

# UK

## Ratings Downgrade

- On Friday night, Moody's downgraded the UK's sovereign rating one notch to Aa1 (with a stable outlook) from Aaa. We had warned several times that the UK is likely to be downgraded by at least one major agency this year<sup>1</sup>. Moody's accept that the current government has *"a strong track record of fiscal consolidation"* and make it clear that the downgrade chiefly reflects the weak state of the economy, citing *"continuing weakness in the UK's medium-term growth outlook"*, the *"challenges that subdued medium-term growth prospects pose to the government's fiscal consolidation programme"* and hence the *"UK's high and rising debt burden"* and diminished fiscal capability to absorb further adverse shocks. Other major ratings agencies are likely to follow with a one notch downgrade during this year.
- In our view, the underlying causes of the UK economy's weakness – and hence the rating downgrade – stem from the surge in private credit and public spending during 2000-07. That has left the UK with an overhang of high household debt and weak structural fiscal position, while the high pound in that earlier period crowded out the UK's export sector and left the UK with diminished capacity to generate export-led growth now. Nevertheless, the downgrade probably will inevitably be seen as a vote of "no confidence" in the current government's economic policies.
- The downgrade has two main implications. First, on economic policy, Moody's stress that the UK's fiscal position will be more secure if economic growth revives, provided recovery is not fiscal-led. Moody's are not advocating extra near-term fiscal consolidation. Expanded upfront fiscal austerity and hence ongoing economic stagnation will not make the UK's medium-term fiscal outlook and rating more secure in our view. Rather, the downgrade is likely to reinforce the official tolerance for a weaker pound to lift exports and emphasis on stimulus through monetary easing (ie QE and credit easing), with a looser inflation target to allow a more pro-growth policy. Second, on politics, the government has recently sought to downplay the significance of losing the AAA rating. But, in practice, we believe it will be a major political blow to the government, which had hoped to establish a narrative for the 2015 general election of having brought the UK back from the fiscal danger zone and on the route back to sustainability. It is possible that this downgrade will produce a widespread sense of national crisis that leads voters to cling to the apparent security and familiarity of the incumbent government, rather than the inevitable uncertainties of a different government. But, most likely, we suspect the downgrade will make it harder for the Conservatives (who are well behind in opinion polls) to win the 2015 election, hence threatening to create pre-election fiscal slippage but more importantly medium-term uncertainties about the fiscal policies of a new (most likely Labour-led) government from 2015 onwards.

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<sup>1</sup> See *"The Looming Budget Dilemma"*, Michael Saunders, UK Economics Weekly, 22 February 2013.

### See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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