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IFS Green Budget 2021

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IFS Green Budget 2021

Citi Contribution

Christian Schulz
Lead Western European Economist
christian.schulz@citi.com
+49 69-1366-8451

Ben Nabarro
Lead UK Economist
benjamin.nabarro@citi.com
+44 20-7986-0870

Agenda

1. **Global economic outlook and topics**
2. **UK economic outlook and topics**

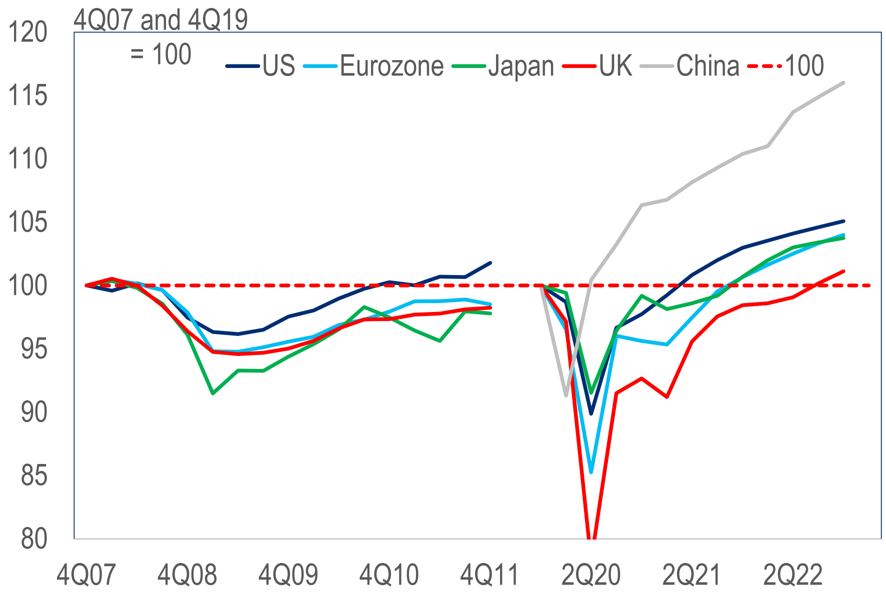
Opportunities and Challenges of the Post-pandemic World

- The pandemic is not over, but economies are now more resilient.
- The rebound can become a recovery.
- For the rest of 2021 and parts of 2022, supply constraints will continue to impinge on growth.
- Supply-demand mismatch, rebuilding profit margins, hot real estate markets, sensitive price expectations and the green transition all point to higher inflation rates for some time.
- The risk of a major fiscal tightening, as happened after the 2008−09 crisis, is low.
- Financing conditions are likely to stay benign.

From Rebound to Recovery

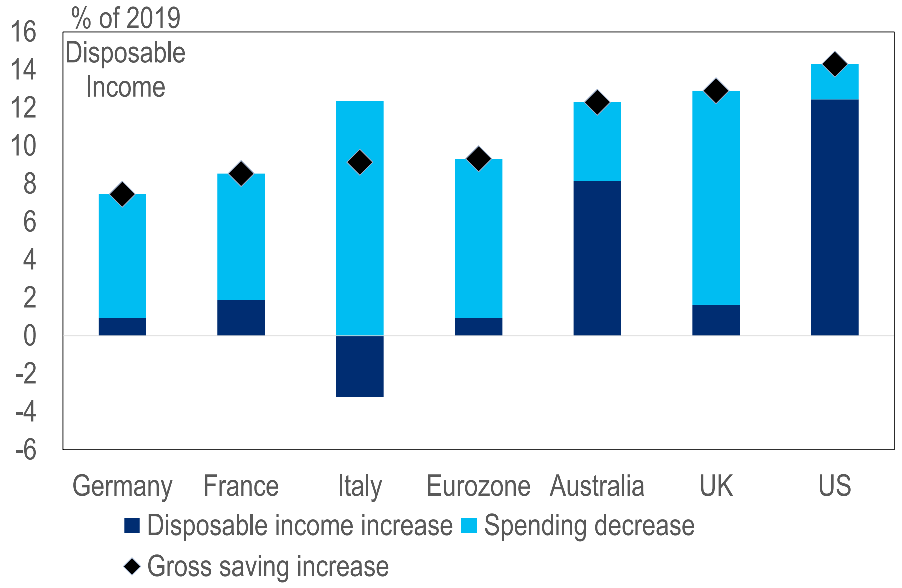
China and the US have already reached pre-crisis GDP levels, Europe should follow this winter. The savings households "forcibly" accumulated have the potential to fuel a self-sustained recovery, if unleashed.

Real GDP in selected economies (Q4 2019 and Q4 2007 = 100)



Sources: ONS, Eurostat, BEA, CAO, CNBS and Citi Research

Cumulative change in gross household saving in selected economies, as % of 2019 disposable income, Q1 2020 – Q2 2021



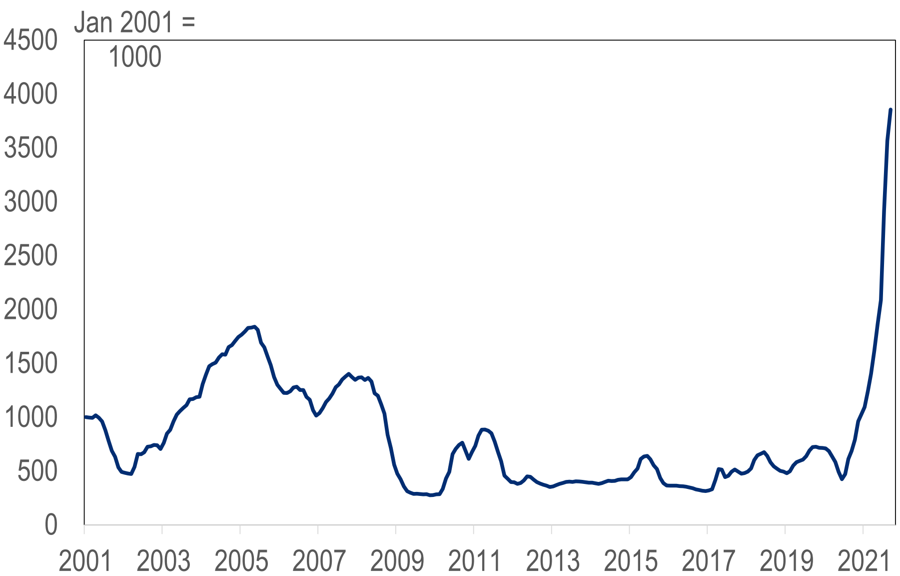
Notes: Gross saving, as opposed to net saving, does not deduct consumption of fixed capital (depreciation). All percentages denote the change relative to 2019 average levels as a % of 2019 total disposable income, i.e. we do not adjust for different pre-pandemic trends.

Source: Eurostat, Bundesbank, INSEE, ONS, ISTAT, BEA, ABS and Citi Research

Supply constraints to weigh on growth, boost inflation

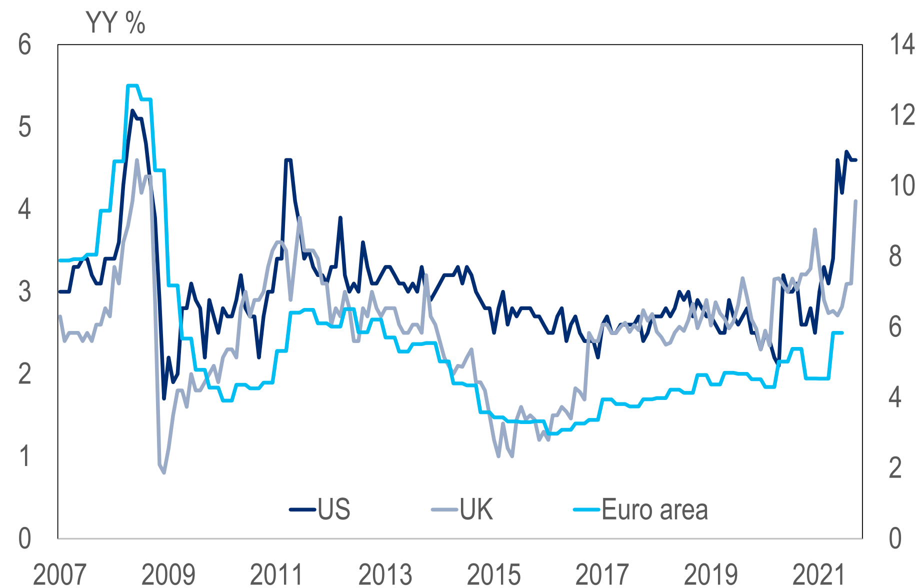
Supply shocks, the green transition, supply-demand mismatch and demand rotation push inflation higher for longer, and cut growth. Labour market data show slack, but some central banks watch inflation expectations

Harper Petersen Freight Rates (January 2001 = 100)



Sources: Harper Petersen and Citi Research

US, UK, Euro Area – Households' 1-year inflation expectations



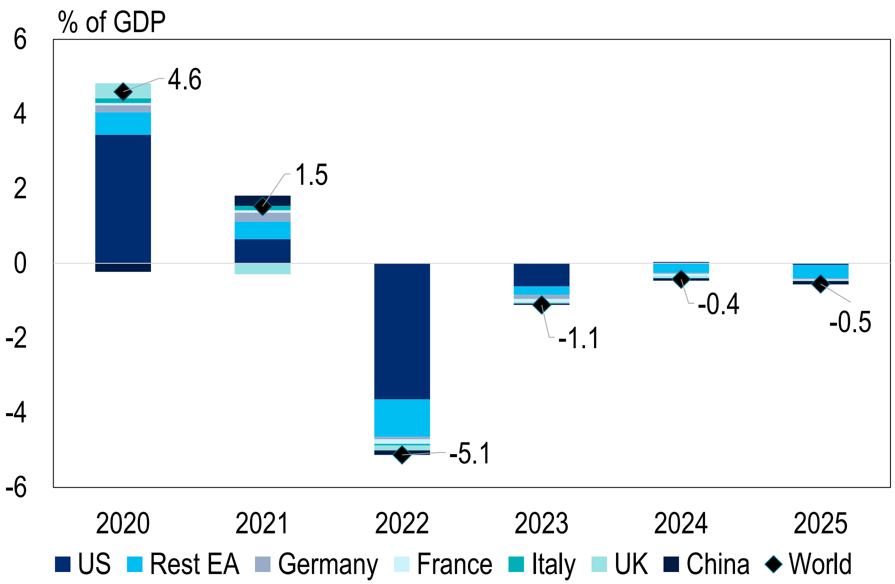
Note: Euro Area right hand side.

Sources: University of Michigan, EU Commission, YouGov and Citi Research

Fiscal and monetary policy more patient than after 2008/9

Most of the pandemic support will be phased out but the US and Europe are ramping up public investment for many years. Central banks are edging towards very gradual normalization.

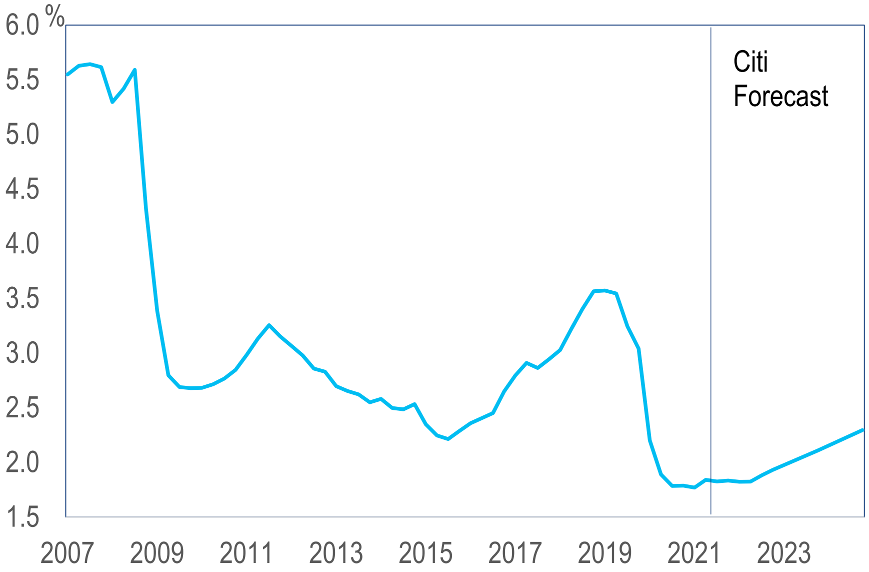
Change in structural fiscal balance (% of world GDP) for selected economies)



Note: change in the general government budget deficit, adjusted for the change in the output gap (with a factor of 0.5).

Source: IMF and Citi Research

Global Central Bank Policy Rate (%, US $ GDP-weighted)



Notes: Gross saving, as opposed to net saving, does not deduct consumption of fixed capital (depreciation). All percentages denote the change relative to 2019 average levels as a % of 2019 total disposable income, i.e. we do not adjust for different pre-pandemic trends.

Source: Eurostat, Bundesbank, INSEE, ONS, ISTAT, BEA, ABS and Citi Research

Still more optimism than a year ago

The pandemic hit was not as bad as feared in 2020 and 2021 and 2022 forecasts are more optimistic.

Real GDP (YY %)	2020	2021	2022	2023	2024
World	-3.5	5.8	4.4	3.1	3.0
Advanced Economies	-4.8	5.1	4.0	2.1	1.8
US	-3.4	5.8	3.8	1.8	1.8
Euro Area	-6.5	5.2	4.7	2.6	2.1
UK	-9.7	6.9	4.4	2.4	1.3
Emerging Markets	-1.7	6.6	4.9	4.4	4.3

Note: Citi Forecasts as of 22 September 2021, see Global Economic Outlook & Strategy - On social change and markets. Arrows denote changes compared to Green Budget 2020. No arrow +/- 0.1pp, 45° arrow 0.1-0.5pp revision, 90° arrow >0.5pp revision

Sources: Citi Research

Agenda

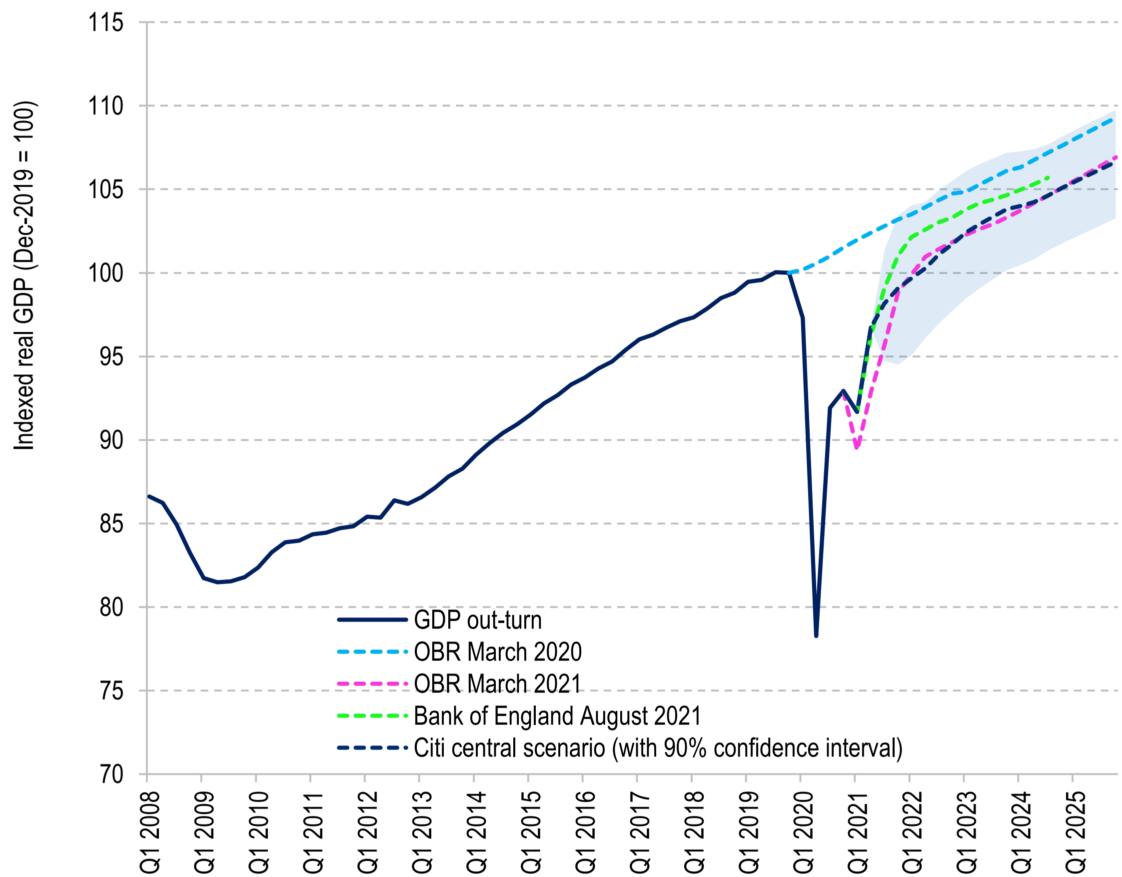
1. **Global outlook:**
2. **UK outlook: The future isn't what it used to be**

Dont Conflate Rebound and Recovery

The UK's economic rebound has been rapid, but uneven. We think a faster recovery to date has few implications for the strength of the medium term recovery. The UK economy is likely to remain a large recession off its pre-pandemic trajectory.

- **A sharp loss in momentum –** faster indicators of UK activity have fallen away sharply in recent months.
- **A lingering gap –** lingering public health concerns, income losses and supply impairments all suggest fading momentum.
- **Unwinding support –**the private economy will increasingly now internalise the aggregate income effects of weaker demand
- **A limited savings boost –** we expect accumulated saving to provide only a limited boost in the UK in the months ahead.

UK real quarterly GDP (Index, Dec-19 = 100)



Notes: Shaded area reflects a 90% confidence interval. OBR and Bank of England series are indexed to the most recent iteration of the Quarterly National Accounts, using the last quarter available when the forecast was made.

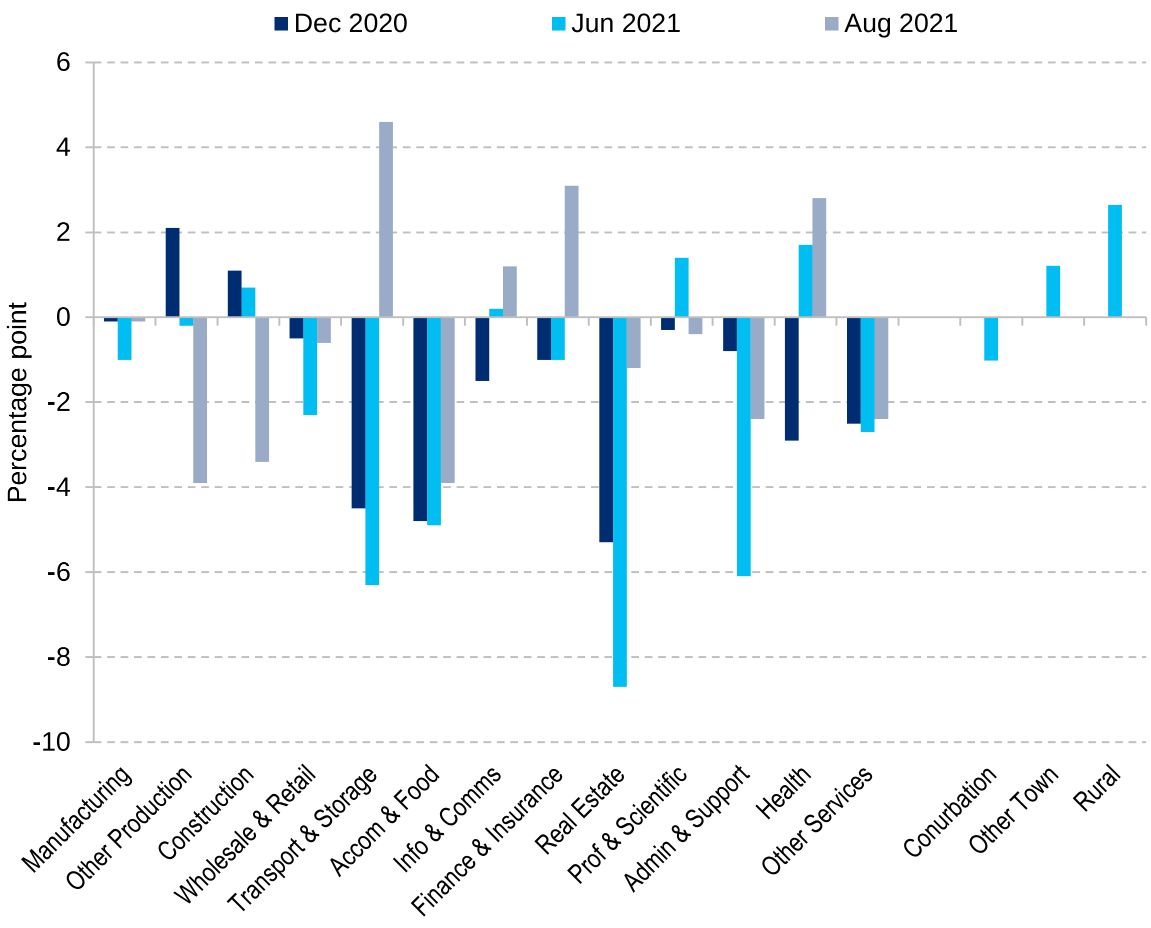
Source: ONS, Bank of England, OBR and Citi Research.

Lasting Reconfiguration

While some asymmetries associated with the acute pandemic period seem to be fading, others are expected to prove more persistent. The latest data suggest many are preparing for a new economy ahead.

- **Persistent dispersion –** sectoral and geographic dispersion remain elevated.
- **Long-term changes –** pandemic related changes to things such as home working, business travel and online purchases look likely to persist.
- **Preparing for a new economy –** firms increasingly expect lasting changes in both practice and output. Firm foundations also suggest changes to come.

Expected Long Term Impact of Covid on Sales (Percentage Points)



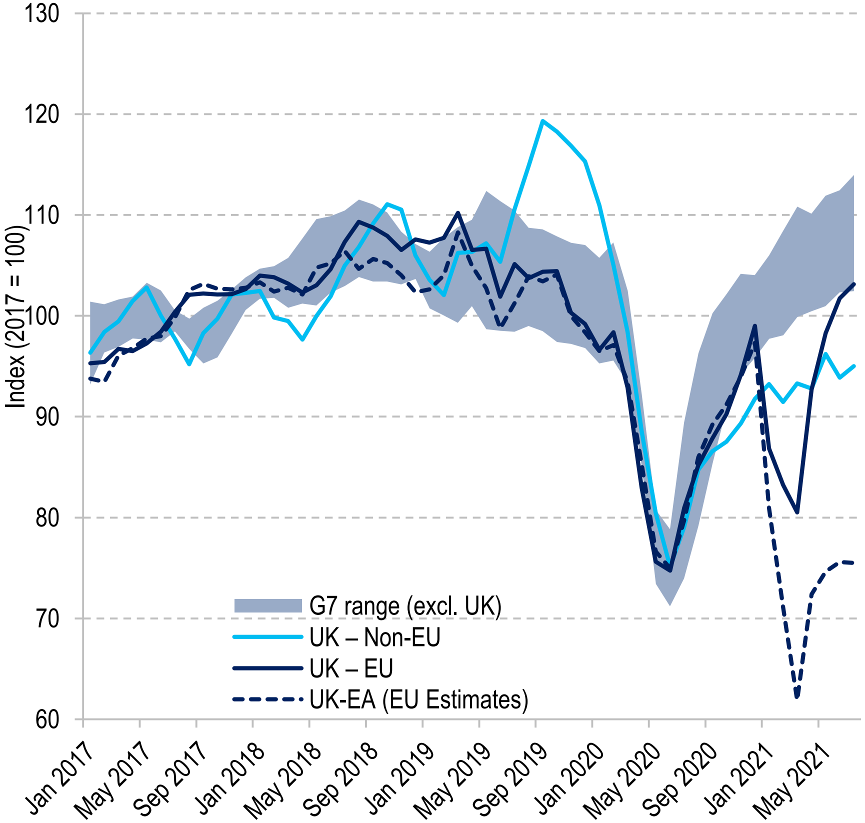
Note: Expectations concern the period 2022+

Source: Bank of England Decision Maker Panel Survey, Broadbent (2021).

Why Brexit will Cast a Long Shadow

The disruptive impact of both Covid and Brexit have compounded one another at the start of 2021. Some of these effects are now dissipating. But acute Brexit-related adjustments here likely lie ahead.

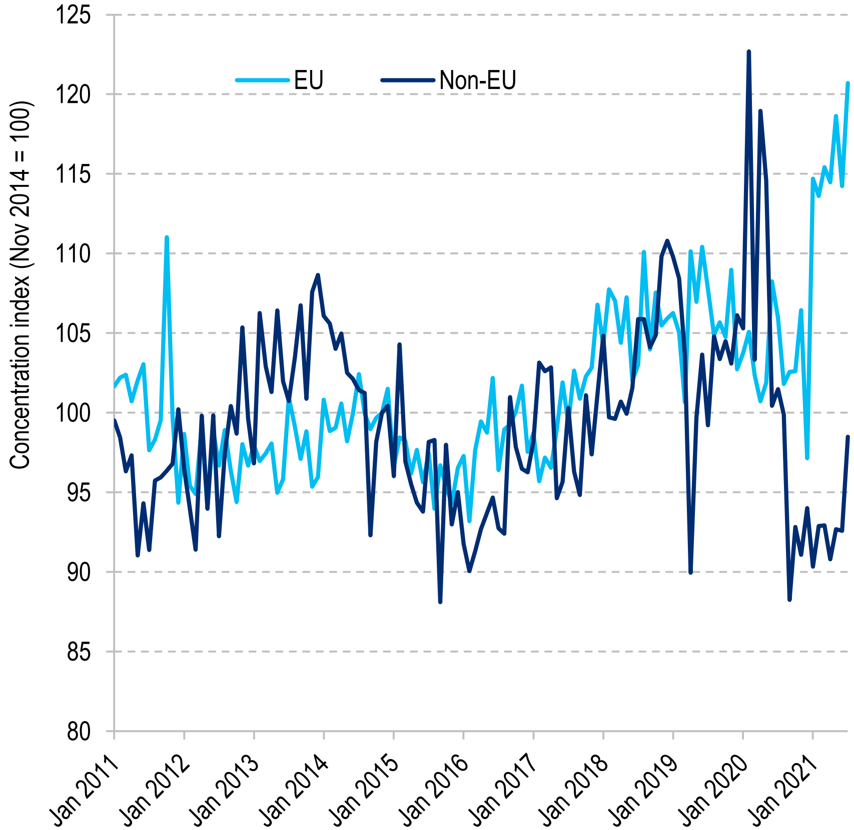
G7 goods exports (indexed, 2017 = 100)



Notes: Measure is a 3-month moving average of nominal goods exports. Countries included: Italy, Japan, Canada, United States, France and Germany

Source: ONS, National Statistical Offices.

UK Goods Export Concentration, EU and Non-EU (Index, 2014 = 100)



Note: Concentration is measured here using a Herfindahl-Hirschman Index across items exported to both the EU and non-EU countries.

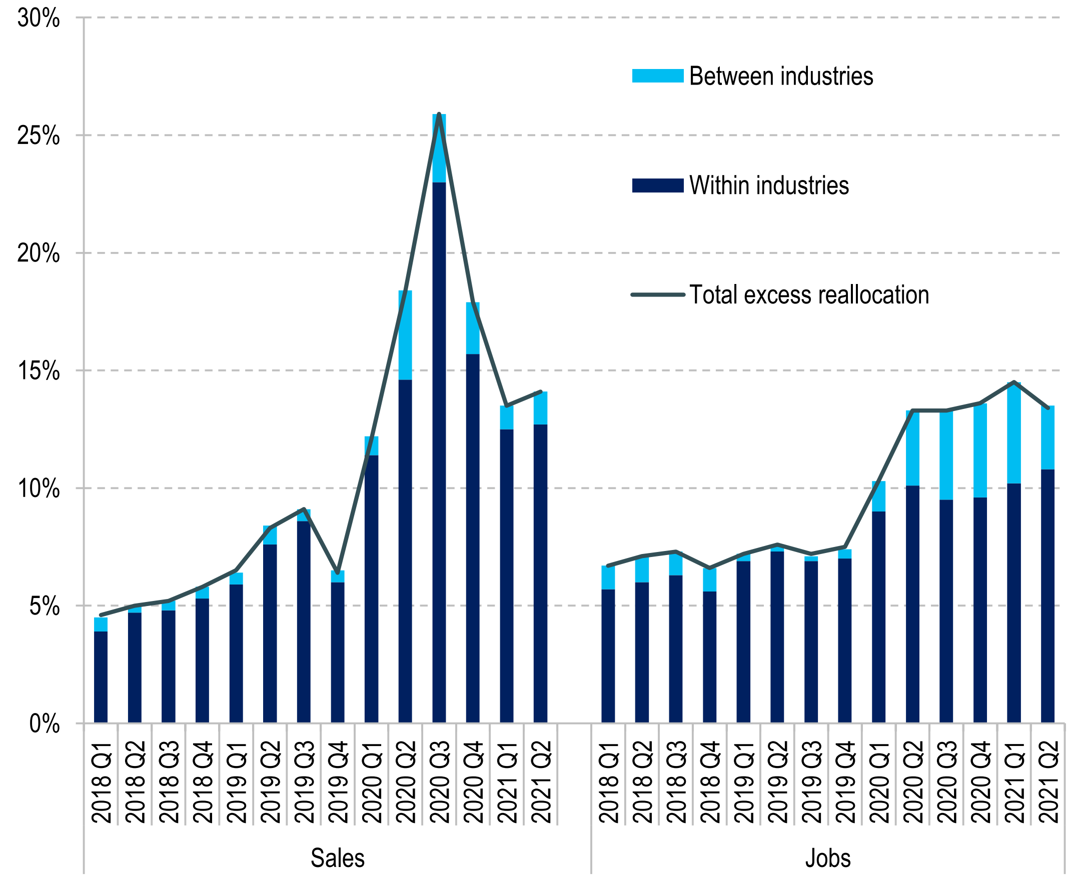
Source: ONS.

A Contorted Rebound – the Labour Market Outlook

Labour demand has rebounded strongly alongside economic activity. However, the recovery also remains highly uneven. We expect many of recent labour market pressures to gradually dissipate as the economy adjusts.

- **Frozen supply –** demand has adjusted over the past 18 months, but the labour market has been frozen by furlough.
- **Surging demand** – as many firms have also sought to hire simultaneously, this has also exacerbated tightness.
- **Fading tightness** - we expect both of these effects to fade in the months ahead. We expect 400-500k redundancies among the furloughed population.
- There is **little evidence of a widespread hit to labour supply.**

Three-year sales and employment 'excess' reallocation, 2018 – 2021



Notes: Excess reallocation is the amount of cross-firm sales and job reallocation in excess of what is required by aggregate changes. This is calculated in a similar fashion to Davis and Haltiwanger (1992).

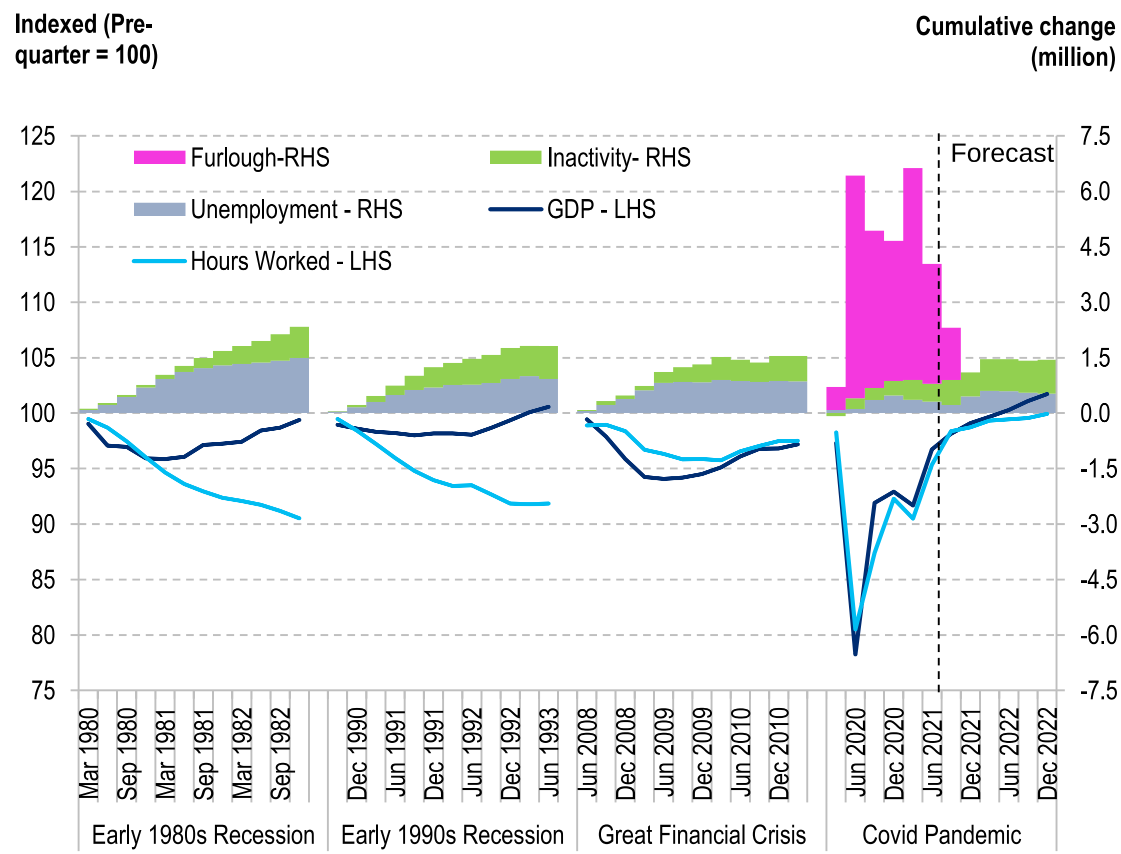
Source: Bank of England.

A Protracted Labour Market Recovery

We expect the labour market to lag rather than lead the recovery in the years ahead. Instead, the recovery appears increasingly capital intensive, while persistent matching issues are also likely to drag.

- **Lagging activity –** with activity lagging pre-pandemic levels, unemployment is likely to rise.
- **A capital intensive recovery** – inter and intra-sectoral shifts imply an increase in capital intensity.
- **Matching** – compositional changes may also mean a structural increase in unemployment.
- **A change in relative wages –** compositional changes and the end of EU immigration imply some changes in the relative value of different skills. Aggregate pay, however, should be more contained.

UK real quarterly GDP (Index, Dec-19 = 100)



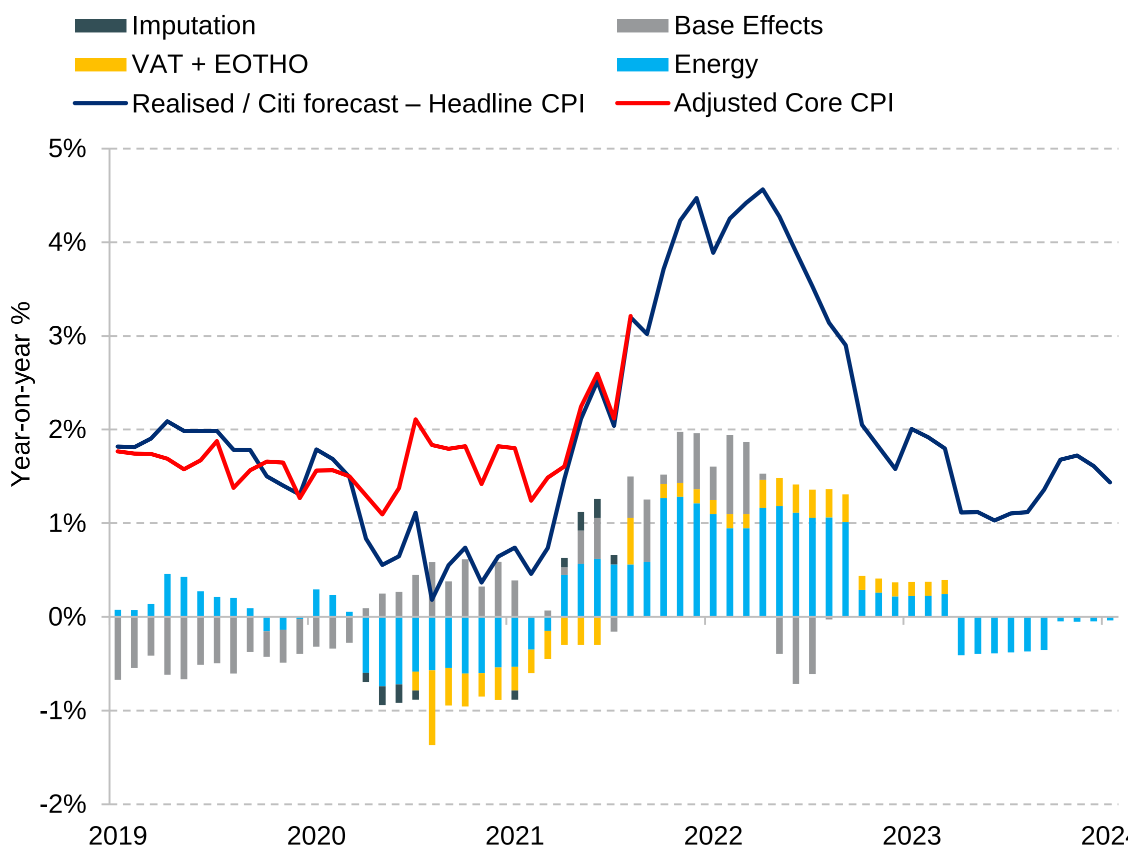
Source: ONS, HMRC.

Could Inflation Prove More Persistent?

Temporary and transitory factors are pushing inflation to around 5% YY in April 2022. However, we continue to see domestic inflationary drivers as more subdued. Inflation expectations remain the key risk.

- **Energy inflation** – increases in wholesale energy prices imply a further sharp increases in household bills in April 2022
- **Imported inflation** – strong demand and supply disruption suggest a strong surge in some prices into Christmas.
- **Domestic inflation more subdued** – domestic services prices have been normalising, but pressures here remain more subdued.
- **Transitory disinflation?** – recent price increases should reverse, weighing on inflation in 2023. Energy price increases today are likely to weigh on household incomes tomorrow.

CPI Inflation, 2019 – 2022 (% YY)



Note: Adjusted core CPI is CPI excluding energy and food and adjusted for the impact of changes in indirect taxes.

Source: ONS, Citi Research.

Conclusion: What is Policy to Do?

Policymakers face an unenviable set of trade offs combatting both high inflation and supporting protracted adjustment. We think policy should err on the side of continued support, subject to inflation expectations.

- **A different recovery -** supply is likely to be more responsive to demand than normal during the coming months.
- **Premature tightening could be particularly costly** - arresting momentum in the recovery could also risk larger permanent output loss.
- The **countervailing risk is long term inflation expectations**. The Bank must react to keep these anchored.
- With **monetary policy space also now heavily constrained,** fiscal policy will likely have to play a greater stabilisation role.
- The ecological transition may mean we have to **deal with more 'stagflationary' shocks in the years to come**

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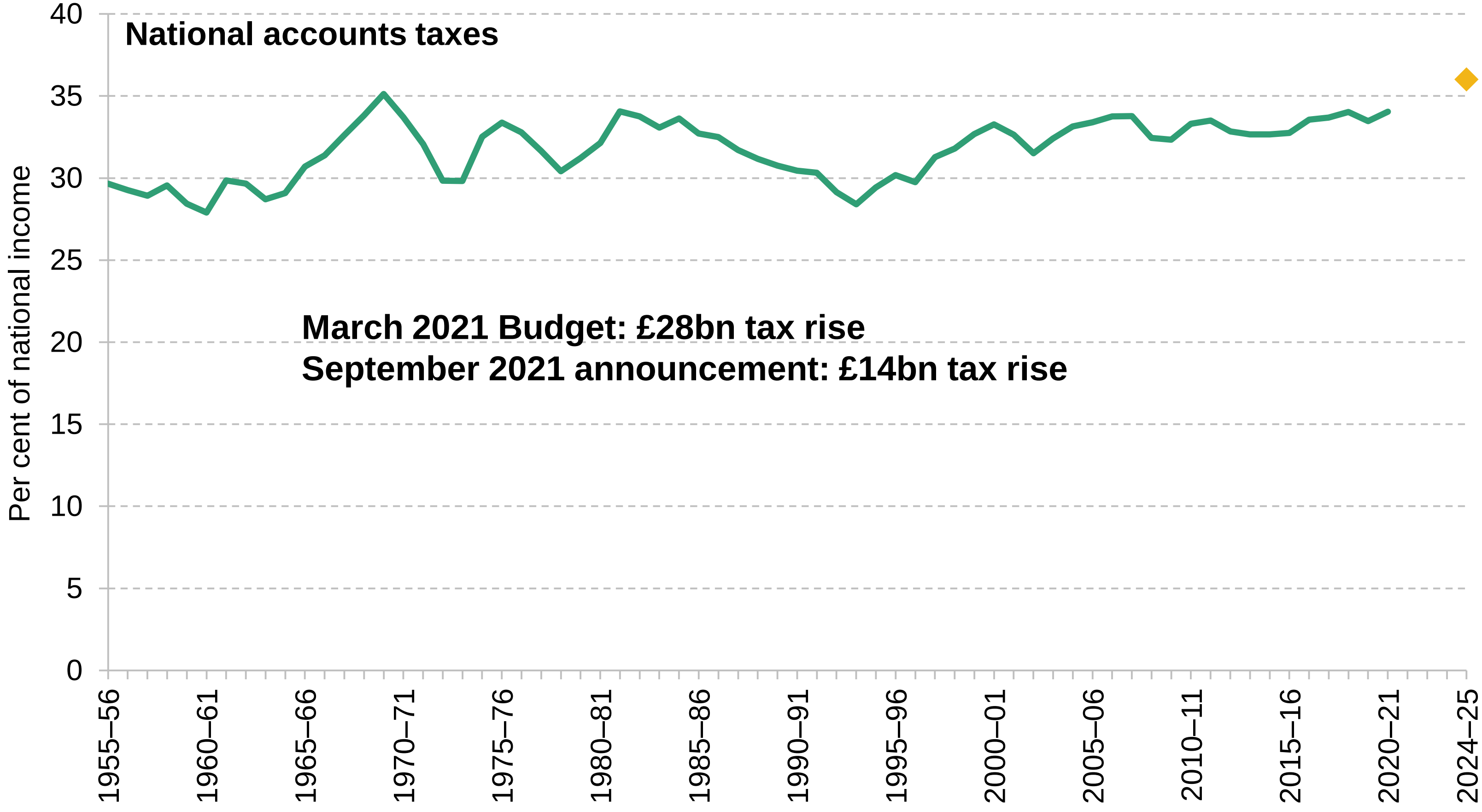
Isabel Stockton

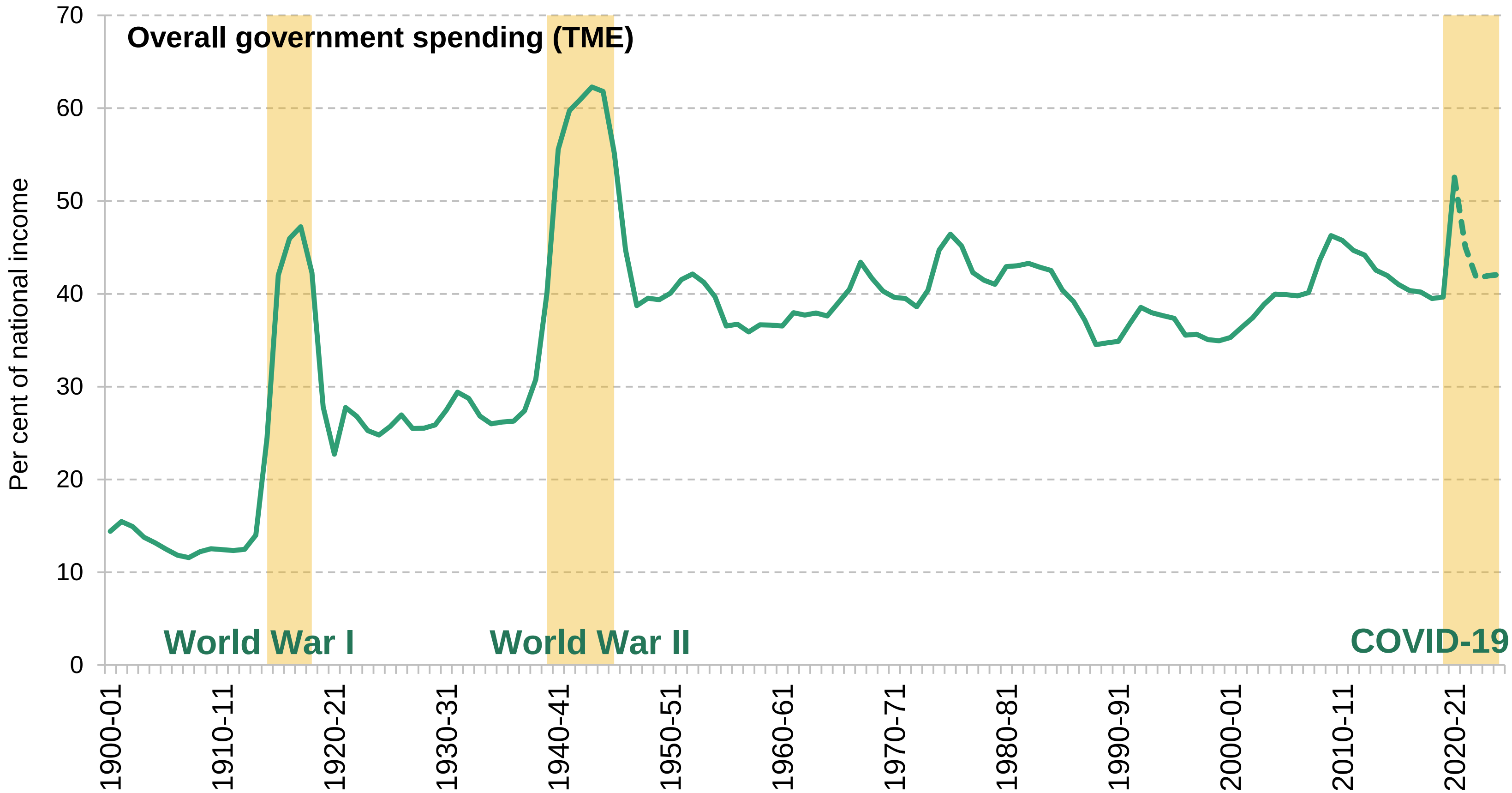
Outlook for the public finances

Taxes set to rise to 36% of national income, their highest sustained level



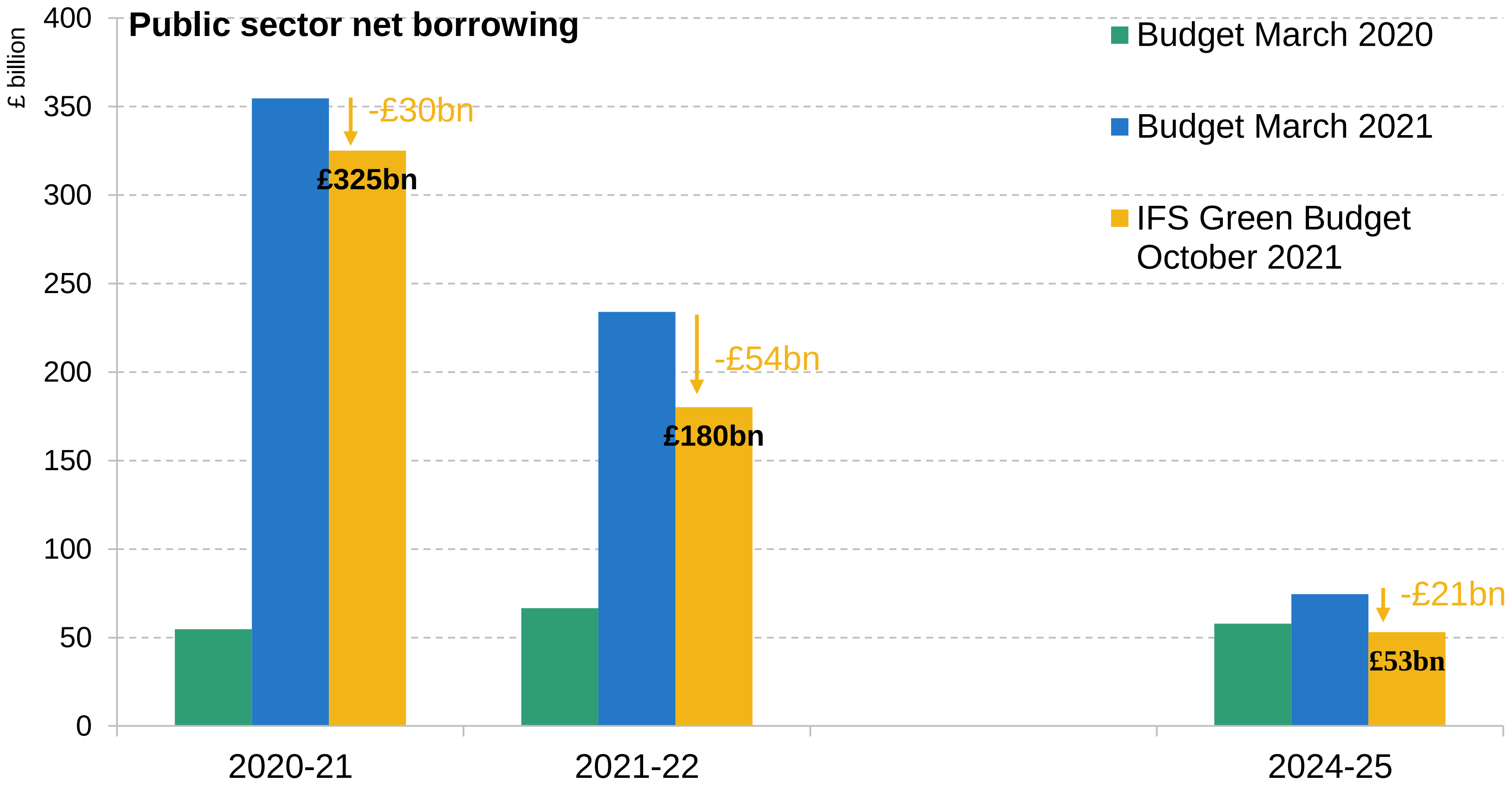
Sources: Office for Budget Responsibility, obr.uk/data; authors' calculations using IFS Green Budget 'central' scenario (Chapter 3)

The size of the state is set to grow to 42% of national income



Sources: OBR Public Sector Finance databank obr.uk/data; authors' calculations using IFS Green Budget 'central' scenario (Chapter 3)

A large reduction in borrowing since March under stated policy

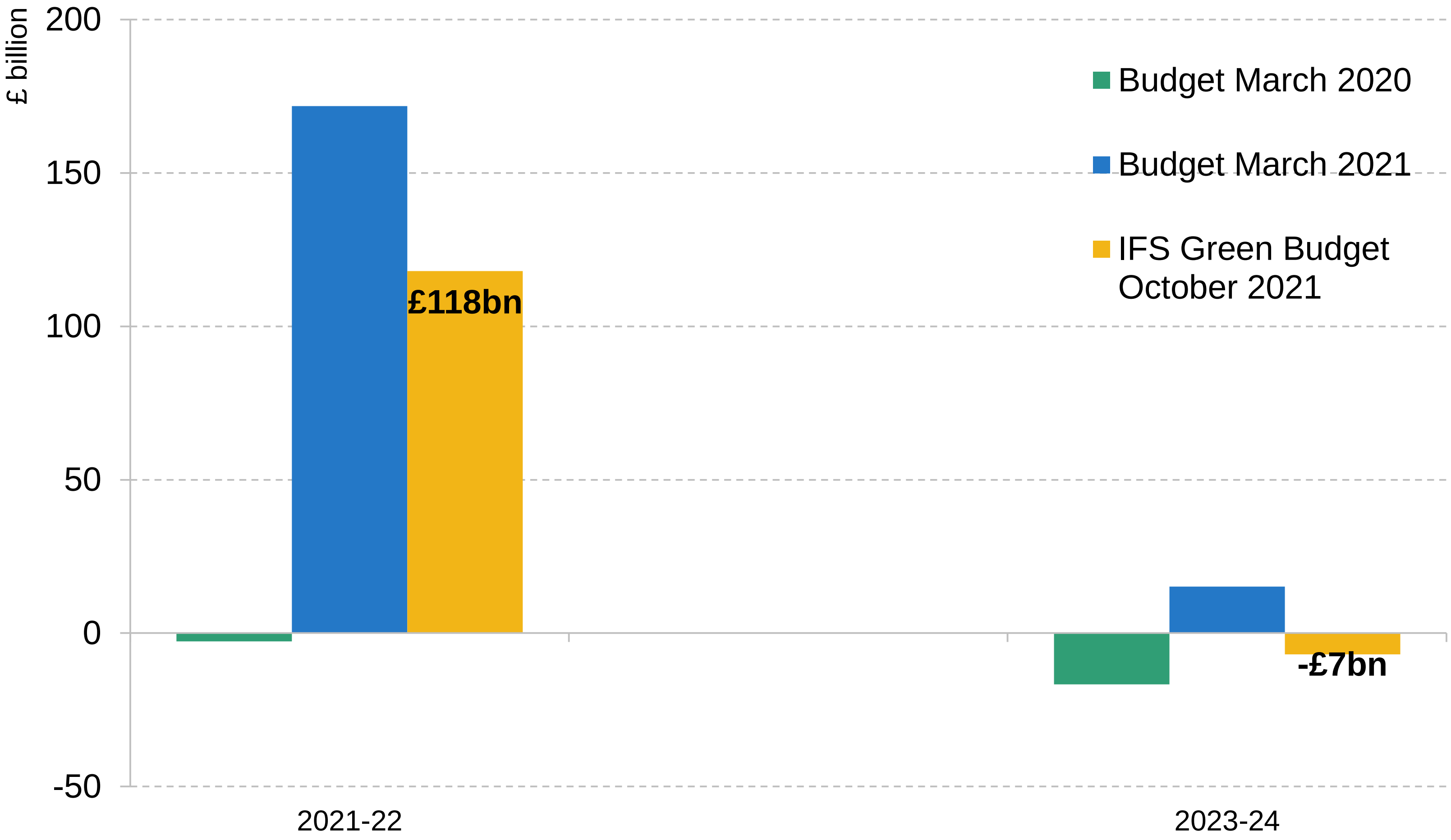


Sources: Table 3.3, IFS Green Budget 2021

Rewriting the fiscal rules

- Emerging consensus around forward-looking current budget target
  - Current budget deficit = deficit excluding investment spending
- This type of target has much to commend it
  - Allows borrowing for investment that benefits future generations
  - Allows gradual adjustment to shocks

Central scenario with current policy: current budget in surplus by 2023-24

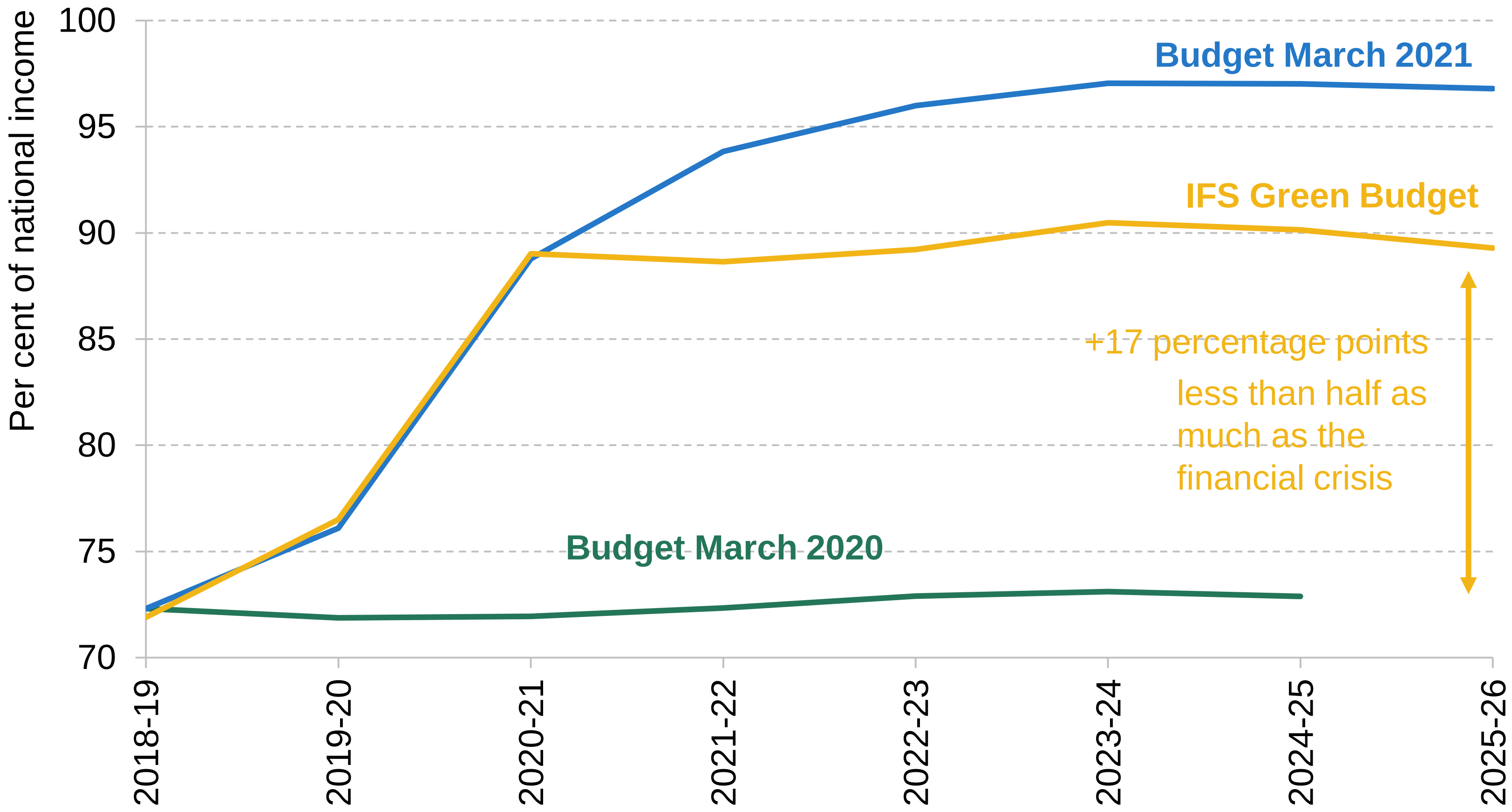


Sources: Table 3.4, IFS Green Budget 2021

Rewriting the fiscal rules

- Emerging consensus around forward-looking current budget target
  - Current budget deficit = deficit excluding investment spending
- This type of target has much to commend it
  - Allows borrowing for investments that benefit future generations
  - Allows gradual adjustment to shocks
- Case for targeting a trajectory for debt alongside this
  - Don’t lose sight of public sector assets
  - But: huge issues with measurement of public sector net worth

Tax rises enough to stabilise debt, but not put it on a clear falling path



Sources: Figure 3.5, IFS Green Budget 2021

After falling for years, debt interest spending now increasing

- Last year (2020-21), debt interest spending was *below* the pre-pandemic forecast, despite huge increase in debt
- But: yields on 30-year bonds up from 0.86% in January, to 1.13% in September
- RPI inflation up from just 1.4% in the year to January to 4.8% in the year to August → feeds through to debt interest through index-linked government bonds
- Central scenario: debt interest spending up by around £15 billion/year
- Increases in debt interest spending are (so far) more than compensated by higher revenues (£53 billion this year)

Long-run fiscal pressures have not gone away

- Ageing, health needs and the net-zero transition all putting major pressure on public finances **by 2030**:
  - Health care and adult social care: additional £28 billion
    - Health and social care levy would need to **more than double** from 1.25% to more than 3% to fund this
  - Direct fiscal impact of net-zero transition: £31 billion
- If both funded through higher borrowing, projected debt would be on a rising and accelerating path

Summary

- Borrowing this year down by over £50bn on the March forecast, but by less than £25bn thereafter
- Higher debt interest spending more than offset by greater revenues
- Planned tax rises of around £40bn sufficient to return to current budget balance and (slowly) falling debt under central forecast
- Huge uncertainty around outlook for growth and revenues
- Rising pressures on public finances from health care, social care, transition to net zero

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Ben Zaranko, IFS

Spending Review 2021:
plans, promises and predicaments

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The Chancellor faces a dilemma

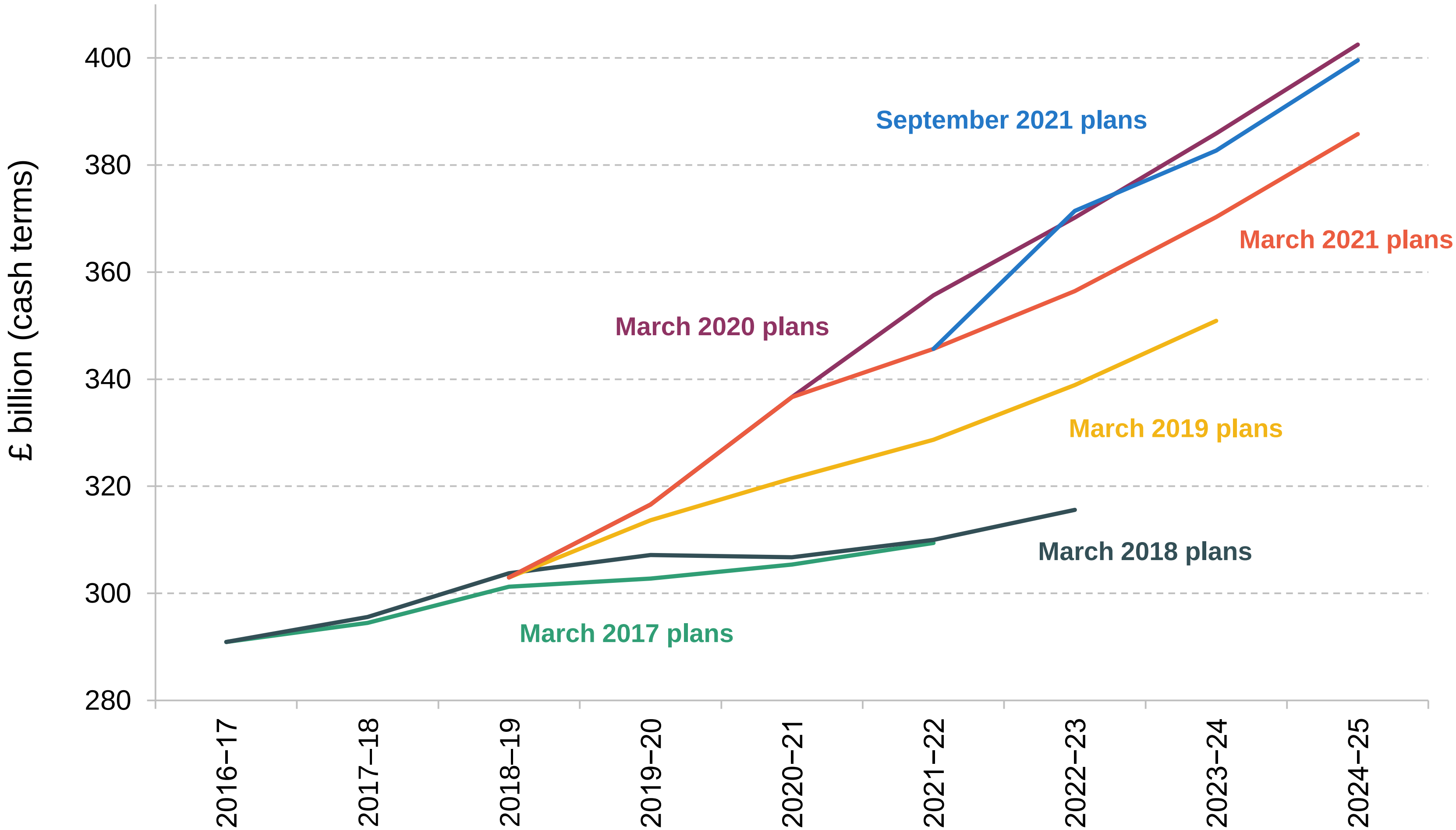
Ahead of the Spending Review on 27 October:

- March 2021 spending plans topped up by ~£14 billion per year
  - Alongside a manifesto-busting tax rise
- Overall funding for public services set to grow at a faster rate than at Labour’s 2007 Spending Review
- Rishi Sunak, a Conservative Chancellor, is set to preside over a lasting increase in the size of the state

But still he faces an unpalatable set of spending choices

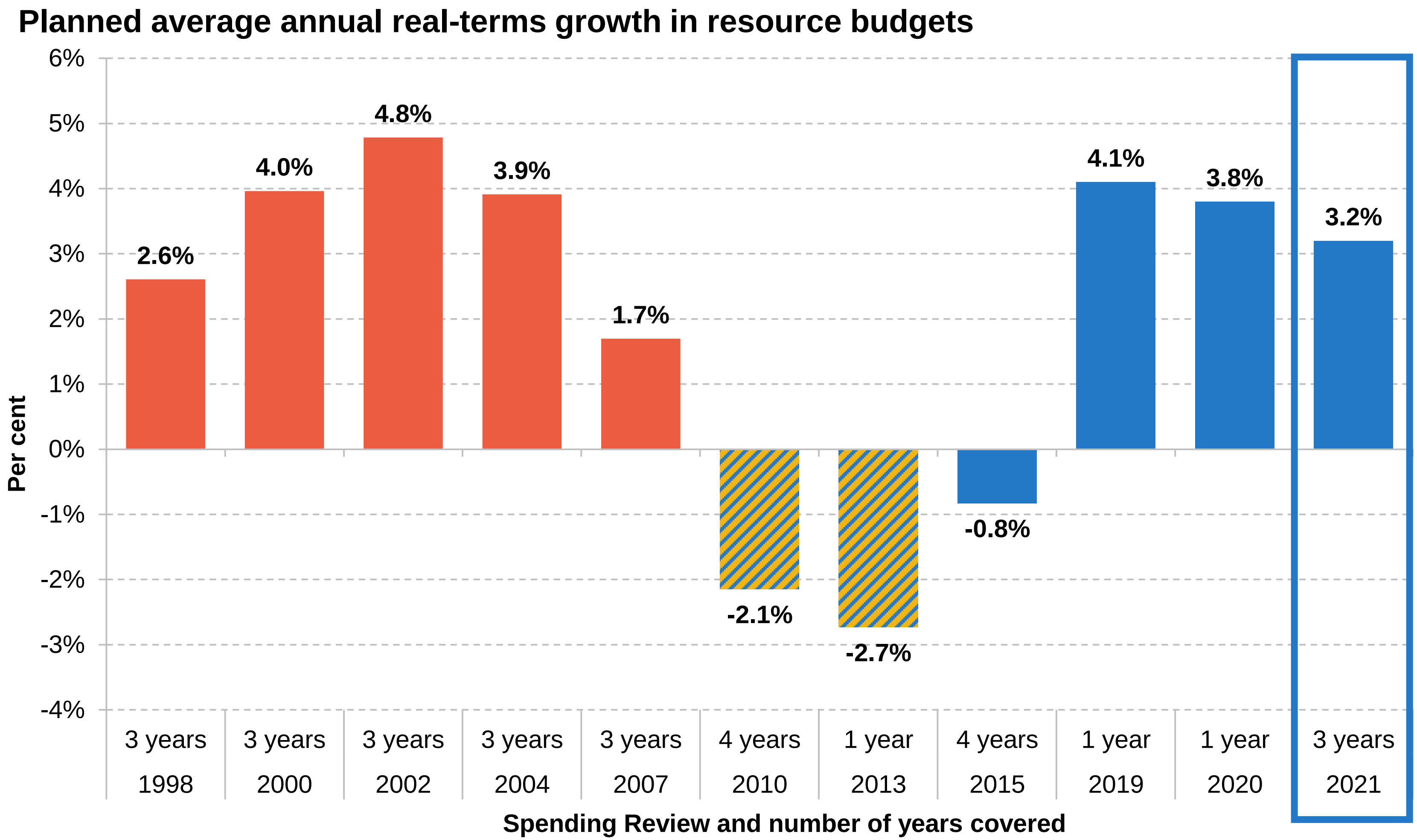
The latest top-up in context (1)

Successive plans for departmental ‘core’ resource (day-to-day) budgets



Notes and sources: see Figure 5.14 of IFS Green Budget 2021.

The latest top-up in context (2)

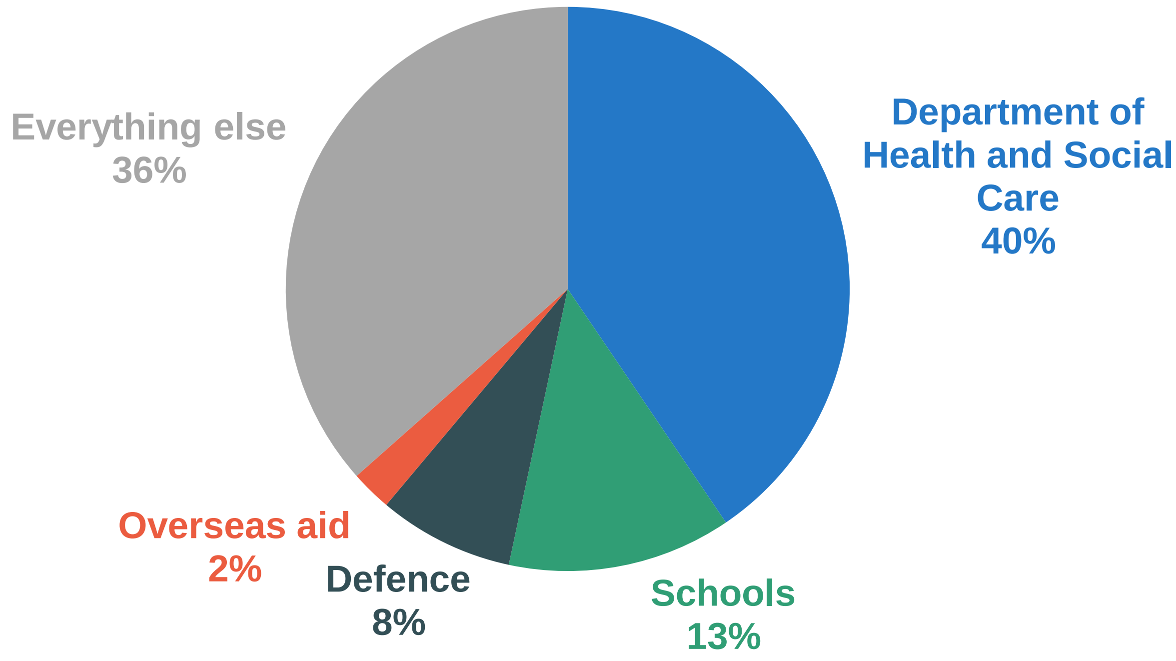


Notes and sources: see Figure 5.13 of IFS Green Budget 2021.

Spending will be rising overall – so what's the problem?

1. Existing commitments tie the Chancellor's hands

Share (%) of total planned departmental resource spending in 2022−23

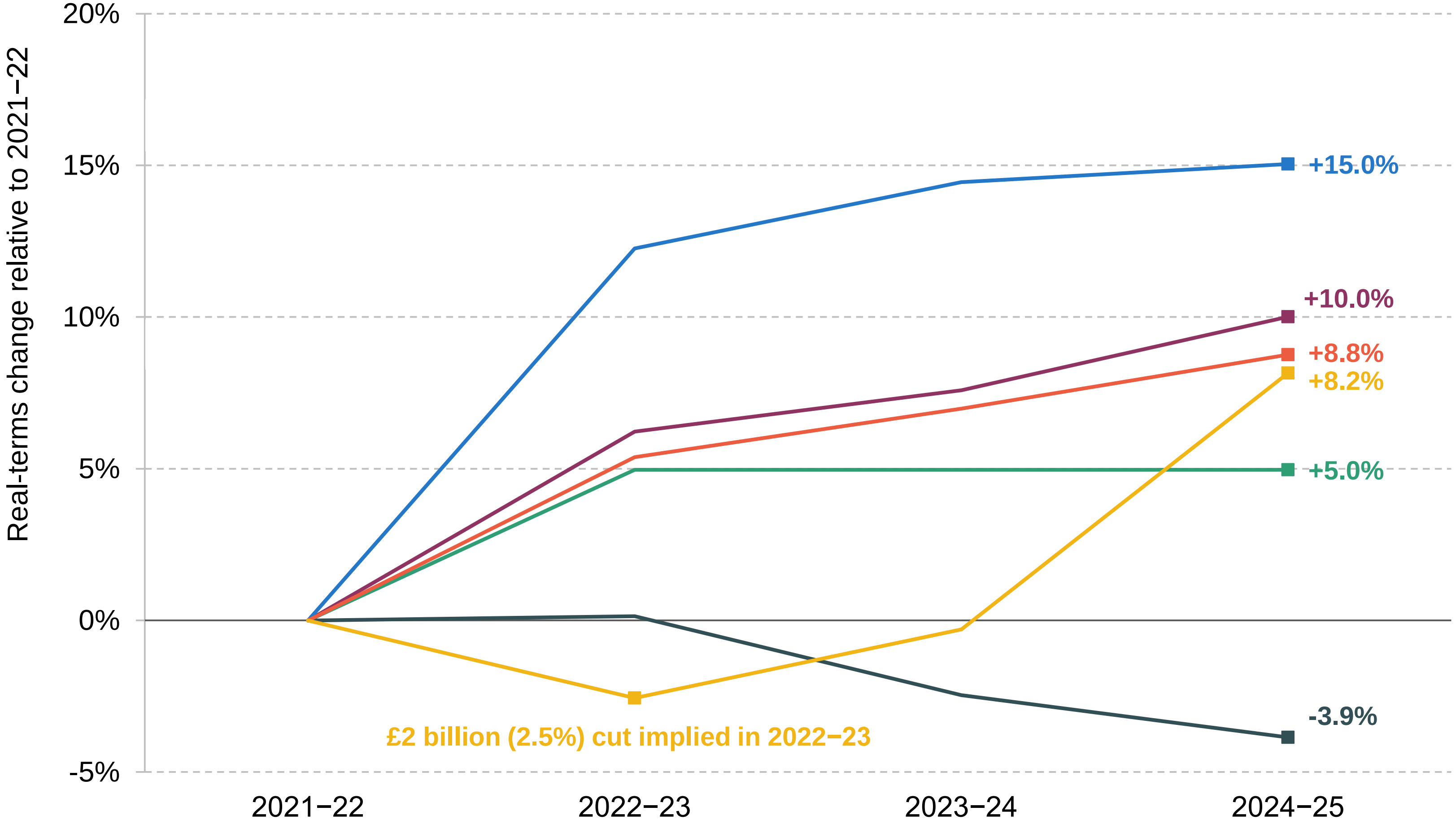


Almost two-thirds of the pot has already been pre-allocated

- Remaining 'unprotected' budgets face a squeeze

The next two years look especially tricky

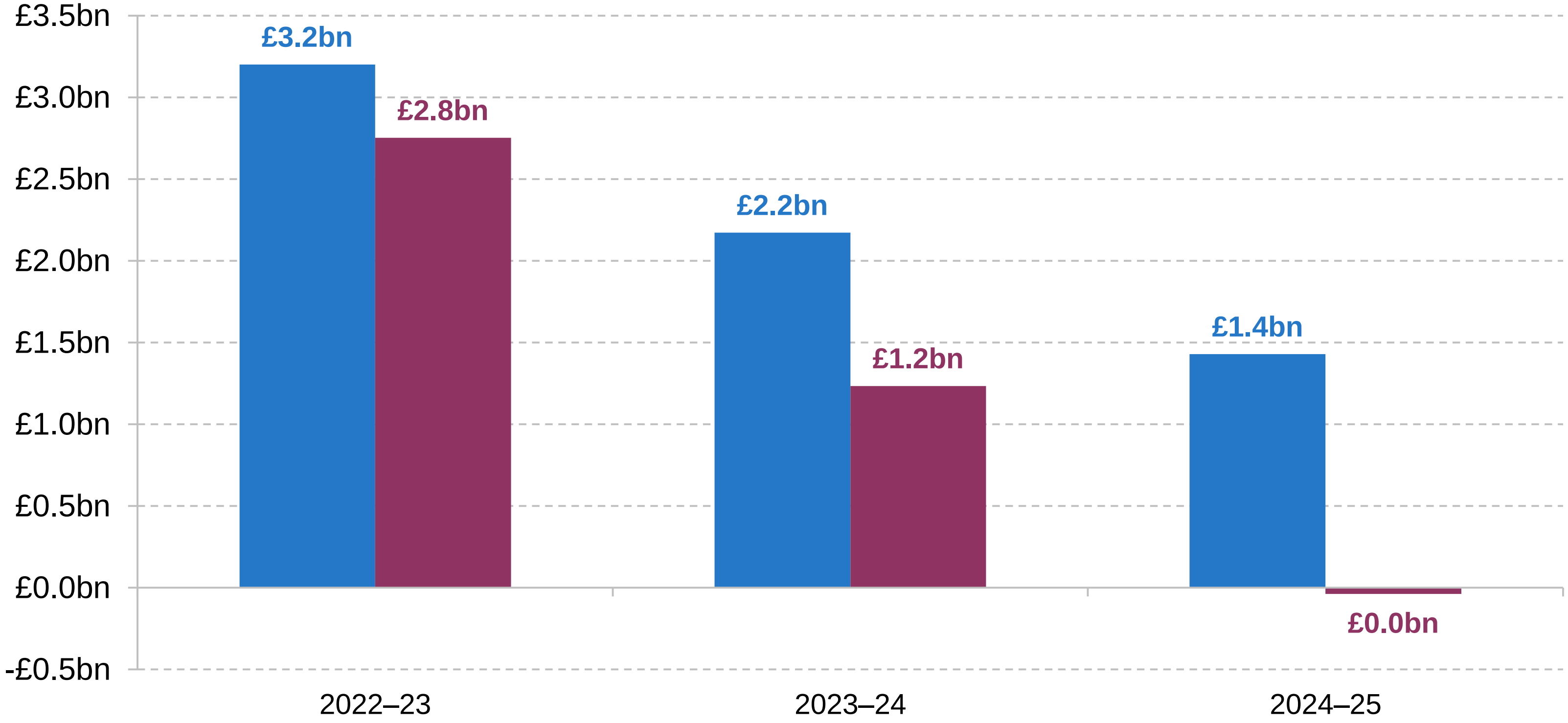
Projected real-terms change in day-to-day public service funding, by area



Notes and sources: see Figure 5.16 of IFS Green Budget 2021.

Those plans imply a tough SR period for (among other areas) local government

Projected funding gap for English councils under latest spending plans



Notes and sources: see Table 7.2 and Online Spreadsheet Appendix to Chapter 7 of IFS Green Budget 2021. Assumes that grants to local government grow in line with the average ‘unprotected’ budget.

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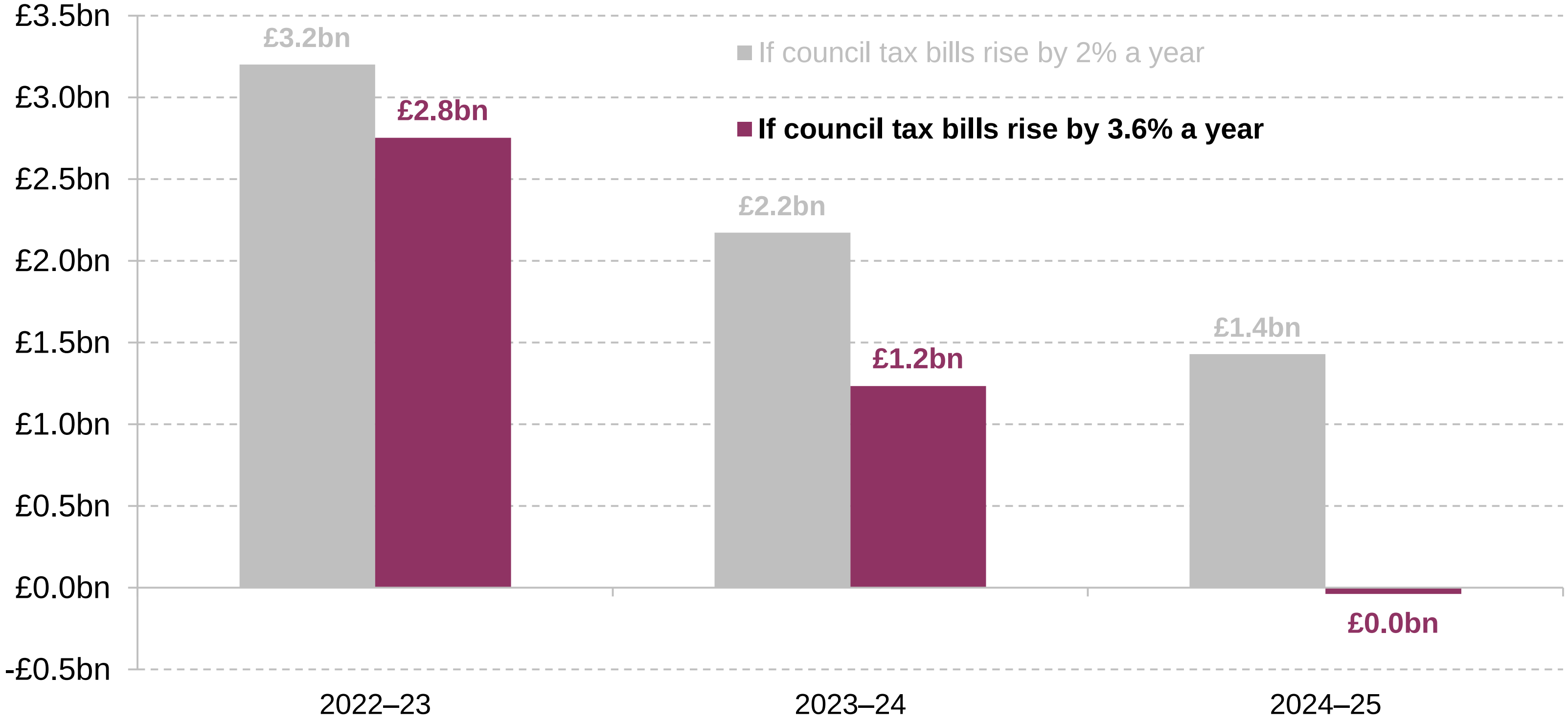


Notes and sources: see Table 7.2 and Online Spreadsheet Appendix to Chapter 7 of IFS Green Budget 2021. Assumes that grants to local government grow in line with the average ‘unprotected’ budget.

Council tax increases of 3.6% p.a. needed just to maintain pre-COVID service provision in 2024−25 (and still not enough in the near-term)

Spending will be rising overall – so what’s the problem?

1. **Existing commitments tie the Chancellor’s hands**
   - NHS, schools, defence, overseas aid
   - Almost two-thirds of the pot already pre-allocated
   - Remaining ‘unprotected’ budgets face a squeeze

2. **Scale of the government’s broader ambitions**
   - Net zero, levelling up, social care reform: all could cost billions

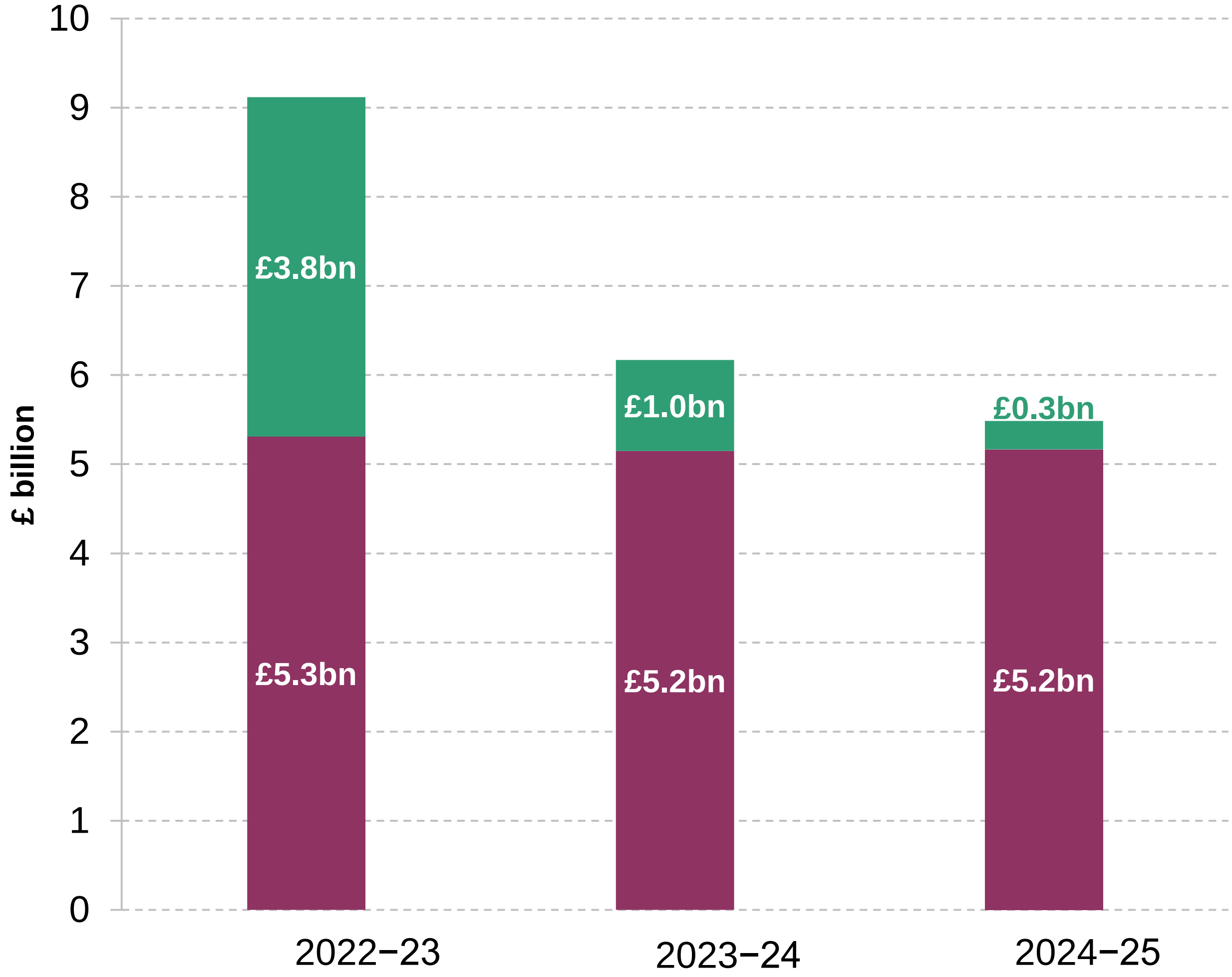
Spending will be rising overall – so what's the problem?

1. **Existing commitments tie the Chancellor's hands**
   - NHS, schools, defence, overseas aid
   - Almost two-thirds of the pot already pre-allocated
   - Remaining 'unprotected' budgets face a squeeze

2. **Scale of the government's broader ambitions**
   - Net zero, levelling up, social care reform: all could cost billions

3. **COVID-19 likely to leave a legacy of funding pressures**
   - 7 September 'almost Budget' provided funding for NHS COVID recovery – but made no allowance for pressures elsewhere

Our central estimates of COVID-related pressures on the NHS



Notes and sources: see Figure 6.24 of IFS Green Budget 2021.

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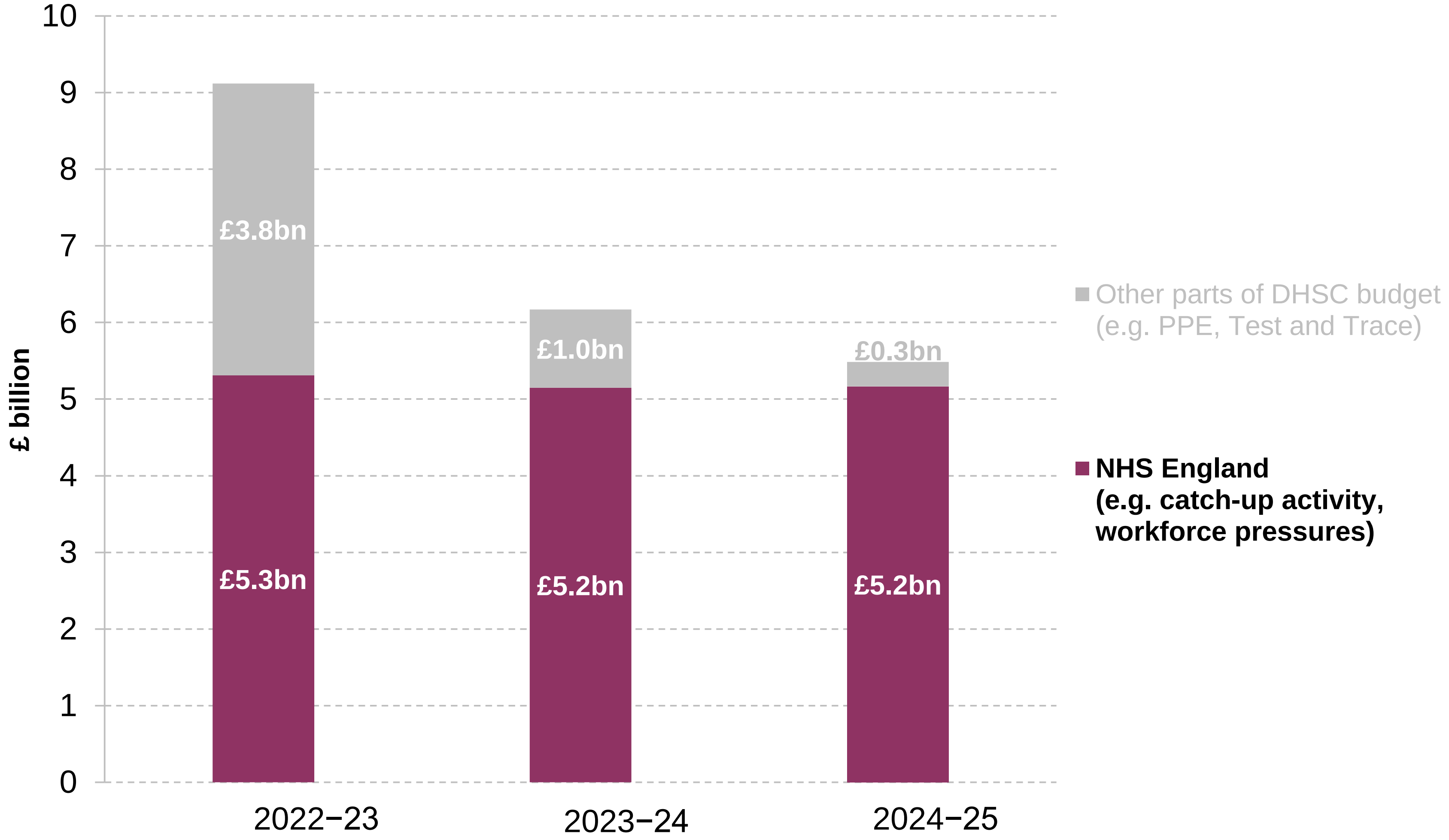
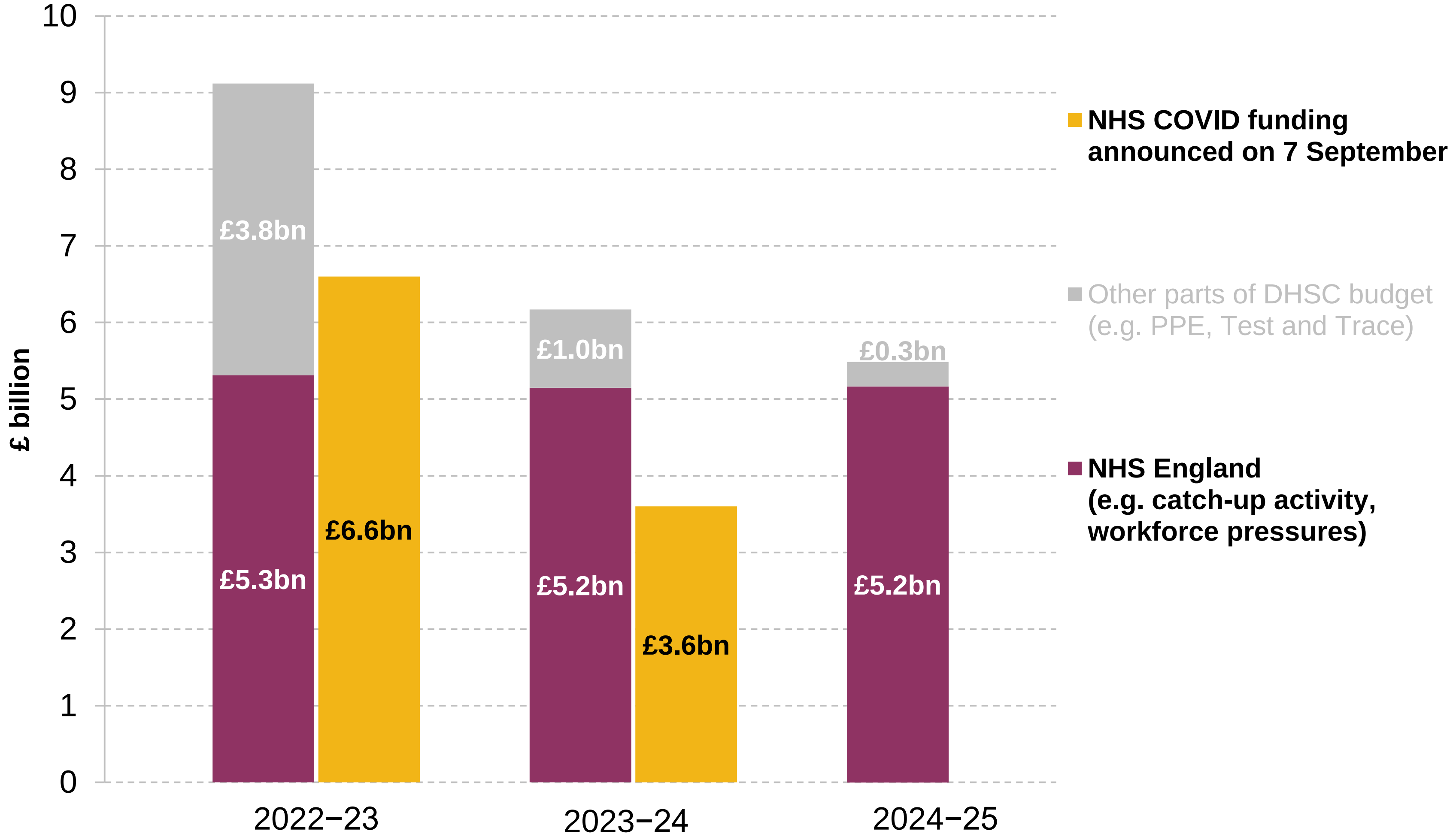


Notes and sources: see Figure 6.24 of IFS Green Budget 2021.

How does this compare to recently announced funding?



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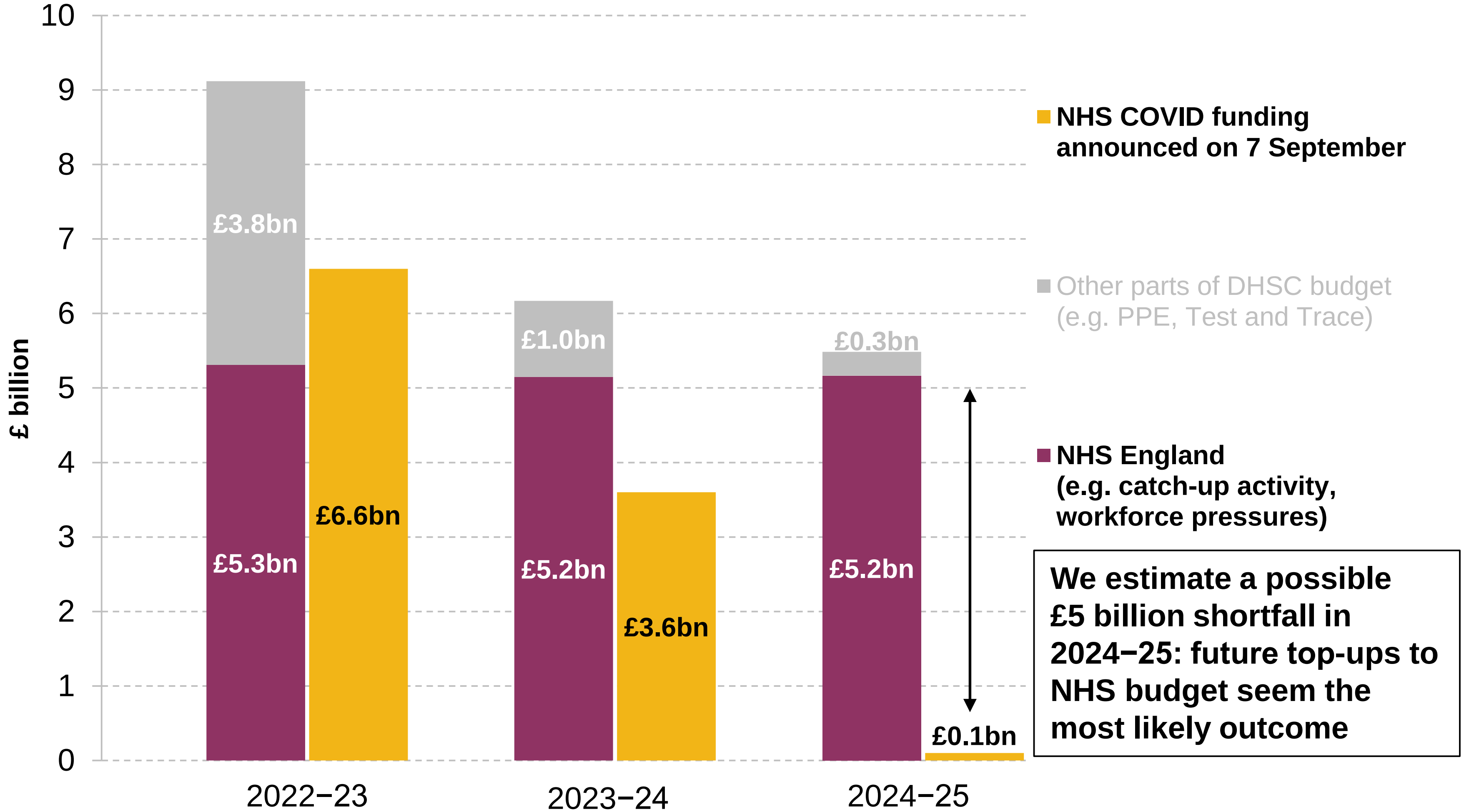
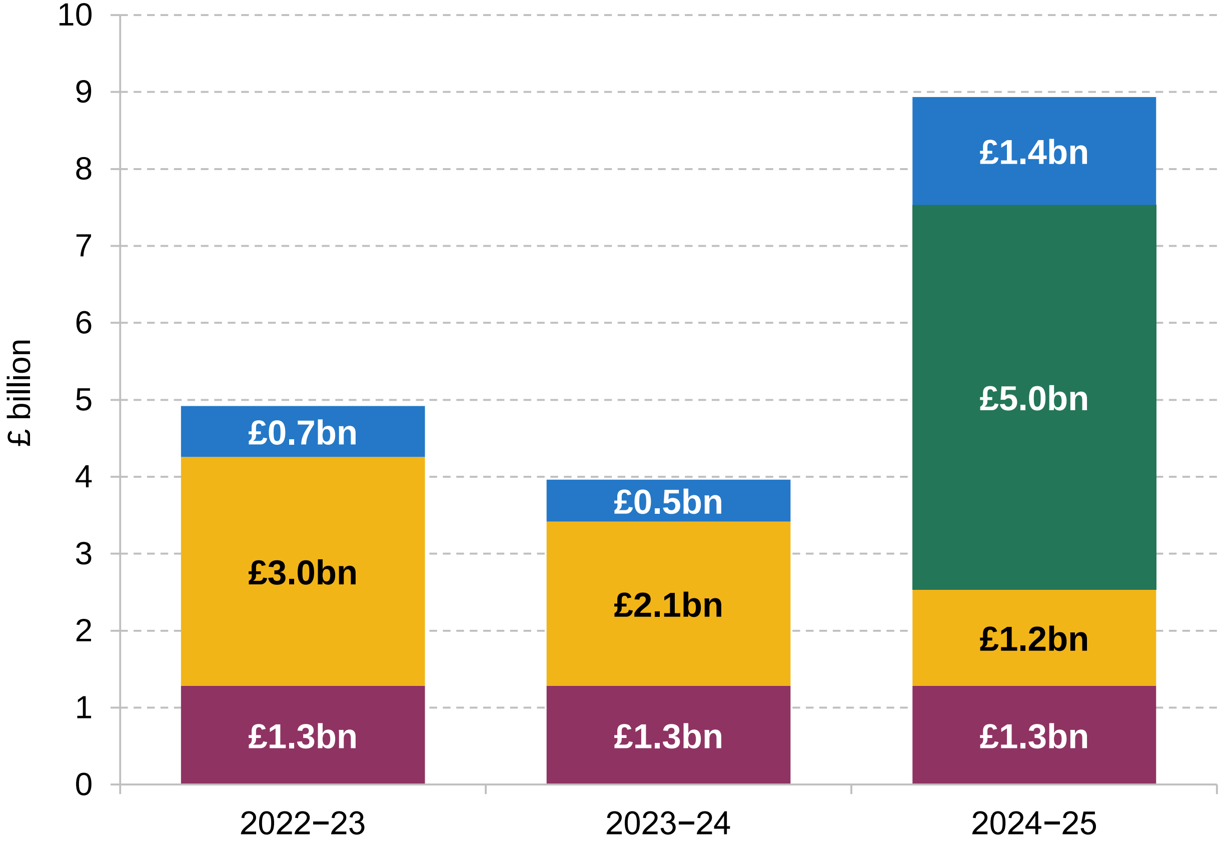


Notes and sources: see Figure 6.24 of IFS Green Budget 2021.

COVID-19 will leave a legacy beyond the NHS

Estimates of selected unfunded pandemic-related spending pressures



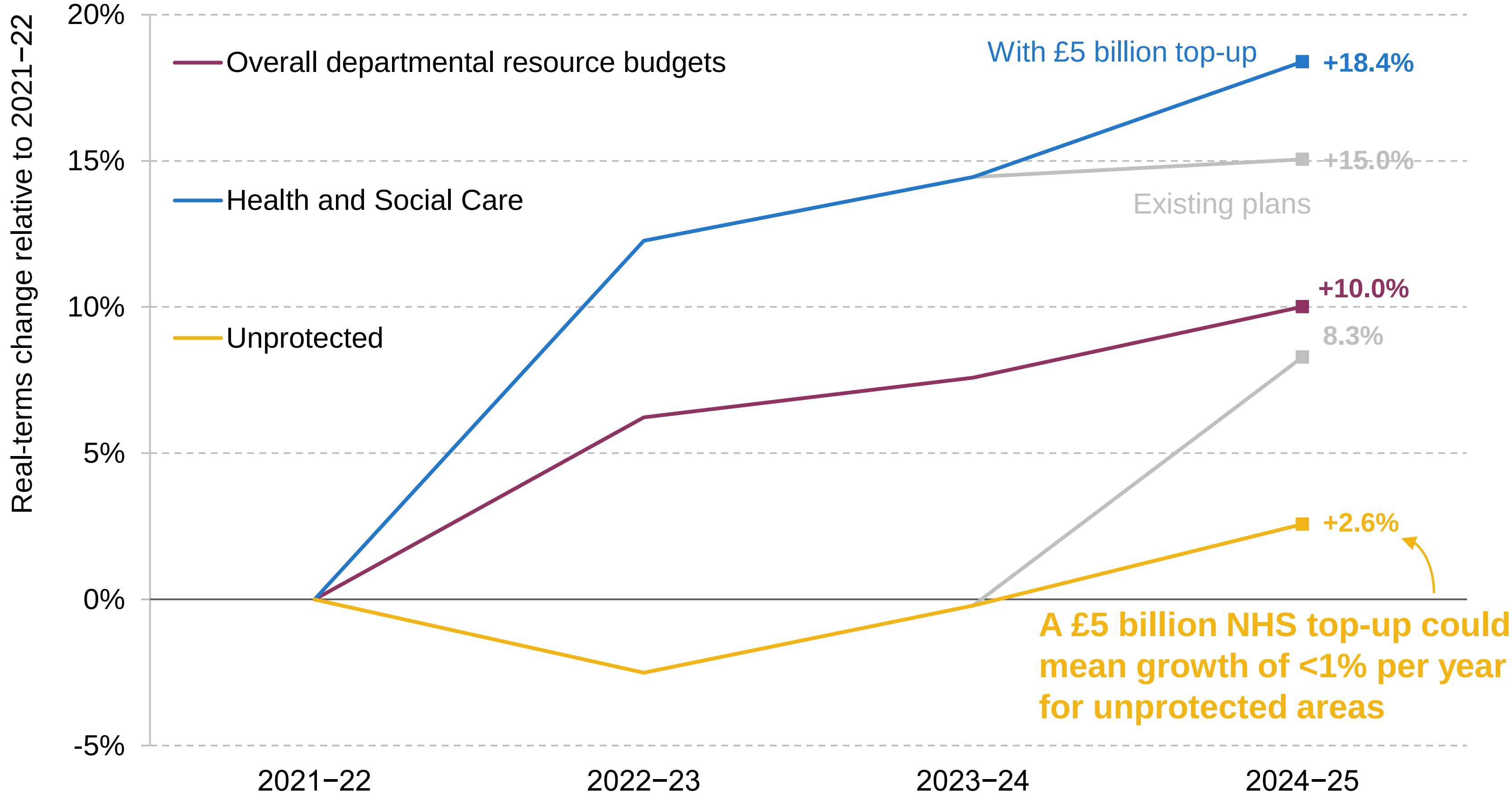
Notes and sources: see Figure 5.10 of IFS Green Budget 2021.

What does all this mean for SR 2021?

- **Overall public service spending set to grow over next three years**
  - No return to full-throated austerity
- **But ‘unprotected’ budgets face real-terms cut over next two years**
  - Includes: local government, further education, prisons, courts
- **Plans imply more funding for ‘unprotected’ budgets in medium term**
  - But will that funding actually materialise?
  - Could easily be eaten up by top-ups or COVID spending elsewhere
  - For instance: what if we’re right and NHS gets a £5bn top-up?

A difficult two years for 'unprotected' areas could very easily become a difficult three

Projected real-terms change in day-to-day public service funding, by area, assuming a £5 billion NHS top-up in 2024−25



Notes and sources: see Figure 5.16 of IFS Green Budget 2021.

Final thoughts

Some big decisions already made, but important choices remain

- Public sector pay policy: an end to the freeze?
  - Many public sector roles pay considerably less than in the past
- Net zero, levelling up, social care: will the funding match the rhetoric?

Big picture: health spend taking up ever-increasing % of the total

- 44% of overall public service spending by 2024−25, up from 42% in 2019−20, 32% in 2009−10 and 27% in 1999−2000
  - Decisions over NHS funding increasingly drive not just the funding outlook for other departments, but also overall fiscal policy

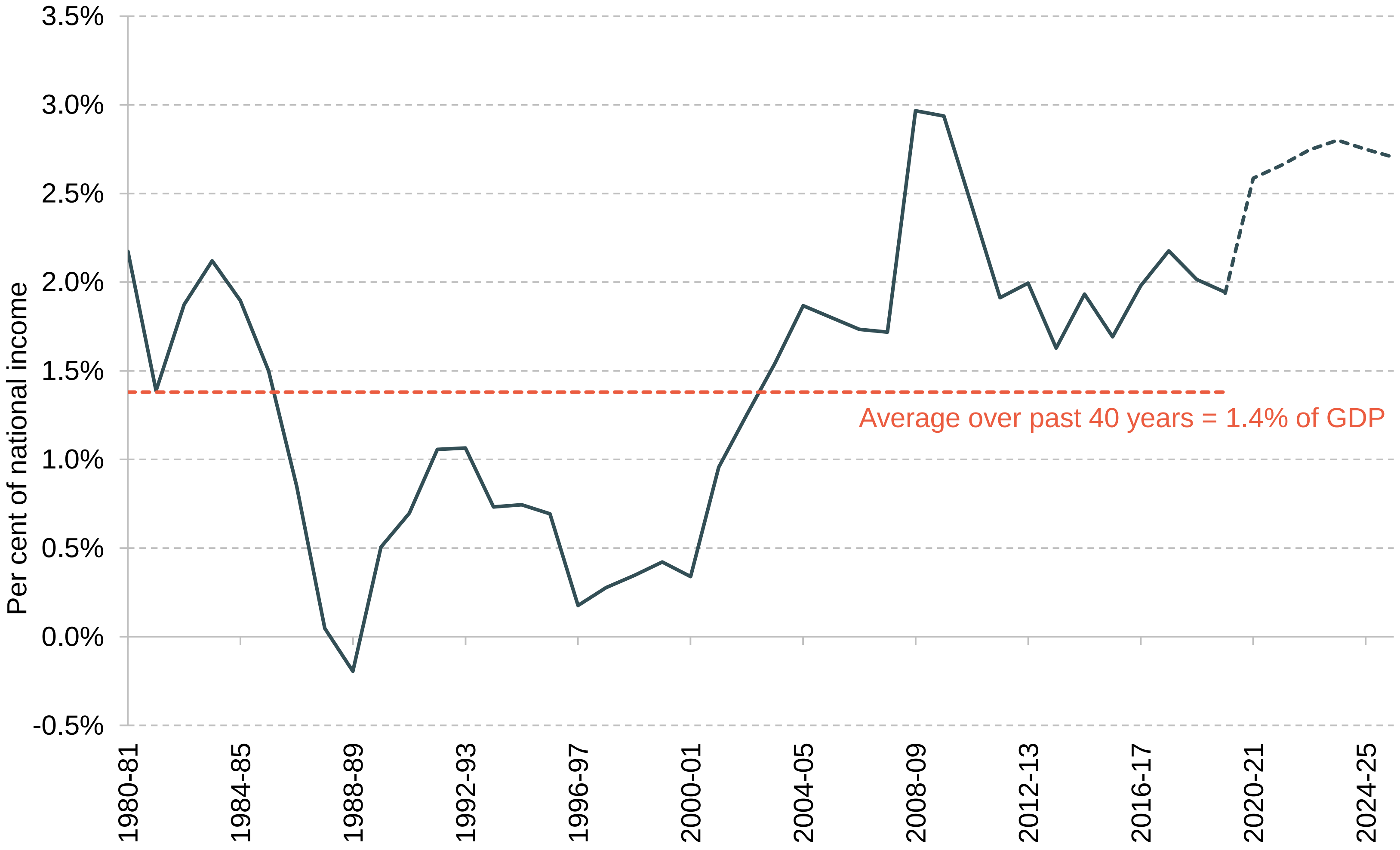
As demographic spending pressures continue to grow, it is likely that so too will the size of the state

The Institute for Fiscal Studies
7 Ridgmount Street
London
WC1E 7AE

www.ifs.org.uk

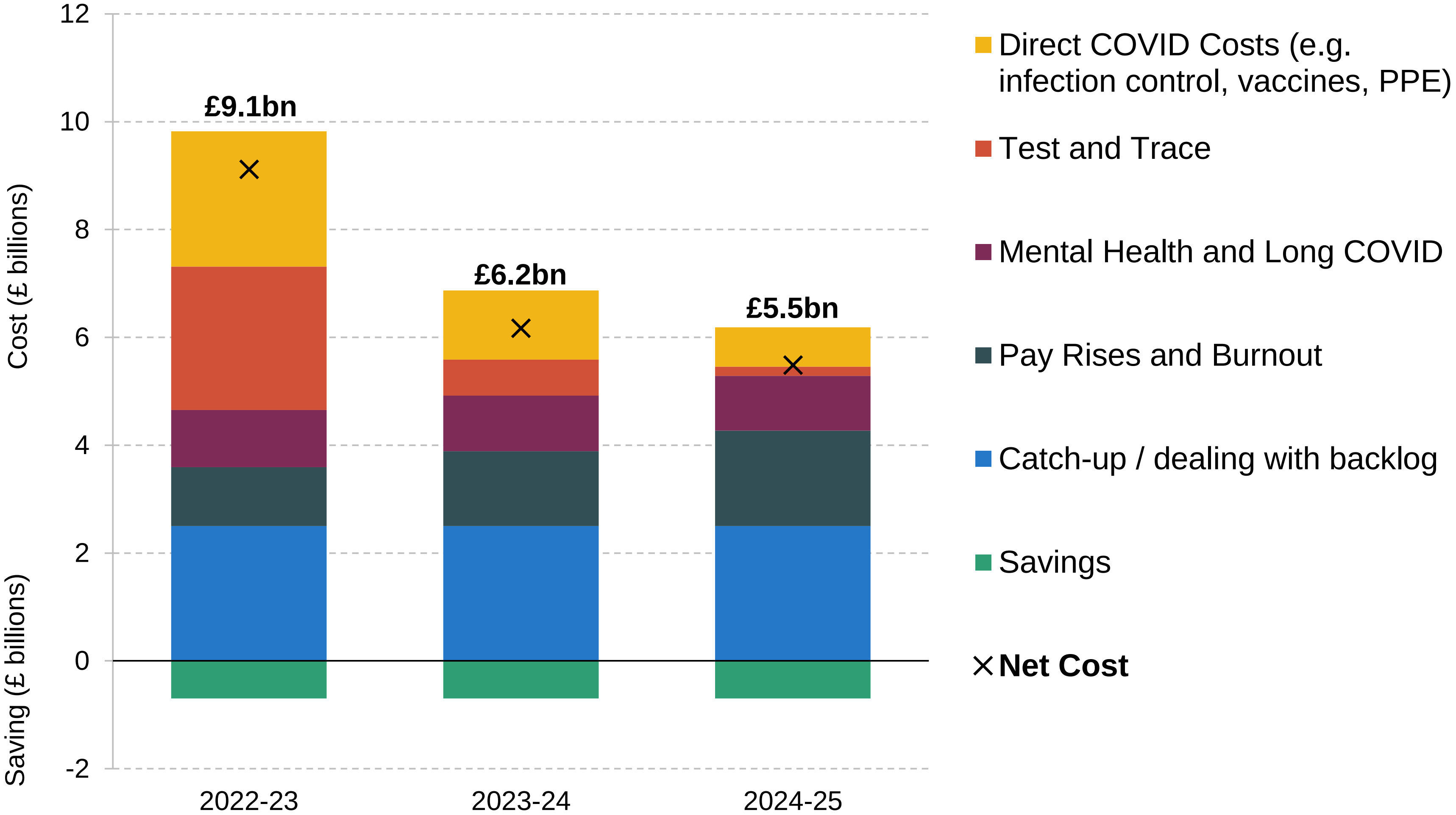
Government investment set to rise

Public sector net investment as % national income



Source: OBR.

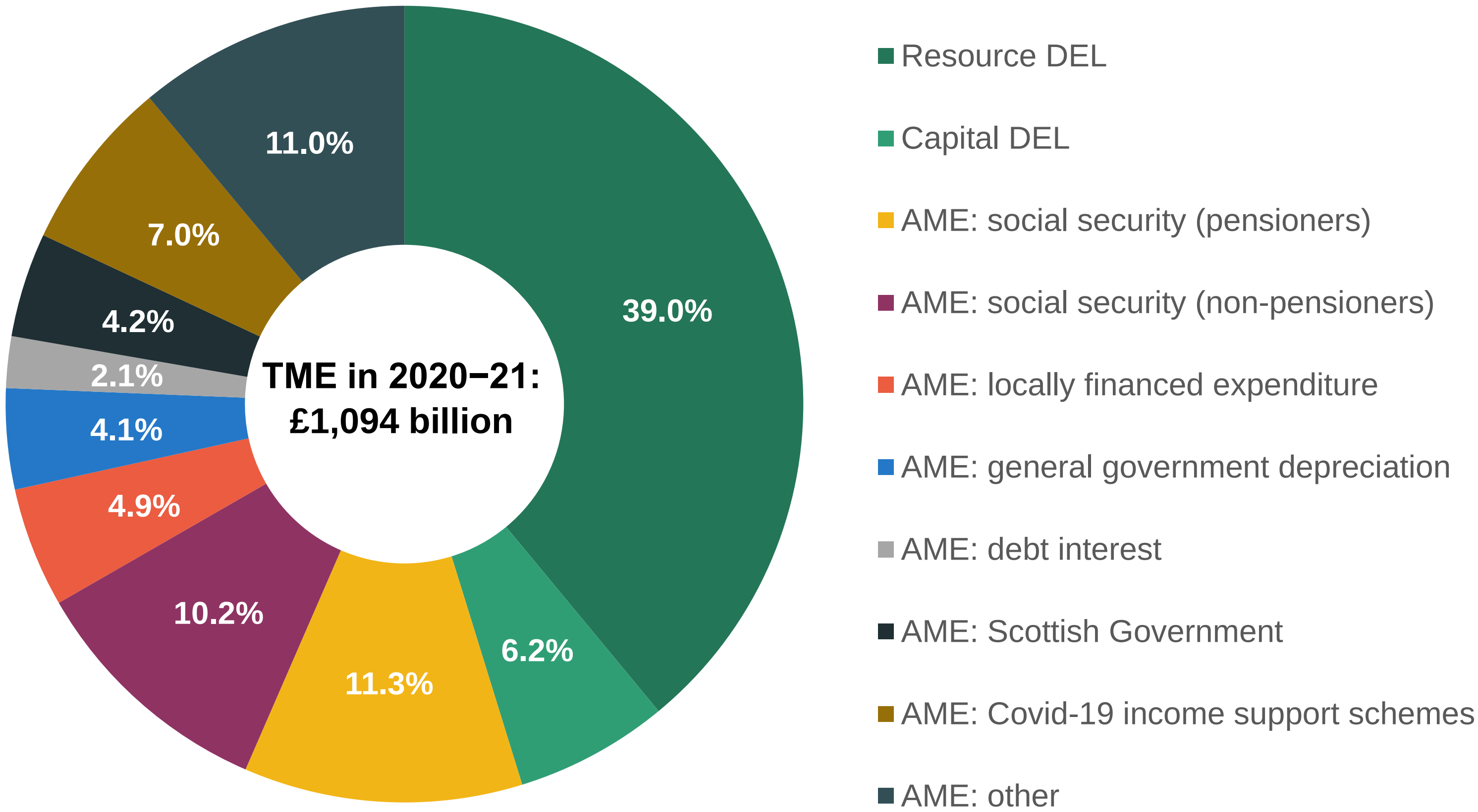
Our central estimates of COVID-related pressures on the NHS



Notes and sources: see Figure 6.24 of IFS Green Budget 2021.

Spending Review 101

Components of Total Managed Expenditure (TME) in 2020−21



A decade of cuts for most departments

IFS

Percentage change in day-to-day departmental budgets, 2009−10 to 2021−22 (excl. virus-related spend)