STRATEGY
ECONOMICS

19TH SEPTEMBER, 2012.

BRITAIN WILL LOSE ITS TRIPLE-A RATING – AND POLITICAL CHAOS WILL FOLLOW

SUMMARY

- **The UK remains a member of a dwindling club of triple-A rated countries.**
- **But its finances are in no better shape than many countries that have already seen their ratings cut.**
- **If the rating is cut, it will provoke political chaos – because the coalition has staked its credibility on maintaining it.**

The unfolding catastrophe in the euro-zone has not been great for the British economy. It has hit exports to its largest and closest market. It had dented business confidence, slowed investment into the whole of Europe, and undermined faith in banks that were already looking none too healthy.

But in one important respect it has been a blessing. It has distracted attention from the dire state of the UK's own economy. When one house is burning down it is easy not to notice that the one next door has dry rot, weeds on the driveway, and a few holes in the roof where the slates used to be.

But Britain's troubles may not be invisible to the markets much longer.

As growth stalls, the deficit rises, and government borrowing tick relentlessly higher it is inconceivable that the UK can remain in the small group of Triple-A rated countries much longer. It is now simply a matter of time before one of the big agencies gets around to cutting the rating.

By itself that might not matter too much. Japan and the US have both lost Triple-A status and carried on much as before. But when it happens, it could trigger the downfall of David Cameron's coalition governments. Combine a ratings cut and political chaos – and the markets may start to take fright. When it happens, sterling, and the FTSE-100 index will take a battering.

One: The UK Is Not a Triple-A Country

Ratings agencies can be behind the curve, and often by a long way. They didn't spot the looming crisis in the sub-prime mortgage market until it was way too late. For a long time after it joined the euro, they thought Greece was getting more creditworthy, not less so. And yet even the sleepiest credit analyst must have noticed by now that something is not quite right with the British economy.

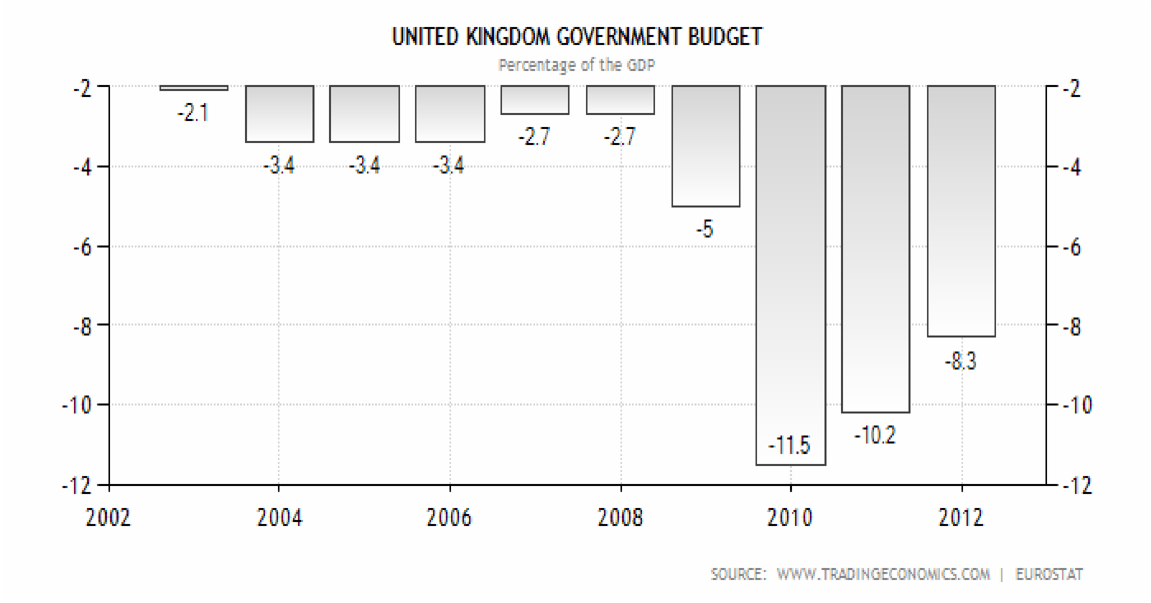
This year, the UK will be lucky if it records any growth at all, and may well slip back into full-scale recession. The Olympics building boom in London has come to a stop, and the tourist spending has gone home. Exports have stalled despite a huge devaluation in the pound. Increasingly, the UK looks like the new Japan. An island economy, burdened down with huge debts, a central bank that prints money to little effect, and a banking system that shows no sign of recovering from the last bubble.

The club of Triple-A countries is getting more and more exclusive all the time. Japan hasn't been a member for years, the US got kicked out last year, and France this year. Germany is still there, although even that powerhouse is on negative watch – ratings agency code for 'watch out, we're about to downgrade you next'. Switzerland is on the inside, along with the Scandinavian countries Sweden, Norway and Finland, as well as the Netherlands. Canada is there, and so is Australia. Hong Kong and Singapore make the cut as you might expect. But that is about it. It is a very select group, composed of countries with above-average growth rates, stable and well-capitalised banking systems, and with welfare, health and pension systems that are properly funded and don't have big open-ended liabilities.

In that club, the UK sticks out like a hip-hop drumbeat on the new Bob Dylan album.

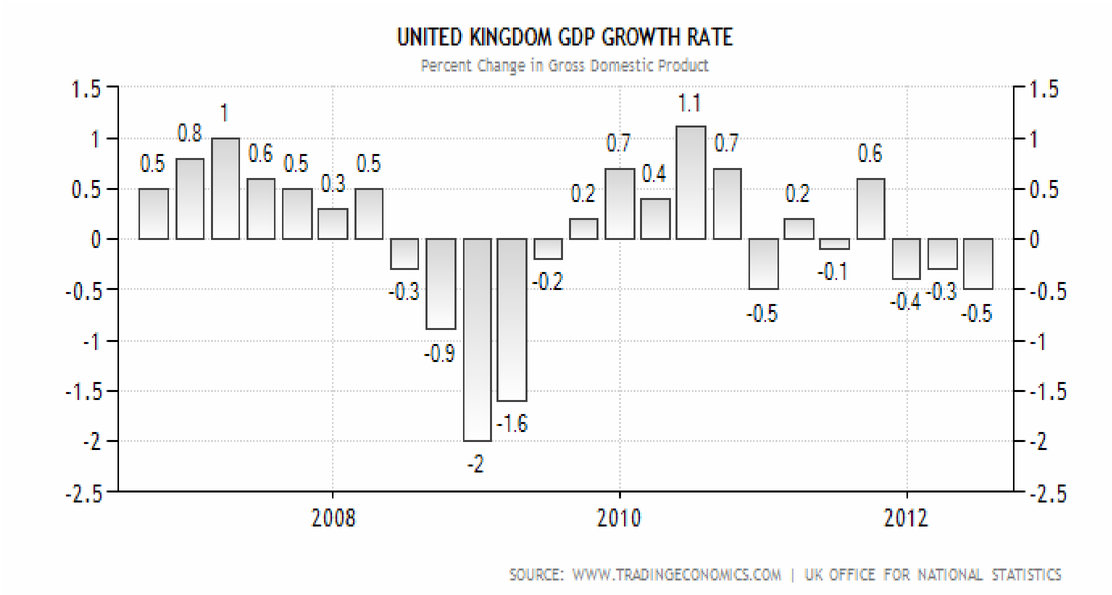
Two: When The Rating Is Cut It will Provoke Political Turmoil

There is nothing stable about the government's finances. Last month, we learnt that the UK had to borrow £600 million in July, even though it is traditionally a very strong month for revenues. There was a drop of 0.8% in tax collected, with corporation tax in particular very weak. Four months into the financial year, the government has already borrowed a massive £44.9bn, £9.3bn higher than the same period in 2011. And this from a government that has pledged to get the deficit down, not increase it.



Just about anyone can see that the deficit is not coming down fast enough. Only 6% of the coalition's targeted reductions in current expenditure have been achieved so far. Overall, the official national debt will rise by £605 billion by 2015, or from 53% of GDP in 2009/10 to 76% of GDP in 2014/15.

But if growth continues to be lower than expected, the figures could easily be a whole lot worse. Rising and persistent debt levels, combined with near permanent recession, or at best sluggish growth, are a lethal combination for debt ratios. Just ask the Italians or the Spanish. Neither government has been particularly extravagant in the past few years. But if an economy refuses to grow, it is very hard to stop the debt-to-GDP ratio getting higher year after year.



Worse, there isn't much sign of structural reform. The state consumes half of GDP. The trade deficit is huge. The government has huge open-ended commitments in healthcare, pensions and welfare – expensive with an aging population. The City's banks are a huge potential liability: one rogue trader at Barclays Capital or HSBC could put a £100 billion on the deficit in a morning.

In short, a ratings cut is done deal. No sane person can put the UK in the same league as Sweden, Canada, or Singapore.

The trouble is, what happens next.

David Cameron's Conservative-Liberal Democrat coalition has committed itself to preserving the support of the ratings agencies and bond markets. Insofar as it has an economic strategy, that's it.

If the Triple-A goes, the coalition may not survive. Cameron could stagger on in charge of puny minority government. Or he could call an election.

The markets can shrug off a ratings cut for a politically stable country. They are used to them – and getting more so all the time. But a ratings cut followed by political chaos? That will be a lot more worrying. All bets will be off. Except this one. You don't want to own sterling, UK bonds or equities when it happens.

- **Matthew Lynn**
(matthew@strategyeconomics.com)

FORECASTS

THE UK ECONOMY

	2012	2013	2014
GROWTH:	-0.2%	0.9%	1.5%
INFLATION:	3.1%	2.9%	2.7%
UNEMPLOYMENT:	9.2%	10.2%	9.5%

THE EUROZONE ECONOMY

	2012	2013	2014
GROWTH:	-0.7%	0.2%	1.2%
INFLATION:	2.0%	1.8%	1.8%
UNEMPLOYMENT:	9.4%	9.2%	9.4%

THE GERMAN ECONOMY:

	2012	2013	2014
GROWTH:	-0.5%	1.0%	1.4%
INFLATION:	2.0%	2.2%	2.4%
UNEMPLOYMENT:	6.6%	6.8%	6.9%

THE FRENCH ECONOMY:

	2012	2013	2014
Growth:	-0.7%	1.0%	1.0%
Inflation:	1.9%	2.3%	2.6%
Unemployment:	8.9%	8.7%	8.8%

The Italian Economy:

	2012	2013	2014
Growth:	-2.5%	-1.7%	0.1%
Inflation:	2.1%	2.0%	2.1%
Unemployment:	8.9%	10.1%	10.7%

The Spanish Economy

	2012	2013	2014
Growth:	-2.0%	-0.5%	0.6%
Inflation:	1.9%	2.1%	2.3%
Unemployment:	22.3%	24.8%	25.6%

Exchange Rates

	2012	2013	2014
Euro/$1:	1.15	1.10	1.21
Pound/$1	1.60	1.71	1.78

Commodities:	2012	2013	2014
Gold:	1,900	2,500	2,600
Brent Crude:	125	140	150

For subscription enquiries contact info@strategyeconomics.com.