

Over the past year, major shocks have hit the economies of every country in the world. While commodity prices have recently eased, the credit shock has intensified into the worst global financial crisis for generations, a crisis that is being addressed by a global policy response of unprecedented scale and scope. These developments mean economic prospects are subject to exceptional uncertainty, but it is clear that the UK, like many advanced economies, has moved into recession. Asset markets and the financial sector have been severely affected, with persistent implications for the public finances.

The economic and fiscal climate is exceptionally challenging, but because of the macroeconomic framework introduced in 1997 the UK is facing these shocks from a solid foundation. The Government remains committed to the macroeconomic framework and the objectives enshrined within it. Credible medium-term objectives and mechanisms for short-term flexibility mean that the Bank of England and the Government can deliver the necessary support to the economy without compromising their respective commitments to low inflation and sound public finances.

The Government's immediate priority is to continue to support the economy through these difficult times. This Pre-Budget Report announces that the Government will support families and businesses, including by:

- temporarily reducing the Value Added Tax (VAT) rate to 15 per cent with effect from 1 December 2008 to 31 December 2009; and
- bringing forward £3 billion of capital spending from 2010-11 to 2008-09 and 2009-10, the years when the impact of the shock is likely to be the strongest.

Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and long-term growth. The Government will therefore deliver a sustained fiscal consolidation from 2010-11, when the economy is expected to be recovering and able to support a reduction in borrowing. In particular:

- the income tax personal allowance will be restricted for those with incomes over £100,000 from April 2010 and a new additional higher rate of income tax of 45 per cent will be introduced for those with incomes above £150,000 from April 2011;
- the employee, employer and self-employed rates of National Insurance Contributions will increase by 0.5 per cent from April 2011, when economic growth is forecast to be above trend rates and real incomes are growing strongly; and
- the Government will increase its Value for Money target in 2010-11 by £5 billion. Current spending will grow on average from 2011-12 to 2013-14 at 1.2 per cent a year in real terms, and public sector net investment will move to 1.8 per cent of GDP by 2013-14.

To underpin this consolidation, consistent with the *Code for Fiscal Stability*, the Government is setting a temporary operating rule: 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.

The fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

## RECENT ECONOMIC DEVELOPMENTS AND THE MACROECONOMIC RESPONSE

**Global economic shocks** 2.1 Since mid-2007, the world's economies have been hit by major shocks. Developments in the US subprime mortgage market triggered a credit shock that has intensified into the worst global financial crisis for generations, a crisis that is being addressed by a global policy response of unprecedented scale and scope. The surge in commodity prices, which had built over a number of years, peaked in July 2008 and has since reversed.

2.2 These economic shocks have affected all countries. The squeeze on real incomes from high commodity prices and the global financial crisis has pushed many advanced economies into recession and led a growing number of emerging economies to require financial support from the International Monetary Fund (IMF) and other sources.

2.3 The Government's macroeconomic framework has been designed to ensure that policymakers have the flexibility to respond appropriately to shocks. Transparency and a commitment to medium-term goals mean that the Bank of England and the Government can deliver the necessary support to the economy without compromising their respective objectives of low inflation and sound public finances over the medium term. Further detail is provided in Box 2.1.

**Monetary policy response** 2.4 Since the onset of the global credit shock in August 2007, the Monetary Policy Committee (MPC) of the Bank of England has cut Bank Rate by a cumulative 2¾ percentage points, from 5¾ per cent to 3 per cent. On 8 October, the MPC cut rates by ½ a percentage point as part of a globally coordinated interest rate cut, and then on 6 November it reduced Bank Rate by a further 1½ percentage points to 3 per cent, its lowest level since 1955. Globally, since the 8 October coordinated action, the US Federal Funds rate has been cut to 1 per cent, and official interest rates have been reduced to 3¼ per cent in the euro area and 0.3 per cent in Japan.

**Fiscal policy response** 2.5 Since Budget 2008, the Government has taken a number of actions which deliver support to the economy, including raising the income tax personal allowance by £600, helping 22 million basic-rate taxpayers and packages of support for homeowners and households facing rising energy bills. This Pre-Budget Report announces that, to provide further support for growth and incomes during the economic downturn, the Government will complement the action taken to date with a fiscal stimulus through:

- a temporary reduction in the VAT rate to 15 per cent with effect from 1 December 2008 to 31 December 2009; and
- bringing forward £3 billion of capital spending from 2010-11 to 2008-09 and 2009-10, the years when the impact of the shock is likely to be the strongest.

2.6 Further support for pensioners, families with children and all taxpayers with modest and middle incomes, including those affected by the removal of the 10 pence starting rate of tax in Budget 2007 – described in Chapter 5 – and to support businesses – set out in Chapter 4 – will also help to mitigate the impact of the economic downturn.

2.7 Discretionary action of £16 billion will deliver a fiscal stimulus package of around 1 per cent of GDP in total in 2009-10, in addition to the support provided by measures in 2008-09.

2.8 As set out in Chapter 3, G20 leaders, at their summit on 15 November, agreed a broader policy response, based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging markets and developing countries. This includes using fiscal measures to stimulate domestic demand with rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.

**Box 2.1: Operation of the macroeconomic framework in exceptional economic circumstances**

The UK macroeconomic framework has been designed to ensure that policymakers have the flexibility to respond appropriately to shocks, while at the same time ensuring transparency in the way policy is formulated and a credible commitment to medium-term goals.

The primary objective of monetary policy is to deliver price stability. However, the monetary policy framework takes into account that the economy can suffer from external events or temporary difficulties. The remit for the MPC recognises that “the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances,” and that “attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output.”<sup>1</sup> The open letter system requires the Governor of the Bank of England to write to the Chancellor explaining the reasons for any deviation in inflation of more than one percentage point above or below target, plus the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC. The transparency and accountability provided by the open letter system allow the MPC the flexibility to deliver the inflation target while avoiding unnecessary volatility in output.

The Government’s fiscal framework, as articulated in the *Code for Fiscal Stability* (“the Code”) and approved by the House of Commons in 1998, was designed to ensure that the Government has the flexibility to respond appropriately to shocks. The Code requires the Government to set out its fiscal policy objectives and a set of operating rules to deliver them. It provides flexibility for the Government to either change its rules or depart from them on a temporary basis to ensure that at all times they are appropriate to deliver the Government’s fiscal policy objectives, including when economic circumstances change significantly. To ensure transparency, the Code requires the Government to state clearly the reasons for any change.

The Government’s fiscal policy objectives remain unchanged. To achieve its objectives, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full.

Consistent with the *Code for Fiscal Stability*, the Government is setting a temporary operating rule: 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.

<sup>1</sup> www.bankofengland.co.uk

**Action to maintain financial stability**

**2.9** In addition to the macroeconomic policy response, with the financial crisis intensifying in early October, the Government acted to maintain financial stability and protect depositors, announcing a comprehensive package of measures:

- first, to address concerns about liquidity, the authorities announced that at least £200 billion would be made available to banks under the Bank of England’s Special Liquidity Scheme (SLS);
- second, to address concerns about solvency, the Government established the Bank Recapitalisation Fund. This makes available new Tier 1 capital to eligible UK banks and building societies, allowing them to strengthen their resources, while maintaining their support for the wider economy; and

- third, to address funding concerns (reflecting a lack of mutual confidence and trust between financial institutions), the Government established a credit guarantee scheme. This makes available to eligible institutions a government guarantee to refinance maturing debt. The credit guarantee is intended to unblock the interbank money market, thereby allowing banks to continue to lend to the wider economy.

**2.10** Further information on these measures is provided in Chapter 3. This action reflected the risk that a widespread bank failure poses to economic output and employment, as explained in Box 3.1, and was critical to mitigating the impact of financial market turbulence on individuals and businesses. Many countries have since taken similar action, modelled on the UK Government's response.

### Recent economic developments

**2.11** In 2006 and 2007, GDP grew by 2¾ and 3 per cent respectively. Reflecting the major shocks to the economy, growth has slowed progressively as credit conditions have tightened and real incomes were squeezed by high commodity prices. Quarterly GDP growth in the first half of 2007 averaged 0.8 per cent, before slowing progressively to average 0.6 per cent in the second half and 0.1 per cent in the first half of 2008. In the third quarter, GDP contracted by 0.5 per cent, the first fall in output since 1992, with negative growth across most sectors of the economy. The distribution sector experienced the largest contraction, consistent with discretionary spending having been held back as consumer sentiment weakened and real incomes were squeezed.

**2.12** CPI inflation increased from 2.2 per cent in December 2007 to 5.2 per cent by September 2008 before falling back sharply to 4.5 per cent in October. Movements in the prices of goods that are most closely linked to global commodity prices accounted for virtually all of the increase. With commodity prices having eased significantly since the summer, petrol and diesel prices have already declined by 12 per cent and food price inflation appears to have passed its peak. Reflecting a combination of factors, including market expectations of substantial monetary policy easing, the sterling exchange rate index has declined by over 20 per cent since its peak in the summer of 2007.

### Economic cycle

**2.13** Evidence from the broad range of cyclical indicators monitored by the Treasury – described further in *Evidence on the economic cycle*, published alongside the Pre-Budget Report – suggests that the economy passed up through trend during the second half of 2006 and remained above trend during the course of 2007. Taken together with the latest National Accounts data, this evidence supports the Treasury's assessment that the economic cycle, judged to have started in the first half of 1997, ended during the second half of 2006.

**2.14** The Comptroller and Auditor General has audited this judgement. Taking all the evidence available as a whole, he judged that it is reasonable to conclude currently that the second half of 2006 marked the end date of the most recently completed economic cycle, and recommended, given the uncertainties in dating economic cycles, including looking ahead and the impact new data might have in the future, that the Treasury keep this assessment under review.

### Global economic prospects

**2.15** Against the backdrop of major economic shocks, world growth is forecast to have slowed to 3½ per cent in 2008 and to fall to just 2 per cent in 2009, significantly below recent trends. Growth across the G7 economies is forecast to have slowed to 1 per cent this year, and to turn negative in 2009, the first year of contraction since 1982. The IMF forecasts output across 31 advanced economies to contract in 2009, for the first time in the post-war period. Many advanced economies are already experiencing falling output, with the euro area and Japan in recession.

**UK growth prospects** **2.16** As described more fully in Annex A, there are a number of channels through which the global credit and commodity price shocks could affect trend output in the UK. For the 2008 Pre-Budget Report, to take account of the likely negative effect of the credit shock on trend output, a phased reduction to the trend level of productivity (and therefore the trend level of output) has been assumed over the two years from mid-2007, a period consistent with the credit conditions assumption that underpins the economic forecast more generally. This adjustment is within the range of external estimates, though it is a key forecasting judgement around which there is very considerable uncertainty.

**2.17** Having slowed progressively over the past year, GDP is forecast to fall by a  $\frac{1}{4}$  per cent on a year earlier in the second half of 2008, leaving output in 2008 as a whole up  $\frac{3}{4}$  per cent on a year earlier. The recession is forecast to continue into the first half of 2009, before GDP growth begins to recover in the second half as credit conditions start to ease and the boost to real incomes from lower commodity prices, the stimulus from monetary and fiscal policy, and the effects of sterling's depreciation, take hold.

**2.18** Growth in 2009 as a whole is forecast to be negative, at  $-1\frac{1}{4}$  to  $-\frac{3}{4}$  per cent. The effect of fiscal stimulus, particularly the temporary cut in the rate of VAT and bringing forward of public investment to 2008-09 and 2009-10, in addition to other measures, is assumed to reduce the extent of the downturn by around  $\frac{1}{2}$  a percentage point. The UK also has relatively powerful automatic stabilisers, which will operate in full to further support the economy. In response to rising unemployment, as set out in Chapter 5 of this Pre-Budget Report, the Government has announced a package of measures to ensure that those facing redundancy and those seeking employment are helped back into work as quickly and efficiently as possible.

**2.19** Credit conditions are assumed to settle at a new norm in 2010, such that the process of efficient credit allocation is restored and the UK's flexible markets can adjust more effectively to changed economic circumstances. As lagged effects feed through, including from fiscal and monetary stimulus and from the depreciation of sterling, growth is expected to pick up progressively through 2010 and 2011 to a little above trend rates. Past recovery phases point to the possibility that, once recovery has taken hold, growth could continue at strong rates for a number of years as spare capacity is brought back into productive use. For example, GDP growth averaged  $3\frac{3}{4}$  per cent a year in the five years from 1982 and again in the five years from 1993. Rebalancing of demand in the economy is forecast to take place over the coming years, with net exports contributing positively to growth in each year and consumer spending forecast to grow at rates slightly below that of the whole economy as households continue to adjust their finances.

**Box 2.2: Fiscal stimulus and economic recovery**

The Government's fiscal stimulus is designed as a timely response to the UK economy entering recession. It supports and reinforces additional stimulus from monetary policy and depreciation of sterling, alongside the boost to real incomes from recent sharp falls in commodity prices. This stimulus, and the assumed easing of credit conditions, supported by the Government's comprehensive measures to stabilise the banking system, is forecast to deliver recovery from the second half of next year. The UK also has relatively powerful automatic stabilisers by international standards, which will operate in full to further support the economy. Consequently, while clear risks remain, particularly relating to prospects for credit conditions easing, the downturn will be shallower than would have been the case in the absence of fiscal support, and growth is forecast to pick up to 1½ to 2 per cent in 2010. This would contrast with the recession of the early 1980s, when the economy continued to contract for a second year, and that of the early 1990s, where the economy grew by only ¼ per cent in the second year of the downturn.

This earlier recovery also reflects differences in the origin of the downturn, and the foundations for recovery being laid sooner than in past recessions. The trigger for this downturn was the major global economic shocks that have hit since mid-2007, when the UK economy was operating close to trend, inflation was close to target and interest rates were below 6 per cent. This contrasts with the late 1970s oil price shock, and the late 1980s overheating domestic economy, which generated high inflation and, because inflation expectations were poorly anchored, high wage inflation. In order to bring inflation under control, interest rates were raised sharply, peaking at 17 per cent in 1980 and 15 per cent in 1990. In 1981 fiscal policy was tightened significantly, while in the early 1990s recession the fiscal stance loosened significantly only in 1992-93, when the economy had begun to grow again. As such, in the early stages of these past recessions, domestic macroeconomic policy acted as a brake on activity. By contrast, the Pre-Budget Report announces a significant fiscal stimulus, and Bank Rate is at a 53-year low of 3 per cent, providing policy stimulus at a time when the effects of the financial crisis on the availability of credit is weighing on growth.

Providing support to the economy now, through fiscal stimulus and support for the banking system, should reduce the extent of the downturn. A failure to provide fiscal stimulus would risk delaying economic recovery and reducing the effectiveness of the Government's intervention in the banking system, with potentially greater fiscal and economic costs in the future.

**UK inflation prospects** 2.20 CPI inflation fell from 5.2 per cent in September to 4.5 per cent in October, suggesting September marked the peak. Global commodity prices have fallen sharply since the summer, which should feed through to consumer prices for petrol, food and household energy with varying lags. Commodity price developments and the emergence of a negative output gap would suggest that inflation will decline rapidly from above 5 per cent to reach the target rate by the middle of 2009, although sterling's depreciation will exert upward pressure. In addition, the temporary reduction of the VAT rate from 17½ per cent to 15 per cent from December 2008 is expected to put further downward pressure on inflation as businesses pass the cut through to prices. The forecast assumes that due to the competitive nature of the UK retail sector, especially during the coming downturn, the majority of the VAT rate cut will be passed through to consumer prices, but that prices will be reduced progressively rather than immediately. This is in line with international evidence. As a result, CPI inflation is forecast to fall below 1 per cent in the second half of 2009.

**2.21** Unlike the initial cut in the VAT rate, the subsequent pre-announced return to 17½ per cent will be anticipated by businesses and consumers, so will be taken into account in prices during the normal process of reviewing prices as other costs and demand factors evolve. Inflation is forecast to move a little above the 2 per cent inflation target following the reversal of the VAT rate cut and as the lagged effects of sterling depreciation on import prices continue to feed through, before returning to target in 2011 as the still negative output gap exerts downward pressure.

**Table 2.1: Summary of UK forecast<sup>1</sup>**

	2007	Forecast			
		2008	2009	2010	2011
GDP growth (per cent)	3	¾	-1¼ to -¾	1½ to 2	2¾ to 3¼
CPI inflation (per cent, Q4)	2	3¾	½	2¼	2

<sup>1</sup> See footnote to Table A9 for explanation of forecast ranges.

**Risks and uncertainty**

**2.22** Economic forecasting inevitably involves judgement about the uncertain path of future events. Given the current context, of shocks that are likely to affect supply potential as well as demand and substantial macroeconomic and financial policy responses, the 2008 Pre-Budget Report forecast involves an even greater reliance on judgement.

**2.23** As was the case at the last Budget and Pre-Budget Report, the key forecast judgement relates to the intensity and duration of the global tightening in credit conditions faced by households and companies. The forecast assumes that, with financial institutions having received significant support from governments around the world, credit conditions should ease over the coming year and return to a new norm from early 2010. The extent of government support and very low level of policy interest rates suggest there is an upside risk to this assumed path of credit conditions, with the possibility that the banking system is able to restore the efficiency of its financial intermediation operation more quickly. Against that, the experience of the past six months, when conditions appeared to be stabilising before deteriorating dramatically in September and October, underlines the significant downside risks that remain.

**2.24** There are uncertainties over the degree to which monetary and fiscal policy easing will support activity. In terms of monetary easing, there have been some encouraging signs that it will filter through to households and companies, though there remain clear risks over how long the availability of credit will remain restricted and the extent to which households and companies will want to increase borrowing in an uncertain economic environment, and when outstanding household borrowing is historically high.

**2.25** In terms of the fiscal stimulus, the key economic risks stem from the degree to which the lower VAT rate is passed through to consumer prices and the extent to which temporarily lower prices stimulate a greater volume of spending. It has been assumed that over time the majority of the VAT rate cut will be passed through to consumer prices. While this suggests a risk to consumer spending from lower pass-through, that would be tempered by the upside risk to corporate profits and perhaps therefore employment if companies were to retain more of the temporary VAT rate cut. With respect to stimulating spending, the forecast assumes that approximately half of the increase in real purchasing power translates into an increased volume of spending, with the remainder used by households to bolster their finances. There are clearly upside and downside risks to this assumption, particularly those related to developments in credit conditions. If credit conditions ease more rapidly than assumed, households will have greater scope to bring forward spending to capitalise on the temporarily lower rate of VAT.

**2.26** From spring 2008 until recently, the risk to inflation was tilted to the upside, with commodity prices reaching record highs in the summer. As commodity prices have fallen sharply and growth has slowed, pressures on inflation have eased. While the depreciation of sterling means there are residual upside risks to inflation from import prices, it seems clear that inflation is set to fall sharply over the coming year. Further downward pressure on inflation will come as the cut in the VAT rate is progressively passed through to prices.

**Public finance projections** **2.27** Developments in the economy and financial markets since Budget 2008, and the updated economic forecast set out above, have substantial implications for the public finance projections. Table 2.2 provides a summary of the Pre-Budget Report projections for key fiscal aggregates, which are discussed later in this chapter and more fully in Annex B.

**2.28** Public sector net borrowing (PSNB) peaks at 8.0 per cent of GDP in 2009-10, reflecting the impact of the economic downturn on receipts, in particular from the financial and housing sectors, the effect of the automatic stabilisers and the action the Government is taking to support the economy. Of this, the discretionary fiscal action the Government is taking to support the economy accounts for 1.1 per cent of GDP, of which around 0.2 per cent of GDP is capital spending. In total, borrowing for capital investment accounts for 2.7 per cent of GDP in 2009-10. Therefore, excluding borrowing for investment and for discretionary action, net borrowing in 2009-10 would be 4.4 per cent of GDP. PSNB then declines to 2.9 per cent of GDP by 2013-14, as the economy recovers and the Government takes action to ensure the sustainability of the public finances. Public sector net debt (PSND) increases over the forecast period, in particular in 2009-10 and 2010-11, reflecting the additional borrowing in these years, then begins to stabilise at just over 57 per cent of GDP by the end of the forecast period.

**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)	2.6	5.3	8.0	6.8	5.3	4.1	2.9
Total change since Budget	0.0	2.4	5.5	4.8	3.7	2.8	-
Impact of discretionary measures on PSNB <sup>1</sup>	0.0	0.6	1.1	-0.3	-0.9	-1.3	-1.6
Surplus on current budget	-0.5	-2.8	-5.3	-4.7	-3.3	-2.2	-1.1
Cyclically-adjusted surplus on current budget	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
Public sector net investment	2.1	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net debt <sup>2</sup>	36.3	41.2	48.2	52.9	55.6	57.1	57.4

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

<sup>2</sup> Debt at end March; GDP centred on end March; excluding financial sector interventions.

**2.29** The uncertainty surrounding economic prospects in turn implies greater than usual risks surrounding the public finance projections. The projections are based on the recovery in economic growth set out above, and a pick up in financial sector profits and asset prices beginning in early 2010. Downside risks to the public finance projections include that the economic downturn is sharper or longer than expected, the economic recovery is slower than expected or that the contraction in the financial sector or the adjustment in the housing market are more protracted. If, however, the substantial stimulus from monetary and fiscal policy, sterling's depreciation and lower commodity prices, takes hold sooner than forecast, the public finance projections would be subject to upside risks.

## SETTING FISCAL POLICY IN EXCEPTIONAL CIRCUMSTANCES

**2.30** The economic downturn caused by these major economic shocks will have a large and persistent impact on the public finances. In the face of such adverse developments, it is important to focus on the purpose of the fiscal framework – to support economic growth by delivering economic stability – and to ensure that fiscal policy decisions are appropriate to achieve this.

**2.31** The Government's objectives for fiscal policy in the face of these shocks remain unchanged:

- 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.

**2.32** In order to ensure sound public finances over the medium term, fiscal policy has been set on the basis of delivering a balanced cyclically-adjusted current budget and a declining debt to GDP ratio once the global shocks have worked their way through the economy in full. The cyclically-adjusted current budget is projected to reach balance in 2015-16. It improves as a proportion of GDP by over 0.5 per cent a year from 2010-11, when the economy is expected to be recovering and able to support a reduction in borrowing. This fiscal consolidation is underpinned by a temporary operating rule. A starting point of low public debt and the action that the Government is taking to ensure fiscal sustainability over the medium term mean borrowing can be allowed to rise to enable the Government to support families and businesses in the short term, including through discretionary fiscal action.

### Delivering fiscal support to the economy

**2.33** The Government's immediate priority is to support the economy through these difficult times, and this support needs to be tailored to address the particular problems that the economy is experiencing.

#### The role for active fiscal policy

**2.34** In current economic circumstances, it is more important than usual for fiscal policy to play a role in supporting economic activity. In general, monetary policy is the primary tool for managing demand in the economy, while fiscal policy supports monetary policy through the automatic stabilisers, helping to smooth the path of the economy. However, while there have been encouraging signs that monetary easing is being passed through to interest rates paid by households and businesses, it is likely that monetary policy may be less effective than normal in stimulating economic activity at present, in particular due to constraints on the availability of credit. Given this, fiscal policy should play a more active, complementary role because it is able to support growth, and people's incomes and purchasing power, directly. In this way, fiscal policy can support monetary policy to limit the extent and duration of the downturn.

**2.35** The role for fiscal policy was recently acknowledged by the Governor of the Bank of England, who stated: "*there are two changes which mean that in these circumstances it is reasonable to think about fiscal policy as a complement to monetary policy. One is... credit constraints on households, which make fiscal policy likely to be more effective, and secondly the fact that the transmission mechanism of monetary policy has been in part impaired through the banking crisis.*"<sup>1</sup>

<sup>1</sup> Transcript of press conference, 12 November 2008, available at [www.bankofengland.co.uk](http://www.bankofengland.co.uk)

**2.36** There is also an important role for private sector investment to play in stimulating the economy, while also ensuring the right infrastructure is in place for longer-term prosperity. A significant level of investment is already planned for 2009-10, particularly in the regulated sectors, and there may be scope for companies to work with regulators within their existing processes to bring further investment forward.

**Delivering fiscal support**

**2.37** The UK has relatively powerful automatic stabilisers by international standards, and these are operating in full to support the economy. This Pre-Budget Report announces that, to provide further support for growth and incomes during the economic downturn, the Government will complement the action taken to date with a fiscal stimulus, including through:

- **a temporary reduction in the VAT rate to 15 per cent with effect from 1 December to 31 December 2009;** and
- **bringing forward £3 billion of capital spending from 2010-11 to 2008-09 and 2009-10,** the years when the impact of the shock is likely to be the strongest – further details are set out in Chapter 6.

**2.38** Further support for pensioners, families with children and all taxpayers with modest and middle incomes, including those affected by the removal of the 10 pence starting rate of tax in Budget 2007 – described in Chapter 5 – and to support businesses – set out in Chapter 4 – will also help to mitigate the impact of the economic downturn.

**2.39** Discretionary action of £16 billion will deliver a fiscal stimulus package of around 1 per cent of GDP in total in 2009-10, in addition to the support provided by measures in 2008-09. A number of advanced economies have announced fiscal support packages of similar magnitude in recent months. *The case for a concerted international fiscal response*,<sup>2</sup> published alongside this Pre Budget Report, sets out the case for a concerted international fiscal response to the current downturn, as endorsed by leaders of the G20 countries at their summit on 15 November 2008. Box 2.3 provides a summary of the document's conclusions.

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<sup>2</sup>*The case for a concerted international fiscal response*, HM Treasury, November 2008.

**Box 2.3: The case for a concerted international fiscal response**

The case for concerted fiscal action has been endorsed by the leaders of the G20 countries. On 15 November they declared that they:

- had agreed to work together to restore global growth; and
- would “use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability”.

A simple, but nonetheless powerful, argument for concerted fiscal action is that this is a global crisis, and therefore requires a global solution. The combined effect of coherent actions taken across countries will be more effective than each country acting alone. In open economies, such as the UK, a proportion of any stimulus will be spent on imports. A concerted stimulus among major trading partners would increase trade flows in both directions.

Decisive concerted action by the world’s leading economies will also provide a strong signal to the private sector of the willingness of governments to act effectively together. This should raise the private sector’s expectations of the economic outlook, and help to reduce the risk of an adverse feedback between low expectations, cautious spending and weak outcomes.

An effective international response does not mean that all countries should take identical actions. Instead, fiscal actions need to be tailored to the situation of each country, taking account of existing levels of public debt.

However, the effectiveness of international fiscal actions will be enhanced if they are concerted, and conform to the “timely, targeted and temporary” principles described below.

**Choice of levers 2.40** For fiscal support to help stabilise the economy effectively it should be:

- timely – it needs to have a swift impact. This requires both that the policy change can be implemented quickly, and that it has a rapid impact on behaviour;
- temporary – to maximise its immediate impact and protect medium-term fiscal sustainability. If action is not taken to maintain sound public finances, there is a risk that higher long-term interest rates will outweigh its stimulus effect; and
- targeted – it is important that the support boosts spending, to maximise the impact on economic activity.

**2.41** The Government has therefore chosen to take fiscal action that meets these criteria. A reduction in the rate of VAT has been chosen as the main lever for the fiscal action as this change can be implemented rapidly (timely), will impact immediately on the purchasing decisions of firms and individuals to boost spending (targeted) and is reversible (temporary). A temporary reduction in the rate of VAT will lower prices for households and should provide help immediately, when they need it most. It will also incentivise them to bring forward the purchase of goods, which will help support firms and the people they employ as the economy slows.

**2.42** Furthermore, bringing forward valuable public investment also pursues these aims by impacting directly on economic activity in the UK (targeted), in particular supporting the construction sector, which is expected to be disproportionately affected by the economic downturn. In order to ensure that increased public spending acts as an effective economic stimulus, the Government has taken the decision to bring forward existing spending programmes, which can support the economy quickly (timely), rather than initiate new projects, which can take considerable time. As the spending plans are being brought forward, the boost to spending is offset in later years (temporary).

**2.43** In addition, Chapter 5 sets out the measures the Government is bringing forward to benefit those on low and middle incomes, helping to boost spending as these households tend to have a higher propensity to increase consumption in response to an increase in income.

**The benefits of support**

**2.44** The precise economic impact of the VAT measure depends on a number of factors, including the extent to which the reduction in prices is passed through to consumers, the extent to which temporarily lower prices stimulate a greater volume of spending, and the amount that is spent on domestically produced goods and services rather than imports. The reduction in the VAT rate is expected to support families' and businesses' finances and spending power in the short term:

- in Britain's competitive retail sector, it is expected that the majority of the VAT reduction will be passed on to consumers through lower prices, increasing the purchasing power of families and individuals;
- where households choose to use this increased purchasing power to increase consumption, it will support growth now, contributing to the profits of businesses and helping to support employment; and
- where it is saved, it will help households to adjust their finances.

**2.45** The economic forecast has made realistic assumptions – informed by the experience of other changes in VAT both in the UK and abroad – on the extent to which a cut in VAT is passed on in the form of lower prices. The forecast assumes that, over time, the majority of the reduction in VAT will be passed on to consumers through lower prices, and that households will spend around half of the increase in real disposable income that results. The increase in public investment will deliver a direct increase in economic activity. Overall, GDP growth in 2009 is forecast to be around ½ a percentage point higher than it would be in the absence of the discretionary action that the Government has taken.

## Ensuring medium-term sustainability

**2.46** By acting quickly and decisively to provide support to the economy when it needs it most, fiscal action – working alongside monetary policy – can help to reduce the impact on individuals and households of the financial markets shock and the risk of a deeper or more prolonged recession.

**2.47** This action will be financed by borrowing in the short term. Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and long-term growth. Fiscal policy has been set on the basis of delivering a balanced cyclically-adjusted current budget and a declining debt to GDP ratio once the global shocks have worked through the economy in full. This Pre-Budget Report sets out measures which put the public finances on a path to achieve a balanced cyclically-adjusted current budget and a declining debt to GDP ratio by 2015-16.

**2.48** These measures are a combination of adjustments to both taxation and spending, implemented at a time when the economy is forecast to be recovering and able to support fiscal consolidation. As set out in more detail in Chapter 5, the Government will make a number of reforms to income tax and national insurance contributions (NICs):

- **the income tax personal allowance will be restricted for those with incomes of over £100,000 – the 2 per cent of people with the highest incomes – from April 2010, when the economy is forecast to be growing;**

- a new additional higher rate of income tax of 45 per cent (and 37.5 per cent for dividend income) will be introduced for those with incomes above £150,000 from April 2011; and
- a 0.5 per cent increase in the employee, employer and self-employed rates of NICs from April 2011, when economic growth is forecast to be above trend rates and real incomes are growing strongly.

**Other tax measures** **2.49** As set out in more detail in Chapter 5, alcohol and tobacco duties will be increased to offset the effects of the temporary reduction in VAT. Maintaining these increases after December 2009 will further support fiscal consolidation.

**Adjusted public spending plans** **2.50** The Pre-Budget Report also announces action to bring forward £3 billion of capital spending to support the economy, increasing capital budgets for 2008-09 and 2009-10. In turn, this means that capital budgets in 2010-11 can be set at a lower level, with total capital DEL budgets over the entire CSR period being no higher as a result. The Pre-Budget Report also announces a £5bn increase in the Government's Value for Money target in 2010-11, with consequential adjustments in departmental resource budgets to be announced at Budget 2009. Further details are provided in Chapter 6.

**2.51** The 2008 Pre-Budget Report fiscal projections are based on an assumption of average growth in current spending of 1.2 per cent a year in real terms over 2011-12, 2012-13 and 2013-14. Net investment moves to 1.8 per cent of GDP by 2013-14, still three times higher as a proportion of GDP than in 1997-98. Taken together these assumptions mean Total Managed Expenditure (TME) growing by 1.1 per cent per year in real terms on average over 2011-12, 2012-13 and 2013-14.

**Impact on the public finances** **2.52** The improvement in the public finances from 2010-11 is shown in Table 2.2 above, with both Public Sector Net Borrowing (PSNB) and the deficit on the current budget declining from this year, including in cyclically adjusted terms. In 2013-14, the action the Government is taking reduces net borrowing by 1.6 per cent of GDP.

## THE FISCAL OUTLOOK

**2.53** Table 2.3 presents the key fiscal aggregates based on the five themes of fiscal consolidation, economic impact, sustainability, financing and European commitments; while Table 2.4 compares the projections for net borrowing, the current balance, net investment and net debt with those published in Budget 2008.

**Impact of the economic downturn** **2.54** The global credit and commodity price shocks have adversely affected economic growth and the financial and property markets in the UK, as they have around the world. These developments also have significant implications for the public finances:

- lower economic growth acts to significantly reduce tax receipts, in particular from income tax, VAT and corporation tax due to lower incomes, consumption and profits;
- the financial crisis additionally affects the tax take from the financial sector, which over recent years has generated about 25 per cent of corporation tax revenue. Earnings and bonuses in that sector are also affected, reducing income tax receipts;
- sharp falls in house and share prices reduce capital gains tax and stamp duty receipts;

- the automatic stabilisers are working to support the economy, increasing spending on social security benefits; and
- higher than expected inflation since Budget 2008 has resulted in higher social security expenditure, reduced tax receipts (due to higher allowances) in 2009-10, and increased the cost of servicing index-linked gilts in 2008-09. These pressures moderate significantly over the projection period, as inflation is expected to fall sharply next year.

**2.55** While economic growth is expected to pick-up progressively through 2010 and 2011 to a little above trend rates, total economic growth over the forecast period is lower than forecast at Budget 2008. Consistent with a rebalancing of the economy, the recovery is expected to be led by investment and exports, sectors that tend to provide less tax receipts than consumption. Furthermore, it is expected that the financial and housing market shocks will have an additional, persistent effect on the public finances. The forecast therefore assumes a deterioration in the public finances over the full forecast period compared to Budget 2008.

**Current  
balance and net  
borrowing**

**2.56** Table 2.3 shows that both the deficit on the current budget and public sector net borrowing (PSNB) are projected to increase significantly in 2009-10. This reflects the impact of the economic downturn on tax receipts, including from the financial and housing markets. It also reflects the action that the Government is taking to support the economy and mitigate the impact of the economic shocks on businesses and individuals. Table 2.4 shows that discretionary support is most significant in 2009-10, acting to reduce the impact of the economic shock when it is expected to be at its strongest. PSNB peaks at 8.0 per cent of GDP in 2009-10. Of this, the discretionary fiscal action the Government is taking to support the economy accounts for 1.1 per cent of GDP, of which around 0.2 per cent of GDP is capital spending. In total, borrowing for capital investment accounts for 2.7 per cent of GDP in 2009-10. Therefore, excluding borrowing for investment and discretionary action, net borrowing in 2009-10 would be 4.4 per cent of GDP.

**2.57** In later years, borrowing declines as a result of the recovery of the economy and the Government's action to ensure the sustainability of the public finances, but remains higher than forecast at Budget because of the persistent effects of the downturn on the level of growth and on the financial and housing sectors in particular. Total public sector net borrowing falls to 2.9 per cent of GDP by the end of the forecast period, reflecting the action the Government is taking to ensure the sustainability of the public finances over the medium term, including through the tightening in discretionary spending set out earlier in this chapter and reflected in Table 2.4. The improvement in the public finances from 2010-11 is shown in Table 2.3, with both PSNB and the deficit on the current budget declining from that year, including in cyclically-adjusted terms.

**Table 2.3: 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
<b>Fiscal consolidation</b>							
Surplus on current budget	-0.5	-2.8	-5.3	-4.7	-3.3	-2.2	-1.1
Cyclically-adjusted surplus on current budget	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
Consolidation in the cyclically-adjusted surplus on current budget <sup>1</sup>	-	-	-	1.0	1.2	0.7	0.6
<b>Economic impact</b>							
Net investment	2.1	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net borrowing (PSNB)	2.6	5.3	8.0	6.8	5.3	4.1	2.9
Cyclically-adjusted PSNB	2.9	5.3	7.2	5.6	4.3	3.5	2.8
<b>Sustainability</b>							
Public sector net debt <sup>2,3</sup>	36.3	41.2	48.2	52.9	55.6	57.1	57.4
Core debt <sup>2,3</sup>	36.5	41.3	47.5	51.0	52.8	53.9	54.2
Net worth <sup>4</sup>	28.8	23.5	16.6	12.9	10.6	9.1	8.7
Primary balance	-1.0	-3.6	-6.7	-4.7	-3.0	-1.6	-0.5
<b>Financing</b>							
Central government net cash requirement	2.3	10.5	8.5	6.9	5.9	4.6	3.7
Public sector net cash requirement <sup>3</sup>	1.5	4.8	8.9	6.9	5.7	4.3	3.4
<b>European commitments</b>							
Treaty deficit <sup>5</sup>	2.8	5.4	8.1	7.0	5.6	4.4	3.3
Cyclically-adjusted Treaty deficit <sup>5</sup>	3.1	5.4	7.3	5.8	4.5	3.8	3.1
Treaty debt ratio <sup>6</sup>	43.2	52.9	60.5	65.1	67.5	68.6	68.5
Memo: Output gap	0.6	-0.3	-1.5	-1.9	-1.3	-0.7	-0.1

<sup>1</sup> Change in the cyclically-adjusted surplus on the previous year.

<sup>2</sup> Debt at end March; GDP centred on end March.

<sup>3</sup> Excluding financial sector interventions.

<sup>4</sup> Estimate at end December; GDP centred on end December.

<sup>5</sup> General government net borrowing on a Maastricht basis.

<sup>6</sup> General government gross debt measures on a Maastricht basis.

## Table 2.4: Fiscal balances compared with Budget 2008

	Outturn <sup>1</sup>	Estimate <sup>2</sup>	Projections			
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
<b>Net borrowing (£ billion)</b>						
<b>Budget 2008</b>	<b>36.4</b>	<b>42.5</b>	<b>38</b>	<b>32</b>	<b>27</b>	<b>23</b>
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
<b>2008 Pre-Budget Report</b>	<b>36.6</b>	<b>77.6</b>	<b>118</b>	<b>105</b>	<b>87</b>	<b>70</b>
<b>Surplus on current budget (£ billion)</b>						
<b>Budget 2008</b>	<b>-7.9</b>	<b>-9.6</b>	<b>-4</b>	<b>4</b>	<b>11</b>	<b>18</b>
Effect of revisions and forecasting changes	1.2	-23.3	-61	-78	-75	-72
Effect of discretionary changes <sup>3</sup>	0.0	-8.3	-13	1	10	16
<b>2008 Pre-Budget Report</b>	<b>-6.7</b>	<b>-41.2</b>	<b>-78</b>	<b>-73</b>	<b>-54</b>	<b>-37</b>
<b>Net investment (£ billion)</b>						
<b>Budget 2008</b>	<b>28.5</b>	<b>32.9</b>	<b>35</b>	<b>37</b>	<b>38</b>	<b>41</b>
Effect of revisions and forecasting changes	1.4	2.5	2 ½	- ½	-2	-1 ½
Effect of discretionary changes <sup>3</sup>	0.0	1.0	3 ½	-3 ½	-4	-6 ½
<b>2008 Pre-Budget Report</b>	<b>29.9</b>	<b>36.5</b>	<b>40</b>	<b>33</b>	<b>33</b>	<b>33</b>
<b>Cyclically-adjusted surplus on current budget (per cent of GDP)</b>						
Budget 2008	-0.7	-0.5	0.1	0.5	0.8	1.0
<b>2008 Pre-Budget Report</b>	<b>-0.8</b>	<b>-2.8</b>	<b>-4.4</b>	<b>-3.4</b>	<b>-2.3</b>	<b>-1.6</b>
<b>Cyclically-adjusted net borrowing (per cent of GDP)</b>						
Budget 2008	2.7	2.7	2.2	1.8	1.5	1.2
<b>2008 Pre-Budget Report</b>	<b>2.9</b>	<b>5.3</b>	<b>7.2</b>	<b>5.6</b>	<b>4.3</b>	<b>3.5</b>
<b>Net debt (per cent of GDP)<sup>4</sup></b>						
Budget 2008	37.1	38.5	39.4	39.8	39.7	39.3
<b>2008 Pre-Budget Report</b>	<b>36.3</b>	<b>41.2</b>	<b>48.2</b>	<b>52.9</b>	<b>55.6</b>	<b>57.1</b>

Note - Totals may not sum due to rounding.

<sup>1</sup> The 2007-08 figures were estimates in Budget 2008.

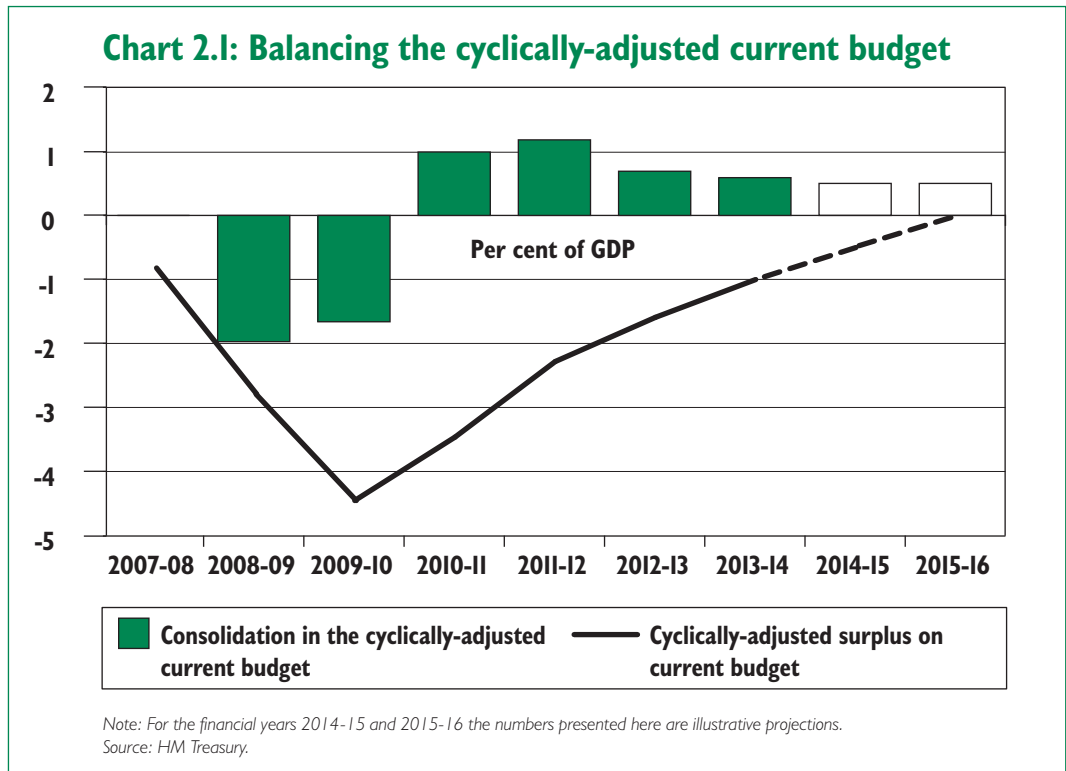
<sup>2</sup> The 2008-09 figures were projections in Budget 2008.

<sup>3</sup> Including changes in forecasting assumptions on spending growth in 2011-12 and 2012-13.

<sup>4</sup> Debt at end March; GDP centred on end March; excluding financial sector interventions.

### Balancing the cyclically-adjusted current budget

**2.58** This Pre-Budget Report puts the public finances on a path to achieve a balanced cyclically-adjusted current budget by 2015-16. The bars on Chart 2.1 show the planned fiscal consolidation in each financial year of the projection period. They show that the Pre-Budget Report fiscal projections entail a planned consolidation in the cyclically-adjusted current budget of over 0.5 per cent of GDP in each of the financial years from 2010-11 to 2013-14. As a result of this sustained consolidation, the cyclically-adjusted current deficit is projected to decrease from 4.4 per cent in 2009-10 to 1.0 per cent in 2013-14. A further adjustment of ½ a per cent of GDP per year in 2014-15 and 2015-16 would eliminate the deficit on the current budget by 2015-16. Therefore the fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a proportion of GDP by 2015-16 when the global shocks will have worked through the economy in full. This is consistent with the Government's temporary operating rule, described below.

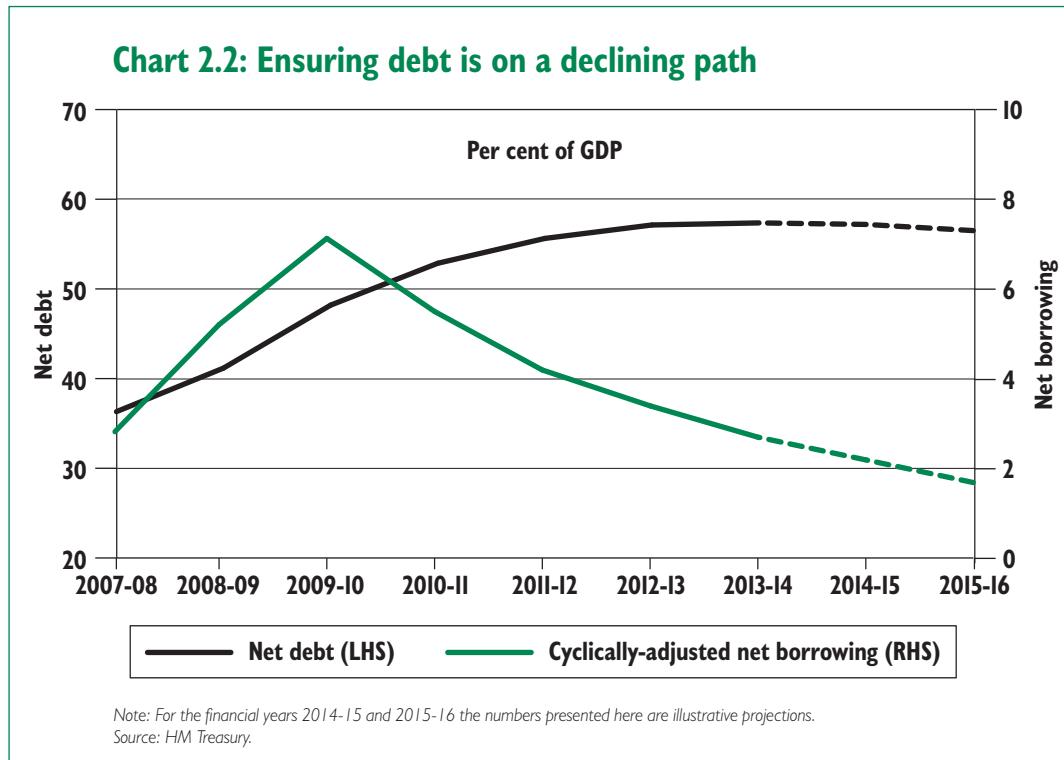


**Declining net debt to GDP ratio**

**2.59** The Government reduced net debt as a proportion of GDP over the previous economic cycle – public sector net debt fell from 42.5 per cent GDP in 1996-97<sup>3</sup> to 36.0 per cent in 2006-07. Holding public debt at a prudent level in normal times allows space for debt to rise to accommodate shocks when they happen. The large and persistent impact of the financial markets shock in particular on the public finances means policy must adjust over a period of time, to avoid a short-term pro-cyclical tightening. This requires public debt to rise to absorb the shock and allow fiscal policy to support the economy, until adjustment has been completed and debt is set on a declining path as a proportion of GDP. Table 2.3 shows that, as a result of the impact of the economic downturn on borrowing, public sector net debt is forecast to increase over the projection period and stabilise at just over 57 per cent of GDP in 2013-14.

**2.60** This Pre-Budget Report puts the public finances on a path that will ensure that the level of public debt will fall as a proportion of GDP in the medium term, once the global shocks have worked their way through the economy in full. Chart 2.2 shows that cyclically-adjusted PSNB is projected to decline from 2009-10, as a result of the planned fiscal consolidation, standing at 2.8 per cent at the end of the projection period in 2013-14. The chart shows illustrative projections based on a further improvement of ½ a per cent of GDP per year in the cyclically-adjusted current budget and assume that public sector net investment is held constant at 1.8 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 2015-16, once the global shocks have worked their way through the economy in full. This is consistent with the Government’s temporary operating rule, described below.

<sup>3</sup>As debt is a stock measure, performance is measured against the end point of the previous cycle.



**Economic impact 2.61** The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing. The overall impact of fiscal policy on the economy is made up of changes in:

- the automatic stabilisers – that part of the change in PSNB resulting from cyclical movements in the economy; and
- the fiscal stance – that part of the change in PSNB that is not a result of cyclical movements in the economy (as measured by changes in cyclically-adjusted PSNB).

**2.62** Chart 2.3 shows the economic impact of planned fiscal policy over the forecast period. It 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 fund a reduction in borrowing at a time when the economy is expected to be recovering and able to support the fiscal consolidation.

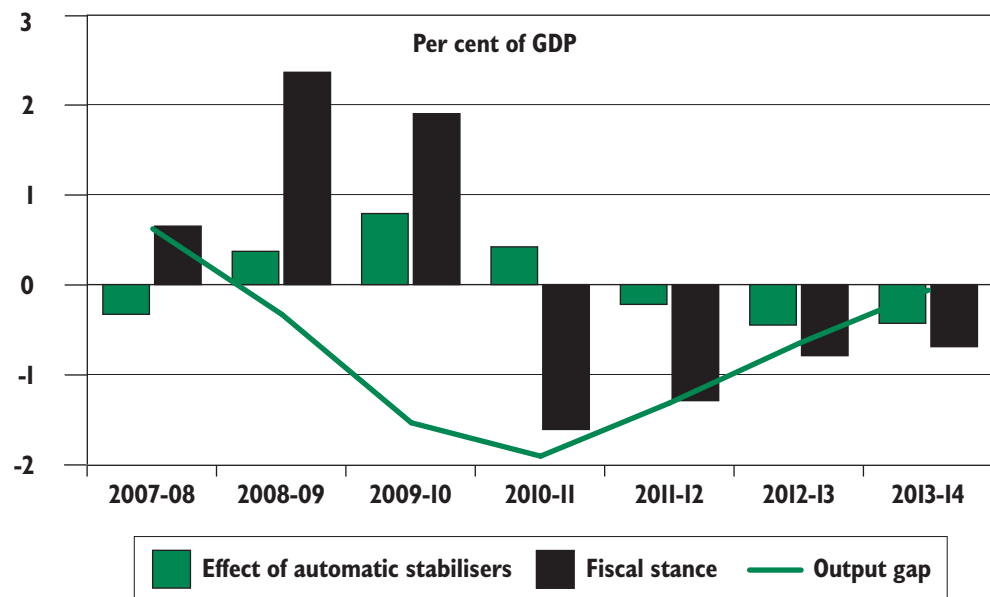
**Box 2.4: The impact on net debt of action to maintain financial stability and protect depositors**

The independent Office for National Statistics will determine how measures to maintain financial stability and protect depositors are classified within the National Accounts, in consultation with Eurostat (the Statistical Office of the European Union) and statistical offices in other member states to ensure consistent interpretation of international statistical guidance.

As any extra liabilities that may become classified to the public sector through these interventions will be temporary and backed by significant financial assets, they do not reflect future calls on the taxpayer. The long-term impact on the public finances, and any burden on future generations, would be determined by any eventual economic profit or loss incurred on the interventions. **As a result, consistent with the treatment of Northern Rock announced in Budget 2008, while the public sector fiscal aggregates continue to be affected by interventions in the financial sector the Government will report on public sector net debt both including and excluding the impact of those interventions.**

The Government will base its fiscal policy, and measurement of its fiscal rules, on aggregates that exclude that impact. Any economic profit or loss on interventions will be included in both measures (and so within the fiscal rules) when that profit or loss crystallises for central government. Annex B sets out in full how the support has been accounted for in the public finances.

**Chart 2.3: Fiscal policy supporting economic stability**



Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB. The effect of the automatic stabilisers equals the change in the cyclical component of PSNB, i.e. the difference between PSNB and the cyclically-adjusted PSNB.

Source: HM Treasury.

**European commitments 2.63** As shown in Table 2.3, the Treaty debt ratio<sup>4</sup> is expected to rise from 43.2 per cent in 2007-08 to 68.5 per cent in 2013-14. European economies have all been affected by the unprecedented global economic shocks, and several European member states are already in recession.<sup>5</sup> Fiscal policy has an important role to play in these exceptional circumstances. The

<sup>4</sup> General government gross debt on a Maastricht basis.

<sup>5</sup> European Commission Economic Forecast Autumn 2008, European Commission, November 2008.

Government's objectives of smoothing the path of the economy in the short term while ensuring sound public finances over the medium term are consistent with the October European Council Conclusions, which confirmed that the Stability and Growth Pact should be applied in a manner that reflects current exceptional economic circumstances.<sup>6</sup>

**Assumptions underpinning forecast** **2.64** The projections for the public finances include the effects of firm decisions announced in this Pre-Budget Report or since Budget 2008, consistent with the requirements of the *Code for Fiscal Stability*. These include the measures set out above to support the economy in the short term and to ensure fiscal sustainability over the medium term, as well as all other decisions announced in this Pre-Budget Report, which are summarised in Chapter 1.

**2.65** These forecasts are based on a range of assumptions and judgements on the public finances, the economy and the interaction between the two. A number of these are designed to provide caution and these are audited by the National Audit Office. A complete list of these assumptions is set out in Annex B.

**2.66** For the 2008 Pre-Budget Report, in addition to auditing the Treasury's dating of the economic cycle, referred to earlier in this chapter, the Comptroller and Auditor General has audited the oil price assumption used for the Treasury's public finance projections. The report concludes that the convention was cautious over the past three years, is designed to provide caution in the future, and remains a reasonable assumption to use going forward.

## Debt management

**2.67** The forecast for the central government net cash requirement (CGNCR) for 2008-09 has been revised, from £59.3 billion at Budget 2008 to £152.9 billion, an increase of £93.6 billion. This significant increase in the Government's cash needs in 2008-09 reflects both the exceptional actions necessary to maintain the stability of the financial system, protect depositors' money and safeguard the interests of taxpayers, and developments in the wider economy, which have adversely affected the public finances forecast.

**2.68** The increase in the Government's cash requirement in 2008-09 since Budget 2008 reflects:

- £37 billion for the Government's Bank Recapitalisation Fund;
- £21 billion to refinance the Bank of England's loans to the Financial Services Compensation Scheme (FSCS) for retail depositors in Bradford & Bingley and in UK subsidiaries of Icelandic banks eligible for payments from the FSCS and the Icelandic Depositors' and Investors' Guarantee Fund (ICS);
- £5.7 billion to refinance the Bank of England's working capital loan to Bradford & Bingley;
- a payment of £5.4 billion for retail depositors in Bradford and Bingley and UK subsidiaries of Icelandic banks covering that part of the deposits above compensation limits;
- partly offset by a downward revision in the forecast of the amount outstanding on the Government's loan to Northern Rock at 31 March 2009 from £14 billion at Budget 2008 to £12.2 billion; and
- a change of £26.5 billion mainly reflecting changes in the fiscal position.

<sup>6</sup> [www.consilium.europa.eu](http://www.consilium.europa.eu)

**2.69** After having adjusted the cash requirement to obtain the financing requirement (see Annex B), the increase in the financing requirement will be met by:

- an increase in the projected contribution to net financing from National Savings and Investments (NS&I) of £7 billion (from £4 billion at Budget 2008 to £11 billion);
- an increase in projected net Treasury bill issuance of £8.7 billion (from £5.8 billion at Budget to £14.5 billion). £7 billion of this increase was announced on 14 October 2008; and
- an increase in planned gilt sales of £66.4 billion (from £80 billion at Budget to £146.4 billion). £30 billion of this increase was announced on 14 October 2008.

**2.70** The Government's debt management objective, as set out in the *Debt and reserves management report 2008-09*, is to minimise, over the long term, the costs of meeting the Government's financing needs, taking account of risk, while ensuring that debt management policy is consistent with the aims of monetary policy. In line with this objective, the Government will, in addition to the issuance announced at Budget 2008, issue a further £37.8 billion in short maturity conventional gilts (of 1-7 year maturity), £20.3 billion in medium maturity conventional gilts (of 7-15 year maturity), £6.3 billion in long maturity conventional gilts (of 15 and over years maturity) and £2 billion in index-linked gilts in 2008-09. The increase in the skew of issuance towards short maturity conventional gilts also reflects the operational requirement to raise a significant amount of additional finance in a relatively short period of time and the short-term nature of some of the items raising the CGNCR in 2008-09. Further details and a revised financing table can be found in Annex B.

## THE MACROECONOMIC FRAMEWORK

**2.71** The Government's macroeconomic framework, introduced in 1997, was designed to maintain stability, in order to promote a strong economy and achieve its objective of a fair society where there is security and opportunity for all. Stability helps individuals, businesses and the Government to plan effectively for the long term, improving the quantity and quality of investment in physical and human capital, and helping to increase productivity.

**2.72** The role of the macroeconomic framework in supporting strong and stable economic performance over the past decade has been acknowledged by international institutions, such as the IMF, as providing a strong foundation to weather global challenges.

**2.73** The Government remains committed to this framework and the objectives enshrined within it. However, in the face of exceptional global economic challenges, it is important to consider the way that the framework is implemented, to ensure it continues to deliver the Government's objectives of stability, growth and employment.

### Financial stability framework

**2.74** The core role of the banking system, and in particular the risk that bank failures pose for the wider economy, requires sector-specific regulation. In the UK, the framework to protect financial stability is enshrined in the 2006 Memorandum of Understanding (MoU) between HM Treasury, the Financial Services Authority (FSA) and the Bank of England (collectively known as 'the Authorities'). The division of responsibilities between the Authorities is based on four principles: clear accountability; transparency; avoidance of duplication; and regular information exchange.

**2.75** International cooperation to ensure financial stability has become increasingly important as the degree of global financial integration has risen. Much of this cooperation takes place within the European Union or through engagement with non-legislative bodies such as the International Monetary Fund, the Financial Stability Forum or global standard-setting bodies like the International Accounting Standards Board.

**2.76** While the Authorities have worked effectively to address the crisis (as discussed in Chapter 3), financial market developments since last summer have exposed shortcomings in both the domestic and international approach to financial regulation and the degree of international cooperation. Far-reaching changes are clearly needed and the Government's priorities in each area are set out in Chapter 3.

## Monetary policy framework

**2.77** The primary objective of monetary policy is to deliver price stability. The monetary policy framework introduced in 1997 provides full operational independence for the Monetary Policy Committee (MPC) in setting interest rates to meet the Government's target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times.

**2.78** 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.

### Performance of the framework

**2.79** Since its introduction in 1997, the monetary policy framework has successfully delivered inflation that has been low and stable by historical and international standards:

- CPI inflation has averaged 2.3 per cent since CPI was made the operational target for monetary policy in December 2003, closely in line with the 2 per cent target;
- on average, the UK has had one of the lowest inflation rates in the G7 so far this decade. This compares with the period from 1980 to 1997 when UK inflation was the second highest of all G7 economies; and
- UK long-term interest rates have averaged 5.1 per cent since 1997 compared with an average of just over 9 per cent in the previous decade.

### Response to economic shocks

**2.80** Macroeconomic policymakers are currently facing difficult challenges in responding to the global credit and commodity price shocks. In these challenging economic circumstances, the monetary policy framework remains the right approach. Its design gives the independent MPC the means to deliver price stability while avoiding unnecessary volatility in output. The Government stands firmly behind the 2 per cent inflation target, and will continue to support the MPC in the forward-looking decisions it takes to ensure that inflation returns to target.

**2.81** The remit<sup>7</sup> for the MPC states that if inflation deviates by more than one percentage point above or below the target, the Governor of the Bank of England must explain in an open letter 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. The open letter system is an integral part of the macroeconomic framework. Open letters are published on the Bank of England and HM Treasury websites.

**2.82** Since Budget 2008, the Governor of the Bank of England has written two open letters to the Chancellor, in June and September, as inflation moved more than 1 per cent above target. As the Governor stated in his September letter, this rise in inflation followed "sharp, largely

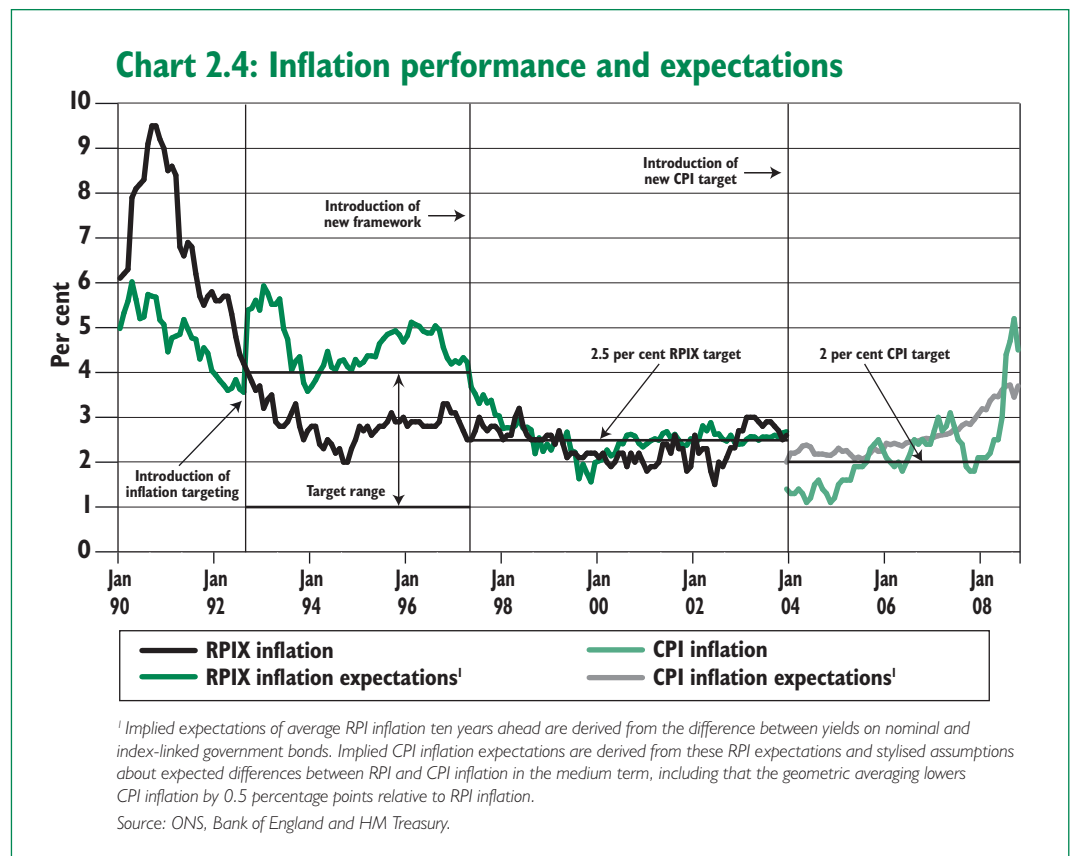
<sup>7</sup>[www.bankofengland.co.uk](http://www.bankofengland.co.uk)

unanticipated, increases in the price of energy and food, reflecting developments in the global balance of demand and supply for these commodities.” In the November Inflation Report, the projection was for inflation to fall back “rapidly in the near term, as the contribution from food and energy diminishes”.

**2.83** Responding to the intensifying global financial crisis, the MPC called a special meeting in October 2008, where the Committee decided to cut the policy rate by ½ a percentage point in a coordinated global action that involved six major central banks, including the Federal Reserve in the US and the European Central Bank. In November, the Bank of England reduced the policy rate by a further 1½ percentage points to 3 per cent, stating that “the risks to inflation have shifted decisively to the downside”.

**2.84** Inflation expectations appear to have remained anchored, testament to the credibility that the monetary policy framework has built since 1997. Survey measures of shorter-term inflation expectations have tended to move up in step with actual inflation, and while many of these measures have been elevated over the recent past, they have fallen back recently. The latest monthly surveys from GfK and YouGov/Citigroup showed a marked decline in inflation expectations – the October YouGov/Citigroup survey reported that the measure of household expectations for five to ten years ahead fell to its lowest level since the survey began in November 2005. Financial market-derived measures of inflation expectations can be affected by other market developments, and have been more difficult to interpret given recent market volatility. However, these data do not appear to point to a de-anchoring of expectations from the inflation target.

**2.85** Throughout this period of above-target inflation, average earnings growth has remained stable and subdued showing that, despite a temporary increase in inflation, wage-setting behaviour remains consistent with achieving the inflation target.



**2.86** The Pre-Budget Report measures have significant effects on the inflation outlook. In particular, the effect of the temporary cut in the rate of VAT is expected to lower inflation in 2009 and to raise it in 2010. The remit for the MPC states that there is a “recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output”. The Pre-Budget Report measures could be considered an example of such a disturbance and therefore the MPC’s remit allows it to look through the short-term movements in inflation that result.

**Developments  
in the monetary  
policy framework**

**2.87** In June 2008, the Chancellor announced further details of reforms to the MPC appointments process. These changes, by injecting more openness and transparency into the process, demonstrate the Government’s commitment to ensure that the monetary policy framework remains at the forefront of international best practice. The changes include a commitment to advertise vacancies for the Governor and Deputy Governors of the Bank of England and external members of the MPC, consistent with the principles of open competition.

**2.88** These changes build on the reforms the Government has already made to the process for MPC appointments, announced in the 2007 Pre-Budget Report.

## Fiscal policy framework

**2.89** Recognising that “the conduct of fiscal policy has a critical influence on economic stability”,<sup>8</sup> a new fiscal framework was outlined in the *Code for fiscal stability* (“the Code”), published alongside Budget 1998 and subsequently underpinned by legislation. The Code specifies five principles that underpin the formulation and implementation of fiscal policy: transparency, stability, responsibility, fairness and efficiency.

**2.90** To increase the transparency and accountability of fiscal decision making, the Code requires the Government to set out in each Budget its fiscal policy objectives and the rules by which it intends to operate fiscal policy. It provides flexibility for the Government to either change its rules or depart from them on a temporary basis to ensure that at all times they are appropriate to deliver the Government’s fiscal policy objectives, including when economic circumstances change significantly.

**Fiscal policy  
objectives**

**2.91** Since 1997, the Government has had two clear and consistent objectives for fiscal policy:

- 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.

**Performance over  
the past cycle**

**2.92** Over the past cycle, these fiscal policy objectives were implemented through two fiscal rules, against which the performance of fiscal policy can be judged:

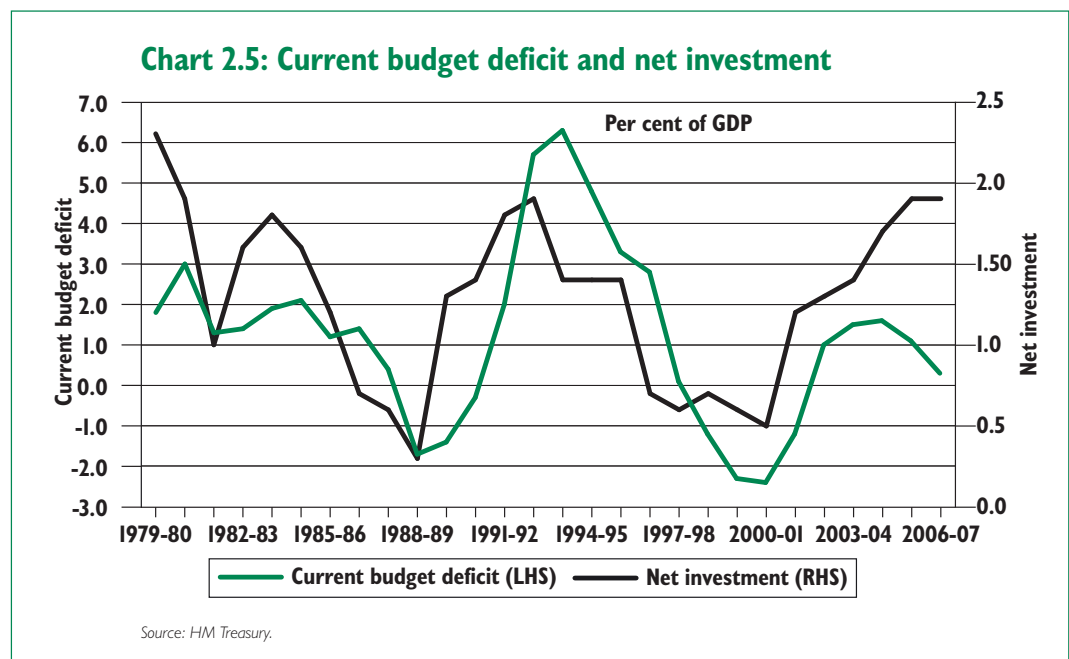
- the golden rule: *over the economic cycle, the Government will borrow only to invest and not to fund current spending*; and
- the sustainable investment rule: *public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level*. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

<sup>8</sup>The Code for Fiscal Stability, HM Treasury, November 1998.

**2.93** As these rules were measured over the course of the economic cycle, the judgement that the cycle ended in the second half of 2006 makes it timely to review performance against them and their success in delivering the Government’s fiscal policy objectives. *The Government’s fiscal framework*<sup>9</sup> provides a more detailed assessment.

**Supporting investment**

**2.94** The golden rule was measured by the average annual surplus on the current budget as a percentage of GDP. The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and it is therefore an important indicator of fairness between generations. By requiring that the current budget be in balance or surplus over the cycle, the golden rule was designed to ensure that the current generation pay for the public services they consume. The golden rule was met over the economic cycle that started in 1997, with an average surplus on the current budget of 0.1 per cent of GDP.



**2.95** One of the key achievements of the fiscal framework has been to address the bias against capital spending that existed in the past and previous underinvestment in public services. Historically, it has been extremely rare for public investment to continue to grow during periods of fiscal consolidation, and prior to the introduction of the framework it had not happened for 40 years. The effectiveness of the golden rule is illustrated by the break in the relationship between borrowing for current spending and borrowing for investment in Chart 2.5. Public sector net investment as a share of GDP has increased significantly, having risen from 0.6 per cent in 1997-98 to 2.1 per cent in 2007-08.

**Maintaining a sustainable level of debt**

**2.96** The sustainable investment rule stated that ‘public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level’. In Budget 1998, the Government announced that it would maintain net debt below 40 per cent of GDP over the course of the cycle. In Budget 2003, the Government strengthened this commitment, stating that to meet the rule with confidence, net debt would be maintained below 40 per cent of GDP in each and every year of the then current cycle.

<sup>9</sup>The Government’s fiscal framework, HM Treasury, November 2008.

**2.97** The sustainable investment rule was met over the previous economic cycle. Net debt was reduced from 42.5 per cent of GDP at the end of 1996-97 to 36.0 per cent in 2006-07, and was maintained below 40 per cent of GDP on average over the cycle. The Government also met its additional commitment to maintain net debt below 40 per cent of GDP in each and every year from 2003-04 to 2006-07. According to latest IMF and OECD data, in 2007, UK net debt was lower as a percentage of GDP than all G7 countries, with the exception of Canada.

**Supporting economic stability**

**2.98** A key consideration in the design of the fiscal rules was that fiscal policy should support monetary policy, in particular through allowing the full operation of the automatic stabilisers. In doing so, fiscal policy can help to support economic stability, reducing volatility in economic output and supporting the delivery of low and stable inflation and lower interest rates.

**2.99** Compared to previous cycles, the introduction of the fiscal framework has helped to ensure that fiscal policy has acted in support of economic stability. During the period from 1997 to 2003, when the economy operated above trend until 2001 and then below trend during the global slowdown from 2001 to 2003, fiscal policy played a significant role in smoothing the path of the economy. Fiscal policy tightened to reduce demand in the economy while it was operating above trend and loosened to support demand, both through the operation of the automatic stabilisers and changes to the fiscal stance, as the economy moved below trend in 2001. Between 2004 and 2007, when the economy was operating close to trend, the degree of fiscal support moderated.

## Responding to current economic circumstances

**2.100** The Government's objectives for fiscal policy in the face of current economic circumstances – to help smooth the path of the economy in the short term, and ensure sustainability over the medium term – remain unchanged. The fiscal rules set for the last economic cycle were met, delivering the Government's objectives. However, applying the rules in these circumstances would not be consistent with achieving the Government's objectives for fiscal policy at a time when it needs to act with monetary policy to support the economy. Three key aspects of the current situation mean that seeking to meet the golden rule and the sustainable investment rule in the face of these shocks would not be appropriate:

- given the distinctive nature of the current global financial crisis, particularly the impact it has had on the monetary transmission mechanism, fiscal policy will need to play a more significant role in the year ahead in helping to support demand within the economy;
- the current economic cycle is projected to be unusual, with the up-phase interrupted by two major global economic shocks. This implies that aiming to balance the current budget on average over the cycle would require damagingly pro-cyclical fiscal policy; and
- the large and persistent impact of these shocks on the public finances mean policy must adjust over a period of time to avoid short-term pro-cyclical tightening. The right approach is to allow public debt to rise to absorb the shock and allow fiscal policy to support the economy, until adjustment has been completed and debt is set on a declining path as a proportion of GDP.

**2.101** Supporting the economy in its recovery from these exceptional events will benefit not only current but also future generations. Responsible and sustainable management of the public finances therefore requires stabilising the financial sector and supporting the long-term growth of the economy. This means allowing borrowing to increase in the short term,

but ensuring a sustainable path for the public finances in the medium term, in addition to the measures the Government has undertaken to maintain financial stability and protect depositors.

**A new fiscal operating rule** **2.102** So, to achieve its objectives, and as provided for in the *Code for fiscal stability*, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full. Consistent with the *Code for Fiscal Stability*, the Government is setting a temporary operating rule: 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.

**2.103** The fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

**2.104** Charts 2.1 and 2.2 illustrate that the fiscal projections set out in the 2008 Pre-Budget Report are consistent with this fiscal operating rule and place the public finances on a path to meet the Government's fiscal objectives in the medium term.

**Delivering the fiscal policy objectives** **2.105** To ensure fiscal policy supports monetary policy and helps to smooth the path of the economy, the temporary operating rule:

- is designed to accommodate an increase in borrowing to support the economy in the short term; and
- is measured on a cyclically-adjusted basis, to allow the automatic stabilisers to operate in full at all times and avoid a sharp, pro-cyclical fiscal tightening.

**2.106** Over the medium term, to ensure sound public finances and that taxation and spending impact fairly within and between generations, the temporary operating rule will:

- ensure that in the medium term borrowing is low and debt is stable and falling as a proportion of GDP;
- continue to protect capital spending and ensure that the public finances are in a position to deliver intergenerational fairness over the medium term; and
- ensure the Government remains on course to deliver sound public finances in the medium term, through a sustained improvement in the underlying position of the public finances.

**Dealing with uncertainty** **2.107** 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 focussed on steady improvement in the public finances allows the Government flexibility to cope with that uncertainty, while constraining fiscal policy to deliver sound public finances over the medium term.

**Cyclical adjustment** **2.108** The temporary operating rule is measured on a cyclically-adjusted basis. To ensure transparency, the Government is publishing alongside the Pre-Budget Report updated estimates of the effects of the economic cycle on the public finances,<sup>10</sup> which suggest that the Treasury's existing cyclical-adjustment coefficients should remain unchanged. In addition,

<sup>10</sup>Public finances and the cycle: Treasury Economic Working Paper No.5, HM Treasury, November 2008.

in the interests of transparency and accountability, **the Government will invite the National Audit Office to review the Treasury's approach to cyclical adjustment.**

**The fiscal rules in the future**

**2.109** The fiscal projections in this Pre-Budget Report show how the Government intends to achieve its objectives in the medium term. In advance of the public finances reaching cyclically-adjusted current balance, the Government will set out how it will apply the fiscal framework in future to continue to deliver those objectives.

**2.110** *The Government's fiscal framework*<sup>11</sup> provides further detail on the performance of the fiscal policy framework over the past cycle, along with the design and implementation of the new fiscal operating rules.

## Public spending framework

**2.111** The fiscal rules underpin the public spending framework. The recent period of strong growth in public spending was necessary to correct for previous under-investment in public services. Over the past ten years, public investment and reform of public service delivery have together generated real improvements in the quality of public services. Going forward, public spending must continue to be set at levels that ensure sustainability and protect intergenerational fairness. Faced with major global economic shocks, the Government's aim when setting its public spending plans is to support the economy in the short term and continue to improve public services, while ensuring fiscal sustainability over the medium term.

## LONG-TERM FISCAL SUSTAINABILITY

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**2.112** The analysis above sets out how the Government will ensure sustainability in the medium term. In addition, the Government must also ensure that fiscal policy is sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects for long-term growth. It would also be inconsistent with the principles for fiscal management set out in the *Code for fiscal stability*.

**2.113** With this in mind, the Government's fiscal framework will ensure a declining path for the level of public sector debt. There is no unique level of public debt, or debt-to-GDP ratio, that represents a prudent and sustainable level. In deciding what the right level of debt is, the Government therefore has to weigh up a number of factors. These include the need for investment, the intergenerational impact of spending and revenues and prospects for the long-term growth of the economy. In the past, evaluation of these different factors led the Government to conclude that over the previous cycle debt should be kept below 40 per cent of GDP.

**2.114** The challenges facing the UK, and the rest of the world, today are very different. While the UK economy no longer suffers from the impacts of underinvestment it saw in 1997, it faces exceptional economic challenges brought on by the credit and commodity price shocks. Supporting the economy in its recovery from these exceptional events will benefit not only current but also future generations. Responsible and sustainable management of the public finances therefore requires stabilising the financial sector and supporting the long-term growth of the economy. This means allowing borrowing to increase in the short term, but ensuring a sustainable path for the public finances in the medium term, in addition to the measures the Government has undertaken to maintain financial stability and protect depositors. The long-term impact on the public finances, and any burden on future generations, of any extra

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<sup>11</sup> *ibid.*

liabilities which may become classified to the public sector through these financial sector interventions will be determined by any eventual economic profit or loss incurred.

**2.115** The Government is in a position to use debt to smooth the path of the economy because debt levels were low by both historical and international standards when the global economic shocks occurred. This highlights the importance of being prepared to deal with the challenges facing the economy, including those that may arise in the more distant future such as demographic change.

**2.116** In the next decade the UK will begin to see the impacts of an ageing population, while further challenges lie ahead with the retirement of the 1960s baby boomers in the 2020s. The 2008 *Long-term public finance report* (LTPFR) provided a full assessment of the impact this will have on the public finances. The analysis showed that, while age-related spending is relatively low by international standards and projected to remain so, demographic change will put pressure on the public finances in the coming decades. To ensure long-term fiscal sustainability it is therefore vital to prepare for these events once the impact of the recent economic shocks has subsided, so the Pre-Budget Report sets fiscal policy to ensure that public debt is returned to a declining path once the global shocks have worked their way through the economy in full. The next Long-term public finance report will be published in 2009.

