

The financial crisis has caused a steep and synchronised global downturn. Recessions are being experienced in all the world's major advanced economies and the world economy is set to contract by 1¼ per cent in 2009, the first fall in the post-war period. The UK Government, as Chair of the G20 in 2009, forged agreement between G20 Leaders on a comprehensive *Global plan for recovery and reform* at the London Summit in April 2009.

The Government is delivering a coherent and comprehensive package of support to restore the flow of credit, support economic recovery in the UK and build a strong economy for the future, while ensuring sound public finances.

The Government is delivering fiscal support worth 4 per cent of GDP in 2009-10 from the measures announced in this Budget, the 2008 Pre-Budget Report and the operation of the automatic stabilisers. The Bank of England has cut Bank Rate to ½ a per cent and announced a £75 billion programme of asset purchases. With substantial macroeconomic stimulus already in the system, this Budget focuses on further targeted support for those most affected by the downturn, and on ensuring a sustained and sustainable recovery, including support for employment and investment.

It will take time for this support to take hold fully. Like most advanced economies, the UK will experience a sharp recession in 2009, with GDP falling by -3½ per cent in 2009, before substantial macroeconomic stimulus drives recovery, with growth of 1¼ per cent forecast in 2010.

Global economic developments will have a profound effect on the fiscal positions of most countries, with debt likely to rise significantly in all advanced economies. In the UK, borrowing is forecast to peak at 12.4 per cent of GDP in 2009-10, before falling as the economy recovers and the Government takes further action to ensure sustainability. Building on the significant fiscal consolidation announced in the 2008 Pre-Budget Report, this Budget sets out tax and spending measures that reduce borrowing by £26½ billion by 2013-14:

- **from April 2010, an additional rate of income tax of 50 per cent will apply to income over £150,000 and the income tax personal allowance will be restricted for those with incomes over £100,000. From April 2011, tax relief on pensions contributions will be restricted for those with incomes of £150,000 and over, and tapered down until it is 20 per cent. Fuel duty will increase by 2 pence per litre on 1 September 2009, and by 1 penny per litre in real terms each year from 2010 to 2013; and**
- **the Government will continue to improve and invest in public services while delivering the additional savings identified by the Operational Efficiency Programme over the next Spending Review period, rising to £9 billion a year by 2013-14. Current spending will grow by an average of 0.7 per cent a year in real terms between 2011-12 and 2013-14 and public sector net investment will move to 1¼ per cent of GDP by 2013-14.**

Reflecting the principle of transparency, the fiscal forecasts include a provisional estimate for the high end of a range for the net impact of unrealised losses on financial sector interventions, equal to 3½ per cent of GDP.

Budget measures contribute to an average reduction in the cyclically-adjusted current budget of over 0.8 per cent a year from 2010-11 to 2013-14. Based on cautious fiscal forecasting assumptions, borrowing declines to 5.5 in 2013-14, and as a result net debt stabilises at 79 per cent of GDP, including potential losses on financial sector interventions, compared with 36 per cent at the end of 2006-07, when the economy was last on trend.

The Budget 2009 fiscal projections are consistent with the temporary fiscal operating rule introduced in the 2008 Pre-Budget Report, entailing a return to cyclically-adjusted current balance and debt falling as a share of the economy by 2017-18, when the global shocks will have worked their way through the economy in full.

OVERVIEW OF RECENT ECONOMIC DEVELOPMENTS AND THE GLOBAL AND UK POLICY RESPONSE

The global economy and international policy response

Global economic shocks and world downturn

2.1 The world economy was hit by a succession of shocks during 2007 and 2008. Initially, credit conditions tightened across advanced economies. Then the rise in global commodity prices squeezed real incomes. Together, these factors pushed many advanced economies into recession. Finally, the intensification of the credit shock into a global financial crisis delivered a severe blow to an already weakened world economy, precipitating a steep and synchronised global downturn.

2.2 Adjustments triggered by the global financial crisis, and exacerbated by the downturn in global trade, are having profound effects on people and businesses across the UK, and around the world:

- as world trade has fallen, manufacturers around the world have been hit hard. In 54 out of 57 countries for which data are available, industrial output fell in the final three months of last year;
- as the private sector has retrenched, economies have contracted. In the US and euro area, GDP fell by 1.6 per cent in the final quarter of 2008, the same rate as in the UK; and
- as economies have contracted, and companies have struggled with cashflow, jobs have been lost, with the unemployment rate rising to 6 per cent on average across the G7 economies.

2.3 Contracting domestic demand in advanced economies is feeding directly through to emerging markets. Steep declines in exports, particularly in a number of Asian countries, highlight how closely aligned prospects in emerging and advanced economies have become in a world economy characterised by integrated global supply chains.

International policy response

2.4 Faced with these exceptional challenges, governments around the world have utilised all available policy levers to support their economies. Banking systems have been recapitalised and action taken to ensure that the presence of impaired assets on banks' balance sheets does not limit access to finance for creditworthy borrowers. To support demand, interest rates have been cut to historic lows, a number of central banks have introduced quantitative easing policies, and governments have adopted expansionary fiscal policies.

2.5 These are worldwide economic difficulties with international causes and consequences for every country, so global solutions are needed. The UK Government took a leading role in forging agreement on the appropriate policy response to these challenges at the London Summit, and will continue to do so through the G20 Presidency in 2009. Box 2.1 sets out the macroeconomic elements of *The global plan for recovery and reform* agreed at the London Summit.

Box 2.1: The global plan for recovery and reform

The Leaders of the Group of Twenty (G20) met at the London Summit in April 2009 and pledged to “do whatever is necessary... to bring the world economy out of recession and prevent a crisis like the one currently affecting the global economy from recurring in the future”.^a They reached agreement on a global plan for recovery and reform, including:

- to restore growth and jobs: a trebling of the resources available to the International Monetary Fund (IMF) to \$750 billion, a new SDR^b allocation of \$250 billion and at least \$100 billion of additional lending by the Multilateral Development Banks to ensure that capital continues to flow to emerging and developing countries, which have been the engine of recent world growth;
- to strengthen the international financial institutions (IFIs): reform of the mandates, scope and governance of the IFIs to strengthen their longer-term relevance, effectiveness and legitimacy. The G20 asked the Prime Minister, as Chairman in 2009, to consult and report back to the next meeting with proposals for further reforms to improve the responsiveness and adaptability of the IFIs;
- to promote global trade and investment: a commitment to reinvigorate world trade and investment, which has underpinned rising prosperity for half a century, to refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions or implementing World Trade Organisation inconsistent measures to stimulate exports, and to ensure \$250 billion of support for trade finance over the next two years; and
- to ensure a fair and sustainable recovery for all: using the additional resources from agreed IMF gold sales to provide \$6 billion additional concessional and flexible finance for the poorest countries over the next 2 to 3 years.

This support builds on the unprecedented and concerted action being undertaken in G20 countries, including:

- fiscal expansion, which the IMF estimate will raise output by 4 per cent, supporting millions of jobs;
- expansionary monetary policies pursued by central banks, which have cut interest rates aggressively in most G20 countries; and
- comprehensive action taken to support the banking system, to provide liquidity, recapitalise institutions and address decisively the problem of impaired assets, implementing policies in line with the agreed G20 framework for restoring lending and repairing the financial sector.

Leaders stated their commitment to deliver the scale of sustained fiscal effort necessary to restore growth, while preserving long-term fiscal sustainability, and to take all necessary actions to restore the normal flow of credit through the financial system and to ensure the soundness of systemically important institutions. Central banks have pledged to maintain expansionary policies for as long as is needed and to use the full range of monetary policy instruments, including unconventional instruments, consistent with price stability. The G20 agreed to conduct all economic policies cooperatively and called on the IMF to assess regularly the actions taken and the actions required to restore growth.

^a www.G20.org

^b Special Drawing Rights. The SDR is the unit of account of the IMF. Its value is based on a basket of key international currencies. For information, see www.imf.org.

Global prospects 2.6 With a sharp recession taking place in the world's economies, global forecasts are subject to very significant uncertainties and risks. World GDP is forecast to fall by 1¼ per cent in 2009, marking the first year of contraction in the post-war period. Advanced economies are expected to contract most sharply, with G7 GDP forecast to fall by 4 per cent. Emerging economies are expected to continue growing, but at a greatly reduced pace, in part reflecting the sharp contraction in world trade. As the global policy response takes hold and credit conditions start to ease, the world economy is forecast to begin to recover towards the end of 2009, with growth picking up through 2010 and 2011. Further detail is provided in Chapter B.

Economic developments in the UK and the Government's policy response

Recent economic developments in the UK 2.7 UK GDP has fallen more sharply than forecast in the 2008 Pre-Budget Report, reflecting the cumulative impact of the succession of shocks that hit the global economy during 2007 and 2008. As credit conditions tightened and global commodity prices squeezed real incomes, growth slowed progressively, with the economy contracting by 0.7 per cent in the third quarter of 2008. In the final quarter of the year, the intensification of the global financial crisis caused a loss of confidence and a further reduction in the availability of credit that led to a sharp 1.6 per cent drop in GDP, in line with falls in activity across advanced economies. Overall, GDP growth slowed from 3 per cent in 2007 to ¾ per cent in 2008.

2.8 Consumer price inflation peaked at 5.2 per cent in September 2008. As commodity price pressures have reversed, inflation has eased in line with the Pre-Budget Report forecast. CPI inflation was 2.9 per cent in March, while RPI inflation was -0.4 per cent.

UK policy response 2.9 Reinforcing the international response, the Government is delivering a coherent and comprehensive package of support, focused on restoring the flow of credit, delivering broader support to the economy, providing targeted support to those most affected by the downturn and to prepare for recovery, and ensuring sustainability.

2.10 The Government has undertaken a series of interventions to support the economy, by focussing on addressing problems in the financial system. These interventions tackle problems at individual institutions, addressing system-wide instability, and getting credit flowing through the economy once more. These share the common purpose of protecting the customers of financial institutions – people and businesses – from the consequences of financial instability and restricted access to credit.

Restoring the flow of credit 2.11 With over £100 billion of funding guaranteed under the Credit Guarantee Scheme, £37 billion of capital injected into banks through the recapitalisation scheme, lending commitments amounting to around £40 billion, and agreement in principle for £585 billion of assets to be protected under the Asset Protection Scheme, the availability of credit to households and businesses should improve through 2009.

Government support for the economy 2.12 In addition to allowing the full operation of the automatic stabilisers, the Government is implementing a timely, targeted and temporary fiscal stimulus, and has authorised the use of a new instrument by the Bank of England to ensure the inflation target can be met. Together, these actions will support the economy during the downturn, helping to reduce the risk of a deeper or more prolonged recession.

Targeted support 2.13 The Government has introduced targeted measures to prepare for recovery and to provide additional support to those who need it most, including measures to provide temporary support through the downturn for employment, investment and mortgage holders.

2.14 Building on the extensive support already in the system, Budget 2009 focuses on further targeted support for employment and investment to ensure a sustained and sustainable recovery.

2.15 In total, significant macroeconomic policy support is in place in the UK, helping the economy, people and businesses: the Bank of England has cut Bank Rate to ½ per cent, a £75 billion programme of asset purchases is under way, and the Government is delivering fiscal support worth 4 per cent of GDP in 2009-10, through discretionary action announced in this Budget and the 2008 Pre-Budget Report and the automatic stabilisers, which the IMF has noted play an important role in supporting economic activity.

Ensuring sustainability 2.16 The Government has acted to protect fiscal sustainability by prioritising its actions carefully, to ensure that they will support recovery and future economic growth, and it remains committed to delivering a sustained fiscal consolidation over the medium term to ensure sound public finances, support orderly rebalancing and provide the platform for strong private-sector recovery.

2.17 Building on the consolidation announced in the 2008 Pre-Budget Report, the Budget sets out plans to deliver a sustained fiscal consolidation once the economy emerges from the downturn. The Budget includes tax and spending decisions that will reduce government borrowing by £26½ billion by 2013-14.

Prospects for the economy and public finances

UK growth prospects 2.18 The Budget 2009 economic forecast reflects the balance of key forecasting judgements relating to the negative effect of the global financial crisis and private sector retrenchment, and the positive effect of large-scale macroeconomic stimulus, both domestically and internationally, on growth. The forecast is underpinned by the assumption that G20 authorities deliver on policy commitments and that they are effective, so that the world economy is forecast to grow by 2½ per cent in 2010, picking up further to 4¼ per cent in 2011. The effects of lower commodity prices and the depreciation of sterling will also support demand.

2.19 In the near term, the negative effects of the steep downturn in global and domestic demand will dominate, with prospects for 2009 revised down substantially since the 2008 Pre-Budget Report. The forecast is based on the judgement that the effects of macroeconomic stimulus increasingly to take hold, driving recovery in demand and output in the UK and globally. The Budget 2009 economic forecast is for a contraction of 3½ per cent, worse than the 1 per cent contraction forecast in the Pre-Budget Report. GDP is forecast to contract sharply in the first half of 2009, to stabilise in the second half of the year, and to pick up progressively through 2010 and 2011 as credit conditions normalise and the effects of significant macroeconomic policy stimulus and the depreciation of sterling take hold.

2.20 The tightening of credit conditions facing households and companies, and the depreciation of sterling since mid-2007, provide the conditions for a rebalancing of demand in the UK economy. This macroeconomic adjustment is likely to entail increased saving by households, increased investment by companies as they respond to new opportunities, and a rebalancing of domestic and external demand.

UK inflation prospects **2.21** CPI inflation is forecast to continue to ease through 2009, moving well below target by the end of the year, and to remain below target during 2010, when the negative output gap is forecast to peak, though downward pressure on inflation is countered by monetary policy support further taking hold. CPI inflation is forecast to return to close to target during 2011 as the lagged effects of monetary policy easing are assumed to have their maximum impact.

2.22 As well as being subject to the same influences as CPI inflation, the RPI measure of inflation will be subject to additional downward pressures during 2009. Further declines in house prices and the lagged feed-through from Bank Rate to mortgage rates will put downward pressure on the measures of housing depreciation and mortgage interest payments included in the RPI. As a result, RPI inflation is forecast to fall further, to -3 per cent by September this year, but to move back above zero in 2010 as these additional downward pressures recede.

Table 2.1: Summary of UK forecast¹

	Forecast				
	2007	2008	2009	2010	2011
GDP growth (per cent)					
Upper end of forecast range	–	–	–3¼	1½	3¾
Economic forecast	3	¾	–3½	1¼	3½
Forecasts underpinning public finance projections	–	–	–3¾	1	3¼
Inflation (per cent, Q4)					
CPI inflation	2	4	1	1	2¼
RPI inflation	4¼	2¾	–1¼	2½	4
GDP deflator	2½	2	¼	1¾	2¾

¹ See footnote to Table B9 for explanation of forecast ranges.

Risks and uncertainty **2.23** All economic forecasts remain subject to exceptional uncertainties across a broad range of factors, including the resolution of the global financial crisis and its impact on confidence and activity, and the implementation and effectiveness of the unprecedented global policy response to the economic downturn. A key uncertainty over near-term prospects in the UK and globally relates to the extent of inventory adjustment taking place in manufacturing and retail sectors, and the extent to which the sharp falls in production have been sufficient to offset the sharp drop in demand.

2.24 Prospects for recovery in advanced economies are closely linked to the delivery and effectiveness of global macroeconomic support. Monetary policy stimulus is largely in place already, but there are uncertainties over the effectiveness of historically low interest rates in encouraging spending when confidence has been severely affected by the global financial crisis. A significant proportion of planned fiscal support around the world is yet to be delivered. The Budget forecast is based on the assumption that it will be delivered as planned, so delays or reversals could represent a risk that the recovery will be weaker or later than forecast. As with monetary policy, there is uncertainty over the effectiveness of fiscal stimulus measures, relating to the degree to which they encourage private sector spending.

2.25 There is also considerable uncertainty over the effectiveness of macroeconomic support. The forecast for the UK is based on the judgement that the £75 billion programme of asset purchases will raise money GDP by approximately the same amount and bring inflation back up to target. It is possible that inflation could react sooner or by more than assumed, or that demand for and supply of credit remain weak, limiting the impact of asset purchases on nominal demand.

2.26 There is uncertainty over the degree to which households will further increase saving to rebuild their finances, and the speed with which any further adjustment will take place. This will be influenced by the degree of confidence they have about the future, especially jobs and repossessions. The Government has therefore targeted action at these areas. These uncertainties present risks to the consumer spending and residential investment forecasts. Businesses have reduced investment in the face of demand uncertainty so that, despite profits falling in the second half of the year, in aggregate the corporate sector continues to run a surplus. Investment is forecast to fall sharply in 2009, before recovering strongly. There are upside and downside risks to this forecast related to the availability of credit and restraint of business confidence.

2.27 The forecast is presented within ½ percentage point ranges, based on alternative assumptions about supply-side performance of the economy, with the public finance projections based on the lower end of the range, where GDP is forecast to contract by 3¾ per cent in 2009 before recovering to 1 per cent in 2010 and 3¼ per cent in 2011.

**Implications
for the public
finances**

2.28 The deterioration in the world and UK economies since the 2008 Pre-Budget Report and the policy action required to address it will have a profound effect on the public finances. Failure to act would have meant far greater risks to the economy and public finances in the future. Moreover, the Government has acted to protect fiscal sustainability by prioritising its actions carefully to ensure that they will support recovery and future economic growth, which will in turn support sound public finances over the medium and long term. **Reflecting the principle of transparency, the fiscal forecasts include a provisional estimate for the high end of a range for the net impact of unrealised losses on financial sector interventions, equal to 3½ per cent of GDP.**

2.29 Table 2.2 below provides a summary of the public finance projections. It shows that public sector net borrowing (PSNB) has increased significantly to provide support for the economy through discretionary fiscal action and the full operation of the automatic stabilisers. From 2.4 per cent of GDP in 2007-08, PSNB increased to 6.3 per cent of GDP in 2008-09, cushioning the economy from the impact of a similarly large downward adjustment to private sector borrowing. PSNB is projected to peak at 12.4 per cent of GDP in 2009-10, as the economic downturn significantly reduces tax receipts for all the main taxes, and in particular from the financial and property sectors.

2.30 Building on the significant consolidation announced in the 2008 Pre-Budget Report, this Budget sets out tax and spending measures that reduce borrowing by £26½ billion by 2013-14. As a result of this action, the cyclically-adjusted current balance improves by, on average, over 0.8 per cent a year from 2010-11 to 2013-14. Based on cautious fiscal forecasting assumptions, PSNB is projected to decline to 5.5 per cent of GDP by 2013-14. Public sector net debt (PSND) increases over the forecast period, before stabilising at 79 per cent of GDP in 2013-14 including unrealised losses on financial sector interventions, compared with 36 per cent at the end of 2006-07 when the economy was last on trend.

2.31 On the assumption that the Government delivers a further consolidation of 0.8 per cent of GDP a year in the cyclically-adjusted current budget beyond 2013-14, the fiscal projections set out in this Budget are consistent with the Government's temporary fiscal operating rule, returning to cyclically-adjusted current balance and debt falling as a proportion of GDP by 2017-18 when the global shocks will have worked their way through the economy in full.

2.32 This forecast represents a cautious projection of the public finances. It is based on the lower end of the GDP forecast range, incorporates a cautious judgement for unrealised losses on financial sector interventions, and uses assumptions on oil prices and equity prices and

the VAT gap that are audited by the National Audit Office and that build increased caution into the public finance projections during a period of recession in particular.

Table 2.2: Summary of fiscal projections

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Public sector net borrowing (PSNB)	2.4	6.3	12.4	11.9	9.1	7.2	5.5
Total change since 2008 Pre-Budget Report	-0.1	0.9	4.4	5.1	3.8	3.1	2.6
Impact of discretionary measures on PSNB ¹	0.0	0.0	0.5	0.0	-0.5	-1.1	-1.5
Surplus on current budget	-0.4	-3.6	-9.3	-9.4	-7.2	-5.6	-4.3
Cyclically-adjusted surplus on current budget	-0.7	-3.1	-6.7	-6.4	-4.9	-3.9	-3.2
Public sector net investment	2.1	2.6	3.1	2.5	1.9	1.6	1.3
Public sector net debt ²	36.5	43.0	55.4	65.0	70.9	74.5	76.2
Public sector net debt including unrealised losses ³	36.5	46.5	59.0	68.4	74.0	77.5	79.0

Note: Figures on a National Accounts basis unless otherwise indicated.

¹ Including changes in forecasting assumptions on spending growth in 2011-12, 2012-13 and 2013-14.

² Debt at end March; GDP centred on end March; excluding liabilities and unrealised losses from financial sector interventions.

³ Debt at end March; GDP centred on end March; including unrealised losses on financial sector interventions.

SUPPORT THROUGH THE DOWNTURN AND PROMOTING RECOVERY

2.33 Reinforcing the international response, the Government is delivering a coherent and comprehensive package of support, focused on restoring the flow of credit, delivering broader support to the economy, providing targeted support to those most affected by the downturn and to prepare for recovery, and ensuring sustainability.

2.34 In addition to direct fiscal support, many of the Government's wider policy interventions, particularly those to support the financial system, will impact on the fiscal position.

Restoring the flow of credit

2.35 The financial system plays a crucial role in all modern economies, affecting the lives of every individual and business. It is the core mechanism by which resources are allocated through the economy, channelling funds from savers to creditworthy borrowers, and thereby supporting productivity, growth and jobs.

2.36 The Government has carried out a series of interventions in the financial system, tackling problems at individual institutions, addressing system-wide instability, and getting credit flowing through the economy once more. These interventions, described in Chapter 3, share the common purpose of protecting the customers of financial institutions – people and businesses – from the consequences of financial instability and restricted access to credit. In particular, by:

- dealing with specific institutions such as Northern Rock and Bradford & Bingley, the Government ensured that problems at one institution did not spread through the banking system, that no retail depositor in UK banks lost money and that borrowers were not unduly disrupted;
- acting decisively as the global financial crisis raised system-wide risks in October 2008 to prevent the collapse of the banking system, and the massive costs that would have entailed for businesses and individuals, and by

comprehensively addressing the needs for liquidity, capital and funding, the Government ensured that the banking system was in a position to support the economy through the provision of credit to creditworthy borrowers; and

- acting to limit the risks attached to banks' existing assets, through the Asset Protection Scheme, and agreeing quantified and legally-binding lending commitments with banks accessing Government support, the Government has enabled around £40 billion of additional lending to individuals and businesses in each of 2009 and 2010.

2.37 This action is in line with the approach agreed by G20 Finance Ministers and Central Bank Governors in March 2009, when they agreed a framework for financial repair and recovery, committing to taking decisive action, where needed, and to use all available tools to restore the full functioning of financial markets, on which further information is provided in Chapter 3.

Asset Protection Scheme 2.38 The Asset Protection Scheme will, in particular, play a key role. Uncertainty around the value of banks' previous investments mean they have an incentive to hoard capital rather than lend to businesses and households. In such circumstances it becomes necessary for governments to bear some of the risk attached to banks' existing assets by providing a manageable maximum loss on these assets to restore confidence in the financial system, and ultimately to increase lending to individuals and businesses.

2.39 Under the Asset Protection Scheme, on which further details are provided in Chapter 3, the Government provides protection against future credit losses on certain assets in exchange for a fee. A 'first loss' (similar to the excess in insurance policies) remains with the institution. The government protection will cover 90 per cent of the credit losses exceeding this amount, with the participating institution retaining the residual exposure. The scheme has been designed to draw a line under problems arising from impaired assets, by putting a floor to banks' exposure to losses associated with these assets, while protecting taxpayers' interests. This scheme has significant implications for the public finances, increasing exposure to financial sector losses. Failure to act would have meant far greater risks to the economy and public finances in the future.

Impact of the interventions 2.40 The Government's interventions in the financial system have therefore protected the economy from the worst costs of financial instability or bank failures, provided the resources and certainty necessary for credit growth, and agreed commitments that will get credit flowing to creditworthy borrowers, so supporting economic recovery.

2.41 The Bank of England's latest *Credit Conditions Survey*, published on 2 April, and its new *Trends in Lending* report, drawing on data collected on behalf of the lending panel and described in Chapter 3, suggest a slight easing in the availability of credit to companies during the first quarter of 2009, and expectations of further easing in the second quarter.¹ The availability of credit to households had continued to tighten, although it was expected to ease in the coming months. The latest Bank of England data show that while effective interest rates paid by households and companies have not fallen by the same amount as Bank Rate has been cut, they have declined significantly.

2.42 It will take time for the effective functioning of the financial system to be fully restored. In the meantime, the Government has taken action to support creditworthy businesses and individuals, including measures to provide temporary support through the downturn for employment, vulnerable industries and mortgage holders, as set out in Chapters 4 and 5.

¹www.bankofengland.co.uk

2.43 The Government will continue to do whatever it takes to maintain financial stability and to take steps to protect people and businesses from the adverse effects of problems in the financial system. Chapter 3 introduces the Government's view of how the regulatory framework for the financial sector needs to be enhanced. In addition, the Government will, before the summer, publish a document describing its approach to the future of financial markets and setting out the actions necessary to achieve it.

Monetary policy action

The monetary policy framework

2.44 Price stability is a precondition for high and stable levels of growth and employment. Monetary policy remains the key tool for the management of demand in the economy and therefore inflation. The monetary policy framework is based on four key principles:

- clear and precise objectives. The primary objective of monetary policy is to deliver price stability. The adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the Monetary Policy Committee (MPC). **The Government reaffirms in Budget 2009 the target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI)**, which applies at all times;
- openness, transparency and accountability. These are enhanced through publication of MPC members' voting records, minutes of MPC meetings and quarterly Inflation Reports; and
- credibility and flexibility to allow the MPC to decide how to react to events, within the constraints of the inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC.

Creation of a new monetary policy instrument

2.45 Since the onset of the financial crisis, as economies have slowed sharply and commodity prices fallen, central banks around the world have cut policy rates to historically low levels to tackle the emerging risk of deflation.

2.46 On 19 January 2009, with Bank Rate at a very low level, the Government established the Asset Purchase Facility (APF), as a further step to help increase the availability of corporate credit and to provide a framework for the MPC to use asset purchases for monetary policy purposes.

Action taken by the Monetary Policy Committee

2.47 Since the 2008 Pre-Budget Report, the Governor of the Bank of England has written two open letters to the Chancellor, in December and March, as inflation remained more than 1 percentage point above target. However, the outlook for inflation in the medium term is now judged by the MPC to be weighed to the downside. In the February Inflation Report, the Bank of England's central projection was for CPI inflation to fall significantly below the 2 per cent target over the forecast period.²

2.48 The Monetary Policy Committee has therefore taken further action to loosen monetary policy. Bank Rate has been cut by a further 2½ percentage points since November, to ½ per

²All open letters are available at www.hm-treasury.gov.uk

cent. At its February meeting, the MPC judged that “*it seemed unlikely that the inflation target could be met solely by cutting Bank Rate*”³ and voted unanimously that the Governor write to the Chancellor to request the use of the APF for monetary policy purposes. Box 2.2 provides further information on the Asset Purchase Facility and its role in the policy of quantitative easing. **The Government confirms that the Asset Purchase Facility will remain in place in financial year 2009-10, and that the Monetary Policy Committee will be able to use the APF for monetary policy purposes**, as set out in the Chancellor's letter to the Governor of 3 March 2009.⁴

Box 2.2: The Asset Purchase Facility

The Bank of England uses monetary policy to ensure it meets the inflation target. Normally, it does so by varying its target for the overnight interest rate, Bank Rate. When the financial system is functioning well, changes in Bank Rate are passed through the financial system, influencing interest rates faced by households and companies.

On 19 January 2009, the Government established the Asset Purchase Facility (APF) to enable the Bank of England to ease improved levels of liquidity in financial markets by making purchases of private sector assets.^a Initially, these interventions were financed by Treasury bills, but on 3 March, with Bank Rate close to zero, the Chancellor agreed to the request from the MPC that purchases could be financed through the issuance of central bank reserves. This means that the MPC can use the APF for monetary policy purposes.

Using the APF, the MPC is able to ease policy further by injecting money into the economy. It does so through the purchase of securities issued by the private sector or the Government with central bank money. That raises the money holdings of the private sector. As investors buy other assets with those money holdings, that lowers the yield of those assets, and reduces the cost of finance. Over time, a lower cost of finance should encourage firms to raise capital to pursue profitable opportunities. In turn, this process should stimulate demand in the economy, ensuring that the inflation target can be met.

The introduction of the APF as a monetary policy tool is consistent with the principles of full operational independence, openness, transparency and accountability. A published exchange of letters on 29 January 2009 established the APF and the operational framework for asset purchases, while in a subsequent exchange of letters on 3 March the Chancellor authorised up to £150 billion of purchases, of which up to £50 billion should be used to purchase private sector assets, in recognition of the importance of supporting the flow of corporate credit. In his letter, the Chancellor highlighted that the objectives of the monetary policy framework remained unchanged; the MPC should continue to maintain price stability and, subject to that, to support the Government's economic policy, in particular its objectives for growth and employment.

At its March meeting, the MPC decided to initiate the purchase of £75 billion of assets using central bank reserves. As of 16 April 2009, the Bank of England had purchased £2.4 billion of commercial paper, £0.5 billion of corporate bonds and £31.5 billion of gilts. These asset purchases have been predominantly financed by the issuance of central bank reserves. The Bank of England is considering how it might extend the APF to purchase a wider range of private sector assets, consistent with the objectives of the facility.

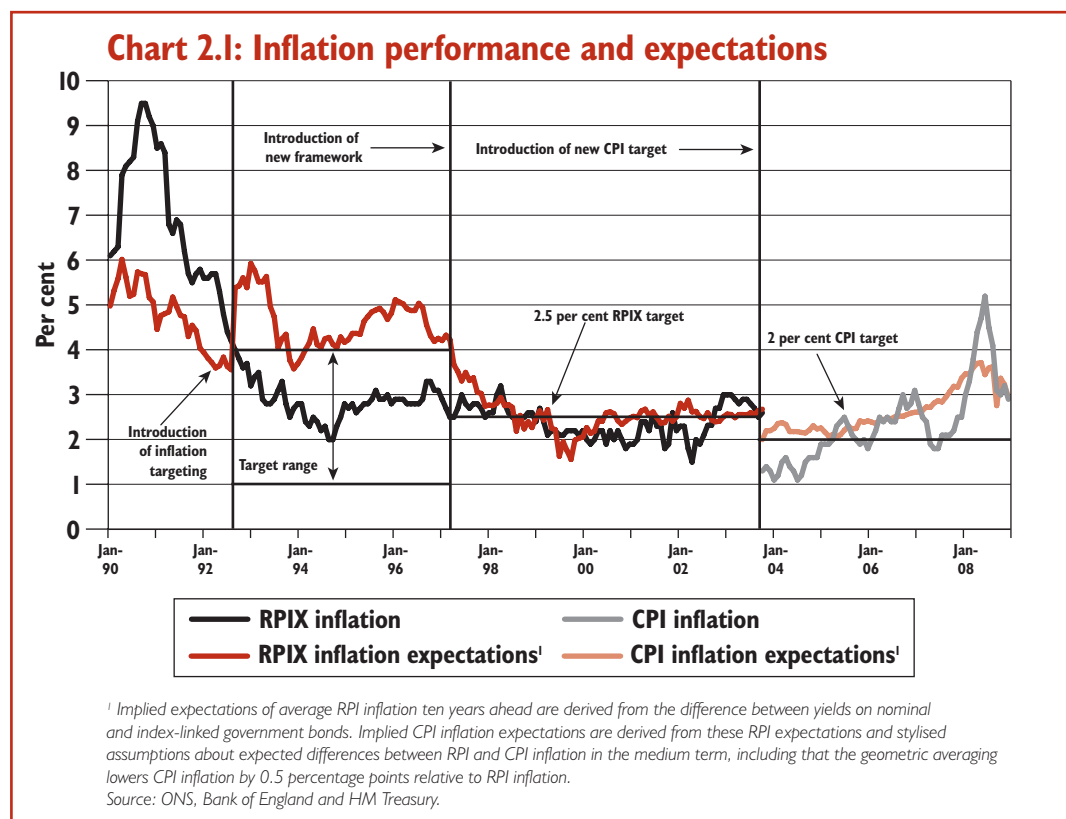
^a The assets authorised for purchase are: paper issued under the Credit Guarantee Scheme (CGS), corporate bonds, commercial paper, syndicated loans, asset-backed securities created in viable securitisation structures, and Government debt for sale on the secondary market.

³ www.bankofengland.co.uk

⁴ www.hm-treasury.gov.uk

The impact of these actions **2.49** Initial evidence suggests that conditions for higher-grade corporate credits may have eased a little, although the extent to which this reflects the operation of the Asset Purchase Facility is unclear. Most notably, £15 billion of sterling-denominated non-financial corporate bonds were issued in the first quarter of this year, almost double the previous quarterly record. That said, there were also record levels of issuance in euro-denominated and dollar-denominated debt. Yields on 10-year gilts have declined by around 45 basis points since the end of January, with a sharp decline following the MPC's announcement in March. Furthermore, the difference between yields on 10-year gilts and German government bonds has fallen by around 40 basis points following the MPC's announcement. Yields on corporate bonds have declined by around 70 basis points since the end of January and there is evidence of commercial paper issuers being able to raise funds at a lower cost. However, movements in corporate sector and government bond yields reflect a variety of factors, making it difficult to isolate and measure the impact of the Bank of England's purchases.

2.50 Inflation expectations appear to have remained anchored, testament to the credibility that the monetary policy framework has built since 1997. As inflation has fallen from its recent peak, survey measures of inflation expectations have also moderated, but remain anchored. CPI inflation has moved within a range of 2.3 percentage points over the past year. However, the YouGov/Citigroup survey measure of household expectations for five to ten years ahead has moved within a narrow range of 1.1 percentage points over the same period. Financial market-derived measures of inflation expectations can be affected by other market developments, and have been more difficult to interpret given financial market volatility. However, these measures do not appear to point to a de-anchoring of expectations from the inflation target, and have moderated from recent peaks.



Forward-looking approach **2.51** At the G20 meeting of Finance Ministers and Central Bank Governors on 14 March, it was agreed that “G20 central banks will maintain expansionary policies as long as needed, using the full range of monetary policy instruments, including unconventional policy instruments, consistent with price stability.” The Government will continue to support the Bank of England in the forward-looking decisions it takes to meet the inflation target.

Setting fiscal policy to support the economy and to ensure sustainability

2.52 The actions that the Government has taken since the onset of the crisis have been consistent with its fiscal policy objectives:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and
- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

2.53 In addition to direct fiscal support, many of the Government’s wider policy interventions, particularly those to support the financial system, will impact on the fiscal position. The Government is committed to transparency and responsibility in its approach to fiscal policy, consistent with the *Code for fiscal stability*. Box 2.3 sets out the fiscal implications of measures to ensure financial stability and the approach that the Government has taken to the treatment of unrealised losses on its financial sector interventions within the fiscal projections.

Box 2.3: Fiscal implications of measures to ensure financial stability

The Government has made a series of interventions to ensure the stability of the financial system and restore the flow of credit, which is crucial to economic recovery. The long-term impact of these interventions on the sustainability of public finances will be determined not by the face value of the liabilities that the Government has incurred as a result but by any eventual profit or loss that accrues on them, taking account of fees received and the value of investments when they are sold.

Setting out estimates of these losses is inherently difficult in current market conditions. However, in setting plans to meet the Government's fiscal objectives in future it is prudent to make allowance for the potential for losses on these financial sector interventions. As set out in the *Code for fiscal stability*, the Government is committed to reporting as transparently as possible on the fiscal position to enhance public scrutiny of fiscal policy-making. Moreover, given the significant risks the public sector faces on these interventions, responsible management of the public finances requires planning on a cautious assumption of the range of potential outcomes.

The Government provisionally estimates that losses may lie within a potential range from £20 billion to £50 billion (1½ to 3½ per cent of GDP). The actual figure could be either larger or smaller than this range. The estimate is set out as a range because of the inherent uncertainty over potential outcomes from these interventions. In reaching an estimate of the scale of potential net losses, the Government's judgement has been informed by potential income from fees (for example, on the Special Liquidity Scheme and Credit Guarantee Scheme) and investments, data from stress-testing and due diligence exercises undertaken by the Treasury, Financial Services Authority (FSA) and the Bank of England in relation to the various schemes and our assessment of economic conditions. Publishing a range acknowledges the significant degree of uncertainty that remains about the performance of bank assets.

This provisional estimate is a cautious judgement, made for fiscal policy purposes. It is not an estimate of scheme-by-scheme losses over time, as it is impossible to set out accurate overall costs for certain at this point. Part of the problems currently faced by financial markets is uncertainty over the future value of assets, which makes valuing costs and benefits very challenging. Moreover, overall outcomes will depend on prospects for the economy, over which there is significant uncertainty.

The Budget sets out both its baseline fiscal projections, excluding liabilities and unrealised losses from financial sector interventions, and projections for borrowing and debt that include the high end of this range for the net impact of unrealised losses, equal to 3½ per cent of GDP. The Government will continue to develop estimates of losses as schemes are finalised, and as market conditions normalise. It will update its estimates of unrealised losses in subsequent Budgets and Pre-Budget Reports as new and better information becomes available. Box 2.7 sets out the Government's approach to making provision for losses on financial sector interventions in the fiscal forecast.

2.54 The Government has acted to protect fiscal sustainability by prioritising its actions carefully, to ensure that they will support recovery and future economic growth, and it remains committed to delivering a sustained fiscal consolidation over the medium term to ensure sound public finances.

2.55 The IMF has noted that the UK entered the crisis “*with greater space for supportive fiscal policy*” than some countries.⁵ A starting point of low public debt and the action that the Government is taking to protect fiscal sustainability, by providing short-term support on a temporary basis and setting clear plans for consolidation over the medium term, mean borrowing and debt can be allowed some flexibility to rise in the short term to support the economy through the recession and enhance longer-term growth prospects.

2.56 Therefore, to promote economic recovery while protecting fiscal sustainability, Budget 2009:

- announces further targeted and cost-effective fiscal measures, to help those most affected by the downturn and support sustainable growth and employment, with a temporary cost, rather than a permanent impact on government borrowing; and
- sets out plans to deliver a sustained fiscal consolidation once the economy emerges from the downturn, including a combination of adjustments to tax and spending.

Fiscal policy framework 2.57 To underpin its commitment to sustained fiscal consolidation, the Government set a temporary fiscal operating rule in the 2008 Pre-Budget Report: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.

2.58 As there is considerable uncertainty over the path of the economy and the public finances in the short term, and over the persistence of the economic shocks, setting a rule focused on steady improvement in the public finances allows the Government flexibility to adjust to unanticipated developments in the economy, while constraining fiscal policy to deliver sound public finances over the medium term.

International fiscal policy 2.59 There is widespread international agreement on the need for governments to provide fiscal support in the short term, while ensuring the sustainability of fiscal positions over the medium term. The IMF recently noted: “*Macroeconomic policy stimulus will be critical to support demand while financial issues are addressed and to avoid a deep and prolonged recession... fiscal policy must play a central role in supporting demand, while remaining consistent with medium-term sustainability.*”⁶ Box 2.4 summarises international agreements and actions on fiscal policy.

⁵The case for global fiscal stimulus, International Monetary Fund, March 2009.

⁶Note to the Group of Twenty Deputies, International Monetary Fund, February 2009.

Box 2.4: International fiscal policy

This is a global crisis and it requires a global response, including on fiscal policy. The European Council endorsed a European Economic Recovery Plan in December 2008^a that called for a concerted fiscal stimulus equivalent to 1.5 per cent of EU GDP. In April 2009, the Leaders of the G20 also recognised the importance of concerted fiscal action and reasserted their commitment to “*deliver the scale of sustained fiscal effort necessary to restore growth*”. Both the European Council and Leaders of the G20 have also stressed the importance of taking action to reduce borrowing and ensure the sustainability of fiscal positions, in a timeframe consistent with recovery.

In line with measures being taken internationally, in the UK the Government is delivering fiscal support worth 4 per cent of GDP in 2009-10, through the fiscal stimulus package announced in the 2008 Pre-Budget Report, further targeted support announced in this Budget and by allowing the automatic stabilisers to operate in full to support the economy.

As the IMF has noted, differences in the sizes of automatic stabilisers across countries means that “*in order to compare across countries the role fiscal policy is playing in supporting economic activity, it is better to focus not just on its discretionary component*”.^b Chart a shows IMF estimates, produced for the G20, of the average annual effect of discretionary measures and the automatic stabilisers on the fiscal balance of G7 countries over the period 2008 to 2010. It shows that total support being delivered to the UK economy through the automatic stabilisers and discretionary action is in line with the G7 average.

The IMF has observed that the on-going financial crisis has had a major impact on the fiscal balances and debt levels of most countries, and the UK is no exception, as shown by Chart b. This is not just the result of discretionary measures and the operation of the automatic stabilisers, but also from the need for governments to support the financial system and from lower revenues due to falls in asset and commodity prices.

Chart a: G7 average annual effect of discretionary measures and automatic stabilisers 2008-2010

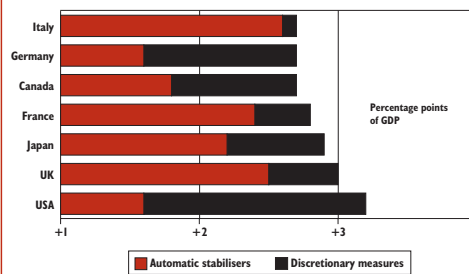
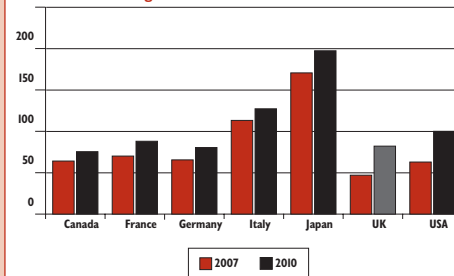


Chart b: OECD gross debt



^a www.consilium.europa.eu

^b *Group of Twenty: global economic policies and prospects*, International Monetary Fund, March 2009

Delivering fiscal support

2.60 In addition to allowing the UK's relatively powerful automatic stabilisers to operate in full, the 2008 Pre-Budget Report announced a timely, targeted and temporary fiscal stimulus package worth around 1 per cent of GDP in 2009-10, including a temporary reduction in the rate of VAT to 15 per cent and bringing forward £3 billion of capital spending. Box 2.5 provides information on the implementation of this stimulus package.

Box 2.5 Implementation of the 2008 Pre-Budget Report fiscal stimulus package

A temporary reduction in the rate of VAT was chosen as the main lever for the fiscal stimulus as it could be implemented very quickly, coming into effect only one week after the announcement of the measure in the 2008 Pre-Budget Report, and, being temporary, could be expected to have a relatively powerful effect on demand by encouraging consumers to bring spending forward. Indeed, the Institute for Fiscal Studies has estimated that the VAT cut has a similar effect on the relative price of current consumption as a 1 per cent cut in interest rates, arguing, “this policy change is likely to be a reasonably effective economic stimulant.”^a

It is too early to make a full evaluation of the impact of the VAT reduction. But there have been some positive early signs of the reduced VAT rate having been passed through into lower prices, providing support to consumer spending. According to the Bank of England’s February 2009 Inflation Report: “*prospects for consumer spending in the near term have been boosted by the temporary reduction in VAT*”. This view is supported by stronger retail sales growth in December, January and February than many commentators had predicted, and significantly stronger than the equivalent point in the recession of the early 1990s. The VAT reduction will, in particular, provide support towards the end of the year when its imminent reversal should provide an incentive for consumers to bring forward spending.

In 2008-09, investment in energy efficiency, the social housing stock, and in further and higher education was brought forward to prepare the economy for a high-tech, low-carbon future. In 2009-10, spending that has been brought forward will help improve transport infrastructure, science research facilities, school buildings and primary healthcare facilities. New arrangements have been put in place to ensure that the additional spending advanced as part of the fiscal stimulus package is delivered in a timely manner. In addition, in March 2009, the Government announced a public sector infrastructure debt-financing unit to provide temporary support for PFI projects, ensuring that vital projects in areas such as schools, waste and housing can proceed as planned. Further details are set out in Chapter 6.

^a IFS Green Budget, January 2009

Further action to support economy **2.61** This Budget announces further targeted support for those most affected by the downturn and to ensure a sustained and sustainable recovery:

- further support for businesses facing cash flow problems, consistent with rebalancing the economy by encouraging investment, and support for key growth industries of the future, set out in Chapter 4;
- further support for households hit hardest by the recession, including savers and pensioners, and additional measures to support employment, set out in Chapter 5;
- further investment in infrastructure and the housing sector, set out in Chapter 6;
- measures to support a move to a low carbon economy, set out in Chapter 7.

2.62 At a time of falling energy and mortgage costs, many households – in particular pensioners and families with children – are also benefiting from significant cash increases in tax credit and benefit rates. In January this year Child Benefit was increased by 6.4 per cent to £20 a week for the first child, and in April the child element of Child Tax Credit was increased by 7.2 per cent, the basic State Pension by 5 per cent, and Jobseeker's Allowance by 6.3 per cent. Furthermore, the Government will at least maintain the cash value of all benefits, tax credits and personal tax allowances and thresholds in April 2010, despite the expectation RPI inflation will be negative in September this year. This means that their real terms value will rise compared with standard indexation policy, increasing the impact of the automatic stabilisers and delivering a real boost to the purchasing power of many households.

**Ensuring
sustainability**

2.63 The Government is committed to ensuring sound public finances and protecting fiscal sustainability. Sound public finances are essential for macroeconomic stability, which gives businesses and individuals the confidence to plan and invest for the long term. They also help to deliver low long-term interest rates, supporting businesses' access to new financing and resources for growth. At the London Summit G20 Leaders resolved to ensure long-term fiscal sustainability and price stability, and to put in place credible exit strategies from the measures that need to be taken now to support the financial sector and restore global demand.

2.64 During a period when demand is very weak and the operation of financial markets and monetary policy are impaired, it is appropriate for the Government to allow borrowing to rise to support the economy. But, in time, the demand for and supply of private sector credit will recover and the efficacy of monetary policy will be restored, enabling businesses to generate renewed economic growth and reducing the role for fiscal policy in stabilising the economy. Setting a credible plan to reduce borrowing over the medium term provides space for the Government to act flexibly in the short term to support the economy, while also promoting confidence in future growth and the private sector investment that will drive economic recovery.

2.65 Building on the significant consolidation announced in the 2008 Pre-Budget Report, this Budget sets out tax and spending measures, implemented at a time when the economy is forecast to be recovering and able to support fiscal consolidation, which reduce borrowing by £26½ billion by 2013-14. The plans presented here will deliver an average adjustment of over 0.8 per cent a year in the cyclically-adjusted current budget between 2010-11 and 2013-14.

**Pace of
consolidation**

2.66 The Government has taken a judgement on the appropriate pace of consolidation of the public finances. This judgement recognises the uncertainty around prospects for the public finances given the exceptional nature and strength of the synchronised global downturn, the need to support the economy through the early stages of the recovery, and the need to deliver sustainable public finances.

2.67 On the assumption that the Government delivers a further consolidation of 0.8 a per cent of GDP a year in the cyclically-adjusted current budget beyond 2013-14, the fiscal projections set out in this Budget are consistent with the Government's temporary fiscal operating rule, returning to cyclically-adjusted current balance and debt falling as a proportion of GDP by 2017-18 when the global shocks will have worked their way through the economy in full. Box 2.6 sets out the Government's approach to ensuring the sustainability of the public finances.

Box 2.6: Ensuring sustainability of the public finances

Since 1997 the Government's medium term objective for fiscal policy has been to ensure sound public finances and that spending and taxation impact fairly within and between generations. Responsible management of the public finances is enshrined in the *Code for fiscal stability*, requiring the Government to ensure that "the fiscal position is sustainable over the long term."

There is no single measure of fiscal sustainability, with policy-makers and economists using a variety of measures to capture different aspects of this concept. One approach is to focus on the conditions required to stabilise public debt. Holding debt to a stable and prudent level in normal times allows space for debt to rise to absorb shocks when they come, while minimising risks to sustainability. However, there are many other factors that also contribute to delivering sustainable public finances. As set out in the OECD Journal on Budgeting in 2005, "contemporary sustainability analysis focuses on fiscal conditions that may retard economic growth, cause tax burdens to rise, or transfer significant costs to future taxpayers".^a This implies that:

- governments should manage their public finances so as to support economic growth, as this ensures a robust economy and improvements in living standards. This is important to provide future revenues to finance public services and spending, thereby ensuring that future obligations can be met;
- governments should seek to deliver sustainability in the tax burden, to ensure that they can continue to meet their obligations in the future. This allows individuals and companies to plan ahead and make the appropriate investment decisions, supporting high and stable levels of long-term economic growth; and
- fairness between and within generations is important to support improvements in the standard of living for both current and future generations.

Reflecting the Government's commitment to ensuring sustainable public finances over the medium term, the temporary fiscal operating rule introduced in the 2008 Pre-Budget Report is designed to underpin a sustained fiscal consolidation once the economy is recovering. In particular, it requires debt to be falling as a proportion of GDP once the global shocks have worked their way through the economy in full, in order to prepare for future shocks and other long-term challenges.

^a www.oecd.org

Tax measures 2.68 As set out in more detail in Chapter 5, the Government will make a number of reforms to support consolidation and reinforce the fairness of the tax system:

- **the income tax personal allowance will be restricted for those with incomes of over £100,000 from April 2010;**
- **an additional rate of income tax of 50 per cent will apply to income over £150,000 from April 2010; and**
- **tax relief on pensions contributions will be restricted for those with incomes of £150,000 and over from April 2011, and tapered down until it is 20 per cent.**

2.69 As set out in Chapter 7, to further support consolidation and to support the move towards a low-carbon and resource efficient economy, **the Government will increase fuel duty by 2 pence per litre on 1 September 2009 and by 1 penny per litre in real terms each year from 2010 to 2013.**

Public spending 2.70 Over the past ten years, public investment and reform of public service delivery have together generated real improvements in the quality of public services. Consistent with its fiscal objectives and the temporary fiscal operating rule, the Government is determined to continue delivering investment and improvements in public services, while ensuring sustainable public finances over the medium term.

2.71 Building on the successful delivery of the £5 billion of additional value for money savings in 2010-11, set out in Chapter 6, Budget 2009 announces a further step change in the Government's efficiency drive from 2011-12 onwards, including that:

- in the next Spending Review, the Operational Efficiency Programme (OEP) has identified scope for greater efficiencies across procurement, back office and IT, and property running costs in 2011-12 and beyond, rising to £9 billion of additional savings by 2013-14;
- the Public Value Programme will be expanded to ensure demanding Value for Money reviews are conducted right across departmental budgets. The expanded Programme will cover a minimum of 50 per cent of each Department's budget, with a particular focus on areas of spend that impact across departmental boundaries;
- building on the findings of the OEP, the Government will put in place new incentives and mechanisms with the aim of realising up to £16 billion of property and other asset sales in the three years from 2011-12, freeing up additional resources on top of capital budgets to fund investment priorities; and
- that the same rigour must also apply to the management of public spending, such as social security and tax credits, that is outside departmental budgets. So building on the reforms set out in the Welfare Reform White Paper in December 2008,⁷ the Government will do more to ensure the working age benefits system is fair, affordable over the long term, and encourages people away from dependency and into work.

2.72 Building on all these reforms, Budget 2009 sets new assumptions for spending growth from 2011-12 onwards, which will ensure continued investment and improvements in front-line public service priorities, while ensuring sustainable public finances in the medium term:

- **current spending will grow by an average of 0.7 per cent a year between 2011-12 and 2013-14 in real terms; and**
- **public sector net investment will move to 1¼ per cent of GDP by 2013-14.**

2.73 By releasing additional efficiency savings through the Operational Efficiency Programme and expanded Public Value Programme, the Government will be able to continue to invest in and improve public services in the years ahead.

⁷*Raising expectations and increasing support: reforming welfare for the future*, Department for Work and Pensions, December 2008

THE FISCAL OUTLOOK

Overview of the fiscal outlook

2.74 Table 2.3 compares the projections for net borrowing, the current balance, net investment and net debt with those published at Budget 2008 and the 2008 Pre-Budget Report. It shows that the global economic shocks and resulting downturn in the UK have had a profound effect on the public finances.

Table 2.3: Fiscal balances compared with Budget 2008 and the 2008 Pre-Budget Report

	Outturn ¹	Estimate ²	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Net borrowing (£ billion)							
Budget 2008	36.4	42.5	38	32	27	23	
Changes to current budget	-1.2	31.6	74	77	65	56	
Changes to net investment	1.4	3.5	5 ½	-4	-5 ½	-8	
2008 Pre-Budget Report	36.6	77.6	118	105	87	70	54
Changes to current budget	-1.4	11.1	53 ½	64 ½	57	54	53 ½
Changes to net investment	-0.6	1.2	3 ½	3 ½	-3 ½	-6 ½	-10 ½
Budget 2009	34.6	90.0	175	173	140	118	97
Surplus on current budget (£ billion)							
Budget 2008	-7.9	-9.6	-4	4	11	18	
Effect of revisions and forecasting changes	1.2	-23.3	-61	-78	-75	-72	
Effect of discretionary changes ³	0.0	-8.3	-13	1	10	16	
2008 Pre-Budget Report	-6.7	-41.2	-78	-73	-54	-37	-21
Effect of revisions and forecasting changes	1.3	-11.1	-48	-64 ½	-63 ½	-66 ½	-71
Effect of discretionary changes ³	0.0	0.0	-5 ½	½	7	12 ½	17 ½
Budget 2009	-5.3	-52.3	-132	-137	-111	-91	-74
Net investment (£ billion)							
Budget 2008	28.5	32.9	35	37	38	41	
Effect of revisions and forecasting changes	1.4	2.5	2 ½	- ½	-2	-1 ½	
Effect of discretionary changes ³	0.0	1.0	3 ½	-3 ½	-4	-6 ½	
2008 Pre-Budget Report	29.9	36.5	40	33	33	33	33
Effect of revisions and forecasting changes	-0.6	1.2	1 ½	2 ½	-2	-1 ½	-1 ½
Effect of discretionary changes ³	0.0	0.0	1 ½	1	-1 ½	-5	-9
Budget 2009	29.3	37.7	44	36	29	26	22
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2008	-0.7	-0.5	0.1	0.5	0.8	1.0	
2008 Pre-Budget Report	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
Budget 2009	-0.7	-3.1	-6.7	-6.4	-4.9	-3.9	-3.2
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2008	2.7	2.7	2.2	1.8	1.5	1.2	
2008 Pre-Budget Report	2.9	5.3	7.2	5.6	4.3	3.5	2.8
Budget 2009	2.7	5.7	9.8	8.9	6.8	5.5	4.5
Net debt (per cent of GDP)⁴							
Budget 2008	37.1	38.5	39.4	39.8	39.7	39.3	
2008 Pre-Budget Report	36.3	41.2	48.2	52.9	55.6	57.1	57.4
Budget 2009	36.5	43.0	55.4	65.0	70.9	74.5	76.2

Note: Figures on a National Accounts basis unless otherwise indicated.

Note: Totals may not sum due to rounding.

¹ The 2007-08 figures were estimates in Budget 2008.

² The 2008-09 figures were projections in Budget 2008.

³ Including changes to forecasting assumptions on spending growth in 2011-12, 2012-13 and 2013-14.

⁴ Debt at end March; GDP centred on end March; excluding liabilities and unrealised losses from financial sector interventions.

2.75 At the time of the 2008 Pre-Budget Report, the financial crisis was still at a relatively early stage. The Pre-Budget Report forecast that its impact on the public finances would be focused on the financial and housing sectors, projecting a significant deterioration in the structural position of the public finances as a result of lower receipts from those sectors, which previously were important sources of tax revenues, in addition to the cyclical impact from lower expected economic growth.

2.76 Since the 2008 Pre-Budget Report, the crisis has broadened out globally and in the UK to affect the whole of the economy, world trade has dropped and UK GDP has fallen more sharply than forecast in the 2008 Pre-Budget Report. The Budget 2009 public finance projections therefore incorporate a cyclical fall in receipts for all the main taxes and an increase in spending, as the Government allows the automatic stabilisers to operate in full. Large falls in VAT, income tax and onshore corporation tax have been experienced in 2008-09, and with overall nominal activity lower than in the 2008 Pre-Budget Report, these taxes remain significantly lower throughout the forecast. The fall in receipts is especially large because of the downwards revision to forecast inflation, compared with the 2008 Pre-Budget Report. In addition, the financial and housing sectors have weakened even further than expected in the 2008 Pre-Budget Report.

2.77 As a result, in the Budget 2009 projections, PSNB is projected to peak at 12.4 per cent of GDP in 2009-10, before declining to 5.5 per cent in 2013-14, as the economy recovers and the Government takes action to ensure the sustainability of the public finances through the discretionary tightening set out earlier in this chapter.

2.78 Table 2.4 shows that the automatic stabilisers account for a significant proportion of the increase in PSNB relative to the 2008 Pre-Budget Report projections throughout the forecast period. This reflects the deeper than expected downturn, which results in a larger than expected negative output gap throughout the forecast period. The table also shows that the discretionary fiscal tightening announced in this Budget reduces borrowing by £26½ billion by 2013-14.

2.79 PSNB in 2013-14 remains higher than forecast in the 2008 Pre-Budget Report because, the overall growth path of nominal activity across the forecast period is lower than forecast at the time of the 2008 Pre-Budget Report. In addition, the projected rebalancing of the economy will result in less tax-rich growth, with receipts from the financial sector in 2013-14 expected, in particular, to be lower than forecast in the Pre-Budget Report. Table 2.6 provides a full summary of the public sector finance projections.

Table 2.4: Public sector net borrowing compared with the 2008 Pre-Budget Report

	£ billion						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
2008 Pre-Budget Report	36.6	77.6	118	105	87	70	54
Changes since the 2008 Pre-Budget Report							
Automatic stabilisers ¹	-2.4	5.0	32	44	35	30 ½	28
Other tax and expenditure changes	0.5	7.3	17 ½	23	26 ½	34	41
Total before discretionary measures	34.6	90.0	168	173	149	135	123
Discretionary measures	0.0	0.0	7 ½	½	-8 ½	-17 ½	-26 ½
Budget 2009	34.6	90.0	175	173	140	118	97

Note: Figures on a National Accounts basis unless otherwise indicated.

¹ The cyclical component of PSNB, i.e. the difference between PSNB and cyclically-adjusted PSNB.

Making provision for financial sector losses 2.80 As explained in Box 2.3, the Budget sets out both its baseline fiscal projections, excluding liabilities and unrealised losses from financial sector interventions, and projections for borrowing and debt that include the high end of an estimated range for the net impact of unrealised losses. Including this provisional estimate means that fiscal policy takes into account the prospect of losses now, rather than waiting for firm estimates of total losses and their likely timings. Table 2.5 sets out the fiscal aggregates on both bases, and Box 2.7 sets out the Government's approach to making provision for these losses in the fiscal forecast.

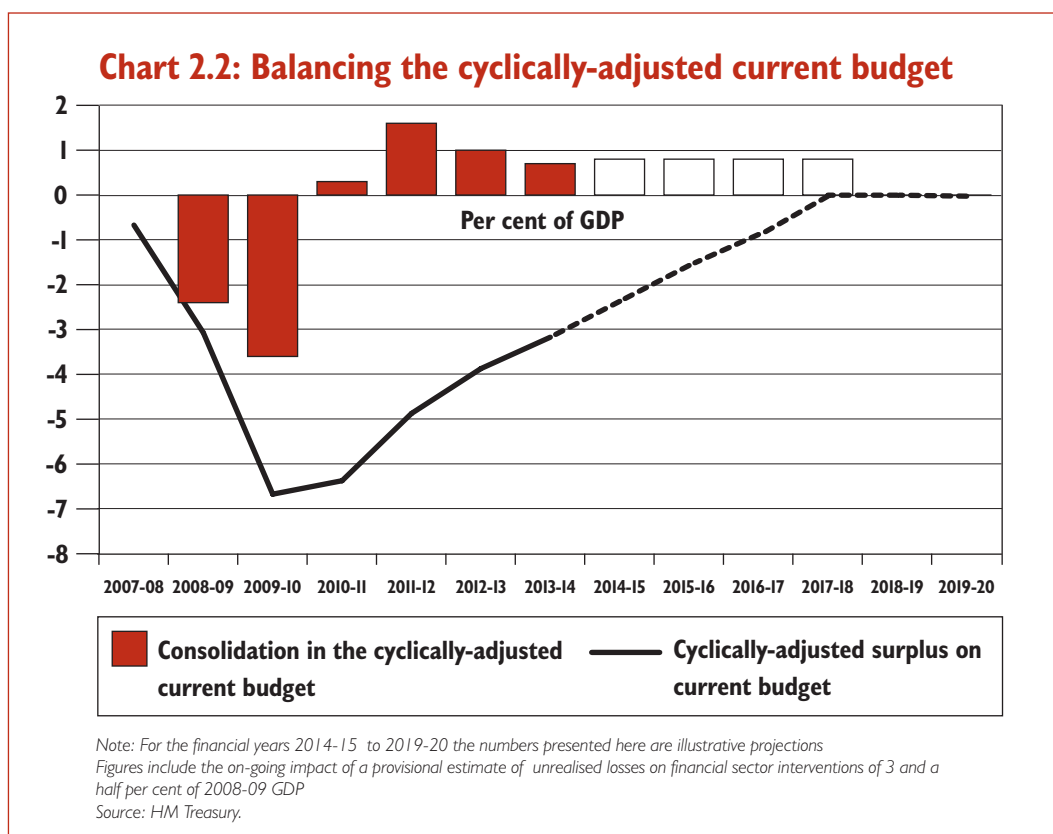
Table 2.5: Fiscal implications of measures to ensure financial stability

	Per cent of GDP					
	Estimate		Projections			
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Fiscal projections excluding liabilities and unrealised losses on financial sector interventions						
Public sector net borrowing	6.3	12.4	11.9	9.1	7.2	5.5
Public sector net debt ¹	43.0	55.4	65.0	70.9	74.5	76.2
Fiscal projections including unrealised losses on financial sector interventions						
Provisional estimate of unrealised losses	+3.5					
Net borrowing ²	9.7	12.4	11.9	9.1	7.2	5.5
Net debt ²	46.5	59.0	68.4	74.0	77.5	79.0

¹ Debt at end March; GDP centred on end March; excluding liabilities and unrealised losses from financial sector interventions.

² Includes unrealised losses equal to £50 billion or 3½ per cent of GDP in 2008-09. This figure is smaller as a share of GDP in future years.

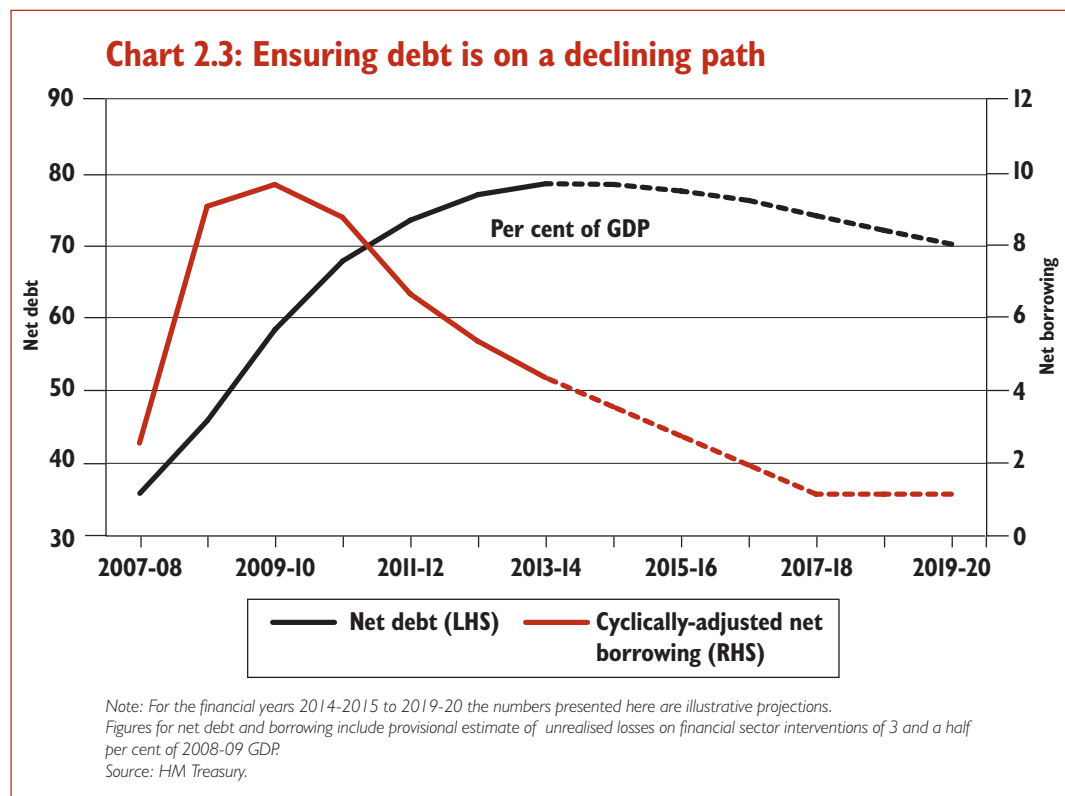
Balancing the cyclically-adjusted current budget 2.81 This Budget puts the public finances on a path to achieve a cyclically-adjusted current balance in 2017-18. The cyclically-adjusted current deficit falls from 6.7 per cent in 2009-10 to 3.2 per cent of GDP in 2013-14, an average improvement of over 0.8 per cent a year. The bars on Chart 2.2 show the planned fiscal consolidation in each financial year of the projection period. A further adjustment of 0.8 per cent of GDP a year from 2014-15 would eliminate the deficit on the cyclically-adjusted current budget by 2017-18.



Declining net debt to GDP ratio

2.82 Public sector net debt (PSND), including unrealised losses from financial sector interventions, increases over the period to 2013-14, in particular in 2009-10 and 2010-11, reflecting the additional borrowing in these years. It then stabilises at around 79 per cent of GDP by the end of the forecast period.

2.83 This Budget puts the public finances on a path to ensure that the level of public sector net debt will fall as a proportion of GDP in the medium term. Chart 2.3 shows that cyclically-adjusted PSNB is projected to decline from its peak in 2009-10, as a result of the Government's planned fiscal consolidation, standing at 4.5 per cent at the end of the projection period in 2013-14. The chart shows illustrative projections based on a further improvement of 0.8 per cent of GDP a year in the cyclically-adjusted current budget and the assumption that public sector net investment will be held constant at 1¼ per cent of GDP. The illustrative projections show that, under these assumptions, cyclically-adjusted PSNB will continue to fall and the public debt to GDP ratio will be declining in 2017-18, once the global shocks have worked their way through the economy in full.

**Consistency with the temporary operating rule**

2.84 The fiscal projections set out in this Budget are consistent with returning to cyclically-adjusted current balance by 2017-18, when the global shocks will have worked their way through the economy in full, and debt falling as a proportion of GDP by 2015-16. This is consistent with the Government's temporary fiscal operating rule, announced in the 2008 Pre-Budget Report.

Stability and Growth Pact

2.85 EU leaders have agreed that the flexibility provided for in the Stability and Growth Pact should be used, and that fiscal consolidation should be undertaken in line with economic recovery. Under the excessive deficit procedure of the Stability and Growth Pact, the EU's Economic and Financial Affairs Council has recommended that the UK brings its deficit below the 3 per cent reference value by 2013-14, with an average annual fiscal effort of more than 1 per cent of GDP from 2010-11. The Treaty debt and deficit measures are shown in Table 2.6.

Economic impact

2.86 The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.4 shows that both the automatic

stabilisers and the fiscal stance act to provide a considerable degree of support to the economy in 2008-09 and 2009-10, during the economic downturn. From 2010-11 the fiscal stance tightens to deliver a reduction in borrowing at a time when the economy is expected to be recovering and able to support the fiscal consolidation, while the automatic stabilisers continue to provide some support in 2010-11, reflecting the lagged impact of the downturn on spending.

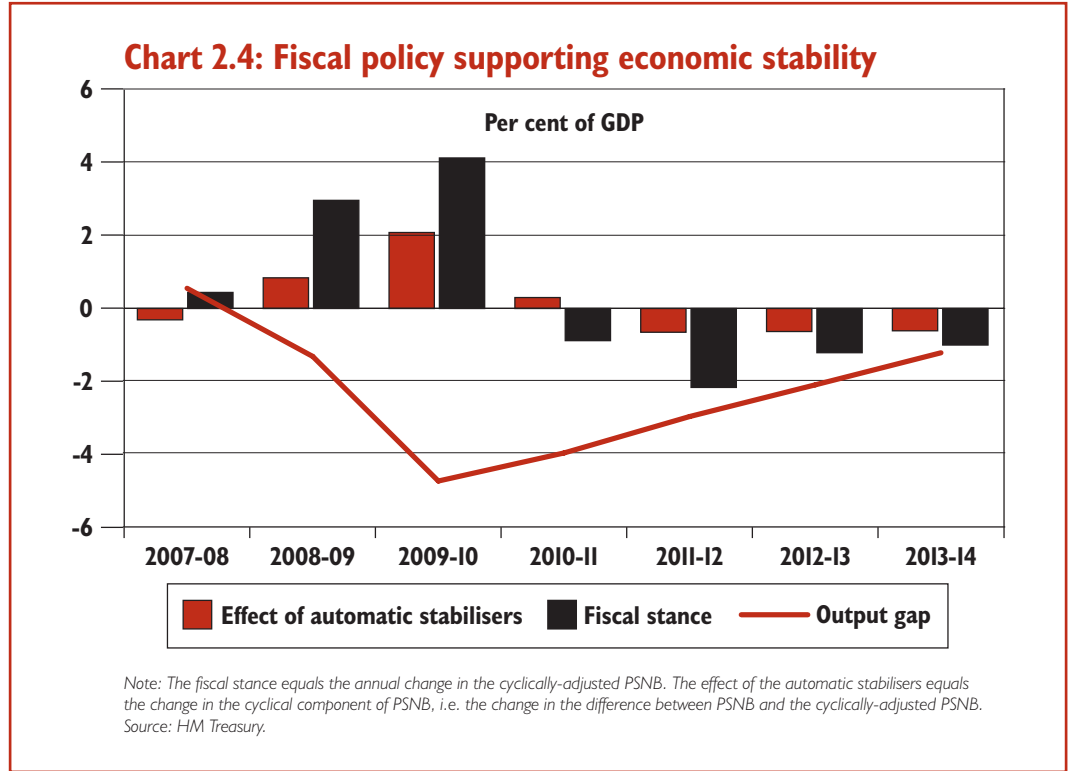


Table 2.6: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Fiscal consolidation							
Surplus on current budget	-0.4	-3.6	-9.3	-9.4	-7.2	-5.6	-4.3
Cyclically-adjusted surplus on current budget	-0.7	-3.1	-6.7	-6.4	-4.9	-3.9	-3.2
Consolidation in the cyclically-adjusted surplus on current budget ¹	-	-	-	0.2	1.5	1.0	0.7
Economic impact							
Net investment	2.1	2.6	3.1	2.5	1.9	1.6	1.3
Public sector net borrowing (PSNB)	2.4	6.3	12.4	11.9	9.1	7.2	5.5
Cyclically-adjusted PSNB	2.7	5.7	9.8	8.9	6.8	5.5	4.5
Sustainability							
Public sector net debt ^{2,3}	36.5	43.0	55.4	65.0	70.9	74.5	76.2
Core debt ^{2,3}	36.6	42.5	52.4	59.2	63.2	65.7	66.9
Net worth ⁴	28.9	25.5	21.1	10.5	4.0	-0.3	-2.9
Primary balance	-0.9	-4.6	-10.8	-9.3	-6.1	-4.1	-2.5
Financing							
Central government net cash requirement	2.3	11.3	15.6	12.3	9.6	7.3	6.0
Public sector net cash requirement ³	1.5	4.2	13.3	12.3	9.7	7.5	6.0
Stability and Growth Pact							
Treaty deficit ⁵	2.8	7.1	12.6	12.0	9.2	7.3	5.8
Cyclically-adjusted Treaty deficit ⁵	3.1	6.6	10.0	9.0	6.9	5.7	4.7
Treaty debt ratio ⁶	43.2	55.2	71.9	82.1	87.2	89.9	90.7
Memo: Output gap	0.6	-1.3	-4.8	-4.0	-3.0	-2.1	-1.2

Note: Figures on a National Accounts basis unless otherwise indicated.

¹ Change in the cyclically-adjusted surplus on the previous year.

² Debt at end March; GDP centred on end March.

³ Excluding liabilities and unrealised losses from financial sector interventions.

⁴ Estimate at end December; GDP centred on end December.

⁵ General government net borrowing on a Maastricht basis.

⁶ General government gross debt measures on a Maastricht basis.

Financing and debt management

2.87 As is the case for other countries, debt issuance in the UK will be higher in 2009-10 than in preceding years. Debt agencies around the world, including the UK Debt Management Office, have an important and essential role in delivering increased debt issuance successfully in the interests of the taxpayer.

2.88 The forecast for the central government net cash requirement (CGNCR) for 2008-09 is £162.4 billion, an increase of £9.5 billion from the 2008 Pre-Budget Report forecast of £152.9 billion.

2.89 The projection for the CGNCR in 2009-10 is £220.8 billion. Gross gilt redemptions are projected at £16.6 billion. Following the relatively large contribution to net financing of £12.5 billion in 2008-09, National Savings and Investments is not expected to make a net contribution to financing in 2009-10, but will broadly maintain the existing level of stock. This projection assumes gross inflows of £13.9 billion in 2009-10.

2.90 The forecast for the net financing requirement in 2009-10 is £237.8 billion. The net financing requirement will be met by:

- gross gilt issuance of £220.0 billion;
- an increase in the Treasury bill stock of £21.6 billion to £65.6 billion; and
- a change in the short-term debt level reflecting the Government's decision to repay £3.8 billion of the remaining balance of the Ways and Means Advance at the Bank of England.

2.91 As set out in the Chancellor's letter to the Governor of the Bank of England of 3 March 2009, debt issuance strategy will not change in response to the Bank's programme of asset purchases financed by the provision of central bank money set out earlier in this chapter. The debt management objective remains "*to minimise, over the long-term, the costs of meeting the Government's financing needs, taking into account risk, whilst ensuring that debt management policy is consistent with the aims of monetary policy*".

2.92 Auctions will remain the Government's primary method by which to issue gilts. However, the Government has decided to use supplementary methods to issue gilts in 2009-10. In particular, the Government has decided to use syndication, and to extend the use of mini tenders, which were first used in October 2008, to issue gilts. Projected gross gilt issuance of £220 billion in 2009-10 will be issued as follows:

- £183 billion (or 83 per cent of total) to be issued by auction;
- £25 billion (or 11 per cent of total) to be issued by syndication; and
- £12 billion (or 6 per cent of total) to be issued by mini tender.

2.93 The use of syndication and mini tenders will facilitate higher issuance of long maturity and index-linked gilts. In 2009-10, in total, the Government is projected to issue:

- £74 billion of short conventional gilts (i.e. 1-7 year maturity), or 34 per cent of total;
- £70 billion of medium conventional gilts (i.e. 7-15 year maturity), or 32 per cent of total;
- £46 billion of long conventional gilts (i.e. maturity of above 15 years), or 21 per cent of total; and
- £30 billion of index-linked gilts, or 13 per cent of total.

2.94 Full details and a revised financing table can be found in Chapter C. Further details can be found in the *Debt and reserves management report 2009-10*, published alongside the Budget.⁸

⁸*Debt and reserves management report 2009-10*, HM Treasury, April 2009

Transparency in the public finances

Assumptions underpinning forecast **2.95** Consistent with the *Code for fiscal stability*, the projections for the public finances include the effects of firm decisions announced in this Budget or since the 2008 Pre-Budget Report, which are summarised in Chapter 1.

2.96 These projections are based on a range of assumptions and judgements on the public finances and the economy, and the interactions between them. A number of these are designed to provide caution and these are audited by the National Audit Office (NAO). Further information on these assumptions is set out in Chapter C

2.97 For Budget 2009, the Comptroller and Auditor General has audited the assumptions for trend growth, short-term interest rates, privatisation proceeds and the Treasury's cyclical-adjustment methodology. His conclusions are outlined in Chapter C.

2.98 Box 2.7 sets out the Government's approach to making provision for financial sector interventions in the fiscal forecast.

Box 2.7: Approach to making provision for losses on financial sector interventions in the fiscal forecast

As set out above, to ensure transparency and responsible management of the public finances, the Government is setting out fiscal projections including an estimate of unrealised losses from financial sector interventions, equal to 3½ per cent of GDP. This provisional estimate is the high end of a range of estimated outcomes for the net impact of future losses on financial sector interventions.

Given the inherent uncertainty, it is not possible to produce a robust estimate of the scale and profile of losses over time. Instead, the fiscal judgement is based on a single estimate, reflecting losses expected to be incurred at some point in the future.

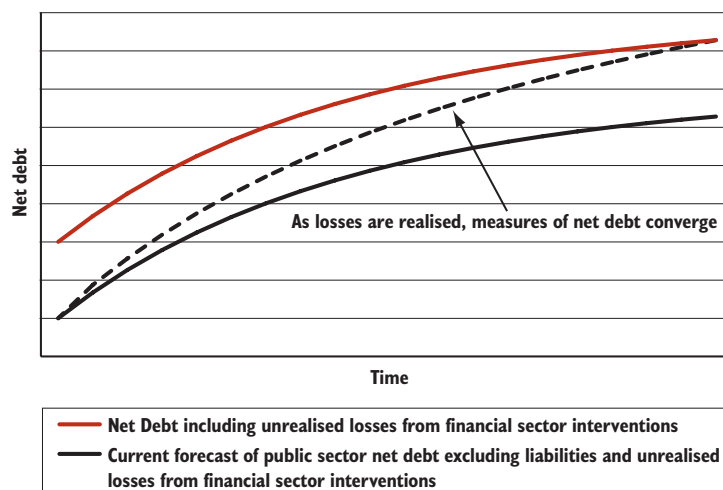
This estimate recognises the full losses in the 2008-09 financial year, in a manner similar to the principle of provisioning for future costs in commercial accounting. This does not reflect cash borrowing in 2008-09, but is instead a recognition that transactions undertaken, and commitments entered into, in that year are expected to have consequences of this magnitude in the future. The higher borrowing results in a higher estimate of debt, extending across the forecast period, and reflecting the Government's current provisional estimate of the medium-term fiscal impact of its financial sector interventions.

To ensure transparency in reporting on the impact of financial sector interventions on the public finances, the Government will publish information on three different bases:

- *including financial sector interventions on a National Accounts basis:* These measures reflect the treatment of financial sector interventions as determined by the national accounts, including temporary and exceptional effects from, for example, the inclusion of the balance sheets and operations of banks classified to the public sector;
- *excluding liabilities and unrealised losses from financial sector interventions:* These measures remove the temporary effects of financial sector interventions on the fiscal aggregates. As losses are realised for central government, and so can be reliably included in the fiscal projections, they will score in these measures; and
- *including unrealised losses on financial sector interventions:* These measures include the anticipated future loss stemming from the Government's financial sector interventions, and so are better measures of the sustainability of the medium-term fiscal position than those on the other two measurement bases. They remove the temporary effects of financial sector interventions on the fiscal aggregates.

As losses crystallise, outturns for net debt, excluding liabilities and unrealised losses, will converge on the projection including the estimate of future losses. This effect is illustrated below.

Chart a: Implications of financial sector losses for debt measures



Risks and uncertainty **2.99** The public finance projections are always subject to a significant degree of uncertainty. As set out earlier in the chapter, and in more detail in Chapter B, the magnitude and complexity of the shocks currently affecting the global economy means the economic outlook is particularly uncertain at the current time. The economic growth path is a key driver of borrowing and debt. As set out in *Public finances and the cycle*,⁹ published alongside the 2008 Pre-Budget Report, a 1 percentage point increase (decrease) in the output gap typically leads to a decrease (increase) in PSNB of 0.5 per cent in that year and 0.2 per cent in the following year, based on an average cycle.

2.100 The outlook for the financial sector, which has been an important source of tax receipts in the UK, is another key uncertainty in the fiscal forecast. The forecast currently assumes that the sector expands from 2010-11 before returning to long-term average growth rates, but that, consistent with a rebalancing of the UK economy in the medium term, it is a less important source of receipts than it has been in the past. Chapter C contains further information on the forecast for financial and housing sector receipts.

2.101 As set out further in Chapter C, during a recessionary period in particular, the NAO-audited assumptions on oil prices, equity prices and the VAT gap build in increased caution to the medium-term forecast.

LONG-TERM FISCAL ISSUES

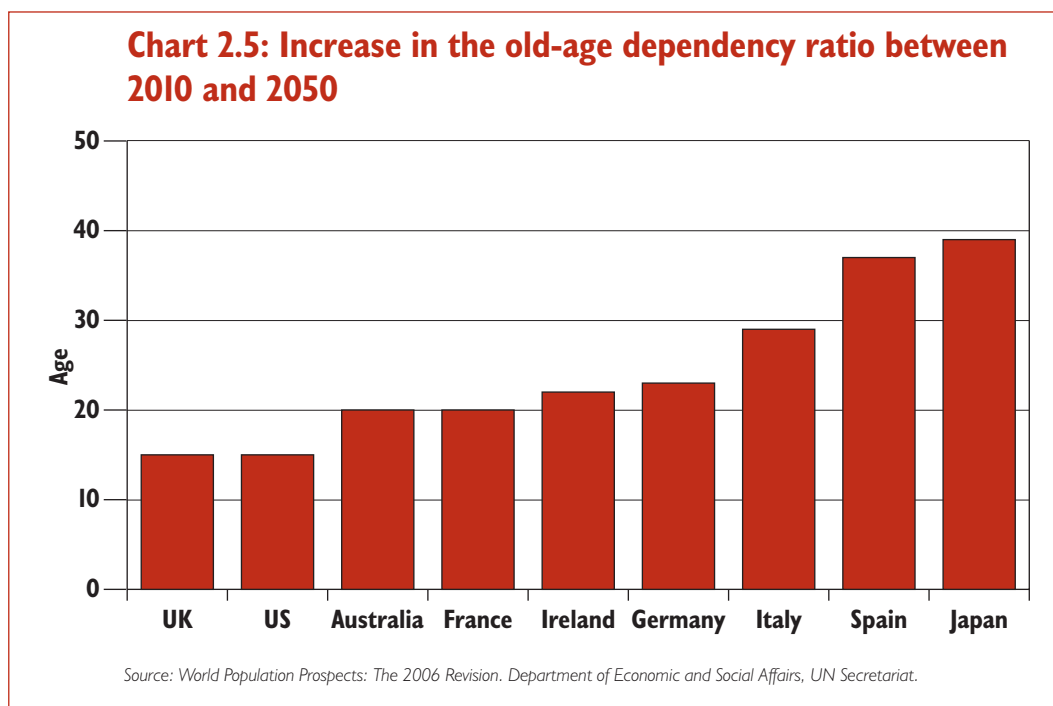
2.102 The temporary fiscal operating rule introduced in the 2008 Pre-Budget Report is designed to underpin a sustained fiscal consolidation once the economy is recovering, and the Budget sets out plans to deliver a sustained fiscal consolidation once the economy emerges from the downturn. This will put the public finances on a sustainable path in the medium term. It is important also to monitor challenges for the public finances in the long term.

2.103 Beyond the period covered in the projections above, the economy and public finances are likely to see the effects of demographic change. As recently highlighted by the International Monetary Fund (IMF) in the context of the impact on countries across the world of the current crisis *“in spite of the large fiscal costs of the crisis, the major threat to long-term fiscal solvency is still represented, at least in advanced countries, by unfavourable demographic trends”*.¹⁰

Demographic change **2.104** Demographic change poses challenges for the economy and public finances in the long term, as the increase in dependents (i.e. children and the retired, who tend to be net consumers of output and public goods and services) is greater than the increase of working-age population (who tend to be net contributors). The main driver of this change is the ageing of populations, a trend that is common across most developed countries. In the UK this means that the old-age dependency ratio (people aged 65 and above versus those aged 16 to 64) is projected to increase by around 15 percentage points from 2010 to 2050. While this is a significant increase, it is relatively low in comparison with some other developed countries, as shown in Chart 2.5, and according to the EU’s Economic Policy Committee (2008) it is the lowest increase among European countries, bar one.

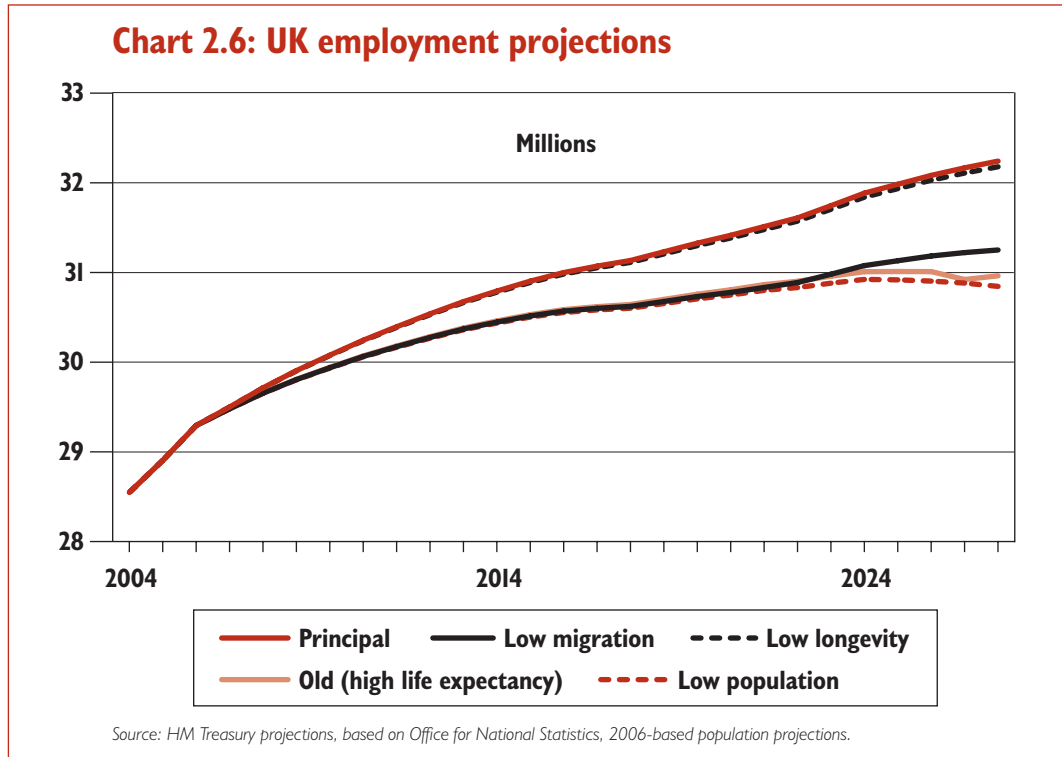
⁹*Public Finances and the Cycle: Treasury Economic Working Paper No.5*, HM Treasury, November 2008.

¹⁰*The State of Public Finances: Outlook and Medium-Term Policies after the 2008 Crisis*, International Monetary Fund, March 2009



2.105 As set out Box 2.6 above, in considering fiscal sustainability a range of factors are important and analysis must take into account economic growth, sustainability of taxes and intergenerational fairness. Managing the public finances so as to support economic growth ensures a robust economy and improvements in living standards. This is important to provide future revenues to finance public services and spending, and thereby ensure that future obligations can be met. High and stable economic growth in the long term will ensure prosperity for future generations and underpin the long-term sustainability of the public finances.

2.106 Demographic change affects the economy mainly through its impact on the proportion of the population of working age and consequently on the level of employment. The Office for National Statistics published its latest population projections in October 2007 and these can be used to provide an estimate of the working-age population over the long term. Employment levels can be projected by using these estimates to model the impact of an ageing workforce on overall participation (with older workers generally having lower participation rates than younger workers) and the effect of current young cohorts gradually replacing current older cohorts. Chart 2.6 shows the results of this analysis for different population variants and it is apparent that, despite adverse demographic change, employment is projected to continue to grow over the long term.



Long-term fiscal impacts

2.107 The Government remains committed to the principle of transparency in the public finances. The *2008 Long-term public finance report*¹¹ provided a comprehensive assessment of the impact of demographic change on the public finances, based on long-term fiscal projections. While demographic structures will change in the longer term, the UK compares favourably in that respect with other European countries, as explained above. The next Long-term public finance report will be published in 2009 and will be able to reflect the EU Economic Policy Committee's latest, 2009, budgetary projections, which give fifty-year projections of age-related expenditure across EU countries. Budget 2009 set out projections for net debt, cyclically-adjusted net borrowing and current balance until 2019-20, consistent with the requirement of the *Code for fiscal stability*.

¹¹ 2008 *Long-term public finance report*, HM Treasury, March 2008.