

UK ECONOMICS FOCUS

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Budget 2009

The tip of the iceberg

- This Budget was a holding operation which left the really tough decisions required to sort out the public finances to be taken by whoever is Chancellor after the next election. **The tax increases and spending cuts announced today are just the tip of the iceberg.**
- **As expected, the key feature of the Budget was the enormous increase in the projections for public borrowing and debt.** Overall, public sector net borrowing is now expected to be a cumulative £270bn higher over the next five years than was predicted in last November's Pre-Budget Report.
- **Perhaps the most startling thing is that, huge though the borrowing figures are, they are still likely to prove to be too low.** The projections are based upon real growth in the economy next year of 1.25%, and no less than 3.5% p.a. thereafter. By contrast, we suspect that there will be a further *decline* in GDP next year and only a moderate recovery when it comes. As a result, we expect public borrowing to soar to £230bn or above next year.
- **The poor outlook for the public finances restricted the fiscal stimulus in the Budget to a paltry 0.5% of GDP, a pathetic figure in view of the seriousness of the recession.** But neither did the Chancellor do a great deal to bring the public finances back towards a sustainable position further ahead. He has been inhibited by both the concern not to make the recession worse by drawing demand out of the economy now, and by his reluctance, for political reasons, to announce either larger tax rises or bigger cuts in spending ahead of next year's general election.
- As a result, the ratio of public debt to GDP now rises to 79% in 2013-14 - double the old ceiling - and is not expected to start to fall again until 2017-18. It looks as though it could be several decades before the debt to GDP ratio is back below 40%. **In these circumstances, the tax increases and squeeze on public spending do not yet go anywhere near far enough.**
- The figures for public borrowing and prospective new issuance do not make comfortable reading for the gilt market. **But, over time, we still expect the combination of low inflation and interest rates, and further official purchases, to push yields lower.**

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The tip of the iceberg

The Budget package

The Chancellor's room for manoeuvre in this Budget was always going to be constrained by the strongly conflicting needs of the economy and the public finances. In the event, it was the latter which had the more dominant influence. The net fiscal boost over the next year is a paltry £5bn, or 0.5% of GDP, smaller than the VAT cut implemented in November's PBR. What's more, this turns into a fiscal *tightening* of 1.5% per annum by the end of the forecast period.

There was no money for any headline grabbing measures. In cash terms, the biggest measure was the £1.6bn worth of increased capital allowances to encourage investment. The other measures of any note had all been flagged in advance – a car scrappage scheme, support for people losing their jobs, a rise in the ISA allowance and help for pensioners with low savings. (See Table 1.)

Also unsurprisingly, the tightening further ahead concentrated on high earners. The new 45% income tax band for those earning over £150,000 was both increased to 50% and brought forward from 2011 to 2010. Tax relief on pension contributions for those earnings over £150,000 will also be reduced from 2011 onwards. And the personal allowance for those earning over £100,000 is to be withdrawn in full.

TABLE 1: BUDGET MEASURES (£M, PRICE INDEXED)

Cost/yield (-/+)	09-10	10-11	11-12
Revenue giveaway:			
Labour market support	-905	-2,005	0
Help for pensioners/families	-660	-285	0
Green measures	-345	-65	+245
Support for business	-3,320	-445	+615
Other	-860	-210	-45
Revenue raising:			
Tax avoidance measures	+260	+370	+420
Duty increases	+670	+1,310	+1,805
Higher rate tax rises	0	+1,230	+2,190
Net total policy decisions	-5,160	-100	+5,230

Source – HM Treasury

The economic forecasts

As expected, Mr Darling was forced to take another large chunk out of this year's GDP growth forecast, dragging the mid-point forecast down from November's PBR figure of -1% to -3.5%. Unsurprisingly, Mr Darling cited the collapse in global trade – the largest since 1945 – as a key culprit for the worsened outlook, with 2009's forecast for exports revised down by a massive 9¼ percentage points. (See Table 2.) While import growth was also revised down substantially, the expected net trade effect on overall growth has been sharply reduced. However, the Chancellor could not ignore the domestically-generated slowdown. He reduced his forecast for household

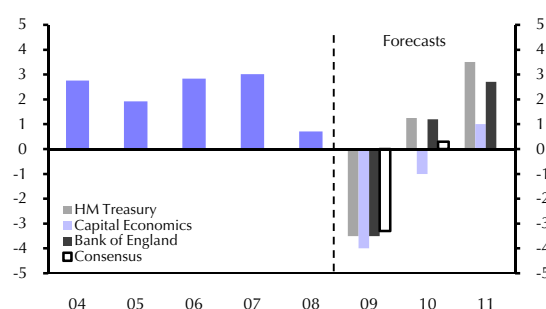
TABLE 2: HM TREASURY FORECASTS 2009 TO 2011 (%Y/Y UNLESS OTHERWISE STATED)

	2009			2010			2011		
	PBR 08	Bud. 09	CE	PBR 08	Bud. 09	CE	PBR 08	Bud. 09	CE
GDP	-1¼ to -¾	-3¼ to -3¼	-4	1½ to 2	1 to 1½	-1	2¾ to 3¼	3¼ to 3¾	2½
Consumption	-1½ to -1	-3¼ to -2¾	-3½	1¼ to 1¾	0 to ½	-1.5	2¼ to 2¾	3 to 3½	0
Govt consumption	2¾	4¾	3	1	1	2	0	-1¼	1.7
Fixed Investment	-8¼ to -7¾	-11¼ to -10¾	-8	2¼ to 2¾	-3¼ to -2¾	-5	6½ to 7	6¼ to 6¾	1.0
Stockbuilding (%GDP)	-¼ to 0	-1	-½	0	1	-0.1	0	0	0
Domestic demand	-2 to -1½	-4 to -3½	-3.4	1½ to 2	½ to 1	-0.8	2½ to 3	2½ to 3	0.7
Exports	¼ to ¾	-9 to -8½	-10	3¼ to 3¾	¾ to 1¼	-3	5¼ to 5¾	4¾ to 5¼	4.5
Imports	-2½ to -2	-9½ to -9	-7½	2½ to 3	-¾ to -¼	-2	4 to 4½	2¼ to 2¾	3.0
Manufacturing output	-3¼ to -2¾	-12¾ to -12¼	-15	1 to 1½	¼ to ¾	-3	1¾ to 2¼	2 to 2½	2
Current account, £bn	-45¾	-49½	-31	-48½	-48¾	-16	-49	-49¾	-10
CPI (Q4)	½	1	0.9	2¼	1	0.7	2	2¼	-0.1

consumption from a mid-point of -1.25% in the PBR to -3. The revisions bring the Treasury's forecasts for 2009 into line with those of the Bank of England (-3.5%) and the consensus (-3.3%), but not with our own (-4.0%). (See Chart 1.)

The bigger issue, however, is the outlook for next year and beyond and, on that, the Chancellor's forecasts continue to look very hopeful. His forecast for growth in 2010 was cut only from a midpoint of 1.75% to 1.25%, well above the consensus forecast of 0.3%.

CHART 1: FORECASTS FOR ANNUAL REAL GDP GROWTH



Source – HM Treasury, Thomson Datastream

Admittedly, he resisted the temptation to add all of the growth lost this year and next back on to the forecasts for the outer years, instead estimating that the one-off drop in trend output caused by the credit crunch will now be around 5% rather than the 4% estimated in the PBR. Nonetheless, he still predicted several years beyond next year of GDP

growth of 3.5%, which looks very optimistic to us given the likely slower growth in credit and likely prolonged adjustment in the household sector.

As for inflation, the Chancellor believes that the very little spare capacity will open up in the economy, causing CPI inflation to return to a level slight above target in 2011. But our more negative forecasts for growth in 2009 and 2010 - coupled with a smaller fall in trend output - suggest that plenty of spare capacity will exist by 2011, restraining the build-up of inflationary pressures in the economy. Needless to say, this will further reduce the growth and level of nominal GDP compared to the Chancellor's forecasts.

The fiscal forecasts

As widely expected, the new fiscal forecasts revealed an enormous rise in the projected level of public borrowing and debt over the next five years. **Altogether, public sector net borrowing (PSNB) was revised up by an eye-watering £270bn over the next five years, with this year's figure alone rising by £57bn from £118bn to £175bn.** This is the equivalent of some 12% of GDP and easily the highest peacetime UK budget deficit on record. Borrowing eases down slowly in the following years but, even by 2013-14, is still close to double the forecast in the PBR at £97bn.

Not surprisingly, the impact of all of this extra borrowing on the outstanding level of public debt is huge. The ratio of debt to GDP is now projected

TABLE 3: SOURCES OF CHANGE IN NET BORROWING FORECAST SINCE 2008 PRE-BUDGET REPORT

Impact on borrowing £bn	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
1. Pre-Budget Report 2008 PSNB Forecast	77	118	105	87	70	54
2. Forecast changes in Budget 2009	13	50	68	62	65	69
Of which: Automatic stabilisers	5.0	32	44	35	31	28
Other tax & spending changes	7.3	18	23	27	34	41
3. Total before discretionary measures (=1+2)	90	168	173	149	135	123
4. Discretionary measures in Budget 2009	0.0	7	0	-9	-17	-26
5. Budget 2009 PSNB Forecast (=3+4)	90	175	173	140	118	97
6. Capital Economics	90	200	230	220	200	180

Source – HM Treasury N.B. Total figures may not sum due to rounding

to rise to some 76% by 2013-14, close to double the 40% ceiling incorporated in the abandoned Sustainable Investment Rule. **Perhaps most strikingly, the longer-term fiscal projections show that the debt ratio is not expected to start to fall until 2017-18 and will presumably take decades to return to current levels.**

Table 3 outlines the changes in the borrowing forecasts in more detail. Needless to say, virtually none of the rise in projected borrowing reflects the discretionary measures included in the Budget itself, though the fiscal tightening reaches 1.5% of GDP by the end of the forecast period. Rather, the vast bulk reflects the natural effects of the weaker outlook for the economy (the so-called automatic stabilisers). Over and above this, however, borrowing eventually rises by a further £40bn per annum in response to various non-cyclical factors, in particular assumed permanently lower levels of activity in tax-conducive sectors like housing and finance. This emphasises the need for further tax rises or spending cuts to close this structural gap.

As widely mooted, the Chancellor made some allowance in the fiscal projections for the costs and losses associated with the various measures implemented to support the banking and financial sectors. These are estimated at around £50bn (or 3.5% of GDP), similar to our own estimate of £60bn, but the amounts are clearly very uncertain and could rise significantly over time.

For accounting purposes, this figure has been added onto the level of borrowing and public debt in 2008-09, though it is stripped out of the headline measures which appear in the key fiscal tables. As those losses and any others are actually realised, however, they could push recorded borrowing and debt higher in future years.

Comparing Mr Darling's projections with our own, we suspect that this year's PSNB forecast of £175bn is likely to prove somewhat optimistic. Our expectation that the economy will actually contract by 4% or so rather than Mr Darling's 3.5% in the calendar year points to a borrowing

total of around £200bn. But it is next year and beyond where the figures diverge more markedly in response to the much slower recovery we anticipate as credit constraints and a period of deleveraging in the household sector hold back GDP growth.

Overall, we think borrowing could be a cumulative £300bn higher than Mr Darling predicts over the next five years. Needless to say, this suggests that a much bigger fiscal consolidation in the form of bigger tax increases or an even tighter squeeze on spending will eventually be required in order to bring the public finances back towards a sustainable position.

Gilt funding & the markets

The Government sharply revised up its estimated gilt issuance this year to some £220bn, from a PBR estimate of £144bn. (See Table 4.) This compares to £146bn of gilt sales in 2008/09, itself almost triple the previous year's total. The extra issuance will be skewed towards the short and middle of the curve, no doubt to take advantage of the lower borrowing costs at shorter maturities at the moment.

TABLE 4: GILT FUNDING ARITHMETIC

£bn	PBR 09	Bud 09	Capital Economics		
	09-10	09-10	09-10	10-11	11-12
CGNCR	126	221	240	230	220
Redemptions	18.1	16.6	18	39	49
Financing for APF	-	-1.0	0.0	0.0	0.0
Financing for reserves	0.0	2.0	0.0	0.0	0.0
Buybacks	0.0	0.0	0.0	0.0	0.0
Financing adjustment	0.0	-0.6	10.0	0.0	0.0
Financing Requirement	144.1	237.8	268	269	269
Less National savings	0.0	0.0	0.0	0.0	0.0
Net Fin'g Requirement	144.1	237.8	268	269	269
Ways and means	-3.8	-3.8	0.0	0.0	0.0
<i>Financed by:</i>					
T bills	0.0	21.6	0.0	0.0	0.0
Gilts, of which	147.9	220	268	269	269
Shorts	63.6	74.0	-	-	-
Mediums	32.5	70.0	-	-	-
Longs	31.1	46.0	-	-	-
Index-linked	20.7	30.0	-	-	-

Source – Debt Management Office

Part of the upward revision to gilt issuance was obviously due to the Chancellor's upwardly revised borrowing figures. However, the central government net cash requirement (CGNCR) was also boosted by the extra support for the banking sector. Financial sector interventions are now estimated to increase the CGNCR by £38bn in 2009/10, reflecting the £19bn of capital the Government has promised to inject into RBS, as well as expected further loans and capital injections to Northern Rock and Bradford and Bingley. **Our own higher forecast for borrowing suggests that gilt sales might actually total some £270bn this year (higher than we previously thought because of the financial interventions) and then remain at close to that level in the following two years.**

Supply concerns could therefore yet put additional upward pressure on bond yields (although the bond market reaction immediately after the Budget was fairly muted). **But we still expect the combination of lower inflation and interest rates, as well as both official purchases and purchases by banks for regulatory purposes, to push yields lower over time.**