



Daily Themes

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Could the UK lose its AAA rating?

There has been considerable discussion in recent months around the chances of a downgrade of UK government debt from its current AAA rating, and what this could mean for sterling and UK bond markets. Although painful, policy tools are available to make substantial cuts to the budget deficit and avoid such a fate, provided there is enough political will. Indeed, the rating agencies are likely to wait until after the UK general election and the details of a post-election interim budget are announced before making any decision on the UK. A hung parliament would increase uncertainty and the risk that not enough is done to keep the agencies happy. Politicians' resolve may also need to be stiffened by bond markets first. In the longer term, an environment of weak growth and deflation would pose the biggest threat to the UK's rating.

Respected bond investor Bill Gross recently said that the UK is 'sitting on a bed of nitro-glycerine' and in danger of a downgrade. His analysis appears to be based on an evaluation of total debt in the UK (public and private), which is amongst the highest of the world's major economies as a proportion of GDP.

However, rating agencies typically focus on government debt levels as the key criteria. Indeed, Standard & Poor's (S&P) changed the outlook for UK government debt to negative from stable on 21st May 2009, citing the likelihood that it would approach 100% of GDP in the medium term. If sustained, this would be 'incompatible with an AAA rating,' S&P said.

A negative rating outlook can be thought of as a bias towards a downgrade, but not a certainty. Rating outlooks assess the potential direction of an

actual rating change, typically over a period of up to two years. Moody's and Fitch have so far maintained a 'stable' outlook on the UK's triple-A rating, but have also highlighted the fiscal challenges it faces.

Politics matter

In its report last year when it changed the UK outlook to negative, S&P emphasised the importance of government policy to the eventual rating, stating that the rating could be lowered if it concluded that 'following the election, the next government's fiscal consolidation plans are unlikely to put the UK debt burden on a secure downward trajectory over the medium term.' Conversely, the agency said the outlook could revert to stable 'if comprehensive measures are implemented to place the public finances on a sustainable footing, or if fiscal outturns are more benign than we currently anticipate.'

The rating agencies are therefore likely to wait for the details of the next government's emergency post-election budget before determining their next move for the UK.

The UK debt-to-GDP ratio is rising very quickly, though from a low base compared to many other advanced economies. For most of this decade the ratio was lower than 40%, whereas it is currently around 55% and expected to be around 65% by the end of fiscal year 2010/11.

The December 2009 Pre-Budget Report estimated that the recession and financial crisis have increased the structural deficit by 5.2% of national income - equivalent to £73 billion in fiscal year 2009/10. Left unaddressed, this would lead to the deficit rising indefinitely, which is obviously unsustainable. However, independent specialists, such as the

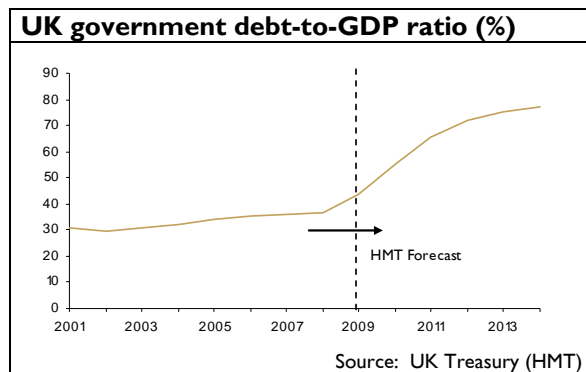
Carl Astorri
+ 44 20 7753 1612
firstname.lastname@coutts.com

Jean-Maurice Ladure
+ 44 20 7753 1469

Henry Lancaster
+ 44 20 7957 2426

Georgios Tsapouris
+44 20 7753 1888

Institute for Fiscal Studies (IFS), say that it is possible to make cuts to spending and increase taxes to bring UK government debt back onto a sustainable path. What's more, all the main political parties are aware of the need for budget cuts, and that the rating agencies are watching closely.



To stabilise the public finances, the present government has planned a fiscal tightening of 5.5% of national income (£77 billion in 2009/10 figures), but spread over eight years so as not to derail the recovery. Of this tightening, 60% will be delivered from 2010 to 2015, with two-thirds of this achieved through spending cuts and the rest through tax increases.

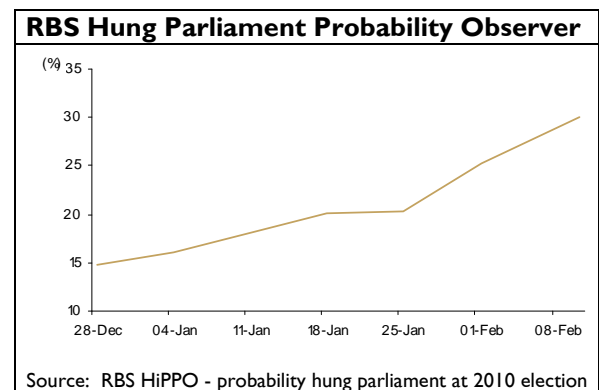
Both Labour and the Conservatives have committed not to cut spending on health, overseas aid and education. This suggests enormous cuts to other services or, more likely, departmental spending cuts combined with policies such as freezing public sector pay, cutting/freezing social security benefits and raising employee public sector pension contributions. Even on health and education there is some 'wobble room' as the commitments are to 'frontline' services, suggesting cuts to capital expenditure or other areas could still occur. The key point is that all the policy levers are in place to make painful and substantial cuts to the budget deficit, and the political parties have accepted in principle that it needs to take place.

Short-term risk is political

However, a hung parliament would make it much harder - though not impossible - to agree where the axe should fall. This would increase the chances of not enough fiscal consolidation measures being taken to keep the rating agencies happy.

Carl Astorri + 44 20 7753 1612
 Jean-Maurice Ladure + 44 20 7753 1469
 firstname.lastname@coutts.com

In contrast, a clear win for one party would make it much more likely that enough deficit cutting measures would be put in place to maintain the AAA rating. It is therefore of some concern for markets that opinion polls have been showing an increasing possibility of a hung parliament after the election, with the latest polls suggesting a 30% chance.



If it looks as if we are heading for a hung parliament, the increased uncertainty could cause some wobbles for sterling and gilts. However, higher gilt yields could also help politicians sell austerity measures to the UK electorate, as has been the case in Ireland and to some extent Greece.

Long-term risk would be deflation

Assuming there is sufficient political will to reduce the deficit after the election, the longer-term prospects for the UK's triple-A rating would depend on the economic outlook. If the UK were to lurch into a weak growth, deflationary environment this would make it much harder to consolidate the public finances and would increase the chances of a rating downgrade at some point.

Weak or negative inflation implies weaker growth in nominal GDP, making the debt-to-GDP ratio higher than it would otherwise be. Weak real growth (adjusted for inflation) implies weaker tax receipts and higher spending on social security, such as unemployment benefits.

The IFS does include a downside scenario in their forecasts. However, this weak growth scenario still assumes that the Bank of England meets its 2% inflation target. Our simulations suggest a combination of weak growth and low or negative

Henry Lancaster + 44 20 7957 2426
 Georgios Tsapouris +44 20 7753 1888

inflation would cause the UK debt-to-GDP ratio to approach 100% by 2014-15, even taking into account the fiscal tightening already proposed. This would likely lead to a downgrade.

Conclusion

In the short term, whether or not the UK avoids a downgrade will be determined by whether there is enough political will to implement spending cuts and tax rises after the election. Policy options are available to reduce the deficit, provided the will is there. In the longer-term, a deflationary environment would present the greatest challenge to fiscal consolidation. However, although this is a risk, it is not our central scenario for the UK.

UK Debt-to-GDP forecasts (%) (under various scenarios)						
Scenarios	2009/10	10/11	11/12	12/13	13/14	14/15
Treasury PBR	55.6	65.4	71.7	75.4	77.1	77.7
IFS baseline	54.9	64.2	70.3	74.0	75.6	76.0
IFS pessimistic (weak growth)	54.5	63.9	71.4	78.8	84.7	89.8
Coutts pessimistic (weak growth, deflation)	54.5	65.2	74.3	83.6	91.7	99.1

Source: IFS, Coutts (our pessimistic scenario assumes 0% inflation)

Carl Astorri
+ 44 20 7753 1612
firstname.lastname@coutts.com

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+ 44 20 7753 1469

Henry Lancaster
+ 44 20 7957 2426

Georgios Tsapouris
+44 20 7753 1888

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