

GDP deflator, the Consumer Price Index, and the calculation of the impact of the inflation shock on the Welsh Government settlement

GDP deflator

The Gross Domestic Product (GDP) deflator is a measure of prices in the domestic economy. It reflects the price of all goods and services produced in the economy relative to their real value, using prices from a base year. The change in the GDP deflator is therefore a broad-based measure of inflation across the domestic economy. It does not take account of changes in the price of imports.

Consumer Price Index

The Consumer Price Index (CPI) expresses the current prices of a basket of goods and services in a period compared to a base period. The basket reflects expenditure patterns of UK consumers.

Discussion

The GDP deflator is generally used to adjust public expenditure series for price changes. It is used to calculate the real terms year-on-year growth rates in the tables supporting spending plans in the Welsh Government's Budget. It also underpins the charts showing real terms time series for the Welsh Government budget in the main Draft Budget narrative document and in the Chief Economist's Report.

The Welsh Government has also estimated the impact of the recent inflation shock on the real terms value of the current Spending Review settlement for 2022-23 to 2024-25. It has done this using forecasts and outturns for both the GDP deflator and the Consumer Price Index.

At the time of the Spending Review, prices in 2024-25 were expected to be 7% or 8% higher than in 2021-22 using the OBR's GDP deflator and CPI forecasts respectively. Using the OBR's latest forecasts, the equivalent figures are now 15% and 20% higher in 2024-25 than in 2021-22.

The deflator and CPI generally grow in similar ways between years. However, they have grown differently in recent years and the size of the price shock compared to expectations has also been quite different. This is partly due to import prices and may also reflect lingering impacts from the pandemic which particularly affected the deflator in 2020-21 and 2021-22. Given these differences, it seems unlikely that the GDP deflator fully reflects the inflationary pressures facing public services. (The below compares the two measures in recent years and using the October 2021 and November 2023 OBR forecasts.)

The Welsh Government has presented the impact of the inflation shock using both price indices in chart 31 of the Chief Economist's Report (reproduced below) and noted that the impact is to reduce the value of the 2024-25 settlement by up to £1.3bn in real terms compared to what was expected at the time of the 2021 Spending Review.

The figures are presented in 2021-22 prices, as that is the year in which the Spending Review took place. Wales Fiscal Analysis at Cardiff University has

produced an estimate of £1.5bn for the impact of the inflation shock on the 2024-25 budget using the CPI, by converting it into 2024-25 prices. That is an equally valid way of presenting this metric.

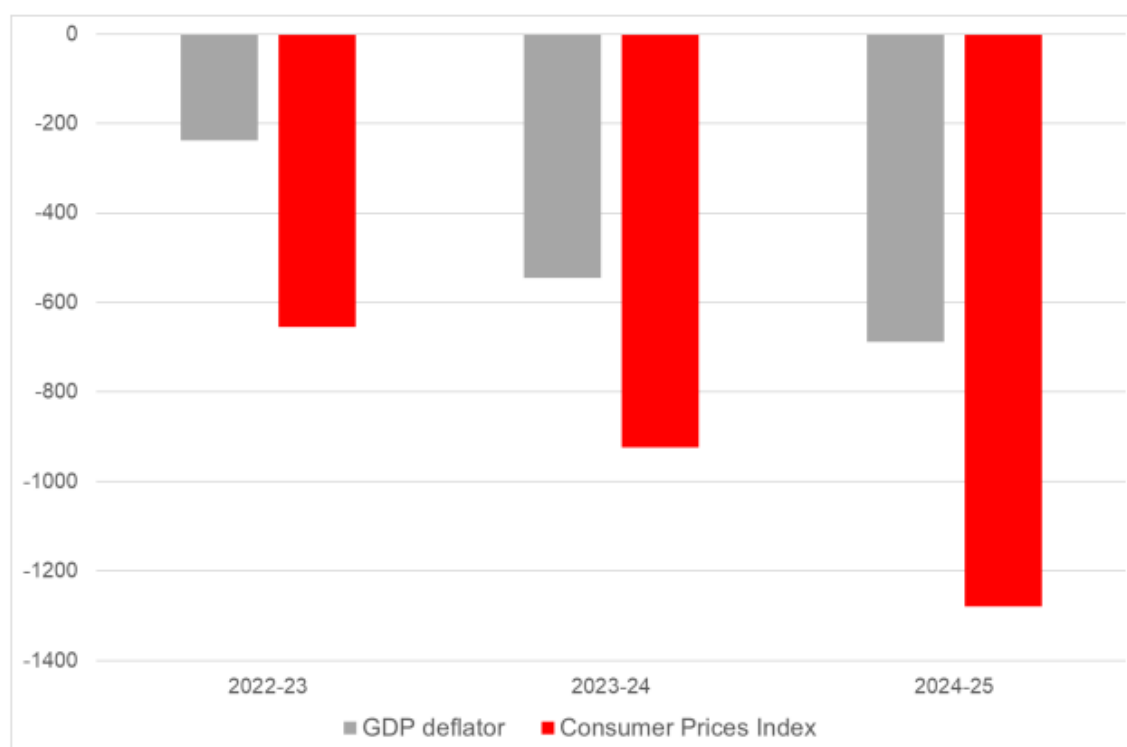
The key message is that, despite increases to the Welsh Government settlement since the last Spending Review, the spending power of the Welsh Government is still considerably lower in real terms than expected at the time of the Review.

Year-on-year growth in prices, data and OBR forecasts (%)

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
<u>October 2021</u>									
GDP deflator	2.2	1.7	2.0	2.4	6.7	-0.7	2.7	2.2	1.9
Consumer price index	1.1	2.8	2.3	1.7	0.6	3.3	3.7	2.3	2.0
<u>November 2023</u>									
GDP deflator	2.3	1.6	2.1	2.4	5.4	-0.8	6.7	6.1	1.7
Consumer price index	1.1	2.8	2.3	1.7	0.6	4.0	10.0	6.1	3.0

Source: HMT, OBR

Chart 31: Real terms difference in Welsh Government settlement since October 2021 using different inflation measures (£m, 2021-22 prices)



Source: Welsh Government