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DEBATE PACK

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The Economy

By Daniel Harari,
Matthew Keep

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Summary

This Debate Pack has been produced ahead of the general debate on 'The Economy', to be held in the Commons Chamber on Thursday 22 March 2018.

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1. Background – Overview of UK economy and public finances

Summary

The UK economy grew by 1.7% in 2017, slightly slower than in 2016. This relatively modest growth reflected subdued growth in consumer spending. Consumers faced higher inflation, a result of past falls in the pound which raised import prices, and lacklustre earnings growth. A stronger export performance has mitigated this to some extent, supported by the lower value of the pound and a resurgent world economy. Much of the world has seen accelerating economic growth of late, including the US and Eurozone.

Inflation, at 2.7% in February, remains above the Bank of England's 2% target, but is expected to fall during the year. Nevertheless, the Monetary Policy Committee has signalled that it is likely to raise interest rates, possibly in May, as it believes the economy is growing slightly above its "speed limit" of around 1.5% per year.

In its new March forecasts, the Office for Budget Responsibility (OBR) made only very small changes to its GDP growth forecasts: up from 1.4% to 1.5% in 2018 but leaving 2019 and 2020 forecasts unchanged at 1.3%. The big picture is that the OBR saw no reason to alter its outlook on the UK economy, which is of a sustainable growth rate of 1.5% per year. This was downgraded from 2.0% in its November set of forecasts.

In 2016/17, government borrowed £46 billion to make up the difference between its spending and income raised from taxes and other sources. Since its 2009/10 peak the UK's borrowing – often referred to as the deficit – has fallen by 70%. Borrowing is now at a similar level to before the 2007-2008 financial crisis. The OBR forecast that borrowing will fall each year to just over billion in 2022/23, which is equivalent to around 1% of GDP.

At 85% of GDP, government debt – largely the stock of borrowing arising from past deficits – remains relatively high by recent standards. Prior to the financial crisis, government debt was around 35% of GDP. The OBR forecast that the debt-to-GDP ratio will fall to just under 78% by 2022/23.

This section is split into three parts:

1.1 Latest developments and prospects for the economy

1.2 Public finances: a look at the budget deficit, debt levels and fiscal targets

1.3 Tables summarising the OBR's latest forecasts

1.1 Latest economic developments

Recent growth performance

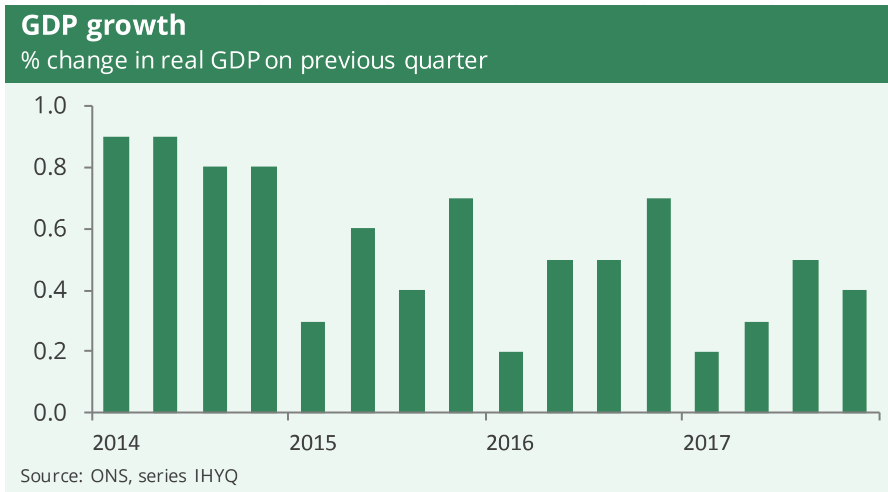
GDP growth was 1.7% in 2017

Economic growth was steady but relatively modest in 2017 at 1.7%. This compares to 1.9% in 2016 and is the lowest annual growth figure since 2012.[1]

Latest quarterly estimates show that growth accelerated somewhat in the second half of 2017 following subdued growth in the first half of

[1] All national accounts data in this section are in real (inflation-adjusted) terms from ONS, Second estimate of GDP: October to December 2017, 22 February 2018

the year. In Q4 2017, GDP increased by 0.4% compared with the previous quarter, slightly lower than the 0.5% recorded in Q3.[2] However, this was up from 0.2% in Q1 and 0.3% in Q2.

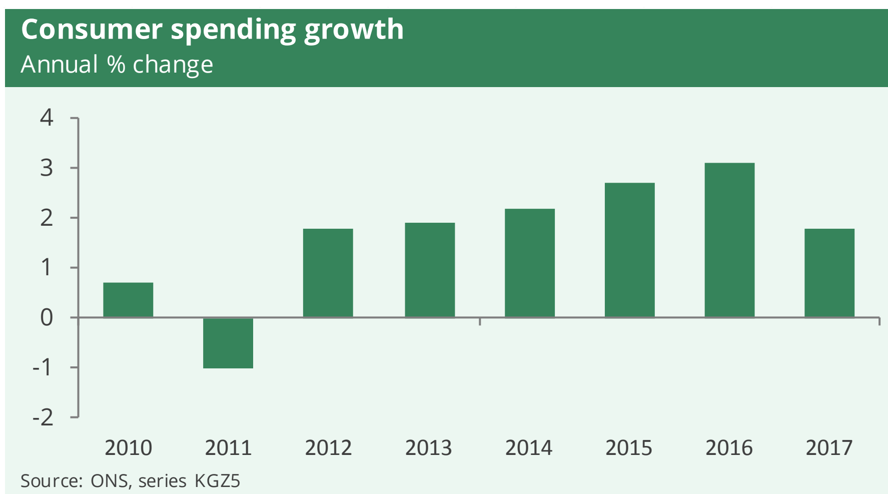


Weaker consumer spending…

The main reason for the subdued growth performance has been a slowdown in consumer spending, which accounts for nearly two-thirds of GDP and is the perennial driver of UK economic growth.[3]

Consumer spending growth slowed in 2017 as budgets were squeezed by higher inflation

Consumers have been hit by rising inflation, caused by higher import prices following past declines in the value of the pound, and weak wage growth. This squeeze on household budgets has led to consumer spending growth in 2017 slowing to its weakest pace since 2012.



…partially offset by higher exports…

Partially mitigating the impact of weaker consumer spending has been the positive contribution of net trade towards GDP growth. This means that the increase in exports was greater than the increase in imports. In 2017, net trade boosted GDP growth by 0.4 percentage points – its first positive impact since 2011.[4]

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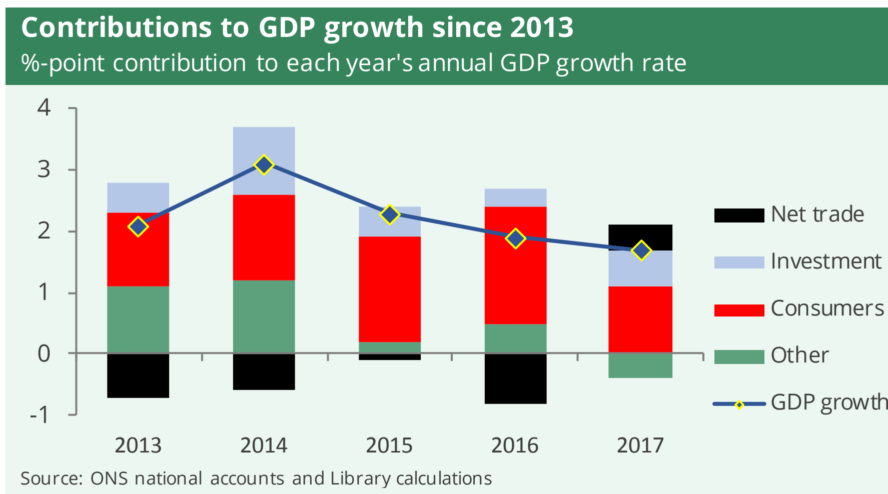
2 Q4 refers to the three-month period October-December, Q3 to July-September etc.
3 Consumer spending is short-hand for final consumption expenditure of households
4 ONS, Second estimate of GDP: October to December 2017, 22 February 2018, table AB

With the contribution of consumer spending waning, overall growth in 2017 of 1.7% was more balanced. Consumer spending still contributed the most at 1.1 percentage points, with net trade and investment providing 0.4 and 0.6 percentage points, respectively. Other elements subtracted 0.4 points from the headline GDP growth figure.[5]



Strong export growth in 2017

The improvement in net trade is a result of strong growth in exports, supported by a resurgent world economy and past declines in the value of the pound (which made UK exports more price competitive internationally). In 2017, exports rose by 5.0% in volume terms (accounting for price changes), with goods exports up by 7.3% and services by 2.3%.[6] (As well as seeing a rise in demand for their goods and services, evidence points towards exporters increasing their profit margins.[7])

As noted, a key factor in the increased demand for UK exports has been the acceleration in global economic growth, which has been broad-based around the world. Stronger economic conditions in the Eurozone are particularly striking given its struggles to achieve sustained growth after the global economic crisis of 2008-2009 and the return to recession from 2011-2013 following debt crises in some of its member countries. Eurozone GDP growth was 2.3% in 2017, the highest in a decade.[8]

…which is boosting the manufacturing sector

Against this backdrop, the manufacturing sector, which exports a large amount of what it produces, has experienced continued strength. Output increased for the ninth successive month in January 2018, the first time this has happened since records began in 1968.[9]

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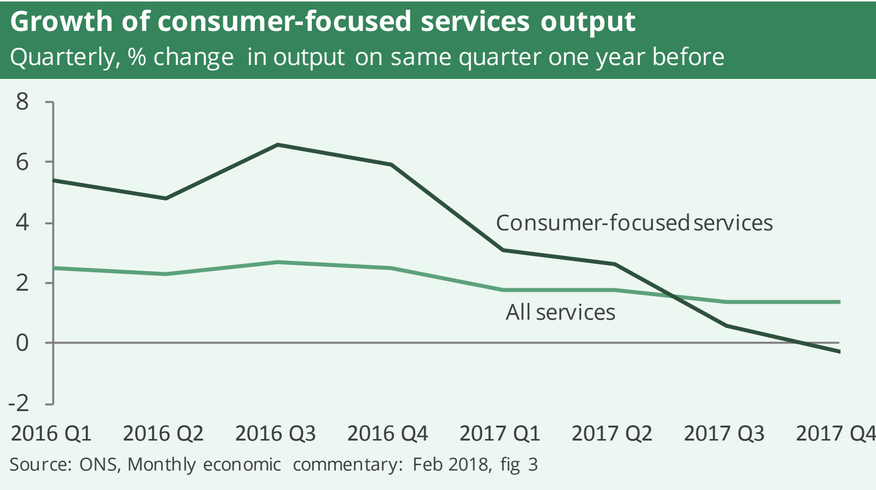
5 Other includes government purchases of goods and services, changes in business inventories and a statistical discrepancy value (for more on this see here).
6 ONS, Second estimate of GDP: October to December 2017, 22 February 2018, table H2
7 Bank of England, Inflation Report: February 2018, p14
8 Eurostat, GDP up by 0.6% in both euro area and EU28, 7 March 2018
9 ONS, Index of Production, UK: January 2018, 9 March 2018

Manufacturing output was 3.5% higher in the second half of 2017 compared with the same period in 2016.[10] In contrast, the services sector was up by 1.4% over this time.[11]

Consumer-focused services industries have experienced a marked slowdown.[12] This reflects the squeeze on consumers' budgets following a decline in real (inflation-adjusted) incomes in 2017. In Q4 2017, output in these services had fallen compared with a year earlier; this compares with growth of over 5% in 2016.[13]

Growth of consumer-focused services output
Quarterly, % change in output on same quarter one year before



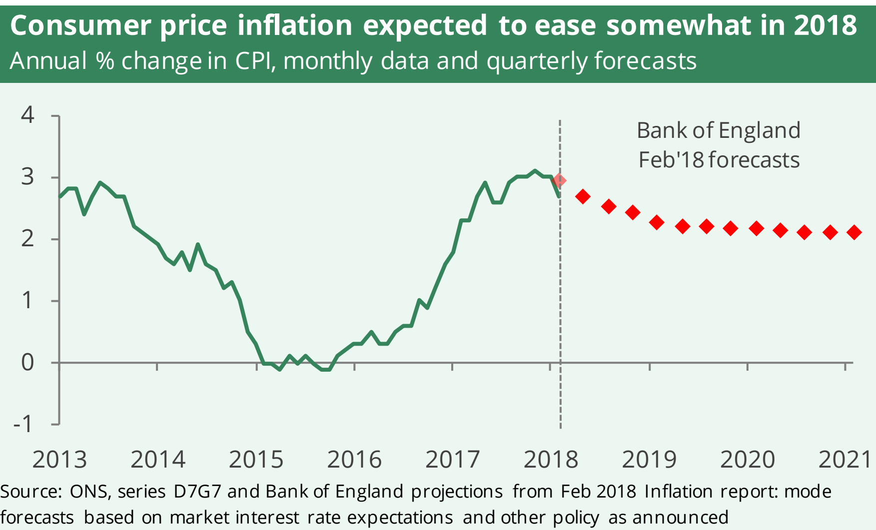
Source: ONS, Monthly economic commentary: Feb 2018, fig 3

Inflation and interest rates

Annual consumer price inflation stood at 2.7% in February, down from 3.0% in January.[14] Inflation increased during 2016 and 2017 as import prices went up. This was a consequence of a fall in the value of the pound from late 2015, and more noticeably following the result of the EU referendum in June 2016.

Inflation was 2.7% in February 2018

Consumer price inflation expected to ease somewhat in 2018
Annual % change in CPI, monthly data and quarterly forecasts



Source: ONS, series D7G7 and Bank of England projections from Feb 2018 Inflation report: mode forecasts based on market interest rate expectations and other policy as announced

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10 Based on ONS series L2KX

11 Based on ONS series L2NC

12 The ONS defines consumer-focused services as: retail trade; food and beverage; publishing, audiovisual and broadcasting activities; and arts, entertainment & recreation

13 ONS, Monthly economic commentary: February 2018, 22 February 2018

14 CPI measure; ONS, UK consumer price inflation: February 2018, 20 March 2018

While Bank of England research suggests it can take up to four years for the full impact of a change in the value of the pound to be felt, the impact will diminish.[15] It is likely that some of the immediate impact of sterling's past fall will drop out of the annual inflation rate during 2018, putting downward pressure on the headline inflation figures.

Most economists therefore expect inflation to slow in 2018. The average forecast of economists is for annual CPI inflation to fall from 3.0% in Q4 2017 to 2.3% in Q4 2018.[16] The Bank of England forecasts inflation to ease to 2.4% in Q4 2018, before falling more slowly to 2.2% in Q4 2019 and 2.1% in Q4 2020.[17]

In March 2018, the OBR forecast inflation to ease to 1.9% on average in the first quarter of 2019 – below the Bank of England's 2% target. In its latest February forecasts, the Bank forecast CPI inflation would be higher at 2.3% during the same time period. The OBR's new CPI forecasts are largely unchanged from November's.

The Bank's Monetary Policy Committee (MPC), which sets interest rates in order to meet its 2% inflation target, believes that the recent decline in real (inflation-adjusted) average wages will soon be coming to an end. This is partly due to its projections for inflation to ease but it also expects wage growth to accelerate. Indeed, it has noted that on some measures pay growth is already starting to pick up.[18]

In the statement accompanying the MPC's February monetary policy meeting, these factors led it to believe that "domestic inflationary pressures are expected to rise".[19] In addition, the MPC believes that the economy is growing slightly above "its speed limit" – the maximum rate before economic growth generates higher inflation.

Many observers think the Bank of England will raised interest rates in May

While not raising interest rates at its February meeting, the MPC signalled that it was more inclined to raise rates earlier than it had previously anticipated.[20] Many observers now expect rates to be raised from 0.5% to 0.75% at the MPC's May policy meeting.

(At the time of writing, the MPC had not yet met for its March policy meeting. A statement following the conclusion of the meeting will be published on the Bank of England website at 12 noon on Thursday 22 March. The MPC is not expected to change policy at this meeting.)

Overall, MPC members have been indicating that under current expectations at least three quarter-point rate increases – which would take interest rates to 1.25% – would be required over the next three years to bring inflation back to target.[21]

15 Bank of England, Inflation Report: February 2017, page 28
16 HM Treasury, Forecasts for the UK economy: a comparison of independent forecasts, 21 February 2018 [to be clear, these are not Treasury forecasts]
17 Bank of England, Inflation Report: February 2018, Based on market's interest rate expectations
18 For instance, 3-month on 3-month growth in average regular pay: Bank of England, Inflation Report: February 2018, p31
19 Bank of England, "Bank Rate maintained at 0.50%", 8 February 2018
20 Bank of England, "Bank Rate maintained at 0.50%", 8 February 2018
21 Bloomberg, "BOE Officials Push Home Message That More Rate Rises are Coming", 12 February 2018

In November, the MPC raised interest rates for the first time since 2007, taking the base rate from 0.25% to 0.5%.[22] This returned rates to the level they were at in the seven years prior to the August 2016 decision to cut rates, which followed the EU referendum result.[23]

Labour market

The data in this section is based on the latest available at the time of writing: for the period October-December 2017. Updated figures for the period November 2017-January 2018 will be published on Wednesday 21 March at 9.30am by the Office for National Statistics.[24]

Employment

The employment rate is near record highs

The UK employment rate was 75.2% at October-December 2017, having reached record highs earlier in 2017. Employment increased by 321,000 compared with the year before and by 88,000 compared with the previous quarter, to reach 32.15 million.[25]

The increase in employment levels was driven by strong growth in the number of full-time employees. Numbers of self-employed workers and part-time employees were both lower than in the previous quarter. It also largely reflected an increase in employment of UK nationals. The number of non-UK nationals in work increased by 33,000 over the year, but this was a much smaller annual increase than those seen between 2013 and 2016.

Unemployment also increased compared with the previous quarter by 46,000, although it was still lower than the year before at 1.47 million. The unemployment rate remains very low by historical standards at 4.4%. Forecasts suggest the rate will remain little changed over the next few years: the Bank of England has suggested it may fall slightly,

22 Bank of England, "Bank Rate increased to 0.50%", 2 November 2017
23 The MPC's quantitative easing (QE) programme, where the Bank creates new money to buy financial assets, remains active and unchanged. QE now totals £445 billion of assets: £435 billion of government bonds and £10 billion of corporate bonds.
24 These will be available here. The Library will provide a summary here later that day.
25 ONS UK Labour Market, February 2018, 21 February 2018

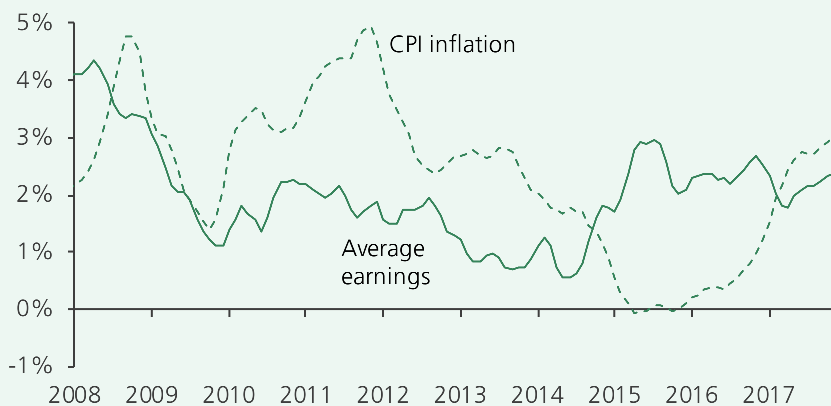
although other forecasters anticipate no change or a slight rise in the unemployment rate.[26]

The rise in employment and unemployment was accompanied by a fall in the number of working-age people who are economically inactive (not in work and not seeking work). 8.77 million people aged 16-64 were economically inactive, 95,000 fewer than the year before.

Pay growth

Average earnings grew more slowly than prices over the past year, although this trend is likely to be reversed in the near future.

Earnings have grown more slowly than prices over the past year, and for most of the past decade



Note: 'average earnings' means average weekly earnings excluding bonuses for employees in Great Britain. Source: ONS series D7BT, KAI9

Average wages rising by less than inflation…

Average weekly earnings for employees in Great Britain were 2.5% higher in the three months to December 2017 compared with the previous year, both including and excluding bonus pay. CPI inflation averaged 3.0% over the same period, meaning average earnings fell by 0.5% after adjusting for inflation.[27] However, as noted above, inflation is expected to ease over the course of 2018.

…but there are signs that wage growth may pick up in the months ahead

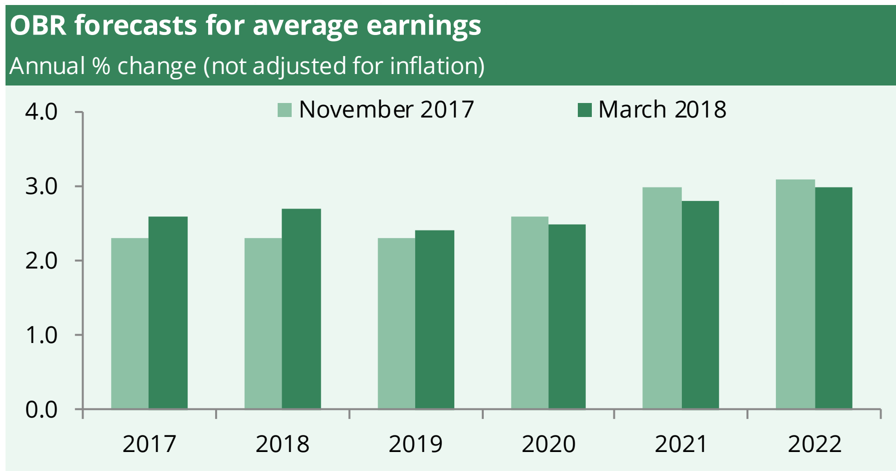
There are also signs that earnings may start growing more strongly in the months ahead. The Bank of England's Agents' annual pay survey reported that the average private sector pay settlement is expected to be 3.1% in 2018, up from 2.6% in 2017.[28] Some of the expected increase in pay reflects how employers respond to difficulties recruiting staff, with surveys indicating an increase in recruitment difficulties in 2017.[29]

In its new set of forecasts published alongside the Spring Statement, the OBR revised up average wage growth forecasts for 2018 to 2.7% compared with 2.3% previously, a result it says of "early indications of stronger growth in pay settlements" this year.[30] However, growth rates

26 Bank of England, Inflation Report: February 2018, Section 5 and HM Treasury, Forecasts for the UK economy: a comparison of independent forecasts, Feb 2018
27 ONS UK Labour Market, February 2018, 21 February 2018
28 Bank of England, Agents' summary of business conditions - February 2018 update
29 Bank of England, Inflation Report, February 2018, pp20, 32
30 OBR, Economic and fiscal outlook, March 2018, para 1.22

have been lowered a little in the later years of the forecast – for example, from 3.0% to 2.8% in 2021 and from 3.1% to 3.0% in 2022.

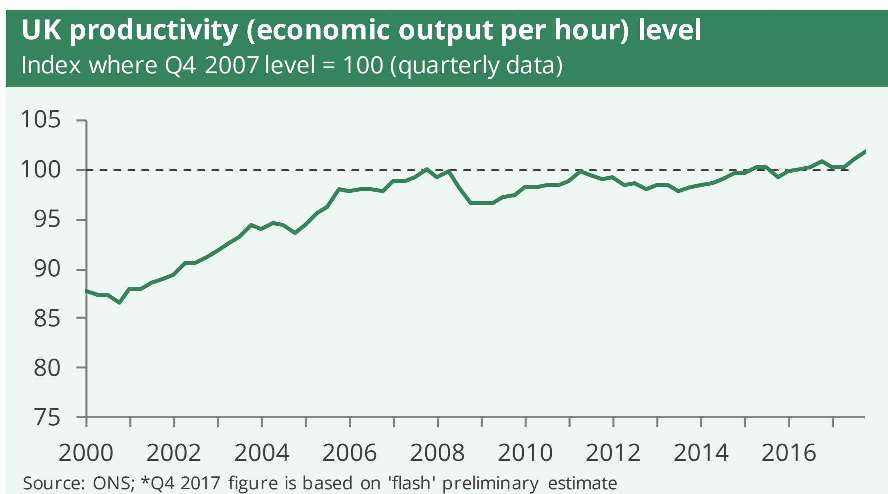
Average earnings growth adjusted for inflation – real earnings – are forecast by the OBR to "remain subdued, averaging just 0.7% a year" over the next five years.[31]



Productivity

Economic growth since the 2008/09 recession has been attained by a large increase in employment instead of via improvements in productivity.

Productivity – the amount that is produced for a given input – has been very weak over the past decade. Instead of growing at its historical average rate of around 2% per year, economic output per hour has increased only very slowly.[32]



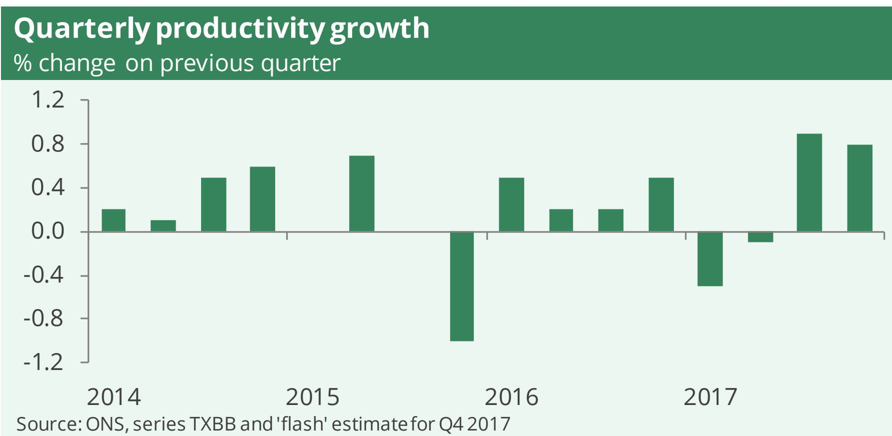
Over the long term, productivity growth is essential for increases in living standards. The more productive an economy is, the more can be produced in a sustainable fashion. In other words, productivity is crucial in determining the long-term growth rates. This, in turn, increases tax revenues and lowers government budget deficits. Of course, lower

[31] OBR, Economic and fiscal outlook, March 2018, para 1.22
[32] ONS, UK productivity flash estimate: October to December 2017, 21 February 2018

productivity growth results in the opposite: lower GDP growth and higher budget deficits.

The persistent weakness in productivity growth has led many forecasters to downgrade their expectations of the rates of productivity growth that the economy can achieve consistently to around 1% per year. This includes the Bank of England and the Office for Budget Responsibility (OBR). In November 2017, the OBR lowered its productivity growth forecasts, noting its persistent weakness since the 2008/09 recession. This, in turn, led it to cut its forecasts for GDP growth.[33]

Amongst all this gloom, recent productivity data has been encouraging. Following quarterly declines in productivity in the first half of 2017, productivity grew by 0.9% in Q3 compared with the previous quarter and then by 0.8% in Q4. This was the fastest increase recorded in a six-month period in a decade.[34] Quarterly figures tend to be volatile, so it is too early to say whether this is the start of a long-awaited turnaround.



The OBR certainly does not believe it does. In its *Economic and fiscal outlook* published alongside the Spring Statement it predicted the recent productivity upturn was a result of an unexpected fall in hours worked (which pushed up productivity) and would be reversed.[35] To that end, it forecast a decline in quarterly productivity in the first quarter of 2018.[36]

In summary, the OBR does not see an underlying improvement in the productivity figures and has not altered its outlook from November, when it reduced its expectations of the UK's productivity potential.

Growth outlook

The economic outlook for 2018 has on balance probably become a little brighter over the past few months. This is principally due to the improved global economic environment, which is expected to boost UK exports. Consumer spending may also pick up if household purchasing power benefits from the expected slowing of inflation.

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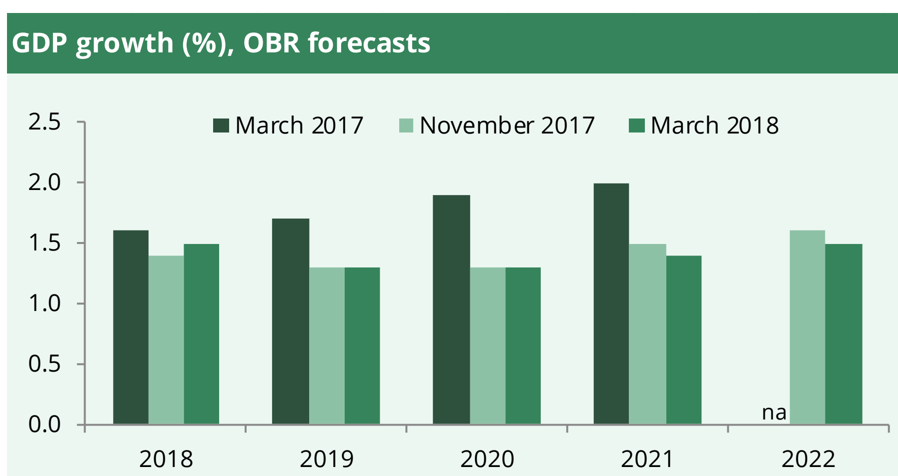
33 For more see Commons Library briefing paper, Autumn Budget 2017: A summary
34 ONS, UK productivity flash estimate: October to December 2017, 21 February 2018
35 OBR, Economic and fiscal outlook, March 2018, para 1.5
36 OBR, March 2018 Economic and fiscal outlook – supplementary economy tables, table 1.6

Risks to the outlook include uncertainty related to Brexit and whether, as is generally expected by economic forecasters, a 'smooth' departure from the EU is secured by the time the UK leaves in late March 2019. Even so, Brexit-related uncertainty may already be "weighing on business investment growth" in the words of the Bank of England.[37]

OBR forecasts for GDP growth were largely unchanged

In its March 2018 forecasts, the OBR made only very small changes to its GDP growth forecasts compared to its November 2017 projections. It revised up its 2018 growth forecasts from 1.4% to 1.5% on the back of "the unexpected strength of the world economy". However, while leaving 2019 and 2020 forecasts unchanged, it slightly lowered GDP growth in 2021 and 2022 by 0.1%-points in each year, to 1.4% and 1.5%, respectively.[38]

GDP growth (%), OBR forecasts



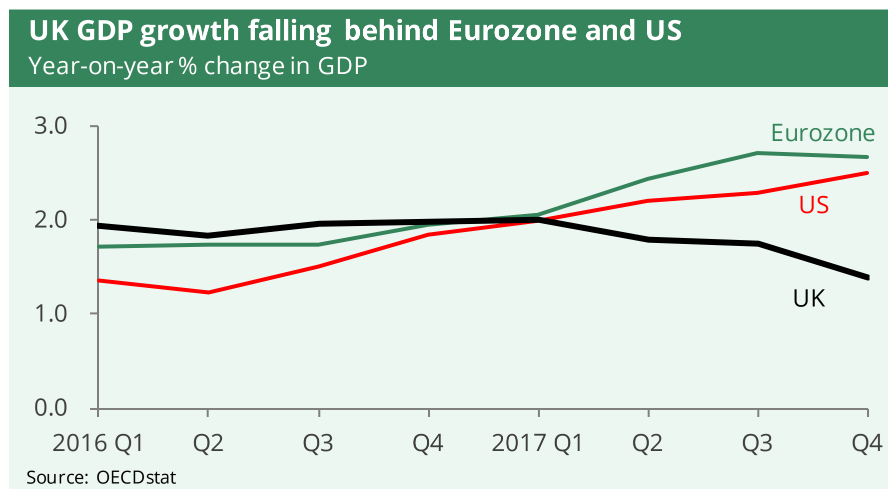
The big picture is that the OBR saw no reason to alter its outlook on the UK economy, which in November was downgraded sharply. Indeed, the OBR's estimate of the economy's sustainable growth rate remains at around 1.5% per year, down from 2% prior to November's downgrade. As described in the section above, this was mostly a result of lower productivity growth forecasts, reflecting its poor performance since the 2008/09 financial crisis.

In addition, not only does the OBR think that growth is currently around its sustainable rate – "its speed limit" as the Bank of England often calls it – but also that the economy is currently operating slightly above its capacity. In other words, the economy is slightly overheating. Although the economy's productive capacity can't be observed directly – meaning estimates of it are necessarily imprecise – it signals the OBR's belief that there is no slack left in the economy for faster growth to be easily achieved.

37 Bank of England, Inflation Report: February 2018, Box 3 and pp16,40
38 OBR, Economic and fiscal outlook, March 2018, table 3.10, p.83

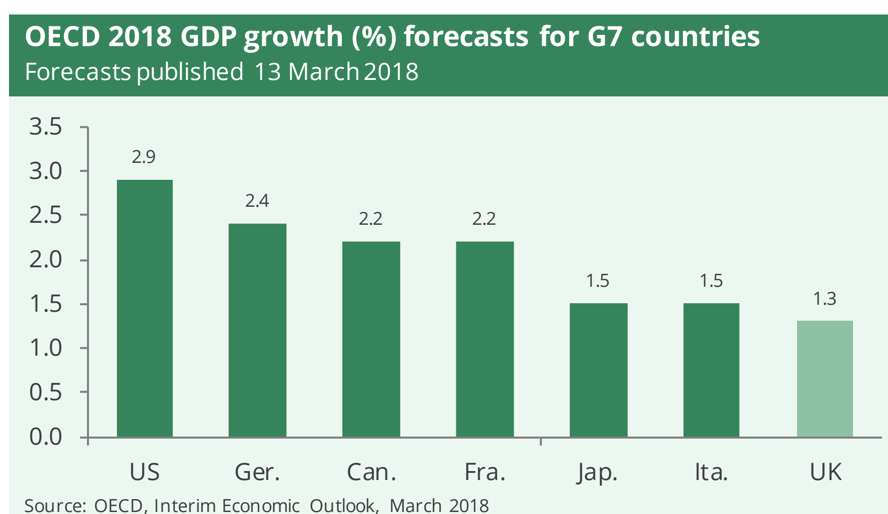
Box 1.1: Global economic conditions and international comparisons

As noted, the world economy has been strengthening, with growth accelerating in most regions. GDP growth in the Eurozone has been on an upward trend, with GDP 2.7% higher in Q4 2017 compared with a year before – its highest growth rate for a decade. Growth in the US also accelerated in 2017, up to 2.5% in Q4 2017. In contrast, UK GDP growth has been slowing (on a year-on-year basis) to 1.4% in Q4 2017.[39]



On 13 March the OECD published a new set of forecasts, upgrading its projections for world growth noting that "the global economic expansion is strengthening" and that growth is steady or improving in most of the G20 economies.[40] It expects recent tax policy changes to boost US GDP growth in the short term and boosted its forecasts for the Eurozone. The OECD did warn of the risks to the outlook posed by a rise in protectionism, referring to recent US intentions to raise tariffs on selected products.

UK GDP growth forecasts for 2018 were raised slightly to 1.3% from 1.2% previously, while for 2019 it was unchanged at 1.1%. This compares with growth forecasts of 2.7% and 2.5%, respectively, for the US and 2.2% and 2.0% for the Eurozone.[41]



39 OECDstat, GDP growth
40 OECD, OECD sees stronger world economy, but tensions are rising, 13 March 2018
41 OECD, Interim Economic Outlook, 13 March 2018

1.2 The Public Finances

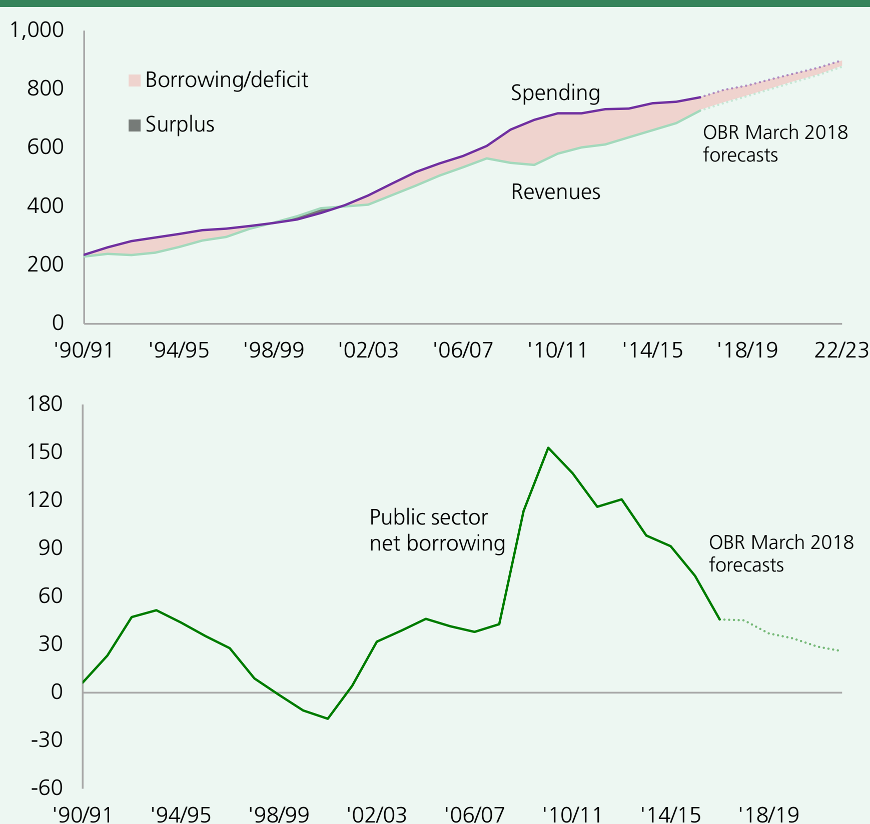
The deficit: public sector net borrowing

When government spends more than it receives in taxes and other revenues, it needs to borrow to cover the difference. This borrowing is known as 'public sector net borrowing', but is often referred to as the deficit. Borrowing has fallen considerably since the high levels it reached during the financial crisis. Borrowing has decreased from a peak of £153 billion in 2009/10 to £46 billion in 2016/17.[42]

Public sector net borrowing, often referred to as the deficit, was £46 billion in 2016/17, equivalent to 2.3% of GDP.

The £46 billion borrowed in 2016/17 is equivalent to 2.3% of GDP, which is similar to the level it was prior to the 2007-2008 financial crisis.

When total spending is higher than revenues, the government has a deficit and must borrow, £ billion



Government borrowing is forecast to fall

In March 2018, the OBR forecast borrowing to fall each year from 2.2% of GDP in 2017/18, to 0.9% in 2022/23.

As the chart below shows, the OBR attributes much of the forecast fall in borrowing between 2017/18 and 2022/23 to reductions in departments' day-to-day spending on public services (RDEL in the chart). Lower welfare spending contributes around 0.3% of GDP towards the forecast fall in borrowing, while higher receipts are forecast to lower borrowing by 0.1% of GDP. Increases to capital spending (CDEL in the chart) are forecast to increase borrowing by 0.5% of GDP.

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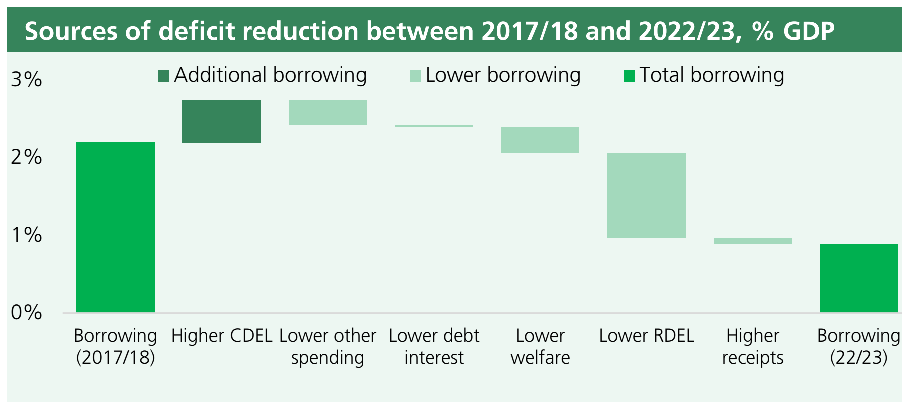
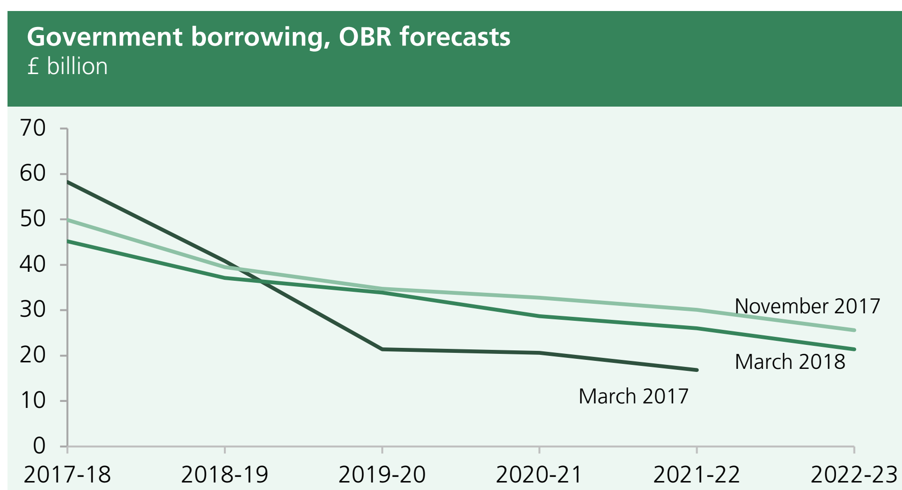
[42] All figures in this section are from ONS' public sector finances or the OBR's economic and fiscal outlook – March 2018.



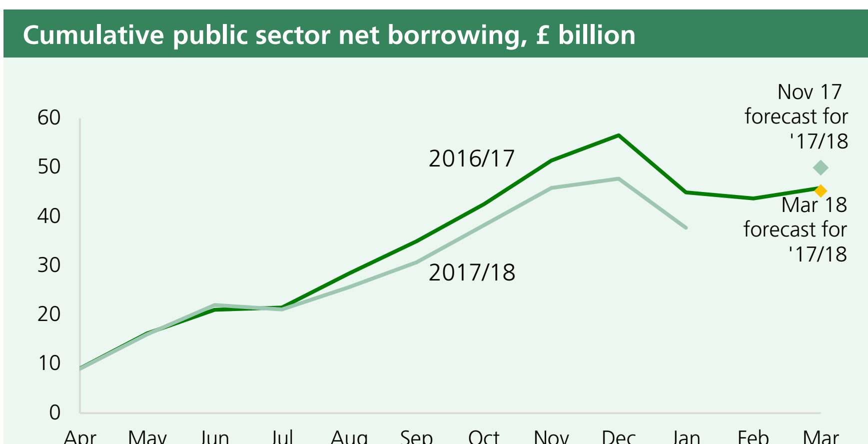
What revisions did the OBR make in its latest forecast?

In March, the OBR forecast the government would borrow a little less than it had expected previously. The changes only go a small way to reversing the gloomier outlook the OBR predicted for the public finances in November 2017. In November, the OBR lowered its forecast for economic growth largely as a result of its decision to lower assumptions of productivity growth (see previous section). Generally speaking, lower economic growth means reduced government tax revenues, and more borrowing.



Broadly speaking, the OBR now expect tax receipts to be stronger than in their November 2017 forecast, and this has reduced forecasted borrowing in all years of their March 2018 forecast. The OBR also increased its forecasts for government spending – largely due to items such as debt interest and local authority spending – but these increases were smaller than those forecast for receipts.

It was widely expected that the OBR would lower its 2017/18 borrowing forecast following the release of positive provisional outturn data for the first ten months of 2017/18. However, the revision – an improvement of £4.7 billion – was a little smaller than some expected.

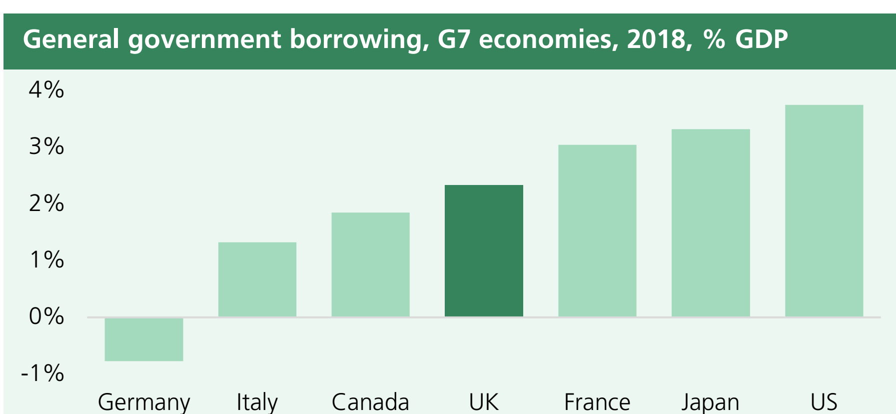


The OBR believe that much of the improvement in borrowing comes from the economy performing above its sustainable rate – its 'speed limit' in the words of the Bank of England. This means that the OBR's forecasts for structural borrowing – the underlying borrowing which the OBR would expect to remain if the economy was running at a sustainable level – was little changed on average in the OBR's March 2018 forecast, compared with its previous forecast (See box 1.3 for more on structural borrowing)

International comparisons

In October 2017, the IMF – which uses a slightly different measure of government borrowing – forecast UK government borrowing of 2.3% of GDP in 2018, which places the UK in the middle of the advanced economies of the G7. France, Japan and the US are expected to borrow more as a percentage of GDP than the UK; Canada, Italy and Germany are expected to borrow less.

The IMF's forecast for UK government borrowing is higher than the European Union average of 1.2%.[43]



The current budget deficit

The current budget deficit is the difference between government current spending – day-to-day spending on running public services, grants and administration – and government income from taxes and other sources. Unlike public sector net borrowing, the current budget deficit doesn't include investment spending and therefore is said to

The current budget deficit was £7 billion in 2016/17, equivalent to 0.4% of GDP.

43 IMF, *World Economic Outlook Database*, October 2017

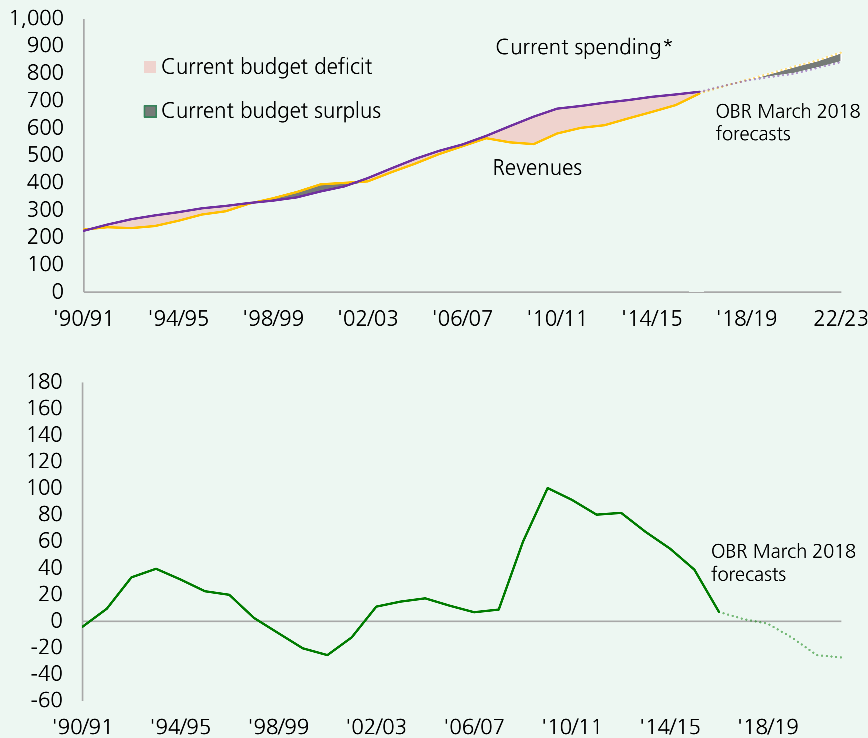
measure the degree to which taxpayers meet the cost of paying for the services provided to them.

Opposition parties have proposed targets for the public finances that focus on the current budget,[44] rather than public sector net borrowing – which is the Government's preferred measure. Focusing on the current budget would allow borrowing for investment purposes.

The current budget deficit was £7 billion in 2016/17, equivalent to 0.4% of GDP. The current budget has fallen significantly since its peak of £100 billion in 2009/10.

In March 2018 the OBR forecast that the current budget would reach a small surplus in 2018/19. If a surplus is reached government will receive more in taxes and other revenues than its current spending – the day-to-day spending on running public services, grants and administration.

When current spending is higher than revenues, the government has a current budget deficit, £ billion



note: * current spending including depreciation

Recent media reports have highlighted that the current budget was in surplus in the 12 months ending in January 2018, and during the 2017 calendar year.[45] However, the OBR haven't forecast a current budget surplus in 2017/18. The OBR expect additional local authority current spending to mean that the current budget will have a small deficit across the financial year 2017/18.

[44] Labour Party Manifesto 2017; Liberal Democrat Manifesto 2017; SNP, *What do the SNP propose as an alternative to austerity?*

[45] George Osborne austerity target is hit – 2 years late: Improvement in public finances puts day-to-day budget into surplus, *FT*, 1 March 2018

Public sector net debt

Public sector net debt is the overall level of government indebtedness, built up over many years. Broadly speaking, it is the stock of borrowing arising from past deficits.

Before the financial crisis, public sector net debt was around 34-35% of GDP. As a result of the crisis, debt increased sharply. Public sector net debt was 85% of GDP at the end of 2016/17, a debt-to-GDP ratio not seen since the mid-to-late 1960s.[46]

Public sector net debt – broadly speaking the stock of borrowing from past deficits – was 85.3% of GDP at the end of 2016/17.

In March 2018, the OBR forecast that the debt-to-GDP ratio would increase in 2017/18, fall ever so slightly in 2018/19 and a little further in 2019/20. By 2022/23 the OBR forecast that the ratio will have fallen to just under 78% of GDP.

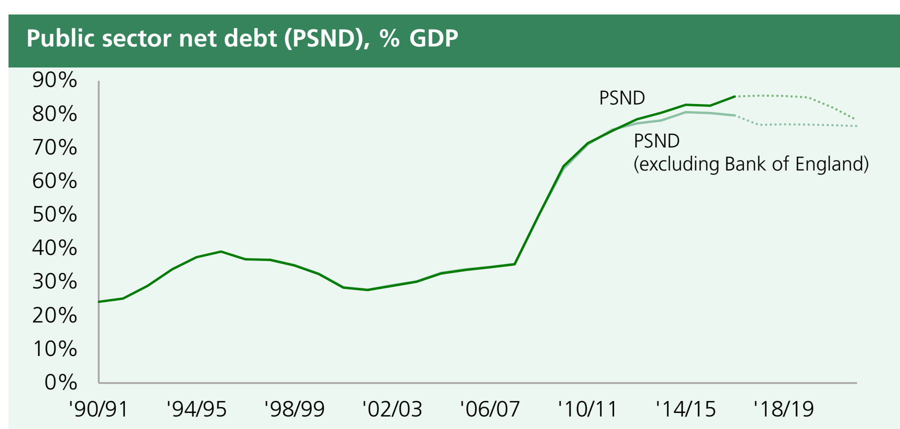
What revisions did the OBR make in its latest forecast?

In March 2018, the OBR forecast the debt-to-GDP ratio to be around 1% of GDP lower in all years of the forecast, compared with its November 2017 forecast. Some of this revision is a result of the OBR expecting the level of GDP in cash terms to be higher in all years, while some is due to the forecast cash level of debt being lower.[47]

Debt excluding the Bank of England

In August 2016, following the EU referendum result, the Bank of England (the Bank) took some action to support the economy. The Bank's package of measures has some impact on public sector net debt, as the Bank is part of the public sector. The impact is largely temporary, so the ONS and OBR have published a measure of public sector net debt that excludes the Bank of England. On this measure the path of public sector net debt is smoother.

Public sector net debt (PSND), % GDP



International comparisons

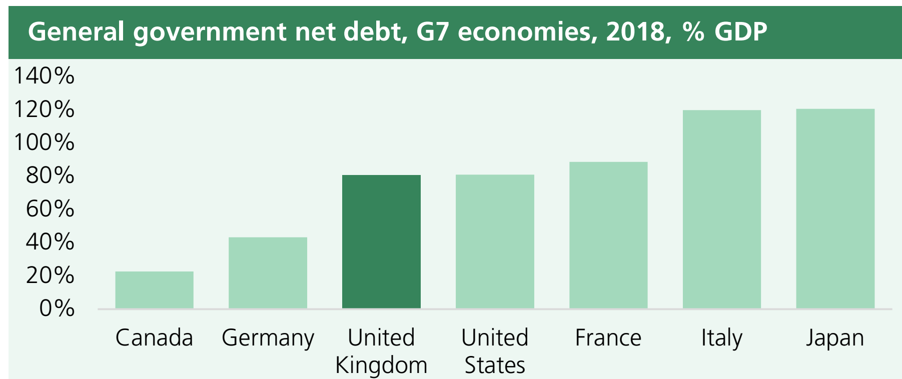
The IMF – which uses a slightly different measure of government debt – forecast that the UK's net debt in 2018 is set to be 80.6% of GDP, broadly similar to that of the US.

The UK's debt is lower than four of the G7 economies. However, by European standards the UK's debt-to-GDP ratio is relatively large. The

46 OBR, *Public finances databank*, March 2018
47 OBR, Economic and fiscal outlook – March 2018, paras 4.196 – 4.204

IMF forecast that the UK's net debt in 2018 will be higher than the EU average of 69%.[48]

General government net debt, G7 economies, 2018, % GDP



The UK's government net debt-to-GDP ratio in 2018 is forecast to be lower than in Japan, Italy, France and the US.

Government's objective and targets for the public finances

In its March 2018 forecast the OBR assessed the Government's progress against its targets for the public finances. The targets support the Government's overall objective for the public finances, which is reaching a budget surplus in the middle of the next decade. A surplus is when government spending is less than government income (from taxes and other sources).

The OBR judged that the Government is on course to meet its targets for structural borrowing, debt and welfare spending. However, the OBR judged that meeting the Government's overall objective for the public finances "looks challenging".

Box 1.2: The Charter for Budget Responsibility (the Charter)

The Charter for Budget Responsibility sets out the OBR's role, how it performs its duties and the required content of its key publications. The Charter also sets out the Government's targets for the public finances – which are often referred to as its fiscal targets – and how the Government's policy for the public finances operates.

The Charter has been changed on several occasions since its introduction in 2011. The latest version was proposed alongside Autumn Statement 2016 and came into force on Tuesday 24 January 2017 when the House of Commons approved it.

The Library briefing *The Office for Budget Responsibility and Charter for Budget Responsibility* discusses all of the targets and their predecessors.

Objective for the public finances

The Government's objective for fiscal policy is to return the 'public finances to balance at the earliest date in the next Parliament'. The objective aims to provide sustainable public finances, ensure confidence in the economy, and support the effectiveness of monetary policy. If the public finances are in balance government spending is no more than government income.

When the objective was introduced in autumn 2016, its wording suggested the deficit would be eliminated by 2025 at the latest. Interpretation of the target date is now uncertain given the early

48 IMF, *World Economic Outlook Database*, October 2017

election in 2017, but the Conservative Manifesto suggests the Government are still aiming at the 'middle of the next decade'.[49] The Treasury Committee recommended that the Government clear up this ambiguity by updating the Charter at Spring Statement 2018 – no update was published.[50]

What was the OBR's judgement in March 2018?

Given the ambiguity over the final date for the objective, the OBR considered whether the Government was on course to balance the budget in both 2022/23 and 2025/26.

The OBR's forecast doesn't yet cover 2025/26 – their five-year forecast horizon extends to 2022/23. However, with its forecast for 2022/23 showing a budget deficit, the OBR says that achieving a budget balance in 2025/26 "appears challenging from a variety of perspectives".[51]

The OBR forecasts a deficit of £21.4 billion, or 0.9% of GDP, in 2022/23. Therefore, against this target date the Government's objective for the public finances would be missed.

Borrowing target: the fiscal mandate

The Government has targets to support it in achieving its overall fiscal objective. Chief amongst these is the fiscal mandate, a target for controlling the level of borrowing.

The fiscal mandate focuses on an adjusted version of borrowing. The fiscal mandate is:

- a target to reduce cyclically adjusted public sector net borrowing to below 2% of GDP by 2020/21.

The adjustment means the target focuses on structural borrowing, or the element that remains once borrowing related to the ups and downs of the economy are removed. This is what is meant by 'cyclically adjusted': removing the parts of borrowing related to the economic cycle.

What was the OBR's judgement in March 2018?

The OBR forecasts that the Government is on course to meet the fiscal mandate. The OBR forecast that in 2020/21 cyclically adjusted net borrowing would be 1.3% of GDP, so the target is on track to be achieved with a margin of 0.7 per cent of GDP or £15.4 billion. In the OBR's forecast, cyclically adjusted net borrowing falls below 2% of GDP in 2018/19, two years ahead of the required date.[52]

Box 1.3: Structural borrowing, cyclical elements and the output gap

Structural borrowing

Structural borrowing is the level of borrowing we would expect to remain if the economy was running at a sustainable level of employment and activity. Structural elements are the underlying or persistent

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[49] 2017 Conservative Manifesto, page 14
[50] Treasury Committee, *Autumn Budget 2017*, 17 January 2018, HC600 2017-19, para 55
[51] OBR. Economic and fiscal outlook – March 2018, paras 5.17 – 5.18
[52] ibid., paras 5.8 – 5.10

part of government borrowing, which are unrelated to the economic cycle. The OBR never knows what the economy's normal level is, so it estimates it through the output gap (see below).

Cyclical elements of borrowing

Cyclical elements of borrowing refer to the effect of the economic cycle on the level of government borrowing. In a recession, government borrowing tends to increase as tax receipts are reduced and spending on benefits increases. The reverse happens when the economy is growing strongly. These effects are sometimes known as the economy's 'automatic stabilisers'.

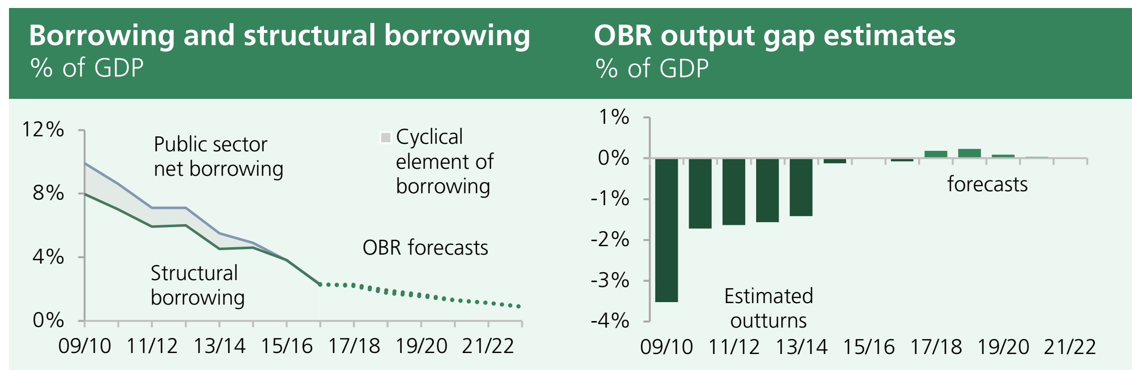
The output gap

The difference between the actual level of economic output and what could be achieved if the economy was operating at full potential is known as the 'output gap'. A negative output gap suggests that the economy is operating below its potential level and has idle resources. A positive output gap suggests that the economy is operating above potential, or overheating.

A big problem for policymakers is that the level of potential output cannot be directly measured and consequently neither can the output gap. Therefore economists must estimate what the output gap is.

March 2018 estimates

The OBR estimates that the economy is operating a little above its capacity in 2017/18, with a small positive output gap of 0.2%. As the economy is thought to be running slightly above its capacity, the OBR judge that structural borrowing is a little higher than public sector net borrowing . This means that the OBR doesn't expect economic growth to eliminate parts of borrowing. In contrast, in 2009/10 the OBR estimated that the output gap was -3.5%; that is the economy was thought to be running 3.5% below capacity. As the economy was thought to be running below capacity the OBR judged structural borrowing to be lower than overall borrowing. This meant that the remaining part of overall borrowing was thought to be cyclical – related to the economic cycle – which would disappear as the economy returned to capacity.



The debt target

The fiscal mandate is supplemented with a debt target. The supplementary target is for public sector net debt as a percentage of GDP – the debt-to-GDP ratio – to be falling in 2020/21.

Supplementary debt target: a target for public sector net debt as a percentage of GDP to be falling in 2020/21.

The IFS has pointed out that the timing of the debt target makes it "particularly easy to meet given temporary factors that are likely to reduce PSND [public sector net debt] in that year."[53] The temporary factors mentioned refer to a Bank of England scheme, the loans for which are expected to begin being repaid to the Bank in 2020/21.[54] The loans are part of the public sector's debt, so when they are repaid they decrease debt. The IFS has estimated that this effect means that in order

[53] IFS. *The IFS Green Budget: February 2017*, page 78

[54] The scheme is the Term Funding Scheme, under which up to £140 billion of loans are to be made available to UK banks and building societies until the end of February 2018, with the loans to be repaid within four years of being taken out

for the supplementary debt target not to be met the budget deficit would have to be around or over 4% of GDP in 2020/21.[55]

What was the OBR's judgement in March 2018?

The OBR forecasts that the Government is on course to meet the debt target. The OBR expect the debt-to-GDP ratio to be broadly stable between 2017/18 and 2018/19, and to fall in each subsequent year of the forecast.[56]

The Welfare Cap

The Government has a further target for controlling spending on around 55% of welfare spending – the welfare cap. The target is for relevant welfare spending to be within the cap level. The main areas of welfare spending excluded from the cap are pensions and Jobseekers Allowance payments.

The Charter for Budget Responsibility requires the Government to set a new welfare cap at the first Budget of a new Parliament. The Government did so at Autumn Budget 2017. The cap is for 2022/23 and will be formally judged by the OBR in the first Budget of the next Parliament. In the interim years the OBR will monitor progress against the cap.

The Charter has not yet been updated with the new welfare cap, so it currently includes the target set at Autumn Statement 2016. The Government may take the opportunity of the spring statement to publish an update of the Charter. Any revisions will only take effect once approved by a vote in the House of Commons.

The Library briefing *The welfare cap* goes into further detail on the cap.

What was the OBR's judgement in March 2018?

The OBR view is that the welfare cap is set to be met.[57]

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[55] IFS, *The IFS Green Budget: February 2017*, page 78
[56] OBR, Economic and fiscal outlook – March 2018, paras 5.11 – 5.14
[57] ibid., paras 5.14 – 5.16

1.3 Summary of OBR forecasts

The tables below summarise the Office for Budget Responsibility's (OBR's) latest set of forecasts for the economy and the public finances.[58]

OBR forecasts: economy

	2017	2018	2019	2020	2021	2022
GDP growth (%)						
November 2017	1.5	1.4	1.3	1.3	1.5	1.6
March 2018	1.7	1.5	1.3	1.3	1.4	1.5
Productivity growth (%)						
November 2017	0.0	0.9	1.0	1.2	1.3	1.3
March 2018	0.6	0.8	0.9	1.0	1.1	1.2
CPI inflation (%)						
November 2017	2.7	2.4	1.9	2.0	2.0	2.0
March 2018	2.7	2.4	1.8	1.9	2.0	2.0
ILO unemployment rate, %						
November 2017	4.4	4.3	4.4	4.6	4.6	4.6
March 2018	4.4	4.4	4.5	4.6	4.6	4.6
Average earnings, % change on previous year						
November 2017	2.3	2.3	2.3	2.6	3.0	3.1
March 2018	2.6	2.7	2.4	2.5	2.8	3.0

OBR forecasts: public finances

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Net borrowing, £ billion						
November 2017	49.9	39.5	34.7	32.8	30.1	25.6
March 2018	45.2	37.1	33.9	28.7	26.0	21.4
Net borrowing, % of GDP						
November 2017	2.4	1.9	1.6	1.5	1.3	1.1
March 2018	2.2	1.8	1.6	1.3	1.1	0.9
Cyclically adjusted net borrowing, % of GDP						
November 2017	2.3	1.8	1.5	1.3	1.2	1.1
March 2018	2.3	1.9	1.6	1.3	1.1	0.9
Net debt, £ billion						
November 2017	1,791	1,840	1,885	1,879	1,853	1,909
March 2018	1,783	1,835	1,880	1,868	1,841	1,893
Net debt, % of GDP						
November 2017	86.5	86.4	86.1	83.1	79.3	79.1
March 2018	85.6	85.5	85.1	82.1	78.3	77.9

58 OBR, Economic and fiscal outlook – March 2018

2. Press Articles

UK growth forecast raised by British Chambers of Commerce

BBC, 19 March 2018

Fairytale thinking is the great survivor of the financial crisis

Paul Johnson

The Times, 19 March 2018

The upturn could come faster than we think: Despite gloomy forecasts, our services-led economy contains the seeds of its own recovery

Ed Conway

The Times, 16 March 2018

We know what's wrong with the UK economy. Now it's time to fix it: A decade on from the crash and with the Brexit fog clearing, there's an opportunity to make real and lasting change

Larry Elliott

The Guardian, 15 March 2018

Philip Hammond has unwisely outsourced his spending plans: The chancellor cedes central lever of government power to unelected officials

Chris Giles

Financial Times, 15 March 2018

Tax rises of £40bn 'needed by mid-2020s' to cut deficit

BBC, 14 March 2018

The chancellor boasts of good news, but the Brexit effect is plain to see: This year Britain may have the slowest-growing economy in the G20

The Economist, 14 March 2018

Budget watchdog plays 'Eeyore' to Hammond's 'Tigger': Office for Budget Responsibility fails to reflect chancellor's optimism

Chris Giles

Financial Times, 13 March 2018

'Tigger' Philip Hammond is full of bounce – but long-term outlook is gloomy: Chancellor put a positive spin on the economy, but OBR thinks it will take many years to get better

Larry Elliott

The Guardian, 13 March 2018

Spring Statement: Why is the chancellor so upbeat about the economy?

BBC, 13 March 2018

Philip Hammond delivers scant fiscal cheer amid Brexit gloom: The chancellor's minimalist Spring Statement ignored long-term perils

Financial Times, 13 March 2018

3. Press releases

Overview of the March 2018 Economic and fiscal outlook

Office for Budget Responsibility

March 13, 2018

Relatively little time has passed since our November forecast and the outlook for the economy and public finances looks broadly the same. The economy has slightly more momentum in the near term, thanks to the unexpected strength of the world economy, but there seems little reason to change our view of its medium-term growth potential. And while the budget deficit looks likely to come in almost £5 billion lower this year than we expected in November, the explanations for this imply smaller downward revisions for future years. As a result, the Government's headroom against its fiscal targets is virtually unchanged.

The Chancellor has kept to his word in announcing no new fiscal policy measures in the Spring Statement. The main Government decisions affecting this forecast are his decision to reduce the proportion of debt that will be issued as index-linked gilts, February's local government finance settlement and decisions taken by the Scottish and Welsh Governments since the Chancellor's Autumn Budget in November. These have modest fiscal implications.

Growth and employment have performed broadly as expected since November and we have made only small revisions to our economy forecast. The latest data show real GDP growth slowing from 1.9 per cent in 2016 to 1.7 per cent in 2017 (and to 1.4 per cent in the year to the fourth quarter of 2017). We expect growth of 1.5 per cent in 2018, slowing a little more in 2019, then picking up modestly over the subsequent three years. At 1.4 per cent a year, the average growth rate over the forecast is unchanged from November.

The vote to leave the European Union appears to have slowed the economy, but by less than we expected immediately after the referendum – thanks in part to the willingness of consumers to maintain spending by reducing their saving. But it is important not to put too much weight on early estimates of economic activity either side of the referendum, not least because the bottom-up measures of GDP growth in the National Accounts differ as to whether growth slowed down, speeded up or remained stable between 2016 and 2017.

The biggest surprise in the economic data released since November is that productivity growth – measured as output per hour – has been much stronger than expected. But that reflects a much weaker path for average hours worked, rather than stronger output or weaker employment growth. The fall in average hours over the second half of 2017 is the largest since mid-2011 and second largest since the financial crisis. But in 2011 the fall in hours and associated pick-up in productivity growth proved to be erratic and were soon reversed. We assume for now that the same will be true on this occasion.

We now expect the budget deficit to come in at £45.2 billion this year, £4.7 billion less than we forecast in November and fractionally lower than the latest estimate for 2016-17. Receipts growth in general has been a little stronger than expected, while self-assessment income tax receipts look likely to fall by £0.2 billion rather than the £3.1 billion we assumed in November. The downward revision to the deficit is smaller than you would get simply by extrapolating the data for the year to date, largely because we expect local authorities to underspend their budgets by less than the Office for National Statistics is currently provisionally assuming. Firm outturn data will not be available before September.

Borrowing is forecast to continue falling from 2018-19 onwards, with the deficit dropping below 2 per cent of GDP next year and below 1 per cent of GDP in the final year of the forecast. The downward revision relative to November diminishes over the next two years, thanks to upward revisions to debt interest and some other spending. Thereafter it is broadly stable at around £4 billion a year. But given the signs of greater cyclical pressure in the economy, we have revised our assumptions about the output gap and the extent to which borrowing is cyclical or structural. We see much of the improvement in borrowing since November as cyclical, with our forecast for the structural deficit little changed on average and improved by just £0.3 billion in the Government's target year of 2020-21.

On this basis, our central forecast implies that the Government's fiscal mandate – for cyclically adjusted borrowing to lie below 2 per cent of GDP in 2020-21 – would be met by a margin of 0.7 per cent of GDP, unchanged from our November forecast. Public sector net debt falls by 3.0 per cent of GDP in 2020-21, meeting the supplementary debt target – again by the same margin as in our November forecast. And the subset of spending covered by the welfare cap remains below the stipulated level in 2022-23.

Our forecasts continue to be based on broad-brush assumptions about the economy and public finances after the UK's exit from the EU, pending a meaningful basis upon which to predict the precise end-point of the Brexit negotiations. One area where sufficient clarity is now available to be more specific relates to the financial settlement – the 'divorce bill' – that the UK will pay after leaving the EU on 29 March 2019. The December 2017 joint report by the UK and EU negotiators detailed the components of this settlement. The Treasury estimated at the time that it would amount to £35 billion to £39 billion. Using assumptions consistent with our central economic and fiscal forecasts, we estimate the settlement would cost £37.1 billion, with around 75 per cent falling due within our five-year forecast period.

4. Parliamentary material

Spring Statement

HC Deb 13 March 2018, c 717-758

5. Further reading

5.1 General

Spring Statement 2018

HM Treasury, 13 March 2018

Spring Statement 2018: what you need to know: The Chancellor has presented his first Spring Statement to Parliament – here's a summary of what he said

HM Treasury, 13 March 2018

Economic and fiscal outlook – March 2018

Office for Budget Responsibility, 13 March 2018

Spring Statement 2018: An assessment

Institute for Fiscal Studies, 14 March 2018

5.2 House of Commons Library material

The Library's briefings and other relevant parliamentary material on Brexit are pulled together in parliament's Brexit hub.

Economic Indicators

8 March 2018

Spring Statement 2018: background briefing

8 March 2018

Spring Statement 2018: a summary

13 March 2018

DEBATE PACK
CDP-2018-0076
20 March 2018

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