EFO launch presentation

Introduction

Good afternoon Ladies and Gentlemen

My name is Robert Chote, Chairman of the Office for Budget Responsibility, and I would like to welcome you to the launch of our November 2010 *Economic and fiscal outlook*. My thanks to the Institute for Government for agreeing to host the event.

In this document we set out our forecasts for the economy and the public finances over the next five years, and assess whether the Government's tax and spending decisions are consistent with its medium-term fiscal objectives. We also make a preliminary assessment of longer-term fiscal sustainability, although we shall return to that issue in more detail in our *Fiscal sustainability report* next year. In all this we build on the firm foundations laid by the interim OBR in the summer.

There is of course considerable uncertainty around any set of economic and fiscal forecasts. Our central forecasts are median forecasts. In other words we think that they are as likely to be too high as too low. Throughout the document we are explicit about the degree of uncertainty suggested by past official forecasting errors. We also use sensitivity and scenario analysis to test how vulnerable the Government's targets are to potential errors in our central projections.

These forecasts are the collective view of the three independent members of the OBR's Budget Responsibility Committee – myself, Steve Nickell and Graham Parker.

Needless to say, we have relied enormously on the hard work of our full-time OBR staff, to whom we are very grateful. Given the highly disaggregated nature of the forecasts we produce, we have also drawn on the help and expertise of officials in HM Revenue & Customs, the Treasury, the Department for Work and Pensions and many other government departments. And we are very grateful to them too.

That said, let me be clear that the members of the BRC take full responsibility for all the assumptions, judgements and conclusions in this

document. And I am pleased to report we have not come under any pressure from ministers or their advisers to change any of them. We presented a provisional forecast to the Chancellor of the Exchequer on November 18th, so that he could ask questions and confirm whether he wished to make any new policy announcements that would require inclusion in the published forecast. He did not and we made no changes in the fourth and final round of the forecast as a consequence of that meeting. The Treasury were given a draft copy of the final document 24 working hours before publication, in line with the pre-release policy for data releases by the Office for National Statistics.

I should point out that it is only because there are no new costable measures being announced today that we are able to present our conclusions to you before the Chancellor makes his statement in the House of Commons at 3.30. I hope that we will have done something to increase the index of general wellbeing by giving you a little more time to digest the numbers today, but of course we won't be able to do the same at Budget time or if measures that need to be costed and scored are announced at the time of future autumn forecasts.

Let me now talk you through the conclusions of the Outlook. We will then have a brief opportunity to take questions, leaving plenty of time for you to get to the House of Commons and find out if the Chancellor agrees with them.

Key points

Let me begin with an overall summary:

- The economy has recovered more strongly over recent months than the interim OBR expected when its made its forecast at the time of the June Budget, while the public finances have performed broadly as expected.

- Looking ahead, we expect some of the recent good news on growth to persist and we have therefore revised the expected level of GDP slightly higher across the forecast horizon. But we believe that most of the unexpected growth was a timing effect and so we expect the pace of growth to slow more sharply into

the early part of next year. As a result, we have revised our growth forecasts up a little for 2010 and down a little for 2011.

- We expect the economy to continue to recover over the rest of the forecast horizon, but at a slower pace than we saw in the recoveries from the previous three recessions. We expect employment growth in the market sector to more than offset looming cuts in general government employment, just as it did during the fiscal consolidation of the mid 1990s.

- Our forecasts for public sector net borrowing have changed only modestly from those published by the interim OBR in June. This reflects the fact that we expect both revenues and spending to be lower over the next few years than looked likely in June, with offsetting effects on the budget deficit. The medium term outlook for public sector net debt is also little changed.

- We believe that the Government has a better than 50 per cent chance of meeting the medium-term fiscal targets that it has set itself – and fractionally more margin for error in doing so than in June. The biggest economic risk to this outcome arises if we have significantly overestimated the level of economic activity that the economy can sustain without upward pressure on inflation. As always, there is also considerable uncertainty about the levels of revenue and spending we would see in any given state of the economy.

- Looking over the longer term, the Government's fiscal consolidation looks sufficient to put public sector net debt on a downward trajectory as a share of national income beyond the end of our medium-term forecast horizon. If left unaddressed, pressures on spending from an ageing population would likely push debt up again. The UK is not unique in this and will be only one of many countries having to address this issue once the current consolidation is complete.

The bottom line from all this is that on current evidence we believe that the Government's planned fiscal consolidation is consistent with achieving the medium-term fiscal targets that it has set itself and with sustaining an (albeit relatively slow) economic recovery. But it is beyond

our remit to judge whether the consolidation plan it has adopted is the best that could have chosen, in size, speed or composition. Those are judgements on which reasonable people can and do disagree.

Economic outlook

Now let me talk in a little more detail about our forecasts for the economy and how they have been influenced by recent developments.

The June forecast assumed a steady profile for the recovery this year and next, with GDP growing by around 0.6 per cent a quarter on average. But data since June has shown stronger-than-expected growth in the second and third quarters of the year.

We believe that about one-third of this unexpected strength is evidence of greater lasting momentum in the recovery, but that about two-thirds is a timing effect: firms are making more rapid progress in rebuilding their stocks and construction output has been growing unsustainably rapidly. We therefore expect growth to be slightly slower going into next year than seemed likely in June, but to pick up thereafter.

If we turn to calendar year growth rates, this quarterly profile leads us to revise up our forecast for 2010 from 1.2 to 1.8 per cent, and to revise down our forecast for 2011 from 2.3 per cent to 2.1 per cent. However, recent construction data suggests that second quarter growth could be overstated, reducing the 2010 forecast a little.

Looking further ahead, we expect a similar growth path to the June forecast, but with the recovery accelerating slightly less quickly. You will note that the calendar year growth rate never reaches 3 per cent in our central forecast. So this would be a slower recovery than we saw in the 1970s, 1980s or 1990s. This relatively sluggish outlook reflects the gradual normalisation of credit conditions, efforts to reduce private sector indebtedness and the impact of the fiscal consolidation.

In terms of the composition of growth, we continue to expect a rebalancing away from consumer spending and towards business investment and net exports:

- We have revised down our medium-term consumer spending forecast since June, reflecting weaker expected growth in household disposable incomes.

- We expect the recent tentative signs of a recovery in business investment to come to fruition, with the likely medium-term strength of investment growth in part reflecting the unusual depth of the decline during the recession.

- And we expect net trade to make a growing contribution to the recovery, as the impact of sterling's depreciation eventually feeds through to export volumes as it did in the 1990s. Demand in UK export markets is expected to grow by about 6 per cent a year in the medium term.

The outlook for GDP is mirrored in our forecasts for the labour market.

The June forecast predicted a very slow pick-up in employment during this year, but the latest data show an increase of around 350,000 between the first and third quarters. Employment has already reached levels that the interim OBR did not anticipate until mid-2012. Three-quarters of the additional employment has been part-time, but part-timers have also been working longer hours.

Looking ahead, we expect employment to fall a little in the short term as growth slows below trend, but then to pick up again. Over the full forecast horizon, we expect employment to rise from 29.1 million this year to 30.1 million in 2015. We expect employment growth in the market sector to more than offset cuts in general government employment, just as it did in the consolidation of the mid-1990s.

As you will recall, the interim OBR estimated that general government employment would fall by 490,000 over the four years of the Spending Review. We have updated and simplified the methodology they used, looking at all categories of spending that could finance general government employment. This would have given us a decline of 460,000 in June. Since then, the Government has loosened the squeeze on public services spending somewhat, by announcing more welfare cuts. The pool of money available to finance general government employment in 2015–16 is 2.5 per cent higher now than it was in the June Budget. And,

as a result, we now expect general government employment to fall by 330,000 over the Spending Review period to 2014–15. We estimate that the Government's policy to freeze total public spending in real terms in 2015–16 would imply a further fall of 80,000 in that year, in the absence of further cuts in welfare or other annually managed spending.

Turning to unemployment, we expect a small increase in the ILO unemployment rate in the short-term as growth slows into next year. We expect unemployment to peak next year at a little over 8 percent of the labour force before falling steadily to a little over 6 percent in 2015–16. Our unemployment forecast is slightly higher across the horizon than in June, mostly because of the latest evidence on flows from labour market inactivity to unemployment.

The scale of the economic recovery we expect over the medium term in part reflects our assessment of the amount of spare capacity in the economy. Evidence from a wide variety of economic indicators suggests to us that GDP was running about 4 per cent below potential at the end of 2009, falling to around 3¼ per cent in the second quarter of 2010. We project that this 'output gap' will close in 2016-17. As you know, the output gap is very hard to quantify with any confidence. But our estimate lies within the range of estimates produced by other leading forecasters.

Turning to prices, CPI inflation has remained somewhat higher than the interim OBR forecast in June. We expect it to fall from 3.2 per cent this year to 1.9 per cent in 2012 as the short-term effects of the VAT rise and other temporary factors fall away. We assume that monetary policy evolves in line with market expectations and that CPI inflation settles around the Bank of England's 2 per cent target from 2013.

The GDP deflator – the broadest measure of general inflation in the domestic economy – has picked up in recent quarters. Looking at it together with real GDP growth, we find that growth in nominal cash spending in the economy is already back to the 6 per cent or so annual rate which was typical of the decade or more prior to the recession. This provides further reassurance that demand is growing sufficiently strongly to sustain the recovery.

That said, there clearly remains considerable uncertainty around our central growth forecast. This chart shows the outcomes you might expect if you believed that our forecasts were likely to be as accurate in the future as official forecasts have been in the past. Each coloured area contains 10 per cent of the probability distribution.

In light of this uncertainty, we do not rely entirely on our central economic forecast to assess the Government's progress towards its fiscal objectives. We also use sensitivity and scenario analysis to illustrate some of the risks. I will come back to that in a few minutes, but let me first say a little more about our central fiscal forecasts.

The fiscal outlook

Our central forecast is that public sector net borrowing will total £148.5 billion this year, £1 billion less than the interim OBR forecast in June. This headline measure of the budget deficit is expected to fall from its peak of 11.1 per cent of GDP in 2009-10 to 1 per cent of GDP in 2015-16, very much in line with the June forecast. Over this period revenues are expected to rise and spending on public services and social security to fall as shares of national income, partly offset by much smaller increases in debt interest and net public sector pension payments.

The difference between this forecast and the June forecast is dwarfed by the uncertainty around either suggested by errors in past official forecasts. This is not surprising. The deficit is the difference between much larger figures for total revenues and total spending, each of which is influenced by numerous economic and non-economic determinants. As with GDP growth earlier, we can show the probability distribution of outcomes implied by past forecast errors in a fan chart.

The very small changes in our forecasts for public sector net borrowing mask falls in both revenues and spending since June. These have offsetting effects on the deficit.

We expect receipts to be higher than previously forecast in the short term, especially VAT which remains higher throughout the forecast horizon. But this will be offset in the medium term by the impact of lower expected onshore corporation tax receipts, plus the impact of lower property prices, interest rates and oil prices on a variety of

revenue streams. This leaves the receipts forecast for 2015-16 about £2½ billion lower than in June.

Spending is also expected to be lower in the medium term than forecast in June. This reflects lower debt interest costs and a fall in expected net spending on public sector pensions. There are also several large and mostly offsetting policy effects from the Spending Review, notably the decision to cut capital spending by less than the Government planned in June, plus the use of welfare cuts to finance higher current spending on public services.

Our forecasts for public sector net debt are fractionally lower than in June – and therefore still peak at around 70 per cent of GDP. The expected cash level of public sector net debt has been pushed slightly higher by the increase in the stock of student loan debt that is likely to result from the Government's higher reduction reforms. We estimate that this will increase net debt by around £13 billion by 2015–16. But this effect is offset by the fact that nominal GDP is likely to be slightly higher than expected in June, which will pull net debt down a little as a share of GDP.

Let me briefly mention the direct fiscal consequences of the UK's contribution to the support package for Ireland, which was announced last night. As we set out in paragraphs 133 and 134 of Chapter 4 the only element that would directly affect the public finances would be the £3.2 billion bilateral loan. The loan itself would be a financial transaction and would therefore increase the central government net cash requirement and public sector net debt, but not public sector net borrowing. Any profit the taxpayer made on the difference between the interest rates at which the UK government can borrow and the interest rates at which it lends to Ireland would reduce public sector net borrowing. As the timing of the loan, the duration of the loan and the precise interest rate on the loan have not been announced, we could not have scored it in this forecast in any event. But clearly the sums involved are too small to make a material difference to the outlook.

The Government's medium-term fiscal targets

So what does our expected outlook for the public finances imply for the achievement of the Government's fiscal objectives?

In the June Budget the Chancellor set out two medium-term fiscal targets:

- The fiscal mandate requires the Government to balance the cyclically adjusted current budget by the end of the five-year forecasting horizon, which for the purposes of this forecast is 2015–16. This implies that revenues must exceed non-investment spending in that year, after taking account of the temporary impact of any remaining spare capacity in the economy.

- A supplementary target also requires public sector net debt to be falling in 2015–6. This target will remain fixed to this particular year, even when the end of the forecasting horizon moves further into the future.

This chart shows our central forecasts for the cyclically adjusted current budget balance and for public sector net debt across the horizon. As you can see, the forecast shows the mandate being achieved in 2015–16 with 0.9 per cent of GDP to spare, fractionally more than the June forecast suggested. Indeed, you can see that our central forecast also implies that the Government has a better than 50 per cent chance of achieving the mandate in the previous year.

There is, of course, considerable uncertainty around this forecast. And so we can use the familiar fan chart to show the probability of different outturns for the cyclically adjusted current budget balance, based on past Budget and Pre-Budget Report forecasting errors. As usual, each band encompasses 10 per cent of the probability distribution. This suggests that on past forecasting performance the Government has an approximately 70 per cent chance of achieving the mandate in 2015–16.

Turning back to public sector net debt, we see once again that the Government is on course to hit its target, as the central forecast shows the debt ratio falling in 2015-16. And once again, this target is also more likely than not to be achieved in the previous year.

But, moving beyond the lessons of past forecasting performance, we can also test how sensitive the achievement of the mandate is some of the

key judgments in our economic forecast. Two obvious questions to ask are:

- Will the mandate still be achieved if the potential output of the economy and the amount of spare capacity is bigger or smaller than our central forecast suggests?

- And will the mandate still be achieved if the recovery is quicker or slower than our central forecast suggests?

This chart shows some answers to these questions.

You can see that the cyclically adjusted current budget balance is not much affected by modest changes in the pace of recovery – in other words whether we use up the spare capacity in the economy a year or two earlier or later.

More important is the amount of spare capacity that we have to begin with. The less there is, the less scope there is for the economy to grow while it returns to trend, and the worse the remaining budget surplus or deficit will look when it has done so. Roughly speaking we would need to have overestimated the potential of the economy and the amount of spare capacity by around 1½ per cent of GDP for the Government no longer to be on course to achieve the mandate.

The supplementary target is not particularly vulnerable to either the size of the output gap or the speed of recovery. That is because the budget deficit would need to be significantly larger than we currently expect in 2015-16 for debt to be rising.

We also show in the report that neither the mandate nor the supplementary target would be particularly vulnerable to a near-term rise in gilt rates. That is because the long average maturity of UK government debt means that it would take some time for higher gilt yields to feed through to the average interest rate on the outstanding stock. But changes in gilt yields would have a bigger effect in the longer-term.

These are relatively mechanistic ways of stress-testing the Government's fiscal targets. Reflecting the differences of views among external

forecasters, the Outlook also discusses the fiscal impact of two illustrative alternative economic forecasts. They are for illustration and we do not attach particular probabilities to them.

The first is a scenario in which the economy grows at the same pace as in our central forecast, but with the long-awaited rebalancing of activity away from domestic demand and towards net exports remaining elusive. This actually improves the Government's chances of achieving the mandate, as consumer spending is higher and consumption is a relatively 'revenue rich' form of demand. But given that we would be consuming more now and consuming less in the future, the beneficial fiscal impact would be expected to reverse in the longer term.

The second is a scenario is which demand in the economy is persistently weaker than in our central forecast, perhaps because wage pressures make it harder for the Bank of England to maintain the our central forecast for demand without imperilling the inflation target it has been given. The potential threat to the mandate is less the fact that weaker growth would push up borrowing for a while than the possibility that it would also pull down the expected future level of potential output. This increases the structural component of government borrowing. That said, under the particular scenario that we have used in the document, the Government still has a better than 50 per cent chance of achieving the mandate, albeit with slightly less margin for error than in the central forecast.

Long-term fiscal sustainability

Finally, before concluding, let me say a little about whether the Government's policies look consistent with longer-term fiscal sustainability. We make a very provisional assessment of this in the Outlook, as we shall be returning to this issue in more depth in our *Fiscal sustainability report* next summer.

Given the amount of uncertainty that surrounds forecasts over a five-year horizon, projections over a 40 or 50 year horizon need to be treated with even more caution. They are illustrative projections rather than detailed forecasts.

Our starting point is to assume that revenues and spending (other than on debt interest) are held constant as shares of national income beyond the end of our medium-term forecasting horizon – the difference between the two being the primary budget balance. Debt will be on a sustainable trajectory as long as the average nominal interest rate on the public sector's net debt does not exceed the growth rate nominal GDP by an amount greater that the primary budget surplus as a share of national income.

On the central assumptions we make in Chapter 5, the primary budget surplus is assumed to settle at around 2 per cent of GDP, nominal GDP growth at around 5 per cent a year and the average interest rate on the debt stock at about 4½ per cent. This means that public sector net debt is comfortably on a downward trajectory.

We can test the sensitivity of this trajectory by assuming that economic growth is one percentage point higher or lower – the former reduces the debt ratio and the latter increases it. We can also see what happens if gilt rates are up to 150 basis points higher or lower – the former increases debt and the latter reduces it. In both cases, these variations have a significant impact on the levels of public sector net debt that we might expect, but they do not push us onto an unsustainable path.

But what if public spending (even excluding debt interest) was not to be constant as a share of national income beyond the end of our medium-term forecasting horizon?

One obvious source of pressure would be demographic change, in particular the ageing of the population and its consequences for spending in areas such as pensions, health and long-term care. The Treasury estimated the impact of these pressures in its 2009 *Long Term Public Finance Report*, and we update them here simply to reflect the long-term population growth assumptions we are using.

Policy changes on pension and benefit uprating, higher education and perhaps soon the funding of long-term care will all affect these estimates and we will update them accordingly in our next and future *Fiscal sustainability reports*.

But, for the time being, the existing figures provide a rough but useful yardstick. You can see that they imply eventual upward pressure on spending of 4.6 per cent of GDP if you include pensions and 3.3 per cent of GDP if you exclude them. Either would be enough to push the primary balance into deficit by a large enough amount eventually to put public sector net debt on an upward trajectory.

It should be said, of course, that the UK is not alone in facing these pressures. Reports by the IMF, the European Commission and the Bank for International Settlements have identified similar challenges confronting many industrial countries. The UK will be only one of many nations having to decide how to respond to them once the immediate challenge of the current consolidation has passed.

Conclusion

So to conclude and summarise one more time: our central forecast suggests that the Government's planned fiscal consolidation is more likely than not to be consistent with achieving the medium term fiscal targets that the Government has set itself and with sustaining an (albeit relatively slow) economic recovery. But there are of course considerable uncertainties around both the economic and fiscal forecasts and in four months time we will have our next chance to assess the outlook.