

UK Budget acknowledges deterioration in public finances

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Summary

• Overview

UK Budget 2009 announcements were as grim as expected. Official borrowing will reach over 12% of the economy in the current financial year, or £175bn. It will fall only slightly in 2010/11 to £173bn, and to 11.9% of the economy if the official forecast of 1.25% growth for 2010 proves correct. If the official growth forecast is not met, however, the actual borrowing outcome in 2010/2011 may be as much or higher than this year. These figures must be seen against the backdrop of a continuing global financial crisis and a world economy in synchronised recession, making it the worst downturn since the 1940s. In spite of the efforts to mitigate the effect of the current crisis, it is still not even clear that the worst is yet over. This is the context for the big increases in public sector government borrowing that were announced in the 2009 Budget. When will recession end and borrowing start falling? From the Budget details, the next two years are assumed to be the worst and so borrowing only starts to fall steeply from 2011/12 as economic growth is assumed to rise by 3.5% in 2011. There will likely be vigorous debate about whether the medium term projection is one that sets out a path to sustainable deficits. However, the official assumption is that by 2013/14, government borrowing is down to 5.5% of gdp from a peak of over 12% this year and balance is achieved by 2017/18. This is based on tough spending control and assumptions about strong economic growth, efficiency savings and fiscal drag.

Budget 2009 showed a sharp deterioration in the public finances, with official borrowing set to exceed 12% of the economy this year...

...however, public spending growth will only slow after trend growth returns in 2011, as net debt as a share of the economy nears 80%

The growth forecast is pretty much in line with consensus for 2009 but above for 2010, at -3.5% and 1.25%, respectively

The business specific measures announced were fairly small in relation to the size of the increase in borrowing set to take place

• Fiscal outlook

The economic downturn is squeezing tax revenues whilst at the same time boosting spending, as unemployment rises. The increase in the Budget deficit to 12% of the economy is a consequence of this, as efforts to rein in the deficit while the recession is ongoing, say through tax rises or spending cuts, would simply make the downturn in the economy worse and ultimately raise the deficit even more. This is partly why it is assumed that public spending growth will slow sharply after trend growth returns, to 0.7% from 2011/12, after a rise of 1.2% this fiscal year and next. But the outlook for the public finances is grim, with net borrowing of 12.4% of the economy this year and 11.9% in 2010/11. By 2013/14, the deficit is projected to decline to 5.5% of the economy, partly a result of an economic assumption that sees growth of 3.5% in 2011 and 2¾% growth a year thereafter. Net debt as a share of the economy is projected to fall back from a 79% peak, from 2013/14 onwards. The stance of the public sector in the medium term is geared towards a net tightening position, as tax revenues rise as a share of the economy though not enough by itself to achieve stability without other assumptions.

• Economic outlook

The UK's economic outlook is not the worst amongst the top seven developed economies, but the official view from the Treasury is that there will be a contraction of 3.5% this year followed by a recovery next year to 1.25% growth. The forecast is pretty much in line with the consensus for 2009 but above for 2010. Much of the reduction in the ratios of borrowing and debt in the medium term projections is dependant on the Treasury forecast for economic growth being proved correct. Inflation is set to stay low for this year and next; exports to rise as the pound stays weak and consumer spending to weaken as unemployment rises.

• Company and market impact

The business specific measures announced were aimed at protecting hi tech or 'green' sectors, autos and housing and related activities but were understandably fairly small in relation to the size of the increase in borrowing set to take place. The financial market impact has been relatively muted but the announcement of big increases in government debt and borrowing may cause further unease in gilts and foreign exchange markets unless they are convinced that the deficits will come down. But there has not yet been enough time to assess whether the financial market reaction is that these projections are worse than expected or are in line, in which case there may clearly be little if any negative reaction.

Trevor Williams, Chief Economist, Corporate Markets

Fiscal Arithmetic

- Government borrowing to be £175bn in 2009/2010 and fall only slightly to £173bn in 2010/11, record levels. Last year the Budget deficit was 6.3% of the economy, this year it will reach just over 12%. Net debt will rise to just under 80%; not a record, but the highest since the 1960s.
- The Budget forecasts are an acknowledgement of the reality that the combined effect of the financial crisis and the global economic recession is severely impacting revenues and boosting government spending at a time that taxes cannot be raised or spending cut without worsening the downturn. Hence, the fiscal position will be very challenging for the UK in the foreseeable future.
- There will be a public sector spending squeeze once economic recovery is underway, in order to bring down public sector net debt. From 2011/12, the Budget projections assume that public sector spending rises by 0.7% a year, roughly half of the 1.2% expected this year and next.
- Such a restriction on public spending growth is necessary to reassure those buying the gilts being issued that the public finances are on a sustainable path in the medium term.

Table 1: Summary of Budget 2009 vs. PBR 2008

	Outturn 2007-08	Estimate 2008-09	Projections	
			2009-10	2010-11
Surplus on current budget (£ billion)				
Budget 2008	-7.9	-9.6	-4	4
Effect of revisions and forecasting changes	1.2	-23.3	-61	-78
Effect of discretionary changes	0	-8.3	-13	1
2008 Pre-budget report	-6.7	-41.2	-78	-73
Effect of revisions and forecasting changes	1.3	-11.1	-48	-64.5
Effect of discretionary changes	0	0	-5.5	0.5
Budget 2009	-5.3	-52.3	-132	-137
Net borrowing (£ billion)				
Budget 2008	36.4	42.5	38	32
Changes to current budget	-1.2	31.6	74	77
Changes to net investment	1.4	3.5	5.5	-4
2008 Pre-budget report	36.6	77.6	118	105
Changes to current budget	-1.4	11.1	53.5	64.5
Changes to net investment	-0.6	1.2	3.5	3.5
Budget 2009	34.6	90	175	173

Short term

Forecasting changes account for the largest proportion of the revisions in Budget 2009 compared with the Pre-Budget Report (PBR) last year and Budget 2008. The main reason for this is, of course, the financial crisis and the global recession. Discretionary changes account for a small amount of the total revision, less than £10bn last year. Budget 2009 now expects the government to borrow £90bn in 2008/2009, from £77.6bn in the PBR and £42.5bn in Budget 2008. Commensurate with the rise in borrowing is a rise in net debt, from an expected peak of 57% of the economy in the PBR to 79% in Budget 2009. This will take the UK's net debt position from below the OECD average to being in line with it, even though the OECD average rises as a result of higher government borrowing around the world. Going forward, borrowing is set to remain large next year, 2010/2011, as the economy is expected to recover only modestly, by 1.25%. However, the strength of the economic recovery expected by the Treasury is above the consensus of independent forecasters, which is for growth of just 0.3%. This implies that government borrowing could be as high as this year's £175bn or greater, see chart a. The size of the forecast errors, see table 2, highlights the large uncertainty that exists around projections of public sector borrowing - the difference between total government revenue and expenditure - which can diverge markedly, see chart b.

Chart a: Government borrowing is rising sharply...

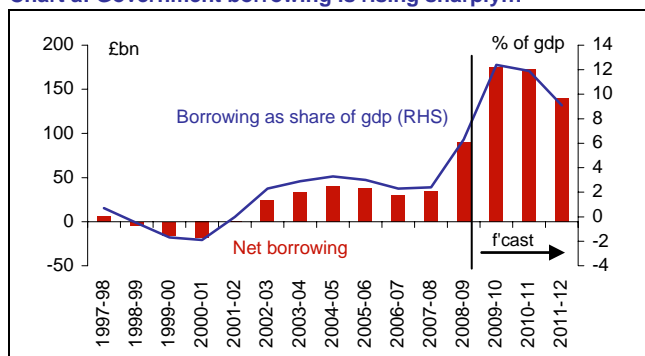


Chart b: ... as current receipts fall below current expenditure...

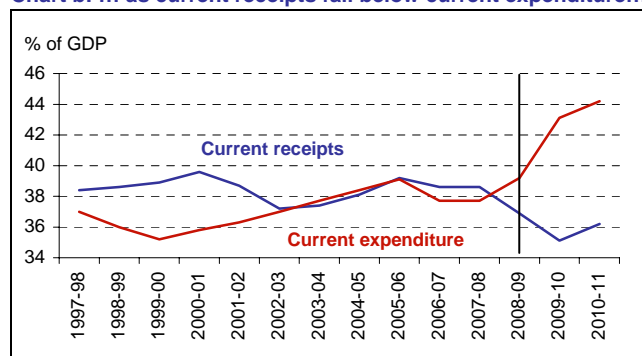


Table 2: Treasury errors in forecasting public sector net borrowing are large

Time period	Average absolute error (% of national income)	Average absolute error (£ billion)
One year ahead	1.0	15
Two years ahead	1.5	22
Three years ahead	1.9	28
Four years ahead	2.4	35

Medium term

- The deterioration in public sector borrowing is not unusual in the sense that the size of the errors for the years ahead are so large that in the normal course of events there should be a lot of caution around any future point estimate, see table 2. This is especially the case given the current recession and financial market dislocation. Chart c shows that the medium term government borrowing trend is significantly higher than was expected a year ago or even five months ago.
- This means that there will have to be credible announcements about how the borrowing gap and debt will reduce in future years; otherwise the funding of the borrowing could become a serious issue for sterling and the gilt markets.
- This is why chart d is so important, as it shows the official projections that rough balance for borrowing is achieved in 2017/18 and debt is falling. This rests on strong official growth assumptions and tight control of spending.

Chart c: ...leading to a sharp rise in government borrowing...

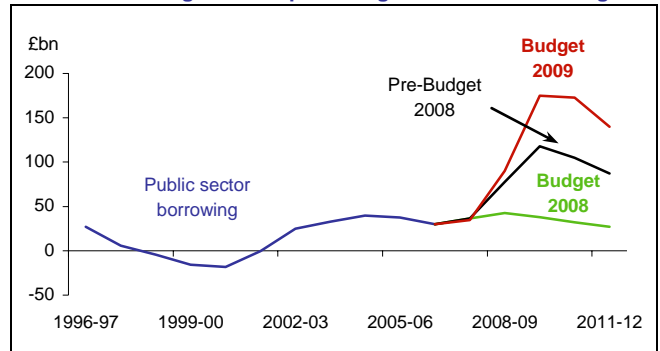
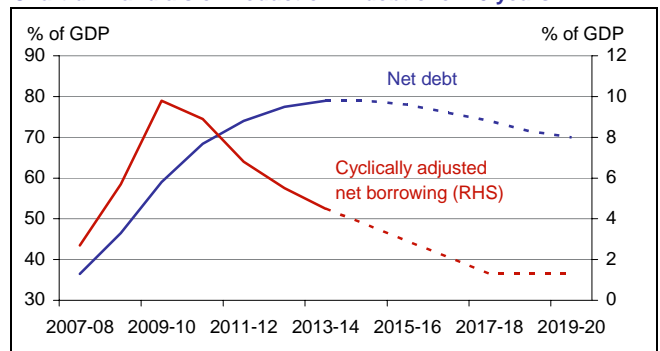


Chart d: ...and a slow reduction in debt over 10 years



Projections in the Budget for medium term spending and revenue show that government spending will rise more slowly than revenue. This is necessary in order to reassure buyers of the debt that will be issued in order to cover the large borrowing requirement that borrowing will not continue to expand in future years. This is why, from 2011/2012, the Chancellor announced that real (inflation adjusted) government spending will rise by just 0.7% a year, down from 1.2% a year in the next two years. As a consequence of higher borrowing, net debt is set to rise to 79% of the economy before falling back. This is the highest level since 1968 but is not especially high in the context of the UK's long run debt profile, see chart e. The UK's debt ratio is not the highest of the advanced economies – Japan has that distinction. But in order to prevent it from getting worse the UK is on track for the tightest spending squeeze for decades, 0.7% a year. Indeed, the forecasts do not show rough balance in net borrowing until 2018. And this is based on 'efficiency' savings, official growth projections being achieved, tight spending control and 'fiscal drag' – not adjusting tax allowances in line with inflation. Some question whether these assumptions will be achieved. Hence, the challenge for the UK in the next decade will be to grow the economy as public sector spending shrinks. UK economic growth has come from higher leverage in the last 10 years, in the consumer and the government sector, the message in Budget 2009 is that this period is now over.

Chart e: In the medium term, government debt is rising back towards its long run average...

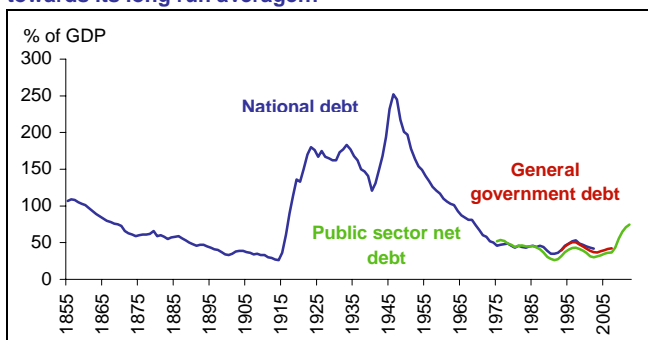
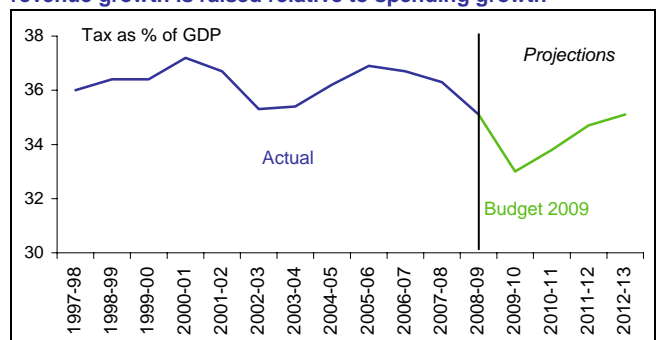


Chart f: ...and the tax share of gdp is projected to rise as revenue growth is raised relative to spending growth



Economic projections

- **Growth forecast for 2009 slashed to -3.5%, but projected growth in 2010 and beyond are significantly higher than consensus**
- **Annual CPI inflation is forecast to slow to 1% in Q4 2009 and not rise above the 2% target until 2011**
- **If the growth forecasts turn out to be too strong from 2010 onwards, government borrowing and debt levels may risk being even higher than currently projected**

The economic growth assumptions underpinning the fiscal arithmetic in the last section are on the optimistic end of the range of current consensus forecasts. According to the Chancellor, positive growth will return towards the end of this year. Nevertheless, the Treasury's forecast for 2009 as a whole is -3.5%, sharply lower than the -1% forecast in last November's Pre-Budget Report, and is now broadly in line with consensus forecast. However, the Treasury expects UK growth to recover by 1.25% in 2010 (in contrast with consensus 0.3% and IMF -0.4%) and 3.5% in 2011. Moreover, the long-term trend rate of growth was left unchanged at 2.75%, in contrast with estimates that it may now be lower at around 2.25%, if not below that.

It is worth delving into the detail in order to assess the risks to the forecasts. The economic recovery, particularly from 2011, is predicated on a strong rebound in household consumption and fixed investment, as well as a positive contribution from net trade. Household consumption is forecast fall 3% this year and remain weak in 2010 (rising 0.25%), but to soar 3.25% in 2011. The strong rise in household consumption in 2011 comes despite claimant count unemployment assumed to rise by another million to 2.44mln by end-2010 and is partly based on the assumption that the savings ratio rises only moderately to 5.5% by 2011 and that CPI inflation is still only 1% at end-2010 (providing a boost to real incomes). The risk is that the savings ratio rises more rapidly, especially with unemployment increasing, and our forecasts suggest CPI may rise back towards the 2% target by end-2010.

Business fixed investment is forecast to fall sharply by 11.25% this year, before recovering through next year and rebounding strongly in 2011, helped by policy measures and an easing of the credit crunch. Investment in dwellings follows a similar profile but is forecast to fall more sharply this year and next. Government consumption and fixed investment contract from 2011, as the budget deficit is reduced from very high levels.

Table 1: Budget 2009 - summary of official growth forecasts*

% change on yr	2008	2009	2010
Real GDP			
Budget 2008	2.00	2.50	2.75
Pre-budget report	0.75	-1.00	1.75
Budget 2009	0.75	-3.50	1.25
Difference with last PBR	0	-2.50	-0.50
Domestic demand			
Budget 2008	1.50	2.25	2.75
Pre-budget report	0.75	-1.75	1.75
Budget 2009	0.75	-3.75	0.75
Difference with last PBR	0	-2.00	-1.00
CPI Inflation (Q4)			
Budget 2008	2.50	2.00	2.00
Pre-budget report	3.75	0.50	2.25
Budget 2009	4.00	1.00	1.00
Difference with last PBR	0.25	0.50	-1.25
Current account (% gdp)			
Budget 2008	-5.00	-4.50	-4.00
Pre-budget report	-2.75	-2.75	-2.75
Budget 2009	-1.75	-3.50	-3.50
Difference with last PBR	1.00	-0.75	-0.75
Manufacturing output			
Budget 2008	1.00	2.00	2.00
Pre-budget report	-1.25	-3.00	1.25
Budget 2009	-2.75	-12.50	0.50
Difference with last PBR	-1.50	-9.50	-0.75

* Midpoint of forecasts taken

The Treasury projections also assume that net trade makes a positive contribution to economic growth over the forecast horizon. UK exporters are therefore expected to benefit from a recovery in world trade and the weaker sterling exchange rate. Yet, the current account deficit is projected to widen to around 3.5% of GDP in 2009 and 2010, due to the waning impact of lower repatriated profits by foreign banks in the UK that took place last year.

The outlook for credit markets and world trade are major sources of uncertainty for any economic forecast. The Treasury expects global economic growth to fall 1.25% this year, but rise 2.5% in 2010 and 4.5% in 2011. This is underpinned by an assumption that the credit crisis will continue to ease. Anecdotal evidence suggests that the availability of credit is becoming less restrictive and the Treasury assumes that the spread between 3m libor and expected policy rates (currently just above 100bps) will continue to fall in the coming months.

But a key risk is the extent to which further credit losses and writedowns may dampen lending growth. The IMF's latest forecasts suggest that total global losses in financial institutions could be \$4.1trn, compared with \$1.3trn currently declared. That, combined with weaker government spending growth and a less robust rebound in private sector demand, suggests downside risks to the Treasury's UK growth forecasts for 2010 and beyond. As mentioned earlier, the risk is that the Treasury's trend growth assumption of 2.75% (or even the more cautious 2.5% used in the fiscal arithmetic) may be too high.

Overall, downside risks to the Treasury's growth forecasts mean that the budget deficit may rise even higher than currently expected (£175bn in 2009/10 and £173bn in 2010/11). This implies that gilt issuance, which will soar to £220bn in 2009/10, will remain high and that gilt yields may need to rise significantly to attract domestic funding and also overseas funding, especially if the pound remains weak to support export growth. However, there is huge uncertainty about economic forecasts going forward and so a range of possible outcomes have relatively little probability differences between them.

Chart a: The Treasury revises down growth sharply

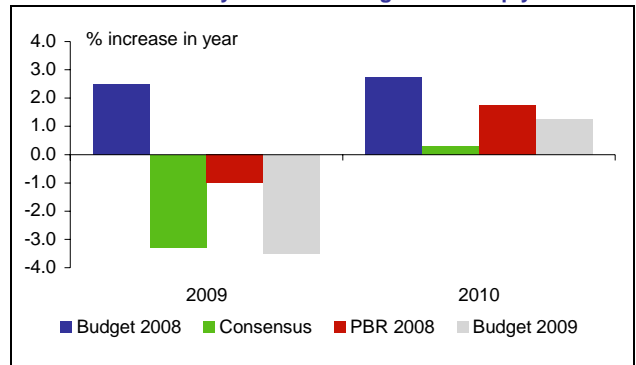


Chart b: Economic recovery to take root next year

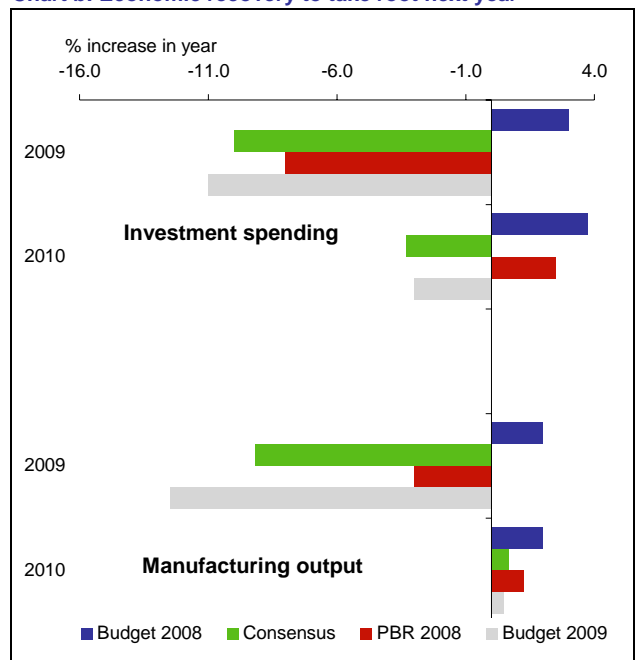


Chart c: Official CPI forecasts are weaker than consensus

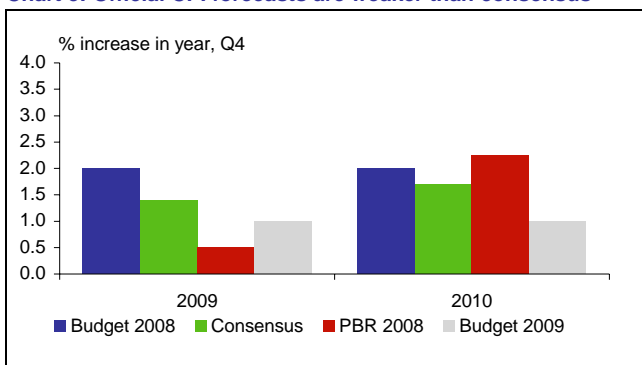
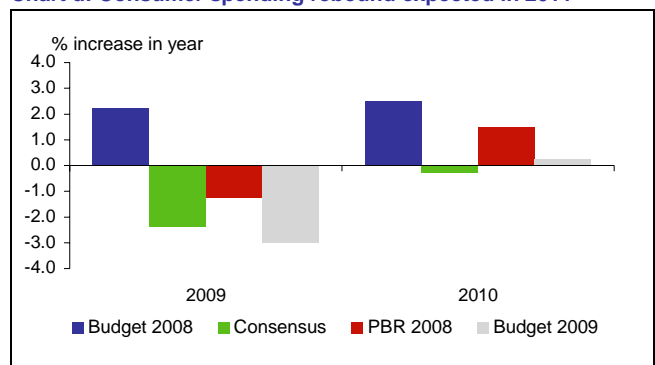


Chart d: Consumer spending rebound expected in 2011



The Business Sector - impact of the Budget Report

General measures

- The estimated cost to the Exchequer from the business policy measures announced in Budget 2009 is £3,945m in 2009-10 when the economic recession is deepest, dropping sharply to a cumulative £410m in 2010-11 and a gain to the Treasury of £1,245m in 2011-12 as the economy recovers, see table 1. So the three-year cumulative cost of these measures is £3,110m. Included within this, the Exchequer plans to raise a cumulative £820m from business through tax avoidance measures.
- The measures focus on supporting business' short-term cash flow and improving innovation and competitiveness in order to generate sustainable import substitution and export growth. The Chancellor outlined that the UK's competitive exchange rate will help UK companies during the recovery stage and outlined plans to support exporters via an intention to consult on improvements to the export credit guarantee scheme.
- Cash flow enhancing measures include increasing capital allowances for new investment to 40% for one year with effect from April 2009 (cumulative cost of £1,450m), a deferral of business rate payments (cost of £700m in 2009/10) and extending the enhanced loss relief scheme (cumulative cost of £295m) to November 2010 for companies and to end fiscal 2009/10 for unincorporated businesses and extending the HRMC's Business Payment Support Service.
- Moreover, the introduction of a 'top up' trade credit insurance scheme in which government will offer to match private sector trade credit insurance provision from 1 May to end-December this year to companies that have had cover reduced since 1 April, is expected to support cash flow positions dented by a rise in customer non-payment.
- To enhance industrial competitiveness, a £750m Strategic Investment Fund has been created to support advanced industrial projects of strategic importance, of which £250m will be earmarked specifically for low carbon projects.
- A package of reforms to the taxation of foreign profits has been announced, including the introduction of an exemption for foreign dividends from 1 July 2009, supported by a limited restriction to the interest reduction rules to be introduced for accounting periods beginning on or after 1 January 2010.

Sector specific measures

Budget 2009 gives specific support to consumer and strategically important sectors:

- **Agriculture** - agricultural property and woodlands relief extension.
- **Car dealerships and manufacturers** - vehicle scrapping scheme, co-funded with industry that will enable consumers who scrap vehicles more than 10 years old to replace them with new vehicles at a discount of £2,000. There is an estimated cost of £300m to the Exchequer, with funding matched by manufacturers participating in the scheme, which will end in March 2010 or when allocated funding has been drawn down.
- **Commercial property** - no direct measures, but the government aims for £16bn of property asset sales in the three years to 2011-12 which may impact capital valuations.
- **Environmental industry** - measures to encourage energy efficiency and build a low carbon recovery. £500m of additional spending as part of an overall £1.4bn package of targeted support to boost spending on Britain's low-carbon technologies and support energy & resource efficiency. Extra support for offshore wind investment is expected to support £9bn of investment and provide energy for up to 2.8m homes.
- **House-building** - £600m funding for a package of measures to build more homes, including £400m to unlock currently stalled housing developments, an £80m extension to the shared equity scheme and HomeBuy Direct and £100m of new funding for local authorities to deliver new social housing at higher energy efficiency standards. This spending is expected to deliver up to 10,000 new homes in England within the next two years. In addition, £50m is being provided to upgrade housing for the armed forces in this fiscal year. To provide incentive to house-buyers, the government is expecting £20bn of mortgage lending from banks this year; has announced a scheme to run alongside the existing Credit Guarantee scheme, guaranteeing residential mortgage-backed securities at least until October 2009 and is extending the extension of the stamp duty holiday for all houses costing up to £175,000 until the end of the year.
- **Household services** - an additional £375m has been allocated to support energy and resource efficiency in businesses, public buildings and households over the next two years and £70m for decentralised small-scale and community low-carbon energy.
- **North Sea oil industry** - £15m worth of incentives are being offered to encourage investment in small and technically challenged North Sea oil & gas fields. This is expected to unlock around 2bn barrels of oil and gas reserves.
- **Schools and infrastructure** - £200m for accelerating higher education building projects in 2009-10.

Table 1: Budget 2009 policy decisions

£ million (+ve is an Exchequer yield) (Indexed)	2009-10	2010-11	2011-12
Supporting Business			
Business rates: deferral of payments	-700	335	320
First-year capital allowances: one year increase to 40%	-1640	-190	380
Loss carry back: further temporary extension	-55	-195	-45
Car scrappage	-300	0	0
Strategic Investment Fund	-400	-350	0
Lloyd's UK dividend exemption	-10	-10	-10
Loan relationships: late paid interest to connected companies	-5	-15	-5
North Sea fiscal regime: incentives for investment	0	-5	-10
Residence and domicile: consequential changes	-5	-5	-5
VAT package: refund scheme	0	-5	-5
Agricultural property and woodlands relief extension	-5	-5	-5
Building colleges for the future	-200	0	0
	-3320	-445	615
Helping People Fairly			
Support for housing supply	-420	-180	0
Armed forces accommodation	-50	25	0
	-470	-155	0
Preparing for a green economy			
Support for low carbon technologies	-160	-65	0
Support for energy and resource efficiency	-220	-55	0
Landfill tax reform	30	70	70
Landfill tax rates	-5	-25	80
Enhanced capital allowances	10	15	15
Company car tax rates	0	0	85
	-345	-60	250
Protecting revenue			
Foreign exchange: targeted anti-avoidance rule	20	20	20
Corporate intangible assets regime: countering abuse	70	130	110
Manufactured overseas dividends: avoidance	0	0	50
Double tax relief avoidance	100	100	200
	190	250	380
Total Policy Decisions	-3,945	-410	1,245

Key personal tax changes from 2010-11 onwards

- Major changes to personal taxes in Budget 2009 were primarily aimed at those with incomes over £100,000. Otherwise, bands, rates and allowances changed in line with previous announcements.
- A new rate of income tax of 50% will apply to incomes over £150,000. This replaces the 45% rate announced at the 2008 Pre-Budget Report (PBR), which was due for introduction in April 2011. Dividend income will also be taxed at 42.5% and a 50% rate is applicable to trusts.
- The personal tax allowance will be reduced at a rate of £1 for every £2 over £100,000 until fully withdrawn. This replaces the two-stage withdrawal process announced at the 2008 PBR.

Table 1: Income tax bands

2008-2009	£ a year	2009-2010	£ a year
Basic rate 20 per cent	0 – 34,800	Basic rate 20 per cent	0 – 37,400
Higher rate 40 per cent	over 34,800	Higher rate 40 per cent	over 37,400

Table 2: Personal tax allowances 2009-10

	£ a year		
	2008-2009	2009-10	Increase
Personal allowance			
age under 65	6,035	6,475	440
age 65-74	9,030	9,490	460
age 75 and over	9,180	9,640	460
Married couple's allowance			
aged less than 75 and born before 6th April 1935	6,535	-	-
aged 75 and over	6,625	6,965	340
minimum amount	2,540	2,670	130
Income limit for age-related allowances	21,800	22,900	1,100
Blind person's allowance	1,800	1,890	90

Other selective measures affecting individuals

- Tax relief on pension contributions for those earning over £150,000 will be restricted from April 2011, and tapered down until it is 20%.
- Alcohol and tobacco duty rates will increase by 2%, from 23 April and 22 April, respectively.
- The main fuel duty rate will increase by 2 pence per litre on 1 September 2009. Then, from 1 April 2010, and on the same date in each year to 2013, main road fuel duty will rise by 1p per litre above indexation.
- The annual investment limit for Individual Saving Accounts (ISAs) is increased to £10,200, with up to £5,100 of which can be saved in cash. The higher limits are available to all from April 2010 and to people aged 50 and over from 6 October 2009.
- The capital gains tax annual exempt amount rises in line with statutory indexation to £10,100.
- The Inheritance Tax threshold is raised to £325,000 in 2009/10.
- The existing stamp duty holiday for houses costing up to £175,000 is extended until December 09.
- Statutory redundancy pay will be raised to a weekly rate of £380, subject to Parliamentary approval.
- An additional payment worth £100 or £50 will be paid alongside this year's Winter Fuel Payment for households with someone aged over 80 and over 60, respectively.
- Grandparents and other family members will be able to gain National Insurance credits toward the basic State Pension for caring for their grandchildren or family members aged 12 or younger.
- The Government will contribute £100 per year to the Child Trust Fund account of disabled children, with severely disabled children receiving £200.
- An additional £1.7bn, to the £1.3bn provided to the Department for Work and Pensions at the 2008 PBR, will be provided to help Jobcentre Plus to deal with the larger volume of claimants.
- The Government announced a new guarantee of six months work or training for everyone under the age of 25 who has been on Jobseekers Allowance for 12 months.
- The Government announced a temporary scheme to enable consumers to scrap vehicles older than 10 years to replace them with new vehicles at a discount of £2,000.

Financial Markets

Gilts

The Debt Management Office (DMO) announced a sharp upward revision to debt issuance for the current fiscal year. Preliminary estimates, based on the borrowing projection in the November 2008 PBR, were published only a month ago and projected total gilt issuance of £147.9bn. However, the DMO announced today that issuance would now be a record £220bn, with the bulk of the additional sales concentrated in medium term (7y-15y) maturities. The total stock of conventional and index-linked gilts at end-March 2009 was £713.2bn. Gross debt issuance is expected to be £241.6bn in 2009/10, including an increase in Treasury bill stock of £21.6bn and a repayment of £3.8bn of the remaining balance of the Ways and Means advance at the Bank of England (BoE).

Although the bulk, £183bn (83% of planned issuance), will be by pre-announced auctions, a new initiative is the decision to use syndication and to extend the use of mini-tenders to issue gilts this fiscal year. The syndication process is planned to issue £25bn, split between £13bn of long term and £12bn of index-linked paper. The assumption is that £12bn will be sold via mini-tenders, equally split between long maturity and index-linked gilts. Syndication means that the Government will pay a fee to banks or so-called lead managers to arrange the sale and to minimize the risk of an auction being under subscribed. The strategy could particularly be effective for long maturity and index-linked sales which have in the recent past struggled to attract sufficient buyers. Mini-tenders are operations conducted directly with GEMM's by the DMO's dealing desk (GEMM stands for 'Gilt Edged Market Maker', of which there are 16 in the UK).

The sharp rise in the total financing requirement to £237.8bn for 2009/10 largely reflects the upward revision to the Central Government Net Cash Requirement (CGNCR) to £220.8bn, from £162.4bn in 2008/09. National Savings and Investments is not expected to make a net contribution to financing in 2009/10.

Chart a: Proportion of medium-term paper set to rise

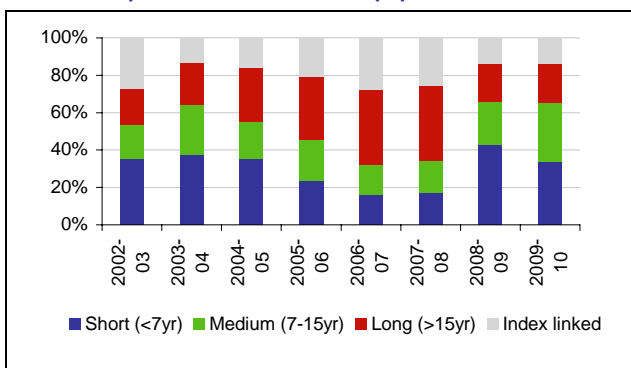
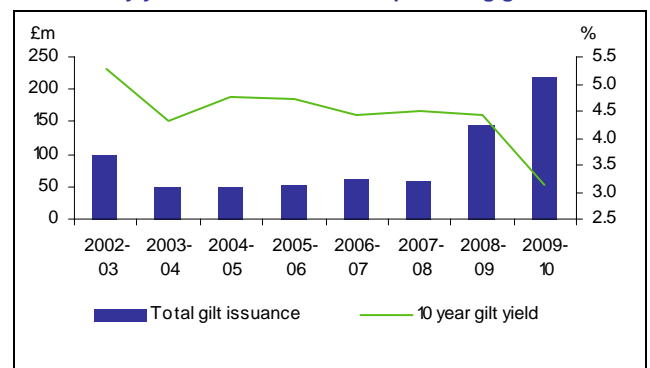


Chart b: 10y yields have declined despite rising gilt issuance



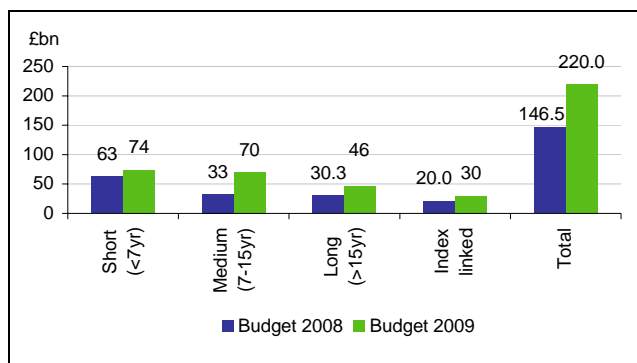
The DMO announced that the gilt issuance strategy has not been altered as a result of the asset transactions undertaken by the BoE. This follows BoE governor King's assertion earlier this year that it was important for the government's debt management policy to remain consistent with the aims of monetary policy, and that the issuance strategy should not be changed as a result of transactions undertaken through the Asset Purchase Facility. The BoE confirmed earlier this month that it would continue with the purchase of assets until it meets the £75bn target set out in March and only consider whether to use the second £75bn tranche. The Bank has so far bought £38bn of government paper. Clearly, the sharp rise in planned gilt issuance will have implications for the BoE's efforts to use quantitative easing to ensure the inflation target is met over the medium term.

It is noteworthy that the sale of medium term maturities (7y-15y) has nearly doubled over the last 12 months from just 16% in Budget 2008 to 31.8% in Budget 2009. The reduction in long dated maturities (over 15y) from 30.3% to 20.9% and index-linked paper from 22.5% to 13.6% should make the sales process less vulnerable to disappointment, a risk that is also being addressed through syndication. It therefore comes as no surprise to see the long end of the curve out performing this afternoon (i.e. yields rising less) compared to the medium term section of the curve. 20y and 30y yields are up 10bp and 6bp respectively at 4.35% and 4.42%. Medium term gilts are taking a big hit, with 8y yields climbing 15bp to 2.95% and 10y paper adding 14bp to 3.45%. The short-dated maturities are virtually unchanged. Sterling fell considerably against its major counterparts and slipped to intra-day lows of 1.4398 vs the dollar and 0.8988 vs the euro. UK 5y credit default swaps widened out today to 100bp, capping a 15bp rise since last Friday. Going forward, overseas buyers of sterling denominated assets could influence the price at which the DMO sells gilts.

A shortfall in the government's tax revenues and the risk of a weaker growth profile for the UK economy than projected in today's Budget implies that the DMO may even have to revise up its issuance program in the 2009 PBR later this year. Given the potential size of new gilt issuance, the structure of the yield curve will be very sensitive to the performance of the economy and it is reasonable to assume upward pressure on yields may

intensify at some stage in the future. The greatest pressure is likely to be concentrated in the medium-term maturities, given this area primarily represents where additional issuance will be targeted. However, the yield curve will also be heavily influenced by the policy actions of the BoE and developments in international financial markets. In particular, slow economic growth and low inflation will likely keep gilt demand strong near term. Medium term, economic recovery and a better climate for other investments could have other implications.

Chart c: Total issuance is set to reach £220bn in 2009/10



Source: DMO

Planned gilt sales in 2009/10 include:

- £74bn in short term conventional gilts
- £70bn in medium-term conventional gilts
- £46bn in long-term conventional gilts; of which £27bn by auction, £13bn by syndication and £6bn by mini tender
- £30bn in index linked; of which £12bn by auction, £12bn by syndication and £6bn by mini tender

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Appendix

Table 1: Budget 2009 policy decisions

(+ve is an Exchequer yield) (indexed)	2009-10	2010-11	2011-12
Supporting Business			
Business rates: deferral of payments	-700	335	320
First-year capital allowances: one year increase to 40%	-1640	-190	380
Loss carry back: further temporary extension	-55	-195	-45
Car scrappage	-300	0	0
Strategic Investment Fund	-400	-350	0
Lloyd's UK dividend exemption	-10	-10	-10
Loan relationships: late paid interest to connected companies	-5	-15	-5
North Sea fiscal regime: incentives for investment	0	-5	-10
Residence and domicile: consequential changes	-5	-5	-5
VAT package: refund scheme	*	-5	-5
Agricultural property and woodlands relief extension	-5	-5	-5
Building colleges for the future	-200	0	0
	-3320	-445	615
Helping People Fairly			
DWP additional employment funding	-590	-1080	0
Employment: guarantee for young people (1)	-300	-900	-
Increase in Statutory redundancy pay	-15	-25	-
Age related payments to pensioner households	-600	0	0
Increase ISA limits	-5	-20	-60
Increase pension credit capital disregards	-60	-130	-
Working Tax Credit run-ons: extension	-5	-10	-
Child Trust Fund: extra payment for disabled children	0	-15	-
Increase Child Element of Child Tax Credit	0	-140	-
Housing Benefit/Council Tax Benefit overpayments: remove double subsidy provision	0	10	-
Housing Benefit/Council Tax Benefit: earnings disregard	0	-5	-
Housing Benefit: managing gains from Local Housing Allowance	0	145	-
Increase Social Fund	-125	-145	0
Support for mortgage interest	-135	0	0
SDLT holiday for residential homes: extension to 31 December 2009	-90	0	0
Support for housing supply	-420	-180	0
Local authority guideline rent increases in 2009-10	-10	-10	0
Repeal furnished holiday letting rules	0	-15	20
Reduced VAT rate for children's car seat bases	*	-5	-5
Financial assistance for charities	-20	0	0
Armed forces accommodation	-50	25	-
	-2425	-2500	-45
Preparing for a green economy			
Support for low carbon technologies	-160	-65	0
Support for energy and resource efficiency	-220	-55	0
Landfill tax reform	30	70	70
Landfill tax rates	-5	-25	80
Enhanced capital allowances	10	15	15
Company car tax rates	0	0	85
Vehicle excise duty	0	-5	-5
VAT: Revalorisation of fuel scale charges	0	0	0
	-345	-65	245
Ensuring sustainability of the public finances			
Fuel duty increases	600	1250	1750
Income Tax: full withdrawal of personal allowance from £100,000 (2)	0	100	180
Income Tax: increase additional rate to 50% from £150,000 and increase trust rate to 50% from 2010 (3)	0	1130	1810
Pension Tax: restrict tax relief to 20% above £150,000 (4)	0	0	200
Tobacco: 2% increase in specific duty	60	60	60
Gambling participation fees: removal of VAT	-50	-55	-60
Gaming duty on casino card rooms	5	5	5
Bingo duty: increase rate to 22%	35	35	35
Amusement machine license duty: increase rates	20	15	15
	670	2540	3995
Protecting revenue			
Foreign exchange: targeted anti avoidance rule	20	20	20
Corporate intangible assets regime: countering abuse	70	130	110
Review of Alcohol Fraud Strategy	20	10	10
Manufactured overseas dividends: avoidance	0	0	50
Double tax relief: avoidance	100	100	200
Living accommodation benefit charge: avoidance	45	45	55
Publishing names of serious tax defaulters	0	20	60
Accountability of senior accounting officers	0	40	50
Review of powers: debt management	5	5	135
	260	370	690
TOTAL POLICY DECISIONS	-5160	-100	5,500
Additional items			
Reserve: support for military operations	-1900	0	0
Reprofile addition to 2008-09 DEL reserve	-500	-500	0
Memo: Resetting AME margin	-1000	-2000	0

* included within the current spending growth assumption for 2011-12 onwards; * Negligible; 1. Gross costs are £1.4 billion over 2009-10 and 2010-11. The figures in the table are net of associated savings; 2. This modifies the yield published at PBR 2008 for the staged restriction of the personal allowance. The total yield in 2012-13 from the removal of the personal allowance will be £1.5 billion; 3. This measure is in addition to the yield published at PBR 2008 for the 45% additional rate commencing from 2011-12. The total yield in 2012-13 from the 50% additional rate will be £2.4 billion; 4. Yield increases due to lagged effect of self-assessment. For 2012-13, the yield is £3.1 billion.

Table 2: Current and capital budgets show net borrowing rising

£ billion	Outturn	Estimate	Projections				
	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014
Current budget							
Current receipts	548.0	530.7	496	528	577	620	662
Current expenditure	535.6	564.5	608	645	666	689	712
Depreciation	17.8	18.6	20	21	22	23	24
Surplus on current budget	-5.3	-52.3	-132	-137	-111	-91	-74
Capital budget							
Gross investment	47.1	56.2	63	57	51	49	46
Less depreciation	-17.8	-18.6	-20	-21	-22	-23	-24
Net investment	29.3	37.7	44	36	29	26	22
Net borrowing	34.6	90.0	175	173	140	118	97

Table 3: Summary of public sector finances

% of GDP	Outturn	Estimate	Projections				
	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014
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
European commitments							
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

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

² Debt at end March; GDP centred on end March

³ Excluding 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

Table 4: Fiscal balances compared with Pre-Budget 2008 Report

% of GDP	Outturn ¹	Estimate ²	Projections				
	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014
Net borrowing (£ billion)							
2008 Pre-Budget Report	36.6	77.6	118	105	87	70	54
Changes to current budget	-1.4	11.1	53.5	64.5	57	54	53.5
Changes to net investment	-0.6	1.2	3.5	3.5	-3.5	-6.5	-10.5
2009 Budget Report	34.6	90.0	175	173	140	118	97
Surplus on current budget (£ billion)							
2008 Pre-Budget Report	-6.7	-41.2	-78	-73	-54	-37	-21
Effect of revisions and forecasting changes	1.3	-11.1	-48	-64.5	-63.5	-66.5	-71
Effect of discretionary changes ³	0.0	0.0	-5.5	0.5	7	12.5	17.5
2009 Budget Report	-5.3	-52.3	-132	-137	-111	-91	-74
Net investment (£ billion)							
2008 Pre-Budget Report	29.9	36.5	40	33	33	33	33
Effect of revisions and forecasting changes	-0.6	1.2	1.5	2.5	-2	-1.5	-1.5
Effect of discretionary changes ³	0.0	0.0	1.5	1	-1.5	-5	-9
2009 Budget Report	29.3	37.7	44	36	29	26	22
Cyclically-adjusted surplus on current budget (% of GDP)							
2008 Pre-Budget Report	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
2009 Budget Report	-0.7	-3.1	-6.7	-6.4	-4.9	-3.9	-3.2
Cyclically-adjusted net borrowing (% of GDP)							
2008 Pre-Budget Report	2.9	5.3	7.2	5.6	4.3	3.5	2.8
2009 Budget Report	2.7	5.7	9.8	8.9	6.8	5.5	4.5
Net debt (% of GDP)⁴							
2008 Pre-Budget Report	36.3	41.2	48.2	52.9	55.6	57.1	57.4
2009 Budget Report	36.5	43.0	55.4	65.0	70.9	74.5	76.2

NB: Totals may not sum due to rounding

¹ The 2008-2009 figures were estimates in Budget 2009

² The 2009-2010 figures were estimates in Budget 2009

³ Including changes in forecasting assumptions on spending growth in 2012-13 and 2013-2014

⁴ Debt at end March; GDP centred on end March; excluding financial sector interventions

Table 5: Summary of economic prospects

% changes on a year earlier unless otherwise stated	Forecast				Average errors for	
	2008	2009	2010	2011	2009	2010
Output at constant market prices						
Gross domestic product (GDP)	0.75	-3.5	1.25	3.5	0.75	0.75
Manufacturing output	-2.75	-12.5	0.5	2.25	1.75	2.0
Expenditure components of GDP at constant market prices						
Domestic demand	0.75	-3.75	0.75	2.75	0.75	0.75
Household consumption	1.25	-3.0	0.25	3.25	0.75	1.0
General government consumption	3.5	4.75	1.0	-1.25	1.0	0.75
Fixed investment	-3.0	-11.0	-3.0	6.5	2.25	2.0
Change in inventories	-0.5	-1.0	1.0	0.0	0.25	0.25
Exports of goods and services	0.0	-8.75	1.0	5.0	2.5	4.25
Imports of goods and services	-0.5	-9.25	-0.5	2.5	3.0	3.0
Balance of payments current account						
£ billion	-24.5	-48.5	-51.0	-48.75	11.75	9.5
% of GDP	-1.75	-3.5	-3.5	-3.25	0.75	0.75
Inflation						
CPI (Q4)	4	1	1	2.25	0.5	0.75
Producer output prices (Q4)	5.5	-0.5	0.25	1.5	1.25	1.75
GDP deflator at market prices	2.25	1.5	1.25	2.25	0.5	0.5
Money GDP at market prices						
£ billion	1,443	1,411 to 1,415	1,443 to 1,454	1,525 to 1,544	12.75	11.25
% change	3	2.25	2.5	6.0	1.0	0.75

Chart a: Government spending by function 2009-10 - Total managed expenditure: £671 billion

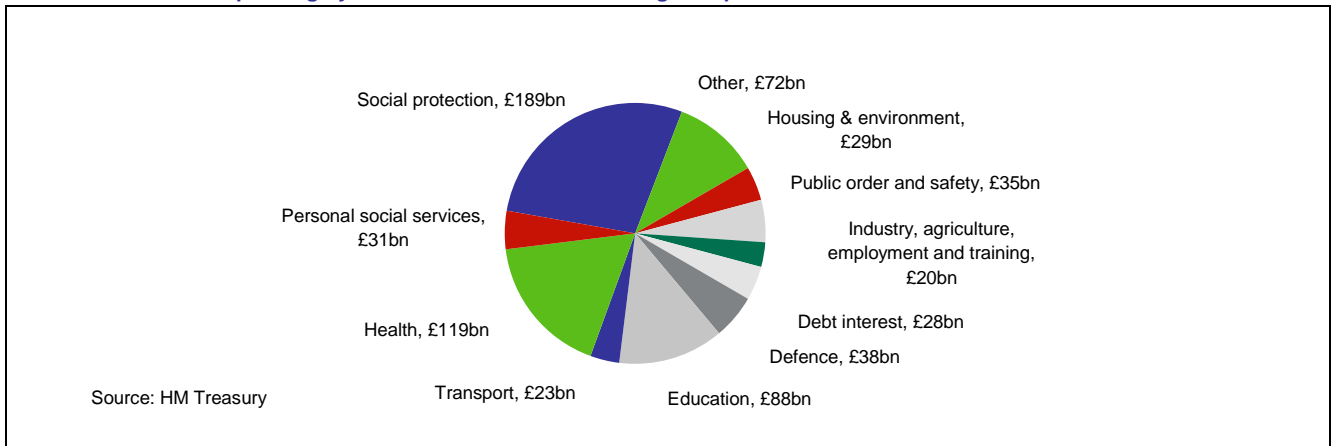
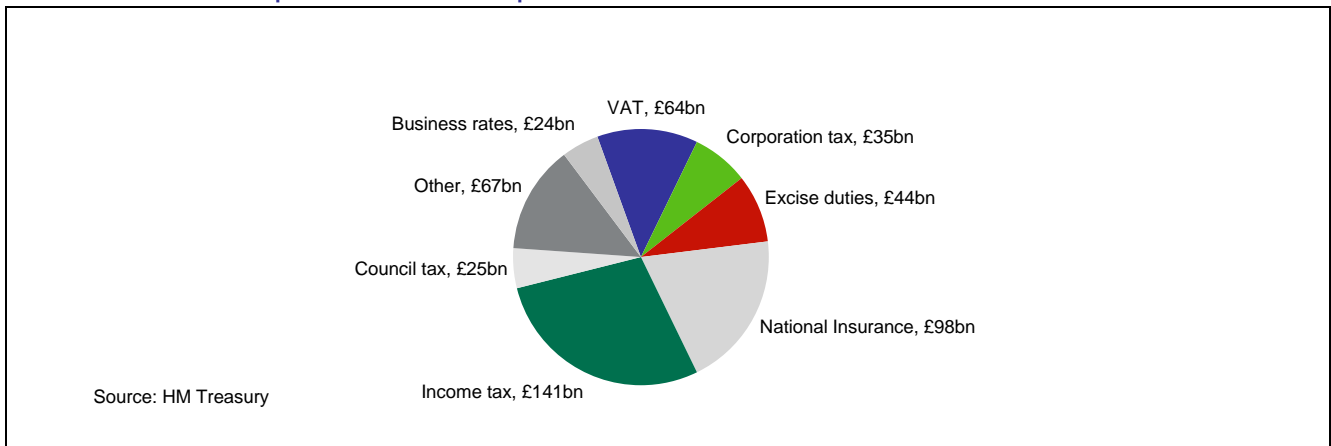


Chart b: Government receipts 2009-10 - Total receipts: £496 billion



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