October 2021 Economic and Fiscal Outlook

Transcript of Presentation by

Richard Hughes, Chair, Office for Budget Responsibility

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1. Cover slide

2. Introduction

- Good afternoon everyone and welcome to this online presentation of our October 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 once again essential to putting this latest forecast together.

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

- Our forecast closed to new economic data on 24th September and takes account of all policy measures up to and including those announced in the Chancellor's Budget and Spending Review earlier today.

- We closed our pre-measures forecast earlier than usual to provide the Chancellor with a stable basis on which to complete the 2021 Spending Review negotiations, the first multi-year review in six years.

- And I will say more about what taking on the latest economic and market data would imply for our forecast at the end of my presentation.

4. Epidemiological developments

- But let me start, as we have in all of our presentations over the last 18 months, with a summary of how developments related to the coronavirus pandemic have affected our forecast.

- This Budget and Spending Review were prepared against a much-improved epidemiological backdrop from that which prevailed at the time of our last forecast in March.

- Vaccines have now been rolled out to 79 per cent of the target population and public health restrictions have been lifted broadly in line with the Government's roadmap and now stand among the most permissive in Europe, as illustrated by the chart on the left.

- And as you can see from the chart on the right, while case numbers have risen over the summer and through the autumn, the vaccines have so far proven highly effective in breaking the link between infections (which currently stand at around three quarters of their peak at the turn of the year) and hospitalisations and deaths (which remain one-fifth and one-tenth of their respective peaks in January).

- In our latest forecast, we *do* expect a further increase in both covid and other infections to lead to either a modest tightening of public health restrictions or greater voluntary social distancing over the winter. But we assume there is no return to a nationwide lockdown.

- Over the medium term, we assume the vaccine, booster programme, and acquired immunity are sufficient to keep the virus in check with minimal additional public health measures.

- However there remain significant epidemiological risks to the economic outlook from either the emergence of vaccine-escaping variants or declining vaccine-conferred immunity, which could require the reimposition of more stringent public health measures while new vaccines are developed and rolled out.

5. Economic developments since March

- Turning to what this has meant for *economic* developments since our last forecast, the first thing you will note from a comparison between our March and October forecasts for GDP is that we overestimated the fall in output associated with the last lockdown.

- The latest data shows that GDP fell by just 1.4 per cent in the first quarter of this year as opposed to the 3.8 per cent we assumed back in March.

- This has been part of a pattern of underestimating the adaptability of the UK economy to pandemic conditions which we explored in our *Fiscal risks report* in July and informed our revised judgement in this *EFO* about the permanent scarring effect of the pandemic on output, which I will come onto later.

- From this slightly higher starting level of output, the rollout of the vaccine and lifting of public health restrictions unleashed a surge in demand over the summer which took output to only 1.1 per cent below its pre-pandemic level by August.

- However, this strong rebound in demand created its own challenges as it bumped up against both domestic and international supply constraints in energy, product, and labour markets going into the autumn.

- These supply shortages and bottlenecks, which have been exacerbated in the UK's case by post-Brexit restrictions on trade and migration, are expected to act as a brake on the pace of recovery over the next two quarters, before easing by the middle of next year.

- Despite these near-term headwinds, output is still expected to grow by 6½ per cent this year and regain its pre-pandemic level around the turn of the year, 2½ per cent faster and several months earlier than we forecast in March respectively.

6. CPI Inflation

- The combination of a strong rebound in demand and constrained supply, both in the UK and around the world, has already pushed inflation above 3 per cent in August and we expect it to peak at 4.4 per cent in the middle of next year before it falls back to its 2 per cent target in the medium term.

- There is clearly a risk that inflation could rise by more than this and persist for longer. So, in our *EFO*, we also present two scenarios in which inflation peaks 1 percentage point higher at 5.4 per cent and takes 1 year longer to return to target than in our central forecast.

- Given the much greater inflation sensitivity of the Government's debt stock in recent decades, we also show what this higher and more persistent inflation would mean for the public finances.

7. Unemployment

- One unambiguously positive effect of the stronger recovery since March has been its impact on the labour market.

- The rapid reopening of the retail, hospitality, and other sectors has drawn 3.2 million workers off furlough since March, leaving only 1.3 million on the scheme when it closed in September.

- And continued strong demand for workers, with a record 1.1 million vacancies advertised in the three months to September, has led us to assume only a modest uptick in unemployment to 5¼ per cent this winter, 1¼ percentage points below the peak we expected in March.

8. Economic scarring from the pandemic

- Looking out over the next five years, our medium-term forecasts since the start of the pandemic have been anchored by an assumption that it would lead to a 3 per cent permanent reduction in the supply capacity of the UK economy, relative to its pre-pandemic trajectory.

- Against the backdrop of a stronger recovery in output and employment, and drawing on the latest analysis and discussions with a range of outside experts, we have revised down this scarring assumption from 3 to 2 per cent in our latest forecast.

- You can see from the chart on the left, that this partly reflects the good news we've had about the resilience of the labour market which has led us to reduce our estimates of the impact of the pandemic on the future rates of unemployment and inactivity.

- But we still expect there to be 160,000 fewer people in the labour force over the medium term than we did in March 2020 due to lower net migration and a lower participation rate among the resident population.

- We have also revised down our estimate of the amount of investment lost as a result of the pandemic. The latest data shows that business investment has fallen by less than we originally thought, and we have revised up our forecast in the medium term as corporate balance sheets have held up better than expected.

- However, this stronger picture on investment still leaves the total capital stock in the medium term 1.6 per cent lower compared with what we forecast before the pandemic.

- And the changes in how and where economic activity takes place as a result of higher post-pandemic rates of remote working and online shopping may imply some writing down in the value of existing capital assets.

- For these reasons, we still expect capital shallowing to account for around a third of overall scarring.

- We have also revised down our estimate of the impact of the pandemic on total factor productivity to reflect the fact that corporate balance sheets, FDI, and investment in intangible assets have held up better than expected, while analysis of business surveys suggests more benefit from the closing of less productive firms.

- As you can see on the right, the downward revision in our overall scarring assumption from 3 to 2 per cent puts us in the middle of the scarring estimates produced by other independent forecasters over the past few months which run from 1 to 3 per cent.

- We will keep this judgement under review in future forecasts as new data come in and we learn more about how the post-pandemic economy performs after the unprecedented government support it has received over the past 18 months is fully withdrawn.

9. Medium-term economic outlook

- The downward revision to our estimate of scarring creates space for continued strong real growth into next year where GDP is expected to grow by 6 per cent before settling down to its trend growth rate of around 1¾ per cent by the end of the forecast.

- Higher real growth over the medium term coupled with higher inflation in the near term, means that the level of *nominal* GDP is 4.2 per cent higher by 2025 than assumed in our last forecast and broadly in line with our pre-pandemic forecast in March 2020.

- The composition of this upward revision to growth in *nominal* GDP is particularly good news for the public finances as we have also revised up the labour and consumption shares of that GDP.

- These upward revisions, along with the additional fiscal drag caused by the March Budget's five-year freeze in the income tax thresholds, makes the additional GDP particularly tax rich given the high effective tax rates on labour income and consumption.

10. Government borrowing

- So let me now turn to what this latest economic outlook, plus the policies announced in today's Budget and Spending Review, imply for the public finances.

- Based on our latest forecast, borrowing still peaks at a post-war high of £320 billion or 15.2 per cent of GDP last fiscal year. This is £35 billion lower than we expected in March due in large part to underspending by Government departments, especially in the case of the NHS Test and Trace programme.

- Borrowing falls to £183 billion this year, £83 billion next year, and then to around £45 billion over the remaining three years of the forecast.

- Borrowing is lower in every year than in our March 2021 forecast and even falls below our pre-pandemic March 2020 forecast by the middle of the decade.

11. Source of changes in borrowing since March

- To illustrate what drives the change in borrowing relative our last forecast, this chart breaks that difference down into:

    - First, changes arising from our improved economic forecast (shown in darker shades of blue and red).

    - And second, changes arising from discretionary policy decisions taken by the Chancellor (shown in lighter shades of blue and red)

- You can see that our forecast changes improve the borrowing picture relative to March by around £35 billion a year over the Spending Review period, with higher growth and inflation pushing up receipts by around £50 billion a year but also spending on welfare, debt interest, and other items by around £15 billion a year.

- On top of this £35 billion *pre-measures* windfall since March, the Chancellor has raised a further £15 billion a year in net tax increases, most notably in the form of the new health and social care levy announced in September.

- With an extra £50 billion a year of additional revenue to deploy in this Budget and Spending Review, the Chancellor spends around £30 billion of it:

    - with half of this going directly from the new levy into the NHS and social care budget

    - and the other half undoing the cuts to the departmental spending he pencilled since the start of the pandemic.

- He keeps the remaining £20 billion a year in extra revenue to reduce borrowing, which is given an added boost of £5 billion a year over the Spending Review period by the stimulative effect of the net fiscal loosening.

12. Tax revenues

- Looking in more detail at the tax side of the ledger, it is hard to understate how much revenue the Chancellor has raised over the past 12 months.

- The combination of corporate and personal tax rises announced in March, September, and in this Budget means that this Chancellor has announced more tax rises this year than in any single year since Norman Lamont and Ken Clarke's two 1993 Budgets in the aftermath of Black Wednesday.

- And these tax rises, coupled with the fiscal drag assumed in our forecast, raise the overall tax burden from 33½ per cent of GDP pre-pandemic to above 36 per cent of GDP at the forecast horizon, which would be the highest level since the tail end of Clement Attlee's Government in the early 1950s – as shown in the chart on the left.

- The chart on the right looks in more detail at this 2¾ per cent of GDP increase in the tax take and shows that:

    - Just under one-third comes from the fiscal drag in the tax system the Chancellor inherited when he took over the job in February of last year.

    - Another one-third from cancelling the planned 2 per cent corporation tax cut in the March 2020 Budget and the further increase in the main rate of CT from 19 to 25 per cent, announced in March of this year

- Just under one-fifth comes from the freezing of personal tax allowances and thresholds also announced in the March Budget.

- Another fifth comes from the new Health and Social Care Levy announced in September

- And other net tax increases are largely offset by a freeze in fuel duty and the lasting effects of the pandemic on some specific tax bases.

13. Public spending

- Turning to the spending side of the ledger, the Chancellor uses 60 per cent of the increase in revenues relative to our March forecast to permanently increase the size of the post-pandemic state in his three-year Spending Review.

- So while public spending falls back from its peacetime high of 53 per cent of GDP last year as pandemic support is withdrawn, it settles just below 42 per cent of GDP in the final three years of the forecast period.

- That's nearly 2 per cent of GDP higher than before the pandemic and takes the size of the state to its highest sustained level since the late 1970s, and before the privatisations of the 80s and 90s.

- However, the shape of this post-pandemic state reflects how much our society and our world have changed in the intervening half century.

- As you can see from the chart on the right comparing the composition of spending in the late 1970s and the mid-2020s, by the end of the next Spending Review period:

    - We will be spending 60 per cent more of our national income on the NHS, social care, and pensions, reflecting the increase in the share of the population over 65 from one-in-seven of us in the late 1970s to one-in-five of us by the middle of this decade.

    - Two other budget items have made room for this increase in age-related spending:

        - The first is defence spending which has halved since the height of the Cold War from 4 per cent of GDP to the NATO minimum of 2 per cent.

        - The second is the cost of servicing our debt which has also halved, despite the level of that debt more than doubling as a share of GDP since the late 70s.

- One final item that bears further scrutiny is the level of investment in infrastructure captured in the grey bar.

    - Unlike his predecessors, this Chancellor did not cut investment spending in response to the deterioration in the fiscal position in the wake of the pandemic.

    - Instead, he maintained the large increases he announced in the March 2020 Budget which take total public investment up to its highest sustained level for 40 years.

    - In this Spending Review much of that increase in investment has gone on the Government's stated priorities of improving regional transport links and addressing some of the economy-wide costs of getting to net zero carbon emissions by 2050.

- However, on the latter objective, one should bear in mind that the Budget also freezes fuel duties and cuts air passenger duties for domestic flights – both of which are likely to increase, rather than cut, our carbon emissions.

- You can read more about how the policies announced in the Government's Net Zero Strategy and in this Budget compare with our own estimates of the potential fiscal cost of getting to net zero in a Box at the end of Chapter 3 of the EFO.

14. Public sector balance sheet

- The roughly £25 billion per year left over after the Chancellor completed his multi-year Spending Review is sufficient to stabilise the debt-to-GDP ratio just below the 100 per cent of GDP mark.

- Debt peaks at 98 per cent of GDP this year and then begins to fall as a share of GDP over the next five years, both with and without the help of the winding down of the Bank of England's Term Funding Scheme – though only just in the latter case.

- The eagle eyed amongst you may notice that there is now a fourth line at the bottom of our chart of different balance sheet metrics.

- That is because, in this EFO, we have produced our first ever forecast of public sector net worth – the most comprehensive measure of the public sector balance sheet which, rather than just focusing on debt, takes account of all assets and liabilities in public hands.

15. Public sector net worth

- You can see from this deconstruction of net worth into its component assets and liabilities how much the government's balance sheet has expanded in recent years, first in the wake of the 2008 financial crisis and again in the wake of the pandemic.

- You can also see how the composition of the balance sheet has changed over time:

    - With the state taking on a growing stock of loans and equities on the asset side (first from banks and now in start-up companies whose activities ranging from internet satellites to in-home spa treatments);

    - And on the liabilities side, one can see the substitution of Bank of England reserves in exchange for gilts via the Bank's QE operations, which is gradually reversed over the forecast period.

- You can learn more about how we constructed this forecast in a working paper published alongside this EFO.

16. Fiscal rules

- Turning to more conventional measures of the public finances, the Chancellor published alongside today's Budget a new Charter for Budget Responsibility setting out his fiscal rules for the remainder of the Parliament.

- The UK has effectively operated without a fiscal framework since the pandemic struck. But the Chancellor has repeatedly spoken of his desire to balance the current budget and get debt falling as a share of GDP once it was over.

- He has now codified those fiscal objectives as rolling targets over the next three years, alongside two caps on welfare and investment spending,

- This makes for an unprecedented four statutory targets for fiscal policy – all of which are met in our central forecast.

- The Charter also includes a wider set of indicators related to the affordability of debt and health of the balance sheet which it will also take account of when making fiscal policy.

17. Headroom against the fiscal rules

- And while Chancellor is on track to meet his fiscal rules, he has left himself only the slimmest of margins against his headline target of getting debt falling by 2024-25 with just £17.5 billion (0.6 per cent of GDP) to spare.

- To put what might sound like a large amount of money in context:

    - This is the second smallest margin that any Chancellor has ever had when setting a new set of rules – and all of the previous were broken.

    - It's one-sixth of our average forecast error for the change in the debt-to-GDP ratio three years ahead.

    - And it would easily be wiped out by 1 per cent lower GDP growth or 1 per cent higher interest rates in the target year.

- Now both of his headline targets are set over a rolling three-year horizon, so the Chancellor always has the option of doing better next year.

- But with underlying debt trending down only slightly over the forecast period and the balance of risks to both inflation and interest rates tilted toward the upside, we are likely to be in for another white-knuckle ride over the remainder of this Parliament.

18. News since closing the forecast

- As I mentioned at the start of my presentation, there has been some interest in the fact that we closed our pre-measures earlier than usual in this EFO.

- All operational forecasting, be it in the public or private sectors, requires forecasters to trade off:

    - on the one hand, providing the decision-makers who use their forecasts a stable basis on which to make those decisions;

    - and on the other, taking on the very latest data that might affect those forecasts but could also disrupt those decisions.

- My predecessor had previously extended Chancellor Osborne additional time between the closure of our pre-measures forecast and Budget Day to conduct the 2015 Spending Review negotiations, the last multi-year exercise.

- In this instance, because Chancellor Sunak was negotiating the first multi-year Spending Review in six years, and doing so in the aftermath of a pandemic, we also judged that it was in the public interest to give him more time than usual to agree the budgets of 23 Government Departments over the next three years.

- But we also committed, as we always do, that if information came to light after we closed our forecast that we believed would materially alter our view of the economic or fiscal outlook, then we would illustrate the effect of that news on our forecast.

- In this case, there were several developments after we closed our pre-measures economy forecast on 24 September including:

    - On the positive side, the upward revisions to the level of nominal GDP in the past and to the pace of real GDP growth since the start of the pandemic in the Quarterly National Accounts.

    - On the negative side, rising energy prices, growing evidence of supply bottlenecks, and higher market expectations for interest rates as a result of these inflationary pressures.

- On balance, the information that came to light since we closed our forecast does not materially alter our assessment of near- or medium-term economic prospects.

    - In the near term, the higher starting point due to faster growth during the pandemic has been offset by increased evidence of supply bottlenecks and inflation headwinds over the past few months. We judge that together they put the level of real GDP at the beginning of next year back in line with our forecast.

    - In the medium term, the news since we closed our forecast sheds no meaningful additional light in either direction on our scarring judgement as its largely reflected the strength of demand in the face of temporary supply constraints rather than telling us something new about the underlying supply potential of the economy.

- Nevertheless, developments since our forecast closed *would* have a modest adverse fiscal implications.

- As shown in the chart on the right, taking on market data from last Friday the 22nd October would have only slightly reduced the margin that the Chancellor has against his fiscal rules in 2024-25:

    - Knocking £3.6 billion off his £25.1 billion headroom against balancing the current budget.

    - And consequently knocking £1.9 billion off his £17.5 billion headroom in the case of debt falling

- But given the interest that some have taken in the timetable leading up to this forecast, we will be taking the following four additional steps to provide assurance concerning the integrity, transparency, and objectivity of the forecasts we produce:

    - First, we have provided a detailed account of the forecast process in the Foreword to the EFO document.

    - Second, we will be publishing the correspondence between the OBR and Treasury relating to the timetable for this Budget.

    - Third, we will be seeking public input into a review of the Memorandum of Understanding that will govern the forecast process and timetable for future EFOs.

    - Fourth, we have asked the OBR's Non-Executive Directors Chris Kelly and Bronwyn Curtis to conduct a review of the decision-making process around the forecast timetable for this Budget. Their findings and recommendation will be published as further input into the revisions to the MoU.

- We would encourage anyone with views on where and how our forecasts should strike the balance between our equally important responsibilities of:

    - providing the Government with a stable basis for making fiscal policy decisions,

    - and providing Parliament and the public with an up-to-date understanding of the economic and fiscal implications of those decisions,

- to share their thoughts with us as part of that review of the MoU.

19. Conclusion

- So in conclusion, the UK economy seems to have emerged from the worst of the pandemic bearing lighter scars than we initially feared, and that is due in no small part to the extraordinary support it has been given by fiscal policy over the past 18 months.

- On top of the proceeds from this stronger economic recovery, the Chancellor has raised taxes by more this year than any Chancellor since 1993 (and even then it took two Chancellors) and taken the tax burden to its highest level since the early 1950s.

- He has used the bulk of this extra revenue to pay for a larger post-pandemic state with new responsibilities, in normal times, for:

  - Proving greater insurance against the growing cost of aging;

  - Narrowing the gap in life chances between different parts of the country;

  - And helping the economy along the path to net zero by 2050.

- And this is to say nothing of the extraordinary support it has recently provided in times of crisis – and may be called upon to do so again in response to future shocks.

- There are those who have already questioned whether the tax burden will ever reach the levels presaged in our forecasts and argue that taxes will be cut before they rise this high.

- It's not for us to opine on the desirability of this. But if this is indeed the case, then – based on the forecast I've outlined today – it would merely raise two further questions for those who have to make fiscal policy:

  - Which responsibilities that the state has now taken would it then retreat from to accommodate these tax cuts?

  - And if the answer is none, then would we be content to see our debt continue to rise in normal times, given what we *now* know about how much the *next* crisis might cost us?

- And finally, before turning to your questions, I thought it important to mention that this forecast marks Charlie Bean's last as a member of the OBR's Budget Responsibility Committee.

- Charlie is one of the best known and most respected macroeconomists in the country with a 40-year career which has included spells as an advisor to the Treasury, Chief Economist and Deputy Governor of the Bank of England, Chair of the Economics Department at LSE, and President of the Royal Economic Society.

- We have been extraordinarily fortunate here at the OBR to have been a 5-year waypoint on his eventful journey in public service. His depth of expertise and experience has been especially valuable over the last 18 months in helping us to understand the implications of the coronavirus pandemic on our economic lives and prospects.

- Andy, the staff, and I will get our chance to say our goodbyes properly when Charlie steps down at the end of the year, but in the meantime you will get one last chance to ask him about our latest forecast.

- And, on that bittersweet note, I'll ask Charlie and Andy to join me to take your questions.