<u>March 2015 *Economic and Fiscal Outlook* Briefing</u>

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Good afternoon ladies and gentlemen.

My name is Robert Chote, Chairman of the OBR, and I would like to welcome you to this briefing on our final *Economic and Fiscal Outlook* of this Parliament.

I am going to take you through some of the highlights of the publication and then we will be very happy to answer your questions. The slides and my speaking notes will be available after we finish.

[SLIDE] Let me start with some background.

The EFO contains our latest five-year forecasts for the economy and the public finances and an assessment of the Government's progress against the two new fiscal targets that it has set itself.

The views expressed in the EFO are the responsibility of the Budget Responsibility Committee. But we have relied on the hard work of the OBR's staff and on the help of officials in numerous departments and agencies. Our thanks to them all.

As usual, the forecast went through a number of iterations to reflect new judgements, new data and proposed policy measures. We provided the Chancellor with a final pre-measures forecast on March 6th and then met him to discuss the forecast and the measures on March 9th.

As you will be aware, the OBR is required to produce its forecasts on the basis of current stated Government policy, not on how we think policy is likely to evolve. In order to do so, we need the Government to make an assumption about the path of public spending beyond the years for which it has detailed departmental plans. The Treasury has provided us with such an assumption and has told us that it is, and I quote, "the Government's agreed position for Budget 2015" - and that it was, and I quote again, “discussed by the ‘quad’ and agreed by both parties in the Coalition”. Of course, as you know, both parties have said that they would pursue different policies if either was to govern alone.

[SLIDE] Now let me summarise the main features of this EFO forecast.

Since our last forecast in December, there have been a number of developments with implications for the economy and public finances:

- A further sharp fall in oil prices;
- A further substantial rise in net inward migration;
- A fall in market interest rate expectations;
- Downward revisions to estimates of GDP growth last year;
- Another disappointing quarter for productivity growth, and;
- Gloomier forecasts for the world economy and trade growth.

Taken together, these have had a relatively modest net effect on our economic forecasts, moving GDP growth by no more than 0.2 percentage points in any year. They have also had a relatively modest net effect on our forecasts for public sector net borrowing, but this is partly because of the medium-term spending assumption.

If we turn to the new policy decisions and assumptions that the Government has made in this Budget, there are a number of things to note.

First, as in almost every fiscal event during this Parliament, the Treasury’s scorecard of policy measures looks pretty neutral, with ‘giveaways’ and ‘takeaways’ broadly offsetting each other and having very little net impact on the outlook for the budget balance.

As usual, most of the action takes place in the Government’s increasingly complicated medium-term spending assumption. In this Budget, the new assumption agreed by the Coalition delivers a slightly tighter squeeze on total spending through to 2018-19 and then a much looser one in 2019-

20, so that total spending is no longer on course to reach its lowest share of GDP since before the war. In addition to its tax and spending decisions, the Government has also announced significant new sales of financial assets next year that help to get the debt-to-GDP ratio falling more quickly, but at the cost of forgoing future flows of revenue.

[SLIDE] So let me say a little more about economic developments since December.

The starting point for our forecast was a weaker picture of economic growth over the previous two years. The Office for National Statistics has revised down its estimate of economic growth from the first quarter of 2013 to the third quarter of 2014 from 5.1 to 4.5 per cent. The initial estimates of growth in the fourth quarter were also slightly weaker than we expected at 0.5 per cent.

Employment came in broadly in line with our forecasts in the fourth quarter, but hours worked were slightly stronger. This meant that productivity measured as output per hour fell slightly in the quarter and was once again weaker than we had expected.

New data show that net inward migration rose to 298,000 in the year to September 2014, up from 210,000 in the year to September 2013. We had assumed in our previous forecast that it would fall towards 105,000 a year by mid-2019, given the international environment and the Government's declared aim to reduce it. In the light of the new data, we now assume that it will fall only towards 165,000 a year.

In financial markets, expectations of future interest rates have fallen again. The market is now pricing in base rates of 1.7 per cent at the end of our forecast, down from 2.2 per cent in December.

The spot oil price has fallen by 27 per cent since our December forecast, although part of this decline is expected to reverse. Our medium term assumption for the oil price – based on futures prices over the next two years – is 17 per cent lower than in December.

[SLIDE] The net effect of all this on our economic growth forecasts is relatively small. The lower oil price reduces inflation and increases real wage growth. We expect this to boost consumer spending temporarily.

Largely as a result, we have revised up our forecasts for economic growth this year and next to 2.5 and 2.3 per cent respectively. The boost to consumption more than offsets a weaker outlook for export growth and cuts in North Sea oil and gas production in these two years, but the fall in oil production continues and slightly reduces growth in 2017. Growth is also slightly higher in 2019 than in December, reflecting the effect of the higher net migration assumption on employment growth.

[SLIDE] If we think about cumulative GDP growth over the period from last autumn to the end of the forecast, the overall picture is slightly more positive than in December. We have revised up our estimate of cumulative growth in potential output – the amount that can be produced while keeping inflation stable – by 0.6 percentage points. This can be explained by our moving from the ONS's low migration population projections to its principal projections. This increases the population and projected employment rate. The fall in the oil price also boosts potential output growth by encouraging greater capital investment, but we judge that this boost is offset by the recent weakness of labour productivity relative to our forecast.

We assume that the Bank of England keeps output in line with its potential in the medium term in order to keep inflation on target. So actual output also grows 0.6 percentage points more strongly than in December. But our calculation of potential output is based on non-oil gross value added. So when we factor in the weaker outlook for oil production, the net upward revision to cumulative GDP growth is 0.4 percentage points over the forecast, raising it from 13.3 per cent to 13.7 per cent.

[SLIDE] The near term boost to GDP growth means that we now expect the remaining spare capacity in the economy to be used up by late 2017, about a year and a half earlier than we forecast in December.

[SLIDE] Our central GDP projections are somewhat weaker than those of the Bank of England, partly because the Bank tries to predict future data revisions. They are also fractionally below the outside average forecast. The path of GDP is always uncertain, but the direct and indirect impact of the recent oil price fall makes it all the more so in this forecast.

[SLIDE] The oil price decline has also led us to revise down our forecasts for inflation. We expect CPI inflation to fall near zero in the first half of this year, quite possibly turning negative in some months. It then picks up quite sharply but remains slightly below the Bank's 2 per cent target until 2019.

[SLIDE] The fall in inflation this year delivers a temporary boost to real wage growth, which rises to 1.4 per cent this year – the highest figure since 2007 and up from 0.1 per cent in 2014. We expect this to average 1¾ per cent over the medium term, but as always, the long-term prospects for real wage and income growth depend on a return to sustained productivity growth – which so far remains elusive.

[SLIDE] In terms of the sectoral picture, while the lower oil price boosts consumption, we see weaker business investment – especially in the North Sea – and also weaker residential investment. We have revised down our near-term forecasts for house price growth, in light of recent data, but pushed them up later thanks to stronger real household income growth. Our forecast for housing transactions is weaker throughout the forecast.

Household debt is expected to start rising again relative to household income from 2015, but more slowly than in our December forecast. This reflects recent outturn data, lower property transactions and weaker household investment and consumption later in the forecast.

[SLIDE] Looking to the external sector, we expect the current account of the balance of payments to have been in the red by 5.4 per cent of GDP last year – the biggest peacetime deficit at least since 1830. The recent deterioration largely reflects a fall in the investment income balance, notably a fall in the returns on our foreign direct investment overseas – although this may partly be explained by the fines and compensation paid by BP and some large banks. We expect the investment balance to return to surplus over the forecast, but the pace and scale of any improvement is far from certain. The trade balance is expected to remain in deficit and to act as a modest drag on GDP growth throughout the forecast.

[SLIDE] Now let me turn to the public finances.

The big picture is that tax receipts are lower across the forecast, but spending slightly more so. As a result, the budget balance is slightly stronger in each year through to 2018-19 than in our December forecast. In contrast, the surplus forecast for 2019-20 is considerably smaller than in December, because the government has dropped the cut in spending as a share of GDP that it had pencilled in at the Autumn Statement. As a result, public sector net debt continues to rise in cash terms in that year rather than falling as it did in December. But, as a share of GDP, net debt now starts falling a year earlier - in 2015-16 – thanks to the announcement of £20 billion in additional asset sales next year.

[SLIDE] So let us look at the figures in more detail.

This table shows our December forecasts for public sector net borrowing at the top and explains how they have changed to reach today's figures at the bottom. (A plus sign by a receipts figure means that it has added to borrowing since our last forecast – in other words, that we have revised it down.) The change between December and March reflects changes to the economic and fiscal forecast, plus the direct effect of the Budget policy announcements.

[SLIDE] You can see here that the budget position has improved slightly – by up to £2 billion a year – through to 2018-19. And then in 2019-20, the projected budget surplus is £16 billion smaller than in December.

[SLIDE] Turning to the fiscal year just ending, we have revised down our estimate of the deficit by just over £1 billion to £90.2 billion. Receipts are expected to be just over £1 billion higher than in December, with stronger revenues from corporation tax, PAYE income tax and VAT outweighing weaker revenues from self-assessment and stamp duty.

Spending is unchanged, with a £2.4 billion upward revision to investment spending outweighing a £2.4 billion fall in current spending. The extra capital spending is from local authorities and Network Rail, but it also includes a classification change. The fall in current spending is mostly a drop in interest payments on index-linked gilts thanks to the fall in oil prices lowering RPI inflation.

[SLIDE] Looking forward, revenues and spending are both around £3 to £6 billion lower in each year through to 2018-19 than we forecast in December. The main reasons for the fall in receipts are:

- Lower RPI inflation, which reduces excise, fuel duty and business rates, as well as interest payments on student loans;

- Weaker property transactions, which reduce stamp duty receipts;

- Lower interest rates and asset sales, which reduce income from the Government's stock of financial assets;

- The fall in the oil price, which reduces North Sea receipts, and;

- Lower operating surpluses from public corporations.

These outweigh higher receipts from income tax, VAT and onshore corporation tax.

The main reasons for lower spending are lower inflation and interest rates, which reduce debt interest payments. Lower inflation also helps reduce welfare costs and net public service pension spending, by slowing the pace of uprating. The impact of these changes on the budget deficit is dampened by the government's medium term spending assumptions, which ensure that some of the changes beyond 2015-16 are offset by higher implied spending on public services rather than lowering government borrowing.

[SLIDE] The explicit policy measures listed on the Budget scorecard have little net effect in any year of the forecast, as the giveaways broadly offset the takeaways.

[SLIDE] The increase in the bank levy is the biggest revenue raiser, bringing in an extra £4.4 billion over the forecast period. Other measures bring in smaller amounts, adding up to £8.1 billion in total.

These pay for three main giveaways: further increases in the income tax personal allowance (costing £5.7 billion), the saving allowance (costing £3 billion) and the subsidy for first time buyers (costing £2 billion).

In the Annex of our publication, we give each policy measure an uncertainty rating in terms of how much it will cost or raise. We identify eight measures for which the costing has high or very high uncertainty, including the tax and benefit consequences of the latest reforms to the annuities market and the hugely uncertain effects on North Sea production and investment of changes to the fiscal regime.

[SLIDE] So the forecast changes to receipts and spending largely offset each other – and the scorecard policy measures have little net impact. Against that backdrop the Government has ensured that borrowing is lower (or the surplus higher) through to 2018-19 by tightening its medium term spending assumption to reduce total spending by around £2 billion a year from 2016-17.

[SLIDE] The picture in 2019-20 is very different. Rather than tighten the spending assumption, the Government has loosened it significantly, dropping the cut in spending as a share of GDP that it had pencilled in at the Autumn Statement. This pushes up total spending by more than £20 billion relative to our December forecast. And that in turn pushes up government pay and procurement and so nominal GDP, which helps to explain why the forecast change in receipts in the second line turns around in that year.

The medium term spending assumption specifies a path for total spending in the years beyond those for which the Government has detailed departmental plans - in other words from 2016-17 onwards in this forecast. Back in 2011, we could explain the Government's spending assumption in our EFO in just 29 words. But it has now become so complicated that it requires 428 words [SLIDE]. It is unfortunate that this assumption has become so complex and opaque, because in an era of fiscally neutral Budget and Autumn Statement scorecards, it has become the main mechanism by which the Government achieves the outcomes for the budget balance that it wants to see across the forecast.

Let us have a look in a bit more detail at the impact of the changes in the spending forecast and the policy assumption.

[SLIDE] This table shows our December forecasts for total public spending at the top and then the various changes in the components of spending that lead us to the current forecast at the bottom.

[SLIDE] What you can see is that debt interest and welfare spending have both been revised down significantly since December across the forecast. Between 2016-17 and 2018-19 the Government has banked some of these savings to ensure that spending in total is over £6 billion lower than at the Autumn Statement and helps push the budget deficit down.

[SLIDE] But the debt interest and welfare savings are large enough that they have also loosened the implied squeeze on day-to-day departmental public services spending by between £2 and £5 billion in each of those three years. But this pales in comparison to 2019-20. [SLIDE]Thanks to the loosening in the earlier years – plus the decision to drop the cut in total public spending as a share of GDP pencilled in at the Autumn Statement – implied day to day public spending on public services is now £28.5 billion higher than in December. This is equivalent to 1.3 per cent of GDP or roughly the entire day-to-day departmental budget of the Ministry of Defence.

[SLIDE] Why has the Government done this? Well one consequence is that public services spending is no longer set to fall to its lowest share of GDP since before the war, as it was in our December forecast.

Looking at the annual figures, total spending now falls to 36.0 per cent of GDP in 2018-19 and 2019-20, fractionally higher than the previous post-war lows of 35.8 per cent of GDP in 1957-58 and 35.9 per cent of GDP in 1999-2000. Tax and other receipts are expected to remain at similar levels to those of recent decades.

[SLIDE] But another consequence of these changes is for implied spending on public services.

The real cut in public services spending planned for the coming year is slightly smaller than the likely average for the current Parliament. But the squeeze then becomes much more severe than anything we have seen to date in 2016-17 and 2017-18. This helps achieve the Government's desire to meet its new fiscal mandate with room to spare – more of that in a minute – and to achieve £30 billion of consolidation by 2017-18 on its own definition. The squeeze then slackens in 2018-19 before going into reverse in 2019-20. The 4.3 per cent implied increase in that year would be the largest for a decade.

[SLIDE] That leaves something of a rollercoaster profile through the next Parliament.

[SLIDE] Our latest forecast suggests that the budget deficit will have fallen by 41 per cent in cash terms and 51 per cent as a share of GDP between its post-war peak in 2009-10 and the current fiscal year just ending. Looking forward, we expect to move from a deficit of 5.0 per cent of GDP this year to a surplus of 0.3 per cent of GDP in 2019-20.

This chart shows how we get there. Despite the relaxation of the squeeze in this forecast, further implied cuts in public services spending deliver around 70 per cent of the improvement in the budget balance over the next five years. Lower welfare spending is the next biggest contributor, explained largely by inflation uprating of most benefits and lower caseloads for those sensitive to the economic cycle.

Higher revenues deliver only a tenth of the improvement, mostly fiscal drag in income tax and a rise in interest income from the government's financial assets. We show in the EFO that in the UK, revenue increases have delivered less of the improvement in the budget deficit that we have seen to date than they have in a number of other big economies.

[SLIDE] Now let me turn to the Government's new formal fiscal targets – or 'aims' as it preferred to describe them in the latest Charter for Budget Responsibility. The 'fiscal mandate' requires the government to balance the cyclically adjusted current budget, in other words to borrow no more than it needs to finance investment, adjusting for the state of the economic cycle. In 2010 the Government said that the mandate had to be met in the fifth year of the forecast, but it has now brought this forward to the third year – 2017-18 in this forecast.

This table shows that we expect the Government to meet the new mandate with 0.8 per cent of GDP to spare, up from 0.7 per cent in our December forecast. This room for manoeuvre depends crucially on the very sharp cuts in real public services spending pencilled in for 2016-17 and 2017-18. The mandate would also be met at the old five-year horizon – but by less than in December because of the extra spending the Government has pencilled in for 2019-20.

[SLIDE] Given the size and distribution of past official forecasting errors, we estimate that the Government would have a 65 per cent chance of meeting the mandate at the new date and a 75 per cent chance of doing so at the old date.

[SLIDE] The Government's supplementary fiscal target requires the debt-to-GDP ratio to be falling in 2016-17. The debt-to-GDP ratio is lower in every year of the forecast than in December, peaking at just over 80 per cent of GDP – roughly twice its level prior to the crisis.

[SLIDE] This table shows that we expect net debt to fall by 0.5 per cent of GDP in 2016-17, thus meeting the new target by the same margin that our December forecast would have suggested.

But, just three months after dropping it, the Government is now also on course to achieve the old supplementary target. Net debt is expected to fall by 0.2 per cent of GDP between this year and next, rather than rising by 0.8 per cent as in our December forecast.

[SLIDE] The Government has got itself back on course to achieve the old target by announcing two major asset sales to take place next fiscal year. We assume that the Government will raise £11 billion selling mortgage-based assets held by UKAR from Northern Rock Asset Management, principally the Granite securitisation vehicle. The Government has also announced the sale of a further £9 billion of shares in Lloyds Bank.

We only include asset sales in our forecast when the government's announcement is firm and detailed enough for us to be confident that we can identify what will be sold, when it will be sold and how much it might be sold for. That said, there are always uncertainties around sales of this sort, not least depending on prevailing market conditions.

The asset sales help the Government bring net debt down because the National Accounts do not include the present value of the income that will be foregone as an offsetting cut in liquid assets. But it is important to remember that if you sell a financial asset for roughly the net present value of the future income stream that it would generate, then net debt only falls temporarily and the underlying health of the public finances is unaffected. We assume that the sale of Granite and the Lloyds shares would reduce future income by around £10 billion over the remainder of the five-year forecast horizon and by more thereafter.

[SLIDE] This chart illustrates the importance of the asset sales in getting the Government back over the line. It shows our forecasts for the change in the net debt to GDP ratio in 2015-16 at every fiscal event since the June 2010 budget. Back then we expected the ratio to fall by 2 per cent and for the supplementary target to be met with ease. But this margin was gradually eroded and by March 2013 we expected it to be missed by 2.4 per cent of GDP. This deterioration reflected greater pessimism regarding the outlook for the primary budget balance, in other words the budget deficit excluding interest payments and receipts.

What is striking in this chart is that we are no more optimistic about the primary budget balance now than we were in March 2013. The Government is back on course in part because the difference between interest rates and GDP growth is expected to be more favourable. But the main reason is that there are a number of factors reducing public sector net debt next year that do not reduce borrowing, of which the sales of financial assets are the most important.

[SLIDE] So let me conclude by summarising some of the things that the Government has achieved for the public finances in this Budget, how it has achieved them and what other consequences that has:

- First, it has succeeded in getting public sector net debt falling as a share of GDP a year earlier. It has done this primarily by announcing new sales of financial assets.

- Second, it is on course to achieve its new fiscal mandate with room to spare in 2017-18. It has achieved this by continuing to pencil in a much tighter squeeze on implied public services spending in the second and third years of the next parliament than we have seen to date.

- Third, it has ensured that the budget deficit is forecast to be lower each year to 2018-19 than in our last forecast. It has achieved this by tightening the assumed squeeze on total public spending from 2016-17 to 2018-19.

- Fourth, it has ensured that total public spending is no longer set to fall to a post-war low as a share of GDP. It has achieved this by dropping the cut in public spending as a share of GDP in 2019-20 that it had pencilled in at the Autumn Statement.

One important consequence of all of this is that implied public services spending is on a rollercoaster profile through the next parliament, with deeper real cuts in the second and third years than we have seen to date followed by the sharpest increase for a decade in the fifth.

It is important to emphasise that this profile arises from what the Government itself describes as a 'fiscal assumption' and not from firm and detailed departmental plans. But it will form the baseline for whichever party or parties are in government after the election and have to carry out the next spending review. This profile for implied public services spending may have ticked a number of boxes for this Budget, but it will not have made that task any easier.