

## March 2019 Economic and Fiscal Outlook

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Good afternoon. My name is Robert Chote, Chairman of the OBR, and I would like to welcome you to this briefing on our March 2019 *EFO*.

[SLIDE] Let me start with the usual 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 its various fiscal and welfare spending targets.

The views expressed are those of the independent Budget Responsibility Committee. But, as always, we have relied on the hard work of the OBR's staff and of numerous officials in other departments and agencies.

As usual, the forecast went through several iterations to reflect new judgements, new data and policy measures. We provided the Chancellor with a final pre-measures forecast on February the 27<sup>th</sup> and met with him to discuss it on the 5<sup>th</sup> of March. We provided a near-final draft to him on the 8<sup>th</sup> of March to allow him to prepare his statement to Parliament

I am pleased to say that we have come under no pressure to change any of our conclusions. The forecast process has also been smoother than it was in October, although it did not help that the date of the Spring Statement was only confirmed several weeks after the formal 10-week deadline. We have been provided with almost all the information we required, although we do have some outstanding queries with DWP on disability benefits spending.

[SLIDE] So now let me turn to a brief overview of the report.

Economic growth has slowed more sharply than we expected since October and survey data point to a weak first quarter. As a result we have revised down our forecast for real GDP growth in 2019, but our forecast for cumulative growth over the medium term is little changed.

The outlook for the public finances is somewhat brighter, both this year and over the medium term. This largely reflects the strength of income tax receipts, including broad-based strength in self-assessment payments in January, some of which persists over the rest of the forecast. And lower debt interest spending, thanks to lower RPI inflation in the near term and to lower market interest rates thereafter. Before taking policy measures into account, we have revised the deficit down by just under £3 billion this year, rising to more than £8 billion by 2023-24. As a share of GDP, this is an average-sized revision for a spring forecast.

Presented with this good news, the Chancellor has banked most of it in lower borrowing. But he has also increased his cash public spending plans to protect the real-terms objectives that he had in the Autumn from the impact of higher whole-economy inflation. Together with 20 or so other policy announcements since the Budget, this increases borrowing by £0.7 billion next year, rising to £2.1 billion in 2023-24. This is a relatively modest change by past standards, but fiscal policy has been loosened at every spring and autumn fiscal event since the EU referendum.

Taking both forecast and policy decisions into account, we now expect the budget deficit to drop from £22.8 billion this year to £13.5 billion in 2023-24. The Government is aiming to balance the budget by 2025-26, although the Chancellor has said that this objective could be revisited. Past forecast performance suggests that there is a 40 per cent chance of balancing the budget by 2023-24, although the ageing population is likely to put greater upward pressure on spending in subsequent years than it has done recently.

As regards the Government's other targets, the Chancellor's room for manoeuvre against the 'fiscal mandate' in 2020-21 has risen from £15.4 billion in October to £26.6 billion – although this reflects a relatively big improvement in the structural budget deficit in that particular year that diminishes over the remainder of the forecast. His supplementary target to reduce net debt as a share of GDP in 2020-21 is met by the same margin that he had in October. The welfare cap is also adhered to.

Reflecting stated government policy at the time we closed the EFO, these forecasts are based on the same broad-brush assumptions regarding the impact of Brexit that we have made in our other forecasts since the referendum. This means that we assume a relatively orderly exit from the EU to whatever long-term relationship is eventually agreed. As we have

said before, a disorderly one could have a severe short-term impact on the economy and the public finances – but one that is very difficult to quantify.

I'll return to 'no deal' risks later, but let me first take you through the central forecast numbers in a little more detail.

[SLIDE] Let's begin with real GDP growth. This chart shows the recent outturns and near-term forecasts for quarterly GDP growth at the time of our October forecast – a pretty stable picture showing growth of roughly 0.4 per cent a quarter. [SLIDE] Since then growth has come in a little higher than we expected in the third quarter of 2018, but significantly lower in the fourth. The particular weakness of activity in December – plus recent survey data – suggests that the first quarter this year will be weak as well. The month-on-month bounce-back reported in yesterday's January GDP data – which we had not seen when we closed our forecast – looks consistent with our prediction of 0.2 per cent growth in the first quarter. We have revised growth slightly lower through the next four quarters.

[SLIDE] As this chart shows, the downward revisions to our near-term GDP forecast open up a very small margin of spare capacity that is then closed subsequently as the Bank of England pursues the inflation target.

[SLIDE] In calendar year terms, this lowers our growth forecast for 2019 from 1.6 per cent [SLIDE] to 1.2 per cent. But we haven't changed our view of the economy's medium-term growth potential, so slightly slower growth early in the forecast means slightly faster growth later as the output gap closes. Growth settles down at around 1.6 per cent a year from 2021 onwards.

Experience tells us that growth is unlikely to be anything like as smooth as this and that there is a roughly one-in-two chance of a recession in any five-year period. [SLIDE] We can illustrate the uncertainty that lies around our central forecast with a probability fan chart based on past forecast performance. This implies a roughly one-in-five chance of the economy shrinking in 2020 and the same of it growing by 2½ per cent or more.

The recent weakness of the economy in part reflects the impact of the referendum vote to leave the EU. [SLIDE] Our final pre-referendum forecast in March 2016 had real GDP growing by 5.5 per cent between the second quarter of 2016 and the end of 2018. [SLIDE] In our first post-referendum forecast we lowered that to 4.1 per cent. [SLIDE] The latest

outturn data show growth of 4.2 per cent, with the economy holding up better than expected to begin with but then slowing more quickly. Business investment in particular has weakened, falling in each quarter of 2018.

Ironically, even though we emphasised the particular uncertainty surrounding the economic outlook in the wake of the referendum, November 2016 was the most accurate 2½ year GDP forecast we have produced to date.

Most public discussion of economic forecasts focuses on real GDP, but it is nominal GDP – the cash value of income and spending in the economy – that is more important if you want to understand the path of the public finances. We expect nominal GDP to grow by 18.5 per cent between 2018 and 2023, up fractionally from 18.3 per cent in October.

[SLIDE] This slide shows revisions since October cumulatively over the forecast. You can see that 0.2 percentage point upward revision to nominal GDP growth by the end. But this nominal growth is also more tax rich than it was in October. [SLIDE] Within nominal GDP, growth in labour income – which is relatively highly taxed – has been revised up by closer to 1 percentage point. [SLIDE] This reflects an upward revision to average earnings growth that more than offsets a downward revision to employment growth. This make the composition of labour income more tax-rich than it was in the autumn. Indeed, as I'll explain in a minute, news about the earnings distribution since October also points in the direction of more tax-rich growth.

Faster growth in relatively tax-rich components of labour income means more income tax and national insurance receipts. And, because we assume that it feeds through to nominal consumer spending, more VAT and excise duty as well. This compositional change helps explain why the downward revisions to the budget deficit get bigger over time.

Let's look at a few other elements of the economic forecast and its underpinning assumptions that matter for the public finances.

[SLIDE] This chart shows that market expectations of Bank Rate have fallen since October and that the same is true of 20-year gilt yields. Both help explain the downward revisions to our debt interest forecast. However, both are also likely to reflect the market pricing in some probability of a disruptive no deal Brexit. So some of this could be reversed if that is taken

off the table.

[SLIDE] This chart shows that oil prices are significantly lower than we assumed they would be in October, which has helped pull down CPI inflation. And weaker house price growth further reduces RPI inflation. The fall in RPI inflation, shown on the right, lowers debt interest spending by reducing accrued interest on index-linked gilts.

[SLIDE] So now let us turn to the public finances themselves. This chart shows the cumulative budget deficit through 2017-18 and 2018-19, based on the data that was available in October. [SLIDE] And this is the picture now. The ONS has revised the 2017-18 deficit slightly higher, while the new outturn data for this year are dominated by a big improvement in January, the most important month for tax receipts. Our forecast for the full-year deficit has been revised down by £2.7 billion to £22.8 billion.

[SLIDE] So why the downward revision? This table shows the change in the forecast since October, excluding the modest impact of new policy measures. [SLIDE] The top rows show that the pre-measures forecast has improved by £2.9 billion. [SLIDE] On the receipts side, this is more than explained by income tax and NICs. Self-assessment receipts from 2017-18 liabilities came in stronger than expected, while PAYE income tax receipts have been boosted by stronger earnings growth, especially for the highest paid employees. Mean total pay for the top 0.1 per cent of the employee earnings distribution (as captured in HMRC's PAYE 'real-time information' returns) was almost 6 per cent up on a year earlier between April and September, compared to a 3.7 per cent rise overall. This relates to just 31,000 taxpayers, but they pay £600,000 each on average.

[SLIDE] On the spending side, debt interest spending is lower – thanks primarily to lower RPI inflation (via index-linked gilts). We also assume that government departments will underspend the limits they have agreed with the Treasury by a little more than we thought in October. This more than outweighs higher local authority spending and other spending.

[SLIDE] So how does the picture this year fit in with the rest of the forecast? This chart shows the budget deficit forecast from October [SLIDE] and the pre-measures forecast from today. You can see that the underlying improvement rises from £2.9 billion this year to £8.4 billion in 2023-24.

[SLIDE] And where does this come from? [SLIDE] Like this year, the biggest

improvement over the forecast comes from income tax – thanks not just to the stronger starting point, but also slightly stronger earnings growth over the forecast. [SLIDE] And debt interest is also lower, with lower RPI inflation helping in the near term and lower market interest rates helping over the rest of the forecast.

These offset the weakness of [SLIDE] other receipts, thanks to lower oil and gas prices, lower equity and house prices, and lower interest received on the government's assets. [SLIDE] And higher spending in some years, initially thanks to local authorities and later thanks to higher disability benefit spending. On average over the forecast, the pre-measures deficit is 0.3 per cent of GDP lower than it was in October.

[SLIDE] This chart compares that average revision with those in previous OBR forecasts. As you can see, it is small relative to many of our autumn forecasts, but in line with the average for spring ones. One relatively unusual feature is that the revisions to receipts and debt interest both push borrowing in the same direction (as they did in October, but on only three occasions prior to that). As I noted a moment ago, this may be because market interest rates reflect some pricing in of a disruptive Brexit, while our receipts forecast assumes a smooth one. So there is obviously some inconsistency here that events will eventually resolve.

[SLIDE] So let us return to the picture I showed a moment ago of our October deficit forecast and our March pre-measures forecast [SLIDE] and then add the impact of the policy measures announced since the Budget. As you know, the Treasury does not regard this as a full-blown fiscal event and so there is no Red Book or scorecard of policy measures. But there are 20 or so measures that we have had to scrutinise and take into account.

In total they increase borrowing by £0.3 billion this year, rising to £2.1 billion in 2023-24. As you can see, this offsets only a relatively small proportion of the underlying forecast improvement. This is in marked contrast to the October Budget, when there was a much larger underlying improvement and the Government spent almost all of it.

[SLIDE] This chart breaks down the impact of the new policy measures.

[SLIDE] As you can see, in common with October, the biggest contributor is an increase in departmental spending plans. By the end of the forecast the Government has penciled in an extra £0.8 billion to keep non-NHS current

spending flat in real terms, despite an increase in our whole economy inflation forecast, and in January it agreed another £0.8 billion to maintain the real-terms NHS spending level that was announced last summer and confirmed in the Budget. Drawing perhaps on hope rather than experience, the Treasury assures us that this is the last time the NHS budget will be adjusted.

[SLIDE] The other measures add up to a small net giveaway that is uneven over the forecast. They include several policy changes affecting universal credit and disability benefits, including delays to the 'managed migration' phases of both personal independence payments and universal credit. On the revenue side, they include raising probate fees and doubling the immigration health surcharge.

[SLIDE] The direct cost of these measures is partially offset by an indirect effect on borrowing. The fiscal giveaway boosts the cash size of the economy and tax receipts, while the increases in departmental spending raise public service pension contributions.

[SLIDE] This chart shows the average underlying forecast revision and the average impact of policy measures as a share of GDP in each of our forecasts to date. You can see that since the referendum there has been a consistent pattern in which fiscal policy is loosened – not always by very much – at each fiscal event, whether our underlying forecast revisions show an improvement or a deterioration in the outlook for the deficit. This has materially eased the planned squeeze on public spending that the Chancellor inherited from his predecessor.

[SLIDE] So now let me turn to the Government's fiscal and spending targets and how the combination of our underlying forecast revisions and the measures announced since the Budget affect the Government's chances of meeting them.

The slide summarises. The Government remains on course to meet both its fiscal mandate for the structural budget deficit and its supplementary target to reduce the debt-to-GDP ratio. And it also remains on course to stay within its welfare spending cap. The Government's fiscal objective to balance the Budget by 2025-26 lies beyond our forecast horizon. That said, the Government does not appear to be on course to achieve that on current policy, but the odds are better than they were in October.

[SLIDE] Looking at the targets individually, the fiscal mandate requires the Government to bring the structural budget deficit below 2 per cent of GDP by 2020-21. The structural deficit is the one you would see if activity in the economy was running at its potential level, consistent with stable inflation.

This chart shows the path of the structural budget deficit from our October forecast – and the 2 per cent ceiling. By 2020-21 the deficit was forecast to fall to 1.3 per cent of GDP, thanks to lower spending and a rise in receipts as a share of GDP. That left headroom against the target of 0.7 per cent of GDP or £15.4 billion.

[SLIDE] Our pre-measures revision lowers the structural deficit to 0.8 per cent of GDP in the target year in this forecast and increases the margin to 1.2 per cent of GDP – or £27.8 billion. [SLIDE] The policy measures since October shave that back slightly to £26.6 billion, but do not affect the share of GDP to one decimal place.

[SLIDE] It is worth noting that this increase in the Chancellor's room for manoeuvre against the mandate is helped by the fact that the downward revision to the structural budget deficit since October is larger in the mandate year than in any other year of the forecast. The fiscal costs of the temporary near-term weakness of the economy are swamped by the gains from higher income tax and lower debt interest spending. But, as you can see here, the improvement in the structural deficit since October is 40 per cent smaller by the end of the forecast.

[SLIDE] Needless to say, it is important to recognize the uncertainty that lies around the central forecast, based on the accuracy of past ones. On that basis, the Government's current room for manoeuvre translates into a roughly 75 per cent probability of achieving the mandate on current policy, up from 65 per cent in October.

[SLIDE] Turning to the supplementary fiscal target, this requires public sector net debt to fall as a share of GDP in 2020-21. In our October forecast net debt peaked at 85.2 per cent of GDP in 2016-17 and fell by 3.2 per cent of GDP in the target year. [SLIDE] In this forecast the peak is 85.1 per cent in 2016-17 and it still drops by 3.2 per cent in the target year. The ending of the Bank of England's Term Funding Scheme (or TFS) contributes 2.2 percentage points of that.



Net debt falls to 73.0 per cent of GDP by 2023-24, down from 74.1 per cent in October. The improvement reflects the upward revision to nominal GDP and a £37 billion reduction in cumulative borrowing over the forecast. Policy decisions have only a very small impact.

The Government describes the fiscal mandate and the supplementary debt target as 'interim targets'. Its formal 'fiscal objective' is to bring the public finances to balance as soon as possible in the next Parliament. When the target was set, this would have been 2025-26 at the latest.

[SLIDE] The chances of meeting the objective have improved since October, as the deficit in 2023-24 has been revised down from £19.8 billion to £13.5 billion – 0.5 per cent of GDP, as you can see here.

[SLIDE] On past forecast performance, that implies a 40 per cent chance of balancing the budget in that year. But, on the central forecast, further policy measures would likely be required to remove the remaining deficit over the subsequent two years – and that would be a period in which the ageing population is likely to put greater upward pressure on spending than it has done in recent years.

[SLIDE] The outlook for the economy and the public finances is, as usual, clouded by many risks and uncertainties that we discuss in the report. Among them of course is the possibility of a disruptive 'no deal' Brexit. This is not Government policy so we have not produced a detailed assessment of its fiscal impact. But we do draw some broad lessons from our past scenario analysis. Among them:

- First, the range of possible outcomes is large, given the uncertainty both around the economic impact and around the nature and effectiveness of any policy response;
- Second, the short-term shock to the economy would no doubt have fiscal costs, but the more significant channels would probably be via its longer-term impact on potential output; and
- Third, the direct fiscal effects of any policy response would also affect the final path of the deficit, though this is presently unknowable. For example, we do not know how the Government would alter the fiscal stance, for example to support demand or to address short-term supply problems.

[SLIDE] One risk to the public finance metrics that we do expect to crystallise in the coming months is an improvement in the accounting treatment of student loans. As we pointed out in a working paper last year, the current treatment creates a number of ‘fiscal illusions’ in the official data, notably that the true cost of student loans takes a long time to show up in the measured budget deficit – flattering the numbers in the meantime.

The ONS is now on the case and from September student loans will be treated partly as a loan and partly as a grant, reflecting the fact that a large proportion of the loan outlay and associated interest is not expected to be repaid. This will have the effect of increasing measured spending and reducing measured interest receipts, so that the budget deficit is no longer seriously undermeasured. We do not know exactly how this will be done, but – as this chart shows – we estimate that it could add around £10½ billion to the deficit this year, rising to £13½ billion by 2023-24. This would absorb around half the Government’s room for manoeuvre against the fiscal mandate and would also make it harder to balance the budget. But it remains to be seen whether and how the Government will change student finance policy once it is accounted for more sensibly or whether it will rejig its fiscal targets when the new treatment is implemented.

[SLIDE] So now let me conclude.

This has not been a full blown fiscal event, but neither was it a complete non-event. Assuming a non-disruptive Brexit, the near-term outlook for the economy looks a little weaker than it did in October, but the public finances have outperformed expectations and the budget deficit has been revised down modestly across the forecast. The Government has banked most of the proceeds, but the Chancellor has also topped up departmental spending plans to offset an upward revision to whole economy inflation. The outlook is of course clouded by uncertainty, not least thanks to Brexit, and we will have to see how many of the clouds have lifted by the time we are asked for our next forecast.

Thank you.