NATIONAL NEWS

Bad news forecast for embattled chancellor

Number crunching

An FT study of the OBR's equations suggests its public finance predictions will be gloomy, writes **Chris Giles**

Economic forecasting models are extremely large and complex beasts. But their most important results rely on a small number of crucial judgments taken by humans – not on complex equations and huge arrays of computed data.

The Office for Budget Responsibility has broken the mould over the past two years by revealing this mundane truth and encouraging outsiders to replicate its judgments.

Its willingness to publish methods sometimes lays the fiscal watchdog open to criticism, but has enhanced the understanding of fiscal forecasts and the difficult judgments they involve.

For the second year, the Financial Times has replicated and updated the core elements of the OBR's model as it prepares to deliver its latest outlook for public finances to the Treasury before George Osborne's December 5 Autumn Statement. The FT's findings suggest – just as last year – that the forecast will bring another stack of bad news for the chancellor.

The starting point for most economic forecasts is an estimate of spare capacity. Even though it is impossible to have much confidence in any estimate of spare capacity, they determine the speed of any recovery in a forecasting model. If lots of spare capacity is assumed, the future will be bright. But if there is little left, growth is likely to be slower.

Since 2011, the OBR has published the equations underpinning its techniques to estimate spare capacity, and the FT has replicated and updated the work.

A purely mechanical extrapolation of the spare capacity indicators for the second quarter of 2012 spells bad news for the chancellor, showing little increase in the room to grow, even though the economy has tanked this year.

But there are good reasons why the OBR might make a judgment not to take its methodology on spare capacity at face value.

Economists such as Richard Barwell of Royal Bank of Scotland, who has undertaken a study of the cyclical indicators underpinning the OBR's methods, is disparaging of their forecasting power. "I would be a little wary of basing a critical component of my model on these really bad indicators, which give obviously misleading answers," he said.

Even more worrying for the OBR is that one of the main causes of the weak spare capacity result in its model rests on a tiny assumption that links the final answer to work done by the Organisation for Economic Co-operation and Development. Changes to the OECD's own output gap assumptions since March have made the outlook even worse for the chancellor if the OBR were to adopt it at face value.

Robert Chote, who chairs the OBR, reserves the right not to follow his published results mechanically.

If the OBR's judgment on spare capacity is not likely to be as bad as it could be for the chancellor, the second and third big calls they need to make are more problematic.

With economic growth so feeble, the OBR showed itself last year to be wary of assuming that growth potential can bounce back immediately in future. Mr Chote takes a similar view this year, the OBR will again limit scope for rapid catch-up growth. The Bank of England implicitly made the same call in August, so there is a good chance the OBR will follow suit.

The third key judgment is whether the OBR will seek to correct a common error made by forecasters recently of overestimating growth of nominal output. With the cash size of the economy growing slower than expected, tax revenues, which are strongly linked to this measure, have been disappointing.

The OBR's existing nominal forecast for gross domestic product is pretty bullish, and this is an obvious area where the human touch on the numbers – to make future assumption more like this year – is likely to make life difficult for the coalition.

Put these three crucial judgments together – Mr Osborne getting the benefit of the doubt on spare capacity, but being hit by an assumption of lower potential growth and slower nominal GDP growth – and the forecasts for the public finances will be much weaker than in March.

> Only using pretty extreme judgments would things look OK for Mr Osborne

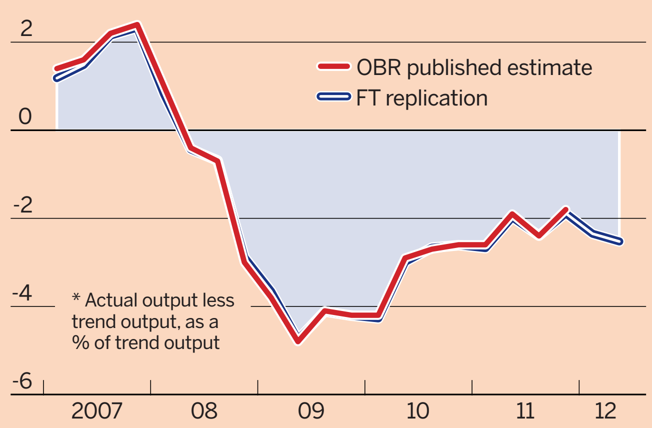
Even with conservative changes, the chancellor was already sailing so close to the wind that he would probably miss his previous ambition to eliminate the current structural deficit by 2016-17, and the date by which the debt burden begins to fall slips one and possibly two years.

Only using pretty extreme judgments would things look OK for Mr Osborne in the OBR's modelling framework. Unfortunately for him, the OBR has an independent reputation to defend, so that outcome is not at all likely.

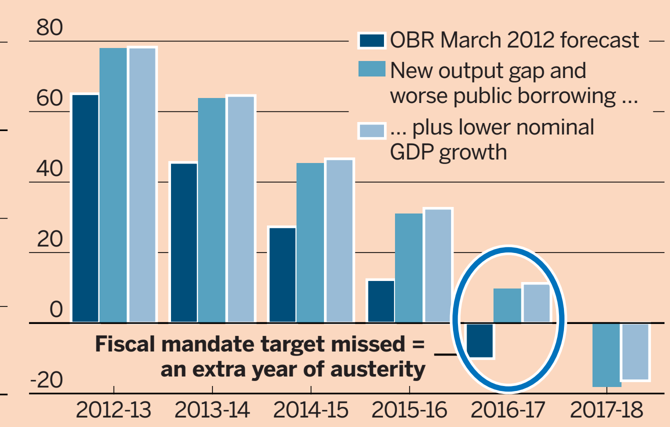
Warning signs

Unions lead protests against public sector spending cuts last year Getty

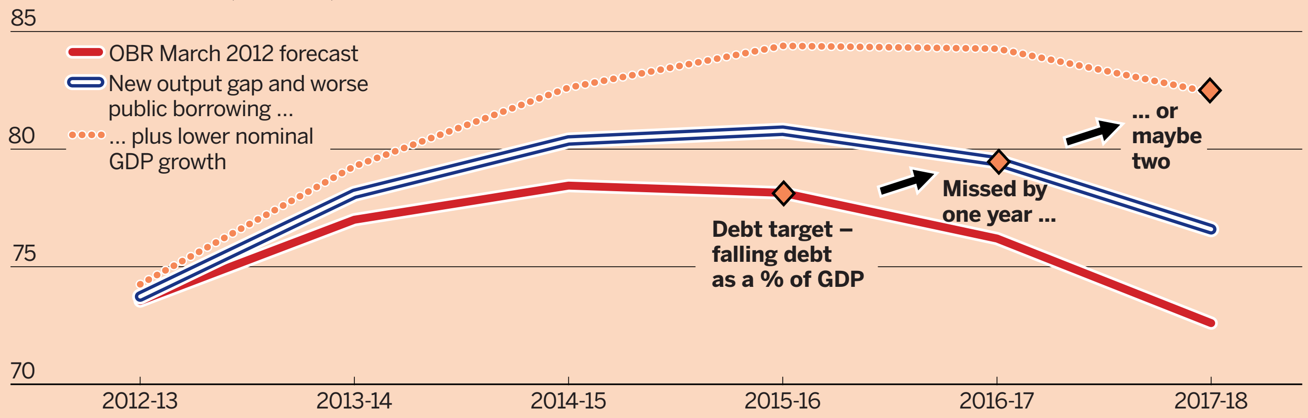
The FT has replicated the OBR's methodology ...
Aggregate composite estimates of the output gap* (%)



... implying the books will not balance in 2016-17 as hoped
Current structural deficit (£bn)



The debt target might take up to two years longer to achieve
Public sector net debt (% of GDP)



Source: OBR, FT calculations

FT Graphic

Manufacturing

EEF calls for greater focus on growth

Manufacturers are keener on seeing new growth-boosting measures by the coalition than on reducing the fiscal deficit, according to a survey by the EEF industry federation, writes **Brian Groom.**

Four-fifths of companies said they wanted further steps to strengthen growth, ahead of the speech by George Osborne, the chancellor, to the Conservative party conference today.

A little more than a quarter still saw reducing the structural deficit as a top priority, the survey of 369 manufacturers found.

The EEF said that while business still saw fiscal credibility as vital, there was a growing realisation that sustainable progress in reducing the deficit would only be made if there were a strategy to deliver stronger growth.

Terry Scuoler, chief executive, said: "Manufacturers have always supported the need to reduce the deficit and get the public finances back in order. However, this was conditional on government also committing to delivering on the plan for growth."

There had been promising announcements on infrastructure, access to finance and regulation, he said, but "government has yet to demonstrate to business that it has the same clarity and laser-like focus on growth across departments that it has on reducing the deficit".

A separate survey of 1,000 engineers by Matchtech, a recruitment company, found 53 per cent had lost confidence in government policy towards the industry.

Cameron vows press will not face 'heavy-handed' state intervention

By Helen Warrell

David Cameron has confirmed he will stand by his previous vow to implement the Leveson inquiry's recommendations but promised there will be no "heavy-handed state intervention" of the press following the phone-hacking scandal.

The prime minister was questioned about his plans for action after the inquiry after more than 50 phone-hacking victims, including Hugh Grant, Charlotte Church and Jude Law, signed a letter urging him not to merely uphold the existing self-regulation structure or try to give this route "another chance".

In the letter – published by The Observer newspaper yesterday – the victims said they were "alarmed and distressed" at press reports that senior ministers had already decided to reject calls for statutory intervention.

But Mr Cameron told the BBC's Andrew Marr that he would "absolutely" abide by Lord Justice Leveson's suggestions on media standards and ethics when they are unveiled in November, providing they were not, in Mr Marr's words, "bonkers".

"The status quo is not an option," the prime minister said. "We've got to have a regulatory system that works for . . . ordinary people who get caught up in this world and treated very, very badly. How do you get this balance right? We don't want heavy-handed state intervention."

Mr Grant, who had appeared earlier on the same TV programme, laid out his vision of a reasonable regulatory system that would need just a "tiny dab of statute" to give it teeth.

Hugh Grant: 'tiny dab of statute' required

Charlotte Church: victim of phone hacking

"There is no one who has any intention of the state regulating the content of newspapers," the actor said. "All that may come out of Leveson is a suggestion for instead of the press regulating themselves – this system which has proven over 50 years again and again to have failed – for there to be an independent regulator, independent of the newspaper industry but also, crucially, independent of government."

Mr Grant said that without proper statutory intervention, there was a danger that newspaper editors would simply ignore a new regulator.

Although the majority of the press is deeply opposed to statutory regulation, there is a widespread expectation Lord Justice Leveson will recommend at least some "enabling" statute to set up the new system.

This would aggravate those who suggest that the introduction of statute would encroach on the UK's free and independent press, currently unfettered by state influence. There are also signs that the Conservatives themselves are resistant to the idea of bringing in laws on press freedom.

The Leveson inquiry was initially set up to examine relationships between the press, politicians and police after allegations of phone hacking at News International publications exploded into scandal last summer.

Lord Justice Leveson is now considering the eight months of evidence from hacking victims, journalists, leading media figures and politicians.

However, he will not be able to begin the second section of his inquiry into improper media conduct until police investigations have been concluded.

Consultancy cuts blamed for rail fiasco

By Mark Odell, Rose Jacobs and Jim Pickard

A decision to save £1m in consultants' fees led to problems that forced the scrapping of the West Coast main line contract, critics have claimed, a fiasco that has left the transport department in crisis and the taxpayer facing costs that could run into hundreds of million of pounds.

The cancelling of the contract to FirstGroup came after a legal challenge by incumbent Virgin Rail forced the transport department to carry out due diligence of the tender process, which threw up "significant technical flaws".

The department said last week those flaws were only confirmed by a team from PwC called in days before Patrick McLoughlin, transport secretary, decided to scrap the contract. Ministers have blamed officials for the failings and suspended three civil servants.

However, officials and consultants involved in rail franchises told the Financial Times that much of the blame lies with Francis Maude, cabinet office minister, who has led a drive to cut the use of consultants across Whitehall.

George Muir, former director-general of the Association of Train Operating Companies, said: "I am told that it is all about austerity and the DfT trying to do as much of it in-house and spending as little as possible on consultants.

"It is certainly true that if they had spent some more money on consultants, they wouldn't have made these arithmetical errors."

Louise Ellman, chair of the transport select committee, said of the lack of financial consultants advising the department: "This could be very significant and we need to know more about what happened in this respect."

The department was split over whether to hire a financial adviser for the West Coast and other contracts, said one person close to the process. The department decided in the end to hire WS Atkins and Eversheds, technical and legal advisers. The West Coast award was the first big rail franchise let without the department using one of the big financial consultants such as Ernst & Young, KPMG or PwC.

The department had typically racked up fees of £700,000 to £1m using financial consultants to oversee rail franchise competitions.

At the very least, £40m in bid costs will be returned to the four groups that sought to run the line. But transport experts say the U-turn could lead to further costs including potential legal action from FirstGroup, compensation claims from those bidding for future franchises and lower revenues due to less aggressive bids on future rail franchises.