ESSENTIAL READING

MPC MEMBERS

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BUDGET 2015: OVERVIEW

Key Points

- **The government remains on track to meet its fiscal rules, with only small revisions to headline fiscal aggregates. The government will meet its debt target a year earlier than required (and previously forecast) as a result of newly announced asset sales.** (Section A)
- **Real GDP growth has been revised up in earlier years of the OBR forecast, but remains below that in the February 2015 Inflation Report. The profile for CPI inflation follows that in the February IR in the near-term, but does not approach target until 2017, in part reflecting the slow pass through of sterling's recent appreciation.** (Section B)
- **The Budget contained a mix of offsetting giveaways and takeaways. There were notable announcements around: the income tax personal allowance; savings & pensions; a new "Help-to-buy ISA" and North Sea taxation.** (Section C)
- *A full set of charts summarising and comparing the OBR and Inflation Report forecasts can be found in*

A) Fiscal forecast

1 The government remains on track to meet its two new fiscal rules. It has both a deficit and a debt rule; the OBR believe that there is a more than 50% chance that the former will be met, while under the Budget plans the latter will be met a year earlier than required. The rules were updated following Autumn Statement 2014 and are now:

> **Deficit** (the 'mandate'): *"a forward-looking aim to achieve cyclically-adjusted current balance by the end of the third year of the rolling, 5-year forecast period"* [Currently 2017-18]
>
> **Debt** (the 'supplementary target'): *"an aim for public sector net debt as a percentage of GDP to be falling in 2016-17"*

2 Table 1 sets out the forecast for the key fiscal aggregates. The profiles for public sector net borrowing (PSNB) and the cyclically-adjusted current budget (CACB) are largely unchanged, except in the final year of the forecast, a result of a revised spending assumption (see below).

3 The most significant change in the headline aggregates is to public sector net debt (PSND). Debt has been revised down by around 1ppt of GDP from 2015-16 onwards. This allows the government to meet its debt rule in 2015-16 – the year it first promised to do so in 2010 and a year earlier than the now revised debt rule requires.

4 While several factors affect the debt forecast, the key change that allows the government to meet its target early is the newly announced asset sales taking place in 2015-16. The sale of assets held by UK Asset Resolution and more of the government's shares in Lloyds Banking Group are expected to raise around £20bn in 2015-16, compared to a total £25bn downward revision.

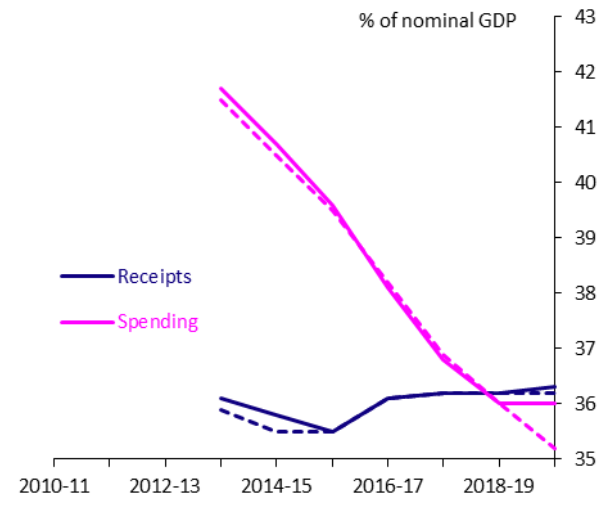
Table 1: Key fiscal aggregates (%GDP)

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Headline fiscal aggregates							
Public sector net borrowing	5.6	5.0	4.0	2.0	0.6	-0.2	-0.3
Cyclically adjusted net borrowing	4.1	4.2	3.7	1.9	0.6	-0.3	-0.3
Current budget deficit	4.1	3.3	2.4	0.5	-0.8	-1.7	-1.7
Fiscal mandate & supplementary target							
Cyclically adjusted current budget	2.6	2.5	2.1	0.4	-0.8	-1.7	-1.7
Public sector net debt	79.1	80.4	80.2	79.8	77.8	74.8	71.6
	Changes since December forecast						
Headline fiscal aggregates							
Public sector net borrowing	0.0	0.0	0.0	-0.1	-0.1	-0.1	0.7
Cyclically adjusted net borrowing	0.0	0.0	0.1	0.1	0.1	0.0	0.8
Current budget deficit	0.0	0.2	0.2	0.3	0.3	0.3	-0.5
Fiscal mandate & supplementary target							
Cyclically adjusted current budget	0.0	0.2	0.1	0.1	0.2	0.2	-0.5
Public sector net debt	0.3	0.0	-0.9	-0.9	-1.0	-1.4	-1.2

Source: Economic & Fiscal Outlook, March 2015

5 While the headline forecasts for receipts and spending (chart 1) were largely unchanged compared to the Autumn Statement, there were some large changes in the mix of spending. "Annually managed expenditure", which is largely made up of pension, welfare and debt interest spending, was revised down considerably (£14.4bn by 2019-20); this results from lower interest rates and RPI inflation, which reduce debt interest and welfare spending. That in turn has implications for day-to-day government spending, as set out below.

Chart 1: Receipts & spending



**Solid lines are EFO Mar 2015, dashed EFO Dec 2014*

6 Government spending beyond financial year 2015-16 is very uncertain due to it not being covered by a Spending Review, which sets out detailed departmental spending plans. As a result

spending over this period is determined by a "policy assumption" that can and does change between fiscal events. Any changes to spending (Total Managed Expenditure, TME) beyond 2015-16 can therefore be explained by this assumption, rather than explicit policy announcements.

7 The spending assumptions in the Budget were very similar to the 2014 Autumn Statement apart from for 2019-20. As a result over the period 2016-17 to 2018-19 TME is slightly lower than expected at the time of the Autumn Statement, but considerably higher in 2019-20. TME is now assumed to increase in line with nominal GDP rather than the GDP deflator in the final year of the forecast.

8 There are two key points to note. First, the fiscal assumption implies lower spending between 2016-17 and 2018-19 because of lower TME (over 2010-11-2014-15), which was driven by falling central government debt interest payments due to lower RPI. Second and directly related to the first point, lower RPI means debt interest payments are also lower over the forecast period. Therefore despite a lower overall spending envelope, a smaller absolute amount is being devoted to spending on elements such as interest payments (and unemployment benefits). So, the government will have more money for day to day departmental spending.

B) Economy forecast

Chart 2: Real GDP

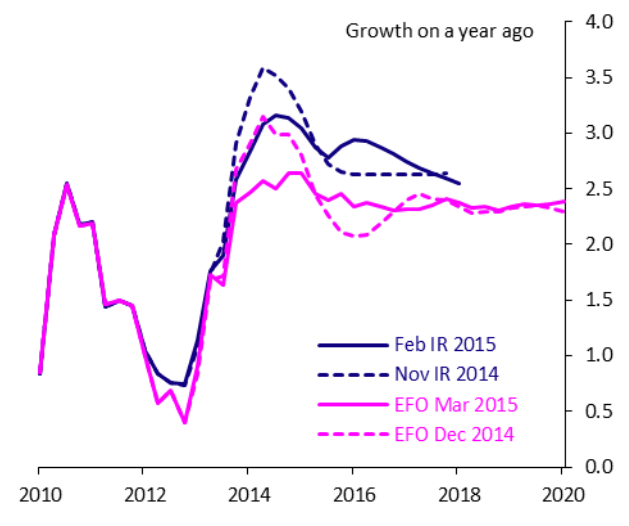
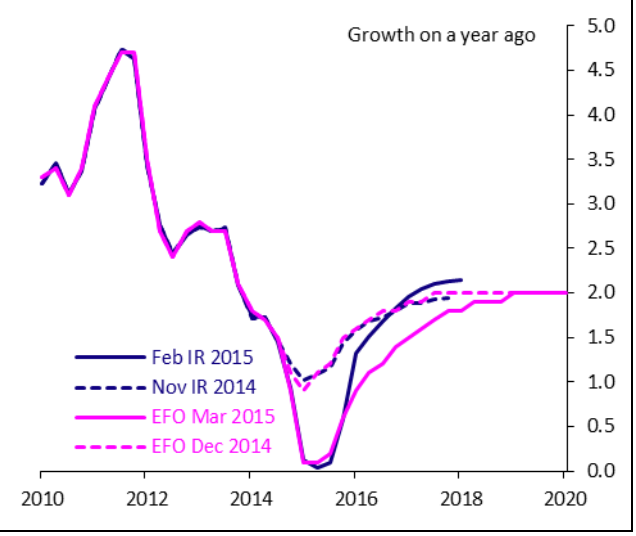


Chart 3: CPI inflation

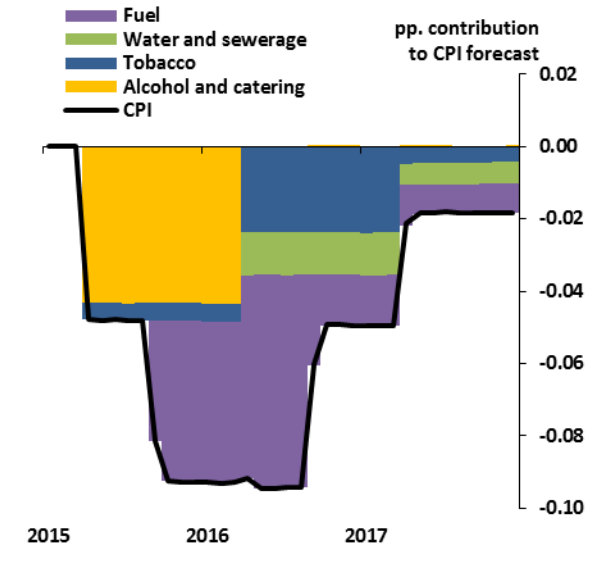


9 The OBR is now forecasting 2015 real GDP growth of 2.5%, 0.1pp higher than at the time of the Autumn Statement and consistent with a 0.7% Q1 quarterly growth estimate (the OBR have no equivalent back casting assumption to us) and 0.6% growth thereafter. They then forecast 2.3% GDP growth in calendar years 2016, 17 and 18, slightly revised up in 2016 and slightly down in 2017. Our February IR projections remain significantly stronger over this period (at 2.9% in 2015 and 16, and 2.7% in 2017). And that difference is driven by a stronger consumption forecast in the first two years and stronger business investment growth in 2017.

10 The OBR revised down its CPI forecast by up to 1pp for this year, bringing it closer to the February Inflation Report and reflecting the falls in the oil price since December's Autumn Statement. But in 2016 the OBR forecast is up to 0.5pp lower than in the Inflation Report and is 0.3pp lower at the end of 2017. The OBR partially attribute the slower return to target to the lagged effects of import price weakness following sterling's recent appreciation.

11 An initial estimate of the impact of the Budget on the STIF builds to -0.1pp from September, reflecting the OBR's lower RPI forecasts (for duties), reductions in beer, cider and spirit duties in April and the removal of September's fuel duty increase (Chart 4). We had reduced our forecast for duties ahead of the Budget to reflect recent lower RPI outturns, but the Budget still presents downside news.

Chart 4: Impact on the STIF of duty changes and revised forecasts



12 The OBR has revised down its long run forecast for the wedge between CPI and RPI inflation to 1.0%, from 1.4% previously. That is now lower than the Bank's own estimate of 1.3%. The lower forecast reflects a slightly lower contribution from housing, partly reflecting a lower outlook for wage growth, and a lower contribution from other factors including the difference in weights used in the two inflation baskets.

13 Elsewhere in the OBR's economic projections, their forecast for the household saving ratio was revised up by around 2pp throughout such that the ratio remains just over 7%. And, although the net investment income deficit within the current account continues to disappear over the five year forecast, it does so more slowly than previously consistent with a story of a delayed pickup in rates of return on our overseas (FDI) asset holdings. Big picture though, the OBR's forecasts for the sectoral balances imply that the main counterpart to the ongoing fiscal consolidation is an improvement in the UK's external position. That stands in contrast with the narrative in the February IR that also relies on some shift to domestic private sector dissaving (driven more by PNFCs than the household sector).

14 The OBR have judged that the Help to Buy expansion (see section C) will have negligible impacts on the house price and housing transactions forecast. However, they have revised up their medium term house price forecast due to higher projected real household incomes. Their forecast is now significantly higher than the Feb IR with annual growth rates peaking at 7.0% compared to our 5.1%. The OBR have revised down their transactions forecast in the near term due to weaker mortgage approvals, and further out due to a reduction in the assumption of the medium term

turnover rate. Their residential investment forecast is now weaker in the near term than in December and growth is even weaker than our Feb IR dwellings forecast throughout 2015.

15 The OBR have revised up their assumption for migration relative to the Autumn Statement. The ONS publish a range of population projections based on different assumptions around migration, etc. The OBR previously used the low migration projection in their forecast, assuming migration of 105k a year by mid-2019. This was lower than the ONS principal projection, which fed into the February 2015 Inflation Report forecast, of migration of 165k a year in the long-term. The OBR now assume net migration flows will follow the levels assumed in the ONS principal population projections 'given the much higher than assumed flows in recent data' (net migration in the year to September 2014 was 298k). This raises cumulative potential growth in the OBR forecast and is one of the drivers of the upward revision to the GDP forecast. The OBR have also made an upward revision to the trend employment rate, as the age structure of inward migrants is assumed to be skewed towards those of working age.

C) Key policy announcements

16 While the total "giveaways" in the Budget were offset by the "takeaways", giveaways tended to occur in earlier years, funded by takeaways in later years. The key policy announcements were: increases in the income tax personal allowance in 2016-17 and 2017-18; a package of tax avoidance measures; a Help-to-buy ISA; a package of measures on pensions and saving; a package of tax changes for the North Sea. These last three packages of measures are considered in further detail below.

17 The new **Help to Buy: ISA** will allow first time buyers to save up to £12,000 and receive a 25% bonus (up to £3,000) from the government if the savings are used for house purchase. A maximum of £200 per month of savings, with an initial deposit maximum of £1000, means that it will take 4.5 years to benefit from the maximum bonus. A person can have one HtB: ISA account each (so a joint purchase is eligible for two bonuses) and the savings can be used for a first home worth less than £450,000 in London and less than £250,000 elsewhere in the UK. A saver will still only be allowed one cash ISA and therefore cannot have a HtB: ISA and another ISA, although the HtB ISA will earn an interest rate set by the bank or building society. The HtB: ISA is projected to cost the government £45m in 2015-16, rising to £835m in 2019-20 which, given that accounts can only be opened for a period of 4 years after launch, this is likely to be close to the peak cost.

18 From April 2016, a new **Personal Savings Allowance** will be created. The first £1000 of savings income will be exempt from tax for basic rate taxpayers, and the first £500 for higher rate taxpayers. The automatic deduction of 20% income tax by lenders on non-ISA savings will also be abolished. In addition, ISA savers will be able to withdraw and replace money from their cash ISA

without counting towards their annual ISA subscription limit, as long as the repayment is made in the same tax year as the withdrawal.

19 HMT estimate that 95% of taxpayers will pay no tax on savings, and households could save up to £200 on their annual tax bill. The OBR have not incorporated any impact from this policy on their forecasts. The direction of the impact on household consumption is uncertain since it will depend on whether the income or substitution effect dominates for savers. In addition, households are only likely to be affected if they already exceed their annual ISA saving limit.

20 It is possible that this policy will encourage households to change the composition of their asset holdings. At the margin, the Personal Savings Allowance will make deposits more attractive relative to equities, pensions or houses, although the Bank's internal models suggest that any increase in the stock of deposits is likely to come through slowly.

21 **Changes to pension annuities policy**: From April 2016, people who are already receiving income from an annuity will be able to sell that income to a third party, subject to agreement from their annuity provider. The proceeds of the sale could be taken directly or drawn down over several years and would be taxed at the marginal rate. The company which buys the annuity will continue to receive the monthly rate until the death of the annuity holder. It is assumed that this policy will encourage a secondary market in annuities, and the government is publishing a consultation on how best to remove the barriers to its creation.

22 The policy is likely to be a response to criticism of last year's budget that it did not help those with existing annuity contracts. The policy is at an early stage and considerable work needs to be done on delivering a working market in annuity sales to third parties, so it is difficult to judge take up at present. However there are no immediate prudential concerns as individuals can only sell to a third party so there will be no change in the volume or timing of liabilities for insurance companies according to the latest intelligence from HMT. The concerns are likely to centre around the FCA, since it is possible that the third party companies will not give pensioners a good deal when they sell their annuities.

23 The annuities market is worth £12bn per annum and there were 6 million pension annuity policies in payment in 2013 according to the ABI. The main impact of the policy is likely to be on household asset holdings – for example households may decide to put cash in a 'draw down product' or take it as a lump sum. It is also likely that many households will simply choose to keep their annuities. There may be an additional positive impact on household consumption if households draw the cash as a lump sum, although HMT judge that such effects are likely to be small.

24 In response to the impact of falling oil prices on the **UK extraction sector**, the government announced a number of supportive measures including: a new investment allowance; a 10% cut in the supplementary charge; and a 15% cut in Petroleum Revenue Tax. The OBR report sets out in some detail the impact of the lower oil price on its projections for production and capital expenditure in the sector, and the extent to which the new measures may offset. For example, an assumed offset from the measures means that the OBR projects around a 20% fall in production over their five year forecast period rather than around a 30% fall (with the weakness coming through gradually rather than being front loaded). In terms of investment, the projections imply around a 70% fall over five years that is only slightly mitigated by the additional measures. Overall, the OBR's projections are more pessimistic than the ones underlying the MPC's February IR forecast, even taking into account the boost from the new measures. We will re-evaluate our own judgements ahead of the next pre-MPC and forthcoming forecast round.

25 At the macro level, the OBR assumes a boost to non-oil business investment in response to lower oil prices and hence a small and gradual boost to the capital stock and potential productivity growth (in fact, somewhat smaller than their previous assessment published in 2010). But, given recent weakness in observed labour productivity, they offset this boost to potential supply with a judgement that trend TFP is again likely to be weaker than previously assumed such that overall potential productivity is unchanged.

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18 March 2015