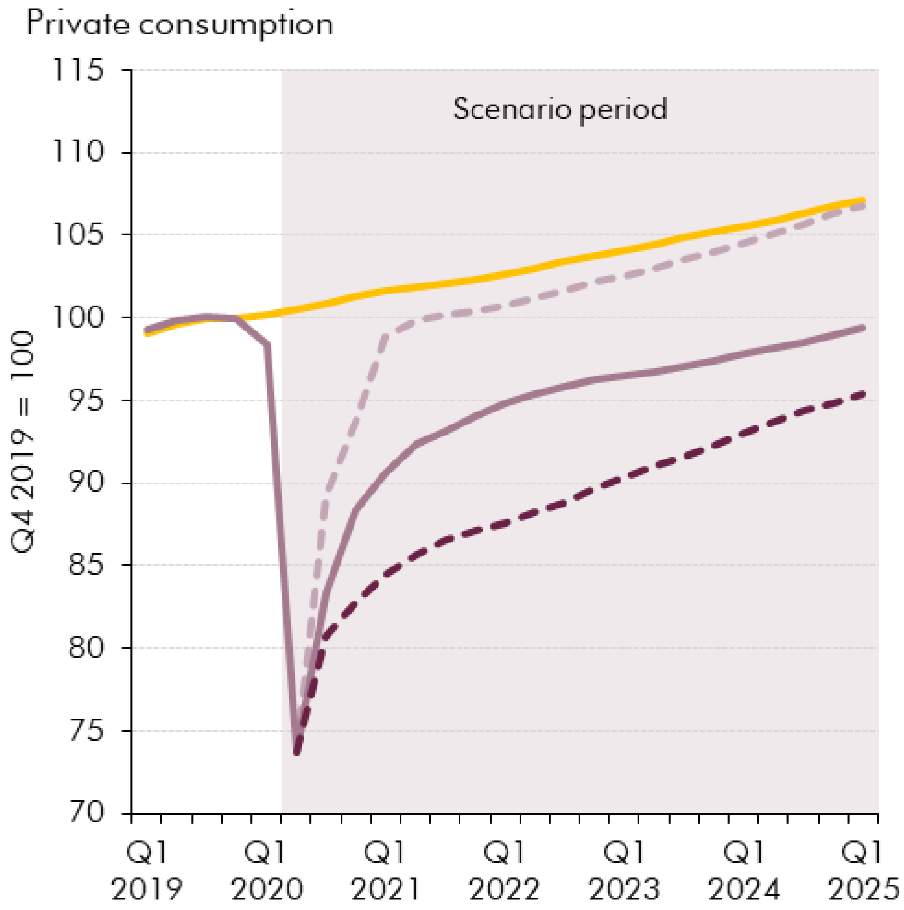
Source: ONS, OBR

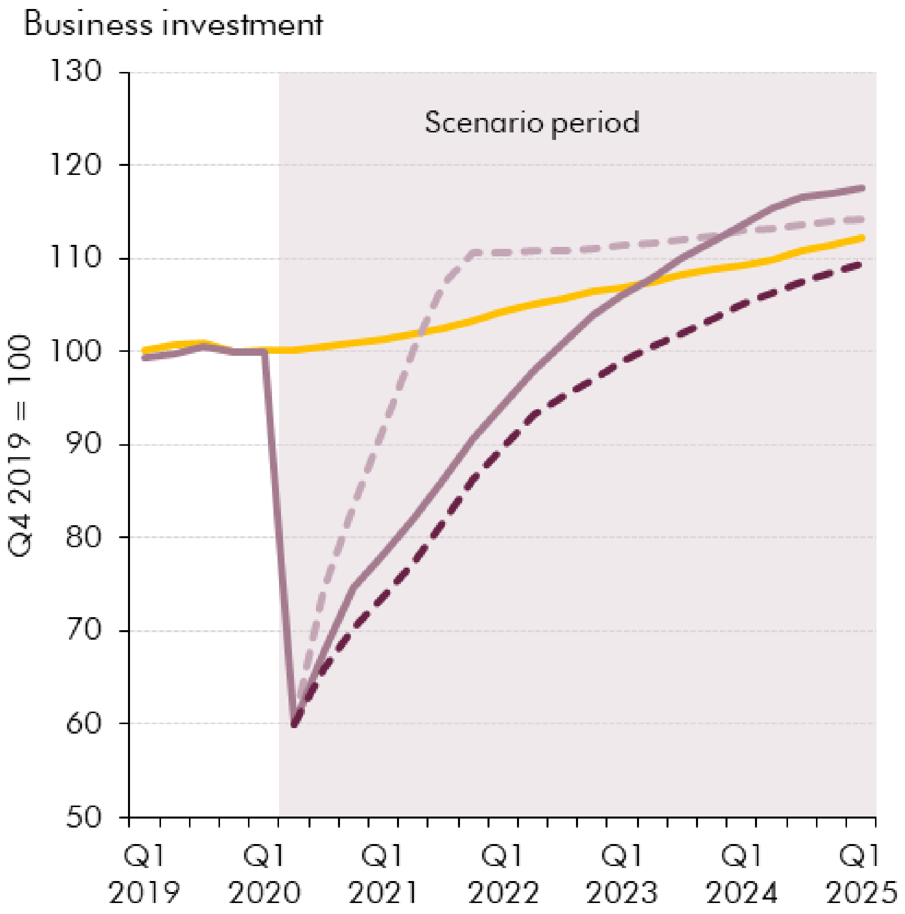
Real GDP versus March forecast



Source: HM Treasury, OBR

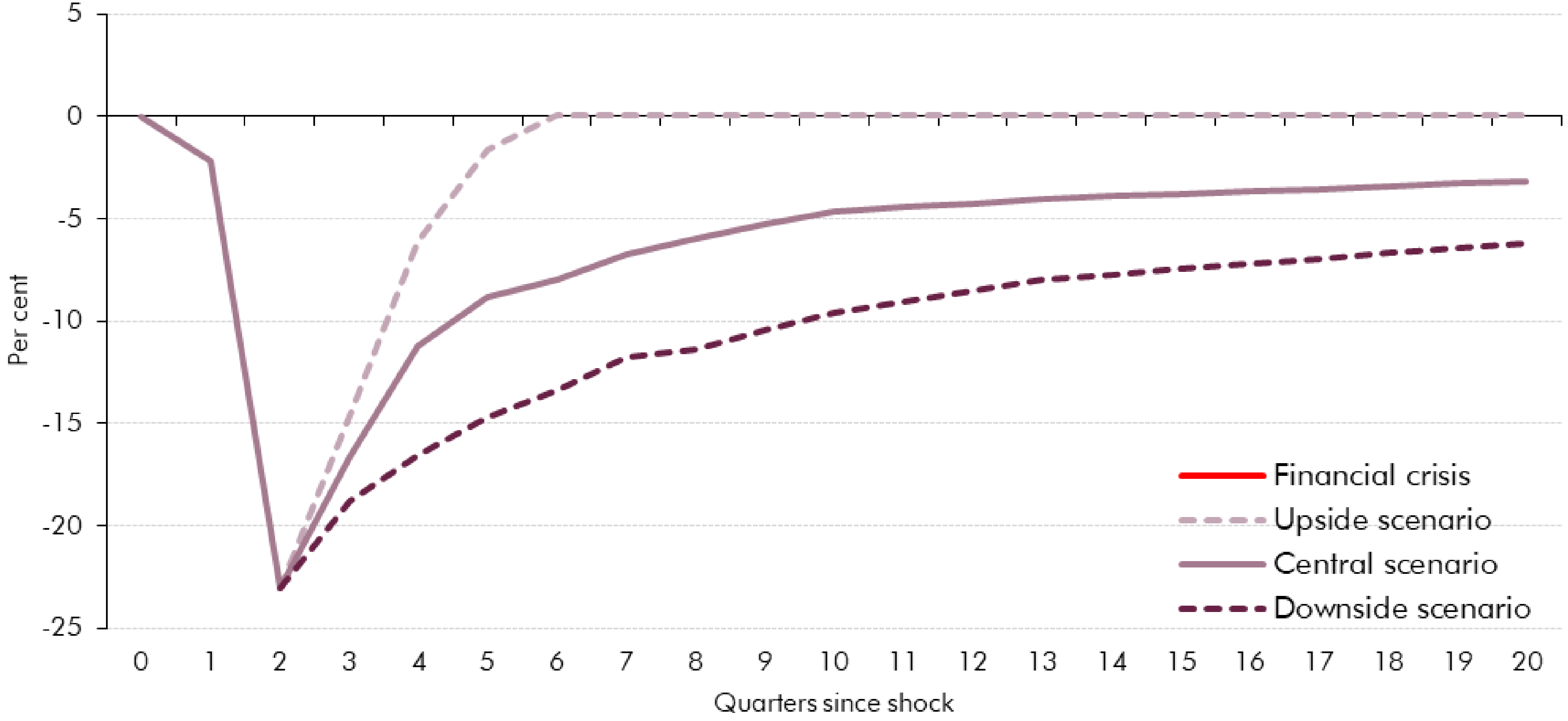
Consumption and business investment





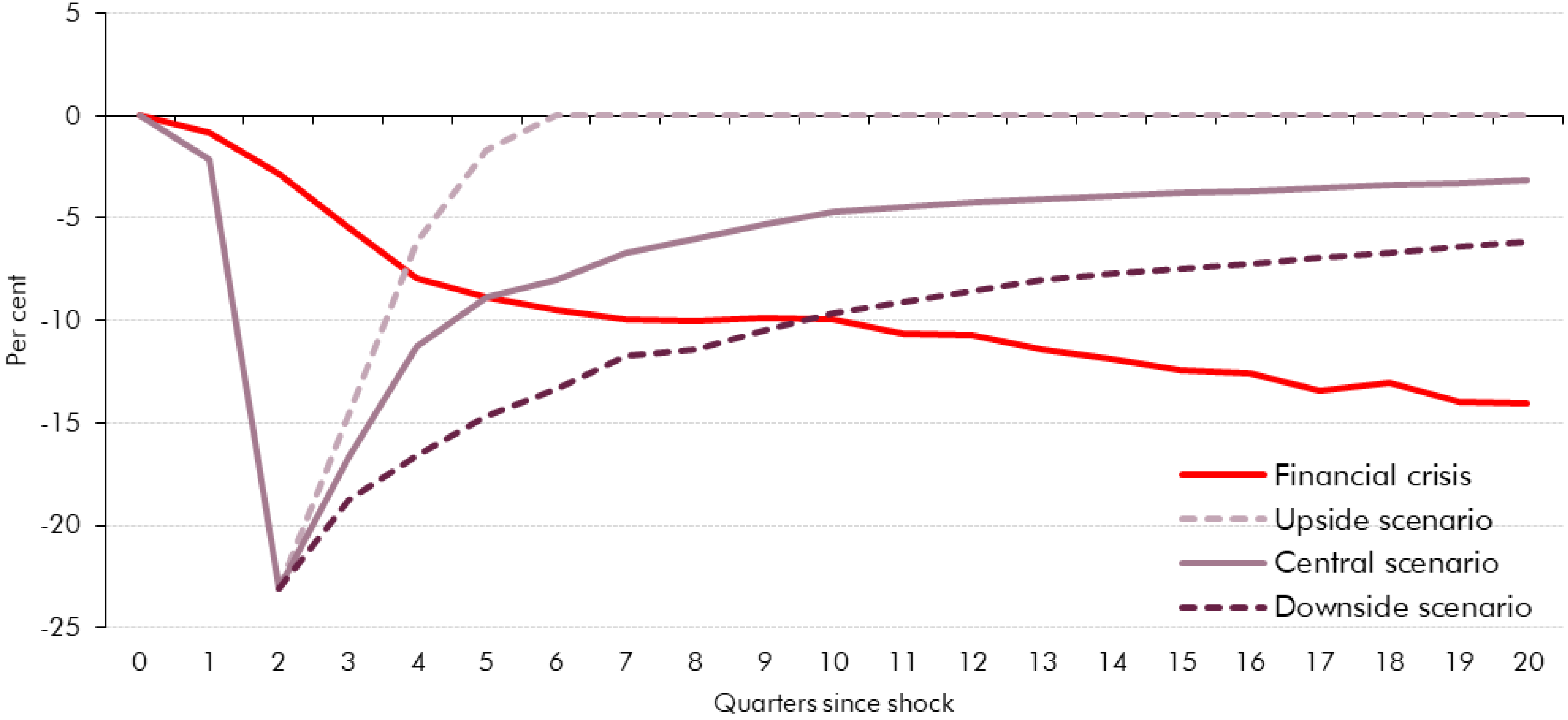
Source: ONS, OBR

Real GDP shortfalls vs pre-shock forecasts



Note: The 'shock' refers to the first quarter in which GDP contracted. For the central, upside and downside scenarios, it is Q1 2020 and for the financial crisis, it is Q2 2008.
Source: ONS, OBR

Real GDP shortfalls vs pre-shock forecasts



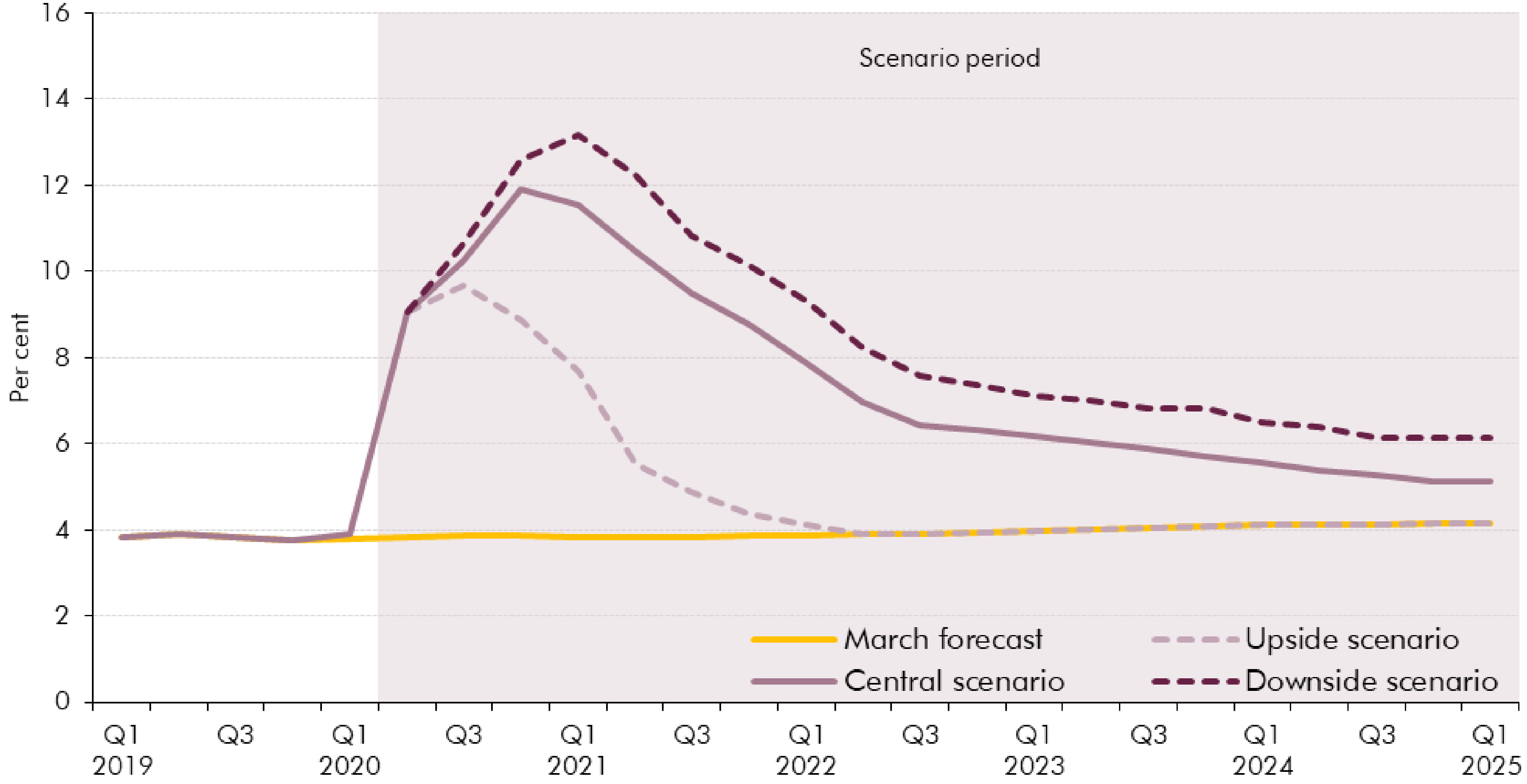
Note: The 'shock' refers to the first quarter in which GDP contracted. For the central, upside and downside scenarios, it is Q1 2020 and for the financial crisis, it is Q2 2008.
Source: ONS, OBR

The labour market

- **In the second quarter, relative to March, we assume**
  – Total hours worked down 29%
  – Employment down 5% (1.8m)
  – Average hours down 25%
  – Output-per-hour up 8% (sectoral impact plus furloughing dominated by low paid)

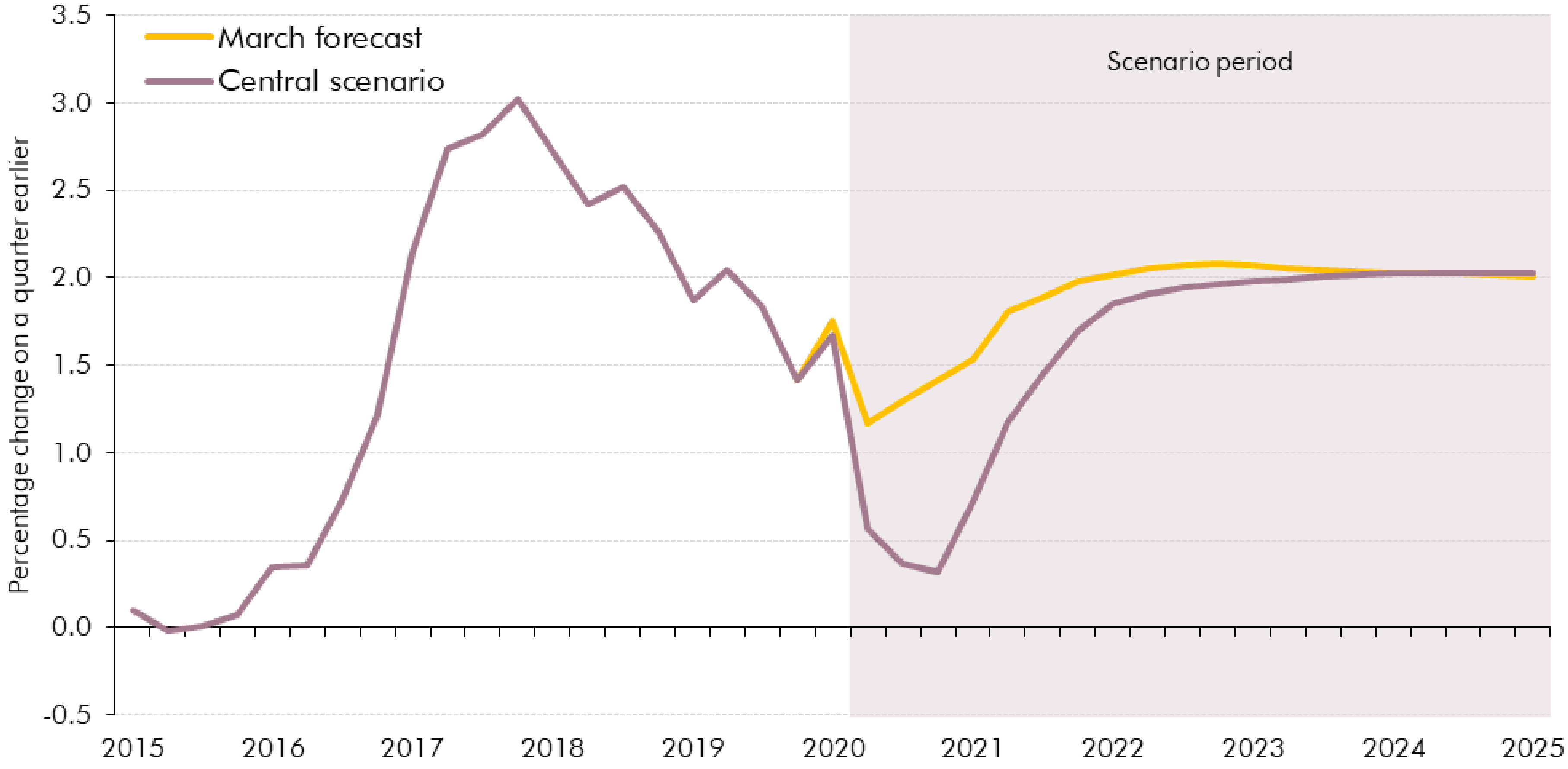
- **Looking ahead**
  – Proportions of furloughed workers entering unemployment: 10%, 15% and 20%
  – Scarring - unemployment rate at five-year horizon: 4.1%, 5.1% and 6.1%

Unemployment rate



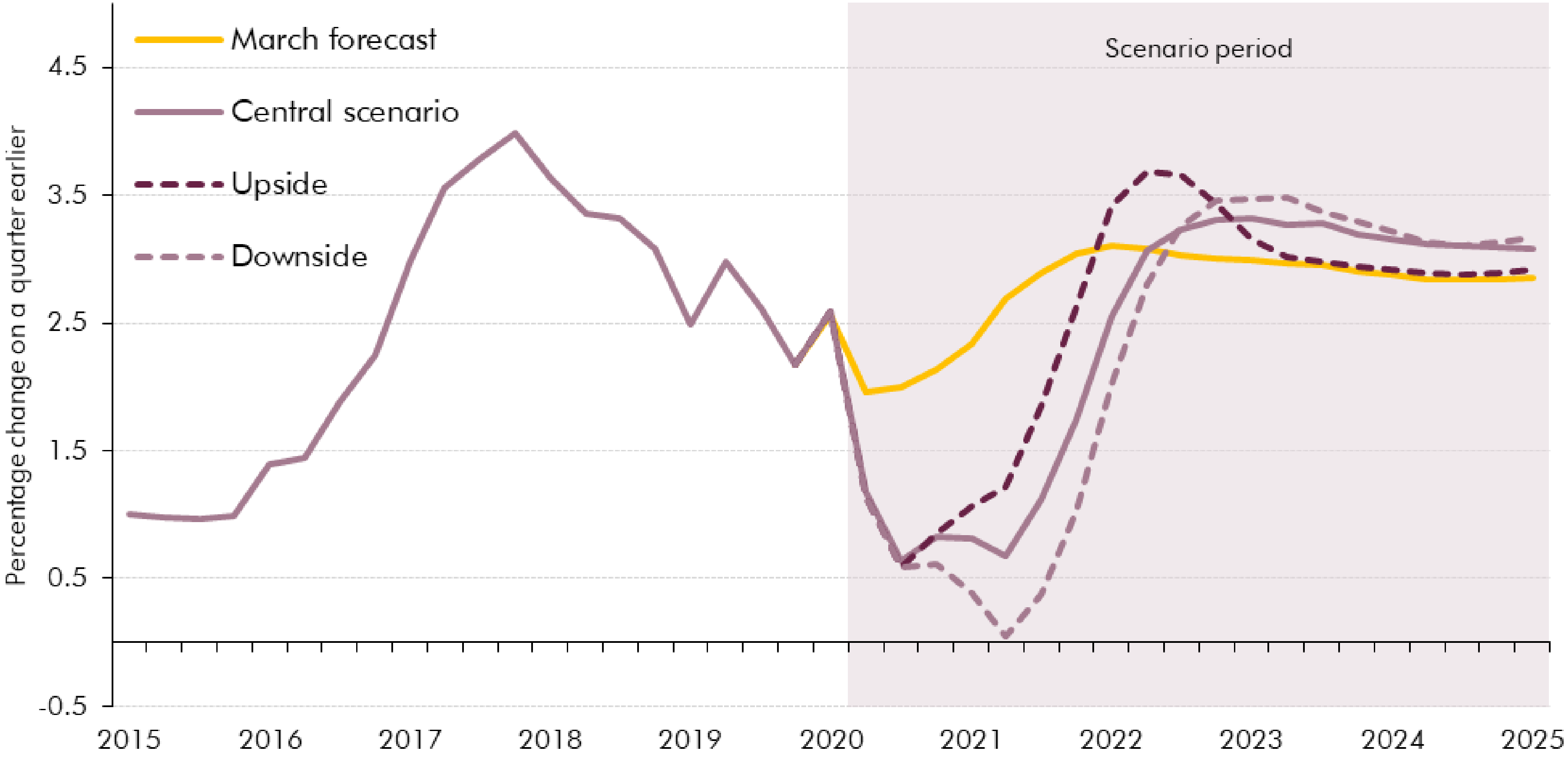
Source: OBR, ONS

CPI inflation



Note: The central, upside and downside scenario paths for inflation have the same assumptions.
Source: ONS, OBR

RPI inflation



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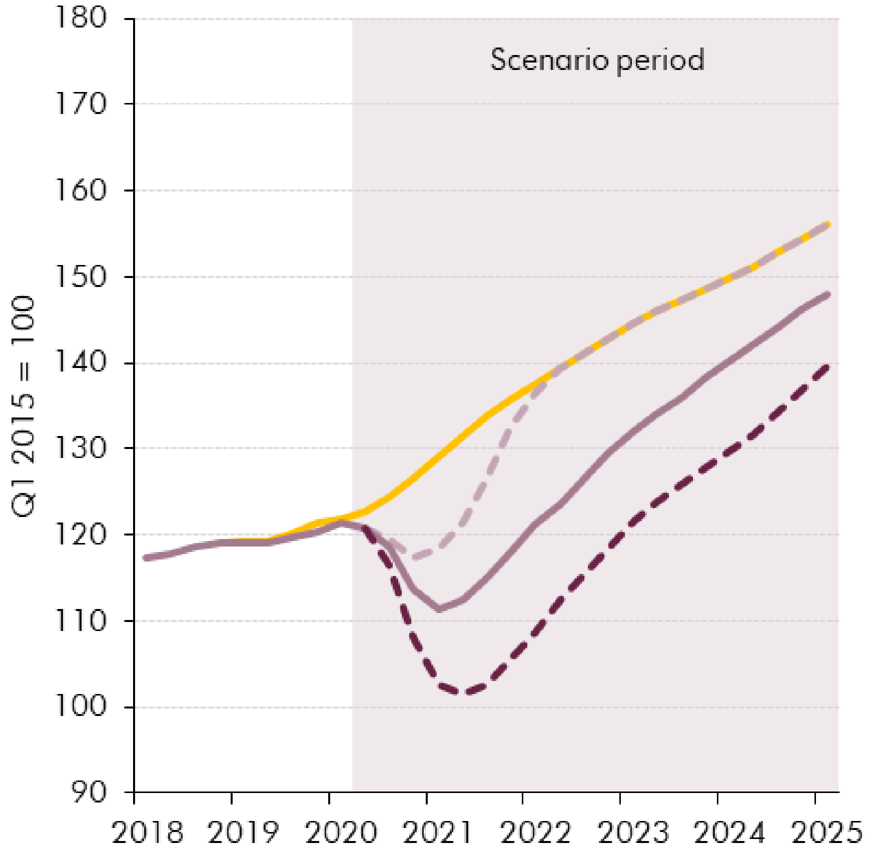
Source: ONS, OBR

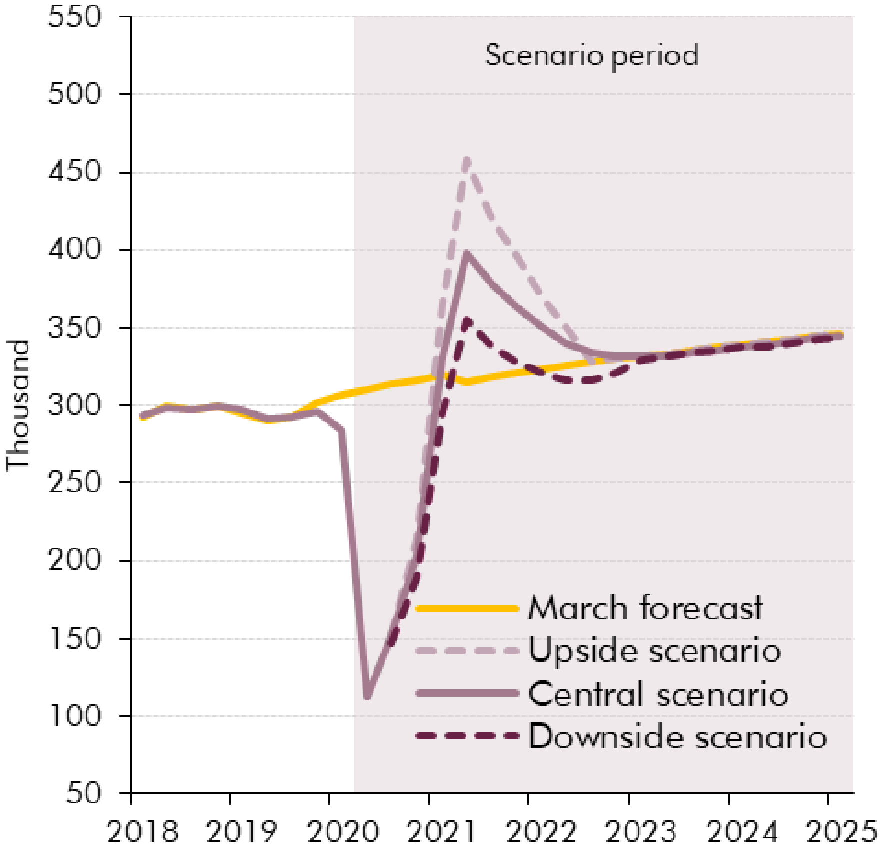
Housing market

House prices



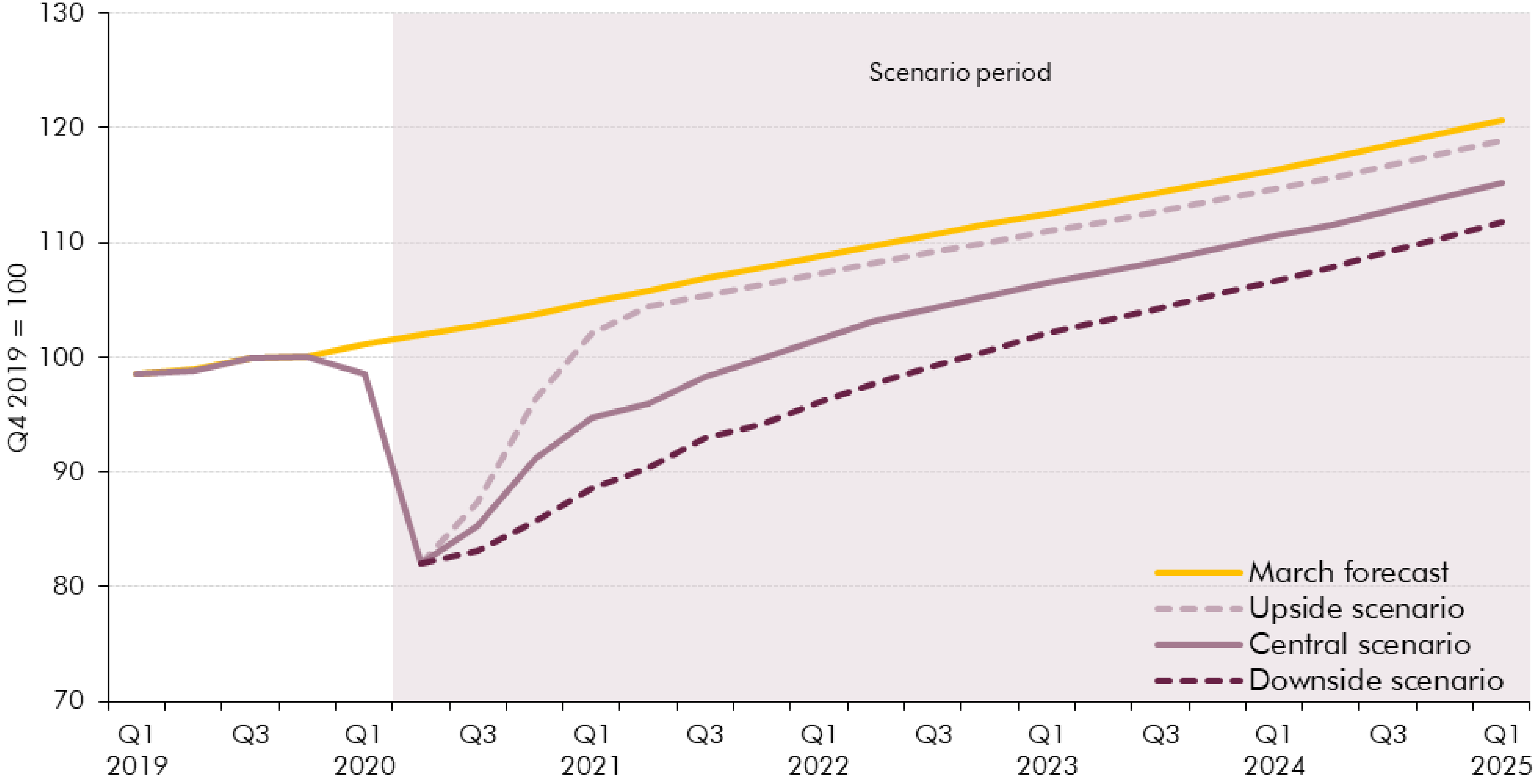
Source: ONS, OBR

Residential property transactions



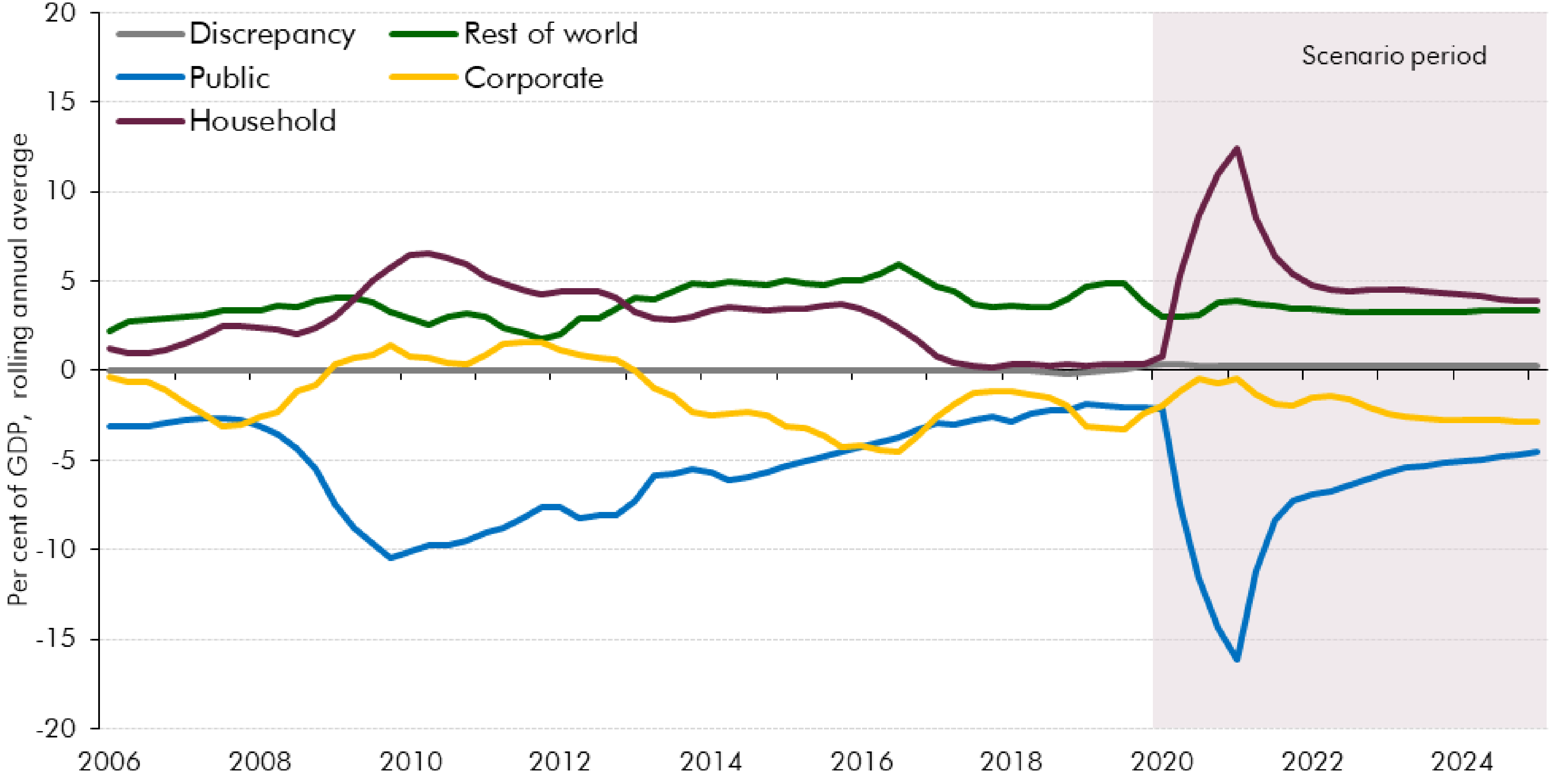
Source: HMRC, OBR

Nominal GDP



Source: ONS, OBR

Sectoral net lending



Source: ONS, OBR

Impact of the SEU

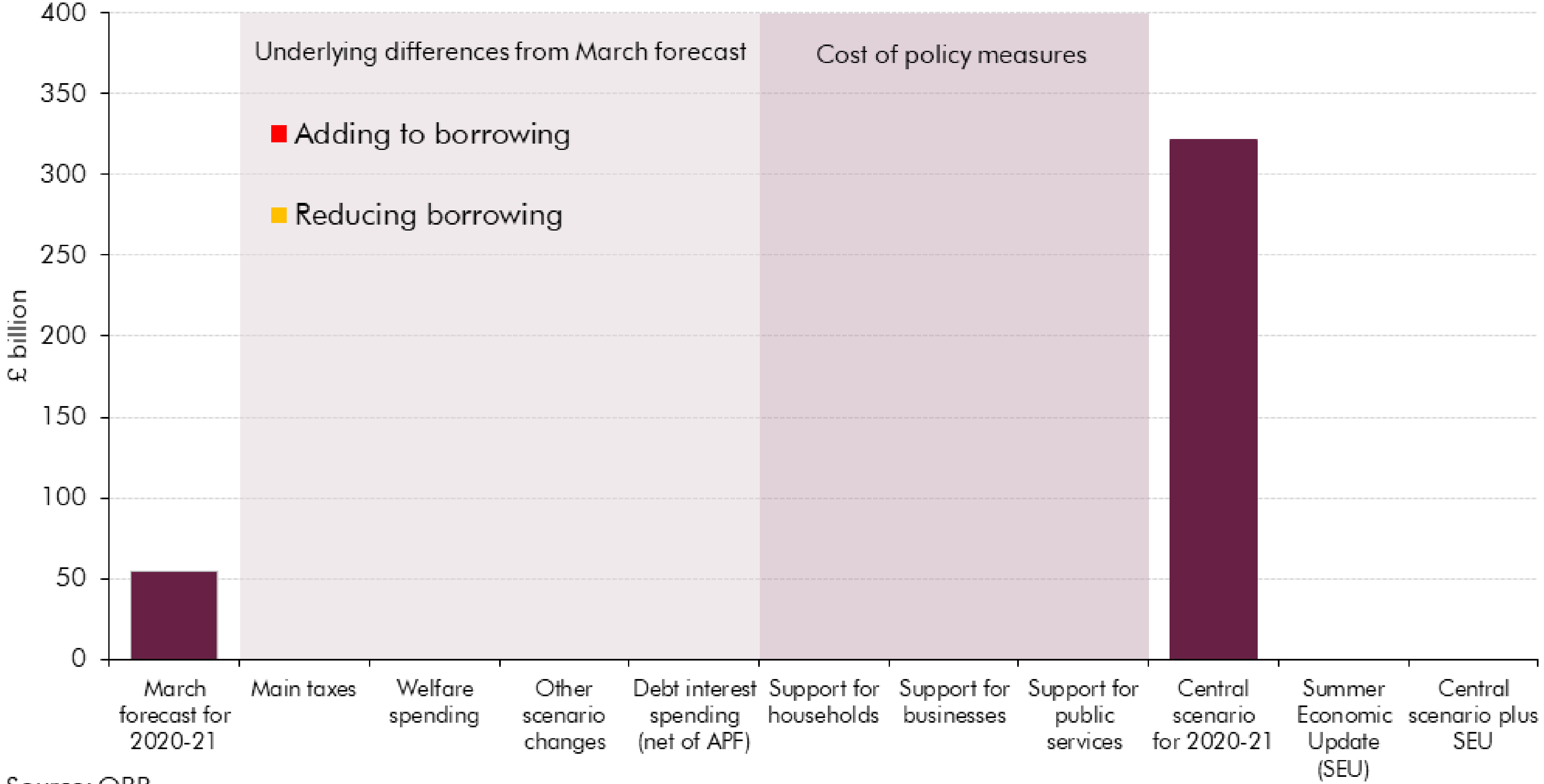
- **Treasury announced jobs package worth 'up to £30bn' and footnoted departmental spending increases of £32.9bn**
  - We estimate overall cost of around £50bn

- **Economic impact**
  - Demand boost raises GDP by around 1½ per cent this year, then fades
  - Temporary VAT cut lowers then raises inflation
  - Stamp duty cut raises transactions this year by 100k, then lowers
  - Job effects beyond demand boost unclear
    - Some modest benefits, but job retention bonus largely deadweight

From economic to fiscal scenarios

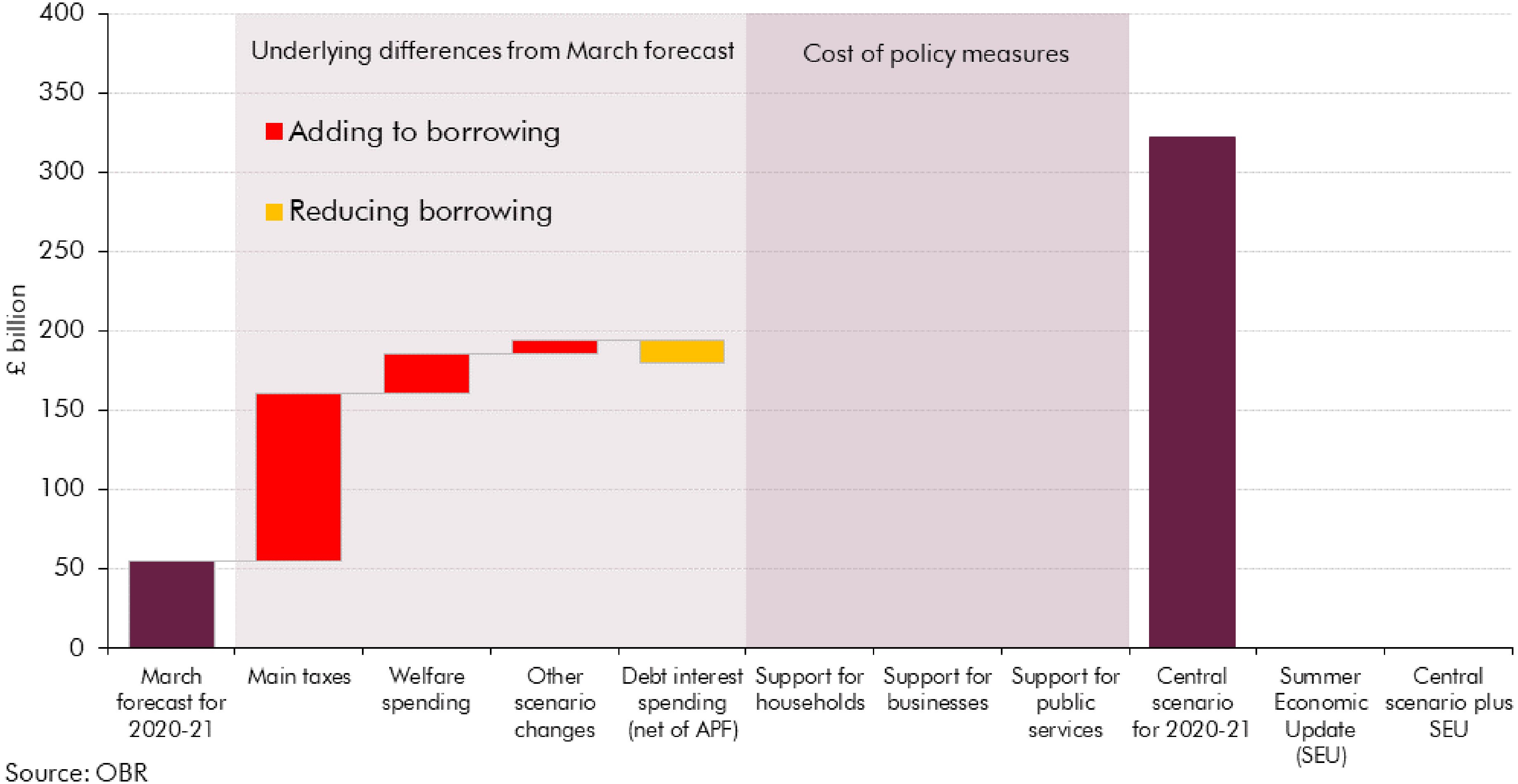
- Normally we prepare a pre-measures forecast and then add the direct effect of measures and their indirect effect via the economy.
- But it is impossible to quantify the economic catastrophe that would have resulted if the Government and Bank had done nothing
- So we add the direct impact of measures to an underlying fiscal scenario that includes their economic impact
- We take into account post-virus policy response, but not other (relatively minor) policy changes announced since March
- In the FSR we develop the central scenario in a relatively detailed bottom-up way and then ready-reckon the upside and downside scenarios from that.

Borrowing in 2020-21: central scenario



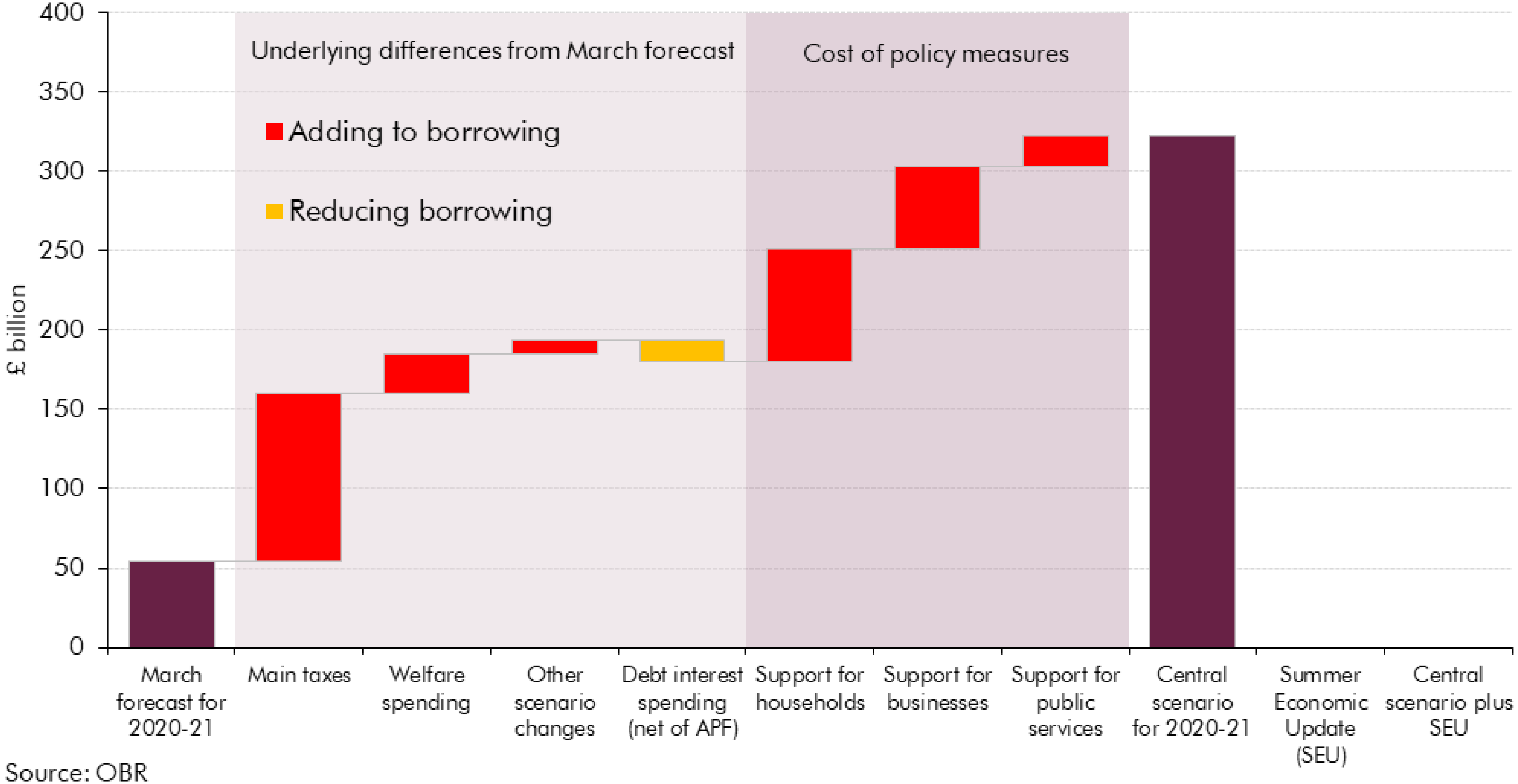
Source: OBR

Borrowing in 2020-21: central scenario



Source: OBR

Borrowing in 2020-21: central scenario



Source: OBR

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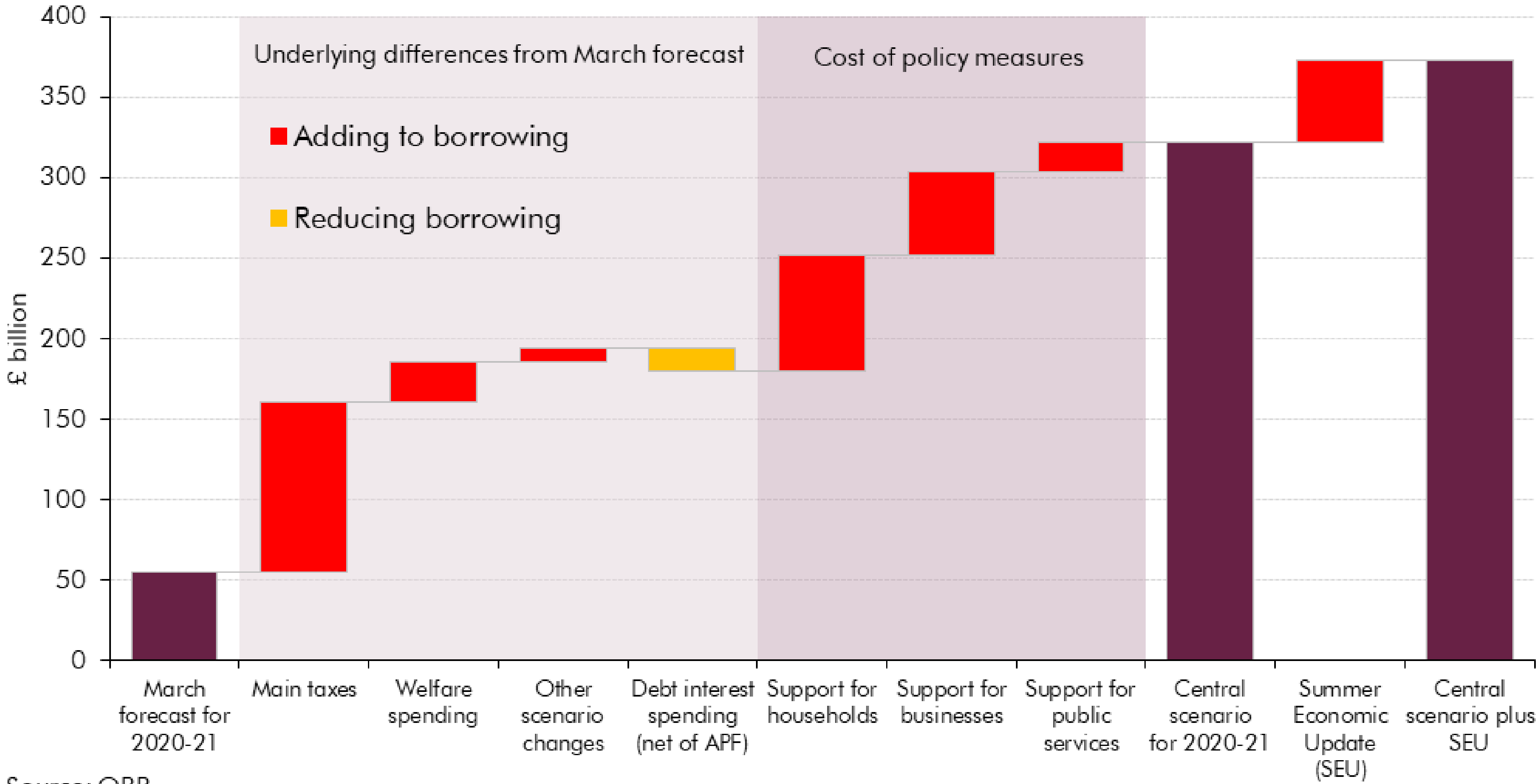
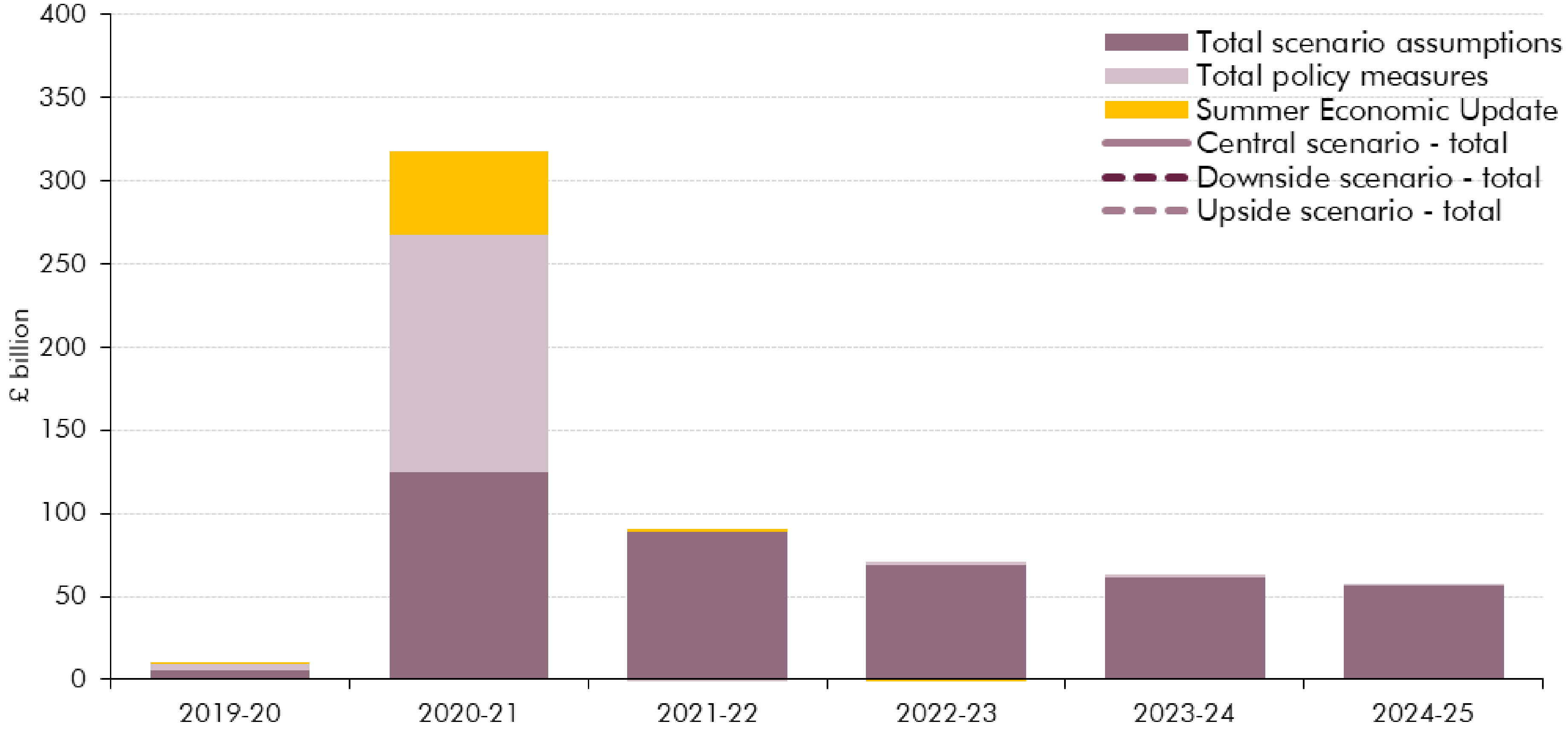


Source: OBR

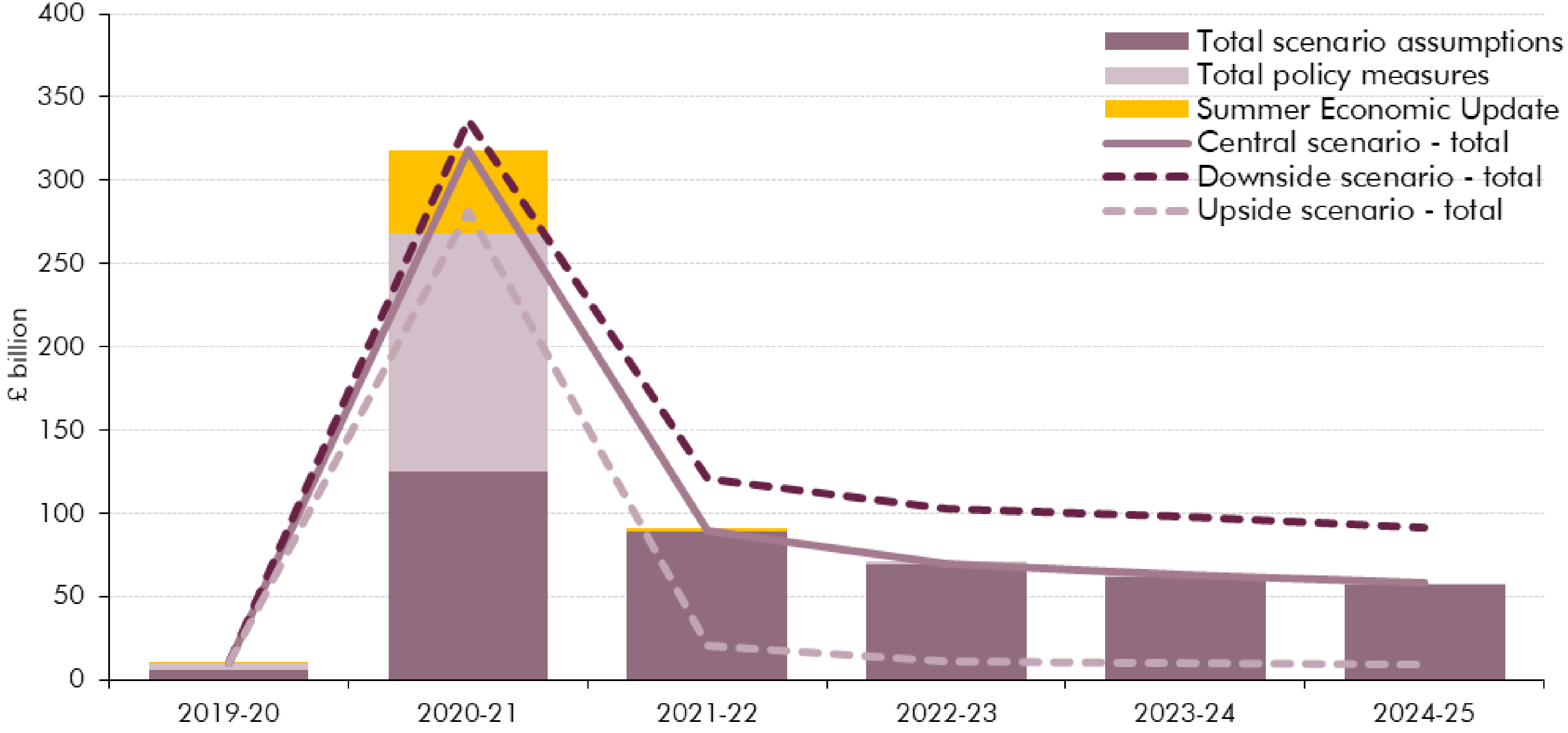
Borrowing vs March: central scenario



Note: In 2019-20, 'Other factors' reflects all non-policy-related differences, including both scenario assumptions and new outturn data.

Source: ONS, OBR

Borrowing vs March: scenarios



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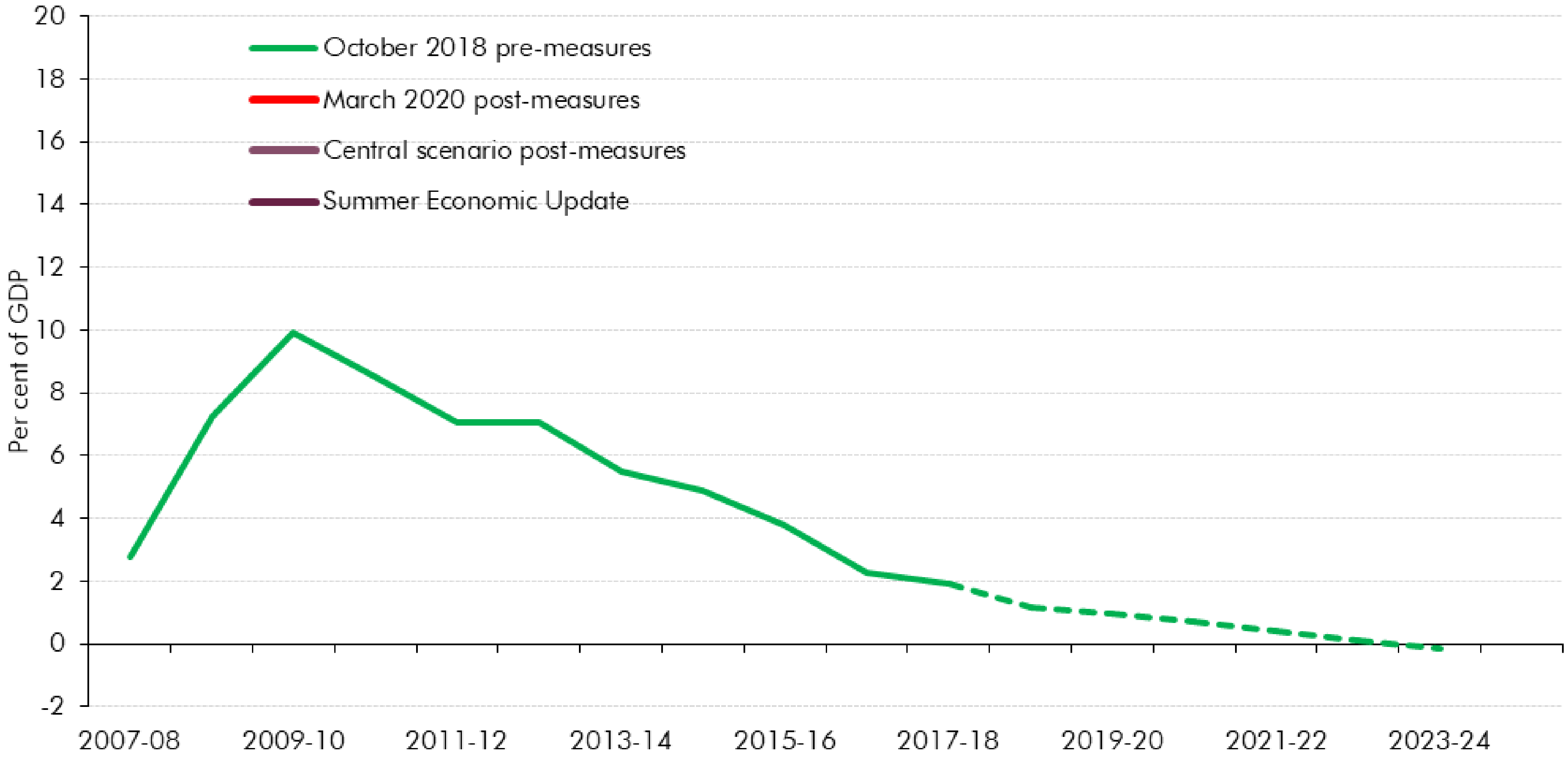
Evolution of net borrowing



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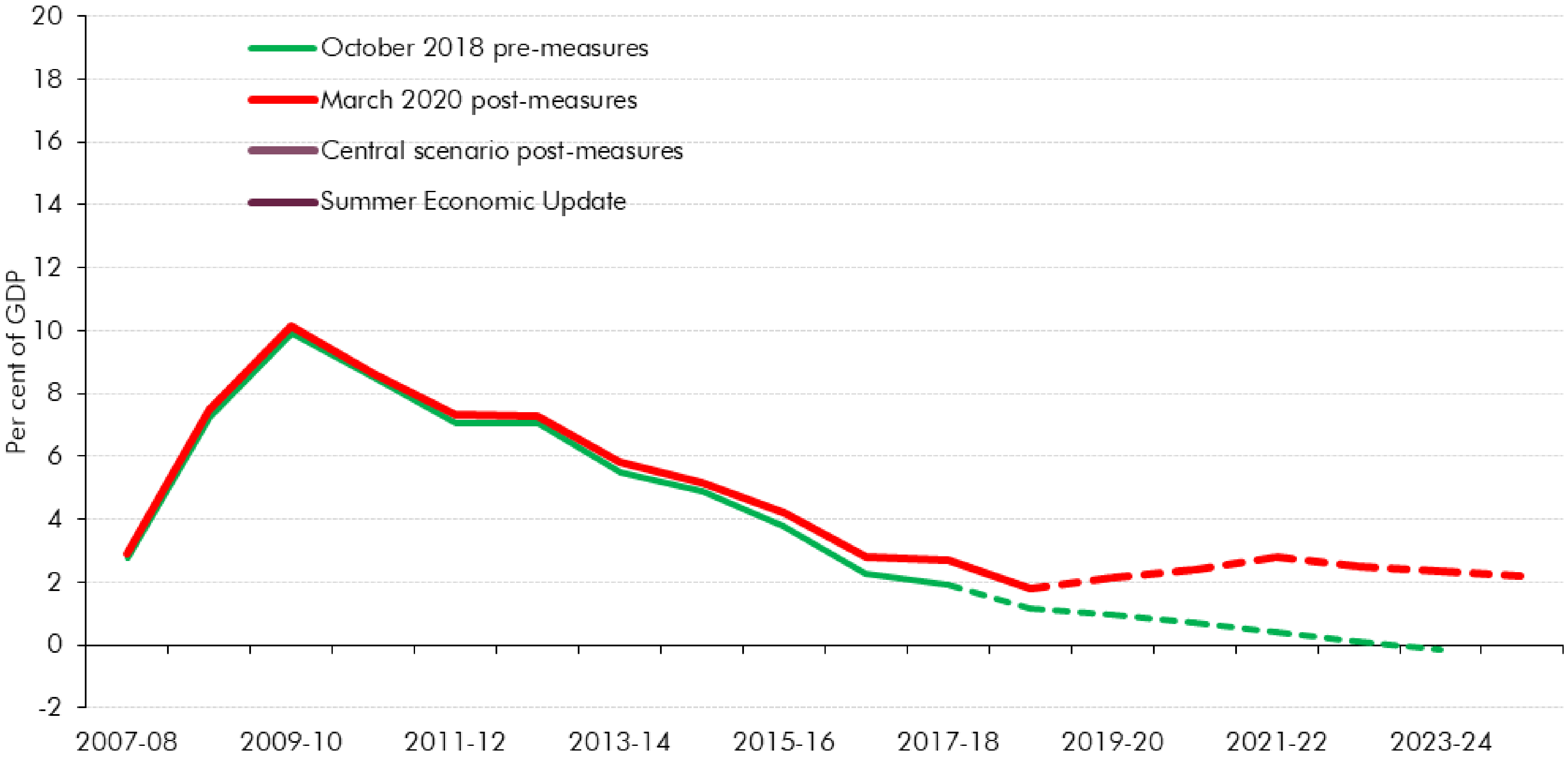

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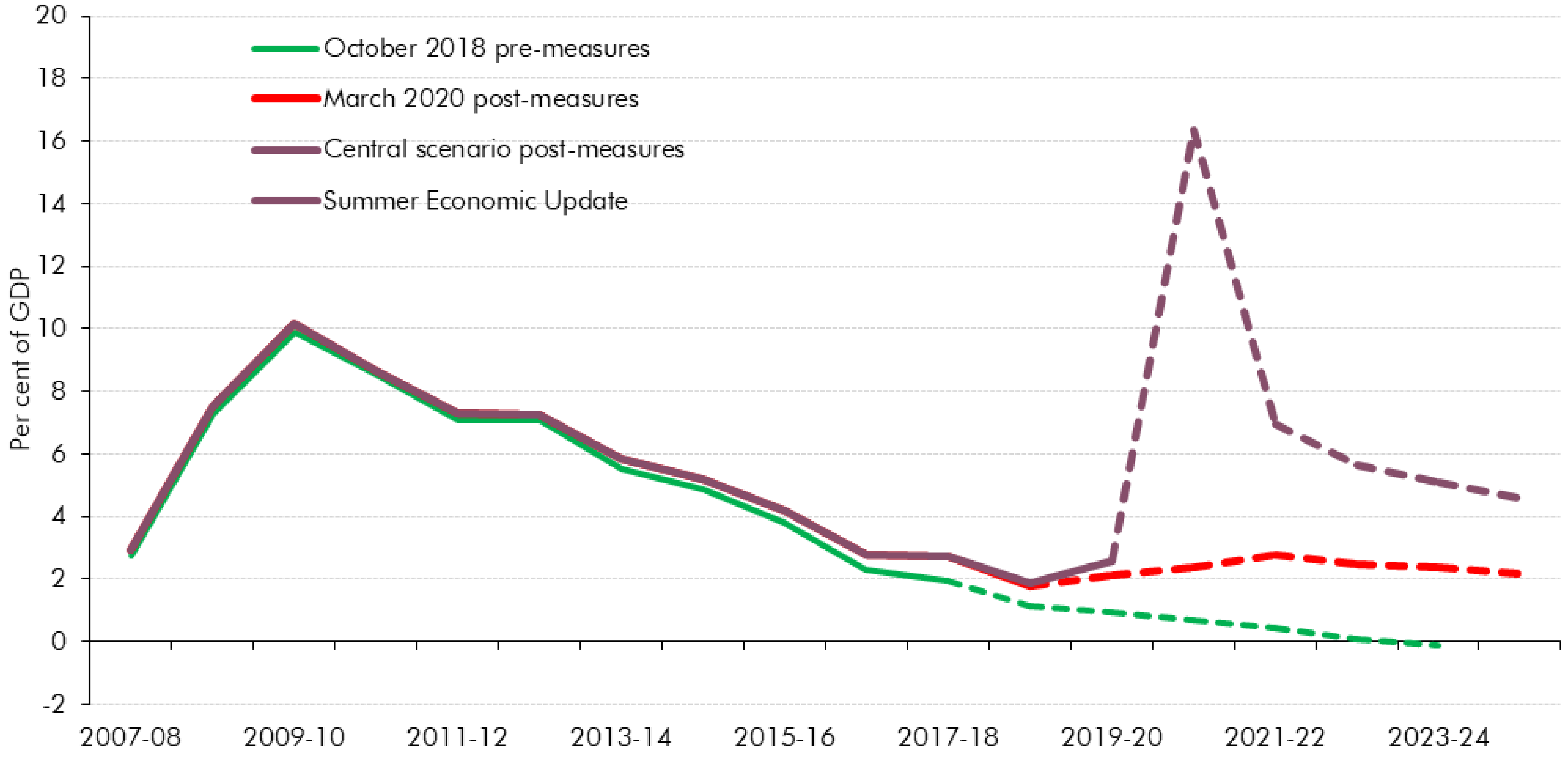

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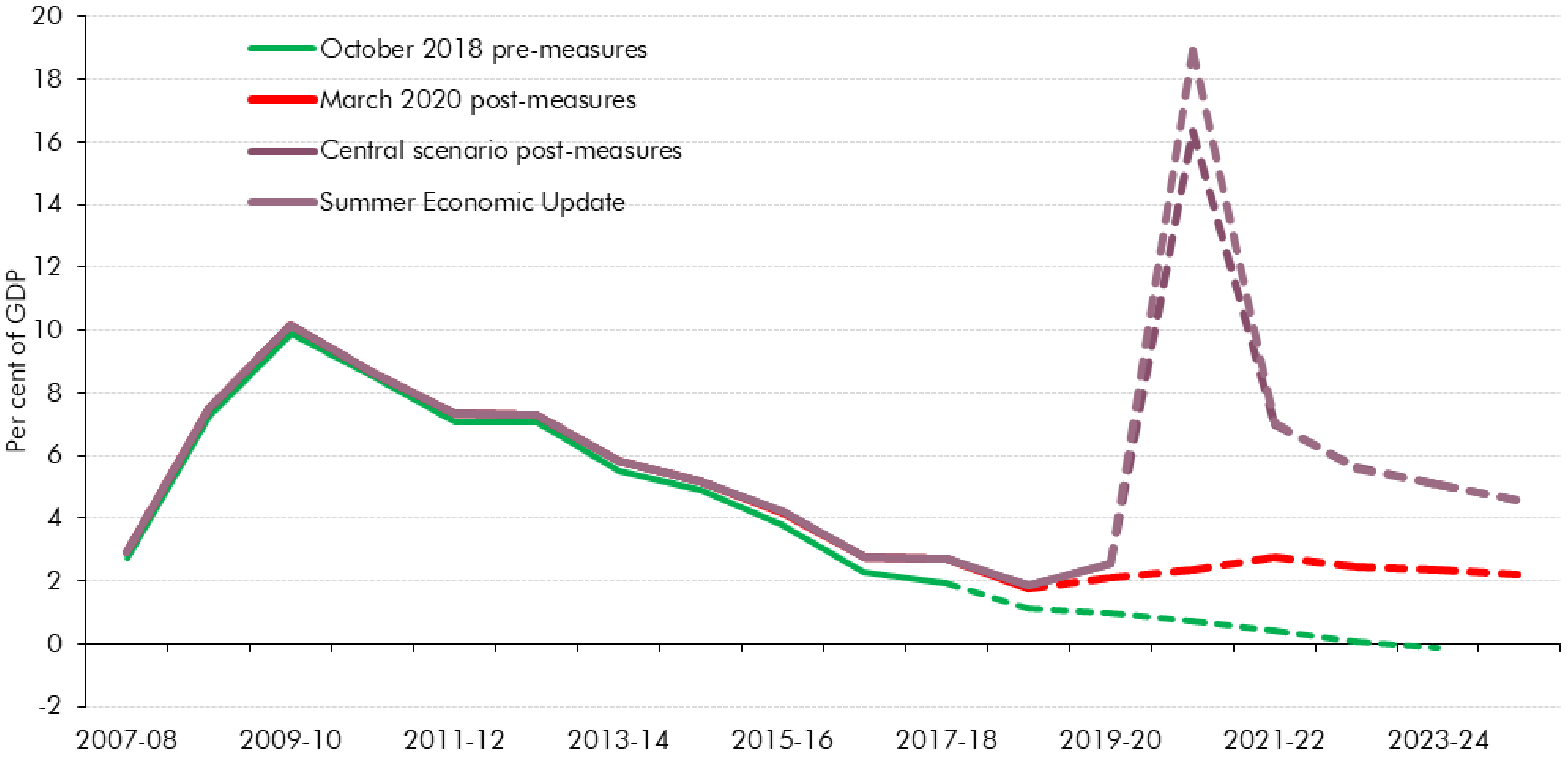
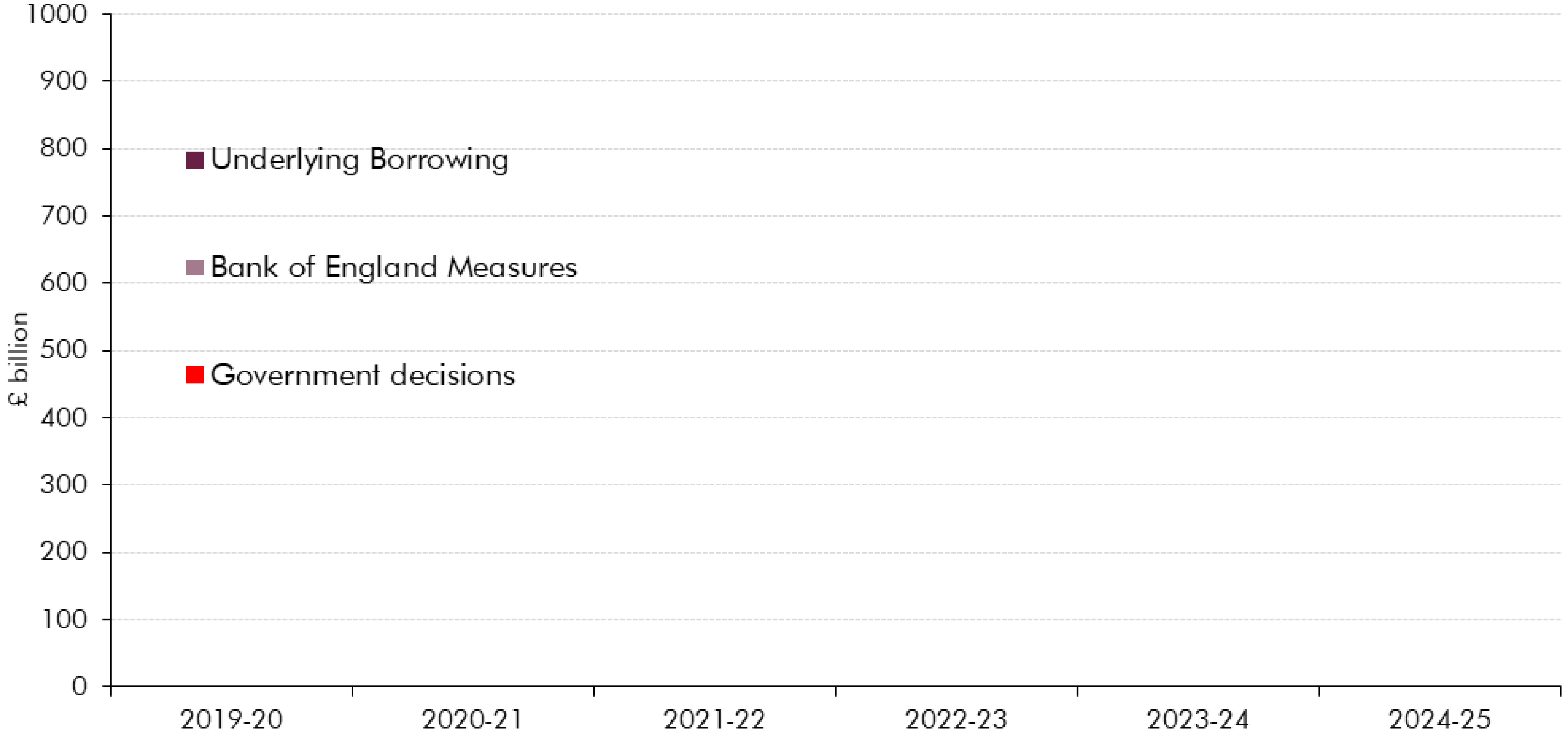


Source: ONS, OBR

Net debt vs March: central scenario



Source: ONS, OBR
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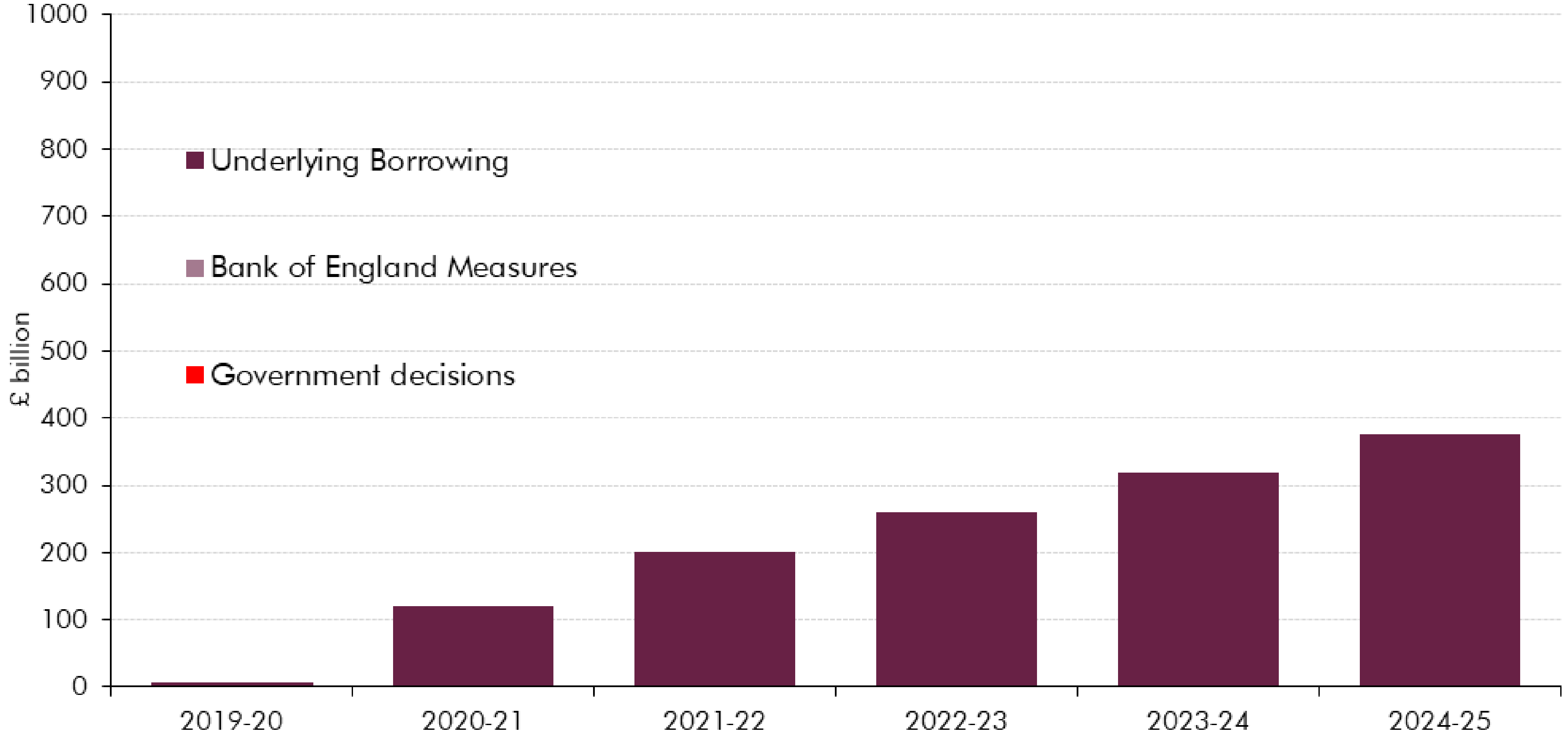

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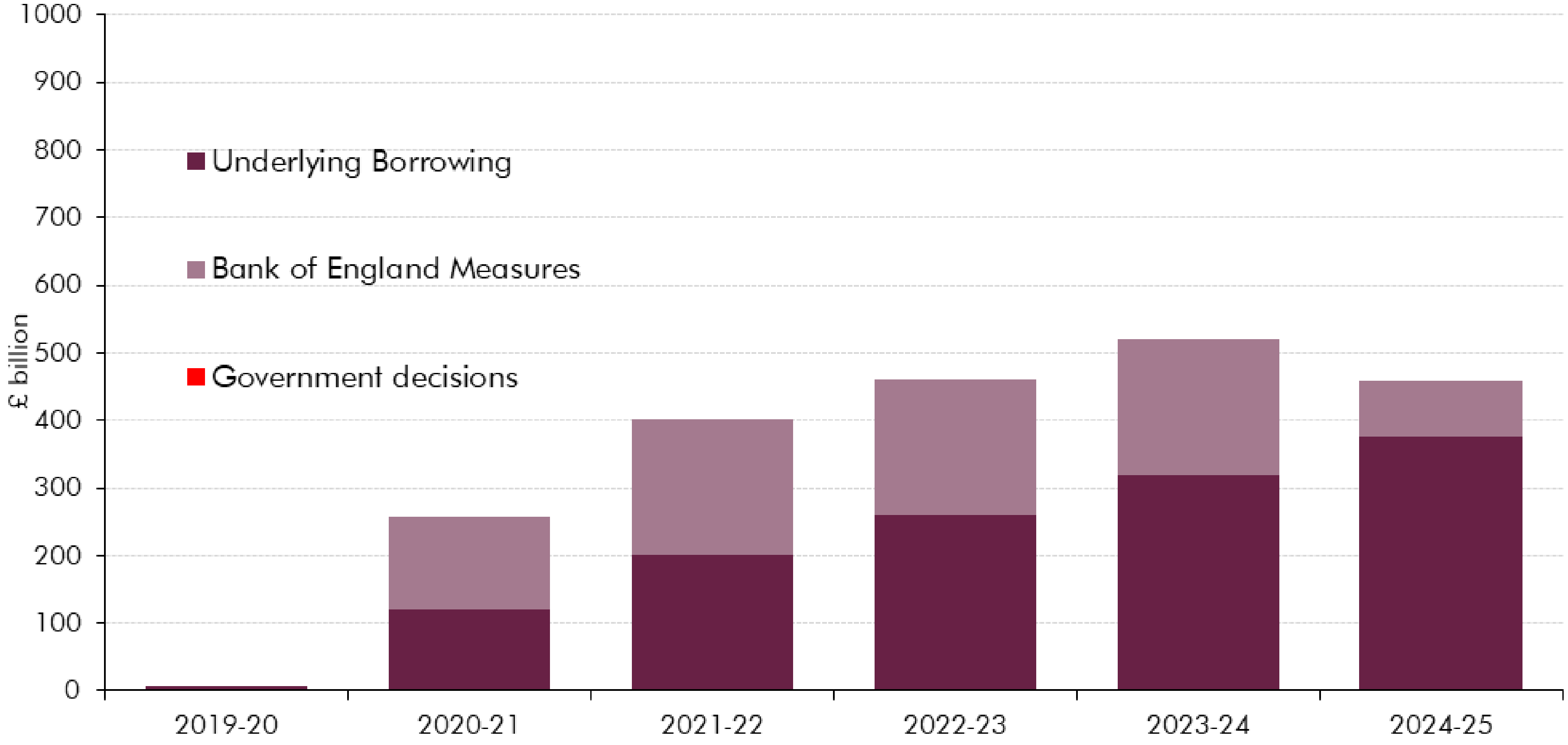

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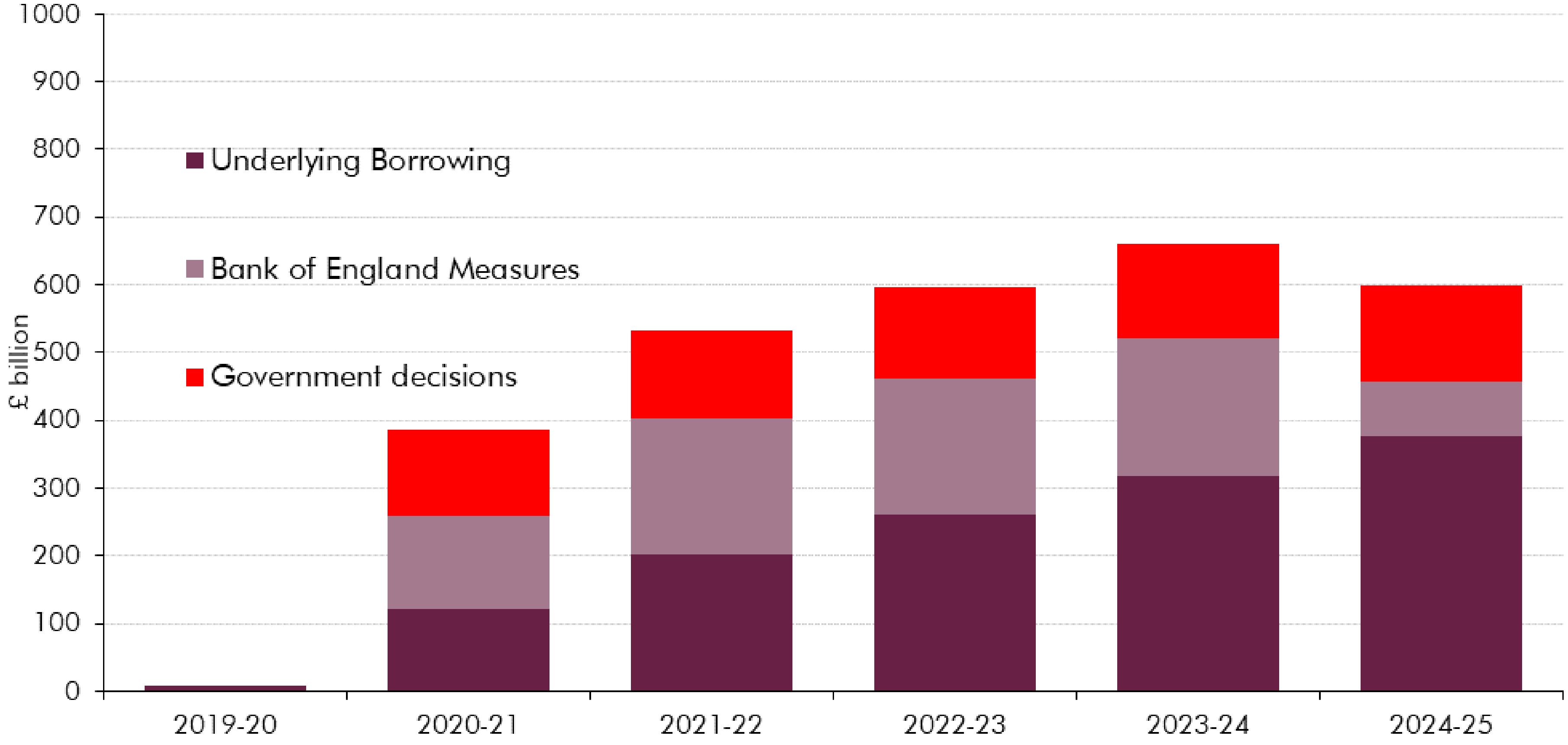

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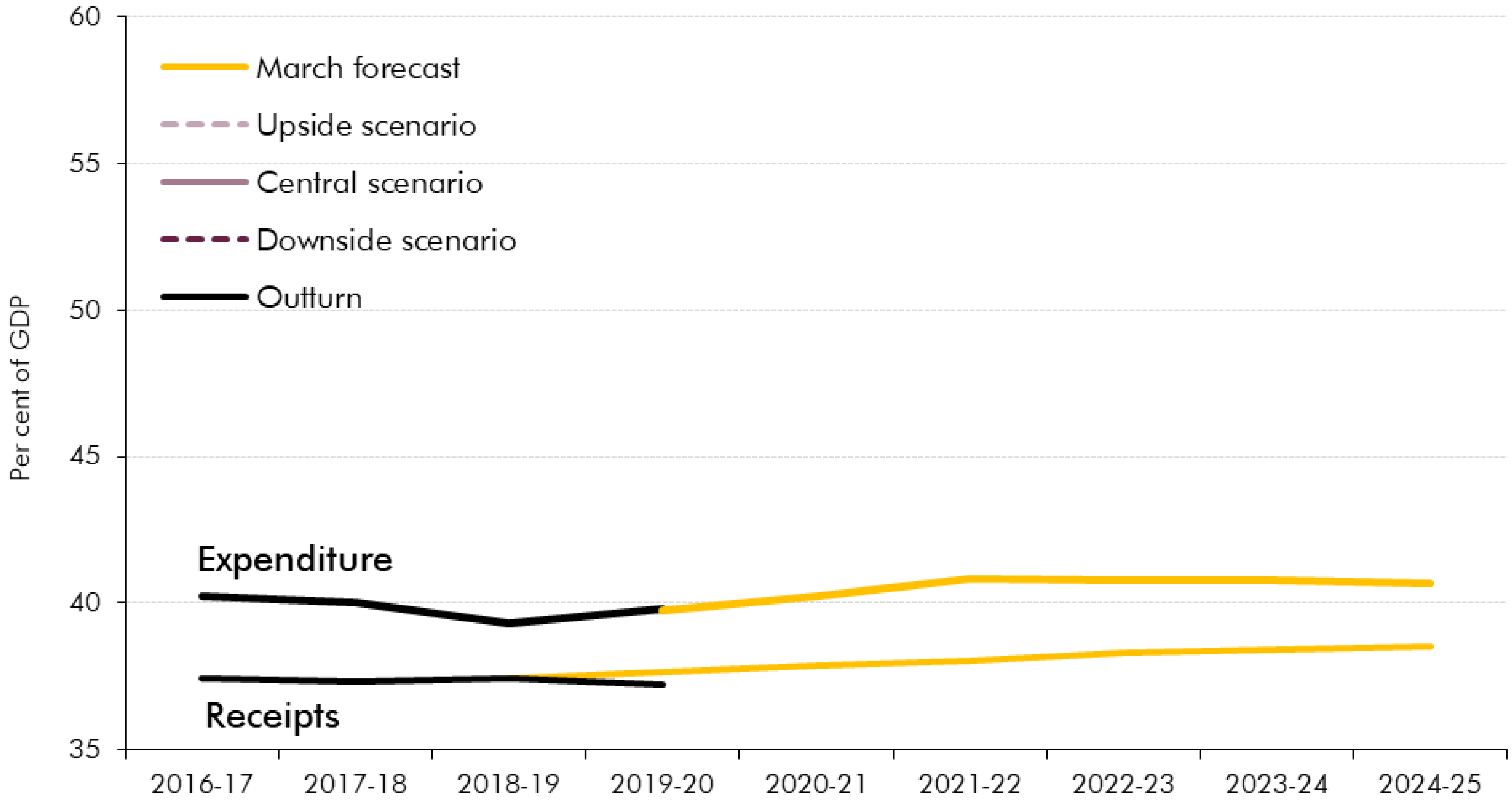
Comparing the scenarios: tax and spend



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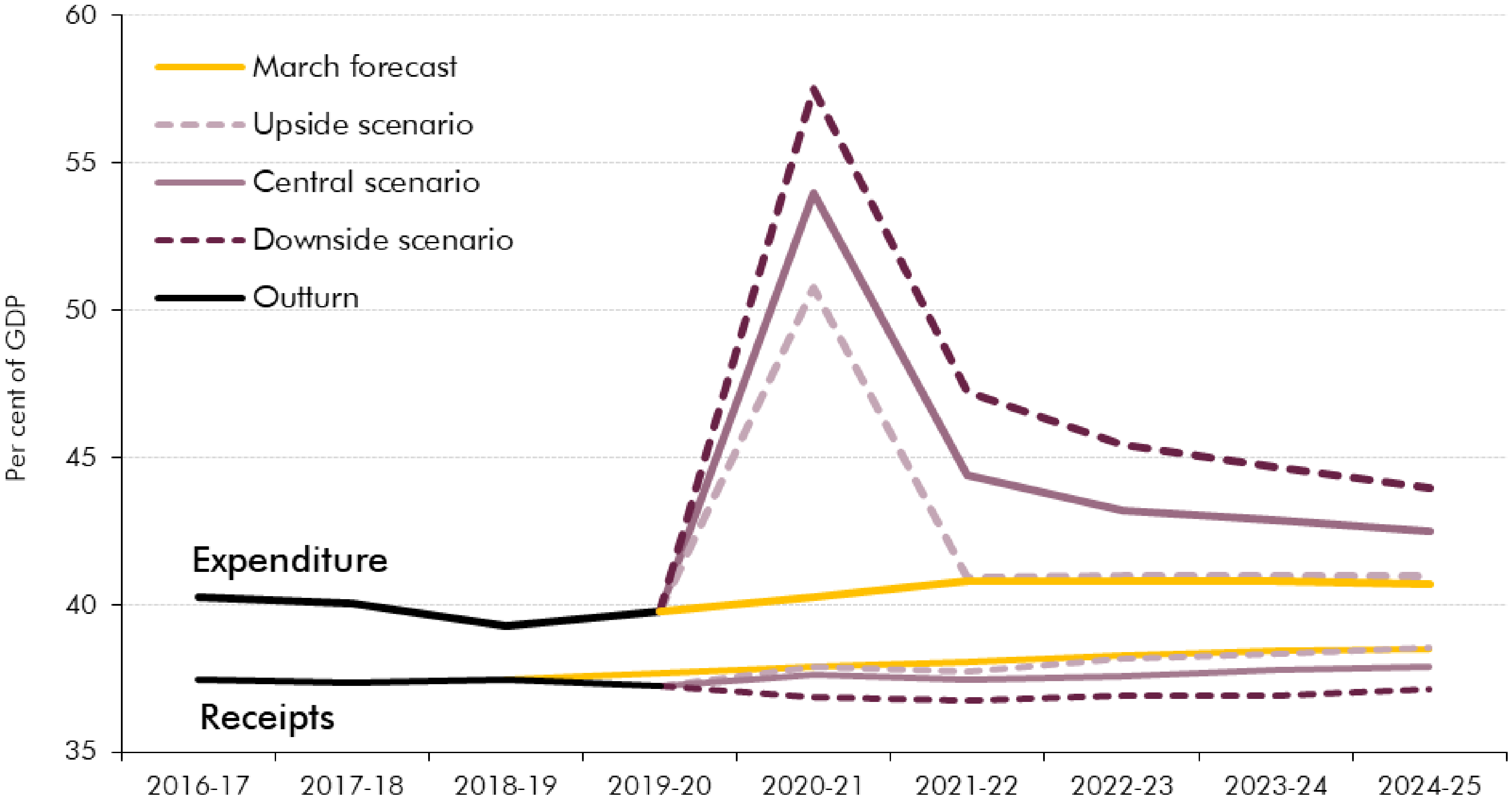

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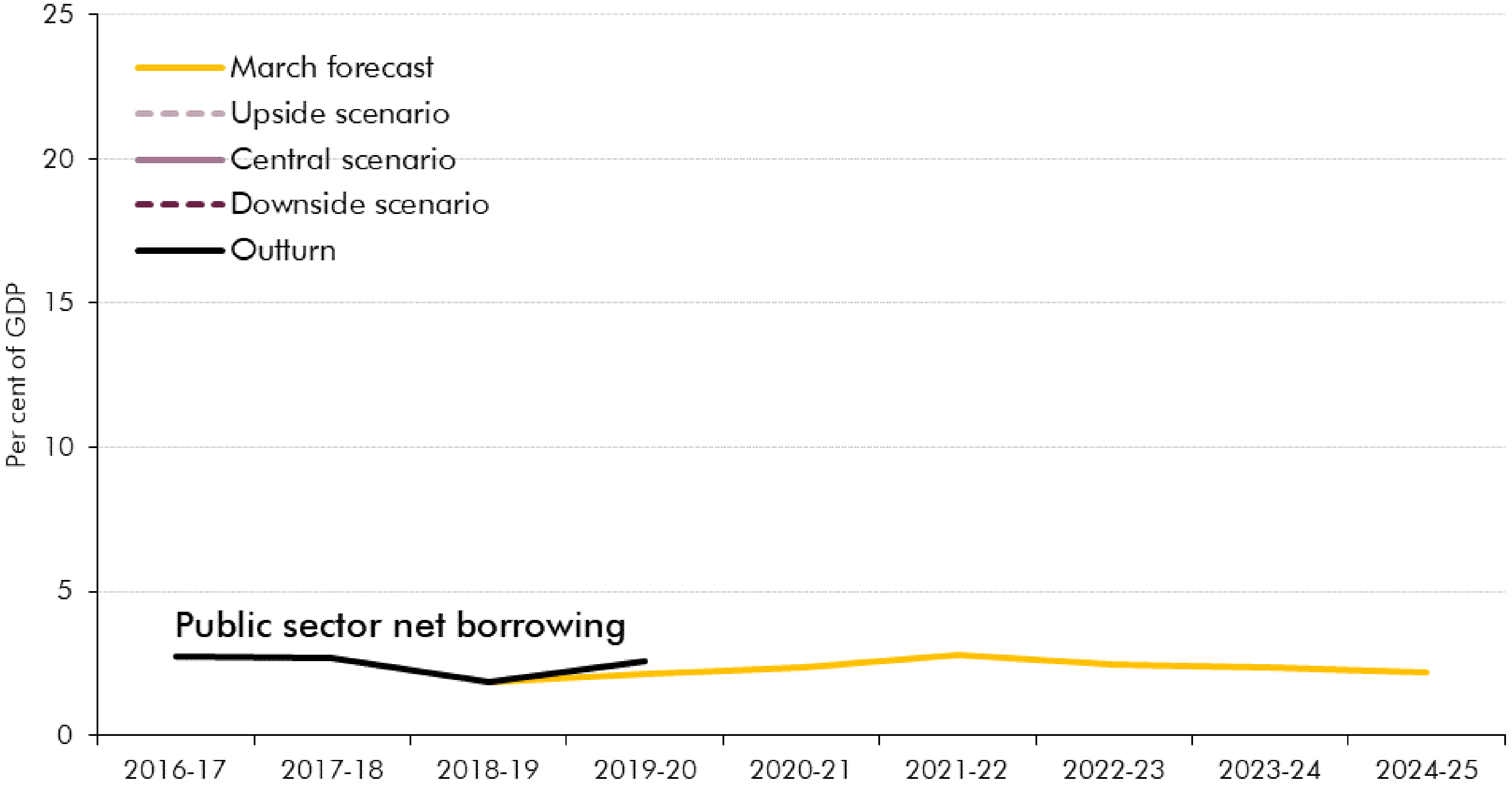

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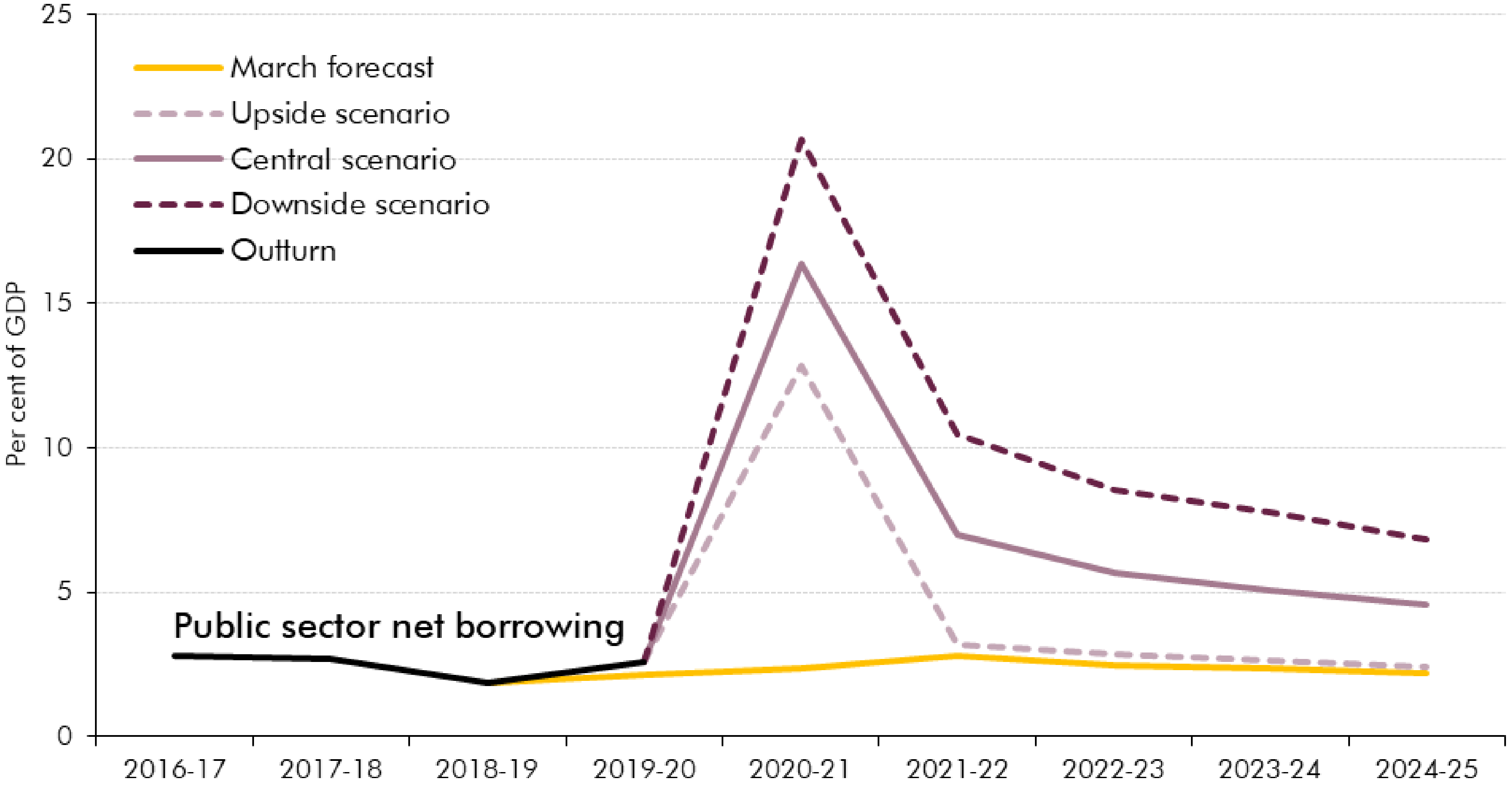

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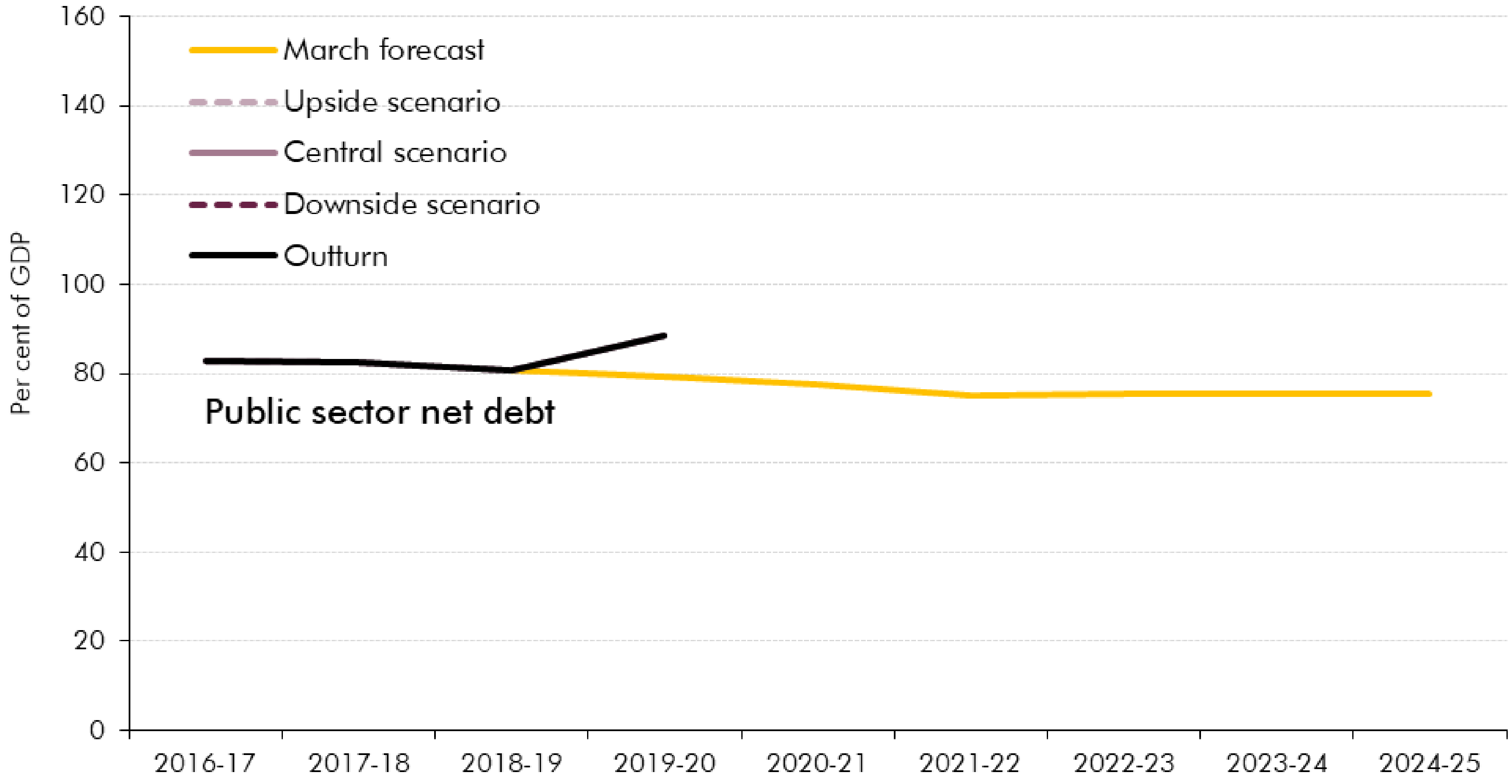

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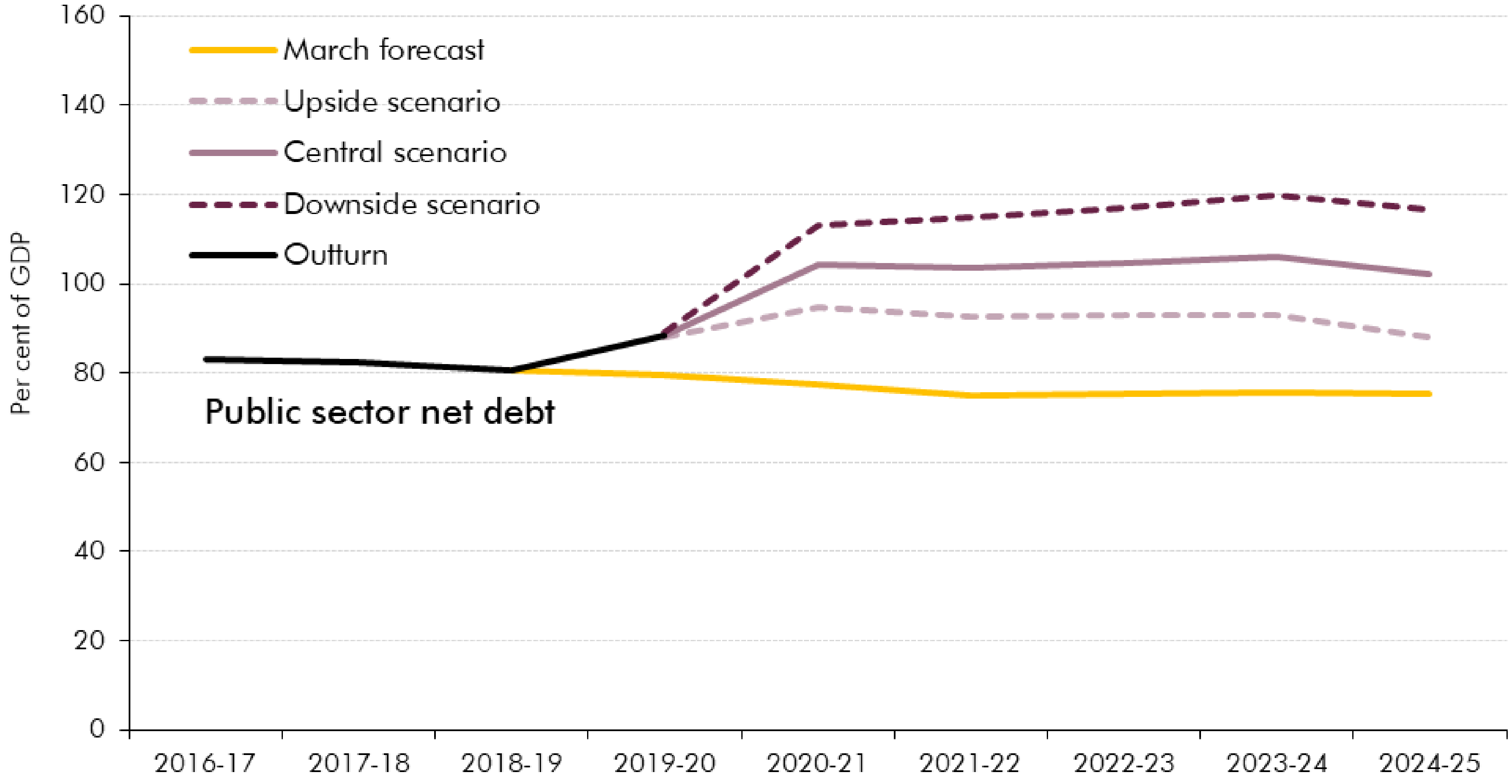

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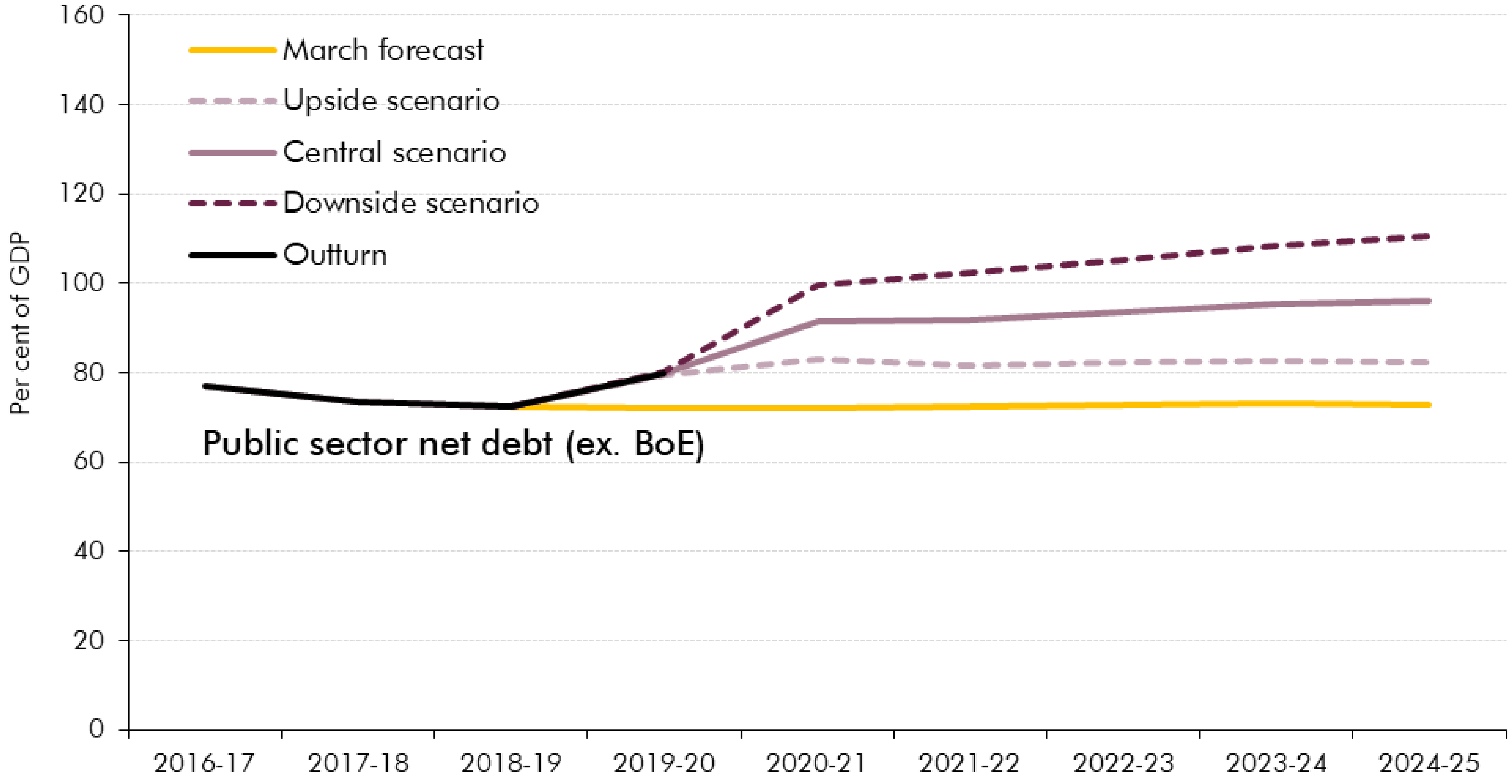


Implications for Budget targets

	March	Upside	Central	Downside
Current budget rule: balanced by 2022-23	✓	✓	✗	✗
Investment rule: net investment no more than 3% on average	✓	✗	✗	✗
Debt-interest-to-revenue ratio: interest costs no more than 6% of revenue	✓	✓	✓	✓

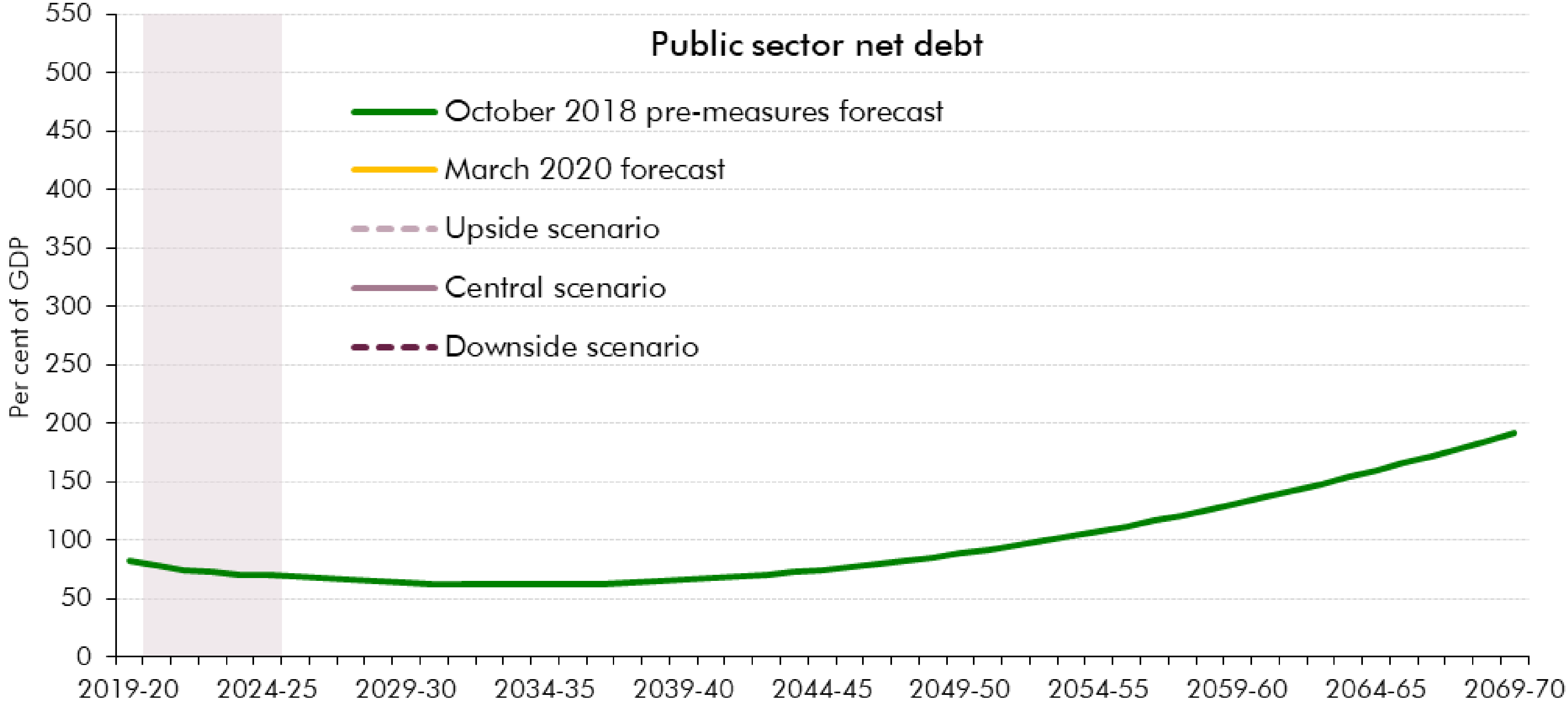
Long-term projections

- **Simpler approach than in a normal FSR**

- **Key/new components**
  - Non-demographic cost pressures in health and social care
  - Population ageing
  - Move to 2018-based population projections
  - New migration assumption in March forecast

- **Jumping-off point**
  - Primary deficit in 2024-25 was 1.1% of GDP in March
  - 1.6% (upside), 3.7% (central) and 5.9% (downside)

Long-term projections: net debt



Note: The October 2018 forecasts' 2024-25 jumping-off points are assumed to equal their 2023-24 medium-term horizon values.
Source: ONS, OBR

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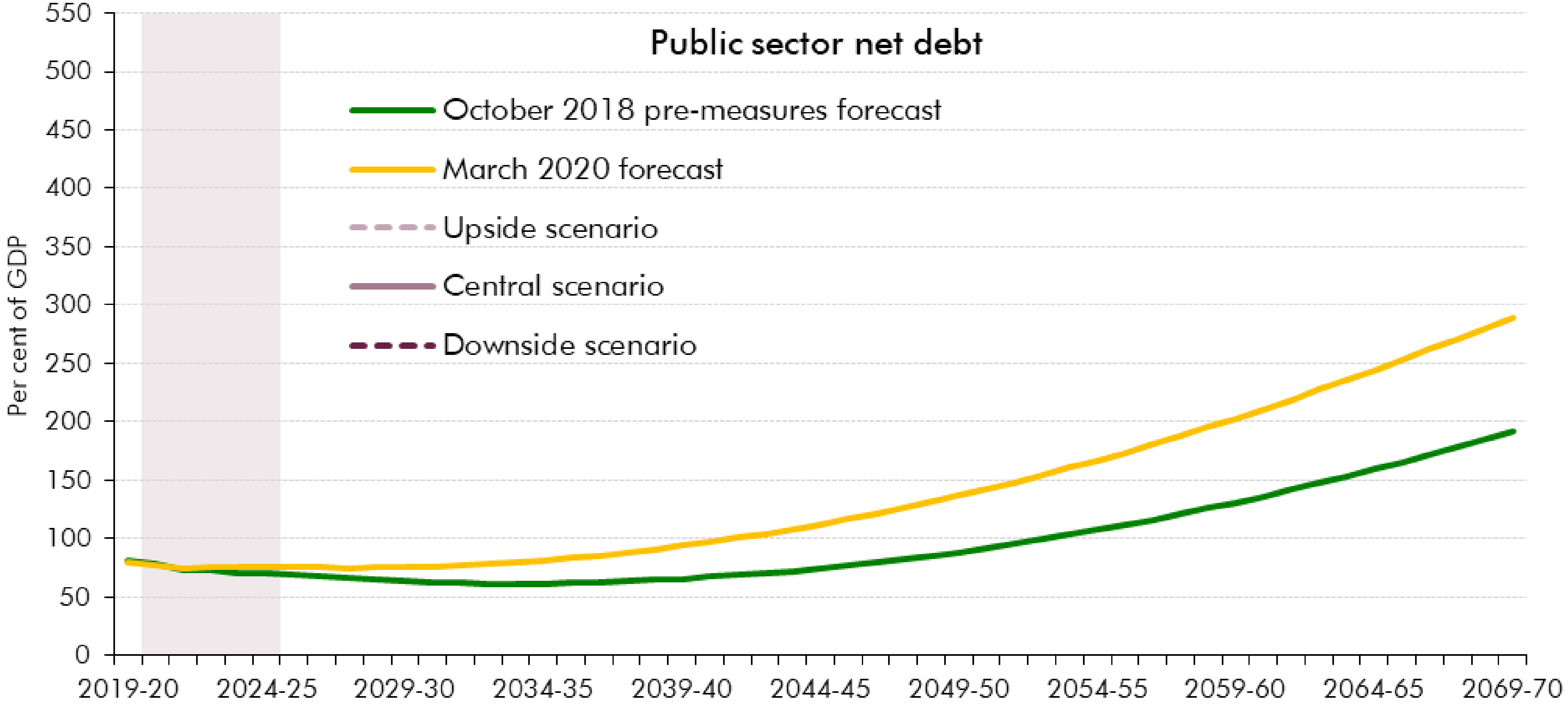

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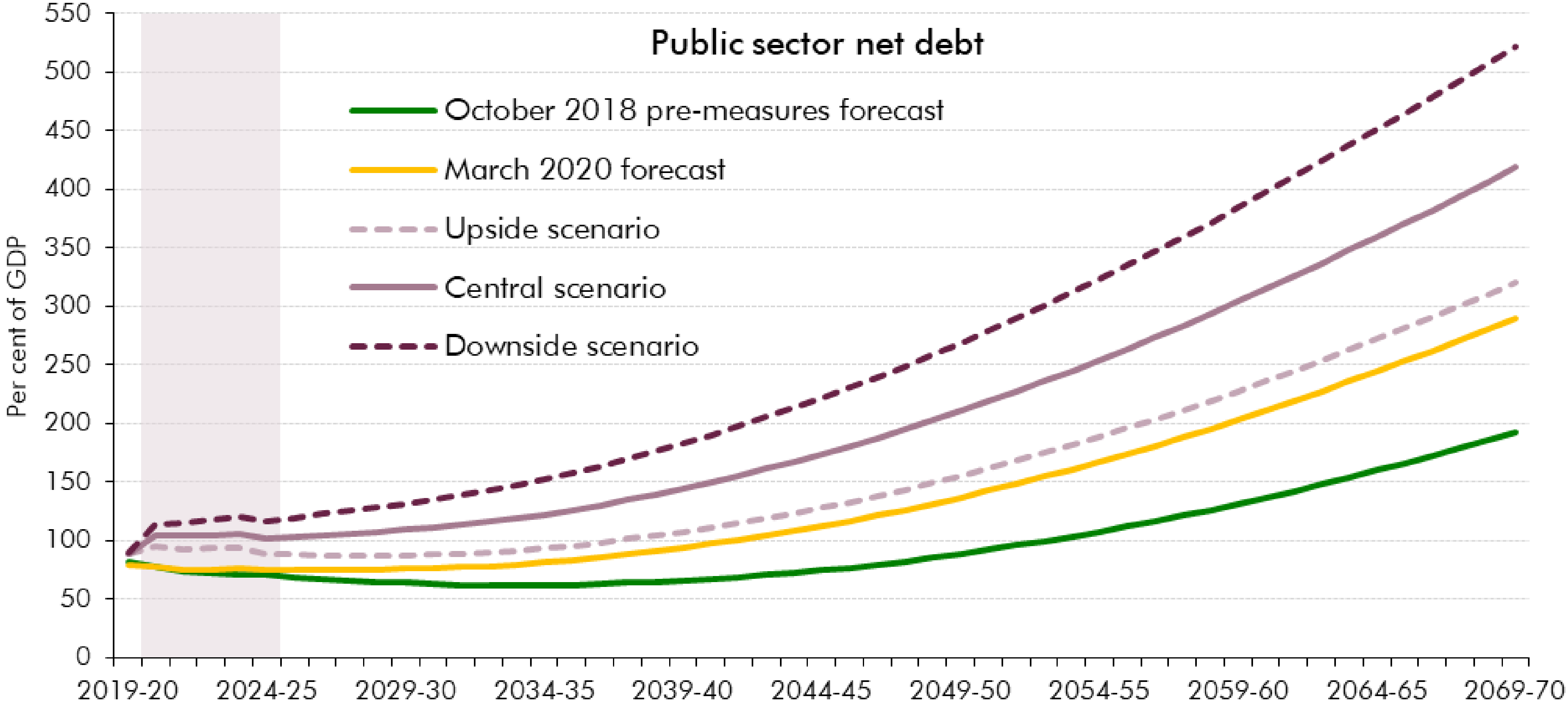

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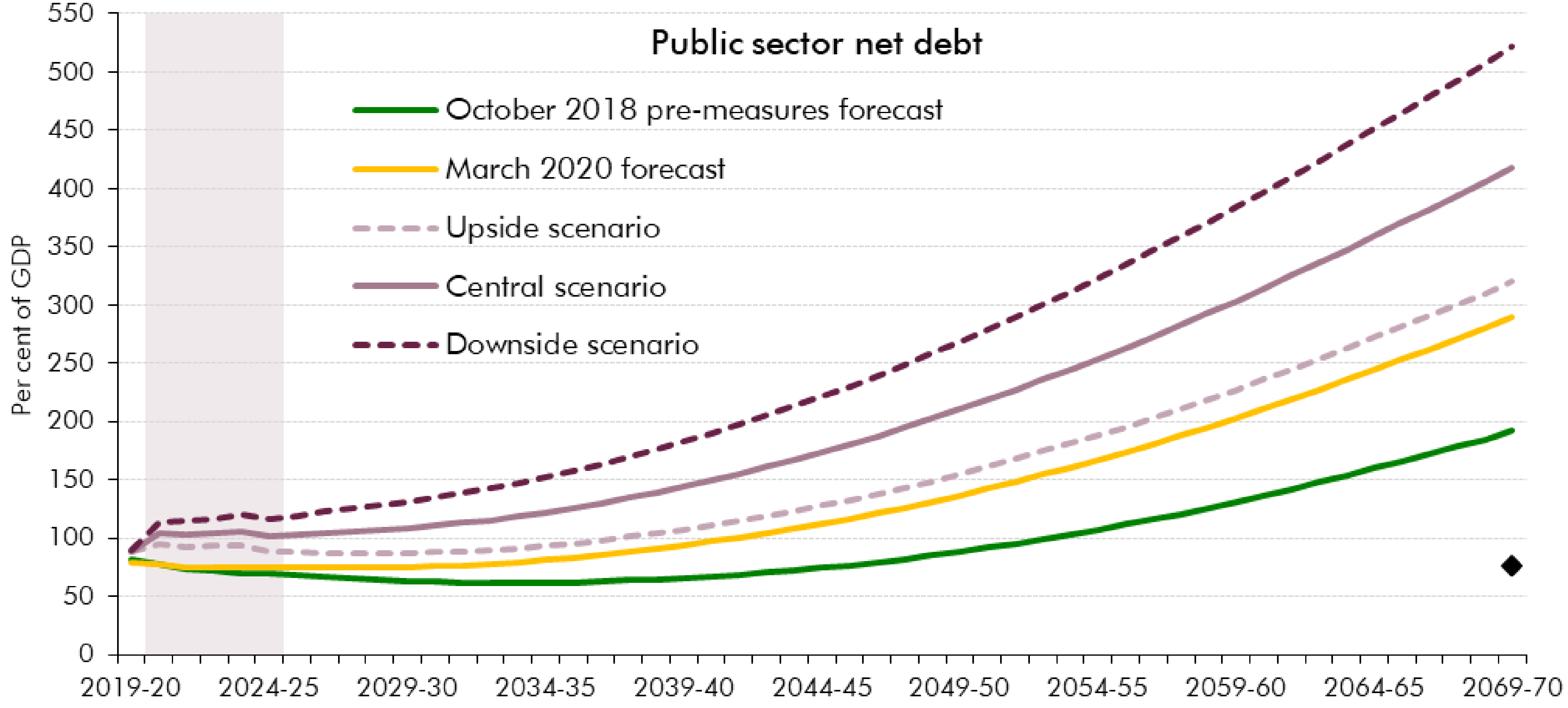
Long-term projections: net debt



Note: The October 2018 forecasts' 2024-25 jumping-off points are assumed to equal their 2023-24 medium-term horizon values.
Source: ONS, OBR

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Risks: macro and financial sector

- Recession risk has crystallised. Are big shocks now the norm?
- Outlook for potential output even more uncertain
- Risks have not yet crystallised in the financial sector, thanks in large part to government supporting individuals and businesses

Risks: revenue

- Composition of output, expenditure and income
- Loss of tax buoyancy
- Firms going bust before they can pay their taxes
- Demands on HMRC may reduce compliance

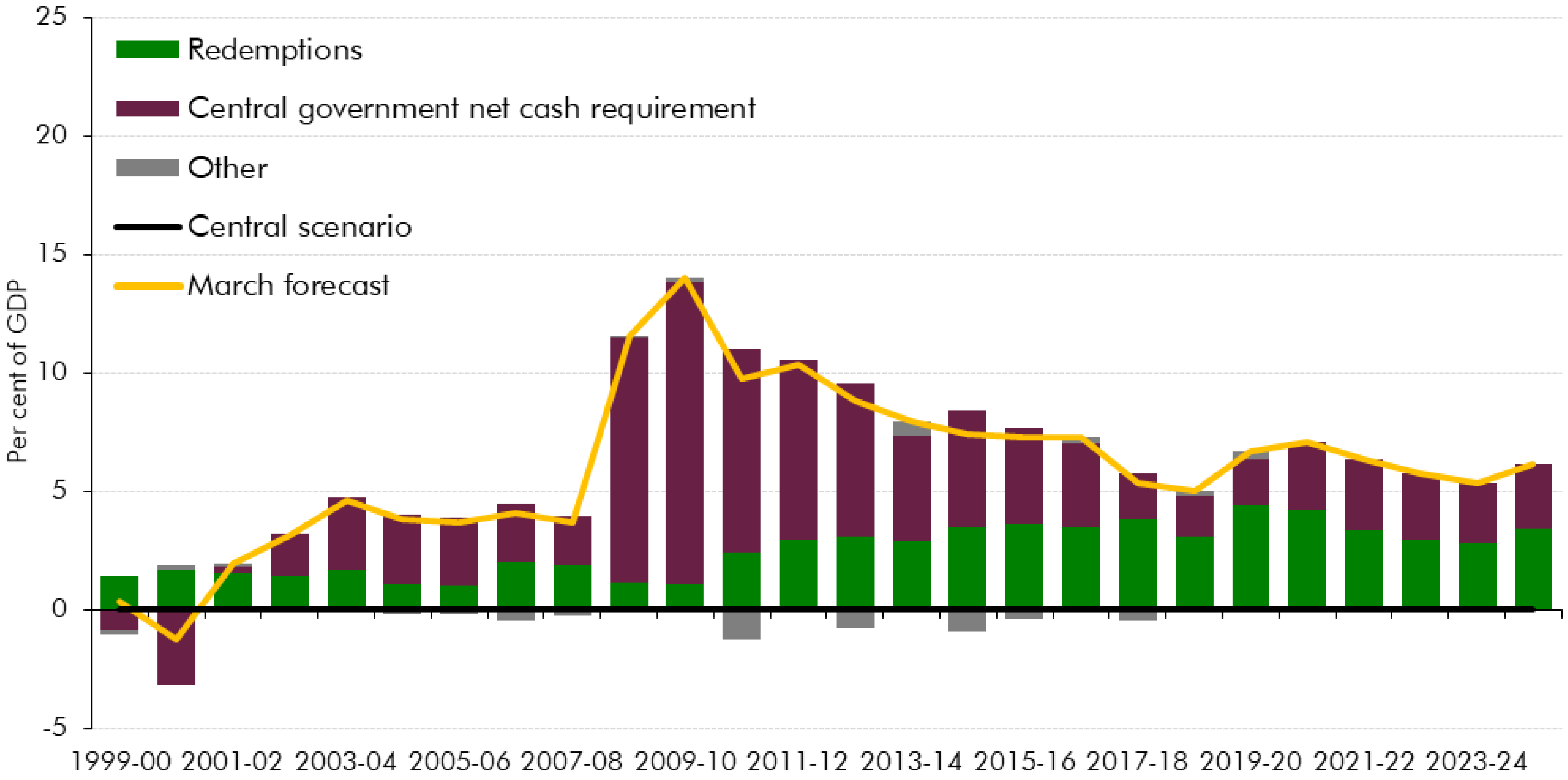
Risks: spending

- NHS and social care post-coronavirus
- Chronic health conditions
- Temporary support measures becoming permanent
- Pressures on local authority finances

Risks: balance sheet exposures

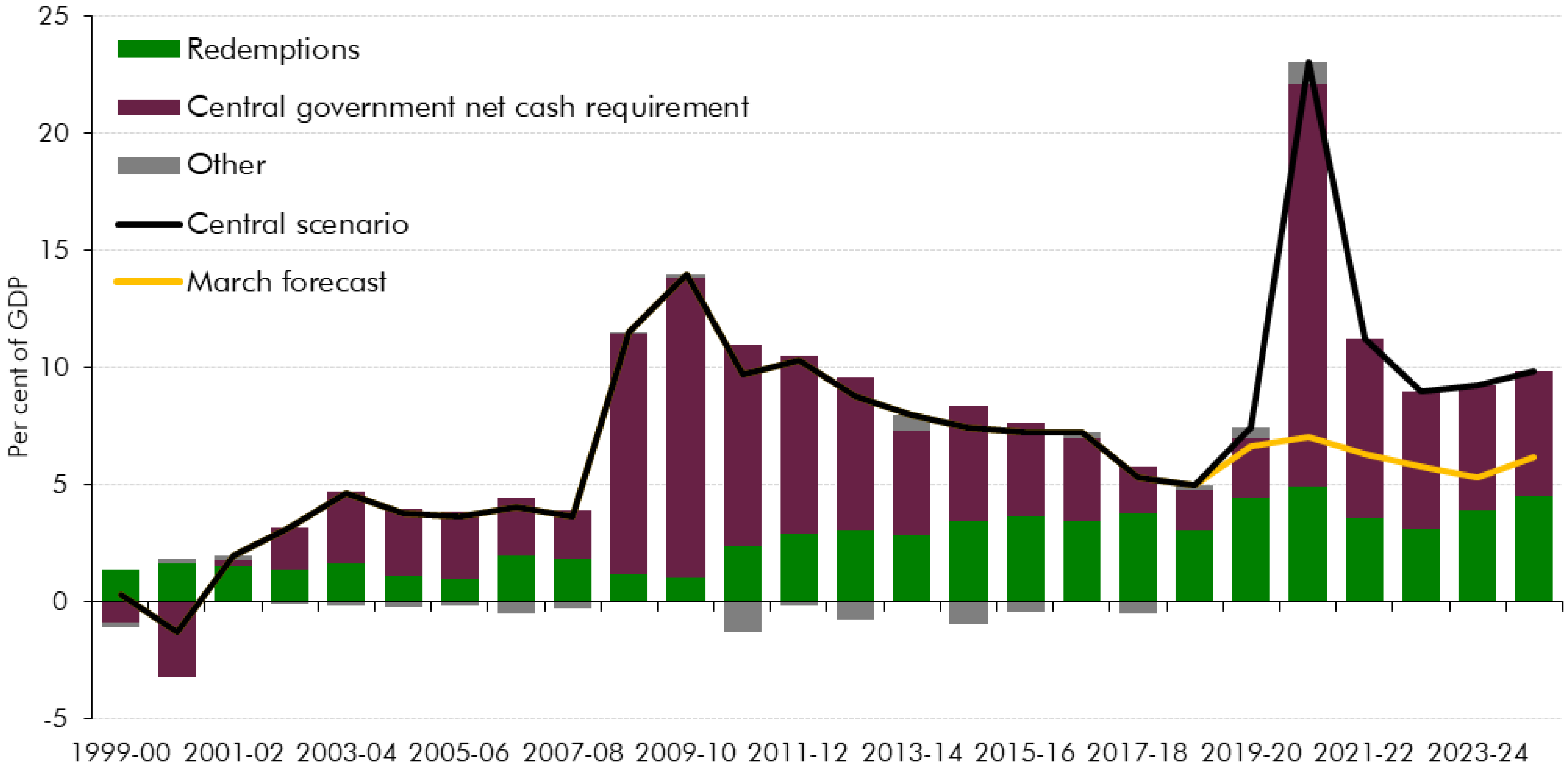
- Explicit contingent liabilities – £330bn in loan guarantees
- Implicit guarantees
- Nationalisation and reclassification risk

Gross financing requirement: March



Source: DMO, OBR

Gross financing requirement: central



Source: DMO, OBR

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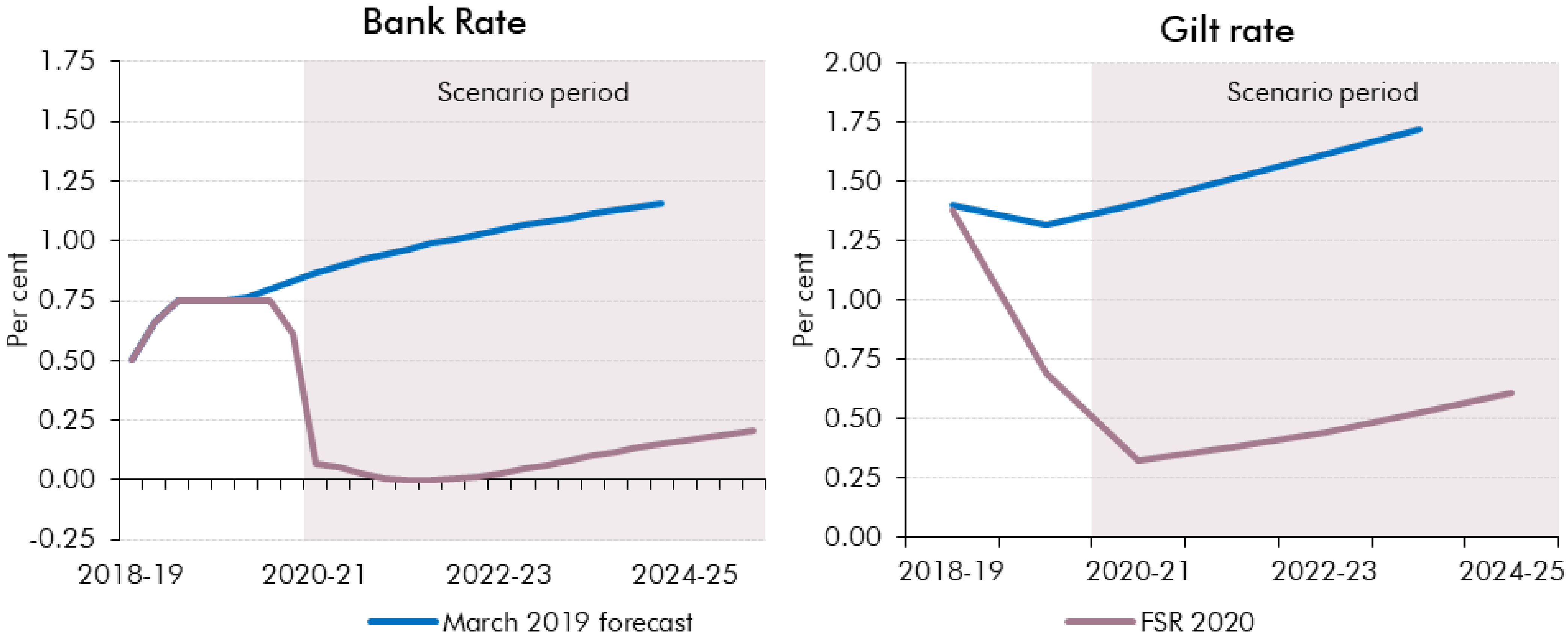
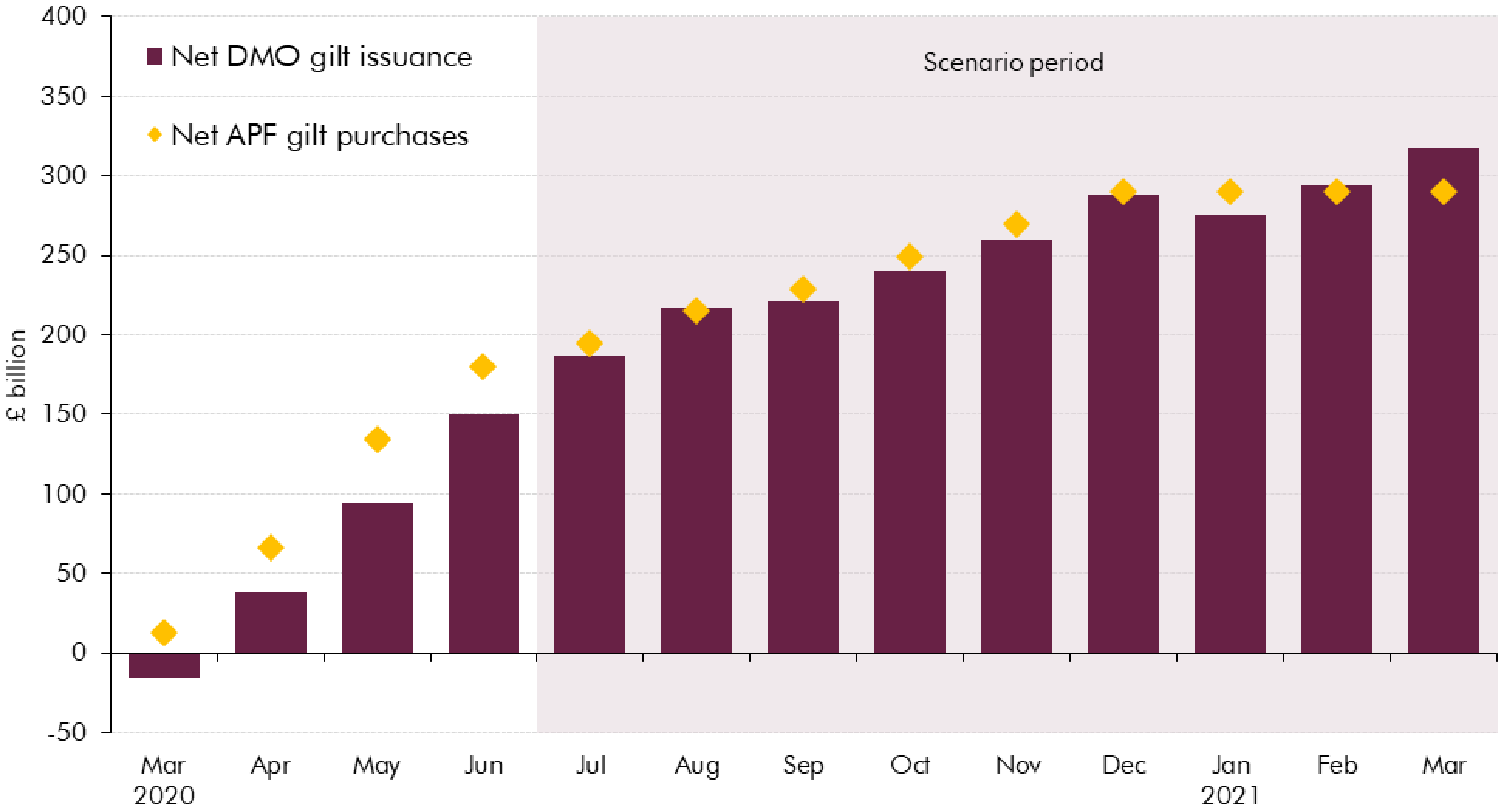
Government borrowing costs



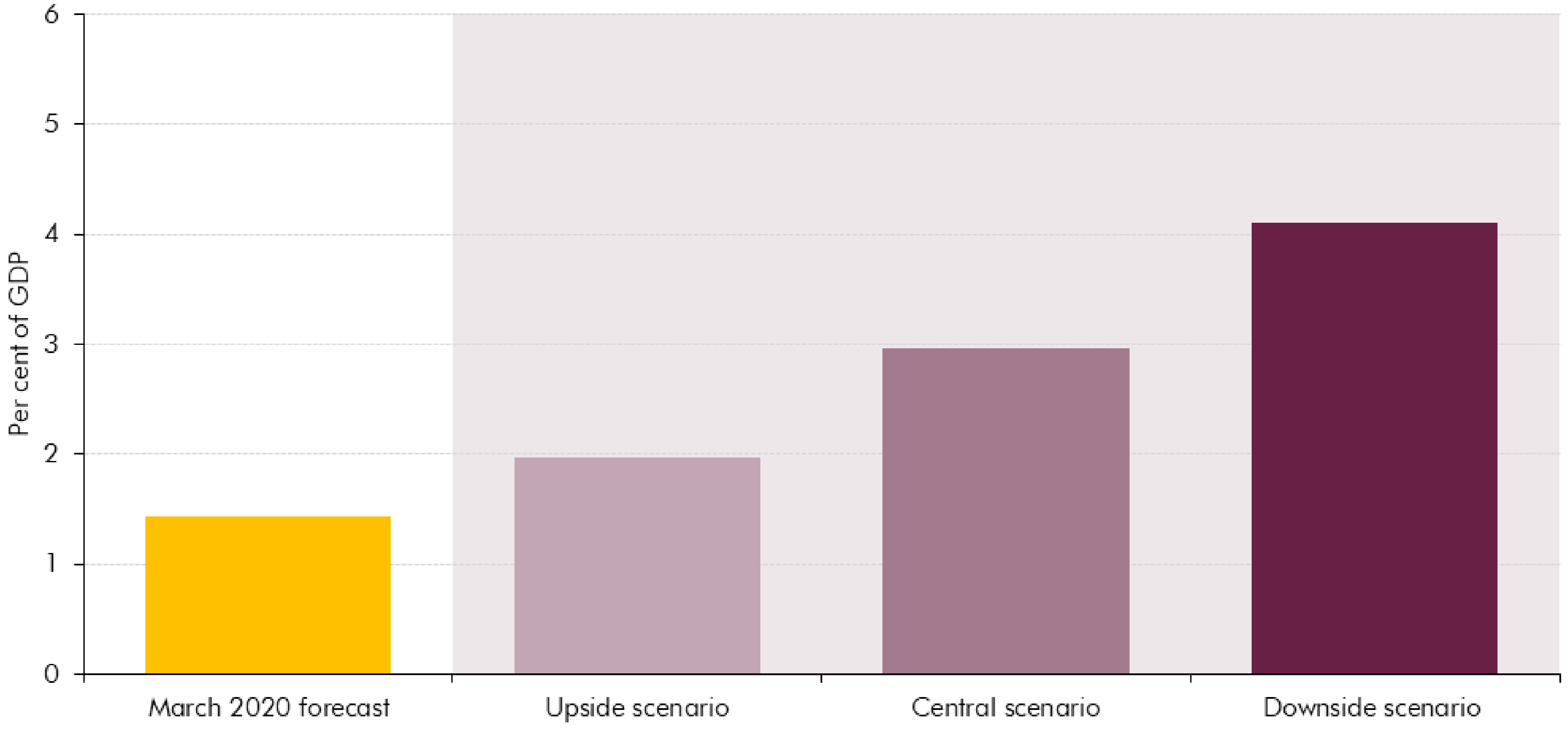
Note: Gilt rates are the weighted average interest rate on conventional gilts.
Source: OBR

Gilt issuance and QE



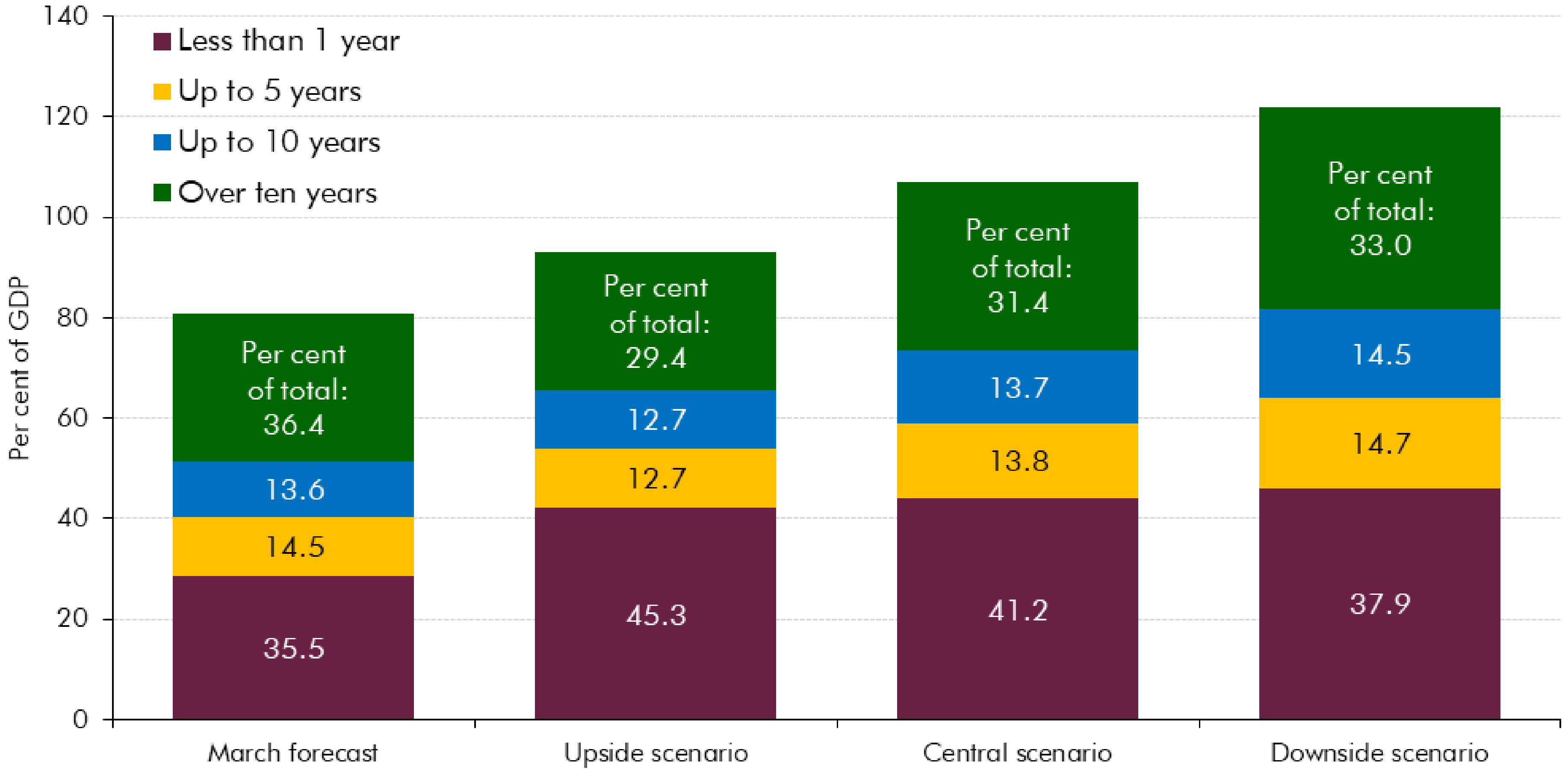
Source: Bank of England, Debt Management Office, OBR

Debt-stabilising primary deficit



Source: OBR

Public sector debt by maturity



Source: Debt Management Office, OBR

Conclusion

- A large and abrupt shock to the public finances
- But how much is temporary; how much is permanent?
- Borrowing costs are low, but for how long?
- Fiscal strategy will need to reflect current priorities and future pressures and needs – including fiscal space
- Cherish the institutions that can give people confidence