MOODY'S
INVESTORS SERVICE

CREDIT OPINION
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Update

Government of United Kingdom – Aa3 stable

Regular update

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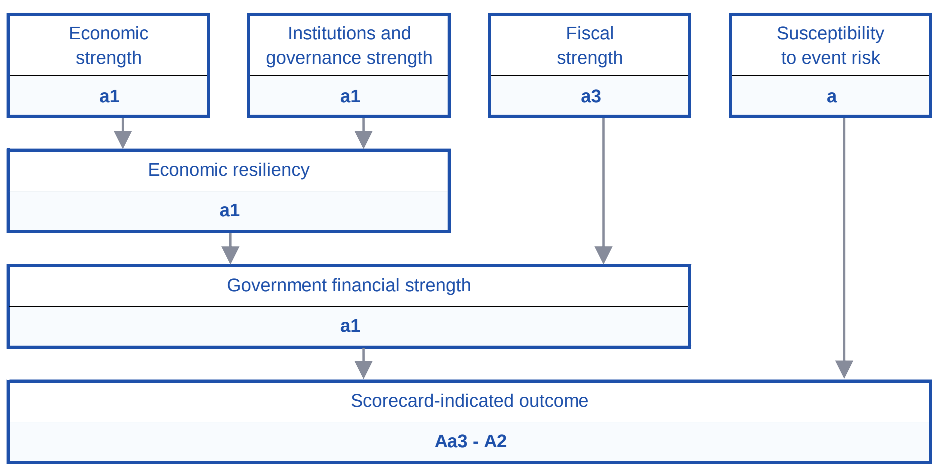
Summary

The credit profile of the United Kingdom (UK, Aa3 stable) is supported by a large, flexible and competitive economy and robust institutions, although the serious challenges raised by Brexit have weakened them. Even before the coronavirus outbreak, strong social and political pressure to raise government spending after years of austerity were likely to limit any improvement in the public finances. Reduced trade with its largest partner, the European Union (EU, Aaa stable), following the UK's exit from the Single Market will weaken the economy's medium-term growth prospects, as will some scarring from the coronavirus pandemic.

Exhibit 1
The United Kingdom's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

» A large, flexible and competitive economy with high levels of wealth;

This publication provides an update on the sovereign credit profile and may also discuss the likely credit implications of a new development or trend for the sovereign. It does not announce a credit rating action.

» Limited government financing risks;

» A sound and highly credible monetary policy framework.

Credit challenges

» Weaker longer-term growth prospects;

» Significant spending pressures that will likely keep the debt burden elevated;

» Weak productivity growth, high household debt and a large current-account deficit.

Rating outlook

The stable outlook reflects our view that the upside and downside credit risks are balanced, at least over the coming 12-18 months. The UK's intrinsic economic and institutional strengths, as well as the likely level where debt will stabilize, compare well to peers at the Aa3 rating level. The economic costs and ongoing uncertainty around the full extent of the future relationship with the EU are captured in the UK's Aa3 rating.

Factors that could lead to an upgrade

The UK's outlook, and ultimately its rating, could improve if there were indications that the apparent erosion in institutional strength is reversing. In particular, indications that British institutions are reverting to the capability and predictability that has traditionally characterised the UK's institutional framework would be positive. Such an outcome would most likely be characterised by the development of a credible strategy to achieve medium-term fiscal objectives that rebuild the UK's fiscal strength. Passage of economic policies that could sustainably boost growth potential would also be credit positive.

Factors that could lead to a downgrade

The UK's rating would likely come under downward pressure if we were to conclude that the UK's fiscal strength was likely to deteriorate due to growth pressures, higher-than-expected deficits, or higher funding costs. A further structural weakening in economic fundamentals would also undermine the UK's credit profile. While it is unlikely at this stage, indications that sterling's status as a reserve currency was in question would also exert downward pressure on the outlook and eventually the rating.

Key indicators

United Kingdom	2015	2016	2017	2018	2019E	2020E	2021F	2022F
Real GDP (% change)	2.6	2.3	2.1	1.7	1.7	-9.7	6.7	4.8
Inflation (CPI, % change, Dec/Dec)	0.5	1.8	2.7	2.0	1.3	0.8	4.0	2.5
Gen. gov. financial balance/GDP (%)	-4.5	-3.3	-2.4	-2.2	-2.3	-12.0	-8.6	-5.9
Gen. gov. primary balance/GDP (%)	-2.2	-0.9	0.3	0.2	-0.2	-10.1	-6.3	-3.6
Gen. gov. debt/GDP (%)	86.0	85.8	85.2	84.5	83.8	102.3	101.8	100.0
Gen. gov. debt/revenues (%)	229.9	227.0	222.3	220.8	219.7	265.7	263.9	260.4
Gen. gov. interest payment/revenues (%)	6.1	6.3	6.9	6.3	5.5	4.9	5.8	5.9
Current Account Balance/GDP (%)	-5.2	-5.3	-3.6	-3.9	-2.7	-2.6	-3.5	-3.0

Source: Moody's Investors Service

Detailed credit considerations

We assess the UK's **economic strength** to be "a1", one notch above the initial score of "a2" on account of our view that the pandemic-induced increase in growth volatility is not a structural feature of the economy and therefore not indicative of lower economic strength. The score reflects the UK's large, diversified and competitive economy, especially in the services sector and a flexible labour market, which has helped to keep the unemployment rate lower than it has been for many close peers following the global financial crisis. Economic growth has also been stronger than among many peers over the past several years, reaching close to 2% on average during 2013-19, which was one of the strongest growth performances among advanced economies. However, this has been accompanied by weak productivity growth.

The coronavirus outbreak has had a profound impact on economic activity, particularly given the reliance of the UK on services which involve greater levels of social interaction. While the successful vaccine rollout and the removal of most restrictions has supported the rebound of the economy during the first half of 2021, some permanent scarring on the UK's economy appears likely in view of the impact on investment and the labour market to-date, weighing on the medium-term growth outlook.

More generally, we do not expect growth to recover to its historic trend growth rate, also in part because Brexit will continue to hinder both trade and investment even under the last-minute agreement reached with the EU at the end of 2020. The EU absorbs around half of the UK's total exports and an even higher 60% of its exports of intermediate goods. While the Trade and Cooperation Agreement (TCA) signed in end-2020 allows for tariff-free and quota-free goods exports under certain conditions, UK exporters now face significant non-tariff barriers in trading with the EU. Furthermore, the agreement largely lacks substance on services trade – exports of services from the UK will need to contend with myriad complex country and sector-specific EU regulations – which is vital to the UK economy, prolonging Brexit-related economic uncertainty. The Office for Budget Responsibility (OBR) estimates a long-term loss in productivity of around 4% from the TCA's terms compared with remaining in the EU.

Looking ahead, we also consider that new trade deals with non-EU countries will not have a material positive impact on the overall cost arising from Brexit, given that most of these will serve to largely replicate previous trading arrangements that the UK had under its EU membership and that the economic impact of recently agreed trade deals is very small. Furthermore, we expect the governance provisions in the agreement, including those designed to protect the integrity of the EU single market, will keep the UK largely tethered to the EU's regulatory framework for the foreseeable future, albeit with less influence than under EU membership, further cementing the economic disadvantages of its post-Brexit relationship with the EU.

We consider the UK's **institutions and governance strength** to be “a1”. The score reflects our view that predictability and effectiveness of economic and fiscal policymaking – an important aspect of institutional strength – has diminished. This reduced institutional capacity to manage change in a predictable and confidence-building manner is evident with regard to the UK's approach to Brexit and the ongoing uncertainty it has created. However, the erosion in the predictability of policymaking and respect for rules and norms is perhaps most clearly reflected in the conduct of fiscal policy. The UK's broad fiscal framework, characterised by features such as multi-year budget plans and more detailed revenue and spending decisions announced for the outer years of the planning period, has weakened. This weakening in the safeguards provided by the fiscal framework and the overall deterioration in our assessment of the quality of institutions has made policy planning more unpredictable. The government is currently conducting a review of the fiscal framework and new fiscal rules are due to be set out later in the year, which will be important in terms of providing greater clarity on and help to anchor the medium-term fiscal stance.

That said, many aspects of the UK's institutional strength continue to be very strong, such as the rule of law, a highly credible central bank which has engendered confidence in policy making, and a professional and highly qualified civil service. The establishment of the OBR back in 2010 as an independent fiscal watchdog and economic and fiscal forecaster was an enhancement to the country's fiscal policy framework. Over the past decade, the UK also moved to strengthen its domestic banking system by increasing bank capital requirements and improving bank supervision.

We assess the UK government's **fiscal strength** at “a3”, which reflects our expectation that the public debt ratio will not materially decline from its currently high level over the coming years. As is the case for many highly rated countries, the government's fiscal response to the coronavirus outbreak will have a significant impact on both the deficit and the public debt ratio. However, the economic slowdown under way even before the coronavirus outbreak and strong social and political pressure to raise spending after many years of expenditure cuts will complicate fiscal consolidation efforts. The final score is set one notch below the initial score after the initial score rose to “a2” on account of recent improvements to our fiscal forecasts. We will wait to see evidence of fiscal consolidation resuming after the coronavirus shock before aligning our assessment for fiscal strength with the higher initial score, particularly given the notable spending pressures that the UK government faces in the coming years.

The UK's government debt affordability assessment is supported by gross borrowing requirements which are low relative to other highly rated and indebted sovereigns, reflecting the long average maturity of its outstanding debt stock and its large domestic investor base. However, the structure of the UK's debt stock is less robust to increases in funding costs than it once was, given the significant (albeit declining) stock of inflation-linked debt and that the larger debt load, combined with the reduction in the effective maturity stemming from the Bank of England's asset purchases, have increased the susceptibility to higher interest rates.

We currently assess the country's **susceptibility to event risk** as "a", driven by domestic political risk and banking sector risk.

Domestic political risks reflect the challenges to post-Brexit co-operation with the EU. The transition to the new economic and political relationship with the EU has been far from smooth with negative implications for the UK's economic prospects and global reputation. In the absence of close cooperation, it will be harder for the UK to move forward on the many issues left unsettled by the TCA and navigate the enormous challenges posed by the new complex trading arrangements. The political risk score of "a" also reflects the fact that, while still a remote scenario, Brexit has reignited the debate around independence for the home nations of the UK, and Scotland in particular.

While the banking sector is very large, we believe that the related contingent liability for the government's balance sheet has materially declined as a result of the measures implemented by the UK authorities in recent years and those that are planned for the future. The government's willingness to use its new powers in a systemic crisis remain to be tested, but the UK's bank resolution and bail-in regimes, and the related ring-fencing framework, are very advanced.

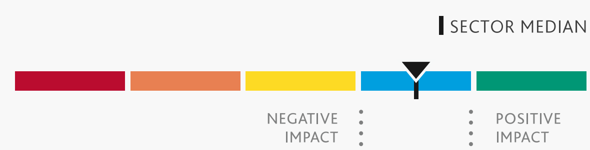
The UK's large current-account deficit is potentially another source of vulnerability. The emergence of pressures on the exchange rate in the context of substantial and persistent capital outflows could raise questions about the funding of the current-account deficit and more fundamentally about the role of Sterling as one of the few global reserve currencies. However, this is a longer-term risk.

ESG considerations

United Kingdom's ESG Credit Impact Score is neutral-to-low CIS-2.

Exhibit 3
ESG Credit Impact Score

CIS-2
Neutral-to-Low

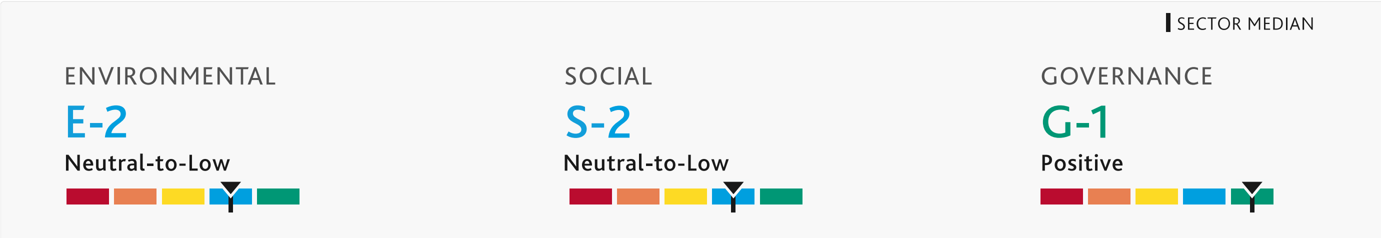


For an issuer scored CIS-2 (Neutral-to-Low), its ESG attributes are overall considered as having a neutral-to-low impact on the current rating; i.e., the overall influence of these attributes on the rating is non-material.

Source: Moody's Investors Service

The UK's ESG Credit Impact Score is neutral to low (**CIS-2**), reflecting low exposure to environmental and social risks and, like many other advanced economies, very strong governance profile and in general capacity to respond to shocks.

Exhibit 4
ESG Issuer Profile Scores



Source: Moody's Investors Service

Environmental

Its overall E issuer profile score is neutral to low (**E-2**), reflecting low exposure to environmental risks across most categories.

Social

We assess its S issuer profile score as neutral to low (**S-2**), reflecting low exposure to social risks over most categories. The only category that entails moderately negative risk is demographics: demographic change in the form of relatively fast aging of the population poses long-term fiscal sustainability challenges to the UK. Health care in particular will become an increasingly important source of fiscal risk in the absence of reforms. The UK's labour and income score reflects the country's very flexible labour market as well as rising income and wealth inequalities, which have had political and policy ramifications.

Governance

The UK's very strong institutions and governance profile support its rating and this is captured by a positive G issuer profile score (**G-1**). The UK scores very highly on institutional factors, as captured in the Worldwide Governance Indicators, reflecting strong policy effectiveness and rule of law. Coupled with high wealth levels and moderate government financial strength this supports a high degree of resilience.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

All of these considerations are further discussed in the "Detailed credit considerations" section above. Our approach to ESG is explained in our report on how the scores depict varied and largely credit-negative impact of ESG factors and our cross-sector methodology General Principles for Assessing Environmental, Social and Governance Risks Methodology.

Recent developments

Supply shortages will weigh on economic activity but will largely prove temporary

We forecast the UK economy will grow by around 6.7% this year after a successful vaccination rollout allowed for the gradual unlocking of the economy with most of the restrictions having been lifted since mid-July. The rebound was stronger than we forecast in the second quarter with real GDP expanding by 5.5% relative to Q1, driven by a strong increase in private consumption as households deployed their excess savings. The savings rate dropped to 11.7% in the second quarter of 2021, its lowest level since the start of the pandemic, though it still remains higher than before the pandemic. However, we expect growth to moderate in the second half of 2021 as a result of lingering supply-side bottlenecks, the withdrawal of most pandemic-related government support measures and the impact of rising coronavirus cases on confidence. After the initial boost from the reopening, monthly estimates of GDP show that activity moderated, expanding by 0.3% between June and August.

Supply-side disruptions are weighing on economic activity as supply has struggled to keep pace with the strong recovery in demand in some sectors. Together with higher commodity prices, we expect these dynamics to push inflation to around 4% by the end of this year. Supply bottlenecks have been compounded by labour shortages, reflecting both the pandemic and the tighter immigration rules since Brexit. The number of job vacancies rose to a record 1.2 million at the end of September, with only 1.45 unemployed people per vacancy, the lowest on record. However, labour demand is yet to translate into strong employment growth with the number of people employed still about 2% below its 2019 levels both as a result of an increase in inactivity and net emigration after Brexit.[1] Sectors such as hospitality and transport that were the most reliant on workers from the EU have reported higher increases in vacancies (see Exhibit 5). At the same time, the inactivity rate is at its highest since 2011 at 36.7%.

However, we expect the worst of the supply disruptions to be temporary as the shortfall in supply is gradually filled and as consumers gain in confidence and redirect a greater share of their spending towards services, helping to maintain strong real GDP growth of 4.8% in 2022. In addition, the withdrawal of government support measures that are likely to have kept some workers away from the labour force will help to support the reallocation of labour between sectors. At the end of August, there were still 1.3 million workers on furlough, a month before the scheme was due to expire, which may help to ease some of the labour shortages. That said, we still expect unemployment to increase since the furlough scheme ended, albeit to a lesser extent than we initially assumed, rising to 4.8% on average over 2021 as a full return of workers to sectors where demand remains weak is unlikely, particularly as the prolonged adjustment from Brexit continues.

Nevertheless, consumption towards the end of 2021 and into next year will face headwinds from the expiration of the furlough scheme and the end of the Universal Credit uplift in October, which had been supportive of household incomes throughout the pandemic. Furthermore, higher inflation including an increase in utility prices and planned tax increases will also erode real purchasing power. In addition, the acceleration of wage growth will likely prove temporary and remain concentrated in some sectors where labour supply is tightest.

Finally, risks to our forecast for relatively robust growth over the next couple of years arise from a worsening in the pandemic, a more protracted reconfiguring of the economy coming out of the pandemic, and the potential for more persistent inflationary dynamics. Risks related to the coronavirus remain high, particularly given the elevated number of cases in the UK. The reintroduction of strict restrictions on economic activity is not our base case given the high rates of vaccination in the country but the degree of effectiveness of existing vaccines against future variants cannot be known. A prolonged mismatch between those sectors requiring labour and skill availability, particularly in the context of reduced immigration, may dampen the recovery by more than we expect. Furthermore, a more sustained rise in price growth into 2022, which in turn prompts a faster than expected tightening in monetary policy, would further weigh on real incomes, particularly if wages do not keep pace.

At the same time, Brexit-related uncertainty will continue to act as a headwind to private investment and growth. The relationship with the EU remains fragile, which will make it harder for the UK to move forward on the many issues left unsettled by the Trade and Cooperation Agreement (TCA) and Withdrawal Agreement, including ways to smooth the implementation of the Northern Ireland Protocol and facilitate trade in the important services sector which is largely undefined in the agreement. The EU proposed in October to cut checks on most food items entering Northern Ireland from Great Britain but the continued role of the European Court of Justice remains a sticking point for the UK government. We expect discussions to remain protracted and prolong Brexit-related economic uncertainty.

National Insurance rate rise is a step toward tackling some of the UK's longer-term fiscal challenges but forthcoming budget will provide an indication of future fiscal tightening

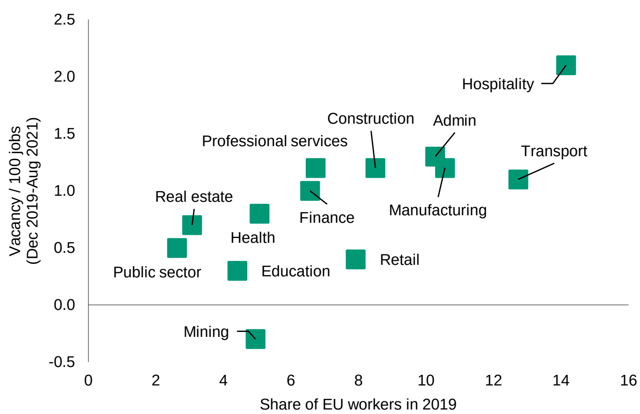
The economic recovery has helped boost government revenue collection while spending has been lower than forecast mostly due to lower than expected demand for pandemic-related measures. Central government revenue grew 9.7% in the first eight months to August 2021 while expenditure increased by 2.8%. We expect the deficit to decline to 8.6% of GDP in 2021, an improvement from our previous expectation of 10%. The gradual expiry of support measures will help to contain expenditure growth next year even though the pandemic will continue to put upward pressure on government spending given its impact on public services, including on the provision of health, education and justice.

Ahead of the Spending Review and Budget on 27 October, the government has announced an increase in the rates of national insurance contributions and dividend tax, both rising by 1.25 percentage points (pp) from April 2022. The additional revenue is estimated at £14 billion annually (0.6% of GDP) and will be earmarked for health and social care spending rather than tackle the fiscal legacy of the pandemic. Although the measure helps to address some of the long-term budgetary pressures stemming from the UK's ageing population and long-standing weaknesses in the public health system, it is unlikely to be sufficient to meet growing demand for health and social care. The Institute for Fiscal Studies (IFS) estimates that the rate of national insurance contributions would need to rise by an additional 1.9 percentage points by 2030 in order to fund the expected increase in spending on health and social care. That said, the announcement shows that the previous political constraints around tax increases are no longer binding.

Under the current spending plan, the deterioration in the UK's fiscal position stemming from the pandemic will not be rapidly reversed, with the government's debt burden forecast to remain at elevated levels. A less robust growth environment in the coming years and the constraints on the government's ability to consolidate the public finances in the aftermath of the pandemic underpin our expectations of a slow reduction of the fiscal deficit towards 4% of GDP by 2025. In addition, we expect that higher interest payments due to the sizeable share of inflation-linked debt, will further constrain fiscal space. The OBR estimates that a 1pp increase in inflation increases interest costs by 0.25pp of GDP and by 0.45pp in the case of a 1pp increase in short-term rates. As a result, we expect that the government debt to GDP ratio will remain broadly stable and elevated at just above 100% through to 2025. Risks to our fiscal forecast emanate from the potential need for greater fiscal support if the economic recovery were to wane faster than we expect.

Exhibit 5

Vacancies increased most in sectors that relied on EU workers

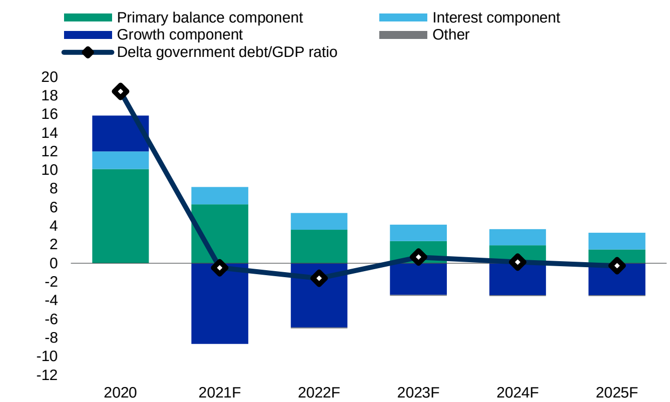


Source: ONS and Moody's Investors Service

Exhibit 6

Debt will likely remain at current levels owing to fiscal pressures and weak growth

Change in debt and components (pp of GDP)



Source: Moody's Investors Service

Moody's rating methodology and scorecard factors: United Kingdom - Aa3 stable

Factor / Sub-Factor	Metric	Indicator Year	Indicator	Initial Factor score	Final Factor score	Weights
Factor 1: Economic strength				a2	a1	50%
Growth dynamics	Average real GDP growth (%)	2016-2025F	1.4	b1		25%
	Volatility in real GDP growth (%)	2011-2020	3.7	caa1		10%
Scale of the economy	Nominal GDP ($ billion)	2020	2,764.2	aaa		30%
National income	GDP per capita (PPP, Intl$)	2020	44,154	aa1		35%
Adjustment to factor 1	*# notches*				1	max ±9
Factor 2: Institutions and governance strength				a1	a1	50%
Quality of institutions	Quality of legislative and executive institutions			a		20%
	Strength of civil society and the judiciary			aaa		20%
Policy effectiveness	Fiscal policy effectiveness			baa		30%
	Monetary and macroeconomic policy effectiveness			aa		30%
Specified adjustment	Government default history and track record of arrears				0	max -3
Other adjustment to factor 2	*# notches*				0	max ±3
F1 x F2: Economic resiliency				a1	a1	
Factor 3: Fiscal strength				a2	a3	
Debt burden	General government debt/GDP (%)	2020	102.3	b3		5%
	General government debt/revenue (%)	2020	265.7	ba2		5%
Debt affordability	General government interest payments/revenue (%)	2020	4.9	aa2		45%
	General government interest payments/GDP (%)	2020	1.9	a1		45%
Specified adjustments	*Total of specified adjustment (# notches)*			-1	-2	max ±6
	Debt trend	2016-2021F	15.9	-1	-2	
	Foreign currency debt/general government debt	2020	0.0	0	0	
	Other non-financial public sector debt/GDP	2020	1.5	0	0	
	Public sector assets/general government debt	2020	0.0	0	0	
Other adjustment to factor 3	*# notches*				0	max ±3
F1 x F2 x F3: Government financial strength				aa3	a1	
Factor 4: Susceptibility to event risk				a	a	Min
Political risk				a		
	Domestic political risk and geopolitical risk			a		
Government liquidity risk				aaa	aaa	
	Ease of access to funding			aaa		
Specified adjustment	High refinancing risk				0	max -2
Banking sector risk				a	a	
	Risk of banking sector credit event (BSCE)	Latest available	baa1	aaa-a3		
	Total domestic bank assets/GDP	2020	397.5	230-400		
Adjustment to F4 BSR	*# notches*				0	max ±2
External vulnerability risk				aaa	aaa	
	External vulnerability risk			aaa		
Adjustment to F4 EVR	*# notches*				0	max ±2
Overall adjustment to F4	*# notches*				0	max -2
F1 x F2 x F3 x F4: Scorecard-indicated outcome				Aa2 - A1	Aa3 - A2	

Note: While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the scorecard-indicated outcome. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the scorecard-indicated outcome. For more information please see our Sovereign Ratings Methodology.

Footnotes: (1) Initial factor score: scorecard indicators combine with the automatic adjustments to produce an initial factor score for every rating factor, as detailed in Moody's Sovereign Ratings Methodology. **(2) Final factor score:** where additional analytical considerations exist, initial factor scores are augmented to produce a final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Ratings Methodology; details on country-specific considerations are provided in Moody's research. **(3) Scorecard-indicated outcome:** Factor 1: Economic Strength, and Factor 2: Institutions and Governance Strength, combine with equal weight into a construct we designate as Economic Resiliency (ER). An aggregation function then combines ER and Factor 3: Fiscal Strength, following a non-linear pattern where Fiscal Strength has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the government financial strength as given by combining the first three factors. **(4) There are 20 ranking categories** for quantitative sub-factors: aaa, aa1, aa2, aa3, a1, a2, a3, baa1, baa2, baa3, ba1, ba2, ba3, b1, b2, b3, caa1, caa2, caa3, ca and 8 ranking categories for qualitative sub-factors: aaa, aa, a, baa, ba, b, caa, ca **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

Moody's related publications

- **Credit Analysis**: Government of United Kingdom – Annual credit analysis, 2 July 2021
- **Credit Opinion:** Government of United Kingdom - Regular Update, 20 April 2021
- **Issuer Comment:** Government of United Kingdom: Legal dispute with the EU signals challenges for post-Brexit cooperation, 17 March 2021
- **Issuer Comment:** Government of United Kingdom : Budget highlights the policy challenges the government faces rebuilding fiscal resilience, 8 March 2021
- **Sector in-depth:** Brexit - United Kingdom: Trade and Cooperation Agreement does not eliminate Brexit uncertainty, 25 January 2021
- **Rating Methodology**: Sovereign Ratings Methodology, 25 November 2019

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 See **Labour market statistics**, October 2021

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