RECOMMENDED READING

Key Issues Meeting 2 follow-ups on the fiscal consolidation

(CAPD)

- **At Key Issues 2 the Governor requested some metrics to compare the consolidation to come over the forecast with the consolidation to date. He also requested a sensitivity analysis of our fiscal multipliers.**
- **In our forecast treatment, the drag on growth from new fiscal measures implemented over the forecast period dominates the unwind of past fiscal shocks.**
- **The action-based consolidation measures collated by the IFS increased at a higher rate over the last three fiscal years than they do over the next three fiscal years. Cyclically-adjusted PSNB *increased* in two out of the last three fiscal years, but is forecast to fall sharply over the next three fiscal years. The action-based measure of fiscal consolidation therefore gives a different reading from that gained by looking at cyclically-adjusted PSNB.**
- **Doubling our fiscal multipliers would lead to an average peak impact across fiscal instruments of about 1.2. With the same persistence assumption as in the forecast, this would double the drag from fiscal policy on GDP growth over the forecast from around 0.2-0.3% in each year to 0.4-0.6%. Assuming instead that fiscal shocks fade completely within 5 years (as the OBR does) would lead the unwind of past shocks to dominate, meaning that fiscal policy contributes positively to GDP growth by 0.5% on average in each year.**

The consolidation to come vs the consolidation to date

Chart 1 shows the assumed impact of the fiscal consolidation on the GDP growth forecast. Fiscal policy has been dragging on growth since 2010, but some of the past fiscal shocks will begin to unwind over the forecast, pushing up on growth. We estimate that the drag on growth from new consolidation measures dominates that unwind, leading to an overall drag on growth of around 0.2-0.3% in each year of the forecast.

Chart 2 shows cumulative changes in the "action-based" consolidation measures collated by the IFS over the last three fiscal years and over the next three fiscal years. On this metric, the pace of the consolidation has been somewhat greater to date than it is expected to be in the years to come.

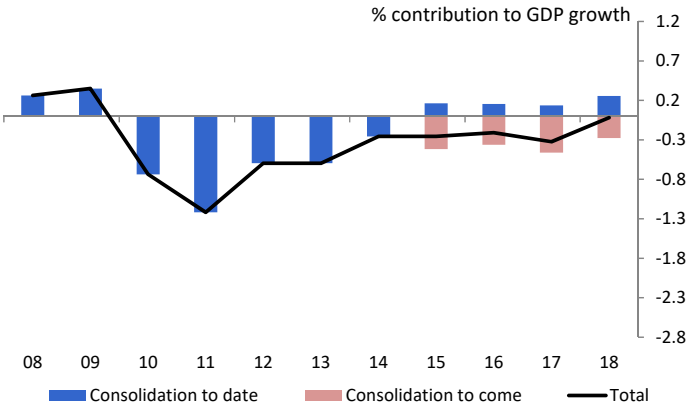
Chart 3 shows cumulative changes in the cyclically-adjusted PSNB over the last three fiscal years and over the next three fiscal years. Cyclically-adjusted PSNB *increased* in two of the last three fiscal years. That's because this metric is also sensitive to factors that have little to do with fiscal consolidation plans per se (such as changes in potential supply and the composition of GDP and income growth), and that's also the reason why we tend to prefer the action-based measures as an input for the forecast treatment of fiscal policy. Cyclically-adjusted PSNB is projected by the OBR to fall in each of the next three fiscal years. On this metric, there's more consolidation to come over the forecast than there has been to date. The action-based measure of fiscal consolidation therefore gives a different reading from that gained by looking at cyclically-adjusted PSNB.

Sensitivity of the forecast to the peak impact and persistence assumptions for fiscal multipliers

With monetary policy and the exchange rate fixed, the average peak multiplier across fiscal instruments embodied in the forecast is around 0.6 and the persistence is over 8 years. Based on a review of the recent literature, we think that doubling the peak multiplier is likely to be an upper bound in terms of empirical plausibility. With the same persistence assumption as in the forecast, this would double the drag from fiscal policy on GDP growth over the forecast from around 0.2-0.3% in each year to 0.4-0.6%, and double the effect on the level of GDP as well (red lines, **Charts 4 and 5**).

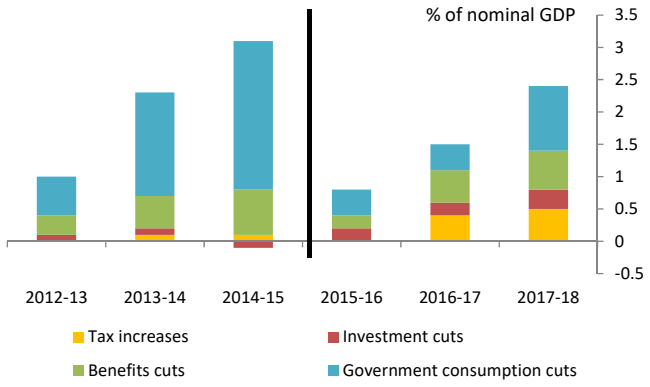
The OBR assume that fiscal shocks fully dissipate within five years. If in addition to doubling the peak multipliers we also make that assumption, then from 2014 onwards the unwind of past consolidation measures begins to dominate the drag from new measures, such that fiscal policy contributes positively to GDP growth over the forecast by around 0.5% a year on average, and some of the level effect of the consolidation begins to dissipate (blue lines, **Charts 4 and 5**).

Chart 1: Assumed effect of fiscal policy on GDP growth (with monetary policy fixed)



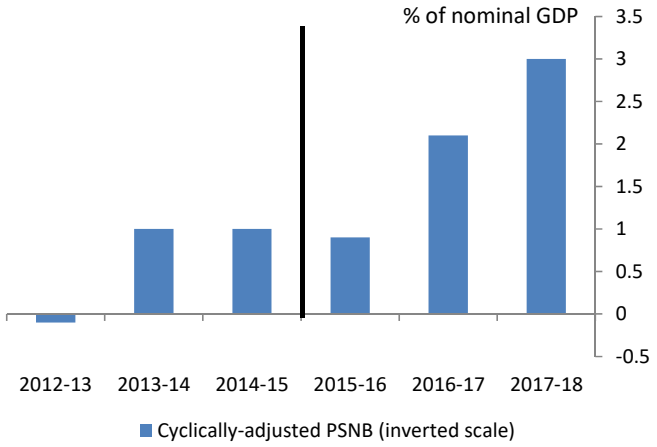
Source: IFS.

Chart 2: Cumulative action-based approach: the consolidation over the last and next three years



Source: IFS.

Chart 3: Cumulative change in the cyclically-adjusted PSNB: the consolidation over the last and next three years



Source: OBR.

Chart 4: GDP level effect of alternative peak multiplier and persistence assumptions

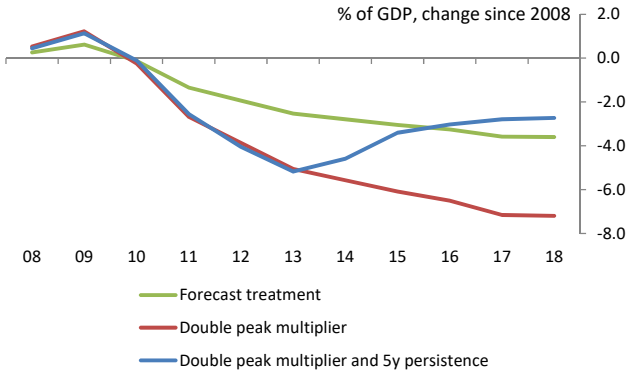
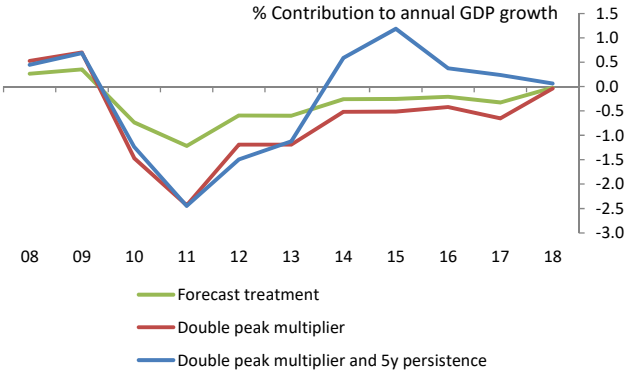



Chart 5: GDP growth effect of alternative peak multiplier and persistence assumptions