Background to the 2011 Autumn Statement

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Section Economic Policy and Statistics Section

The 2011 Autumn Statement will take place on 29 November. The independent Office for Budget Responsibility (OBR) will present revised forecasts for the economy and public finances. The Chancellor will also make a statement to the House. This note sets out the economic and public finance background to the Autumn Statement.

A separate note summarises the main points of the Statement and reaction to it.

Contents

1 Introduction

The Chancellor will present the Autumn Statement to the House of Commons on 29 November. On the same day, the independent Office for Budget Responsibility (OBR) will present revised forecasts for the economy and the public finances. The OBR will also give its assessment of the Government's chances of meeting its fiscal rules.

The economic background to the statement is gloomy. Stephanie Flanders, the BBC's economics editor, has commented that the "statement is not going to be fun for the government or … for all of us".[1] A speech by the Prime Minister on 21 November was interpreted as preparing the ground for a downgrading of forecasts by the OBR.[2] The economy has performed less well than expected by the OBR in its March 2011 Budget forecast. A reduction in its growth forecasts and an increase in forecasts for borrowing seems inevitable. The OECD has cut its forecast for growth in the UK to 0.9% in 2011 and 0.5% in 2012, down from 1.4% and 1.8% respectively.

The Government has attributed poor growth to the levels of debt it inherited and economic problems in the eurozone. The Government has argued that its actions have kept interest rates low in the UK. On 24 November, yields on UK government bonds dipped marginally below those on German bonds. Labour say that the Government's policies are "the biggest economic gamble in a generation" and have failed. They argue that the slowdown in the UK economy is a result of the Government's policies and started before the recent crisis in the eurozone.

The OBR will also report on the Government's targets for public borrowing and debt. The borrowing target has some built in-flexibility so higher borrowing forecasts will not necessarily mean that the Government's fiscal target is missed. Nevertheless, the deterioration in the economic outlook means that it is now likely to have much less room for manoeuvre in meeting its targets. This is a stark contrast to the position in March when the Government was on course to meet the targets a year early.

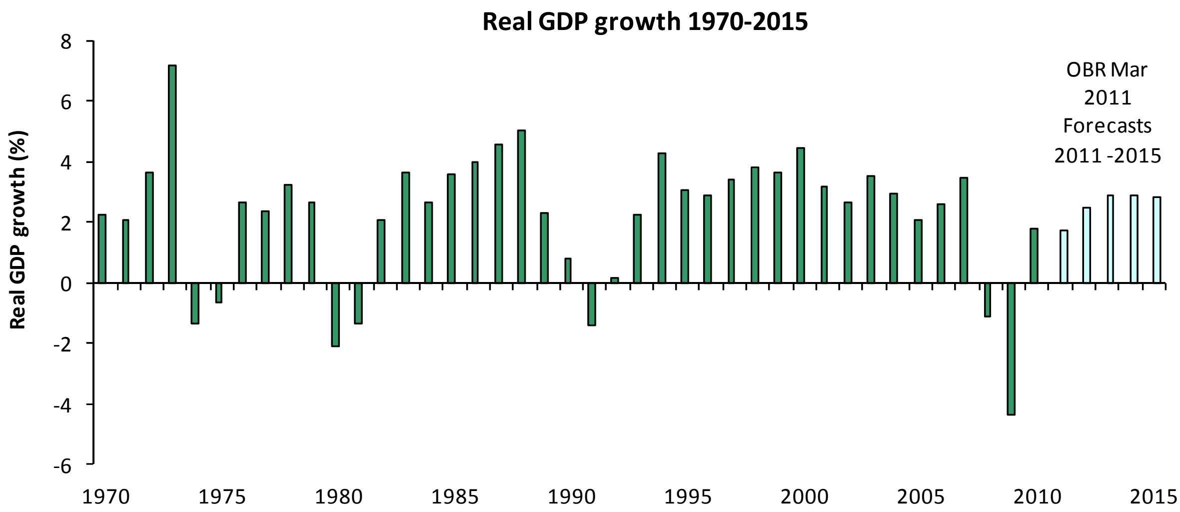
The Autumn Statement is also expected to provide further details on credit easing and plans for infrastructure spending.

1 *Statement of the gloomy obvious,* Stephanie Flanders blog, 22 November 2011
2 *We need to go for growth*, Speech by David Cameron MP at CBI Annual Conference, 21 November 2011

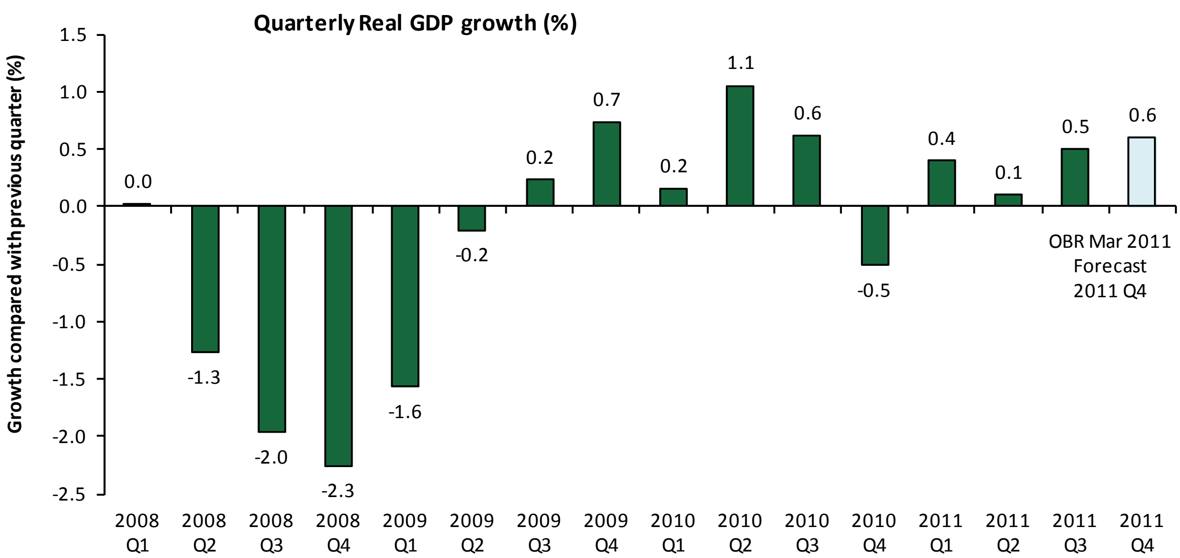
2 The economy

2.1 GDP

The past few years have been very challenging for the UK economy. In 2009 as a whole, the economy saw the sharpest annual fall in GDP (-4.4%) since official figures began in 1949 and the largest fall since 1931, excluding the recession following the Second World War. Though the economy grew by 1.8% in 2010, its future path is far from certain.



The economy moved into recession in Q3 2008 as GDP fell for a second successive quarter. The economy moved out of recession in Q3 2009, following five consecutive quarters of negative growth. The recent path of economic growth is shown in the chart below.



The table below shows contributions to estimated GDP growth in each of the last five quarters by expenditure component of GDP.

Contributions to growth (quarter-on-quarter), of the expenditure components of GDP	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3
Final Consumption Expenditure					
Households	-0.1	-0.1	-0.4	-0.5	0.0
Non Profit Institutions Serving Households	0.0	0.0	0.0	0.1	0.0
General Government	0.0	0.0	0.2	0.3	0.2
Gross Capital Formation	1.5	-1.1	-0.9	0.4	0.7
of which Gross Fixed Capital Formation	0.2	-0.1	-0.4	0.2	0.0
Exports	0.1	1.1	0.5	-0.4	-0.3
Imports	0.8	0.5	-1.0	-0.1	0.1
Net trade	-0.8	0.6	1.4	-0.3	-0.4
Real GDP growth	0.6	-0.5	0.4	0.1	0.5

Source: ONS, Statistical bulletin: Second estimate of GDP - 3rd quarter 2011

The latest estimates of GDP for Q3 2011 suggest that net trade made a negative contribution to GDP growth, despite an overall increase in real GDP growth.

2.2 Growth forecasts

In November 2010 the OBR forecast real GDP growth in 2011 of 2.1%. It was more optimistic for 2012 and 2013 with forecasts of 2.6% and 2.9 % respectively:

> Compared to the interim OBR's June forecast we have increased our expectation of GDP growth this year and reduced it for 2011. We believe that the unexpected strength of GDP growth in the second and third quarters of 2010 was largely a timing effect, with firms rebuilding stocks more quickly than seemed likely in June. That said, we do expect some of the recent strength to persist and have therefore revised up slightly the expected level of GDP across the forecast horizon. Key judgements in our central forecast include that:
>
> the trend rate of growth is projected to be 2.35 per cent, falling back to 2.10 per cent from 2014 due to demographic effects. This is unchanged from the assessment made by the interim OBR;[3]

The OBR's revised forecasts for the March 2011 Budget suggested that "the composition of the recovery we forecast is broadly as we expected in the November *Outlook*".[4] The OBR expect the economy to grow more slowly over the next couple of years, by 1.7% in 2011, 2.5% in 2012 and 2.9% in 2013.

OBR March 2011 forecasts

	2011	2012	2013
GDP growth, %	1.7	2.5	2.9

Source: OBR, *Economic and Fiscal Outlook* , Mar 2011, Table 3.6

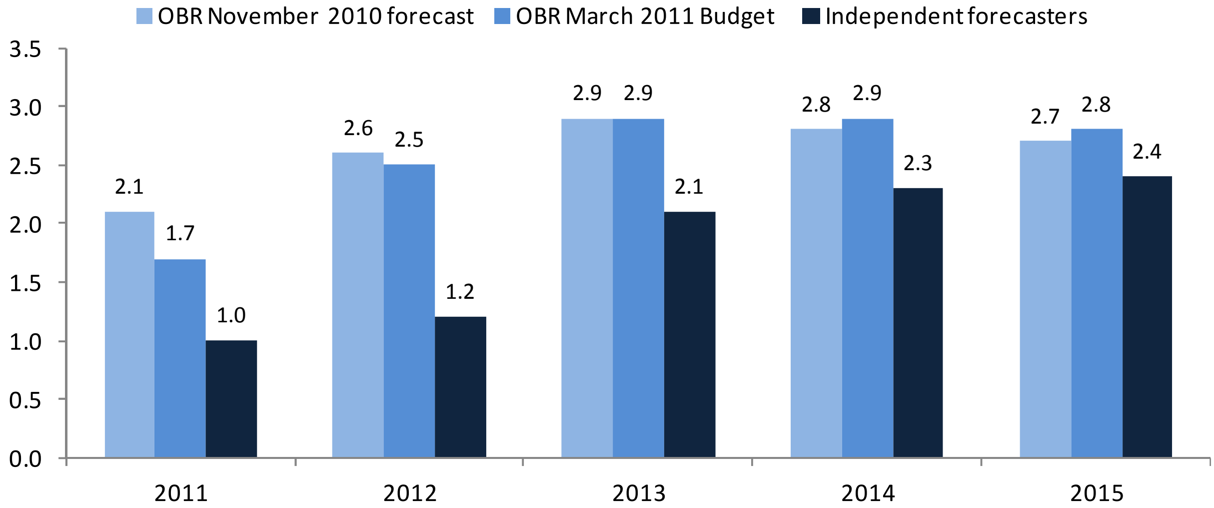
3 OBR, *Economic and Fiscal Outlook*, November 2010, para 3.3
4 OBR, *Economic and Fiscal Outlook*, March 2011, para 3.5

The OBR's central forecasts suggested that:

> the trend growth rate is around 2.35 per cent a year to the end of 2013 and 2.10 per cent thereafter. This is unchanged from the November 2010 *Outlook*. Policy measures announced in the Budget could increase the economy's productive potential, in time, but we do not believe there is strong enough evidence to raise our trend growth assumption now;
>
> based on our assessment of a number of cyclical indicators, we estimate that activity in the economy was running around 3 per cent below potential in the third quarter of 2010, the output gap having narrowed from around -3¼ per cent of potential GDP in the second quarter; [5]

The chart below compares the OBR's March 2011 Budget forecast with the latest average independent forecast and the OBR's November 2010 forecast. However, the range of forecasts may say more about when they were made rather than their accuracy.[6]

Forecasts for real GDP growth, annual % change



The table below shows the extent to which independent forecasters have downgraded the growth outlook for the UK economy. In May 2010 they were forecasting GDP growth in 2011 of 2.2%. Their latest forecast is 1.0%. Forecasts for growth in 2012 have also been cut from 2.4% in May 2010 to 1.2%.

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5 OBR, *Economic and Fiscal Outlook*, March 2011, para 3.4

6 The independent forecasts are from the November edition of the Treasury's *Forecasts for the UK economy*.

Forecasts of growth and inflation
percent

	2011		2012	
	GDP	Inflation (Q4)	GDP	Inflation (Q4)
OBR				
Pre - Budget 2010	2.6	1.6	2.8	2.0
Post-Budget 2010	2.3	2.4	2.8	1.9
Nov-10	2.1	2.8	2.6	1.9
Mar-11	1.7	4.2	2.5	2.5
Average of independent forecasts for last three months				
May-10	2.2	1.8	2.4	1.9
Jun-10	2.2	1.8	n/a	n/a
Jul-10	2.1	2.2	n/a	n/a
Aug-10	2.0	2.4	n/a	n/a
Sep-10	1.9	2.5	n/a	n/a
Oct-10	1.9	2.5	n/a	n/a
Nov-10	1.9	2.6	2.1	1.7
Dec-10	1.9	2.8	n/a	n/a
Jan-11	2.0	3.0	n/a	n/a
Feb-11	1.9	3.2	2.1	2.0
Mar-11	1.8	3.5	2.1	2.1
Apr-11	1.7	3.8	2.1	2.1
May-11	1.6	4.1	2.1	2.1
Jun-11	1.5	4.2	2.1	2.2
Jul-11	1.4	4.4	2.0	2.2
Aug-11	1.3	4.5	2.0	2.2
Sep-11	1.2	4.5	1.8	2.2
Oct-11	1.0	4.6	1.5	2.2
Nov-11	1.0	4.7	1.2	2.2

Source: HMT, *Forecasts for the UK Economy: a comparison of independent forecasts* ; OBR: Economic and Fiscal Outlooks

The OECD's latest forecasts for the UK, published on 28 November, are for growth of 0.9% this year and 0.5% in 2012.[7] This is lower than its previous forecast of 1.4% for 2011 and 1.8% for 2012 published in June.[8] The OECD places the UK fifth out of the G7 for growth in 2011 and 2012. The IMF forecasts growth of 1.1% in 2011 and 1.6% in 2012.[9]

7 OECD, *Economic Outlook*, November 2011
8 OECD, *Economic Outlook*, May 2011
9 IMF, *World Economic Outlook*, September 2011

OECD/IMF forecasts for real GDP growth, %

	OECD		IMF	
	2011	2012	2011	2012
UK	0.9	0.5	1.1	1.6
Canada	2.2	1.9	2.1	1.9
France	1.6	0.3	1.7	1.4
Germany	3.0	0.6	2.7	1.3
Italy	0.7	-0.5	0.6	0.3
Japan	-0.3	2.0	-0.5	2.3
US	1.7	2.0	1.5	1.8
EU27	...	...	1.7	1.4
Euro area	1.6	0.2	1.6	1.1
Total OECD	1.9	1.6	...	...
World	...	...	4.0	4.0

Sources: OECDStat, *Economic Outlook,* No 90, November 2011
IMF, *World Economic Outlook* Database, September 2011

The OECD's *Economic Outlook* comments further on the UK economy:

> Weak international demand, continued retrenchment among households and needed fiscal consolidation has halted the recovery. Growth will start to pick up during 2012 as exports and household consumption recover, with further strengthening in 2013. Unemployment is rising and will reach 9% in 2013, while inflation is presently peaking as anticipated and is expected to fall below the 2% target in 2013 as temporary effects from VAT hikes and commodity prices wane. Monetary policy is supportive, with the Bank rate at 0.5% and quantitative easing being resumed. Further expansions of quantitative measures are warranted. The ambitious fiscal consolidation has bolstered credibility and helped maintain low bond yields, leaving room for automatic stabilisers to work fully to cushion the slowdown.
>
> ***The economy is weakening sharply*** Retrenchment by the household and public sectors continues to be a drag on the economy. Further headwinds come from a weakening global economy, lower asset prices and rising uncertainty related to the euro area debt crisis. With household consumption falling, government spending shrinking and export growth slowing, the economy is weakening. Continued fiscal retrenchment will remain a drag over the coming years, but slowing inflation and gradually recovering export demand from 2012 will shore up consumption and exports and support an initially weak recovery. As consumer confidence improves and real incomes start to rise, consumption growth will gain strength over 2012. In 2013, rising business confidence and increasing capacity utilisation will support business investment, quickening the recovery.[10]

The IMF also stated that:

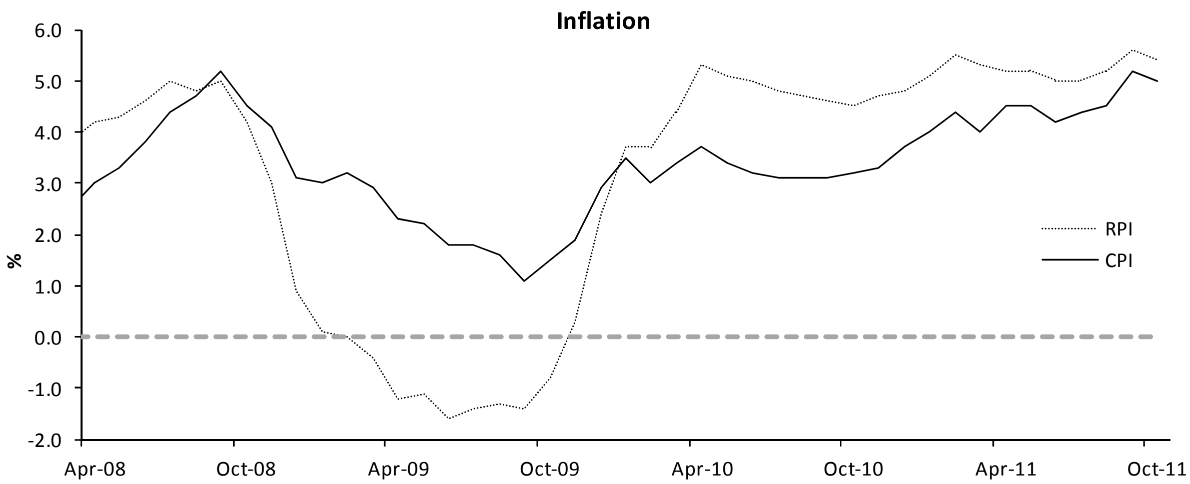
> [Europe] includes a wide spectrum of economies, most of which are likely to grow at less than precrisis averages. A few are shaken by contagion from the euro area periphery and are experiencing increasing market volatility and rising bond spreads (Italy, Spain), while others are less affected. Among the latter, some are projected to enjoy relatively solid growth (Bulgaria, Serbia); others continue to struggle (Croatia, United Kingdom).

[10] OECD, *Economic Outlook*, November 2011, p 99

If activity were to undershoot current expectations, countries that face historically low yields should also consider delaying some of their planned adjustment (Germany, United Kingdom). [11]

2.3 Inflation

After a period of deflation in 2009, inflation has risen on both the retail prices index (RPI) and the consumer prices index (CPI) measures: RPI inflation reached 5.6% in September 2011 – its highest value since June 1991. It fell to 5.4% in October. CPI inflation peaked at 5.2% in September before falling slightly to 5.0% in October (see chart below). The steep rise in inflation has been mainly due to the January 2011 increase in the standard rate of VAT and higher energy costs.



Most forecasters expect RPI inflation to remain high for the immediate future as the impact of the VAT increase to 20% and higher energy prices remain. However, CPI inflation is expected to fall in the longer term as these effects subside and spare capacity in the economy persists.

In March 2011, the OBR forecast that CPI inflation would be 4.2% in 2011, falling back to 2.5% in 2012. The OECD forecasts CPI inflation in the UK of 4.5% this year and 2.7% next year, higher than in the other G7 countries.

OBR March 2011 forecasts

	2011	2012	2013
CPI inflation, %	4.2	2.5	2.0

Source: OBR, *Economic and Fiscal Outlook* , Mar 2011, Table 3.6

[11] IMF, *World Economic Outlook*, September 2011, p 77 & 79

OECD forecasts for inflation, %

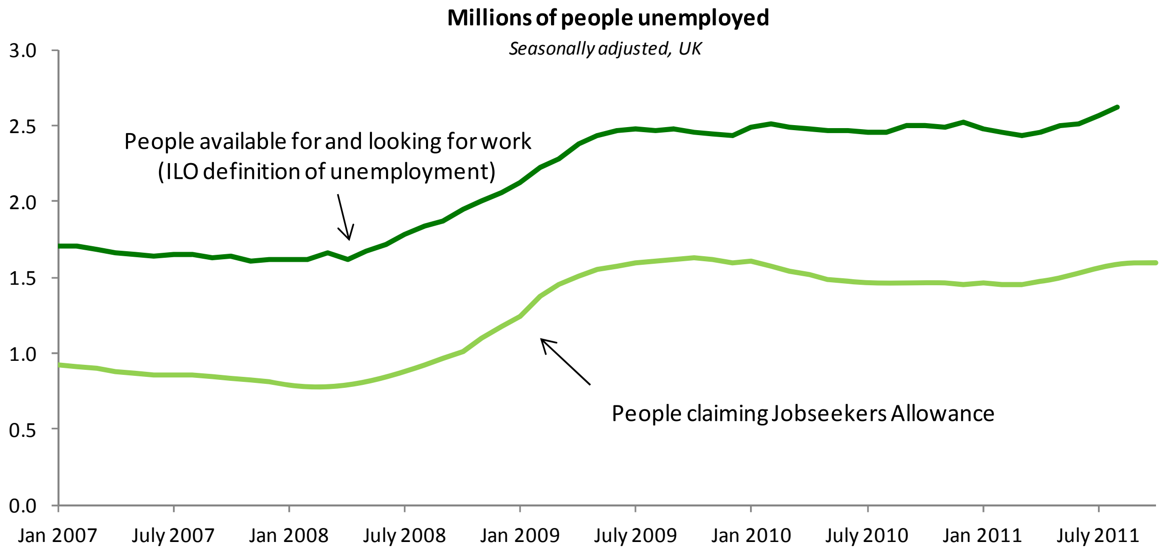
	2011	2012
UK (CPI)	4.5	2.7
Canada	2.8	1.6
France	2.1	1.4
Germany	2.4	1.6
Italy	2.7	1.7
Japan	-0.3	-0.6
US	3.2	2.4
Euro area	2.6	1.2

Source: OECD, *Economic Outlook, November* 2010

3 Employment and unemployment

The number of people in employment fell by 109,000 over the last year, to 29.07 million in July-September 2011. [12] The latest data available on the split between public and private sector employment suggests that public sector employment fell by 240,000 in the year to May-July 2011 whereas private sector employment increased by 264,000.

Unemployment was 2.62 million (8.3% of the economically active) in July-September, a rise of 172,000 compared with the same period a year ago. The number of unemployed people has not been higher since the summer of 1994.



Unemployment among young people has also risen. 1.02 million people aged 16-24 were unemployed (21.9% of the economically active) in July-September, a rise of 112,000 compared with the same period a year ago. The number and the rate are the highest they have been since the Office for National Statistics' current series began in 1992, although other data shows that youth unemployment was higher in the mid-1980s.

Unemployment varies considerably between regions. It is currently highest in the North East, which has almost twice the unemployment rate of the South East, the region with the lowest rate.

[12] Based on employment and unemployment statistics from the Office for National Statistics, Labour Force Survey

There were 464,000 job vacancies in August-October 2011, a very similar level to the year before.

In July-September there were 5.7 unemployed people for each vacancy.

In March 2011, the OBR forecast that the unemployment rate would reach 8.3% in Q3 2011 (as it has done), and then decrease. Recent forecasts by the European Commission suggest that the UK unemployment rate may grow between 2011 and 2012, to 8.6%.

OBR unemployment forecasts from March

Economic and Fiscal Outlook March 2011

	Unemployment rate (% of economically active population)
2011 Q1	8.1
2011 Q2	8.3
2011 Q3	8.3
2011 Q4	8.2
2012 Q1	8.2
2012 Q2	8.1
2012 Q3	8.0
2012 Q4	7.9
2013 Q1	7.8
2013 Q2	7.7
2013 Q3	7.5
2013 Q4	7.4
2014 Q1	7.2
2014 Q2	7.1
2014 Q3	7.0
2014 Q4	6.8
2015 Q1	6.6
2015 Q2	6.5
2015 Q3	6.3

Unemployment in the UK is the fourth highest of the G7 countries. It is lower than France, the US and Italy but higher than Canada, Germany and Japan.

International comparisons of unemployment

OECD Harmonised unemployment rates

%, September 2011 (except where stated)

UK	8.1 (a)
Canada	7.3 (b)
France	9.9
Germany	5.8
Italy	8.3
Japan	4.1
US	9.0 (b)

Source: OECD

Notes: (a) July 2011, (b) October 2011

The OECD's forecasts of unemployment are shown in the table below. In the UK, unemployment is forecast to increase from 8.1% in 2011 to 9.1% in 2013. This would mean UK unemployment being the second highest of the G7 in 2013, below France. UK unemployment would remain below that in the Euro area.

Forecasts of unemployment: international comparisons

%

	2011	**2012**	**2013**
UK	8.1	8.8	9.1
Canada	7.4	7.3	7.2
France	9.2	9.7	9.8
Germany	5.9	5.7	5.5
Italy	8.1	8.3	8.6
Japan	4.6	4.5	4.4
US	9.0	8.9	8.6
Euro area	9.9	10.3	10.3
OECD average	8.0	8.1	7.9

Source: OECD Economic Outlook, November 2011

4 The public finances

4.1 Borrowing

Public sector borrowing increased rapidly after the financial crisis reaching a peak of £156 billion (11.2% of GDP) in 2009/10. In March, the OBR forecast that borrowing would fall to £122 billion (7.9% of GDP) this year. Independent forecasts expect borrowing to be slightly higher than the OBR at £128-29 billion.[13]

Public sector net borrowing

Outturns	£ billion		% GDP
2002/03	25.1		2.3
2003/04	33.0		2.9
2004/05	39.8		3.3
2005/06	37.4		2.9
2006/07	30.9		2.3
2007/08	34.0		2.4
2008/09	96.5		6.8
2009/10	156.3		11.2
2010/11	137.1		9.3
Forecasts	**OBR £ billion**	**Independent forecasts £ billion**	**OBR % GDP**
2011/12	122	129.1	7.9
2012/13	101	117.0	6.2
2013/14	70	98.2	4.1
2014/15	46	81.1	2.5
2015/16	29	..	1.5

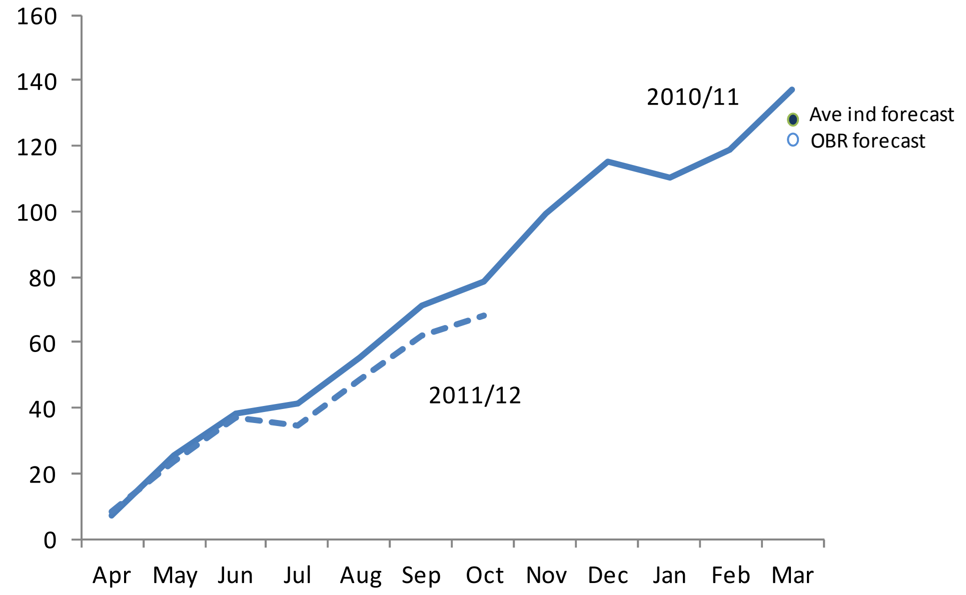
Sources: ONS, HM Treasury, OBR

Note: excludes the effects of financial transactions

Despite slower than expected growth in the economy, borrowing is on target to meet the forecast made by the OBR for this year. Over the first seven months of 2011/12, borrowing has been 13.2% lower than over the same period in 2010/11. For the OBR's current forecast to be hit, borrowing needs to fall by 11.0% this year.

[13] HM Treasury, *Forecasts for the UK economy, A comparison of independent forecasts*, November 2011. For 2011/12, the main average independent forecast is £128 billion. The average of the smaller group of forecasters who produce medium term forecasts is £129 billion. The latter forecasts are shown in the table above.

Cumulative public sector net borrowing
£ billion

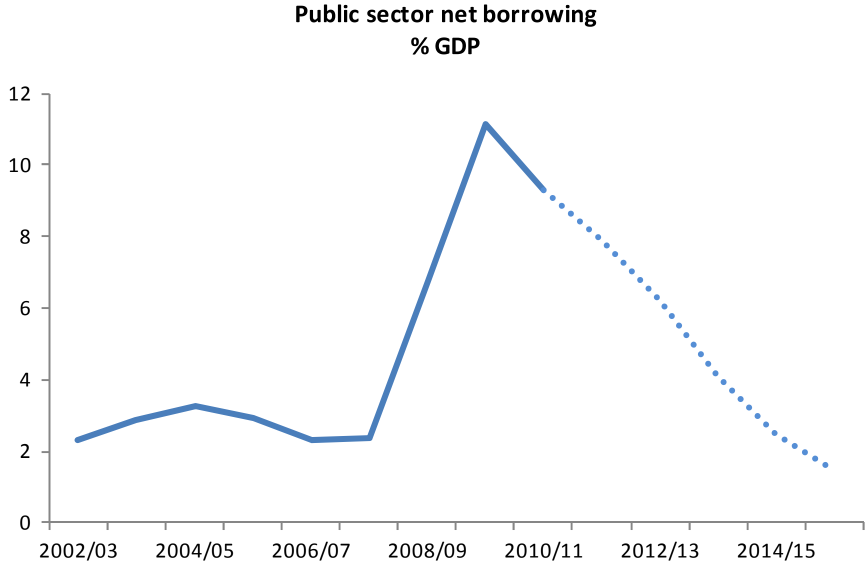


Commenting on the borrowing figures for the year so far, the Institute for Fiscal Studies (IFS) said:

> October is a big month for corporation tax receipts so today's figures, which show that these were lower than in the same month last year, will be disappointing for Mr Osborne as he prepares for next week's Autumn Statement. These weak corporation tax receipts have contributed to an overall picture of lower than expected growth in tax revenues so far this year. Despite this, borrowing has so far this year been broadly in line with the official forecasts for the year as a whole because spending on the administration and delivery of public services has been more subdued than forecast for the year as a whole.
>
> A key judgement for the Office for Budget Responsibility in forming their forecasts next week will be deciding which, if any, of these trends are set to continue. A pickup in spending on public services this year would, if combined with continued weak growth in receipts, lead to borrowing in 2011–12 exceeding the OBR's March 2011 Budget forecast. More importantly a clear risk for future years is that tax receipts continue to underperform while spending departments do manage to exhaust their extremely tight allocations.[14]

In March, the OBR forecast that borrowing would continue to fall, reaching £29 billion (1.5% of GDP) by 2015/16.

[14] IFS Press Release, *IFS analyses of today's public finance figures*, 22 November 2011



4.2 Debt

Public sector debt has also increased rapidly in recent years from around 35% of GDP in the mid-2000s to 60% in 2010/11. It is forecast to reach 66% of GDP this year (£1,046 billion or £1.046 trillion). The OBR forecasts that debt will continue increasing until it reaches 71% of GDP in 2013/14 before falling slightly in the following two years.[15]

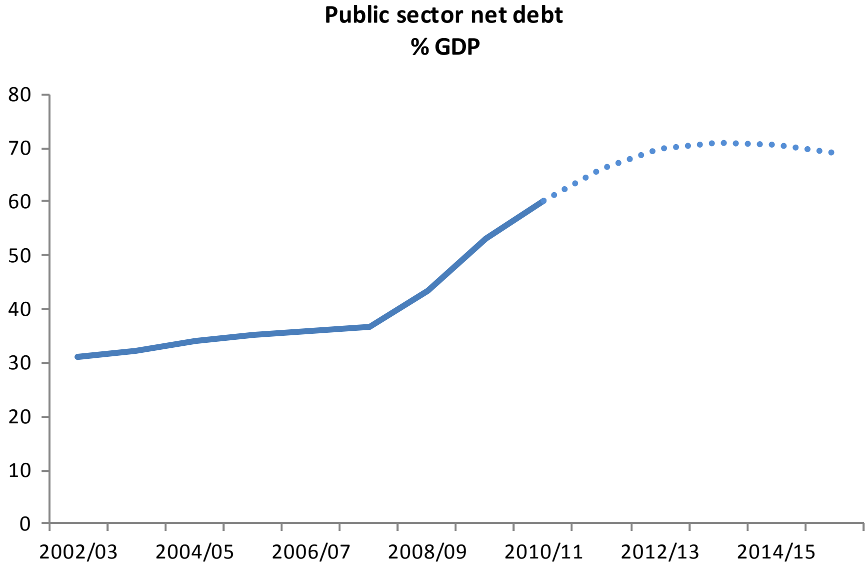
Public sector net debt: outturns and OBR forecast

	£bn	% GDP
2002/03	346.0	30.9
2003/04	381.5	32.1
2004/05	422.1	34.1
2005/06	461.7	35.2
2006/07	497.8	36.1
2007/08	527.2	36.7
2008/09	606.8	43.2
2009/10	760.3	52.9
2010/11	905.3	60.1
2011/12	1,046.0	66.1
2012/13	1,164.0	69.7
2013/14	1,251.0	70.9
2014/15	1,314.0	70.5
2015/16	1,359.0	69.1

Sources: ONS, OBR

Note: excludes financial sector interventions

15 Public sector net debt as a share of GDP is one of the measures targeted by the Chancellor's fiscal rules (see below).



4.3 International comparisons

The table below shows the latest OECD forecasts for UK borrowing and debt. In 2011, the UK is forecast to have the second highest level of government borrowing in the G7. Only the US is forecast to have higher borrowing. Four of the G7 countries are forecast to have higher debt than the UK in 2011.

International comparisons of public borrowing
% GDP

	2011	2012	2013
UK	9.4	8.7	7.3
Canada	5.0	4.1	3.0
France	5.7	4.5	3.0
Germany	1.2	1.1	0.6
Italy	3.6	1.6	0.1
Japan	8.9	8.9	9.5
US	10.0	9.3	8.3
Euro area	4.0	2.9	1.9
Total OECD	6.6	5.9	5.1

Source: OECD Economic Outlook, November 2011

International comparisons of public debt
% GDP

	2011	2012	2013
UK	90.0	97.2	102.3
Canada	87.8	92.8	96.6
France	98.6	102.4	104.1
Germany	86.9	87.3	86.4
Italy	127.7	128.1	126.6
Japan	211.7	219.1	226.8
US	97.6	103.6	108.5
Euro area	95.6	97.9	98.2
Total OECD	101.6	105.7	108.4

Source: OECD Economic Outlook, November 2011

4.4 The fiscal rules

In his first Budget, the Chancellor announced a "fiscal mandate":

> To achieve cyclically adjusted current balance by the end of a rolling five year period[16]

The current balance is a measure of government borrowing, excluding investment spending. There are a number of arguments for excluding investment spending from fiscal rules. First, it allows such spending to be protected. The 2011 Budget said that the fiscal mandate would focus on the current budget "to protect the most productive public investment expenditure."[17] In the past, public investment has sometimes been cut severely during times of public expenditure restraint. Nevertheless, under the Government's plans, public sector net investment is forecast to fall from £49.5 billion in 2009/10 to £24.5 billion in 2015/16. Labour's March 2010 Budget had pencilled in greater cuts with investment falling to £23 billion in 2014/15.

Second, focusing on the current budget allows borrowing for the purpose of investment. This is often justified on the grounds that while future generations will pay for the borrowing, they will also get benefits from this spending.

The fiscal mandate also looks at a cyclically-adjusted measure of the deficit. This means that the mandate takes into account the fact that government borrowing fluctuates with the economic cycle. As a result, the mandate focuses on the structural, or underlying, element of the deficit.

In addition to the borrowing target, there is a supplementary target for government debt. This requires public sector net debt to be falling as a percentage of GDP at a fixed date of 2015/16.

16 At the 2011 Budget, the end of the five year period was 2015/16. In the Autumn Statement it will move forward by a year to 2016/17.
17 HM Treasury, Budget 2011, para 1.25

The OBR assesses whether the Government has a greater than 50:50 chance of meeting its fiscal targets, based on its forecasts for the public finances. The table below shows that both targets are met a year early on the OBR's March forecast. The cyclically-adjusted current balance moves back into surplus in 2014/15. Debt also begins to fall in 2014/15. On the basis of this forecast, the Government has some room for manoeuvre in meeting its fiscal rules.

Government fiscal targets: OBR forecasts, March 2011 *% GDP*

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Cyclically-adjusted current budget balance (a)	-4.6	-3.2	-2.0	-0.6	0.4	0.8
Public sector net debt	60.3	66.1	69.7	70.9	70.5	69.1

Source: OBR, Economic and fiscal outlook, March 2011, Table 5.1

Note: (a) negative figure indicates deficit, positive indicates surplus

However, the economy has performed less well than forecast by the OBR in March with the result that achieving the deficit reduction target now looks much more difficult. The *Financial Times* reported that it now "looks impossible" that the current structural budget deficit will be eliminated by 2014/15. Furthermore, achieving this goal in the following year, 2015/16, also looks unlikely.[18] The Government will, however, be helped by the fact that the borrowing rule is assessed against a rolling five year period. In the Autumn Statement, this will move on by a year to 2016/17 allowing the Government more time to meet its target but also pushing the reference year into the next Parliament.

The borrowing rule focuses on the structural or cyclically-adjusted current deficit. This means that there is a greater chance that it will be broken if more of the downturn is attributed to structural factors. The more this is the case, a greater proportion of the deficit will be due to structural factors and less to the economic cycle. This, in turn, will increase cyclically-adjusted measures of borrowing and leave the Government less room for manoeuvre again its borrowing rule. It is, therefore, not so much changes in the growth forecasts, as the OBR's view on the structural position of the economy, which is relevant to the Government's chances of meeting its borrowing target.

Stephanie Flanders, the BBC's economics editor, has said that the OBR is likely to conclude that much of the slowdown is due to structural factors:

> The bad news for all of us is that the OBR thinks the economy has got less room for manoeuvre as well. If the OBR has followed the same methods it has used in the past, it will have informed the Treasury that the UK now has less room to grow over the next few years, even though growth in the past year has been so much slower than forecast.
>
> Put it another way: the OBR has looked at the growth we've lost over the past year and decided that we're not going to get it back. It seems also to have decided that our trend rate of growth, at least over the next few years, is lower than it previously thought.[19]

She commented further on the chances of the Chancellor meeting his fiscal rules:

[18] "UK debt strategy off track", *Financial Times*, 22 November 2011
[19] *Statement of the gloomy obvious,* Stephanie Flanders blog, 22 November 2011

Will Mr Osborne still meet his two fiscal rules? Economists at Barclays Capital have tried to mimic the likely calculations of the Office for Budget Responsibility. They reckon that the chancellor will be able to say he's meeting his borrowing target, but only just, and only by taking advantage of the fine print.

That chimes with what I have been hearing in Whitehall. What does it mean in practice?

The so-called fiscal mandate says the chancellor has to balance the "current, cyclically adjusted budget" over five years; that's the structural piece of the deficit that is not due to spending on public investment. Back in April, Mr Osborne was going to meet this target a year early, in 2014-15. The new forecasts look set to show the gap closing by 2016-17, and it may only be 50-50 that he manages that.

If he's hitting the target two years late (and only after the next election) the more innocent among you might wonder whether he's missed his five year target after all? But that would be ignoring that crucial fine print.

As I've noted in the past, the rule actually says he has to balance this measure of the budget over a "rolling five year forecast period". The other sound you've been hearing in Whitehall is the sound of rolling forecast periods, rolling forward. So it's goodbye, 2015-16 and hello, 2016-17.

It is not so easy to dispense with the second, debt target, which Mr Osborne imposed on himself, which requires public sector net debt to be falling as a share of GDP at a fixed date of 2015-16. He had leeway here as well: the Budget forecasts showed debt falling from 2013-14 onwards. My sense is that all of that room for manoeuvre has now gone.

But, as Treasury officials have pointed out to me in the past, he only has to show debt falling that one year. It could easily go back up again in 2015-16.

Also, when you think about it, that fixed date is not so very fixed. Does it mean falling, relative to 2014-15, or on course to fall from 2015-16 onwards? Strictly speaking, 2015-16 is not even a date: it is 365 dates.

In short, the debt target is one that the chancellor is unlikely to miss, but both are looking pretty tight.[20]

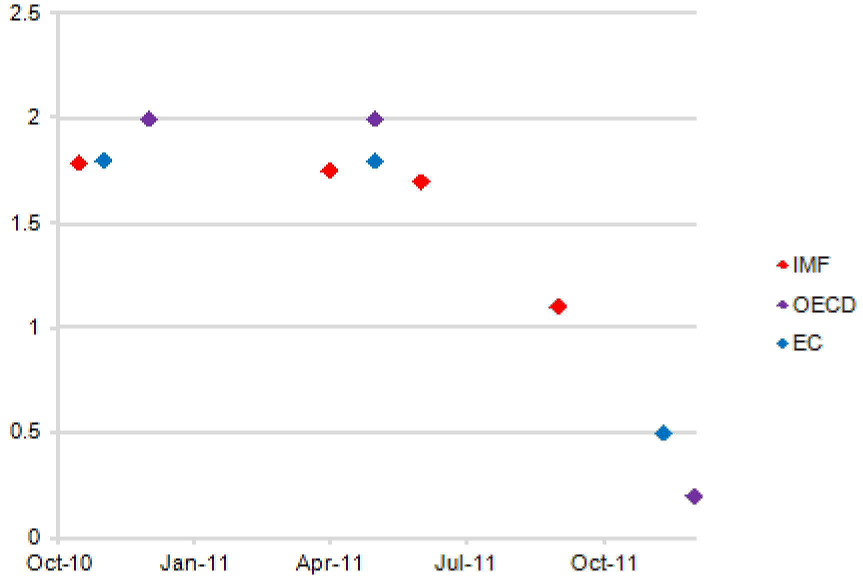
[20] *Statement of the gloomy obvious,* Stephanie Flanders blog, 22 November 2011

5 Developments in the eurozone since March 2011

Since March, the economic situation in the eurozone has worsened considerably. Government borrowing costs, which had already reached unsustainable levels in Greece, Portugal and Ireland, have risen in Spain and Italy and, more recently, France and Belgium. As the "buyers' strike" in government bond markets spreads, the very future of the single currency has been called into question. In Greece, in particular, EU authorities and leaders came to a belated realisation that no amount of austerity and loans would put Greece's debt burden on a sustainable footing: losses of 50% for private sector creditors of the Greek government are planned as part of an agreement reached at the end of October. As well as a de facto concession that Greece would default, EU leaders were also forced to admit that it could leave the eurozone, following former Greek prime minister George Papendreou's unexpected call for a referendum on the October agreement.

Major forecasters have been cutting their growth forecasts for the eurozone in recent months

Forecasts for 2012 GDP growth, eurozone, by date of forecast



The breaking of the taboos that default and euro exit are possible outcomes of the crisis has contributed to uncertainty and market volatility, as has the political deadlock over the appropriate policy responses. Even assuming relatively benign circumstances, the European Commission now forecasts just 0.5% growth across the eurozone in 2012, and the OECD 0.2%, far lower than previous estimates (see chart).[21] far lower than previous estimates (see chart).[22] The risks posed to the euro-area public finances, the financial sector, and the real economy from political crises, defaults and euro break-up mean the final outcome for the euro area in 2012 could be far worse than this.

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21 European Commission *European Economic Forecast, Autumn 2011*. OECD Economic Outlook, November 2011

22 Sources for chart data are IMF *World Economic Outlook*, OECD *Economic Outlook*, and European Commission *European Economic Forecast* (various edns.)

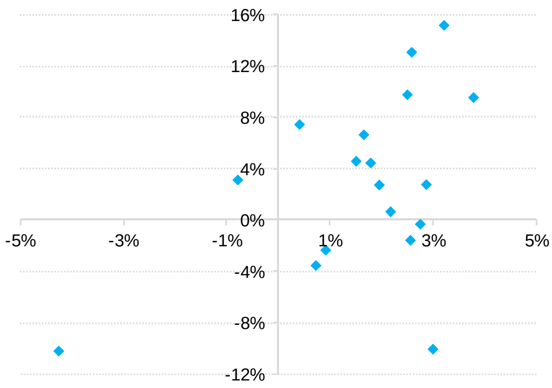
5.1 Implications for the UK

In its November 2011 *Inflation Report*, the Bank of England stated that the failure to resolve the eurozone crisis "poses the single biggest risk to the domestic recovery".[23] With an independent central bank, the epidemic of inexorably rising government borrowing costs is unlikely to spread to the UK; however, its links to the eurozone through trade and the financial sector directly threaten economic growth and the public finances.

5.2 Trade

Around 42% of the UK's exports go to the eurozone,[24] and trade has in the past been affected by the economic situation there (see chart). With domestic demand weak, recent growth in the UK has been export-led, and a contraction in overseas demand would, according to many commentators, put the UK's recovery at risk. With a euro-area recession looking increasingly likely, the Government has stated that it is "working on boosting trade with emerging markets,"[25] although it may be some time before this bears fruit: the trade deficit with non-EU countries widened to record levels in September 2011.

UK exports have in the past been sensitive to the eurozone's economic performance
Year-on-year % change in eurozone growth (horizontal axis) vs % change in UK exports (vertical axis), 1993-2010



Despite the crisis, the euro has not significantly depreciated against the pound. Were the situation to worsen and the euro to lose its value, however, the UK's terms of trade with the eurozone would worsen, thereby weakening exports.

5.3 Financial sector

UK banks have lent extensively to eurozone governments and financial institutions: as at end Q2 2011, total outstanding lending to the eurozone was around $1tn (of which $184bn to sovereigns), and total lending to the eurozone periphery[26] was $286bn (of which $40bn to sovereigns).[27]

Unlike many of their euro-area counterparts, however, UK banks are unlikely to require immediate capital injections to comply with the recent EU agreement to shore up financial sector stability.[28] Were the euro crisis to worsen significantly, though, it is possible that the public sector would be called upon to recapitalise UK banks: in the worst-case scenario, a disorderly euro-area break-up in which outstanding debts were redenominated in national currencies (which, among the euro periphery would depreciate rapidly), would require banks to be urgently recapitalised, possibly using public funds. Moreover, both risk and realisation of losses on euro-area debt would limit banks' capacity to lend to the domestic economy.

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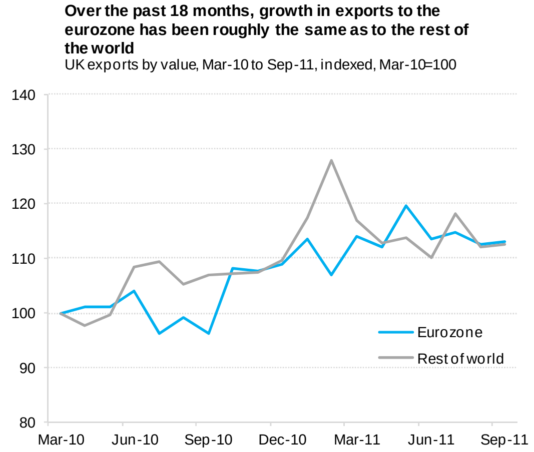
[23] Bank of England *Inflation Report – November 2011*, p.5
[24] ONS *Pink Book 2011*, Table 9.3 (figure is for 2010 and refers to goods and services)
[25] Trade Minister Lord Green, quoted by BBC in *UK clocks up record trade deficit in September*, 9 Nov 2011
[26] Defined as Greece, Ireland, Portugal, Italy and Spain
[27] Bank of England statistical database (series VPQB2S3*xx*; VPQB2S4*xx*; VPQB2S5*xx*) where '*xx*' is ISO 2-character country code
[28] For details of this agreement, see Annex 2 of the Euro Summit Statement, 26 Oct 2011

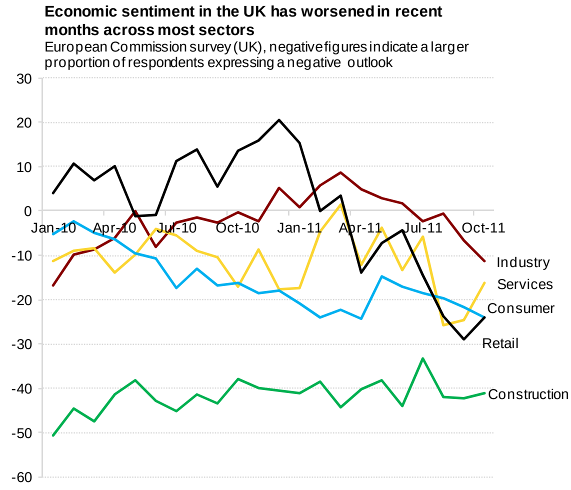
The euro crisis has fuelled risk aversion in the UK wholesale funding markets, with interbank refinancing in Q3 2011 at its lowest level since the start of 2009[29] and the rate at which banks lend to each other rising to its highest level since mid-2009.[30] A reduction in lending between banks, or an increase in its cost, also raises the prospect of a contraction in lending to businesses and individuals.

5.4 Are the effects being felt yet?

In Q2 and Q3 2011, growth in the eurozone slowed to its lowest rate for two years, indicating that the effects of the crisis on the real economy are beginning to be felt there. However, 2011 growth in the eurozone as forecast in March 2011 by the OBR was slightly lower (1.4%) than the November 2011 forecast by the European Commission (1.5%), indicating that the growth performance of the eurozone economies this year is not very different from what was expected at the time of the Budget.

In the UK, there is little evidence to support the idea that the euro crisis has yet significantly affected backward-looking indicators such as GDP, or lagging ones such as unemployment, nor has the growth in UK exports to the eurozone fallen short of that in the rest of the world (see chart). Indeed, many of the worst outcomes of the euro crisis – a loss of access to debt markets and consequent default in Italy and Spain, euro break-up etc. – are fears that may be looking increasingly likely, but as yet have not materialised. This arguably explains why there is more evidence to support the idea that the crisis is affecting firms' and individuals' confidence in the future: a recent poll of business leaders found that 70% said their confidence in the economic outlook had worsened, and the euro crisis was named as the biggest threat to the UK economy in 2012[31] (also see chart, based on a different source).





[29] This is the extent to which banks are able to roll-over existing debt by raising new funds and is a signal of wholesale lending conditions. See, for instance, FT *Relief for cash-strapped lenders*, 16 Nov 2011

[30] As measured by the London Interbank Offered Rate (Libor)

[31] Ipsos/MORI survey for CBI, sample of 122 FTSE 350 executives. Report available here. 70% cited eurozone crisis as potential influence on the economy in 2012; 67% cited a further banking crisis (respondents could select more than one option).

6 Links to further information

HM Treasury

Budget 2011

2010 Autumn Statement: Chancellor's statement

Forecasts for the UK economy:

Public finances databank

OBR

Economic and fiscal outlook, March 2011

Economic and fiscal outlook, November 2010

IFS

IFS Public finance press releases

OECD

Economic Outlook, November 2011

House of Commons Library publications

Economic Indicators Research Paper

(External users: http://www.parliament.uk/topics/Economic-situation.htm)

Youth unemployment statistics (SN/EP/5871)

Unemployment by constituency, November 2011 (RP 11/74)

7 Economic and public finance data since 1990

Economic and public finance data 1979-2010

	Real GDP growth %	Inflation RPI %	Inflation CPI %	Unemployment (b) millions	Unemployment (b) %		Public sector net borrowing % GDP	Public sector net debt % GDP
1979	2.7%	13.4	..	1,471	5.5	**1979/80**	4.1	44.0
1980	-2.1%	18.0	..	2,169	8.0	**1980/81**	4.8	46.1
1981	-1.3%	11.9	..	2,761	10.2	**1981/82**	2.3	46.1
1982	2.1%	8.6	..	2,960	11.1	**1982/83**	3.0	44.8
1983	3.6%	4.6	..	3,167	11.7	**1983/84**	3.8	45.1
1984	2.7%	5.0	..	3,217	11.6	**1984/85**	3.7	45.1
1985	3.6%	6.1	..	3,135	11.3	**1985/86**	2.4	43.2
1986	4.0%	3.4	..	3,156	11.3	**1986/87**	2.0	40.9
1987	4.6%	4.2	..	2,741	9.7	**1987/88**	1.0	36.6
1988	5.0%	4.9	..	2,293	8.0	**1988/89**	-1.3	30.4
1989	2.3%	7.8	5.2	2,021	7.0	**1989/90**	-0.2	27.5
1990	0.8%	9.5	7.0	2,158	7.5	**1990/91**	1.0	26.0
1991	-1.4%	5.9	7.5	2,697	9.5	**1991/92**	3.7	27.2
1992	0.1%	3.7	4.3	2,932	10.4	**1992/93**	7.4	31.4
1993	2.2%	1.6	2.5	2,892	10.3	**1993/94**	7.7	36.5
1994	4.3%	2.4	2.0	2,521	9.0	**1994/95**	6.2	40.1
1995	3.1%	3.5	2.6	2,353	8.3	**1995/96**	4.7	41.9
1996	2.9%	2.4	2.5	2,229	7.8	**1996/97**	3.4	42.1
1997	3.4%	3.1	1.8	1,864	6.5	**1997/98**	0.7	40.8
1998	3.8%	3.4	1.6	1,764	6.1	**1998/99**	-0.5	38.2
1999	3.7%	1.5	1.3	1,684	5.8	**1999/00**	-1.6	35.6
2000	4.5%	3.0	0.8	1,520	5.2	**2000/01**	-1.9	30.9
2001	3.2%	1.8	1.2	1,520	5.2	**2001/02**	0.0	29.6
2002	2.7%	1.7	1.3	1,516	5.1	**2002/03**	2.3	30.9
2003	3.5%	2.9	1.4	1,458	4.9	**2003/04**	2.9	32.1
2004	3.0%	3.0	1.3	1,427	4.7	**2004/05**	3.3	34.1
2005	2.1%	2.8	2.1	1,572	5.2	**2005/06**	2.9	35.2
2006	2.6%	3.2	2.3	1,705	5.5	**2006/07**	2.3	36.1
2007	3.5%	4.3	2.3	1,610	5.2	**2007/08**	2.4	36.7
2008	-1.1%	4.0	3.6	2,003	6.4	**2008/09**	6.8	43.2
2009	-4.4%	-0.5	2.2	2,449	7.8	**2009/10**	11.2	52.9
2010	1.8%	4.6	3.3	2,492	7.9	**2010/11**	9.3	60.1

Source: ONS

Notes: (a) CPI estimated before 1997
(b) ILO/LFS measure of unemployment