

Treasury Select Committee's Enquiry into the Autumn Statement and Office for Budget Responsibility's Economic and Fiscal Outlook, November 2011

National Institute of Economic and Social Research (NIESR), 2 December 2011

Introduction

We welcome the opportunity to submit evidence to the Committee's enquiry into the Chancellor's *Autumn Statement* and the Office for Budget Responsibility's (OBR) latest *Economic and Fiscal Outlook*. This submission begins with a discussion of the OBR's economic forecasts, then discusses the *Fiscal Mandate* and finally policy announcements in the *Autumn Statement*.

The economic outlook

1. A critical assumption underlying the OBR's economic forecast concerns the Euro Area. The OBR assumes that the Euro Area crisis is resolved by 'struggling through' its current difficulties. NIESR published a 'muddling through' scenario in its *October Review*. While the OBR assumption is not fully explained, we assume the two scenarios are similar and therefore that the forecasts are comparable.¹

2. In our 'muddling through' scenario we forecast annual growth of 0.1 per cent in 2012 and 2.2 per cent in 2013. This includes a short recession which starts in the first quarter of 2012 with growth expected to resume in the second half of the year.

3. The OBR has revised down its forecast for this year and next. Table 1 shows the difference in contributions to GDP between the current and previous OBR forecasts. Much of the downward revision to the forecast for this year is due to outturns to data and data revisions since the OBR's March forecasts. The downward revision to 2012 is large (1.8 percentage points). Much has been made of the effect of the Euro Area crisis and its impact on the UK economy. While there is a lower contribution from net trade (0.7 percentage points), much of the rest of the downward revision is due to the outlook for the household sector.

Table 1. Changes to contributions to GDP growth in OBR forecast since March 2011 projections (percentage points)

	2011	2012	2013	2014	2015
GDP	-0.8	-1.8	-0.8	-0.2	0.2
Private consumption	-1.1	-0.7	-0.5	0.1	0.3
Business investment	-0.7	-0.2	-0.3	-0.2	0.4
Dwellings investment	-0.3	-0.1	0.1	0.2	0.2
Government	0.5	0.2	0.0	0.0	-0.4
Change in inventories	-0.2	-0.3	0.0	0.1	0.0
Domestic Demand	-1.6	-1.2	-0.7	0.1	0.5
Net trade	0.5	-0.7	-0.1	-0.3	-0.3

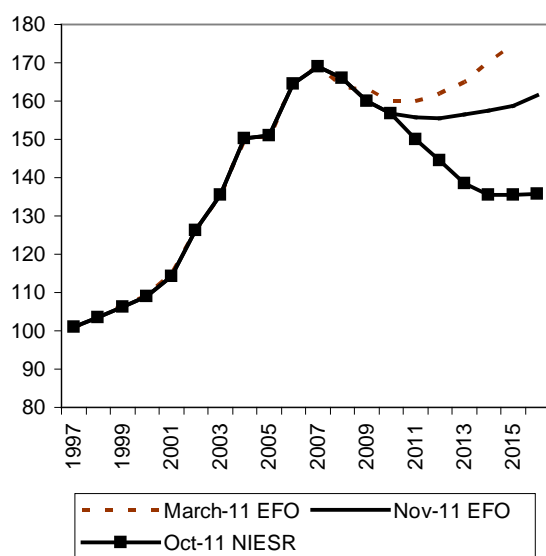
Source: OBR, NIESR calculations.

Note: components may not sum due to rounding.

¹ NIESR's latest forecast is published in the *National Institute Economic Review* in October 2011. We discuss the numbers derived from the 'muddling through' scenario in Holland and Kirby (2011).

4. The OBR have significantly revised down the outlook for consumer spending growth. Real incomes are expected to be weaker primarily due to nominal wage growth lagging the rate of inflation this year and next. Furthermore, the OBR highlight recent data suggesting that the financial consolidation of the household sector has been more pronounced than previously thought. The OBR now expect the housing market to take longer to ‘recover’ than previously. With a weaker housing market in the short-term and more pronounced average propensity to save the outlook for the household debt-to-income ratio is for one of stabilisation rather than a continued rise. This brings the OBR’s forecasts for re-balancing the household sector more in line with the NIESR view (see figure 1).

Figure 1. OBR and NIESR forecasts for the household debt to income ratio (per cent of household gross disposable income, end of year)



Source: OBR and NIESR.

Note: NIESR projection derived from Euro Area ‘muddling through’ (see Holland and Kirby, 2011).

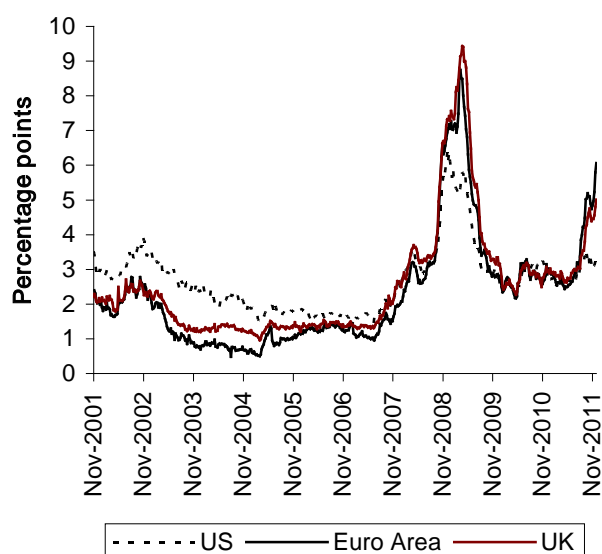
5. We are surprised by the robust outlook for business investment given that the OBR expects the Euro Area to ‘struggle through’ the crisis. The spread on corporate bond yields over government bond yields have widened significantly in the Euro Area and the UK, but not the US. In the Euro Area and the UK these yields are now at their highest level since mid-2009 (see figure 2). The spread in the Euro Area and the UK started to rise around the time of the second Greek bailout negotiations. If business investment responds in the same way as in 2008-9 then we would expect a sharp fall in business investment next year. Even under our ‘best case’ scenario, business investment still declines by 3½ per cent next year. Under the ‘muddling through’ scenario the decline is closer to 12 per cent per annum. This is in comparison to the OBR’s forecast for a growth rate of 7.7 per cent per annum.

6. The OBR has substantially changed its profile for potential output. The average rate of trend growth for 2012-13 has been revised down from 2.35 per cent to 1.6 per cent while the trend rate from 2014 onwards has been revised up to 2.3 per cent from 2.1 per cent. This change in profile reflects the time it takes for "the financial sector and credit conditions to normalise." We welcome this flexible approach to estimating

trend growth and the acceptance of the drag that the impaired financial sector continues to have on activity. But there are substantial differences between the NIESR and the OBR's forecasts for potential output. We estimate a larger negative output gap than the OBR. Related to this, we have not increased our estimate of the permanent loss of output experienced by the UK.

7. It remains our view that in the short term fiscal policy is too tight, and a temporary loosening would improve prospects for output and employment with little or no negative effect on fiscal credibility.

Figure 2. BAA Corporate bond spreads over 10-year government bonds



Source: Datastream; NIESR calculations.

Note: weekly average. Most recent data point is the average of the 4 days to 1st December 2011.

The fiscal mandate

8. It is important to note that the fiscal mandate - "to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period"² - does not *ensure* long run sustainability. It would be consistent with the fiscal mandate for the Government to plan, this year, on a cyclically adjusted current deficit of 10 per cent of GDP for the first year of the forecast period (2012-13), 8 per cent for the second, and so on, achieving balance by the fifth year (2016-17), setting out the necessary tax rises and spending cuts to achieve this plan; and then, next year, even if economic circumstances are entirely unchanged, to delay all the tax rises and spending cuts by one year, so again planning on a deficit of 10 per cent of GDP for the first year of the forecast period and balance by the fifth year (now 2017-18). Of course, this would not be a sustainable path for fiscal policy. This example is obviously extreme. We do not suggest that this or any other government would pursue such a course, only that the remit of the OBR would not prevent it.

² http://cdn.hm-treasury.gov.uk/autumn_statement.pdf para 1.48.

9. It follows that while the *Autumn Statement* sets out plans for significant cuts in public expenditure in 2015-16 and 2016-17, the mandate will not in itself oblige the Government to implement these plans. Suppose that the OBR's forecasts are entirely accurate, and there are no further policy changes. In that case, three years from now, in the 2014-15 *Autumn Statement*, the OBR will be forecasting a cyclically adjusted budget that is in balance in the second year of the forecast period. So the Chancellor would be faced with the choice of implementing these further deep cuts as planned - and therefore achieving the mandate three years early - or, entirely consistent with the mandate, reversing those cuts, and returning to cyclically adjusted balance somewhat later.

10. The point of a fiscal rule is to address time-inconsistency problems, which allow policy-makers to set out a plan of action that is optimal today if private agents - for example, financial markets - believe the government will stick with it.³ But that will come unstuck if they can see now that later on the government would be better-off if it changed course. We believe that this is an important debate (and separate from that over the appropriate short-term fiscal stance) and NIESR will consider and publish a more detailed analysis at a future date.

Youth unemployment

11. The *Autumn Statement* announced a number of measures to address youth unemployment. The "Youth Contract" will provide measures including support for extra jobsearch activity, wage subsidies for employers, and a new programme to support disadvantaged 16-17 year olds into education and training. The proposals reflect the substantial body of evidence that suggests persistent wage and employment "scarring", and longer term social and economic damage, from youth unemployment.

12. The available evidence suggests that the most successful policies are those that encourage and mandate job search and those that offer wage subsidies. The Youth Contract largely reflects that evidence:

- The additional support available through Jobcentre Plus recognises that the Work Programme will only help a small proportion of the total number of young unemployed people. Recent research for the DWP by NIESR (Riley et al, 2011) suggests that Jobcentre Plus has improved job matching in the UK labour market and hence the sustainable level of employment.
- The wage subsidy proposal reverses, to some extent, the abolition (before proper evaluation) of the Future Jobs Fund (FJF). By prioritising jobs in the private sector, it addresses the most important substantive criticism of the FJF, that it was excessively oriented to the public sector. However, it is much less generous than the FJF; the wage subsidy is comparable to that available under the New Deal for Young People.
- The programme to help support 16-17 year olds who are not in education, employment or training may also help reverse some of the damage done by the abolition of the Educational Maintenance Allowance, despite the strong

³ The classic article is Kydland and Prescott (1977). See also Wyplosz (2011).

evaluation evidence that it significantly improved educational participation and qualification attainment among the target group.

- The additional support to encourage firms to take on young apprentices is also welcome.

13. However, success depends on implementation. In current circumstances, DWP and HM Treasury must not allow their (entirely understandable) concern to minimise "deadweight" to delay programme implementation, or to put too many obstacles or conditions in place that inhibit the ability of businesses and young people to access the proposed support (a lesson learned from the FJF experience).

Regional pay

14. The *Autumn Statement* announced that the Government will ask the independent Pay Review Bodies to consider how public sector pay can be made more responsive to local labour markets. Regional pay differentials are much higher in the private than in the public sector, reflecting national pay bargaining is much more prevalent in the latter. This leads to distortions in two respects: in areas where private sector wages are relatively high, the public sector may find it more difficult to recruit and retain good staff; in areas where public sector wages are high, good staff may find the public sector more attractive, crowding out private sector employment and activity. Evidence of the former effect has been found by researchers looking at NHS outcomes.⁴ Moving to a system where public sector pay was more closely related to local labour market conditions could reduce these distortions. It is important to note that this policy change in itself does not necessarily imply either an increase or a decrease in overall public sector pay, but it would certainly be likely to have a positive impact on overall productivity in both the public and private sectors.

Financial market policies⁵

15. The *Autumn Statement* includes a clear acknowledgement that financial market conditions continue to constrain economic activity. This is the clearest statement on the ongoing consequences of the impaired financial system since 2009. We welcome this prioritisation putting the financial system back at the centre of policy. High bank lending spreads relative to loan default rates, persistently high cost of term funding and intermittent issuance into domestic asset backed markets all indicate how much remains to be done to create an efficient system. Where these costs are passed-on to borrowers (above increased risk) this represents a negative externality. Interventions which target externalities are not subsidies. Yet the Government must resist the temptation of short-term fixes at the expense of long-term reform. A characteristic of 'lost decades' is that the long-term reforms are always delayed.

⁴ See Burgess *et al.* (2003).

⁵ The Chancellor announced that the Government will respond with more detail on implementing the Independent Commission on Banking (ICB) recommendations. NIESR has presented an assessment of these recommendations in the latest *National Institute Economic Review* (see Armstrong, 2011).

i. National Loan Guarantee Scheme / Business Finance Partnership

16. The National Loan Guarantee Scheme is a welcome initiative to provide much needed lower cost finance to small and medium sized enterprises (SMEs). Assuming the scheme is similar to the European Investment Bank scheme, then credit risk will remain in the bank while the government guarantee lowers the cost of bank funding for the loan. The £20bn of guarantees made available over two years translates does not translate into the same number of loans. This simply lowers the cost of the SME loans under the scheme (possibly by 1 per cent) while the amount of additional new loan finance will depend on the sensitivity of borrowers to this reduction in price. However, Project Merlin shows it is difficult to see whether this will be a re-financing of existing loans or an incremental loan has been made. The Business Finance Partnership is only £1bn and is likely to have limited impact.

17. Both measures are welcomed, but must be considered as short-term palliatives and no substitute for the necessary reforms to retail banking.

ii. Long term capital market finance

18. The National Infrastructure Plan included in the *Autumn Statement*, contains an aspiration for £20bn of funding from the UK pension industry. From a macroeconomic perspective, it is an entirely appropriate allocation of risk that the pension funds should invest in long-term, less liquid but income earning assets like infrastructure projects. But there has been nothing to prevent this in the past, so the impact will depend on the terms.

19. The Government will establish an industry working group to further develop access to non-bank finance, including bond market finance, for SMEs and mid-sized companies. Yet the reason why such credit markets do not exist is because of well known information-based market failures. Expecting the industry to create these markets is a *non-sequitur* and is an area where the Government must lead.

iii. Housing finance

20. Like SMEs, potential new home owners also face restricted credit availability. According to data from the Department for Communities and Local Government, the average deposit of first time buyers is 30 per cent of the value of the property, higher than at any time on record.⁶ Clearly there are risks to property prices and terms were too lax in the past, but these figures suggest housing finance is unaffordable for many even at the current exceptional official policy rates. However, the policy of providing a mortgage indemnity for first time buyers of new build homes with only a 5 per cent deposit is more of a subsidy to the construction industry than an attempt to improve the chronic problems in housing finance.

21. A far superior allocation of risk from a macroeconomic perspective would be for pension funds to invest in long term very low risk (preferably fixed rate) UK mortgage backed securities, as in other countries. Such securities will not emerge

⁶ In the third quarter of 2011. derived from Table 514, available at: <http://www.communities.gov.uk/housing/housingresearch/housingstatistics/housingstatisticsby/housingmarket/livetable/>

from private markets but need to be standardised with government oversight and preferential treatment as a liquid asset. This would be a serious reform to housing finance, reflecting the extent of the crisis and the public bail-out of the banks. The alternative is to allow banks to continue to use shadow banking markets creating financial risks. Reliance on covered bonds is no panacea and will increase the cost of systemic risk to the public.

22. Given the widely recognised risks in the Autumn Statement emanating from the European banking system it is surprising that the Government did not use this opportunity to announce its willingness to re-open the successful Credit Guarantee System introduced in 2008. This can insulate banks from a rapid escalation of interbank market tension. Only last month the Bank of England's *Systemic Risk Survey* reported a sharp increase in the perceived risk of a systemic event. UK banks have stable short term funding but it would be wise to have insurance in place ahead of a system wide shock.

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