

Witness Name: Richard Hughes

Statement No.: M1/OBR/01

Exhibits:

Dated: 8 March 2023

UK COVID-19 INQUIRY

WITNESS STATEMENT OF RICHARD HUGHES, CHAIR, OFFICE FOR BUDGET RESPONSIBILITY

I, Richard Hughes, will say as follows: -

1. The systematic surveillance of economic and fiscal risks is a relatively new discipline within macroeconomics, and one which has been given added impetus by the succession of large and idiosyncratic shocks that the global economy has faced over the past decade-and-a-half. The OBR have been at the forefront of international practice in the analysis and disclosure of fiscal risks, as recognised by the IMF and OECD (*INQ000119297*, *INQ000119295*). The legislation establishing the OBR in 2010 requires us to set out the main risks that we consider to be relevant in any report that we produce (*section 4, subsection 6(b) of INQ000119299*). Since then, our biannual *Economic and fiscal outlooks (EFOs)* have regularly featured discussion and analysis (in the form of fan charts, sensitivity analysis, and alternative scenarios) of what we considered to be the key risks around our central forecasts. Following a recommendation in the 2015 Treasury Review of the OBR (*paragraph 4.16 of INQ000119292*), in October 2015 our legal remit was extended to include the production of a biennial report on “*the main risks to the public finances, including macroeconomic risks and specific fiscal risks*” (*INQ000119296*). In October 2016 we published a discussion paper seeking views on what such a report should cover (*INQ000119288*), and in July 2017, we published our first *Fiscal risks report (FRR)* (*INQ000119293*). We have since published four such reports, most recently combined with our long-term fiscal

projections in an annual report on *Fiscal risks and sustainability (FRS)* in July 2022 (*INQ000119290*).

2. Our first *FRR* in 2017 attempted to provide an initial survey of the universe of risks to the public finances (*INQ000119293*). These included the kind of financial risks that governments face in 'normal times' such as the rising costs associated with an ageing society or the decline in fuel duty revenue as cars become more fuel efficient. It also considered the Government's potential financial exposure to more acute and severe 'shocks', including through the conduct of a 'fiscal stress test' based on a severe recession scenario used by the Bank of England to assess the financial resilience of the UK banking sector. While the risk of a possible pandemic influenza outbreak was briefly mentioned in this first *FRR*, its economic and fiscal implications were not analysed in any depth (*paragraphs 6.64 and 6.156 of INQ000119293*). At the same time, the increases in government borrowing and debt generated by the 'generic' fiscal stress test were of an order of magnitude not dissimilar to those ultimately brought about by the pandemic.¹
3. Our second *FRR* in 2019 reviewed the risks we had previously identified in light of the Government's response that had been published in 2018 (*INQ000119289*). It also looked more deeply into a set of risks that had been covered in less depth in our 2017 report including from interest rates, climate change, and fiscal policy. While putting together that report, we did consider whether to base that year's fiscal stress test around a possible pandemic outbreak. However, with the risk of a 'no deal' outcome hanging over the ongoing negotiations regarding the UK's departure from the European Union, we decided instead to make that the focus of the fiscal stress test included in that edition of the *FRR*.
4. Following the arrival of Covid in the UK in early 2020, we put understanding and forecasting the economic and fiscal implications of pandemic at the centre of subsequent *FRRs* and *EFOs*. My predecessor and the two other members of the Budget Responsibility Committee at the time gave evidence to the Treasury Select

¹ In this fiscal stress test the deficit rose to to 8.1 per cent of GDP by 2021-22 (of which 7.4 per cent of GDP was deemed structural) and debt rose to around 114 per cent of GDP. Relative to our March 2017 forecast, the deficit was £66.2 billion higher in 2017-18, rising to £158.5 billion higher by 2021-22.

Committee on 17 March 2020 discussing very early reflections on the economic and fiscal shock that was about to unfold (*INQ000119287*). We published a *Coronavirus reference scenario* on 14 April 2020, within three weeks of lockdown measures coming into force, one of the first attempts on the part of any official national economic forecaster to anticipate the short-term economic and fiscal impact of the pandemic (*INQ000119286*). We then repurposed our July 2020 *Fiscal sustainability report (FSR)*, which would ordinarily focus on providing 50-year projections of the public finances, to present three alternative economic and fiscal scenarios depending on the course of the virus and public health response over the ensuing five years (*INQ000119294*). In our three subsequent *EFOs* in November 2020 (*INQ000119283*), March 2021 (*INQ000119285*), and October 2021 (*INQ000119284*), we continued to base our economic and fiscal forecasts on a set of alternative scenarios for the path of pandemic. These were calibrated based on regular discussions with the Government's Chief Medical Officer and epidemiologists from the Scientific Pandemic Influenza Group on Modelling (SPI-M).

5. In our July 2021 *FRR*, the first since the start of the pandemic, rather than reviewing the universe of 97 risks identified in previous two *FRRs* we focused in depth on three large, and potentially catastrophic, threats to the economic and fiscal outlook: the coronavirus pandemic, climate change, and the cost of government debt (*INQ000119291*). The coronavirus chapter: (i) explored the economic and fiscal impact of the pandemic in the UK in historical and international context; (ii) examined the role played by fiscal policy in mitigating the impact of the pandemic on the economy; (iii) identified the immediate fiscal pressures left behind by the pandemic (in particular on the health, education, and transport sectors); and (iv) considered what long-term scars the pandemic could leave on the supply side of the economy.
6. The coronavirus chapter of the July 2021 *FRR* concluded with a set of ten lessons from the pandemic for how economic forecasters and policymakers should approach other potentially catastrophic risks. Updated for subsequent developments, notably the energy crisis precipitated by the Russian invasion of Ukraine six months after we had published the *FRR*, these were:

- a. **Catastrophic risks are real and may have become more frequent.** In the space of a decade-and-a-half, the UK and other advanced economies had experienced three ‘once in a generation’ economic shocks in the form of the financial crisis, the Covid pandemic, and the Russian invasion of Ukraine. The combination of growing financial leverage, economic interdependence, and other manmade risk factors may make future shocks both more frequent and more severe. Producers and users of economic and fiscal forecasts tend to focus on a central view of medium-term prospects in which output returns to a judgementally determined trend as the effects of past shocks dissipate. But it is equally – arguably, more – important to focus on the risks around that forecast that arise from inevitable future shocks. Forecasters should do more to emphasise the uncertainty surrounding both near- and longer-term economic and fiscal prospects.
- b. **Economic shocks affect both supply and demand.** Macroeconomic forecasting and analysis rely on being able to evaluate the effect of a shock – or indeed any news – on both supply and demand and whether those effects are likely to be persistent or transitory. While conventional cyclical shocks affect mainly demand, recent shocks – the financial crisis, Brexit, the pandemic, and the energy crisis – have materially affected both supply and demand. This has exposed how poorly supply-side developments are understood, measured, and modelled relative to textbook business cycle fluctuations in demand. Forecasters need to raise their capacity to assess and monitor both the immediate and longer-term supply-side impact of novel shocks and any policy response.
- c. **Global interconnectedness can be both an asset and a liability.** As one of the most globally connected economies, the UK is highly exposed to risks emanating from abroad in the form of not only pandemic disease but also other forms of economic and financial contagion. However, the UK’s openness to international talent and investment also made it a world leader in the development, production, and rollout of one of the vaccines that helped to bring about an end to the pandemic. The UK’s high degree of

internal and external digital connectivity enabled the UK's largely service-based economy to continue to operate through the pandemic and the Government to deliver timely fiscal support, but also renders the economy vulnerable to other risks such as cyberattacks on critical IT infrastructure (a topic we explored in our subsequent risks report in July 2022 (*INQ000119290*)).

d. **While it may be difficult to predict when catastrophic risks will materialise, it is possible to anticipate their broad effects if they do.**

The risk of a global pandemic was at the top of government risk registers for a decade before coronavirus arrived but attracted relatively little (and in hindsight far too little) attention from the economic community. However, both the experience from previous epidemics such as the 1918 flu, Ebola, and SARS, and modelling by the US Congressional Budget Office and the World Bank, provided clear indications of where and how badly economies might be affected, even though both modelled an influenza rather than coronavirus pandemic. In 2008 the World Bank estimated that a severe and a moderate flu pandemic could reduce global GDP by 4.8 per cent and 2 per cent respectively (*INQ000119280*). The actual fall in global GDP at the height of the pandemic in 2020 was around 3 per cent (*INQ000119298*). The CBO estimated US GDP losses of 4¼ per cent in a severe flu pandemic compared to the 3½ per cent fall in US GDP recorded in 2020 (*INQ000119279*).

e. **When investing in risk prevention, governments tend to only ‘fight the last war’.**

In the decade following the 2008 financial crisis, significant resources were dedicated to improving the oversight and resilience of the financial sector, which paid dividends during the pandemic by helping to prevent it from triggering another financial crisis. And East Asian countries that invested in epidemic surveillance following the SARS and MERS outbreaks were more capable of combating the pandemic from the beginning. However, the 2016 report of the UN High-level Panel on Global Response to Health Crises described the world's preparedness and capacity to respond to a future pandemic as “*woefully insufficient*”

(INQ000119282). The difficulty in anticipating the precise timing and nature of the 'next crisis' puts a premium on governments engaging in horizon-scanning and investing in generic risk management systems and structures.

- f. **There are significant advantages in preventing or halting a process that involves rapidly escalating costs early.** While economic theory and practice emphasise the option value of delaying decisions, this can be suboptimal in the face of rapidly escalating costs. Countries that acted quickly to contain the spread of the virus experienced fewer deaths, shallower recessions, and earlier economic recoveries. These countries did not necessarily see lower fiscal costs from the pandemic, but more of their increase in borrowing was due to discretionary fiscal policy rather than as a result of the decline in output or pressures on their health systems and is therefore more likely to prove reversible.

- g. **People appear willing to make sacrifices for a clearly defined public good.** In the early stages of the pandemic, there was concern about defiance or fatigue in relation to public health restrictions and requirements. In fact, compliance with public health restrictions remained high throughout the pandemic in the UK and vaccine take-up also exceeded expectations. In total, the UK experienced a 10 per cent loss of output and committed 12 per cent of GDP in public funds in order to combat the pandemic in 2020. The annual economic and fiscal costs of tackling other potential catastrophic risks, like climate change, are likely to be just a fraction of this.

- h. **Economies can sometimes adapt remarkably quickly to structural changes.** While the initial shock associated with the pandemic and initial lockdowns was greater than many economists predicted, they were also surprised by the speed and strength of the subsequent recovery in economic activity (including its resilience during subsequent lockdowns). The contribution of prior investments in information technology that enabled people to work, shop, learn, and be entertained online was critical

to enabling this transition, as was fiscal policy in allowing households and firms to maintain consumption, employment, and liquidity through the transition.

i. **Fiscal policy can and needs to be more nimble than was previously thought.** Before the pandemic, one of the central preoccupations among macroeconomists was that monetary policy had been exhausted as the principal instrument for managing fluctuations in aggregate demand but fiscal policy could not act with the speed and scale necessary to prevent lasting damage to the economy. In fact, across advanced economies the pandemic induced a fiscal policy response unprecedented in its speed, scale, and novelty. While this added 18.7 per cent of GDP to the debts of the average advanced economy by the end of 2021, it also prevented the much greater economic costs associated with the deeper, longer, and more disruptive economic contraction that could have resulted from not intervening.

j. **In the absence of perfect foresight, fiscal space may be the single most valuable risk management tool.** Throughout its history, the UK government has relied on its ability to borrow large sums quickly in order to respond comprehensively to major economic and security threats. It was able to do so courtesy of its relatively low levels of public indebtedness, deep and liquid domestic capital market (supported by monetary policy), and by benefiting whenever there has been a general flight to safety. Fiscal policymakers must trade off making significant investments in the prevention of specific potential threats with preserving sufficient fiscal room for manoeuvre to respond to those risks that they did not anticipate or could not prevent.

7. In our subsequent forecasts and risks reports we have sought to put these lessons into practice. Most notably, in choosing our areas of focus in the July 2022 *FRS* (*INQ000119290*), we took explicit account of the 28 risks identified in the Government's 2020 National Risk Register (*INQ000119281*). This prompted us to continue to explore threats that arise from outside the realm of traditional

macroeconomic analysis but could have major economic and fiscal implications, including the risks from rising geopolitical tensions, cyberattacks, and continued high and volatile energy prices. We also considered the potential economic and fiscal consequences of the emergence of a vaccine-escaping variant of Covid.

Statement of Truth

I believe that the facts stated in this witness statement are true. I understand that proceedings may be brought against anyone who makes, or causes to be made, a false statement in a document verified by a statement of truth without an honest belief of its truth.

Signed: _____

Personal Data

Dated: _____ 14 March 2023 _____