March 2021 Economic and Fiscal Outlook

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 2021 Economic and fiscal outlook. Thank you for joining us.

- I am going to take you through the highlights from our latest forecast and then we'll go into an online question and answer session. My slides and speaking notes will be on the website at the end of this event which you can also rewatch on Youtube.

- If you would like to ask a question at any point, please use the Q&A feature, and Charlie, Andy, and I will try to answer as many as possible. Please give your name and institution.

3. **Background**

- Let me start by thanking OBR staff and economists, public health experts, and other analysts across government whose expertise and hard work were essential to putting this latest forecast together.

- Though I should stress that all assumptions, analysis, and conclusions are our own.

- Our forecast closed on the 26 th of February and was conditioned on the Government's February 22nd Roadmap for the lifting of public health restrictions.

- The forecast also takes account of the Trade and Cooperation Agreement concluded between the UK and EU on December 24 as well as initial information on UK-EU trade flows since the agreement came into effect on 1 January.

- The forecast also reflects the fiscal and economic implications of all tax and spending policies announced up to and including the Chancellor's Budget Statement presented earlier today.

- And finally, the forecast is based on the yield curve as it stood on 5th February. Since this time, the yield on 10 year-gilt has risen from 0.5 percent back to its pre-pandemic level of 0.8 per cent. I will say more about what this recent rebound in interest rates implies for the fiscal outlook later in my presentation.

5. November 2020 Coronavirus Scenarios

- This Budget comes a little more than a year after the coronavirus arrived on our shores

- Our last forecast, which was published in the middle of the second lockdown in late November, provided a comprehensive account of the economic and fiscal toll of the pandemic.

- It also provided three scenarios for the future path of the economy and public finances, depending on the course of the virus and the effectiveness of the Government's public health response:

    - In our upside scenario, the virus was quickly brought under control by the second lockdown and swift rollout of effective vaccines. This allowed a rapid lifting of restrictions and output returned to is pre-virus level at end-2021.
    - In our central forecast, the second lockdown was only partly effective in bringing down cases, and vaccines were rolled out more slowly. This allowed only a more gradual lifting of restrictions and output regained its pre-virus level by the end of 2022.
    - And in our downside scenario, the second lockdown failed to bring the number of cases under control and no vaccine proved effective. Tighter restrictions were therefore needed for longer and output regained its pre-virus level only in 2024.

- The degree of long-run scarring to the supply side of the economy associated with the pandemic also varied across these scenarios:

    - With no long-run scarring in the upside scenario;
    - a 3 per cent long-run loss of potential output in our central forecast
    - and 6 per cent scarring in the downside scenario.

- In our latest EFO, we have updated our central forecast to take account of the latest economic, fiscal, and epidemiological developments.

- However, we have left our upside and downside scenarios unchanged to put these recent developments into context. And the course of events over the last 15 weeks has underscored their continued relevance as a guide to the range of possible economic and fiscal outcomes.

6. Course of the pandemic since November

- Indeed, in the period since our last forecast, the course of the pandemic and the Government's public health response have broadly matched our *downside* scenario. Specifically:

    - The emergence of the Kent variant late last year fuelled a resurgence in the number of infections after the second lockdown was lifted.

    - The subsequent spike in coronavirus cases, hospitalisations, and deaths surpassed the levels seen at the height of the first wave of the pandemic in April.

    - And this required the reimposition of a third lockdown in January which will be in place for most of the first quarter of this year.

7. Vaccines

- But there has been more promising news since our November forecast on other fronts, in particular concerning the approval, acquisition, and rollout of vaccines.

- As of the end of February

    - Over 450 million doses of 8 vaccines have been ordered by the Government

    - Over 20 million doses had been administered to more than a third of the adult population.

    - News on the effectiveness of the vaccines has also been positive with rates of hospitalisations and deaths falling by over 75 per cent among those vaccinated

- Rollout of the vaccine to the remainder of the population is proceeding apace and the Government's aiming to offer a first dose to all those over 50 by the 15th of April and all adults by the 31st of July.

- This is ahead of the schedule assumed in our November central forecast and more in line with our *upside* scenario.

8. Adaptation to public health restrictions

- Another positive piece of news over the last three months has been signs that the economy has become increasingly adapted to public health restrictions.

- Evidence of this growing adaptation can be found in the behaviour of both consumers and business over successive lockdowns:

  - Specifically, according to Bank of England card data, the level of consumer spending during the second lockdown in November was just 14 per cent below pre-pandemic levels compared to 44 percent during the first lockdown in April.

  - Consumers have also changed the *way* they spend, with lockdowns accelerating the pre-pandemic trend toward greater online shopping. As you can see from the chart on the left, the share of total retail sales taking place online rose from around 20 per cent in 2019 to over 35 per cent at the peak of the November lockdown.

  - Businesses have also adapted to lockdown conditions by reconfiguring their shops and workplaces to make them covid-secure. As shown in the chart on the right, this meant that only 11 per cent of businesses had to close entirely during the November lockdown compared with 24 per cent back in April.

- And this has all been facilitated by the extraordinary amount of fiscal support that the Government has provided to households and firms over this period.

9. EU Exit

- A third, and more mixed, piece of news since November was the conclusion of a Brexit deal on Christmas Eve, a week before the transition period was due to end.

- As summarised in the table on the left and explained in more detail in Box 2.2 of this EFO, the scope and terms of the Trade and Cooperation Agreement were broadly in line with the typical free trade agreement assumed in our previous forecasts.

- We therefore see no reason to revisit our estimate of a 4 percent long-run loss of productivity associated with leaving the EU on these terms.

- However, the *implementation* of the agreement *was* associated with more disruption to UK-EU trade in the *near-term* than we had assumed.

- Our November forecast assumed some temporary forbearance in the application of the new trading terms on both sides of the border. As it turned out, officials on the EU side began applying customs and other checks from the 1st of January.

- The immediate imposition of these new controls, combined with the introduction of covid related health checks at the Channel ports, led to a reduction in cross-Channel commercial traffic flows in January, as you can see on the right. These have since recovered to more normal levels, so we expect the associated economic costs to be confined to the first quarter of this year.

- However, there still remains significant uncertainty about two aspects of our future trading relationship with the EU:

    - The first is what will happen when the UK begins implementing full customs and other checks on EU imports this summer which will test the preparedness of EU exporters to the UK

    - The second is the nature of our relationship on financial and other services. The TCA concerned itself primarily with goods and discussions concerning an associated memorandum on trade in financial services are ongoing.

- We will update our assessment of the economic impact of Brexit, taking account of developments in these areas, in our Autumn EFO.

10. Near-term economic outlook

- Against this mixed picture concerning developments over the past three months, our latest EFO sets out an updated central forecast for the path of the economy and public finances over the next five years.

- Starting with GDP, this slide shows the path of output since the start of the pandemic and our forecast for the first 3 months of this year.

- You can see that, at the end of last year, output was broadly in line with our November *upside* scenario. This is partly due to historical revisions to output in the health sector, in particular to take account of Test and Trace activities.

- But it also reflected the aforementioned greater resilience of the *private sector* during the last lockdown.

- Excluding health and education, output was only 8 percent below pre-pandemic levels compared to the 11 percent shortfall assumed in our November forecast. Output therefore ended the year 7½ percent below pre-pandemic levels, broadly in line with our *upside* scenario.

- However, the resurgence in infections fuelled by the Kent variant and the eventual reimposition of the stricter third lockdown in January is expected to reduce output by 3.8 per cent in the first quarter of this year. This brings the level of output just below that assumed in our *central* scenario back in November.

11. Medium-term economic outlook

- Looking ahead to the next 5 years, we expect the economy to rebound strongly over the remainder of this year as public health restrictions are lifted in line with the Government's Roadmap, allowing many economic activities to resume.

- Growth moderates towards the end of the year, once the majority of restrictions have been lifted.

- Output returns to its pre-pandemic level in the middle of *next* year, which is around six months earlier than we predicted back in November and reflects the faster rollout of the vaccine and more rapid easing of public health restrictions than we had anticipated.

12. Changes in real GDP since November

- The faster economic recovery over the next two years is given further fuel by three factors:

  - First, the extension of the furlough scheme and other elements of the covid rescue package in this Budget.

  - Second, the rebound in consumption associated with the removal of public health restrictions is given a modest *further* boost from the rundown of some of the savings that some better-off households have built up during the pandemic.

  - Third, there is a much stronger rebound in business investment supported by generous tax incentives announced in this Budget which encourage firms to bring forward investment projects from future periods.

13. Scarring effect of the pandemic

- Thereafter, the level of output is largely determined by our assumption that the pandemic will reduce long-run potential output by around 3 per cent.

- As you can see from this slide, this estimate is broadly in line with those of other independent forecasters whose own estimates range between 1¾ and 6 percent.

- It will be some time before we have any clear evidence of the long-run economic cost of the pandemic. And the evidence that has accrued since November has been mixed:

  - On the one hand, the ONS has revised up its estimates of business investment, suggesting less damage to the capital stock from the pandemic.

  - Against that, the renewed lockdown has led to a further deterioration in the financial position of businesses burdening them with additional debt.

  - Finally, recent analysis of labour market data suggests that the current population may be substantially smaller than official statistics suggest as a result of net outward migration since the start of the pandemic. However, we will not know for certain what effect this has had until the ONS produces new population figures.

- So we continue to assume that the level of output will be reduced by 3 per cent relative to its pre-pandemic path, although potentially due to a different balance of factors.

- And we will also revisit *this* assessment in our next forecast.

14. Unemployment

- Turning to the implications for the labour market, unemployment has risen from 4 per cent on the eve of the pandemic to 5.1 per cent at the end of last year.

- In our previous forecast, we expected unemployment to rise by more than 800,000, partly because the furlough scheme was expected to close in March, leaving workers to fall between the ending of the scheme and the full reopening of the economy.

- The extension of the furlough scheme to the end of September announced in this Budget provides a more effective bridge to a recovering economy and thereby lowers the further rise in the number of jobseekers to less than 500,000.

- So in our latest forecast, unemployment peaks at 6.5 percent (or 2.2 million people) rather than the 7.5 percent assumed in our November forecast

15. Government Borrowing

- Let me now turn to what this latest economic outlook, plus the policies announced in today’s Budget, imply for the public finances.

- We still expect borrowing to reach a post-war high this financial year.

- But it peaks at £355 billion rather than the £394 billion we forecast in November due in large part to underspending against the government’s coronavirus rescue package and stronger receipts from a more resilient economy.

- Borrowing is then higher than our November forecast over the next two years but then falls below it in the final three years

16. Source of change in borrowing

- To illustrate what drives the change in the borrowing relative our November forecast, this chart breaks that difference down into:
  - First changes arising from the economic forecast (shown in red)
  - And second, changes arising from discretionary policy measures (shown in blue)
- You can see that forecast changes improve the borrowing picture relative November this year thanks to higher receipts and under execution of covid-related spending programmes.
- But forecast changes make only a marginal difference to the level of borrowing in future years.
- Instead, it is fiscal policy that drives changes to our borrowing forecast next year and beyond.
- Specifically, fiscal policy adds £60 billion to borrowing next year but reduces it by £32 billion by the end of the forecast period.

17. Budget Policy: Rescue, Recovery, and Repair

- Looking in more detail at the policy measures that the Chancellor announced in this Budget, they can be roughly divided into three categories:
  - First, in 2021-22, the Budget extends virus-related rescue support to households, businesses and public services (represented by the blue bars) until the vaccine rollout is completed later this year

18. Budget Policy: Rescue, Recovery, and Repair

  - Second, over the next three years, the Chancellor looks to provide an added boost to the economic **recovery**, most notably through a temporary tax break (shown in orange) that encourages businesses to bring forward investment spending from the future into this year and next.

19. Budget Policy: Rescue, Recovery, and Repair

  - Third, as the economy normalises, the Chancellor has taken further steps to **repair** the damage to the public finances in the *final* three years of the forecast. He does this by raising the headline corporate tax rate, freezing personal tax allowances and thresholds, and shaving around £4 billion more off departmental spending plans Taken together, these measures (shown in green) cut £32 billion from the deficit in 2025-26.

20. Rescue: Cost of the pandemic

- Looking at each of the three elements in a bit more detail, the £44 billion extension of the covid rescue package raises the total direct cost of the pandemic to the public purse to £344 billion. Of this

    - almost half has gone on the NHS and other public service engaged directly in the fight against the virus

    - a third has gone on support to households in the form of the furlough scheme, self-employment grants, and increases in Universal Credit

    - the final share has gone on support to businesses in the form of grants, business rates holidays, and government-guaranteed loans

21. Recovery: Investment tax allowances

- The centrepiece of the Chancellor's policies for kickstarting the post-pandemic **recovery** is a two-year 130 percent corporation tax super deduction for investments in plant and machinery which is expected to cost £27 billion over three years.

- Capital allowances on these assets are currently 18 percent, so this temporary super deduction provides a very strong incentive for businesses to invest now rather than later.

- Our forecast assumes that it raises total business investment by around 10 per cent in 2022-23, the equivalent of around £20 billion a year.

- However, because it's a time-limited measure, most of this increase in investment is brought forward from future years rather than being a net addition to the long-run capital stock.

- As such, the level of business investment falls back as the tax sudsidy is withdrawn at the beginning of 2023, as you can see in the blue line on this chart.

22. Repair: Corporate tax increases

- Turning to the Chancellor's plan for repairing the damage to the public finances over the long-term, the single biggest contribution comes from the increase in the headline rate of corporation tax from 19 to 25 percent from April 2023

- This returns the UK's headline corporate tax rate to the middle of the pack of advanced economies, as shown on the right.

- To put these numbers in some historical context, corporation tax was introduced by the Wilson Government in 1965 with a headline rate of 40 percent which has been progressively cut since the early 1980s to 19 percent today.

- In fact, this is the first time that any Chancellor has increased the headline corporate tax rate since Denis Healey hiked it from 40 to 52 percent in his 1974 Budget.

- And even after the 6 percent increase in this Budget, the headline rate will still be 3 per cent below the 28 per cent rate that George Osborne inherited in 2010

- However, thanks in part to all the measures that the Treasury has taken *since* 2010 to broaden the corporate tax base, this relatively modest headline rate hike takes the share of GDP collected in corporation tax to over 3 per cent – its highest level since the Lawson boom in the late 1980s and one seldom sustained for very long in the post-war period.

23. Tax burden

- Looking at the implications of this Budget for the tax burden more generally, the increase in corporation tax and freezes to the personal allowance announced by the Chancellor today take the UK's tax/GDP ratio from 34 per cent before the pandemic to 35 per cent by 2025.

- So following this Budget, in a year full of once-in-a-lifetime fiscal numbers, we can now add the highest tax-to-GDP ratio in half a century.

- And the government's ability to deliver and sustain such a high tax burden represents a key risk to the Chancellor's fiscal plans.

24. Debt

- These corporate and personal tax rises play a key role in stabilising and then reducing the level of debt in the wake of the pandemic.

- Debt peaks at 110 per cent of GDP in 2023-24, its highest level since the late 1950s.

- It then falls back in the final two years of the forecast, but stays above 100 per cent of GDP in every year.

25. Legislated fiscal rules

- Where does this leave the Government relative to the fiscal objectives it set for itself?

- Well the fiscal rules currently on the statute books date back to Philip Hammond's Chancellorship and two of them are set to expire at the end of this month.

- But for the record,

    - The objective to reduce the structural deficit below 2 percent of GDP in the next 28 days is missed by £303 billion.

    - Rather than falling as a share of GDP this year, debt rises by 16 per cent of GDP

    - And the Government misses its goal of eliminating the deficit by 2025-26 by £74 billion or 2.8 per cent of GDP

26. New fiscal principles

- Given the continued uncertainty about the economic and fiscal outlook, the Chancellor chose not to announce any new fiscal rules in this Budget.

- But he noted in both the Red Book and in his statement to Parliament an interest in

    - First whether the current budget is in balance – i.e. whether revenues are sufficient to cover day-to-day spending

    - and second whether underlying debt (excluding the uneven effects of the Bank of England) is falling as a share of GDP

- As you can see from the charts on this slide, the policy measures he has announced in this Budget are just about enough to balance the current budget, which he misses by a mere £900 million – which is small change in the world of post-covid fiscal policymaking

- And the tax rises and spending cuts announced in this Budget are also enough to get underlying debt to fall as a share of GDP, but by a similarly small margin in the last two years of the forecast.

27. Pandemic risks

- Given the slim margins against the achievement of these latest fiscal objectives, let me conclude with some reflections on three of the biggest risks to the Chancellor's fiscal plans.

- The first and most important source of risk continues to come from the course of the pandemic.

- The economic recovery we forecast is based on the Government's Roadmap for reopening different sectors of the economy.

- But this Roadmap is based on a set of assumptions about, amongst other things, the effectiveness of the vaccines – including in the face of new variants, the duration of immunity they convey, and people's continued compliance with the public health restrictions while they remain in place.

- If one or more of these assumption fails to hold, according to the epidemiological modelling that accompanied the Roadmap, further spikes in hospitalisations and deaths are possible.

- This could require the reimposition of some or all public health restrictions currently in place, choking off another economic recovery, and requiring a further extension of fiscal support.

28. Spending risks

- A second source of risk comes from within the public finances in the form of the legacy that the pandemic could leave behind for public services.

- While the Treasury has given departments over £150 billion this year and next to pay for the costs of the pandemic, it makes no provision thereafter for any covid-related costs.

- However, the government's own Roadmap discusses the potential need for an annual revaccination programme and standing Test and Trace capacity to keep what is expected to become an endemic virus in check

- And the pandemic has left behind a backlog of postponed procedures in hospitals and a generation of pupils who have missed out on up to six months of schooling

- And having taken the railways back into public ownership and filled the holes in their fare boxes, it is not clear when and if passenger numbers will ever return to levels that will allow this public support to be fully withdrawn.

- Because the Treasury has de facto resorted to annual Spending Rounds for government departments, we don't know what the Government's plan are for dealing with these legacy costs beyond this year.

- Faced with these looming pressures, the Chancellor's response so far has been to cut around £15 billion a year from total departmental spending in the years beyond 2021-22, including a further £4 billion cut in this Budget.

29. Interest rate risks

- A final source of risk to the Chancellor's fiscal plans comes from the financial markets in the form a reversal of the decades' long fall in interest rates.

- This steady decline in interest rates on government debt has given successive Chancellors a bit of extra breathing space when putting together their Budgets

- The fiscal benefit of falling interest rate has been magnified in the wake of the financial crisis by the advent of quantitative easing by central banks which essentially refinances the government's debt at the lower, but also shorter, interest rates paid by central banks on their reserves.

- As we've highlighted in previous EFOs and discuss in detail in Box 4.1 of this one, this has left the public sector as a whole much more exposed to changes in interest rates.

- And indeed, government bond yields in the UK and elsewhere have begun to rise over the past month

- To illustrate the kind of pressure this puts on the public finances, our forecast took a print of the yield curve on 5 February following the Bank of England's Monetary Policy Report

- Since then yields on the government's benchmark 10-year gilt have risen by 0.3 per cent back to their pre-pandemic level of 0.8 per cent

- Considered in isolation, this increase alone would increase debt interest costs by £6bn by the final year of our forecast and therefore be enough to put underlying debt back on a rising path in every year

- And all other things being equal, if interest rates were to rise a full percentage point, this would cost an additional £20 billion and be sufficient to wipe out all of the additional corporation tax revenue raised by the Chancellor in this Budget

- Of course all other things are not equal. Higher interest rate expectations could reflect greater optimism about future GDP growth, and therefore tax revenues, which could offset some of these additional debt servicing costs.

- But even so, it may be that, come the autumn Spending Review, debt interest may go from being a minor relief to a major headache for a Chancellor already trying to cope with the other post-pandemic pressures I highlighted earlier.

30. Conclusion

- So in conclusion, the winter resurgence of infections and third lockdown have delayed the economic recovery we forecast back in November

- But the accelerated rollout of vaccines should enable a faster reopening of the economy and more rapid recovery in GDP later this year. And output is now expected to reach its pre-pandemic level in mid-2022, six months earlier than we predicted in our last forecast

- Against this backdrop of a delayed but stronger economic recovery, the Chancellor used his 2021 Budget to do three things:

    - First, he spends a further £44 billion to extend the covid rescue package until the autumn – when the bulk of the adult population has been vaccinated and the economic recovery is in full swing.

    - Second, he stokes that recovery with £27 billion in generous tax allowances to encourage businesses to bring forward future investment into the next two years.

    - And third, he begins to repair of the damage to the public finances with corporation and personal tax rises and spending cuts that raise £30 billion and take the tax burden to a 50 year high.

- These actions are just about enough to balance the current budget and get debt falling

- But there are major risks to the achievement of both of those objectives from

    - any failure to keep virus in check,

    - the legacy costs of covid for public services,

    - or further rises interest rates.

- Thank you very much for your attention, and with that, we’ll now turn to your questions.