

UK Budget 2003 : Assessment

The Chancellor's Economic Forecasts

- As expected the Chancellor has revised down his growth forecast for 2003 from the growth rate contained in November's pre-budget report. However, he left the forecast for 2004 unchanged.
- At the same time he has raised his forecasts for RPIX at end 2003. The symmetrical inflation target was re-affirmed at 2.5%.

(%)	GDP		RPIX	
	2003	2004	Q4 2003	Q4 2004
November 2002 Pre-Budget Report	2.5 to 3	3.0 to 3.5	2.25	2.5
April 2003 Budget	2.0 to 2.5	3.0 to 3.5	2.75	2.5

- The Chancellor would appear to be more realistic about economic growth this year but may be overly optimistic about the strength of the rebound next year.
- Market consensus is for GDP growth of 2.1% and 2.5% in 2003 and 2004, respectively.
- AIB Economic Research Unit's quarterly GDP growth profile forecast is set out below.

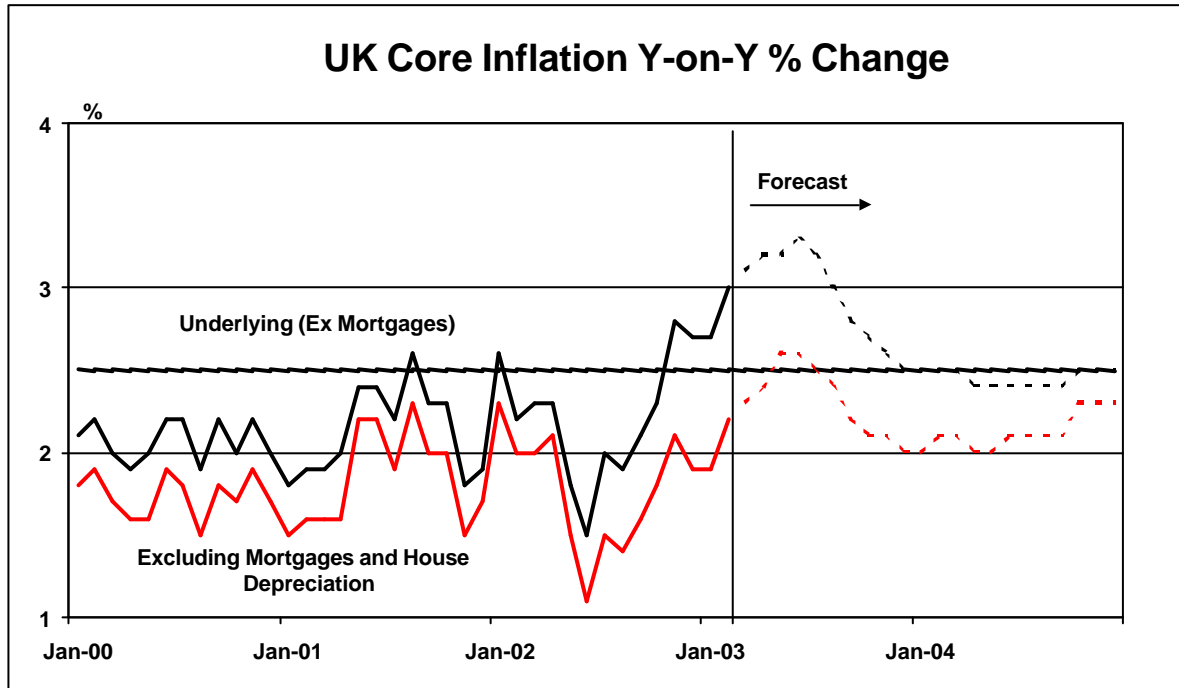
AIB GDP Growth Profile Forecast

	Q1	Q2	Q3	Q4	Year
2003					
Q-on-Q %	0.3	0.3	0.6	0.7	
Y-on-Y %	2.4	2.1	1.6	1.9	2.0
2004					
Q-on-Q %	0.7	0.6	0.8	0.7	
Y-on-Y %	2.3	2.6	2.8	2.8	2.7

- The economy has performed poorly year to date and weak growth is likely to continue during Q2. However, the economy is still in relatively good shape and is well placed to take advantage of the global upswing, which is expected to commence later in the year.
 - All the levers of policy - fiscal, monetary, exchange rate – are primed for economic rebound.
 - Investment should pick-up, given improving corporate balance sheets.
 - Exports to benefit from the weakening of sterling.
 - Continuing strong housing market, stock market recovery, solid real disposable income growth to support household spending.
 - Thus, we expect GDP growth to rise towards trend later in 2003 and average 2.7% in 2004.

AIB Inflation Growth Profile Forecast

- Near term upward pressures from lagged impact of high oil prices, sharply higher council taxes and the strong housing market.
- Underling inflation should then drop back towards target given recent sharp fall in oil prices and with house price inflation expected to moderate significantly.



Monetary Policy Implications

- Markets already discounting a further quarter point rate cut, bringing rates to 3.5%.
- MPC unlikely to act tomorrow in immediate aftermath of budget, but surprise move possible.
- May rate cut more likely in aftermath of likely weak Q1 GDP data and publication of next BoE Inflation Report.
- BoE should be one of the first to tighten policy in 2004 when global economy swings upwards, given tight labour market conditions.
- Markets expectations of 4.25% repo rate by end 2004 may prove overly optimistic if the global and UK economies rebound next year, given limited spare UK capacity.

Deteriorating Official Forecasts for Public Sector Net Borrowing

£bn	2002-03	2003-04	2004-05
March 2002 Budget	11	13	13
November 2002 Pre-Budget Report	20	24	19
April 2003 Budget	24	27	24

Budgetary Situation Deteriorated in 2002/03

- Current budget moved into deficit (-£12bn) compared to £10bn surplus in 2001/02.
- Capital borrowing of £12bn in 2002/03, up from £9bn in 2001/02.
- Public sector net borrowing of £24bn, compared to original target of £11bn, and £1bn surplus in 2001/02.
- Tax receipts much lower than expected.
- Sizeable 6% increase in current spending.

Deficit To Rise Further in 2003/04

- Sizeable increase in tax take and current spending in coming year.
- Capital borrowing to rise to €19bn.
- Public sector net borrowing to increase modestly to £27bn (2.5% of GDP).
- Debt/GDP ratio remains low at 32.2%.
- Public finances still in good shape.

Gilt Market Implications

- Increase in borrowing is slightly less than expected.
- Smaller than expected increase in borrowing in 2004/05 reflects the fact that the Chancellor did not revise downwards his growth forecast for 2004. Thus, the risk is that borrowing in 2004/05 will exceed the official forecast.

£bn	Public Sector Net Borrowing		
	2002-03	2003-04	2004-05
November 2002 Pre Budget report	20	24	19
April 2003 Budget	24	27	24
Market Consensus	22	29	28

- Gilt issuance set to rise sharply from some £26bn in 2002/03 to £47bn in 2003/04.
- Central Government Net Cash Requirement (i.e. net cash borrowing) at £35bn much higher than PSNBR.
- In addition, £20bn of gilt redemptions in 2003/04.
- Thus, total funding requirement of around £55bn. Gilt issuance projected by the Debt Management Office at £47.4bn. (Some funding done in non-gilt sources - bills, foreign currency, cash balances etc).
- Tax and spend budget with marked jump in funding unlikely to form basis for a reversal of the underperformance of gilt market in recent months.
- Market may also be concerned that the PSNB will not fall as forecast in 2004/05 as ambitious growth forecasts may not be realised.
- Ten year gilt-bund spread struggling to stay around 30bps in aftermath of budget.
- UK yield curve may steepen further – long end still looks very expensive given the deterioration in the public finances.

Financial Market Reaction

	12.15pm	1.35pm	3.15pm
GBP/EUR	0.6908	0.6900	0.6870
GBP/USD	1.5559	1.5561	1.5538
3-Mth Futures (%)			
<i>Jun '03</i>	3.48	3.48	3.47
<i>Sept '03</i>	3.44	3.44	3.44
<i>Dec '03</i>	3.51	3.51	3.51
2-Year Gilts (%)	3.48	3.49	3.53
5-Year Gilts (%)	4.08	4.07	4.12
10 Year Gilts (%)	4.44	4.42	4.50
FTSE 100	1,800	1,796	1,836

Forex Market

- Sterling fell to a four year low against the euro prior to the budget on concerns that downgraded growth forecasts and increased borrowing plans would highlight the fragility of the UK economy.
- It pulled off its lows after the budget speech but remains vulnerable to downside pressures.
- The only direct reference made to euro membership was a confirmation that the report on the Treasury's 5 economic tests would be delivered by 1 June.
- During the course of his speech, the Chancellor made numerous references to the lack of convergence between the eurozone and UK economies.

Personal/Consumer Taxation

- All income tax rates and allowances to remain unchanged.
- Duty on beer to rise by 1p per pint, 4p on a bottle of wine.
- Duties on spirits, cider and sparkling wine frozen.
- 8p on pack of 20 cigarettes.
- 1.28p per litre increase in fuel duties deferred for six months until 1 October due to high oil prices. This increase would not be enacted at all if the uncertain global environment still persists at that time.
- Air passenger duties frozen, as well as vehicle excise duty rates for lorries and motor cycles.
- Duties on cars and vans to rise by £5 from 1 May.
- Bingo tax abolished from 4 August.
- Introduction of Child Trust Fund of up to £500 per child.
- Stamp duty unchanged. Chancellor has commissioned a study for the development of a market for long-term fixed rate mortgages. Also commissioned a study on the removal of supply barriers in the housing market.

Corporate Company/ Business Announcements

- Chancellor froze corporation, capital gains and small business corporation tax.
- Stamp duty on business property purchases frozen.
- Increased incentives for R&D and IT functions.
- Reduction in regulatory restrictions to improve business environment.

AIB Economic Research Unit
9th April 2003