

July 2023 *Fiscal risks and sustainability* report

Transcript of Presentation by:

Richard Hughes, Chair, Office for Budget Responsibility

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Responsibility**

1. Opening slide

- Thanks, Laura.
- Good morning, everyone.

2. Content of this report

- This is our second integrated *Fiscal risks and sustainability* report.
- The aim of these reports is to explore the risks, pressures, and threats to the public finances that are not fully captured in our biannual five-year central forecasts.
- In this latest report we look in depth at three risks which have crystallised over the past three years, but whose economic and fiscal consequences continue to unfold.
- The first of these is the rise in health-related inactivity which represents perhaps the most worrying economic and fiscal legacy of the Covid pandemic.
- The second is the spike in gas prices in the wake of the Russian invasion of Ukraine and the impact this has had on energy demand, energy supply, and the fiscal costs of reaching the Government's net zero objective.
- The third is government debt and, in particular, the impact of recent rises in inflation and interest rates on its long-term sustainability.
- Finally, as we have done in every other risk report since 2017, we also provide an update on how the other 54 risks included in our comprehensive fiscal risks register have evolved over the past two years.

3. Change in working-age inactivity since 2020

- Starting with the first of these risks, after rising to an all-time high on the eve of the pandemic, the participation of working-age adults in the labour market has fallen dramatically in its aftermath.
- At its peak in the Autumn of last year, almost 650,000 more adults were outside of the labour force than at the start of 2020.
- As you can see from this chart, some of this increase was driven by temporary or one-off factors – such as:
 - an increase in the number of students going into higher or further education (shown in yellow);
 - and a spate of early retirements during the pandemic (shown in purple).
- But as can be seen from the green bars on this chart, the largest and most durable source of this rise in economic inactivity has been among those citing ill-health as their reason for being neither in employment nor looking for work.
- As of April of this year, their number had risen by 440,000, more than accounting for total change in working-age inactivity over the past three years.

4. The long-term sick inactive population

- This rise in health-related inactivity seems to have been driven by the interplay of three main factors:
 - first, a slowdown, and partial reversal, in the overall rate of improvement in the health of the working population *prior* to the pandemic;
 - second, the impact of the *pandemic itself* on the health of the working-age population both as a direct result of Covid and its disruptive effects on the health service;
 - and third, rising flows onto health-related benefits, with over four-fifths of those inactive for health reasons receiving some form of incapacity benefit.
- Looking in more detail at the characteristics of this population, we find that the recent *increase* in health-related inactivity has been particularly pronounced among those who are:

- older, with those aged 50 to 64 accounting for around half of the post-pandemic increase;
 - who are suffering from mental health problems or other unspecified conditions (possibly including long Covid), which together account for around half of the rise;
 - who are relatively low-skilled, with those with qualifications at A-level or below accounting for nearly three-fifths of the increase;
 - and who were previously employed in lower-paid, customer-facing industries and occupations.
- However, it's important to note that the vast majority of the stock of people inactive for health reasons have been out of work since before the pandemic, and one-in-five have never had a job.

5. Fiscal impact of health-related inactivity

- The fiscal impact of this loss of economic potential can already been seen in our latest forecast with:
 - an additional £7 billion being spent this year on health-related benefits both for those in and out of work;
 - and £9 billion in forgone tax revenue from those no longer working for health reasons or working with a health condition;
 - on top of this, we estimate that each individual moving into health-related inactivity could be costing the health service an additional £900 to £1,800 a year.

6. Scenarios for health-related inactivity

- So arresting and partially reversing the recent rise in health-related inactivity and in-work ill-health could significantly reduce a large and growing pressure on the public finances.
- Based on these estimates, we look at three scenarios for the future evolution of health-related inactivity:
 - the central forecast from our *March 2023 Economic and fiscal outlook*, shown here in green, assumed that the working-age participation rate recovers from 78.6 per cent last year to 79.3 per cent in five years' time;

- an upside scenario, shown here in yellow, assumes a return to pre-pandemic rates of improvement in labour market participation and a reduction in numbers out of the workforce due to long-term sickness by 500,000. Relative to our central forecast, this reduces borrowing by £19 billion in five years and takes 3 percentage points off the debt-to-GDP ratio;
- by contrast, a downside scenario, shown here in blue, in which 500,000 more people are outside the workforce for health reasons, would add over £21 billion to borrowing and see debt continue to rise in every year of the forecast.

7. Energy consumption and gas prices

- Turning to the ongoing fiscal risks emanating from the energy market, despite our comparatively rapid progress in decarbonising over the past 30 years, the UK remains one of the most gas-dependent economies in Europe.
- The UK has delivered the largest reduction in CO₂ emissions of any G7 country since 1990, but as you can see from the chart on the left, this was achieved largely by switching from coal, shown in green, to gas, shown in blue, as our principal source of energy.
- Gas has therefore risen from 24 per cent of total inland energy consumption in 1990 to 40 per cent in 2022. This made the UK the fourth most gas-intensive economy of 40 European countries prior to the Russian invasion of Ukraine.
- And this left us particularly exposed to changes in wholesale gas prices, which peaked at thirteen times their historical level last summer and are expected to remain at twice their historical levels into the mid-2020s.
- This spike in gas prices has already brought with it considerable fiscal costs:
 - both directly in the form of the £78 billion the Government will have spent in energy price support for households and businesses last year and this year;
 - and indirectly in the form of the impact of higher inflation on the cost of inflation-linked benefits and debt.

8. Relative price of energy generation

- Looking forward, higher long-run gas prices set up two conflicting incentives from the perspective of the Government's target of reaching net zero carbon emissions by 2050 and the fiscal costs attached to it.

- On the one hand, rising gas prices make renewable energy relatively cheaper. This was certainly the case when the gas price was at its peak last year, as is shown by the green line on this chart.
- But it should remain the case in the UK even if gas prices fall back, as they are expected to do by the mid-2020s, as shown by the diamonds on the right of this chart.
- This should encourage more private investment in renewables, promoting the decarbonisation of the power sector and reducing the need for government intervention to drive the energy transition.
- On the other hand, higher gas prices strengthen incentives for non-Russian gas producers to expand their production and exports to Europe, in the form of liquified natural gas, or LNG.

9. Renewable energy investment

- So far we've seen little sign in the UK of significant new investment in low-carbon energy and heating technologies in response to the rise in gas prices.
- In fact, while we have historically been one of the leading investors in renewables in the G7, total UK investment in low-carbon technology actually *fell* last year from 1.1 to 0.9 per cent of GDP, behind Germany and France.

10. Gas imports

- By contrast, higher gas prices have spurred a *significant* supply response from gas-exporting countries outside Russia.
- UK imports of LNG from Qatar and the US rose by 40 and 230 per cent respectively in 2022. And global investment in natural gas supply rose by \$30 billion last year and is expected to rise by a further \$15 billion this year.
- As additional global LNG supply comes on stream over the next few years, there is a risk that the UK economy remains relatively highly dependent on imported gas – rather than completing the switch to renewable forms of energy.

11. Scenario for continued gas dependence

- Continuing our dependence on gas at current levels could, in the context of continued price volatility, end up being as fiscally expensive as completing the transition to net zero.

- To illustrate this, we consider a scenario in which upward spikes in wholesale gas prices, on a similar scale to that experienced last year, recur every decade.
- If fiscal policy responds in a similar manner, this could cost the Exchequer around 2-to-3 per cent of GDP per episode and add around 13 per cent of GDP to debt by 2050.
- To put this in perspective, this is about *twice* our central estimate of the total public investment cost of completing the transition to net zero by the middle of this century.

12. Government debt and cost of borrowing

- Turning finally to debt, the succession of crises we have faced over the past two decades in the form of the financial crisis, the pandemic, and now the energy crisis has seen public debt more than treble from below 30 per cent of GDP at the start of the century to 100 per cent of GDP now.
- Up until recently, the fiscal burden of the Government's rising debt stock was offset by low inflation and falling interest rates, with 10-year gilt yields falling from around 6 per cent in 2000 to an all-time low of 0.2 per cent at the depths of the pandemic in 2020.
- However, both of these trends have dramatically reversed over the past year with:
 - RPI inflation peaking at a 40-year high of 13.8 per cent in February of this year;
 - and 10-year gilt yields climbing above 4 per cent in recent months.
- Together these have pushed the share of public resources consumed by servicing our debts to their highest level since the early 1980s.

13. Sensitivity of UK debt to interest and inflation

- While the UK has had debt above 100 per cent of GDP in the past, and other major economies have debt above this level today, several factors render the UK debt position more exposed to a sudden rise in inflation and interest rates than in the past or elsewhere:
 - first, as we have highlighted in previous risks reports, a fiscal side-effect of the Bank of England's quantitative easing operations has been to dramatically shorten the average maturity of the consolidated liabilities of UK public sector from over seven to less than two years. This means that rises in interest rates hit the public finances much more quickly than they have in the past;

- second, as we have also highlighted before, at around one-quarter of the total debt stock, the UK has the highest proportion of inflation-linked debt of any major advanced economy. This means that higher inflation more quickly raises debt-servicing costs and nominal debt levels than in the past or in other countries;
- third, over the past 20 years, the share of UK government debt in foreign private hands has almost doubled from 13 to 25 per cent, the second highest in the G7 after France. This could leave the UK public finances more vulnerable to sudden changes in sentiment among these global investors.

14. Impact of recent interest rate rises

- The greater vulnerability of the UK government debt position was illustrated by the events of the past year. Specifically, over the past 12 months:
 - UK government borrowing costs have risen by more than in any other G7 country and been more volatile than at any time in the past 30 years;
 - and, as you can see from this chart, this rise in interest rates has fed through to the UK's government's debt-servicing costs more than twice as fast as in the past or in other G7 countries;
 - finally, due to our relatively large stock of inflation-linked debt, the rise in global inflation has delivered little net benefit to the UK public finances relative to other countries, many of whom saw their debt-to-GDP ratios fall last year.

15. Long-term debt scenarios

- From this more vulnerable starting position, the UK public finances face the longer-term pressures of an ageing society, a warming planet, and rising geopolitical tensions.
- To illustrate the extent of these pressures, we have generated a partially updated set of long-term debt projections.
- These start from our March *forecast* and take account of the more challenging interest rate outlook as well as the latest demographic data.
- In the baseline projection, shown in green:
 - an ageing society and other long-term trends put downward pressure on tax receipts and upward pressure on health and welfare spending;

- this drives debt from 100 per cent of GDP today up to 310 per cent of GDP by the mid-2070s;
- this is 31 percentage points higher than in last year's long-term projections, shown in yellow.
- While alarming in itself, this *baseline* projection likely understates the full range of potential long-term pressures on the public finances:
 - in particular, it assumes there is no feedback between the level of debt and the interest rate paid on it. Were rates to rise with the level of debt in accordance with standard elasticities, debt could reach 376 per cent of GDP by the mid-2070s, as shown in purple;
 - the baseline projection also ignores potential future shocks to the public finances, when in fact adverse shocks seem to have become more frequent, more severe, and more costly. So far this century, we have experienced three major shocks, each adding around 20 per cent of GDP to debt on average. If shocks continue at this intensity over the next 50 years, this would push debt up to 435 per cent of GDP by the mid-2070s, as shown in the blue line.

16. Conclusion

- In conclusion, the 2020s are turning out to be a very risky era for the public finances.
- In just three years, they have been hit by:
 - the Covid pandemic in early 2020;
 - the energy and cost-of-living crises from mid-2021;
 - and the sudden normalisation of interest rates in 2022.
- This rapid succession of shocks has pushed:
 - government borrowing to its highest level since the mid-1940s;
 - the stock of government debt to its highest level since the early 1960s;
 - and the cost of servicing that debt to its highest level since the early 1980s.

- From this more vulnerable position, the Government faces growing risks and pressures from:
 - rising numbers of people out of work for health reasons;
 - an energy mix which remains highly exposed to volatile gas prices;
 - and a growing debt stock which is increasingly sensitive to changes in inflation and interest rates.
- Early action to tackle these risks and vulnerabilities can help to contain their fiscal consequences.
- While delay or inaction is likely to see debt continuing to rise toward unsustainable levels in the decades to come.
- And with that, I'll hand back to Laura to manage the Q&A.