Office for
Budget
Responsibility

Forecast evaluation report 2012

16 October 2012

The aim of the FER

- We publish 2 EFO forecasts a year
- We emphasise and quantify uncertainty
- But still publish detail of central forecast and evaluate ex post against outturns
- Accountability, self-discipline and learning

The big question (in two parts)

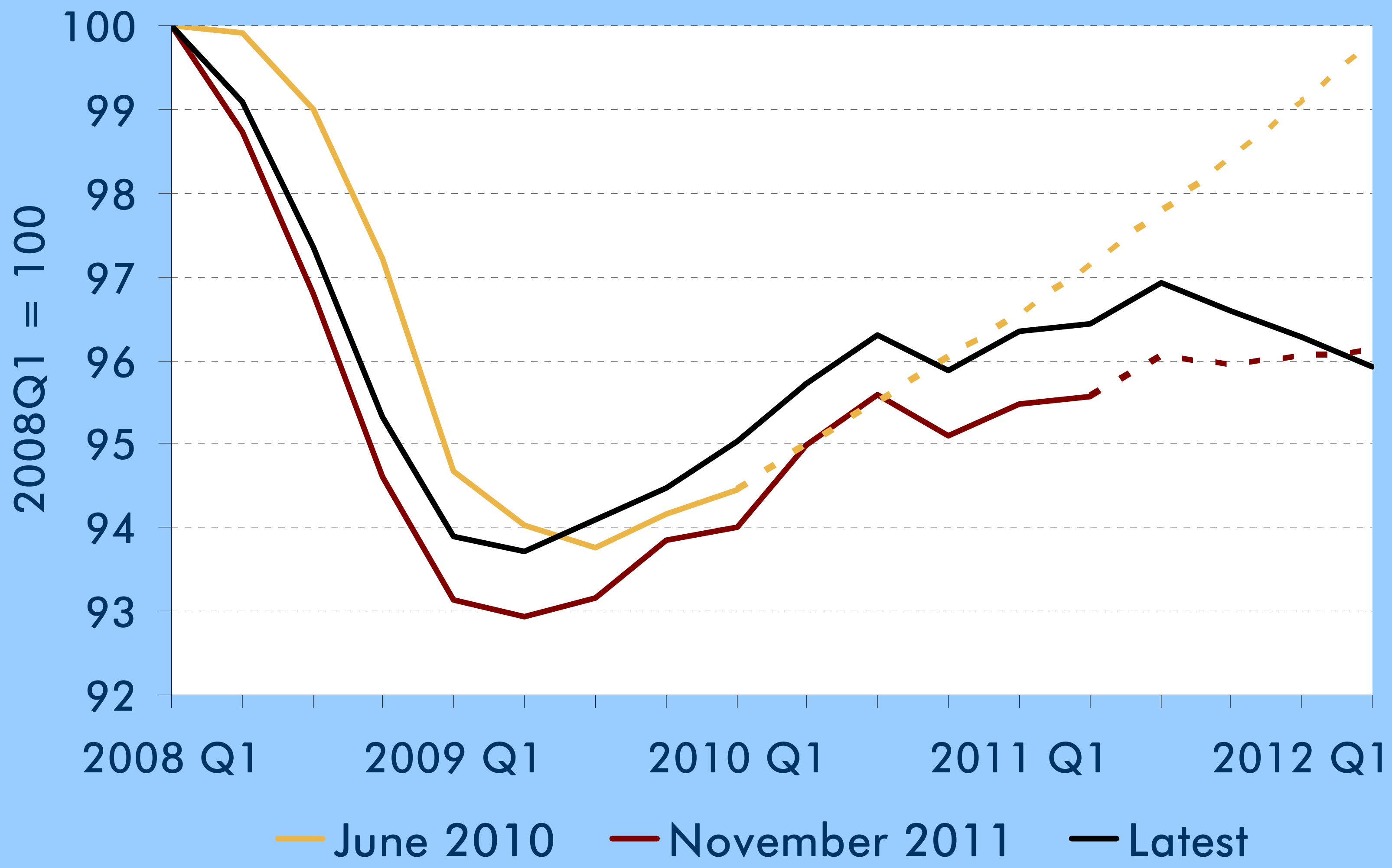
- Why have we and others over-estimated economic growth by so much over the last two years, but yet the budget deficit has shrunk almost exactly as expected?

	GDP growth between 2010Q1 and 2012Q2	Change in PSNB from 2009-10 to 2011-12
June 2010 forecast	+5.7%	–3.5% of GDP
Latest outturn	+0.9%	–3.4% of GDP

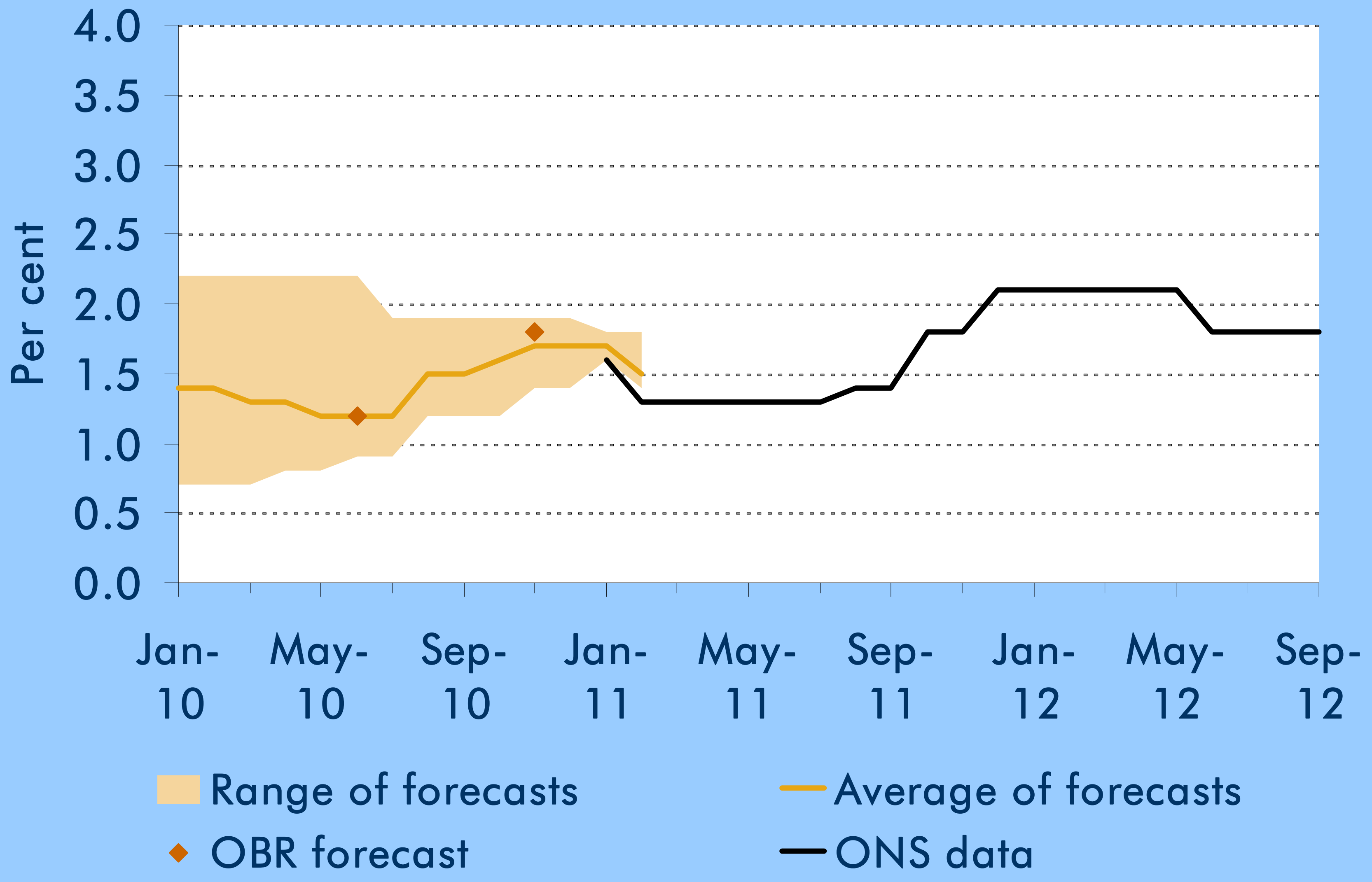
GDP growth forecast overview

- June 2010 forecast: slow but steady recovery
- GDP stronger than expected that summer…
- …but lost momentum into 2011
- November 2011 and March 2012 forecasts: GDP broadly flat to mid-2012
- Instead 'double dip' – three quarterly falls
- Little more than stagnation over whole period

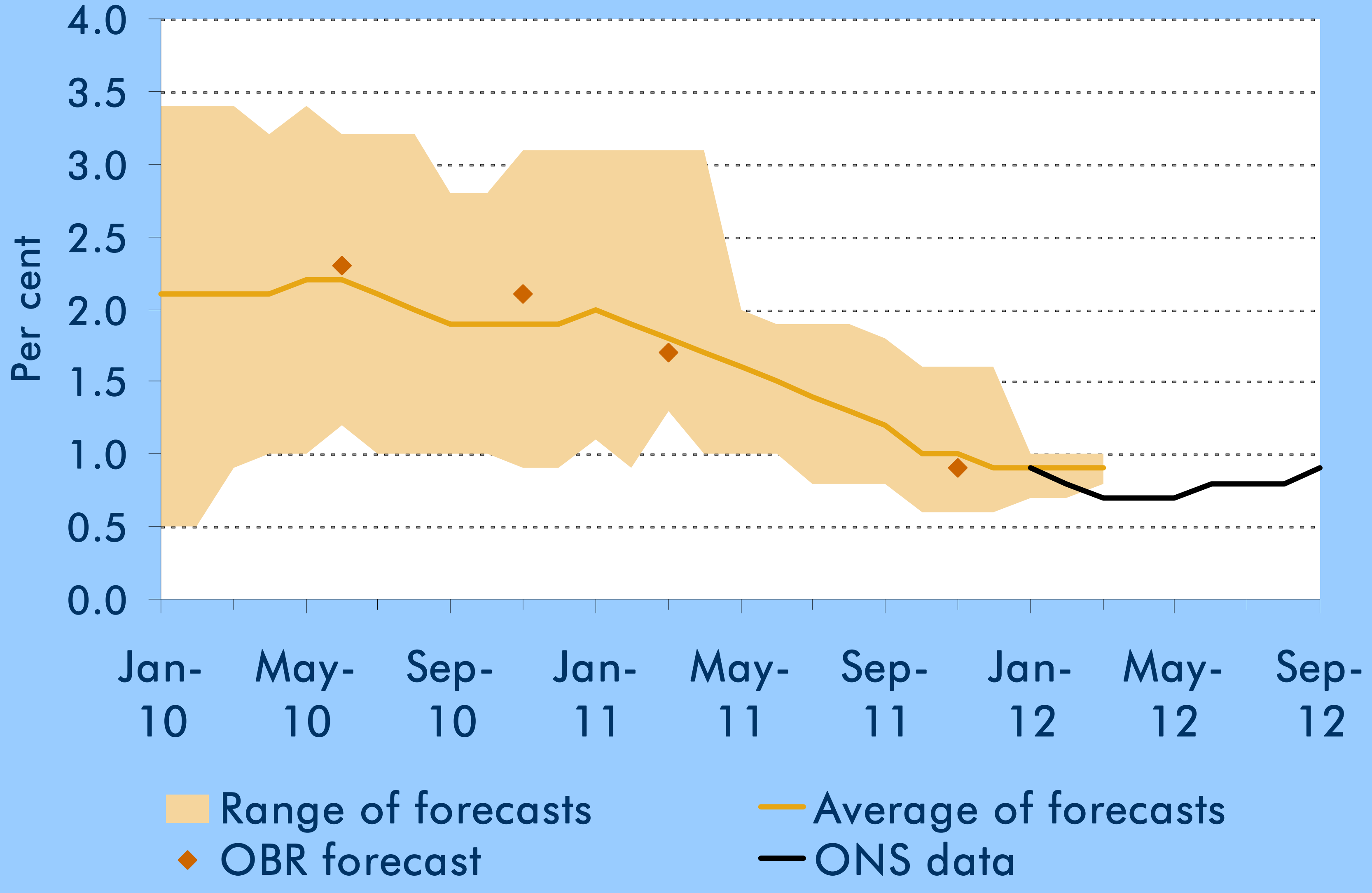
GDP growth forecasts and outturns



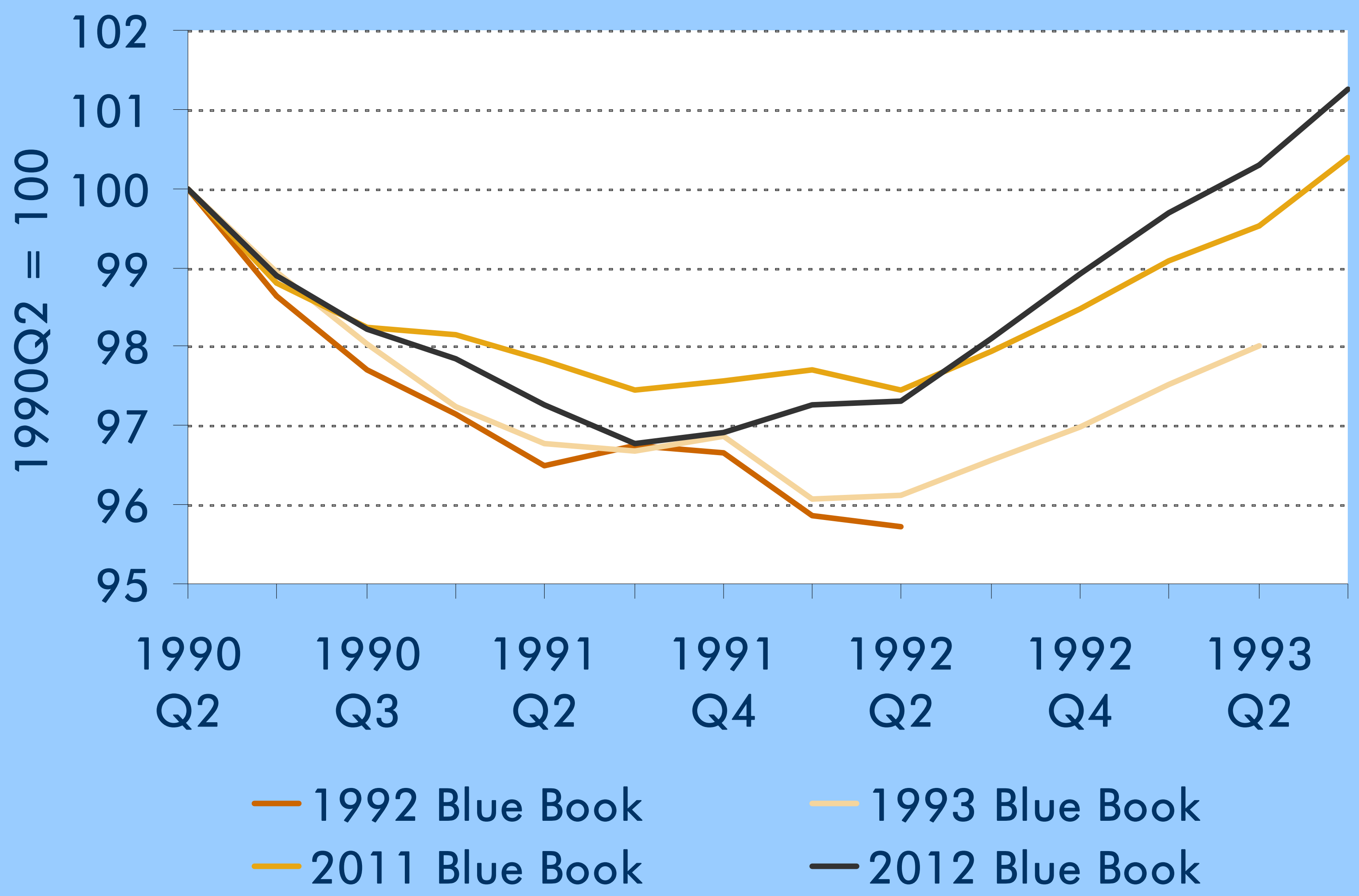
GDP growth in 2010



GDP growth in 2011



Rewriting history: the 1990s recession



Where were the errors (June 2010)?

Contributions to real GDP growth from 2010Q1 to 2012Q2	**June 2010 forecast**	**Latest outturn estimate**	**Error**
Private consumption	**+2.0**		
Private investment	**+2.5**		
Net trade	**+1.9**		
Total government	**–1.5**		
Stockbuilding	**+0.8**		
Total GDP	**+5.7**		

Where were the errors (June 2010)?

Contributions to real GDP growth from 2010Q1 to 2012Q2	**June 2010 forecast**	**Latest outturn estimate**	**Error**
Private consumption	+2.0	**0**	
Private investment	+2.5	**+0.7**	
Net trade	+1.9	**+0.2**	
Total government	–1.5	**–0.7**	
Stockbuilding	+0.8	**+0.5**	
Total GDP	+5.7	**+0.9**	

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Contributions to real GDP growth from 2010Q1 to 2012Q2	**June 2010 forecast**	**Latest outturn estimate**	**Error**
Private consumption	+2.0	0	**–1.9**
Private investment	+2.5	+0.7	**–1.8**
Net trade	+1.9	+0.2	**–1.7**
Total government	–1.5	–0.7	**+0.8**
Stockbuilding	+0.8	+0.5	**–0.3**
Total GDP	+5.7	+0.9	**–4.7**

Where were the errors (Nov 2011)?

Contributions to real GDP growth from 2011Q3 to 2012Q2	**November 2011 forecast**	**Latest outturn estimate**	**Error**
Private consumption	**+0.1**		
Private investment	**+0.4**		
Net trade	**+0.6**		
Total government	**–0.3**		
Stockbuilding	**–0.8**		
Total GDP	**0**		

Where were the errors (Nov 2011)?

Contributions to real GDP growth from 2011Q3 to 2012Q2	**November 2011 forecast**	**Latest outturn estimate**	**Error**
Private consumption	+0.1	**+0.2**	**+0.1**
Private investment	+0.4	**+0.1**	**–0.3**
Net trade	+0.6	**–0.8**	**–1.4**
Total government	–0.3	**+0.3**	**+0.5**
Stockbuilding	–0.8	**–0.8**	**0**
Total GDP	0	**–1.0**	**–1.1**

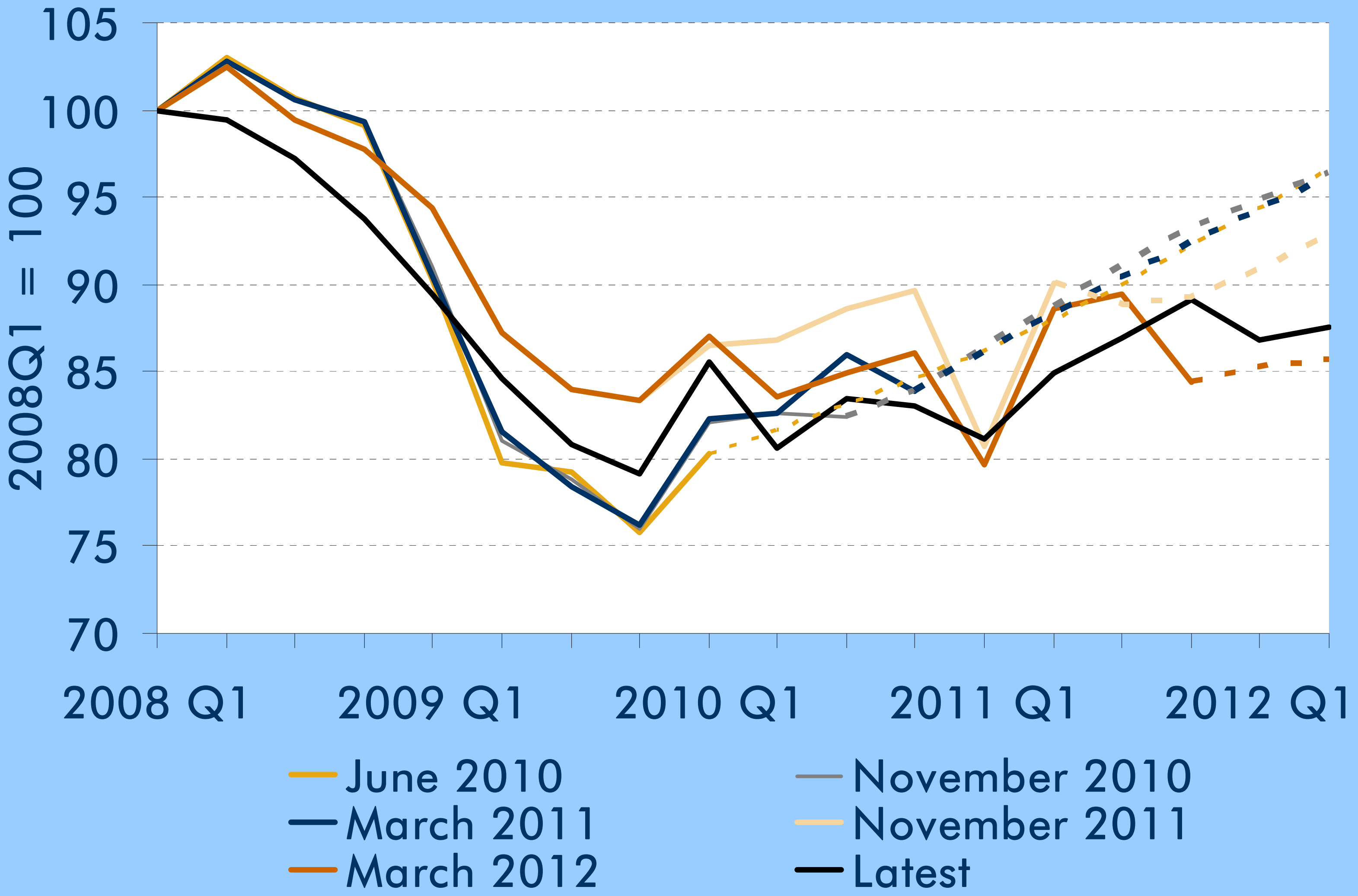
Private consumption

- Error reflects higher prices reducing volume of goods and services you can buy for each £
- Cash value of consumption in line with forecast and little evidence that households deleveraging more quickly than expected
- Households have maintained cash spending in face of weaker incomes by increasing savings less than we expected. Able to do so because balance sheets stronger than we thought

Private investment I

- Error was in business rather than residential investment (perhaps surprisingly as house prices and transactions weaker than expected)
- Business investment very volatile and heavily revised

Business investment



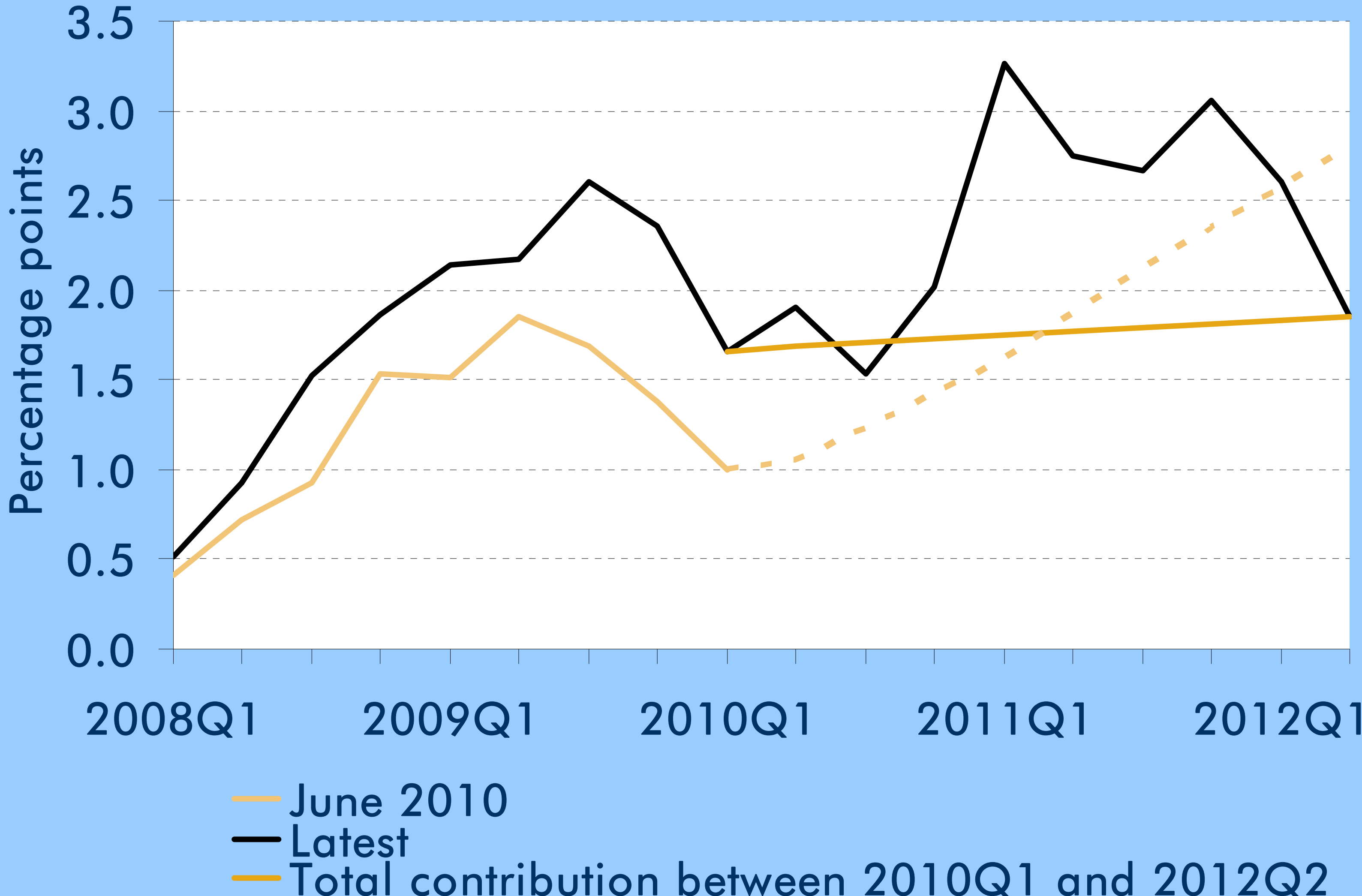
Private investment II

- SME investment likely to have been constrained as credit conditions failed to ease as quickly as we forecast – but perhaps more damaging for innovation and TFP than investment volume
- Conditions better for larger firms who do most of the investment – corporate profitability a bit higher than expected and surplus still large
- So their reluctance more likely pessimism and/or uncertainty regarding future demand

Net trade

- Very little contribution to growth from 2010Q1 to 2012Q2 overall
- But contributed to growth much as expected (c1.5%) from beginning of 2010 to end-2011
- Only for almost all that contribution to be reversed during 2012Q1 and Q2
- ONS have revised up net trade contribution in 2008 and 2009 – fits with weaker £

Net trade contribution to GDP



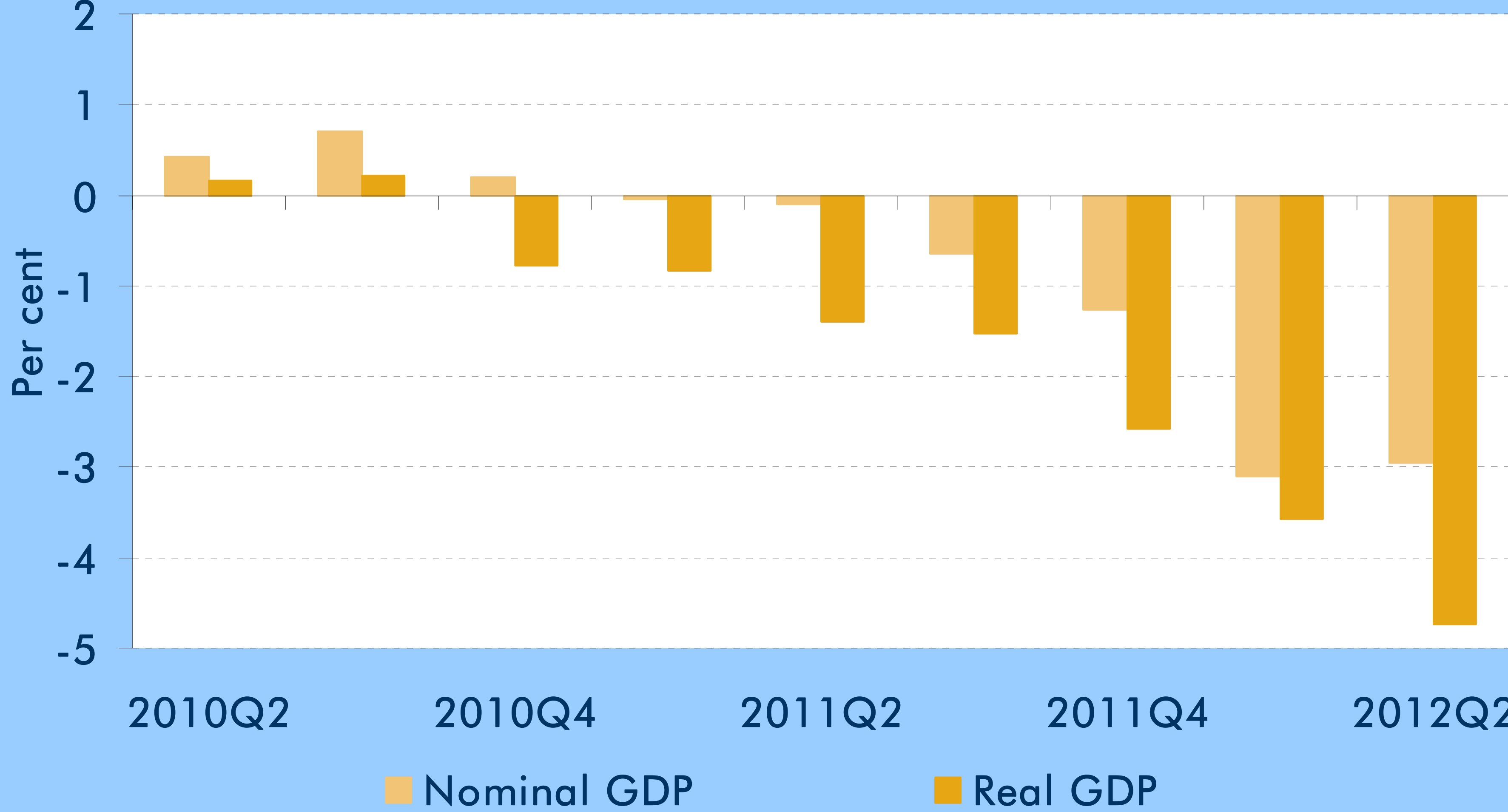
Government

- Has subtracted much less from GDP than we expected - and added to it during double dip
- Cuts have not been reflected in direct measures of government output used in National Accounts to the degree we had assumed
- But focus here on direct contribution to GDP - ignores additional indirect impact via private sector as captured in 'multipliers'

Real GDP not the whole story

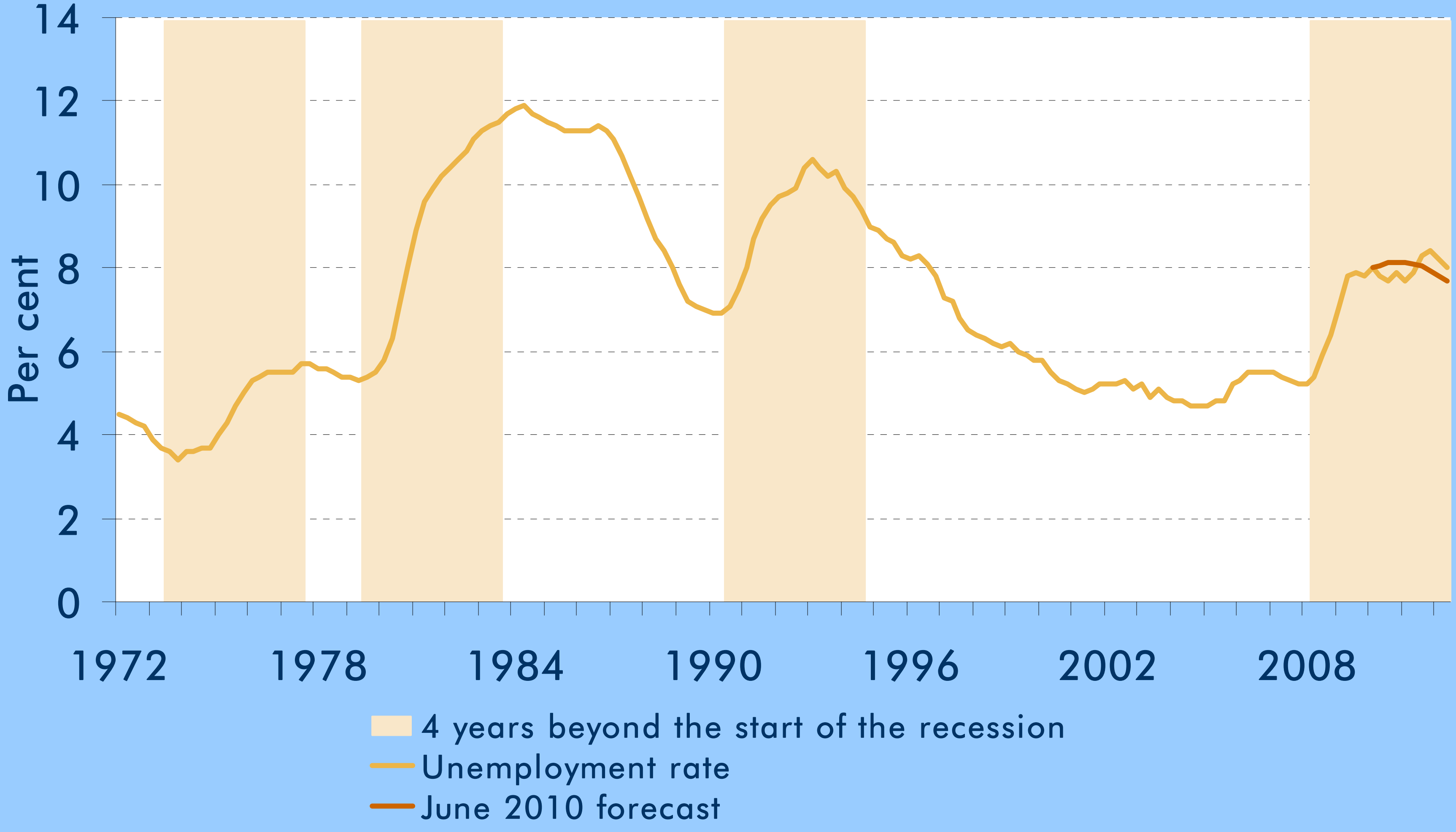
- The behaviour of the economy does not affect the public finances only via real GDP
- Other things matter too e.g.:
  - Nominal GDP
  - The labour market
  - Potential GDP – matters for cyclical/structural split in deficit and for medium-term growth prospects

Nominal and real GDP



Higher-than-expected inflation means level of nominal GDP has not fallen as far short of forecast as real GDP

Unemployment



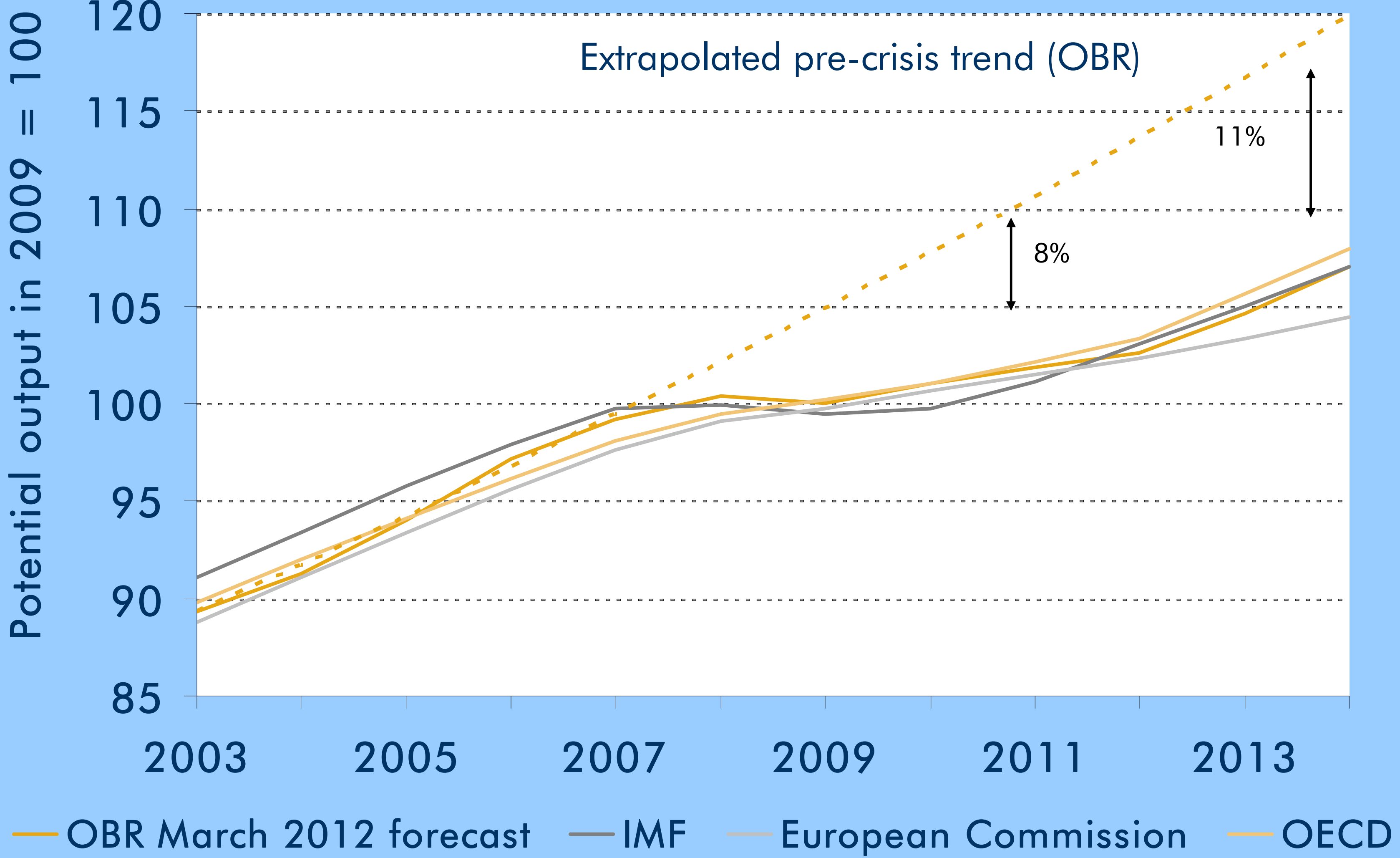
Labour market much stronger than real GDP would suggest

Labour market forecasts (June 2010)

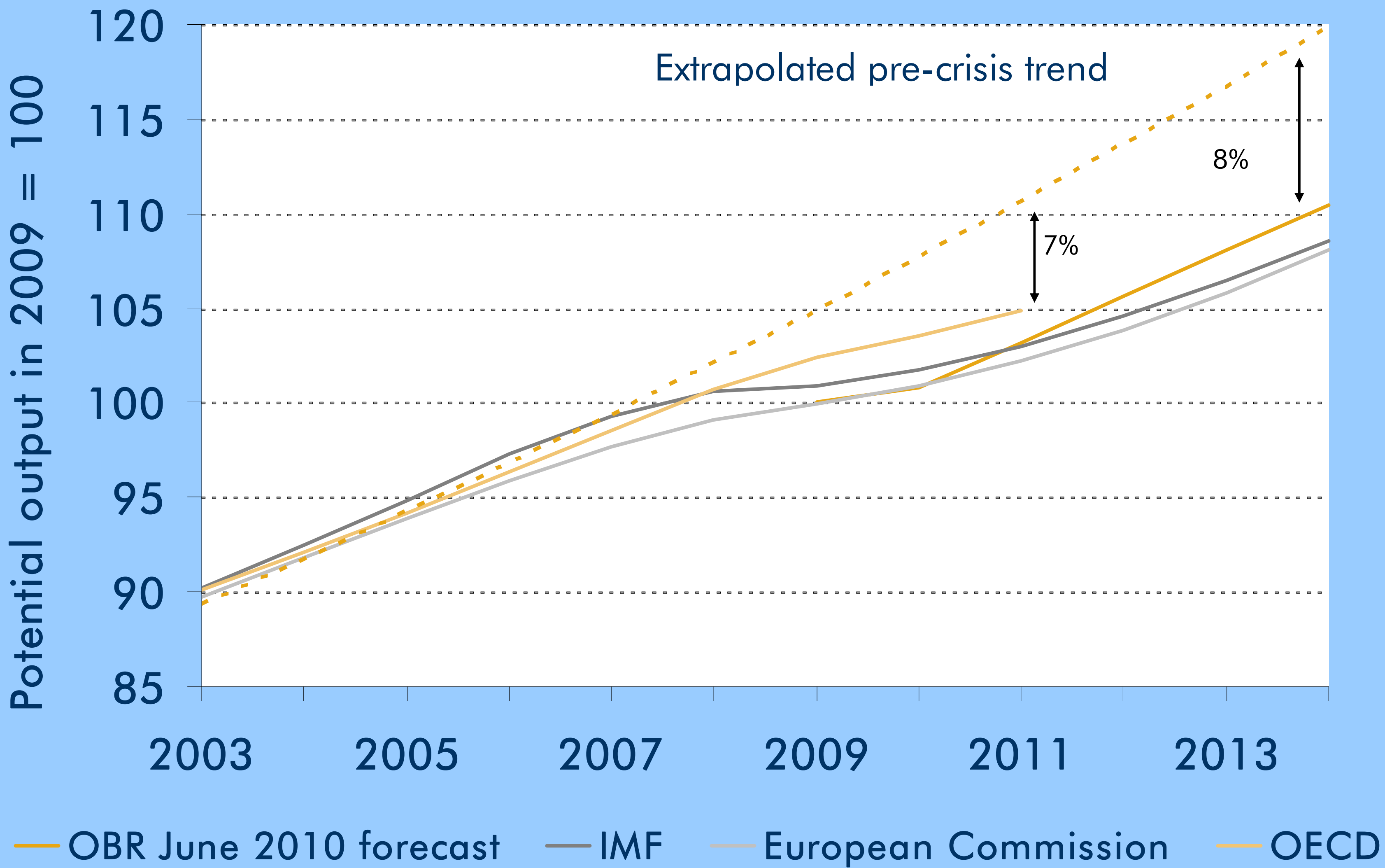
Change between 2010Q1 and 2012Q2	**June 2010 forecast**	**Latest outturn estimate**	**Error**
General government employment	-89	-338	-249
Market sector employment	+399	+1007	+607
Total employment	+311	+669	+358
LFS unemployment	–89	+52	+141
Activity	+222	+721	+499

Rise in employment not simply masking part-time working. Total hours worked mostly above forecast – big productivity puzzle

Potential output: March 2012



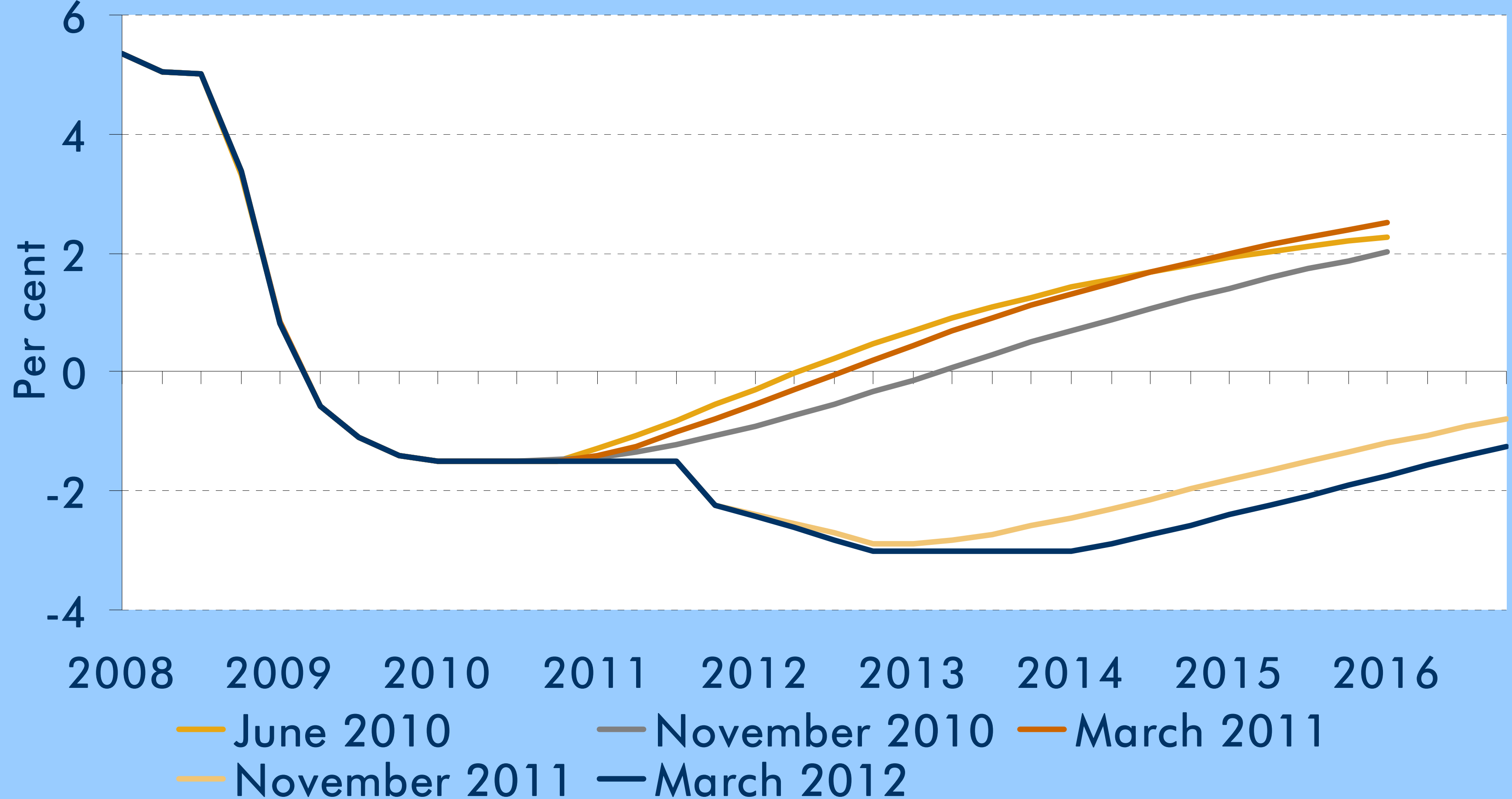
Potential output: June 2010



Monetary and fiscal policy

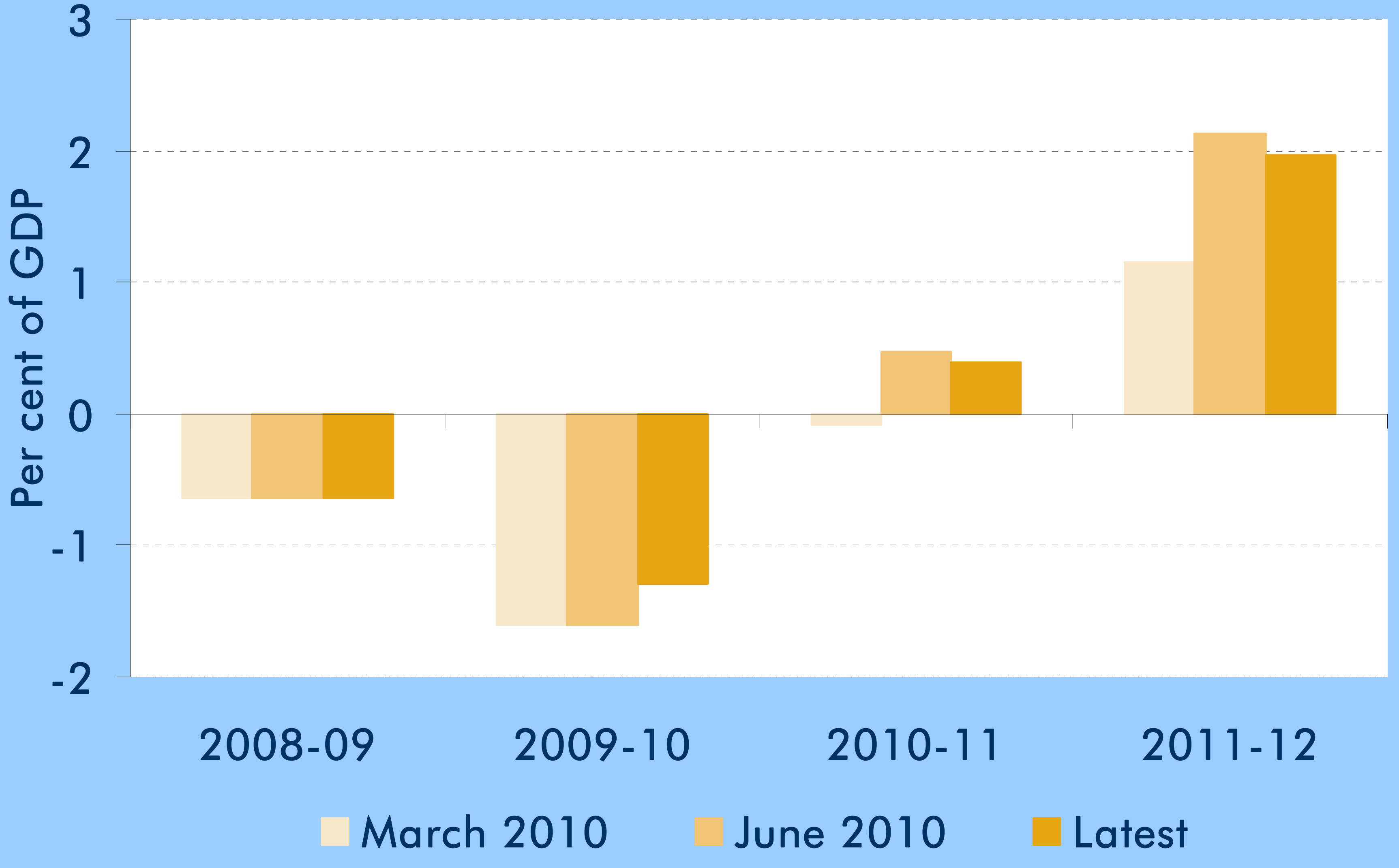
- Economy could have turned out different from forecasts because of policy. Either:
  - The policy changed after the forecast
  - A given policy was more or less positive or negative for growth than assumed

Monetary policy: QE-adjusted base rate



Policy looser than June 2010, but credit spreads wider

Fiscal tightening: Budget 2008 baseline

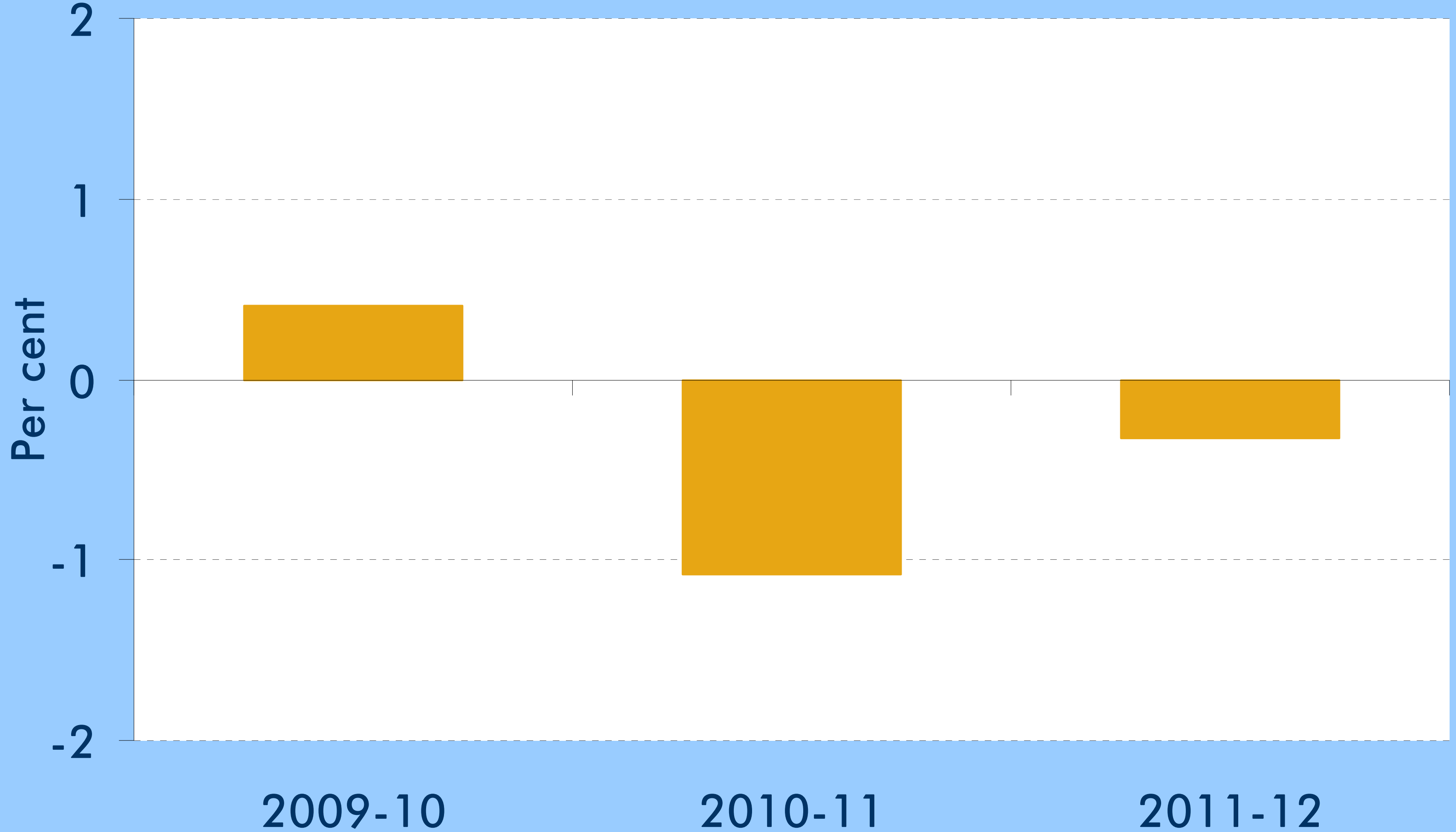


Impact multipliers (June 2010 EFO)

	Change in GDP as proportion of change in fiscal measure
Capital spending	1
Current spending on public services etc	0.6
Current spending on welfare	0.6
Change in VAT rate	0.35
Change in income tax or NICs allowances	0.3

In middle of the then range of external estimates

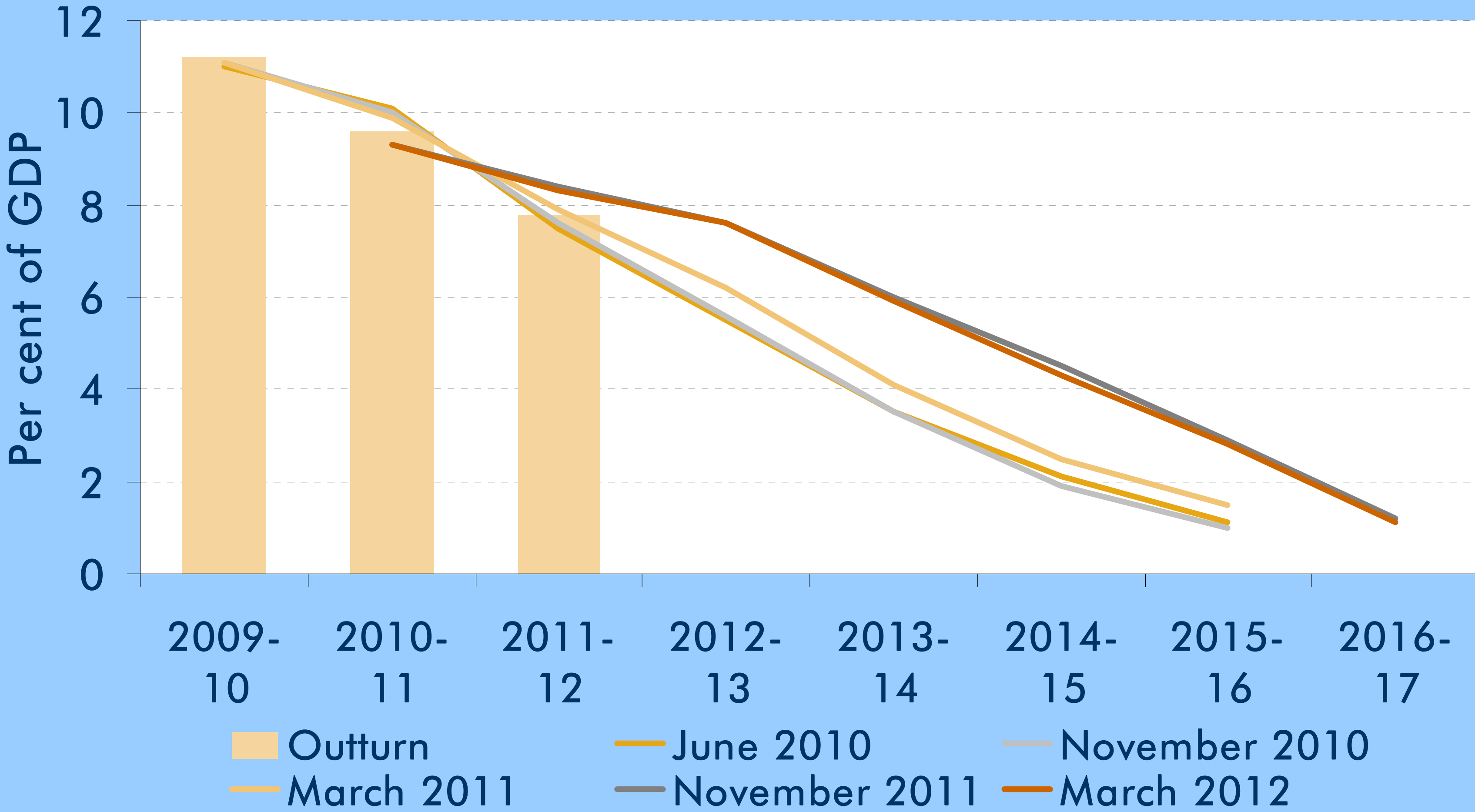
Impact on growth from multipliers



Fiscal consolidation and growth

- Cannot exclude possibility that fiscal consolidation hit growth harder than thought
- But stubborn inflation seems a better explanation for weak real consumption, given no nominal shortfall
- Export markets hit net trade during ‘double dip’
- Hard to distinguish impact of consolidation on investment from other demand, euro, financial sector etc
- Direct government consumption contribution to GDP more positive than we expected

Public sector net borrowing



Bigger revisions to future years than to 2010-11 and 2011-12

Change in PSNB in 2010-11 and 2011-12

	Change from 2009-10 to 2011-12 as % of GDP
Spending, of which:	**-2.4**
Capital	*-1.8*
Social security	*-0.1*
Debt interest	*+0.9*
Other current (mostly public services)	*-1.4*
Receipts, of which:	**+1.1**
VAT	*+1.2*
Public sector net borrowing	**-3.4**

June 2010 forecast for 2010-11

- Borrowing over-predicted by £7.4bn
- Revenues under-predicted by £1.2bn
  - Forecasts for GDP, nominal GDP, consumer spending and wages all relatively accurate, so major tax receipts also
  - Other parts of economic forecast over-predicted revenues, but offset by impact of 50p forestalling and small VAT litigation losses etc
- Spending over-predicted by £6.2 billion
  - Local authorities and (less so) central government underspent, perhaps frontloading cuts

June 2010 forecast for 2011-12

- Borrowing under-predicted by £3.7bn
- Revenues over-predicted by £14.9bn
  - Small error given real GDP shortfall, because nominal GDP, nominal consumption and labour market stronger
  - Also weak oil production, financial sector losses carried forward, and overestimate of 50p receipts (plus forestalling)
- Spending over-predicted by £11.3 billion
  - Local authorities underspent again, and central government more than in 2010-11. Labour market restrains welfare bill
- Additional factors in play for bigger March 2011 errors

Conclusion

- Growth over-estimated thanks to stubborn inflation hitting consumption and export markets hitting net trade. Investment hit by credit conditions and weak confidence in demand. Government spending less negative than expected, but broader fiscal impact?
- Budget deficit still fell in line with forecast as nominal spending and the labour market held up, plus under-spending by local and central government