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MISSION ACCOMPLISHED?

Hammond's choices for the Spring Statement

- **The UK's productivity and growth forecasts took a hammering at the Autumn Budget, but many economic indicators are now looking positive.**
- **Robust global economic growth is shielding the UK from uncertainty and real wages are expected to start growing this year. The UK is now running a current budget surplus, and the more positive outlook could mean the UK's overall budget deficit is eliminated entirely by 2022.**
- **If the forecasts are correct, the UK will see continuing low levels of unemployment and large increases in pay growth until the end of this parliament.**
- **But this should not lead to complacency or fiscal profligacy. The ratio of debt-to-GDP is nearly 90% and there have already been tax and spending changes since the EU referendum that will cost the Exchequer more than £58 billion.**
- **The last two quarters in 2017 saw productivity growth of 0.9% and 0.8%, which is the strongest level since the financial crisis. But there is no guarantee that this will continue.**
- **Given the inherent unreliability of the forecasts, ministers cannot simply assume that things will be fine. In particular, the improved economic outlook should not be used as an excuse to soften fiscal consolidation or assume that no action is required to boost productivity.**

1. INTRODUCTION

The Autumn Budget saw Britain's productivity forecasts slashed, which wiped three percentage points off predicted economic growth over the next five years. This was in recognition, as we pointed out at the time, of the fact that productivity growth in the UK has effectively flat-lined since 2011.

Despite this, and the ongoing confusion and uncertainty about the Brexit negotiations, the UK economy is in reasonably good shape. Britain's economy is being helped along by healthy global growth, and many of the indicators are looking good. Forecasters expect unemployment to remain low, real wages to see substantial growth and real GDP to see modest gains. Even productivity has begun to pick up.

This could lead to improved borrowing forecasts at the Spring Statement, potentially reversing some of the downgrades at the Autumn Budget. Yet the Chancellor should not take all of this for granted – let alone use it as an excuse to open the taps when it comes to public spending.

2. GLOBAL GROWTH IS HELPING TO SHIELD THE UK FROM UNCERTAINTY

Earlier in the decade, there was widespread concern about the prospects for the world economy. In late 2014, David Cameron warned about "red warning lights" flashing. Eighteen months later George Osborne pronounced that the UK faced a "cocktail" of serious threats from slowing global growth. The G20 claimed that Brexit posed a significant danger to the economic health of the international community.

It is safe to say that these warnings were misplaced. The International Monetary Fund (IMF) has recently claimed that the world economy is enjoying its most rapid and widespread growth spurt for seven years. "Global growth has been accelerating since 2016 and all signs point to a continuous strengthening", claimed IMF chief Christine Lagarde at Davos in January.

The economic picture is indeed encouraging. Real global GDP growth is estimated to have picked up from 2.4% in 2016 to 3% in 2017, according to the World Bank. Encouragingly, this pick-up is judged to be "broad-based" and aided by growth in investment and trade. The World Bank expects growth to hover around a very respectable 3% in the coming years (see Table 1).

Table 1: Real Global GDP Growth (outturns and forecasts)

2015	2016	2017	2018	2019	2020
2.8%	2.4%	3%	3.1%	3.0%	2.9%

Source: World Bank

This robust economic picture is helping to shore up growth in the UK. Although the UK economy expanded in 2017 by a relatively modest 1.7%, a more positive global outlook – as well as progress in the Brexit negotiations from phase one to two – has led a paper published by the National Institute of Economic and Social Research (NIESR) to conclude that real UK GDP growth will be nearly 2% in 2018 and 2019. It should be noted that these figures are dependent on the outcome of the Brexit negotiations – the paper assumes the UK achieves "close to full access to the EU market" – but nevertheless they are significantly higher than forecasts set out by the

Office for Budget Responsibility (OBR) in November 2017, which projected GDP growth of just 1.4% in 2018 and 1.3% in 2019.

This could be very good news for Philip Hammond. A report by the Times, which was commenting on the NIESR study, suggested that – if the projections materialised – the UK would "no longer have to borrow to pay for its spending plans in 2022". This implies that public sector net borrowing (PSNB) would be zero by 2022. Just three months ago, the OBR projected that PSNB would be £25.6bn in 2022-23 – equivalent to 1.1% of GDP.

Even if NIESR's growth forecasts are too optimistic, it would seem likely that the fiscal forecast at the Spring Statement will show improvement from last November.

There is also further positive news for the Government. The UK's current spending (which looks at day to day spending only) is now in surplus for the first time since 2002. This means that George Osborne's deficit reduction target of achieving a current spending surplus has been fulfilled – albeit around two years later than he anticipated. There has also been belated vindication for Osborne from the IMF, which found that his policy of controlling spending had resulted in a milder downturn and lower debt than would have been the case if he had focused on tax rises.

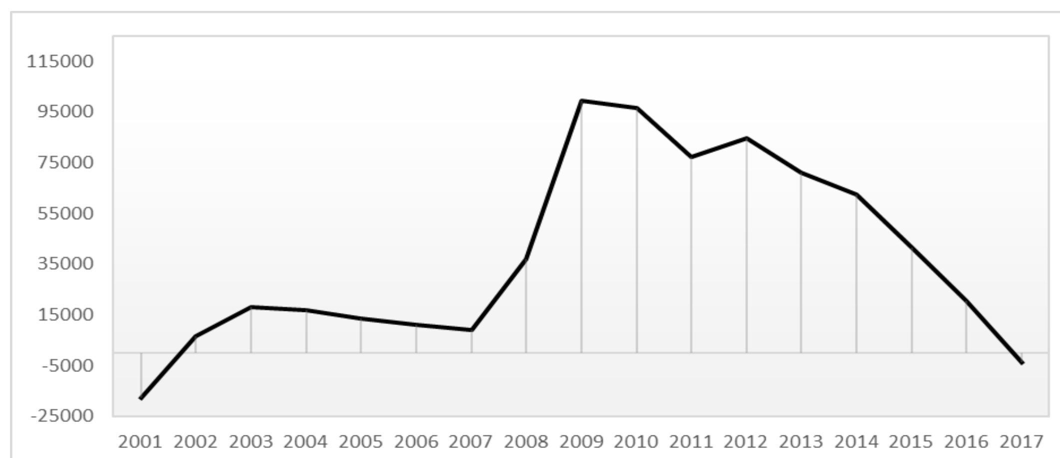
Table 2: Changing Public Sector Net Borrowing Forecasts

A recent study suggests that the UK could balance its budget by 2022

	2021-22	2022-23
MARCH 2017 FORECAST	0.9%	N/A
NOVEMBER 2017 FORECAST	1.3%	1.1%
NIESR FEBRUARY 2018 FORECAST	N/A	0%

Source: Office for Budget Responsibility and NIESR

Figure 1: Public sector current budget deficit, excluding public sector banks (£m)



Source: Office for National Statistics

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3. OTHER INDICATORS ARE ALSO LOOKING POSITIVE

Michael Saunders, an external member of the Monetary Policy Committee (MPC), made a speech in January on "the outlook for jobs and pay". He painted a broadly positive picture for the UK economy. In particular:

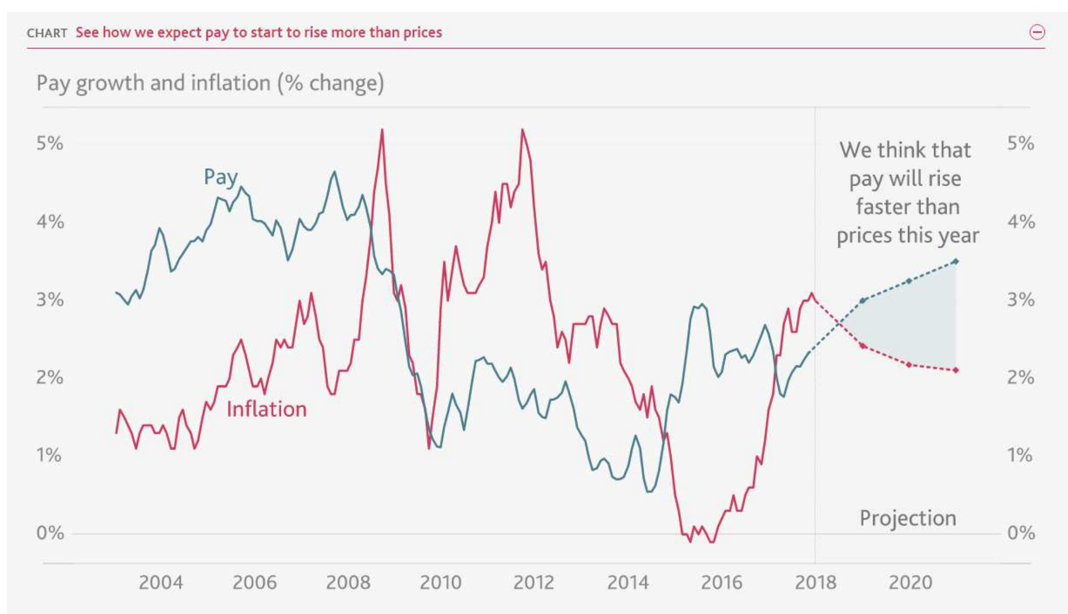
- Global growth and the depreciation of sterling have supported export growth and business confidence.
- Corporate and household balance sheets have become much healthier over the past few years, with lower debt levels relative to income.
- The UK's banking system is now more resilient, because it is better capitalised.

The UK already has the lowest unemployment rate for more than 40 years. But Saunders predicts that the labour market will still see further tightening, which would lead to more declines in both unemployment and underemployment.

He suggests this will in turn lead to an increase in pay growth in 2018, which has been confirmed by the Bank of England's latest inflation report. Indeed, wage increases are expected to exceed inflation at some stage this year, with the differential between pay and prices is set to widen over the next few years (see Figure 2).

As the impact of the pound's depreciation "washes through" the system, inflation is expected to gradually return to the Bank's 2% target, at a time when pay growth is projected to grow. If these forecasts are correct, the UK will see continuing low levels of unemployment and large increases in pay growth until the end of this parliament in 2022.

Figure 2: Pay growth and Inflation [% change] (outturns and forecasts)



Source: Bank of England inflation report (February 2018)

4. BUT THIS IS NO TIME TO RELAX

a. Fiscal consolidation

The temptation for Philip Hammond – or any Chancellor – would be to use this more positive backdrop as an excuse to soften the UK's fiscal consolidation programme. There have, after all, been endless demands for the Government to raise spending on all manner of urgent priorities, from public sector pay to the NHS. But a major relaxation of fiscal discipline would be ill-advised.

In 2010, the Coalition inherited the largest peacetime structural budget deficit in British history. Since then, the overall deficit has been reduced by around three-quarters as a proportion of GDP and the current budget deficit has now been eliminated (day to day spending).

But maintaining such a large budget deficit for so long has inevitably led to an enormous growth in debt levels. According to Trading Economics, the UK's debt-to-GDP ratio has increased from 76% of GDP in 2010 to over 89% of GDP currently. It is vitally important that Hammond seeks to get the debt pile under control – not least because evidence suggest that high debt levels can act as a drag on economic growth.

A paper published by the European Central Bank in 2010 argued that a debt-to-GDP ratio above 90-100% of GDP has "a deleterious impact on long-term growth". Some studies do, of course, disagree with the notion that there is a specific debt-to-GDP ratio above which economic growth is hampered. This very point was made in an IMF working paper entitled "Debt and Growth: Is There a Magic Threshold". However, it did ***not*** argue that debt is irrelevant for economic growth. In particular, the paper claimed that growth is influenced by the trajectory of debt, where countries with high but declining levels of debt grow as fast as their peers.

Of course, the Chancellor could reduce the debt-to-GDP ratio by running a budget deficit that is below the rate of economic growth, rather than an outright surplus. But compared to targeting an outright budget surplus, this leaves little scope for hedging against a future recession – or the uncertainty involved in a "no deal" Brexit scenario. It is also notable that there has already been a significant amount of fiscal loosening since the EU referendum – in large part due to its result.

Looking at the three financial statements since the vote in June 2016, tax and spending changes will cost the Exchequer a cumulative £58 billion by 2022-23 (see Table 3). Much of this extra spending is intended, implicitly or explicitly, to support the economy during the Brexit process. But it does mean that there will be significantly less fiscal headroom, no matter how rosy the forecasts the Chancellor announces.

Table 3: Impact of tax and spending changes since the EU referendum
Figures in £millions

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Autumn Statement 2016	-285	-3,555	-5,695	-7,960	-6,925	-8,715		
Budget 2017 (Spring)		-1,710	-665	825	930	445		
Budget 2017 (Autumn)		-230	-6,045	-9,915	-3,315	-2,960	-2,520	
Total	**-285**	**-5,495**	**-12,405**	**-17,050**	**-9,310**	**-11,230**	**-2,520**	**-58,295**

Source: Budget and Autumn Statement Red Books

b. Productivity problems

Since the financial crisis, productivity has been the Achilles' heel of the UK economy – as outlined in the Centre for Policy Studies bulletin "The Great Productivity Squeeze". Having grown by an average of 2.1% a year over the 35 years prior to the 2008 downturn, productivity has been virtually flat since 2011. Hourly productivity is now a staggering 20% below its pre-crisis trend. This led to the OBR slashing productivity growth forecasts at the 2017 Autumn Budget (see Table 4).

Table 4: Changes to productivity growth forecasts

YEAR	MARCH 2017 OBR FORECAST (%)	NOVEMBER 2017 OBR FORECAST (%)
2017	1.6	0
2018	1.5	0.9
2019	1.7	1
2020	1.8	1.2
2021	1.9	1.3

Source: March and November 2017 Economic and Fiscal Outlooks

Thankfully, while UK productivity has disappointed, the fall in unemployment has been much faster than anticipated. This is unlikely to be coincidental. To a certain extent, the UK's flexible and buoyant labour market has driven slow productivity growth, with some employers substituting labour for capital.

But the UK economy now faces a turning point. With an unemployment rate of just 4.4%, there is limited scope to increase economic activity from higher employment levels. This means that if growth is to be sustained, we will need a strong expansion in productivity. Without it, GDP will falter, the public finances will come under acute pressure, and wages will likely continue to stagnate.

The UK's tightening labour market should now, in theory, lead to an increase in productivity. For example, a scarcity of labour should encourage employers to invest more in capital, which would make workers more productive and boost wages.

Indeed, there are potential some encouraging signs. Quarter on quarter productivity growth has been 0.9% and 0.8% in Q3 2017 and Q4 2017 respectively, according to the Office for National Statistics. This is the strongest growth in productivity across two quarters since the financial crisis.

Despite this, it would be very complacent to simply rely on a tightening labour market to increase productivity and real incomes. It would also be complacent of the Chancellor to focus on rosier forecasts rather than years of sluggish productivity – especially given that over the long term, or even the medium, improving productivity is the only certain route to growth.

As outlined in The Great Productivity Squeeze, there are various things the Government must do to set the conditions for higher productivity – and therefore higher wage growth.

c. But is the productivity picture all that it seems?

Since the Autumn Budget in November, an argument has been made in some quarters that the productivity picture is rosier than it seems: that the problem is not how it is doing, but how it is measured. This, by implication, would mean that the Chancellor can afford to relax when it comes to reform.

Matthew Hancock, now Secretary of State for Digital, Culture, Media and Sport (DCMS), has long highlighted the problems of measuring the productivity of the digital economy in conventional ways.[1] In a ConservativeHome article, he highlighted the following example:

- *"Take Google Maps. Using data from millions of travellers, my phone can tell me that it's quicker to walk across the park than take a taxi. Great! This improves my health, is more pleasant, and saves me time and money. Good for the economy, right? Great for us, great for the economy. But this cuts GDP, and so shows up in the productivity statistics as a fall in productivity."*

DCMS has now funded a project for the Office for National Statistics (ONS) to improve the way that the digital economy's productivity is measured – a move that is well overdue.

There has also been a well-publicised controversy about the measurement of productivity in the telecommunications industry. The ONS has found that inflation in the telecommunications services may have been overstated by 90% between 2010 and 2015, meaning that productivity improvements may have been drastically understated.

There clearly are problems with the way that productivity is being measured, and it is vitally important to investigate and revise methodologies accordingly. But we should not be fooled into thinking that mismeasurement is the sole reason for the UK's lagging productivity. It is not.

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[1] Statisticians traditionally measure productivity by taking GDP as a measure of output and dividing it by the amount of inputs – e.g. dividing GDP by the number of hours worked to calculate labour productivity.

For example, the ONS has been clear that it does not expect the revised forecasts for telecommunications to have a major impact on the aggregate productivity picture. Moreover, the Bank of England suggests that measurement issues account for up to four percentage points of the productivity gap, representing just a fifth of the difference between the pre-crisis trend and the actual outturn.

5. CONCLUSION

At the Autumn Budget 2017, Britain's productivity and growth forecasts took a hammering. Productivity growth has persistently disappointed over the course of this decade, and the dramatic OBR revisions were simply reflecting this fact.

Events since then paint a much more positive picture for the Government. The Bank of England's forecasts of substantial real wage growth up to 2022 will be particularly welcomed by the Government, given that wages were being heavily squeezed at the beginning of this decade.

The more positive global picture is also likely to feed into better growth prospects for the UK and could lead to improved fiscal forecasts. There are even signs of a pick-up in productivity growth, which has been so lacking for the duration of this decade.

This improved backdrop should not, however, lead to a significant increase in spending. The Government has already put in place significant fiscal loosening since the EU referendum; the debt pile is enormous; and the UK may end up needing contingency resources if problems emerge during the Brexit negotiations, or the world economy suffers an unexpected blow.

This is not, in other words, a time for complacency – or inertia. Forecasts, after all, are routinely wrong. The economics journalist David Smith, for example, has highlighted the fact that the Bank of England has "cried wolf" before on pay forecasts. And the more positive productivity data over the last two quarters may well not continue into the next.

It would be hugely irresponsible to simply rely on global growth to shore up the UK economy, and a tightening labour market to boost wages and productivity. The most sustainable way of boosting economic growth and wages is to set the conditions for higher productivity. This means fixing the housing crisis, boosting skills, embracing mechanisation and reforming infrastructure policy – all of the things, in fact, that we outlined in "The Great Productivity Squeeze".

Yes, the Brexit negotiations will and should be the priority for the Government over the coming months. But if we want Britain to prosper after Brexit – whatever form it ends up taking – ministers cannot shirk their duty to keep the public finances strong, and productivity growth high.

Robert Colvile and Daniel Mahoney