Briefing on November 2011 *Economic and fiscal outlook*

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1. Introduction

Good afternoon everyone. My name is Robert Chote, Chairman of the Office for Budget Responsibility. And I would like to welcome you to this briefing on our November 2011 *Economic and fiscal outlook*.

[SLIDE] In this document we set out our forecasts for the economy and for the public finances over the next five years, incorporating the decisions announced by the Chancellor of the Exchequer in his Autumn Statement earlier this afternoon. We then use those forecasts to assess whether the Government is on course to meet the fiscal targets it has set itself.

The assumptions, judgements and conclusions in the EFO are the collective view of the three independent members of the OBR's Budget Responsibility Committee – Steve Nickell, Graham Parker and myself. And I am pleased to report that we have come under no pressure from ministers, advisers or officials to change any of them.

As always, we have relied on the hard work and dedication of the OBR's full time staff. And we have also drawn on the help and expertise of officials from a wide range of government departments and other bodies. We are very grateful to all of them for their time and effort.

Let me start with a brief overview of the main points, before dealing in greater detail first with the economic forecast, then the fiscal forecast, and finally the Government's performance against its targets. My remarks and the slides will be available online at the end of the briefing.

2. Overview

[SLIDE] Let's begin with an overview:

- The economy has grown much less strongly this year than we expected at the time of the Budget in March, largely because higher-than-expected inflation has squeezed household incomes and consumer spending. At 0.9 per cent, we estimate that GDP growth this year is likely to undershoot the predictions of all 38 external forecasters polled by the Treasury back in March.

- We expect the underlying momentum of the economy to weaken further during the final quarter of this year, but then to pick up gradually through next year – assuming that the euro-zone struggles through its current difficulties. Even so, we forecast little increase in headline GDP until the second half of the year. We expect GDP to grow by 0.7 per cent in 2012 as a whole.

- We are also more pessimistic about the economy's medium term growth prospects. And this is for two main reasons:

  - First, there appears to be less spare capacity in the economy than we would have expected given its recent weakness.

  - Second, the economy's productive potential has increased unexpectedly slowly since the end of the recession.

- As a result, by 2016 we expect the economy to be about 3½ per cent smaller than we anticipated in March. Weaker output means weaker revenues, higher spending and a larger budget deficit as shares of national income. What is more, the additional borrowing is structural rather than cyclical – we don't expect it to be reversed by stronger economic growth further into the future.

- On taking office in 2010 the Coalition Government set itself a medium-term fiscal mandate and a supplementary target:

  - to balance the cyclically-adjusted current budget by the end of the rolling, five year forecast, which is now 2016-17;

  - and to see public sector net debt falling in 2015-16.

- As a result of the widening structural budget deficit, and in the absence of any policy decisions in the Autumn Statement, we estimate that the Government would have been on course to miss the fiscal mandate by around 0.3 per cent of GDP or £6 billion in 2016-17. But by pencilling in an extra cut in spending on public services of roughly 1.5 per cent of GDP or £30 billion in that year it has put itself back on course to meet the mandate, albeit with slightly less margin for error than at the time of the March Budget.

- The additional spending cuts also mean that the Government remains on course to achieve the supplementary target, again with slightly less margin for error than in March.

Those are the key points. Now let me take you through the analysis in a little more detail, beginning with the economy.

3. Economic outlook

We begin the economic forecast by thinking about the supply side – the potential of the economy to produce goods and services without putting upward or downward pressure on inflation.

There are two key questions:

- First, how far below potential is the economy running at the moment? How much spare capacity is there?

- And, second, how will the level of potential output change?

The answers to these questions determine how much growth the economy can sustain in the medium term. And, therefore, how much the Government can rely on the recovery to reduce borrowing automatically, without the need for additional policy measures.

[SLIDE] To estimate the amount of spare capacity in the economy we look at business surveys and at what is happening to earnings. Using different statistical techniques, graphed here, our best judgement is that output was about 2½ per cent below potential in the third quarter.

[SLIDE] This is a smaller 'output gap' than we expected in March and smaller than at the end of last year. This is particularly striking when you consider how little GDP growth there has been over that period. If potential output had grown at its long-run average rate of more than 2 per cent a year, as we assumed at Budget time, then the output gap would be around 4½ per cent by now. The fact that it appears not to be highlights that potential output appears to have been growing by only about 1 per cent a year since the end of the recession.

Why might potential output have been growing so slowly?

One possibility is that the structural level of unemployment might have risen. But employment has consistently outperformed expectations, during the recession and the recovery. Long-term unemployment remains below the levels recorded following the recession of the 1990s. And the mismatch between vacancies and unemployment in different industries is near its 10-year average. We might see more of a shake-out in jobs over the winter, but for the time being there is no evidence of a significant structural deterioration in the labour market.

More likely the weakness of potential output reflects the weakness of underlying productivity growth. [SLIDE] Output per hour worked has grown by only 1.4 per cent a year since the recession ended. It remains more than 6 per cent below the level implied by the continuation of its pre-recession trend. [SLIDE] And it is also much weaker now than at the equivalent stage of previous recoveries.

[SLIDE] Explaining why productivity growth has been so weak is not easy.

It does not appear to be the result of weak investment reducing the amount of capital per worker – or of an increase in the relative size of the less productive parts of the economy. The best answer we have for now is that tight credit conditions and the weakness of the financial sector more generally, may be making it difficult for the economy to reallocate capital from inefficient activities to more productive ones.

Whatever the explanation, it no longer seems central to assume that growth in potential output will snap straight back to its pre-crisis average rate. We now assume that it will do so gradually over the next two years as credit conditions and the financial sector normalise.

The narrowing in the output gap and the weakness of potential output growth suggest that the level of potential output will be about 3½ per cent smaller by 2016 than we estimated in March. This loss of potential is the main reason why we are more pessimistic about the underlying health of the public finances than we were at Budget time.

[SLIDE] As this is such a key judgement, it is worth comparing our estimates to those of other leading forecasters. This chart shows that, despite the downward revision I have just described, our estimates of future potential output are broadly in line with those of the OECD and the IMF, and more optimistic than those of the European Commission.

So let's turn from potential output to actual output – and the pace of the recovery.

[SLIDE] This graph of changes in monthly GDP since March shows how little momentum the economy had moving into the current quarter. Business and consumer surveys also point to continued weakness, recent utility price increases are squeezing incomes, and events in the euro area are undermining confidence and threatening tighter credit conditions.

We expect the underlying momentum of the economy to weaken further in the current quarter before picking up gradually through next year, assuming that the euro area struggles through its current difficulties. Taking various one-off factors into account we expect little increase in headline GDP until the second half of next year. Our central forecast is for GDP growth of 0.7 per cent for the year as a whole.

Given that central view, past forecasting performance suggests that there is a roughly one-in-three chance that GDP will fall year-on-year in 2012 or that we will see a technical recession before next summer with two consecutive quarterly falls in output.

[SLIDE] Looking further ahead, we see less scope for above-average rates of growth while the remaining spare capacity in the economy is used up. Our central forecast is for growth of 2.1 per cent in 2013, 2.7 per cent in 2014 and 3 per cent in 2015 and 2016.

The 3 per cent rate in the final two years is slightly higher than in March. But this purely reflects a methodological change in the National Accounts, which means that for a given growth rate of cash spending in the economy, measured real GDP growth is now likely to be 0.2 percentage points higher. It does not imply any meaningful improvement in the economy's long term growth prospects.

How does this outlook compare with other forecasts?

[SLIDE] This chart shows forecasts for the level of GDP through to 2014. As you can see, our new central forecast is significantly weaker than our March one. It is also slightly weaker than the average prediction of external forecasters for most of the period, before catching up towards the end. It is also somewhat weaker than the mean forecast from the Bank of England's latest Inflation Report, but that is partly explained by the fact that the Bank includes expected upward revisions to past GDP data. The uncertainty surrounding each of these forecasts dwarfs the differences between them.

The strength of economic growth certainly matters for the public finances, but so too does its composition. As at Budget time, we expect net trade and business investment to be the strongest motors of growth – although we have revised both of them lower since March.

[SLIDE] In the case of net trade, we expect the same cumulative contribution to GDP growth between 2007 and 2014 as in March. But recent data revisions suggest that exports have picked up more already in response to the weakness of the pound than previously thought, so there is less of a boost still to come. In the case of business investment, we think firms may have less cash available to invest than we previously thought.

[SLIDE] Turning to the outlook for consumer spending, real household disposable income looks likely to have fallen by 2.3 per cent this year – a post-war record – and we do not expect earnings to outpace prices again by a significant margin until 2014. This suggests that having fallen this year, real consumer spending will be broadly flat next year before picking up thereafter as real income growth gradually recovers.

[SLIDE] In the short term we expect that incomes and consumption will be squeezed as CPI inflation remains above 4 per cent this quarter, thanks to recent sharp rises in gas and electricity prices. But we expect inflation to fall sharply next year as January's VAT increase drops out of the annual comparison. We assume that the Bank of England will bring CPI inflation back to the Government's 2 per cent target by 2014.

[SLIDE] Weaker economic growth also means a weaker labour market. We expect ILO unemployment to rise over the next four quarters, peaking at around 2.8 million or 8.7 per cent of the labour force by the end of next year. We expect the claimant count to reach 1.8 million by the second half of next year, up 240,000 from the peak we expected in March.

We have not made any significant adjustments to the economic forecast as a result of the policy measures announced by the Chancellor earlier this afternoon. The cuts in public spending announced for 2015-16 and 2016-17 do reduce the direct contribution to GDP growth from government consumption in those years, but at that time horizon – and given current market interest rate expectations – we assume that the impact of the cuts on total GDP growth will be offset by looser monetary policy than we would otherwise have seen. The other tax and spending measures broadly offset each other in earlier years.

The New Loan Guarantee Scheme has the potential to increase investment and growth, but this depends crucially on the Government's success in ensuring that lower bank funding costs are passed on to SMEs. It also depends on whether the scheme encourages new SME lending or merely subsidises lending that would have happened anyway. And if it does encourage additional SME lending, then it depends on whether this is offset by cuts in other lending, for example to larger businesses or for mortgages. Much will depend on the final design and implementation of the scheme, so we have made no adjustment in this forecast but will revisit it in the spring forecast when the details should be clearer.

We have modestly revised down our inflation forecast to reflect lower fuel duty increases and we have modestly increased our forecast for housing transactions to reflect the new build indemnity scheme.

Compared to March, the outlook for the economy looks even weaker by comparison with previous recoveries. This is perhaps not surprising, as there is plenty of evidence that financial crises inflict much larger and longer-lasting damage than ordinary recessions.

[SLIDE] Of course we now confront an additional threat from the euro area. Our central forecast assumes that the euro area struggles through its current difficulties, but a more disorderly outcome is clearly possible. In the report we discuss the various channels through which this might affect the UK economy, listed here, but we share the MPC's view that it is impossible to quantify the risk in a meaningful fashion as there are so many different ways in which it could unfold. Suffice to say that although we believe that the chances of an outcome stronger or weaker than our central forecast are roughly equal, the chances of a much worse outcome are greater than the chances of a much better one.

3. Fiscal outlook

Now let me turn to the outlook for the public finances.

[SLIDE] Public sector net borrowing 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 budget deficit will also shrink less quickly over the coming five years.

By 2015-16, we expect the deficit to have fallen to 2.9 per cent of GDP, compared to the 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 of its own accord as the economy recovers.

Why is the outlook worse? The main reason is the weaker outlook for economic growth. [SLIDE] By 2015-16 half the fiscal deterioration comes on the revenue side and half on the spending side.

On the revenue side:

- Lower wages and salaries, consumer spending and company profits weaken receipts from income tax, VAT and corporation tax.

- Lower oil prices, share prices and interest rates weaken North Sea taxes, stamp duties and interest receipts.

- And we assume that the sharp fall in financial sector corporation tax payments seen so far this year will not be recovered.

On the spending side

- Departmental spending is mostly fixed in cash terms, so lower total spending in the economy pushes this up as a share of GDP;

- And higher CPI inflation and claimant count unemployment push up the cost of social security and public sector pension payments.

These pressures are partly offset by the impact of lower interest rates and RPI inflation on debt interest costs, and by the additional spending cuts announced in the Autumn Statement.

[SLIDE] The decision to cut spending towards the end of the forecast horizon – and to avoid further reducing capital spending – implies that the real squeeze on non-investment spending on public services will tighten beyond the end of the spending review rather than loosen. This chart shows implied real cuts of 3.5 per cent in 2015-16 and 2.7 per cent in 2016-17 compared to average cuts of 2.3 per cent a year during the spending review. Of course these are not firm plans yet.

The upward revision to public sector net borrowing pushes up our forecast for public sector net debt. So too, but by a much smaller amount, do our forecasts for public sector financial transactions.

[SLIDE] This is largely as a result of student loans. New data from the Office for Fair Access suggests that the average loan per student for tuition fees is now likely to be around £7,000, up from the £6,800 that we assumed in March. Meanwhile, our lower forecast for wages and salaries means that student loan repayments will be lower than previously forecast. So the Government will be paying more out and getting less back over the forecast horizon than we had previously thought.

Taking all this into account, our forecasts for public sector net debt look like this:

- Back in March we expected net debt to peak at 70.9 per cent of GDP in 2013-14.

- In the absence of the Autumn Statement policy measures – which include some extra borrowing to fund capital spending – we would have expected it to peak at 78.1 per cent in 2015-16.

- Including the policy measures we expect it to peak at 78.0 per cent a year earlier in 2014-15, and then reduce more quickly.

[SLIDE] The cuts in public spending that help limit the increase in debt also have an impact on the outlook for public sector jobs.

Back in March we estimated that the Government's firm plans for the Spending Review period, and the figures it had pencilled in thereafter, would imply a 400,000 fall in general government employment between the first quarter of 2011 and the first quarter of 2016.

By deepening and extending the cuts for a year, we estimate that the Autumn Statement now implies a fall of around 710,000 by the first quarter of 2017. These broad estimates are subject to even more uncertainty than usual this time, because we do not know how the decision to recycle savings from pay restraint in the NHS and schools will affect jobs. If the money saved was spent employing more people the job losses could be reduced by up to 50,000. Meanwhile, there is evidence that some employers are seeking to front-load job reductions.

[SLIDE] Our economic and fiscal projections include the impact of all those policy announcements and measures for which there is sufficient detail and certainty to be able to quantify their impact year by year. But in the EFO we also identify a number of policy announcements that could affect our fiscal projections in the future. For example:

- First, the Government intends to take the Royal Mail's historic pension deficit into the public sector, but this requires state aid approval. This has a number of potentially large and complicated effects, including a likely cut in public sector net borrowing of £25 billion in the year in which it takes place. The impact would look strongly beneficial in the short term, but would likely be negative in the longer term as the present value of the pension fund's liabilities exceeds the present value of its assets.

- Second, the UK and Switzerland signed an anti tax evasion deal in August, but it has to be ratified by the Swiss parliament and may require a referendum. Ministers and HMRC have publicly stated that the agreement should yield £4 to 7 billion. We have not yet certified this costing formally, but our initial discussions with HMRC suggest there are significant uncertainties, especially regarding the amount of UK funds in Switzerland and the assumed level of compliance. We currently judge that the yield from the agreement is likely to be towards the lower end of the range.

Having described the outlook for the headline budget deficit and net debt, let us now turn finally to the Government's progress against the specific fiscal targets that it has set itself.

[SLIDE] The Government's main target is the fiscal mandate. This requires it to balance the cyclically-adjusted current budget or CACB at the end of the rolling, five year forecast. This was 2015-16 back in March, but has now rolled forward to 2016-17. The CACB is the difference between revenues and non-investment spending, adjusted for the economic cycle.

This chart shows that in March we forecast that the CACB would be in surplus by 0.8 per cent of GDP in 2015-16 – meeting the mandate at the then five year horizon – and also a year earlier in 2014-15. If we had made a forecast for 2016-17 back in March, that would probably have shown a similar surplus, assuming that non-cyclical spending was held constant as a share of GDP from 2015-16.

[SLIDE] Our downward revision to the actual and potential output of the economy in this forecast worsens the CACB in each year by around 2 per cent of GDP. On its own this would be enough to push the CACB into deficit in each of the three years, pushing the Government off course to achieve the mandate in 2016-17.

[SLIDE] Other forecasting changes for spending and receipts make relatively little difference to this picture.

The policy decisions taken in the Autumn Statement then improve the CACB. If the Treasury had announced no scorecard measures, [SLIDE] the CACB would still have improved by about 0.8 per cent of GDP in 2016-17 as 'unchanged policy' would imply rolling forward the freeze in total public spending previously announced for 2015-16 for an additional year.

[SLIDE] Together with the additional £15 billion spending cut announced on the Treasury scorecard, this gives a discretionary tightening in the CACB of around 1.5 per cent of GDP or £30 billion in total in 2016-17.

This follows a tightening of 0.1 per cent of GDP in 2014-15 and 0.5 per cent in 2015-16.

As you can see from our final forecasts for the CACB, the black line, this is sufficient to ensure that the mandate is met in 2016-17 – with slightly less margin for error than in March – but not enough to keep the CACB in surplus in the two preceding years.

[SLIDE] In addition to the fiscal mandate, the Government has set itself a supplementary target – to have public sector net debt falling in 2015-16 as a share of GDP. As the chart I put up a few moments ago showed, our forecast shows debt falling by 0.3 per cent of GDP that year, meeting the target but with much less margin for error than the 1.4 per cent of GDP fall shown in our March forecast. In the absence of the policy decisions taken in the Autumn Statement, we estimate the debt ratio would have risen by 0.2 per cent of GDP and the target would have been missed.

Needless to say, there is considerable uncertainty around all the forecasts that I have described and around the judgements that we have reached. We address this uncertainty in three ways in the report.

- First, we ask how much confidence we should have that the mandate will be met or missed assuming that our forecasts turn out to be as accurate as past official Budget and Pre-Budget forecasts. [SLIDE] This chart shows a probability distribution around our central forecast for the CACB, based on past forecasting errors. It suggests that the Government now has a roughly 60 per cent chance of meeting the mandate in 2016-17 and a roughly 40 per cent chance of recording a surplus on the CACB in the previous year. This is down from 70 per cent in March.

- [SLIDE] Second, we test how sensitive the public finance forecasts are to differences in four key parameters: the size of the output gap, the pace of the recovery, the interest rates at which the government can borrow, and the impact of the economic cycle. The biggest danger is that we need to reduce our estimate of potential output and the size of the output gap again.

- [SLIDE] Third, we look at three alternative economic scenarios. These are not designed to describe every possible state of the world, but rather to highlight the potential significance of some of the key judgements we have made in the forecast.

- The scenarios are:

    - first, one in which banks' funding costs remain elevated and these keep credit conditions tighter for longer;

    - second, one in which the financial crisis did not depress the level of potential output;

    - and, third, one in which structural unemployment is higher, but the productive potential of the economy is unchanged.

  The first reduces the chances of meeting the mandate, the second increases them and the third has little impact.

As I mentioned earlier, while in principle it would be nice to have a scenario showing the aggregate impact of a disorderly outcome to the euro area crisis, it is impossible to quantify this in a meaningful way because of the variety of different ways in which it could unfold. Needless to say, it is a significant downside risk to the central forecast.

That summarises what we have to say in the EFO. Our role is to set out our best assessment of the outlook for the economy and the public finances in as transparent a way as we can – and to be clear and candid about the uncertainties that lie around it. People will doubtless disagree with some of the assumptions and judgements that we have made, but I hope everyone will recognise it as a solid foundation for the formulation of policy decisions and for public debate more broadly.

Thank you very much. We would be happy to take some questions.