Office for
Budget
Responsibility

PRESS NOTICE **29 November 2011**

Economic and fiscal outlook, November 2011

In our updated forecasts we expect the weaker economic outlook to increase public sector borrowing and debt. In response, the Government has cut its medium-term spending plans in order to keep on track to hit its fiscal targets.

The economic outlook

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.

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.

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).

The fiscal outlook

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.

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. PSND is now forecast to peak at 78 per cent of GDP in 2014-15, which is 7.5 per cent of GDP higher than we expected in March.

Performance against the Government's fiscal targets

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.

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.

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.

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.

Risks and uncertainty

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.

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.

Notes

1. The Office for Budget Responsibility is the UK's independent fiscal watchdog – responsible for producing forecasts for the economy and the public finances, judging progress towards the Government's fiscal targets, and reporting on long-term fiscal sustainability.

2. Our documents are available here: budgetresponsibility.independent.gov.uk

3. Where possible the OBR will release supplementary information on the *Economic and fiscal outlook* at 10am on 6 December, in response to requests received by noon on 2 December. We will release a list of the information to be published at 10am on 5 December. Subsequently we will continue with our standard policy of releasing supplementary information monthly on the day of the HMT/ONS Public Sector Finances release.

4. Questions about the *Economic and fiscal outlook* should be sent to OBRpress@obr.gsi.gov.uk or directed to Mark Dembowicz on 020 7271 2442 or 07827 914326, or Tom Josephs on 020 7271 2408 or 07733 034066.