Debt and Debt Financing

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UK Interest Rate Strategy

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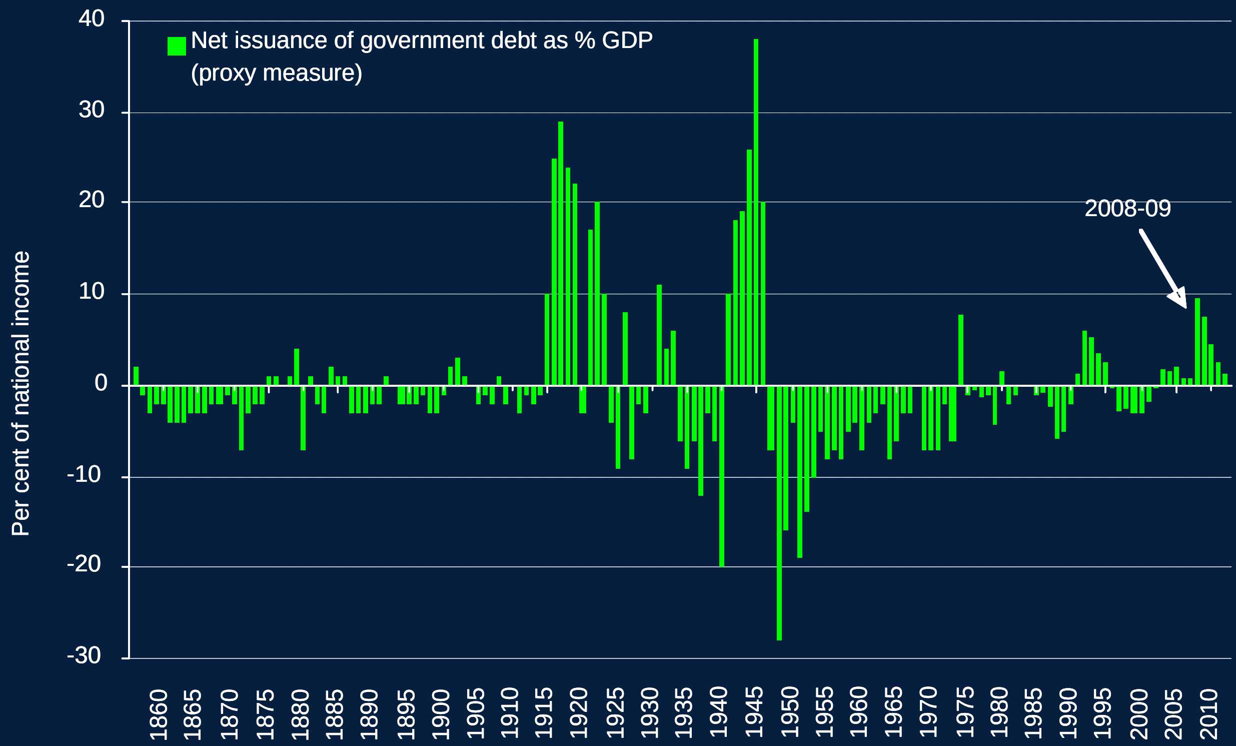
Government net debt issuance

- An exceptional peacetime rise in net debt issuance
- Much of the rise in 2008-09 has reflected bank rescues & recapitalisations



Notes: Series is changes in government debt as a percentage of GDP. Pre-1974 series is gross nominal liabilities of the National Loans Fund (formerly known as the national debt). 1974 onwards it is the general government gross debt. Data beyond 2008–09 use HMT forecasts (for general government gross debt as a percentage of GDP) and are for fiscal year rather than calendar year.
Source: Morgan Stanley Research; DMO; HM Treasury

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Public sector net borrowing and debt/GDP

- Debt/GDP to increase to 68% in five years (central case)
- But a lot of uncertainty around the central forecast

Outlook for Public Sector Net Debt/GDP

% of GDP	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
2008 PBR	36.3	41.2	48.2	52.9	55.6	57.1	57.4
IFS base case	36.3	41.6	49.1	54.6	58.2	60.7	62.1
MS central case	36.3	41.4	49.2	54.5	59.0	63.9	67.7
MS pessimistic case	36.3	41.5	53.9	64.2	74.0	82.6	90.5
MS optimistic case	36.3	40.2	45.6	47.3	46.6	45.7	43.6

Source: IFS; Morgan Stanley Research; HM Treasury

Outlook for Gilt sales

- Gross Gilt Issuance to be very elevated for at least four years
- probably 2½ times levels we are used to

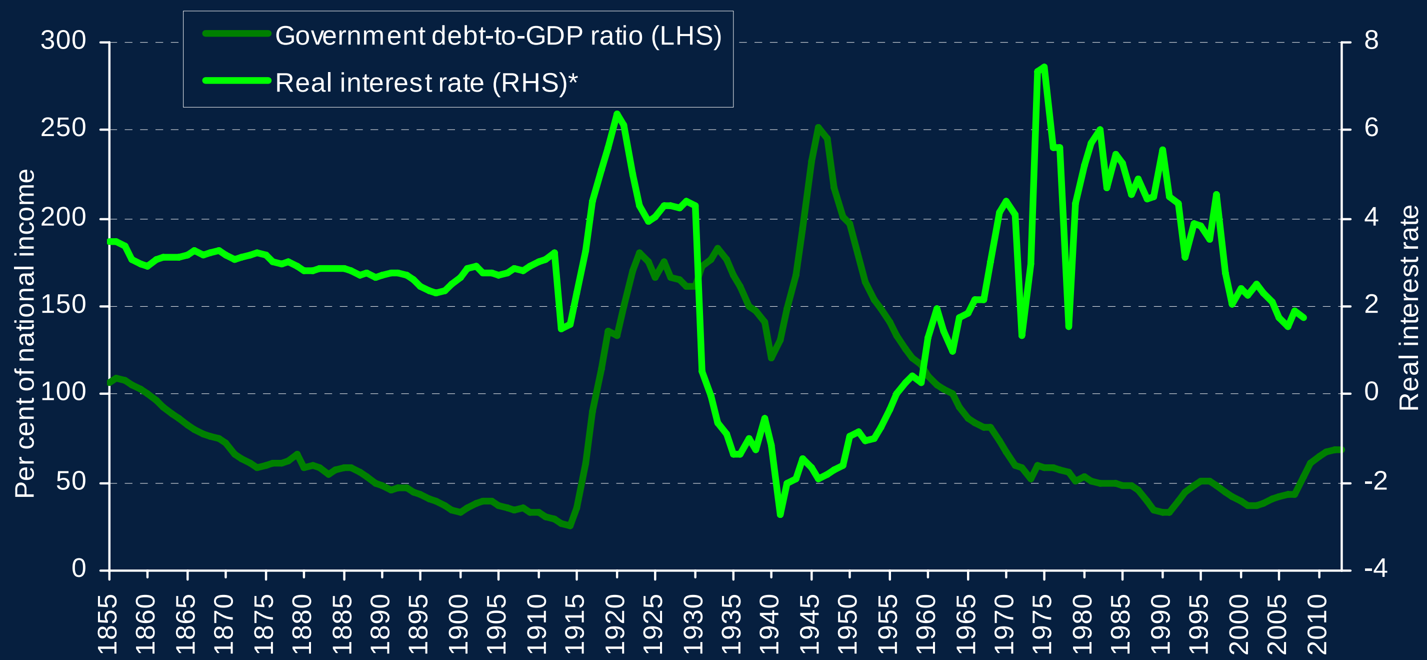
Outlook for Gross Gilt Issuance

£ billion	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
DMO/PBR illustrative gilt sales	*62.5*	*58.4*	*146.4*	*132.9*	*137*	*125*	*94*
IFS base case	62.5	58.4	153.1	139.6	150.5	142	114
MS central case	62.5	58.4	153.0	139.2	146.1	146	128
MS pessimistic case	62.5	58.4	153.0	147.5	172.9	184	174
MS optimistic case	62.5	58.4	142.0	125.9	109.9	79	43

Source: IFS; Morgan Stanley Research; HM Treasury

Effect of increased borrowing: yield levels

- Surprisingly, government borrowing has been poorly correlated with yield levels
- So the coming increase in Gilt issuance won't necessarily lead to higher yields



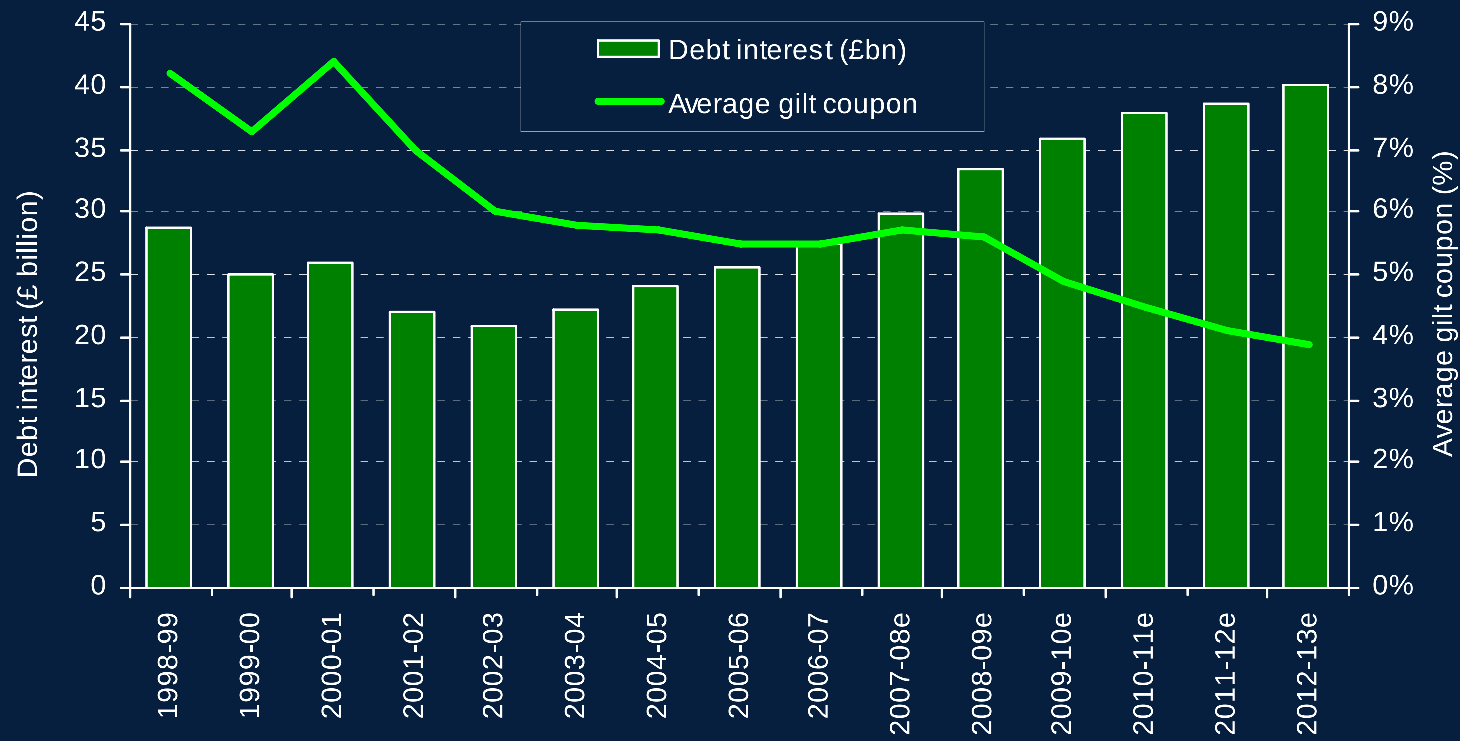
Notes: Pre-1974 series is gross nominal liabilities of the National Loans Fund (formerly known as the national debt). 1974 onwards it is the general government gross debt. Data beyond 2008–09 are HMT forecasts (for general government gross debt as a percentage of GDP) and are for fiscal year rather than calendar year.

* Real interest rate series is the consol rate less long-term expected inflation. For calculation of the latter, we use an econometric model (based on past values of inflation) to project expected inflation at each point in time. For more details, see box 1 in D. Miles et al., Where Should Long-Term Interest Rates Be Today? 9 March 2005.

Sources: DMO; HM Treasury. Estimates of inflation expectations (and of real interest rates) during the years of the Second World War and immediately after are not reliable due to the impact of rationing

Effect of increased borrowing: the interest burden

- With Gilt yields at historic lows, all the issuance in the coming years will probably reduce the average coupon on the Gilt market as a whole
- Although greater sensitivity than usual to change in yields
- In any case, increase in Gilt outstandings will raise annual interest cost by ~£10bn by 2013



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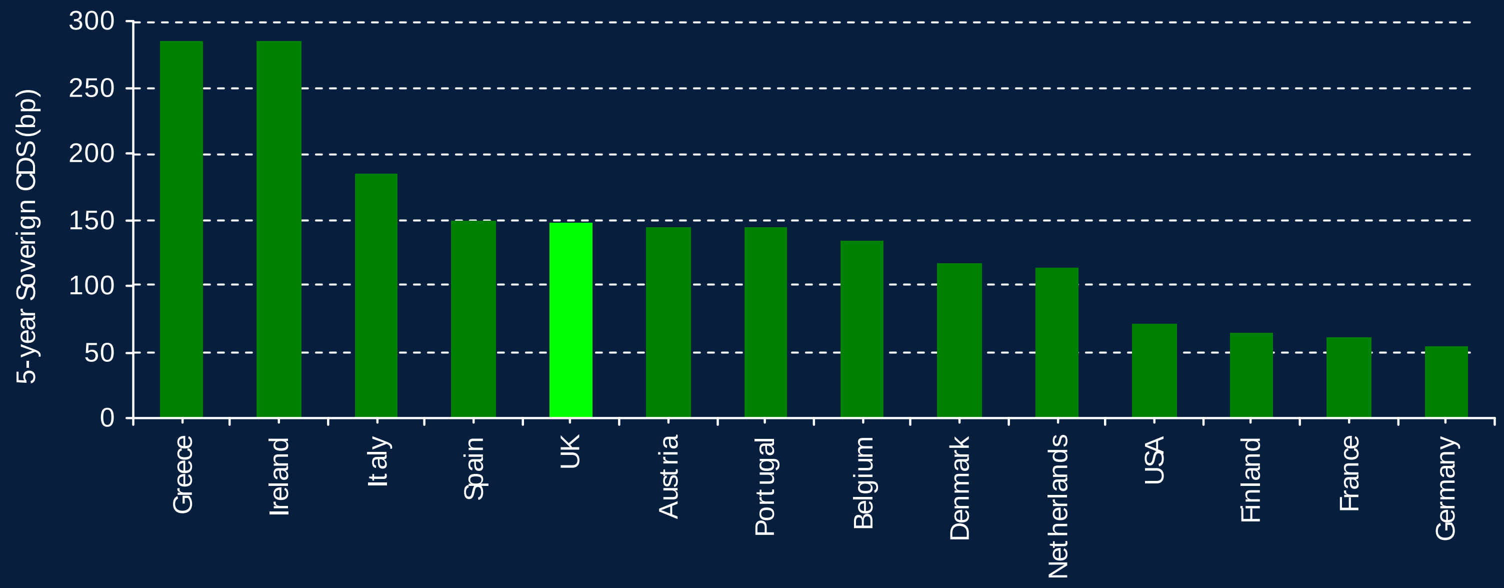
Source: DMO and Morgan Stanley estimates

Effect of increased borrowing: Credit Default Swaps

- UK's CDS premium has risen from 25bp/year in September to over 100bp/year
- UK's CDS-implied default probability is implausibly large
- The UK is not alone among sovereign credits: all sovereign CDS has risen
- CDS premium driven more by the credit crunch than by market pricing of default risk



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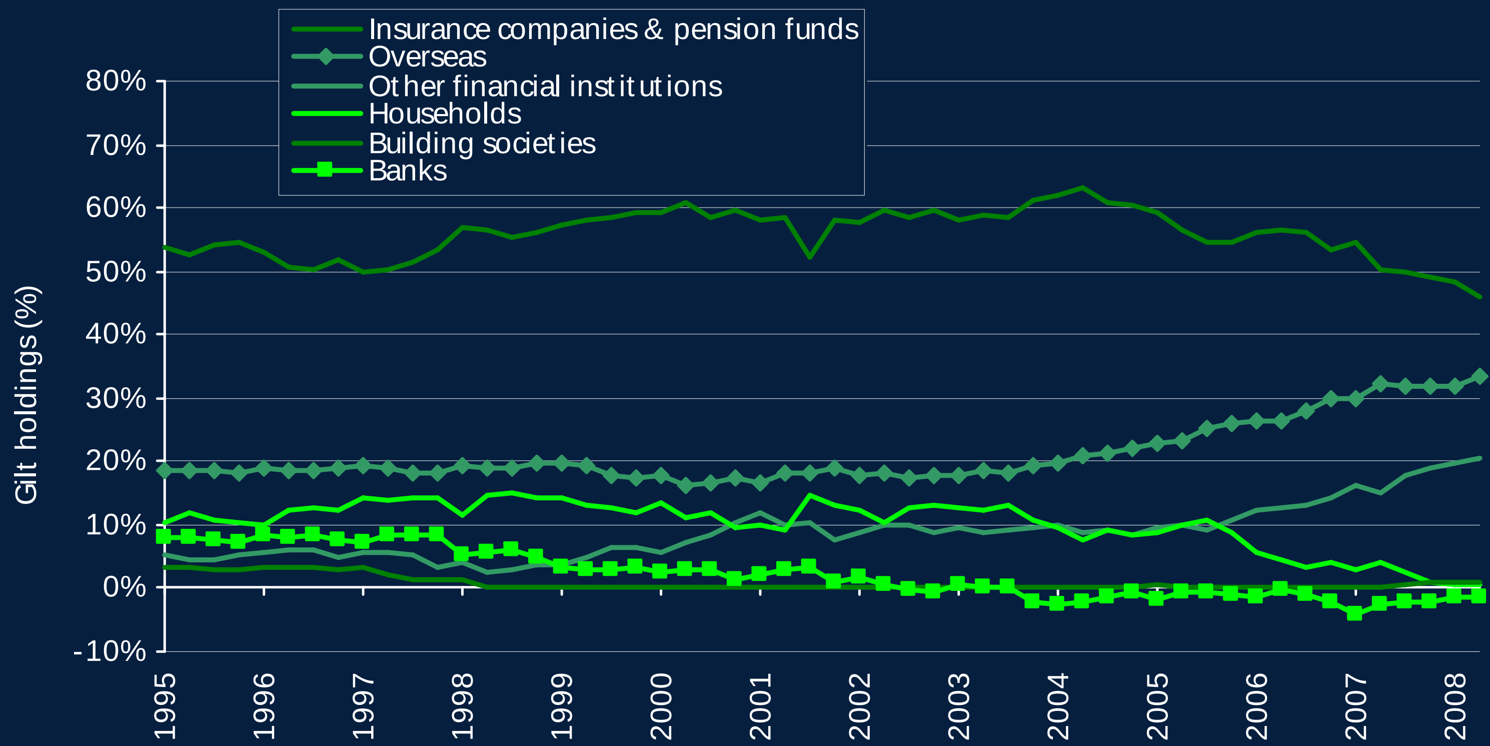
Source: Morgan Stanley (as at 218 January 2009).

Who will buy all the new Gilts?

- Recently, % of Gilts held overseas has risen; % held domestically, particularly by pension & insurance funds, has fallen
- Banks' Gilt holdings are near zero. Could rise very sharply: they are a good asset for banks, partly due to proposed regulatory changes (FSA CP 08/22). Banks should prefer shorter Gilts

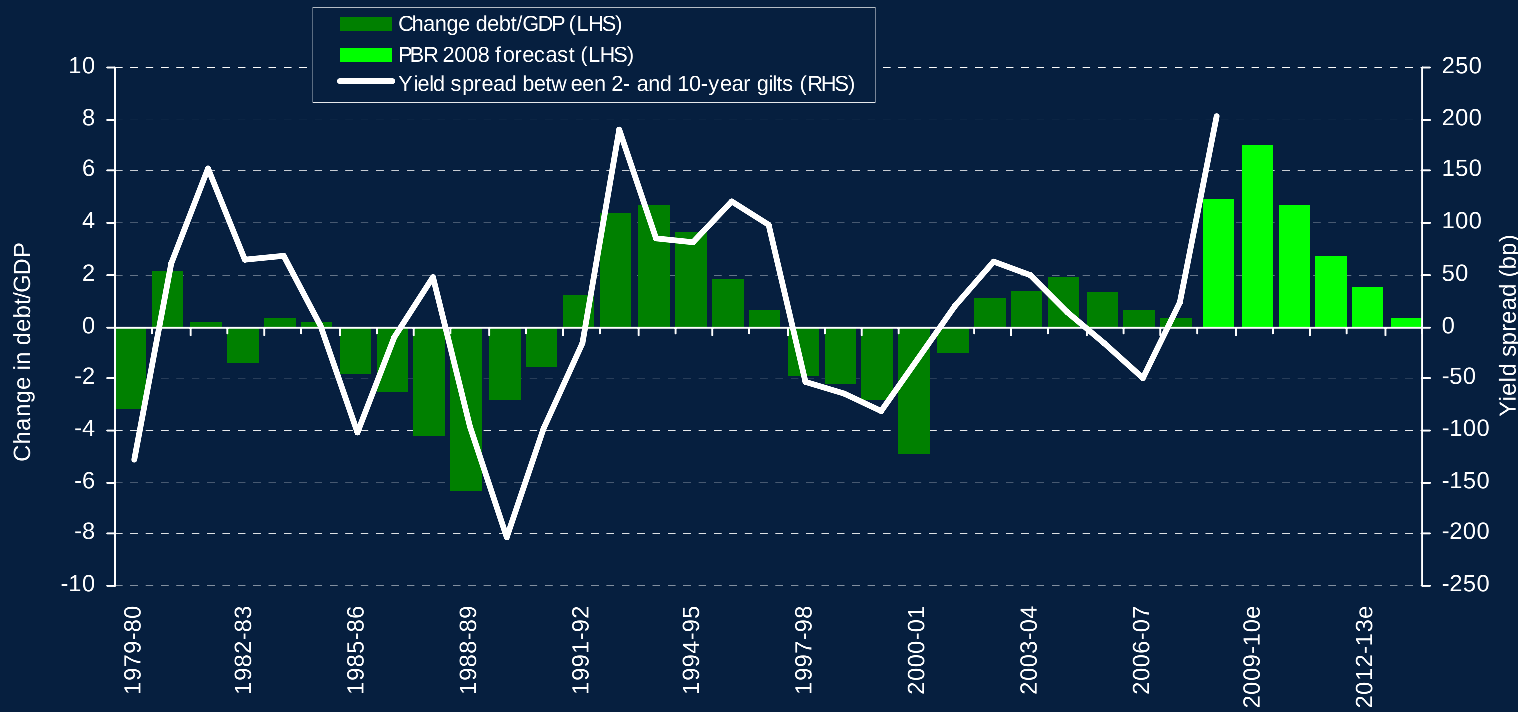


Source: DMO

Morgan Stanley

Optimal debt management: distribution of Gilt issuance

- The yield curve (spread between short- and long-dated Gilt yields) is following its usual pattern of steepening with increased issuance
- An incentive for the DMO to increase the proportion of short-dated issuance
- Though issuance will be higher in every sector



Source: Morgan Stanley

Supplementary methods for distributing Gilts

- Gilts are issued (almost exclusively) via regular auctions
- Increased issuance, coupled with intermediaries' balance sheet constraints, increases the "execution risk" risk of undersubscribed auctions (especially for long-duration and index-linked)
- So DMO is considering various supplementary issuance methods
  – Syndication (incl. DDA)
  – Direct placement of Gilts with investors
  – More mini-tenders
- Results of consultation to be announced at Budget
  – More mini-tenders and possibly a few DDAs are likely
  – Syndication and direct placements would not be welcomed by the market
  – Traditional Gilt auctions will remain the primary channel for Gilt issuance

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