March 2023 Economic and fiscal outlook

Office for **Budget Responsibility**

Transcript of Presentation by:

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1. Opening slide

- I'm going to first take you through our latest forecast for the economy.

- And then turn to what it, and the policies announced by the Chancellor in today's Budget, imply for the public finances.

2. Energy markets

- Economic news since our previous forecast in November has been largely favourable in the near term.

- Gas prices, whose ups and downs have dominated economic prospects for most European countries since Russia's invasion of Ukraine, have fallen more sharply than we expected in November.

- As you can see from the chart on the left, markets now expect wholesale gas prices to more than halve from their quarterly peak of £3.50 a therm last year to £1.50 by the middle of this year.

- As you can see from the chart on the right, this means that retail energy prices are now expected to fall below the Government's energy price guarantee in the second half of this year.

- And the decision in this Budget to extend that guarantee at £2,500 until the end of June means next quarter's household energy bills will remain flat, rather than rising by 20 per cent as they would have done with a £3,000 guarantee.

- This alleviates a key source of financial pressure on both households and business, though market expectations for wholesale gas prices remain more than twice their pre-pandemic level – weighing on our productivity forecast in the medium term.

3. Inflation

- The steeper fall in retail energy prices means we expect overall inflation to fall faster this year – from a quarterly peak of 11 per cent at the end of last year to 3 per cent by the end of this year.

- But the earlier fall in gas prices and stronger domestic price pressures mean that we now expect inflation to oscillate around zero in the middle of the decade – rather than fall meaningfully into negative territory as we forecast in November.

- And inflation doesn't return to its 2 per cent target until early 2028 when the output gap closes and real commodity prices stabilise.

4. Interest rates

- Another source of financial pressure on some households, businesses and the Government has been the sudden rise in interest rates over the course of last year both in the UK and around the world.

- Market expectations for both Bank Rate and gilt yields have jumped around in recent weeks but are generally lower than at the time of our November forecast.

- As you can see from the chart on the left, at the time we took market determinants for this forecast on the 8th of February:

    - Markets expected Bank Rate to peak at 4.3 per cent later this year – before falling back to 3 per cent by the end of the forecast period, half a percentage point lower than was expected back in November.

    - And as you can see from the chart on the right, gilt yields were also about half a percentage point lower in the near term, but largely unchanged from our November forecast at the long end of the curve.

    - And both curves are well below the peaks they reached in the immediate aftermath of the mini-Budget in September.

- Markets have remained volatile since then, with interest rates moving both above and below these assumptions in just the past 10 days.

5. Living standards

- Lower inflation and higher pay growth help to alleviate some of the historic squeeze on living standards that we forecast back in November.

- So rather than falling by 7 per cent over this financial year and next, real household disposable income per person is now expected to fall by a somewhat smaller 6 per cent.

- But that would still represent the largest two-year fall in living standards since records began in the 1950s.

6. GDP

- Turning to what this means for GDP, we now expect a shorter and shallower downturn in the first half of this year.
- This is a consequence of lower energy prices and interest rates reducing some of the near-term pressures on spending by households and businesses.
- From peak to trough, GDP falls by just ½ per cent, much lower than the 2 per cent fall we forecast in November.
- The economy then returns to growth in the second half of the year and output regains its pre-pandemic level in the middle of 2024, six months earlier than we expected in November.

7. Labour market

- However, these more promising near-term developments are set against the backdrop of more persistent structural weaknesses on the supply side of the UK economy – which have been exacerbated by recent shocks.
- The first is the fall in labour market participation since the pandemic, especially among older workers.
- The number of working-age people who are classed as inactive – that is, not employed or looking for work – has risen by around 500,000 since the pandemic, with over half of this increase among those aged between 50 and 64.

- And over half of the increase in this group is among those citing long-term sickness as their reason for being inactive.

- In our latest forecast, some of this decline in the domestic workforce is made up for by a further increase in assumed levels of net migration – which we have revised up from 205,000 to 245,000 a year in the medium term based on the latest ONS projections.

- But we also assume a recovery in participation rates among the resident population, as NHS backlogs begin to be cleared and the policy measures announced in this Budget take effect.

- Overall, we assume that around a quarter of the current shortfall in economic activity relative to our pre-pandemic forecast is reversed by the middle of the decade.
- This leaves the total labour force around 380,000 people smaller than we expected prior to the pandemic.

8. Investment

- A second problem that has acted as a drag on the supply side of the economy in recent years has been a lack of investment on the part of UK businesses.
- As you can see from the blue line on this chart, the volume of real business investment has stagnated since 2016 due, in part, to a succession of shocks:
    - First, the Brexit referendum and ensuing uncertainty surrounding our future trading relationship with the EU.
    - Second, the shock of the pandemic in 2020 and the economic dislocations it brought about.
    - Third, the rise in energy prices brought on by Russia's invasion of Ukraine at the beginning of last year.
    - Finally, the rise in interest rates in recent months, which has increased the costs of financing any new investment.
- All in all, this has left cumulative investment £340 billion, or 20 per cent, lower, than implied by our forecasts back in the first half of 2016.

9. Change in borrowing since November

Cost of Spring Budget policies

- Against that economic backdrop of:
    - lower energy prices and a shorter and shallower contraction in demand in the near term…
    - …but persistent weaknesses on the supply side of the economy holding back the pace of growth in the medium term…
- …the Chancellor has used his Spring Budget to take policy action on three main fronts:
    - First, there is the aforementioned extension of the energy price guarantee, which costs £4 billion next year.

- Second, a package of measures aimed at boosting labour supply whose costs rise to £7 billion by the fifth year. The most expensive of these policies is the provision of 30 hours of free childcare to working parents of children between the ages of nine months and two years.

- Third, a further set of generous, but *temporary*, tax allowances on business investments undertaken over the next three years, whose costs peak at £9 billion in the mid-2020s.

- In additional to these measures, the Chancellor also holds fuel duty rates at their current level for a further year, costing him almost £5 billion this year and £2½ billion a year thereafter. And he's added £2-to-3 billion a year to the defence budget.

- Taken together, these and other measures in the Budget cost around £20 billion a year for the next three years.

- Thereafter, the temporary nature of the investment tax allowances means that the overall cost of policy measures drops to £10 billion in the final year of the forecast – when the Chancellor's fiscal rules currently fall due.

Economic effects

- Offsetting the £10-to-20 billion impact of these policy measures on borrowing is an improvement in the underlying fiscal position.

- This comes from two main sources:

    - First, the improvement in our pre-measures economic forecast, shown in grey, which reduces borrowing by £25 billion per year.

    - And second, the smaller boost to both the demand and supply side of the economy from the policies announced in this Budget, shown in black, which reduce borrowing by a further £2 billion per year.

- Overall, the Chancellor spends around two-thirds of the £25 billion a year improvement in the fiscal outlook since November.

- But that still leaves borrowing lower – by around £12 billion on average over the next five years.

10. Government borrowing

- The net result is an uptick in government borrowing from 5 per cent of GDP in the last financial year to 6 per cent of GDP, or £152 billion, in this financial year.

- It then falls over the remainder of the forecast to around 1¾ per cent of GDP, or £49 billion, as the economy recovers, the rate of corporation tax rises, and temporary measures like the energy price guarantee and business investment allowances expire.

11. Government debt

- Turning to what this implies for the stock of debt, compared with our November forecast, the *level* of underlying Government debt is *lower* in every year – and by around £60 billion in the final year.

- Unfortunately for this Chancellor, like all Chancellors since 2010, his fiscal rules hinge not on the *level* of debt but its *trajectory* – specifically whether it is *falling* as a share of GDP in the fifth and final year of our forecast.

- As you can see from this chart, while the *level* of debt is around 2½ per cent of GDP lower in every year of the forecast, it is only *falling* by 0.2 per cent of GDP, or £6.5 billion in the *final* year.

- That partly reflects the fact that while borrowing in that year is £20 billion lower than we forecast back in November – adding less to the stock of debt – economic growth is slower too – adding less to the growth in the denominator.

12. Headroom against fiscal rules

- This £6½ billion of headroom against the Chancellor's debt-falling target is down from £9 billion at the time of Jeremy Hunt's first fiscal statement in the Autumn.

- It's also, as you can see from this chart, the smallest margin any Chancellor has had against his fiscal mandate since 2010.

- And it's around a quarter of the *average* amount of headroom Chancellors have had against the achievement of their fiscal objectives over this period.

13. Why is it hard to get debt to fall?

- Our latest debt forecast – and the lack of improvement in the Chancellor's headroom against his fiscal targets – raises an important question. Why is it so hard to get government debt to fall?

- Every Chancellor since the financial crisis has made that his goal.

- But debt as a share of GDP is now three times higher than it was before the financial crisis. And we expect it to be more than 5 per cent of GDP higher in five years' time than it is now. What is going on?

- The answer is a combination of four factors:

- First, shocks – the series of crises that the UK economy and public finances have faced over the past decade and a half – in the form of the financial crisis, the pandemic, and now the energy crisis – have been unprecedented in their severity and frequency.

- Indeed, of the nearly 50 per cent of GDP increase in public debt over the past 15 years, almost nine-tenths of it occurred in just four years – the two years following the financial crisis and two years following the pandemic.

- Second, headroom – the room for manoeuvre that Chancellors have typically left themselves against their stated goal of getting debt to fall was never large – and has now become vanishingly small by comparison with the scale of these shocks.

- Under George Osborne, the margin by which debt fell in the fifth year of our forecasts averaged around 2 per cent of GDP. That margin is down to 0.2 per cent of GDP in today's Budget.

- Third, growth, where our medium-term expectations have gotten lower over time. First, because productivity growth disappointed after the financial crisis. Then in anticipation of new trade frictions after Brexit. And more recently because the pandemic and energy crisis have reduced the labour supply and raised the cost of doing business.

- As a result, our estimate of nominal GDP growth in the final year of this forecast is 3.5 per cent. That's down from 5.5 per cent in our June 2010 forecast, 4.2 per cent in March 2016 on the eve of the Brexit referendum, and 3.6 per cent in March 2020 on the eve of the pandemic.

- This means that, for a given level of debt, less can be borrowed without putting debt onto a rising path as a share of a more slowly growing economy.

- And finally, interest rates – which have trebled over the past year on a stock of public debt which is approaching 100 per cent of GDP.

- That has raised our forecast for the annual costs of servicing that debt to 3.3 per cent of GDP in five years' time, which is more than twice the 1.4 per cent we predicted in our March 2020 forecast.

- These higher interest costs add to borrowing and debt, and they leave less for the Chancellor to spend on other things – be they tax cuts or new spending programmes.

- It all adds up to a situation in which Jeremy Hunt today needs to work a lot harder than his predecessors just to keep debt from rising in normal times.

- And normal times have been hard to come by in recent years.

14. Risks to the outlook

- Which leads me to the range of factors that mean the economy and public finances could end up in a very different place from what we forecast today.

- On the economy side, our forecasts are conditioned on market expectations for wholesale gas prices – which could increase the Chancellor's headroom by £4 billion if they fall back to pre-Russian invasion levels or reduce it by £3½ billion if they return to their post-invasion average last year.

- We also assume some recovery in the labour supply, including as a result of the policies announced in this Budget:

    - The Chancellor would have an extra £16 billion against his debt falling target if 500,000 *more* people returned to the labour market – through a of a reversal of recent trends and greater effectiveness of the Government's policies.

    - But if the downward trend in labour participation rates witnessed over the past two years continues over the next five, a further 500,000 people could leave the labour market and the Chancellor miss his fiscal target.

- Our economic forecasts are also conditioned on market expectations for interest rates, which have continued to be highly volatile since their dramatic rise last year.

- If interest rates were 1 percentage point higher or lower – around half the rise in 10-year gilts over the past year and double the volatility over the past month – borrowing in the final year of the forecast would be around £20 higher or lower.

- On the fiscal side, risks also come from both:

    - the Government's stated policies that are *in* our forecast

    - and policy aspirations that are *not* in our forecast.

- Starting with risks around stated policies, our fiscal forecast assumes, as Parliament requires, that the Government goes ahead with its stated policy of an RPI-plus-5p indexation of fuel duty next year and RPI indexation in every year after.

- This is not, perhaps, the assumption everyone would make given the fuel duty rates have been either frozen or cut in every year since 2011.

- If those past actions prove to be a better guide to the future than stated policy, this would cost £4 billion by 2027-28.

- Moving onto risks around aspirations, our forecast assumes that the full expensing of business investment is a temporary measure ending in 2026.

- Making these capital allowances permanent, which the Chancellor has said he would like to do if and when his rules allow – might cost sums approaching £10 billion per year – several billion more than his rules allow at the moment.

- Another aspiration announced this week was the Government's intention to increase defence spending to 2½ per cent of GDP – again as and when resources allow.

- Relative to the NATO 2 per cent commitment, achieving this within our five-year forecast horizon would cost £15 billion – but also put debt on a rising path in every year.

15. Conclusion

- In summary, the economic and fiscal outlook has brightened somewhat since our last forecast in November.

- The near-term downturn is set to be shorter and shallower; medium-term output to be higher; and the budget deficit and public debt to be lower.

- But this reverses only part of the costs of the energy crisis, which are being felt on top of larger costs from the pandemic.

- And persistent supply-side challenges continue to weigh on our future growth prospects.

- Against this backdrop, the Chancellor has spent two-thirds of the improvement in the fiscal outlook on his Budget measures:

    - providing more support with energy bills and investment in the near term;

    - while looking to boost the labour supply in the medium term.

- This lowers inflation this year and raises employment and output over five years.

- But it leaves debt falling by only the narrowest of margins and from its highest level in over 50 years.

- So following another large revision to the fiscal outlook – this time a positive one – the main takeaway from this forecast should not be that debt will fall by a small amount in five years' time.

- It should be to focus on the continued uncertainty around our economic and fiscal prospects.

- We are still recovering from the once-in-a-century shock of the pandemic, while facing an energy crisis on a scale not witnessed for half a century.

- And the events of the past few days are a reminder that surprises can come from unexpected places.

- Managing the public finances over the next five years will, I'm sure, be as much about responding to these risks and shocks as it is about delivering the plans that have been announced today.