



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



**The OBR's economic forecasts are "challenging":
but there'll be no "double dip"**

Introduction: the post-Budget forecast

We discussed the feasibility of the Office for Budget Responsibility's (OBR's) pre-Budget economic forecast in a recent Perspective.¹ We concluded that they looked optimistic – especially relating to investment and the "export-led" improvement in the trade balance.

The post-Budget forecasts look similarly optimistic. Overall growth rates were shaved down for 2010 and 2011, though the rates were nudged up for 2013 and 2014 (see table below). Indeed it can be argued that the post-Budget forecast is even more optimistic than the pre-Budget one. This is not so much because the GDP growth rates have barely changed overall, even though the June Budget was characterised by extra fiscal tightening: as can be seen below the extra "cuts" to public spending are estimated to knock a mere 0.1% off growth for the years 2010-14 (about £1.5bn annually). More interesting, and questionable, is the uplift to the contribution from trade despite unchanged assumptions about the growth of UK export markets and the evidence to date (early days admittedly) that export-led growth is not yet happening.

There is little doubt that the Government and the Bank of England are partly relying on the weak pound (which has however appreciated against both the dollar and especially the euro in recent months) to boost British competitiveness and support growth in the next few years as public spending is curtailed. But in the last three quarters (to 2010Q1) trade has acted as a drag on GDP growth as imports have increased more quickly than exports. The latest trade data (May) were especially disappointing. They showed that imports growth continued to outstrip exports growth.²

Pre-Budget and post-Budget GDP forecasts: contributions to growth (% points)

	2009	2010	2011	2012	2013	2014	2015
OBR pre-Budget forecast:							
GDP (YOY, %)	-4.9	1.3	2.6	2.8	2.8	2.6	
Key components:							
Household consumption	-2.1	0.3	1.0	1.2	1.3	1.3	
Business investment	-2.1	0.1	0.7	1.0	1.1	1.0	
General Government consumption & investment	0.8	0.4	-0.6	-0.5	-0.5	-0.5	
Net trade	0.7	-0.5	0.7	0.8	0.6	0.5	
OBR post-Budget forecast:							
GDP (YOY, %)	-4.9	1.2 (-0.1)	2.3 (-0.3)	2.8	2.9 (0.1)	2.7 (0.1)	2.7
Key components:							
Household consumption	-2.1	0.2 (-0.1)	0.8 (-0.2)	1.1 (-0.1)	1.3	1.4 (0.1)	1.4
Business investment	-2.1	0.1	0.8 (0.1)	1.0	1.1	1.1 (0.1)	1.0

General Government consumption & investment	0.8	0.3 (-0.1)	-0.7 (-0.1)	-0.6 (-0.1)	-0.6 (-0.1)	-0.6 (-0.1)	-0.4
Net trade	0.7	-0.5	0.9 (0.2)	0.9 (0.1)	0.7 (0.1)	0.5	0.5

Sources: (i) Office for Budget Responsibility, *Pre-Budget Forecast June 2010*, table 3.4; (ii) HM Treasury, *Budget 2010*, HC61, June 2010, table C3. Please note that this is not comprehensive. Data in brackets are the differences between the post-Budget and pre-Budget forecasts.

To be fair to the OBR, they do emphasise that their “central case” forecasts should be seen within the context of probabilities and not certainties. Indeed they state that “the probability of growth in 2010 being within 1 percentage point of our central case forecast (i.e. between 0.2% and 2.2%) is 70%. [Whilst] the probability of growth being within 1 percentage point of our central case forecast for 2011 (i.e. between 1.2% and 3.3%) falls to below 40% in 2011 and to around 30% in 2014”.

In addition, the latest IMF forecast for the UK is not markedly different from the OBR’s. The IMF is forecasting GDP growth rates of 1.2% and 2.1% for 2010 and 2011 respectively, compared with 1.3% and 2.5% in April. Even though these figures look unspectacular they compare favourably with the eurozone’s, with growth rates of just 1.0% and 1.3%.³

A double-dip?

There have been some signs recently of a weakening in the recovery, with less upbeat survey results (though still compatible with growth) and an easing back in some house price indicators. In particular NIESR’s rolling 3-month GDP estimate for June suggested some retrenchment. In the 3 months to June NIESR estimated that GDP was 0.7% higher than the previous 3 months, compared with a buoyant 0.9% in the 3 months to May.⁴ (This compared with GDP growth of just 0.3% in the weather-affected first quarter.)

But signs of weakening, or indeed doubts about over-optimistic OBR’s forecasts, should not be interpreted as a harbinger of another period of falling output – in other words a “double dip”. The global economy has been recovering since last summer and evidence of slowdown in the US (which the IMF expects to grow 3.3% this year) or even China (10.5%!) does not indicate another leg of global recession. And in the UK growth is well-established if unspectacular. Provided the Bank of England maintains its very accommodative monetary policy and the eurozone continues to recover, growth should be sustainable. But any increase in interest rates seems premature given the fiscal tightening ahead.⁵ And it should be noted that the aforementioned appreciation of the pound serves to tighten monetary policy and dampen inflationary pressures.

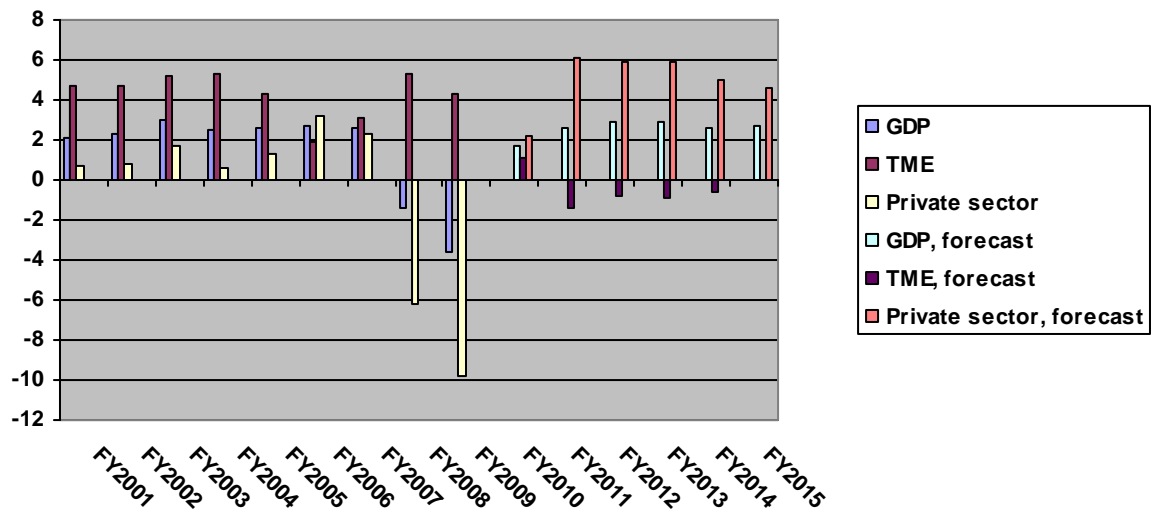
Challenging times ahead for the British economy

The forthcoming fiscal retrenchment will undoubtedly hit economic growth in the near-term. Indeed there is a school of thought that suggests that renewed recession is all but inevitable. As we have already implied, we do not take that view. But, of course, as the public sector pulls back, the private sector will have to “come up to the mark” and make good the lost output and create the jobs. This is eminently achievable and, in starting to reverse the rapid expansion of the public sector of the last decade, should mark the return to a more dynamic economy. But it will be challenging.

Chart 1 (below) shows that for much of the 2000s the growth of total public spending (Total Managed Expenditure (TME)) was significantly higher than for GDP as a whole.⁶ This was especially the case in the early 2000s, when Chancellor Brown turned on the spending taps, and in FY2008 and FY2009 when the recession hit the private sector. It is notable that growth of the private sector was fairly weak throughout the decade as resources were switched to the public sector and the private sector was “crowded out”.

Looking ahead, the Treasury’s spending plans show that TME will be squeezed and indeed fall modestly in real terms, so any growth in the economy will have to come from the private sector. If the OBR’s post-Budget forecast is to be realised then the private sector will have to grow at around 5% a year over the forecast period. The OBR takes the view that this is feasible, given the spare capacity in the economy and the potential increase in business investment.⁷

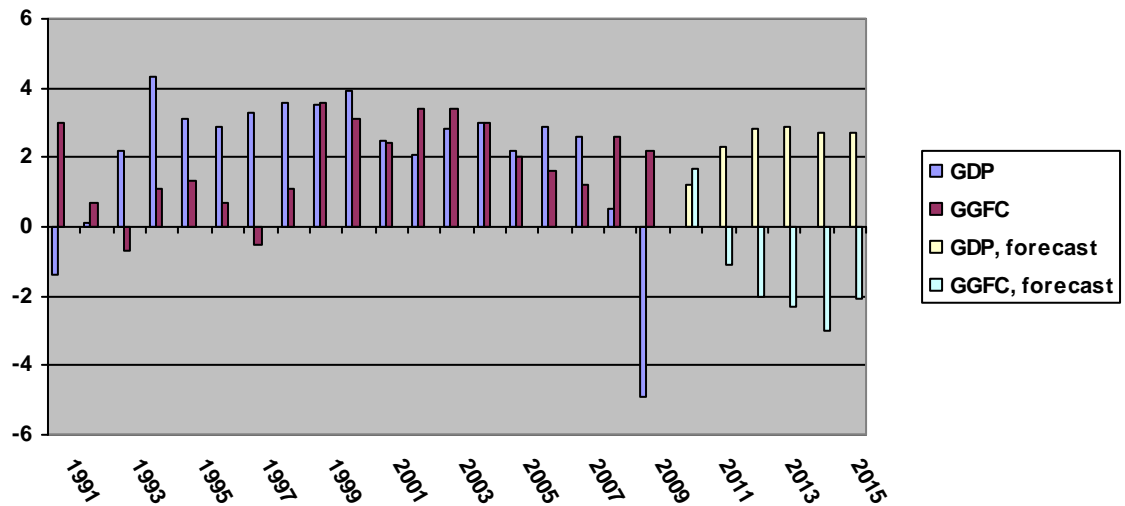
Chart 1 GDP, TME and the “private” sector, real terms, annual growth rates (%)



Sources: HM Treasury, *Budget 2010*, HC61, June 2010 and author’s calculations using FY2008 prices.

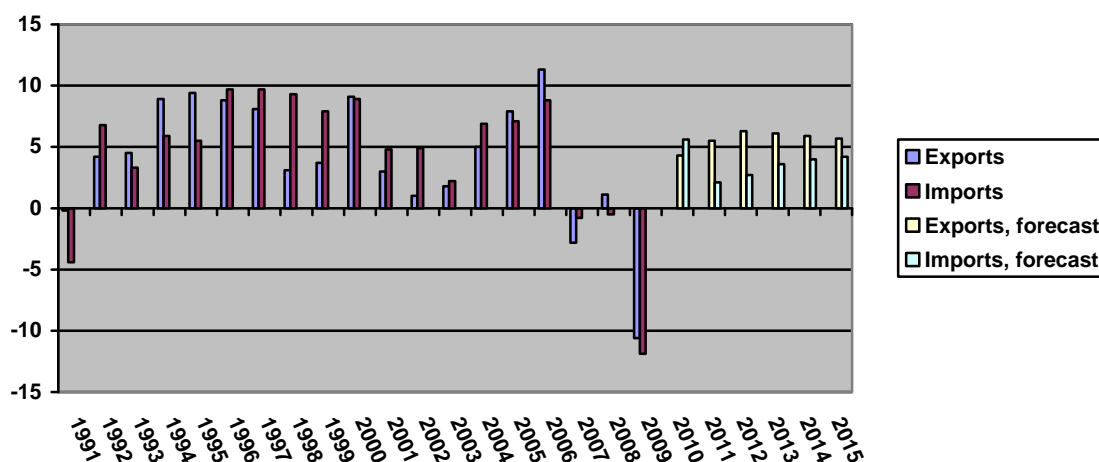
Recent economic history provides a reasonably-close precedent for growth driven by the private sector. In the middle-1990s, after the early 1990s recession, government spending was tightly controlled but the economy still grew strongly (chart 2). But, as a caveat, much of the growth came from net trade (chart 3). As we have already discussed, with some note of scepticism, the OBR is expecting the external sector to significantly contribute to growth over the next half-decade. But whether the trade forecast is achieved or not, growth should be perfectly sustainable and feasible, despite the restrictions on public spending.

Chart 2 GDP and General Government Final Consumption, real terms, annual growth rates (%)



Sources: (i) ONS, (ii) HM Treasury, *Budget 2010*, HC61, June 2010 and author’s calculations using FY2008 prices. General Government comprises central government and local government and excludes public corporations.

Chart 3 Exports and imports of goods and services, real terms, annual growth rates (%)



Sources: (i) ONS and (ii) HM Treasury, *Budget 2010*, HC61, June 2010

OBR employment forecasts

Another reason for suspecting the OBR's forecasts are over-optimistic relates to the reported amendments to the General Government employment assumptions and forecasts prior to the Budget. The OBR's published data are shown in the table below.^{8,9} The post-Budget forecast showed that the cumulative public sector job losses were expected to be 490,000 between FY2010 and FY2014 compared with 460,000 in the pre-Budget forecast.

OBR projections: employment, millions

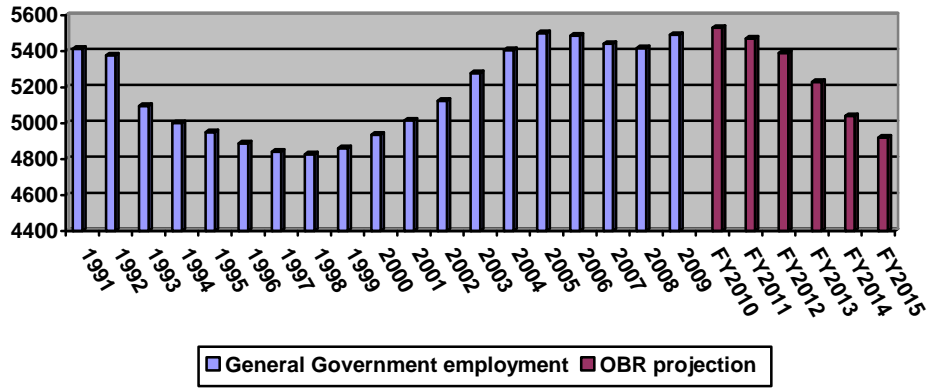
	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015
Whole economy:						
Pre-Budget	28.93	29.17	29.47	29.77	30.02	
Post-Budget	28.89	29.08	29.36	29.69	29.97	30.32
General Government:						
Pre-Budget	5.53	5.40 (-0.13)	5.24 (-0.29)	5.14 (-0.39)	5.07 (-0.46)	Na
Post-Budget	5.53	5.47 (-0.06)	5.39 (-0.14)	5.23 (-0.30)	5.04 (-0.49)	4.92 (-0.61)

Source: OBR press release, 30 June 2010 for pre-Budget (14 June 2010) and post-Budget (22 June 2010). The data are for end-period and whole economy employment is on the LFS basis. The cumulative losses for General Government employment are shown in brackets.

The relatively modest increase in the expected losses between the pre-Budget and post-Budget forecasts was apparently explained by changed assumptions between the two forecasts. Some of the changes were based on explicit policies announced in the Budget, such as the 2-year pay freeze for most public sectors workers. But others were reported to be based on policies that have yet to be announced – or even agreed. The *FT* reported that the OBR had effectively pre-empted the results of the Pensions Commission by assuming employers would lower their future pensions contributions, enabling the forecast to show fewer job losses for a given pay-bill. Similarly the OBR had assumed promotions would slow, which may or may not happen. All in all, these changed assumptions reduced the projected rise in job losses by 175,000 over the next 5 years. The total job losses by FY2015 would therefore have been around 785,000 rather than the 610,000 in the post-Budget forecast.^{11,12}

The relevance to the overall shape of the overall forecast of these changed assumptions is that, if they are not implemented, job losses will be greater and, other things being equal, growth will be poorer. And note that even on the post-Budget forecast of General Government employment, the head count by FY2015 is expected to be down to levels experienced in the late 1990s (chart 4).

Chart 4 General Government employment, head count, thousands

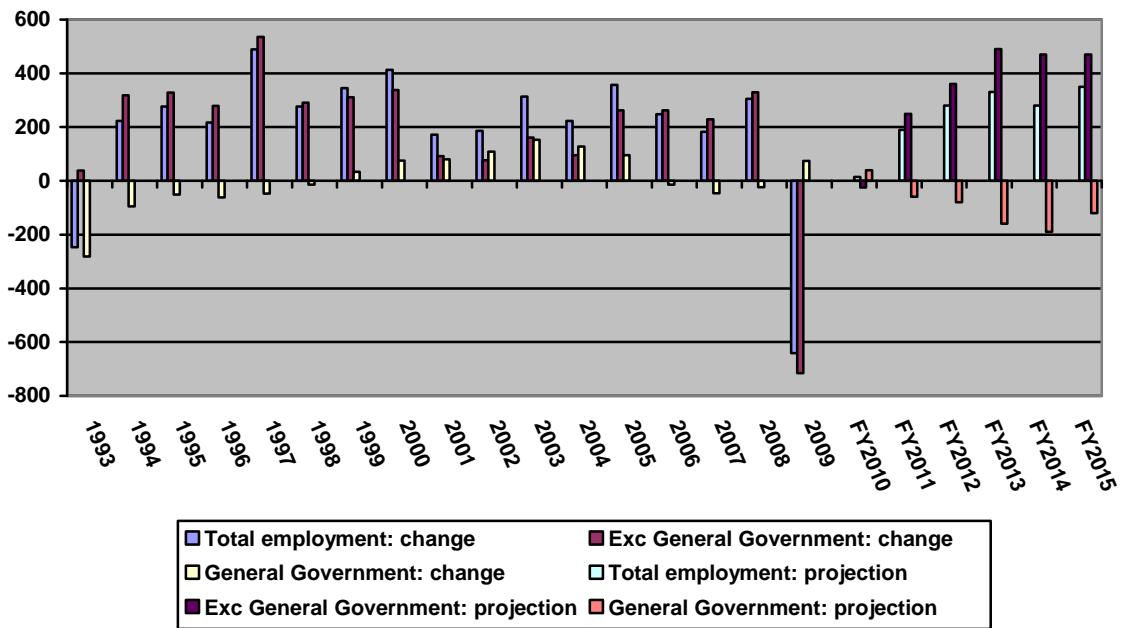


Sources: (i) ONS for past data (annual data refer to 2nd quarter), (ii) OBR projections refer to end period. Note that FE and 6th form colleges were transferred from the public sector (local government sector) to the private sector from April 1993, accounting for a switch of around 250,000 (source: ONS Public Sector Trends).

Private sector job creation

The other side of the OBR's employment forecast is the implied large increase in private sector employment, which is expected to comfortably offset public sector losses. By FY2015, the OBR is expecting over 2 million of new private sector jobs. Again the middle-1990s provides a reasonably close precedent. Few jobs were created by the public sector, but employment grew strongly (chart 5).

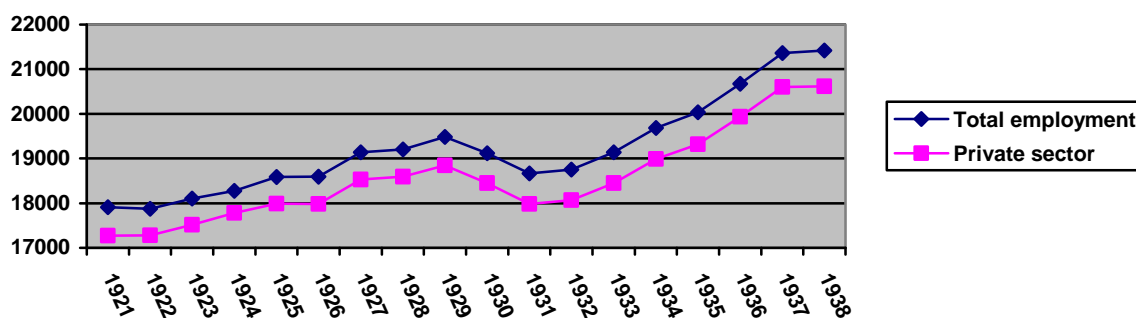
Chart 5 Employment annual changes, head count, thousands



Source: (i) ONS database for past data; (ii) OBR forecast within Treasury Budget Report for projections.

And there is another precedent – the 1930s. The Depression in 1929/30 brought a significant fall in employment with about 1million jobs lost. But within 3 years employment was growing strongly and by 1934 employment had surpassed its 1929 peak (chart 6). Unemployment remained high, but this reflected a rapidly growing working population rather than a lack of employment growth.

Chart 6 Employment, thousands, UK, 1921-38



Source: Thelma Liesner, *Economic Statistics: 1900-83*, The Economist, 1985.

References

1. Ruth Lea, "A game-changing" Budget: the most important for a generation", *Arbuthnot Banking Group*, 21 June 2010.
2. ONS, "UK trade, May 2010, Statistical Bulletin, 9 July 2010.
3. IMF, "World recovery continues, but risks increase, says IMF", 8 July 2010. The IMF upgraded Asia and Brazil significantly compared with April and the US modestly for both 2010 and 2011, despite signs of a weakening US economy. World growth in 2010 and 2011 is now expected to be 4.6% and 4.3% respectively. The IMF's concerns increased because of "uncertainties surrounding sovereign and financial sector risks in parts of the euro area...posing difficulties for both financial stability and the economic outlook".
4. Patrick Hosking, "Recovery shows signs of faltering as Bank keeps rates on hold", *The Times*, 9 July 2010.
5. Bank of England, "Minutes of the MPC meeting, 9 and 10 June 2010", 23 June 2010 showed Andrew Sentance had voted at the June meeting for 0.25% increase in Bank Rate to 0.75%.
6. Total Managed Expenditure (TME) = Departmental Expenditure Limits (DELs) + Annually Managed Expenditure (AME). The largest component of AME is social security.
7. Office for Budget Responsibility, *Pre-Budget Forecast June 2010*, table 3.4; (ii) HM Treasury, *Budget 2010*, HC61, June 2010, estimated that the "output gap", a measure of spare capacity, amounted to 4% of GDP at the end of 2009.
8. "OBR forecast: Employment", press release, 30 June 2010, from www.budgetresponsibility.independent.gov.uk
9. General Government employment excludes public corporations, which are distorted by the recent transfers from the private to the public sector: Northern Rock (Sep 2007), Bradford & Bingley (Sep 2008), RBS and Lloyds Banking Group (Oct 2008).
10. "Late OBR changes shrink job loss figures", *FT*, 9 July 2010.
11. "The OBR must be seen to have teeth", *FT leader*, 10 July 2010.

Ruth Lea, Economic Adviser, Director,
Arbuthnot Banking Group,
ruthlea@arbuthnot.co.uk,
Tel: 07800 608 674