United Kingdom
Report

AA STABLE OUTLOOK

Credit strengths

- Large, wealthy, and diversified economy
- Strong institutional framework
- Robust debt profile and market access

Credit challenges

- High stock of public debt
- Weak external position with persistent current account deficit
- Prolonged post-Brexit uncertainties

Rating rationale

Large, wealthy, and diversified economy: The UK's economy has proven resilient during the Covid-19 crisis and is expected to reach pre-pandemic levels of output by early 2022.

Strong institutional framework: The country benefits from robust financial supervisory, economic, and monetary governance frameworks. This includes the independent Bank of England, which reacted promptly to the Covid-19 crisis by adopting a series of conventional and unconventional measures to support the economy.

Robust debt profile and market access: The UK benefits from strong market access conditions with an average debt maturity of 14.8 years, while the central bank holds a large share of government debt.

Rating challenges include: i) the country's high public debt; ii) a weak external position with persistent current account deficits; and iii) prolonged uncertainties surrounding the implementation of the post-Brexit UK-EU trade agreement.

United Kingdom's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	aaa		+1/3	AA
Public Finance Risk		25%	bb+		+1/3	
External Economic Risk		10%	b		-2/3	
Financial Stability Risk		10%	aaa		+1/3	
ESG Risk	Environmental Risk	5%	aa+		0	
	Social Risk	5%	bbb+		0	
	Governance Risk	10%	aaa		0	
Overall outcome		**aa-**		**+1**	**0**	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings GmbH

Outlook and rating triggers

The Stable Outlook reflects our view that risks to the ratings are balanced over the next 12 to 18 months.

Positive rating-change drivers

- Economic and fiscal policy frameworks place the debt-to-GDP ratio on a stable downward trajectory
- Reduction of external vulnerabilities

Negative rating-change drivers

- Weakening in economic and fiscal outlooks lead to higher debt-to-GDP
- Larger attrition of UK services sector than anticipated due to Brexit and/or materialisation of risks to UK's constitutional integrity
- Increase in external vulnerabilities or challenge to sterling's reserve currency status

Ratings and Outlook

Local and foreign currency

Long-term issuer rating	AA/Stable
Senior unsecured debt	AA/Stable
Short-term issuer rating	S-1+/Stable

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Bloomberg: RESP SCOP

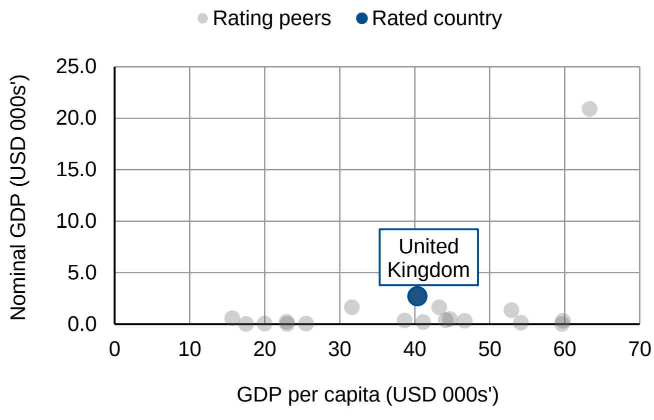
Domestic Economic Risks

- **Growth outlook:** Economic output contracted sharply at the onset of the Covid-19 pandemic, falling by almost 10% in 2020. After a strong rebound in consumption during Q2 2021, labour shortages, supply bottlenecks, rising energy prices and a resurgence in Covid-19 cases during winter months then slowed the recovery in H2 2021. We expect a strong rebound with growth reaching 6.8% in 2021 and 4.6% in 2022 before gradually converging towards the medium-run potential of around 1.5%. Cliff-edge Brexit risk has mostly been eliminated following implementation of the UK-EU Trade and Cooperation Agreement in May 2021, but tensions are likely to persist.
- **Inflation and monetary policy:** Widespread supply shortages continued to put upward pressure on inflation during H2 2021, increasing to 4.2% in October, up from 3.1% in September. The Bank of England expects inflation to reach around 5% in early 2021 before high demand pressures and supply shortages start to ease. However, to return inflation to its 2% target, the Bank also believes that a modest rise in interest rates will be needed. We expect the Bank of England to raise rates by early 2022, becoming the first major central bank to raise rates. Governor Andrew Bailey has indicated that, subject to wider economic conditions, Bank Rate would rise to 0.5% before the stock of purchased assets is reduced by ceasing to reinvest maturing UK government bonds.
- **Labour market:** Unemployment is only marginally higher than it was pre-pandemic. However, some friction persists in labour markets as the employment rate remains 1.1pps below February 2020 levels, job vacancies are at record levels, and weekly earnings have increased. The furlough scheme expired in September 2021, when over a million workers were still supported by the programme. The Office for Budget Responsibility believes that these workers are concentrated in high-vacancy sectors.

Overview of Scope's qualitative assessments for United Kingdom's *Domestic Economic Risks*

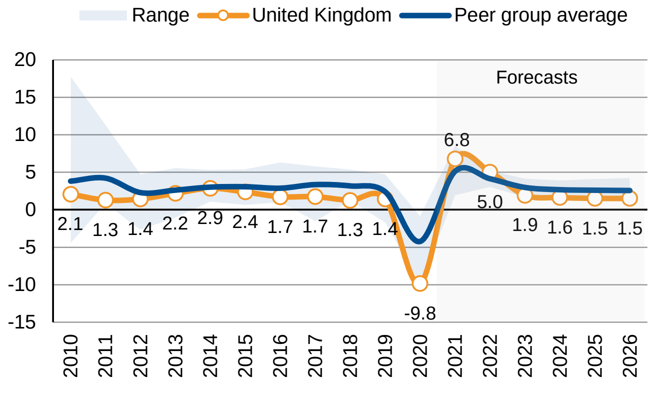
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Growth potential of the economy	Neutral	0	Moderate growth potential, has weakened since 2016 referendum
	Monetary policy framework	Strong	+1/3	Highly credible and effective central bank; independent monetary policy
	Macro-economic stability and sustainability	Neutral	0	Diversified economy and flexible labour market; ongoing economic costs following the Brexit process

Nominal GDP and GDP per capita, USD thousands



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

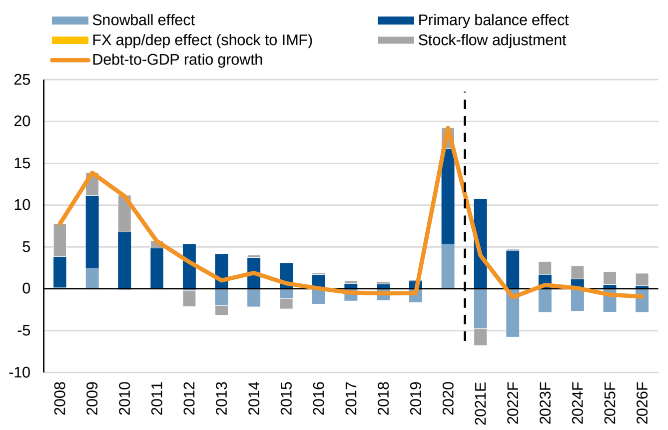
Public Finance Risks

- **Fiscal outlook:** To finance the large fiscal stimulus in response to the pandemic (around 16% of GDP), the UK's budget deficit stood at 12.5% in 2020 and is expected to remain high, at 11.9% in 2021. To return to more sustainable spending levels, the government's new fiscal mandate is to have the public sector net debt-to-GDP ratio fall by the third year of a rolling forecast period. Three supplementary targets are to balance the current budget, to ensure that public sector net investment remains below 3%, and to cap expenditure on welfare. The conservative government has also introduced tax increases including a higher corporate tax rate, a health and social care levy of 1.25% on all workers and employers, and a five-year freeze on personal allowances. These are expected to increase the tax burden from 33.5% in 2019-20 to the highest level since the 1950s at 36.2% in 2026-27.
- **Debt trajectory:** Public debt will have risen to around 108% of GDP this year (from 85% in 2019). Longer run, we project that the proposed fiscal targets will help to stabilise public debt levels, ending our forecast period at 106% of GDP by 2026. The Office for Budget Responsibility expects the government to meet its fiscal targets, although the Chancellor has little headroom amounting to only 0.6% of GDP which would be eliminated if GDP is 1% below expectations.
- **Market access:** The UK benefits from strong market access conditions, with a long average debt maturity (14.8 years as of Q3 2021) compared to its peers. In the October budget, total gross financing needs have been revised down to GBP 178bn from GBP 304bn as forecasted in March. The central bank holds a considerable share of government debt, with the Bank of England being the largest single holder of outstanding gilts and treasury bills.

Overview of Scope's qualitative assessments for United Kingdom's *Public Finance Risks*

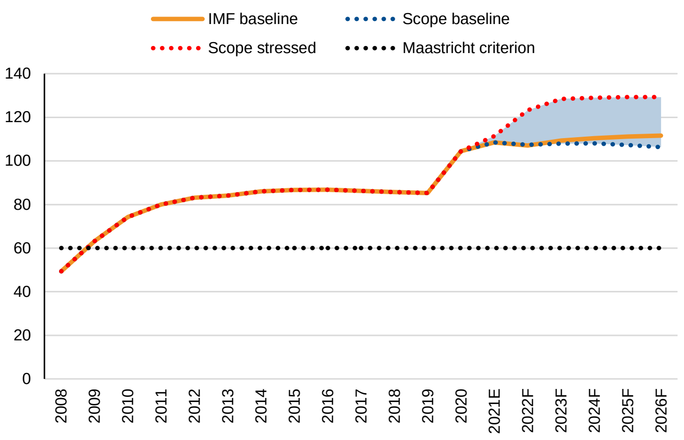
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Fiscal policy framework	Neutral	0	Revised fiscal framework including ambitious targets for public debt levels
	Debt sustainability	Neutral	0	Debt set to remain stable at an elevated level, in line with some peers
	Debt profile and market access	Strong	+1/3	Excellent government market access, long average debt maturity, significant debt held by central bank

Contributions to change in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

External Economic Risks

- **Current account:** The UK has been running a current account deficit for several decades and the current balance remains well below the peer group average. The deficit also remained elevated throughout the pandemic, increasing from 3.1% in 2019 to 3.7% in 2020. This reflects the exceptionally high public sector borrowing in response to the Covid-19 pandemic, which was only partially offset by private savings. The IMF expects the deficit to stabilise at 3.4% in 2021 and 2022. Longer term, the UK's departure from the EU will have an ambiguous effect on the current account deficit as it will reduce both import and export intensity. The full impact will only become evident once the UK-EU agreement is fully implemented, pandemic-related trade disruptions dissipate, and businesses have adjusted to the new norm.

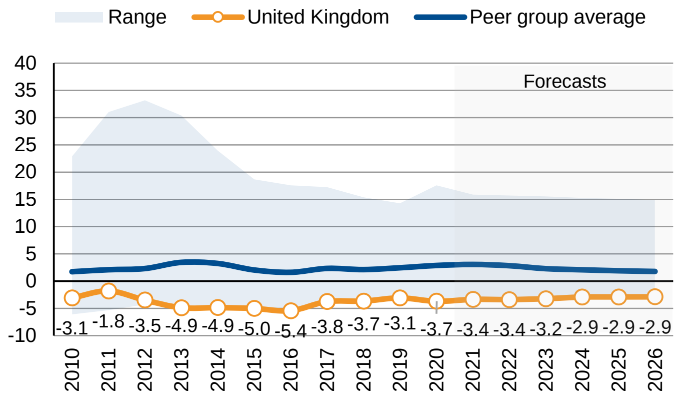
- **External position:** The UK has traditionally been able to finance a significant part of its external position through net foreign direct investment flows. As of 2018, 38% of the FDI stock originated from the EU. Brexit caused a downturn in FDI inflows, lessening the external-financing resilience of the country. The pandemic caused a peak in the external debt ratio rising from 298% in 2019 to 337% of GDP in 2020, before gradually declining to 316% in Q2 2021, of which 205% was short-term debt.

- **Resilience to shocks:** International reserves held by the UK are typically low. Holdings of gross reserves increased in 2008-09 and 2020-21, with the allocation of Special Drawing Rights by the IMF, a rise in the value of gold and a government provision of GBP 72bn of additional financing that ended in March 2020. This led to a 5% of GDP increase of UK reserves in that period, bringing them in line with other comparable economies. Sterling's status as a reserve currency protects the country from external short-term shocks. Moreover, as of Q2 2021, the share of global reserves held in sterling has increased slightly to 4.8% from 4.5% in 2020.

Overview of Scope's qualitative assessments for United Kingdom's *External Economic Risks*

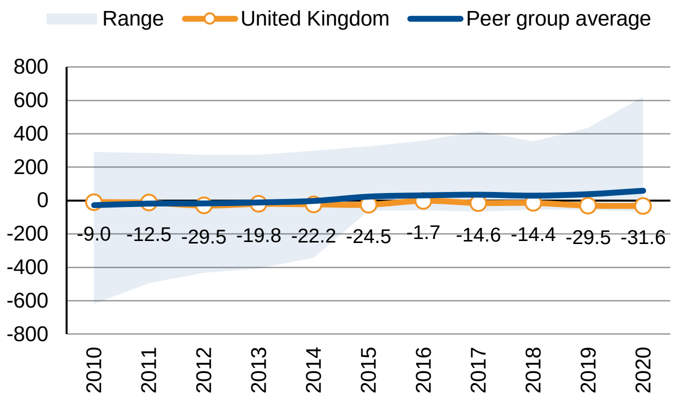
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b	Current account resilience	Weak	-1/3	Consistent current account deficit; weaker services exports may exacerbate external weaknesses, weakened net FDI inflows
	External debt structure	Weak	-1/3	Elevated external debt, with high foreign-currency composition
	Resilience to short-term shocks	Neutral	0	Sterling as a reserve currency shields against short-term external shocks

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

Net international investment position, % of GDP



Source: IMF, Scope Ratings GmbH

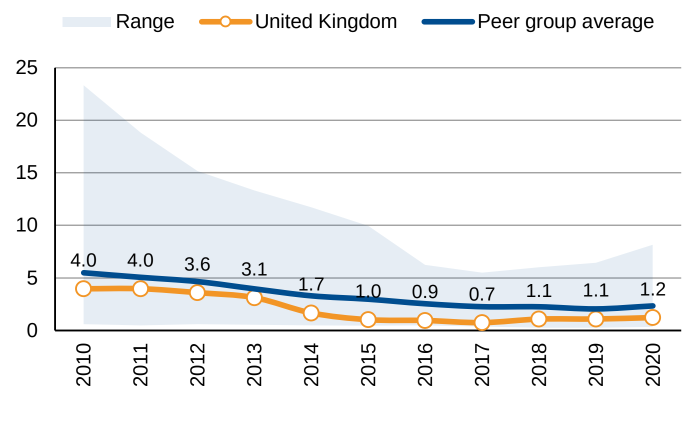
Financial Stability Risks

- **Banking sector:** The UK banking sector appears resilient with stable CET1 capital ratios that increased during the pandemic reaching 18.5% at the end of 2020. Robust liquidity positions and low levels of non-performing loans amounting to 1.2% of total loans allow the banking sector to continue to provide financing to the economy. While profitability declined at the onset of the pandemic, it recovered quickly, reflecting strong investment banking revenues and the partial release of provisions held for expected credit losses in 2020 that did not materialise. In response to the pandemic, the Bank of England's Financial Policy Committee lowered the counter-cyclical capital buffer rate to 0% until at least December 2021.
- **Private debt:** Private-sector debt was high overall, at 245% of GDP, especially for households (167% of GDP), as of end 2020. However, household finances appear resilient, with most that had taken payment deferrals returning to full repayments. The share of households with high debt-servicing burdens reached 1.4% in March 2021, above pre-pandemic levels but lower than 2.7% in 2007. UK corporate debt vulnerabilities have increased modestly, particularly among SMEs. Fiscal support helped to contain a significant increase in insolvencies, although some financial vulnerabilities are likely to materialise as government support is withdrawn.
- **Financial imbalances:** Asset valuations in some markets are elevated and the proportion of issued corporate bonds with high yields is currently at its highest level in the past decade while underwriting standards have loosened. House prices reached their highest level in over a decade during H1 2021. However, the Office for Budget Responsibility expects annual price rises to fall from almost 11% in Q2 2021 to 0.5% by mid-2023 as temporary factors that drive prices higher are expected to fade, bringing the house price/earnings ratios back to around pre-pandemic levels.

Overview of Scope's qualitative assessments for United Kingdom's *Financial Stability Risks*

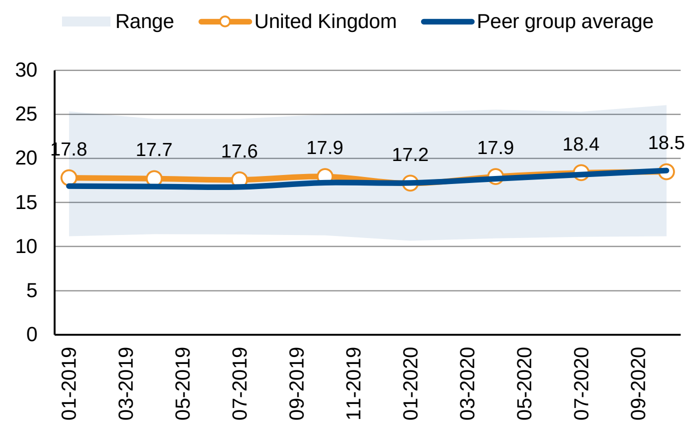
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Banking-system capitalisation remains sound, low NPLs, good profitability
	Banking sector oversight	Strong	+1/3	Sophisticated financial-regulatory system and strong macro-prudential governance framework
	Financial imbalances	Neutral	0	High private debt levels, high asset valuations and evidence of increased risk-taking in financial markets

Non-performing loans, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

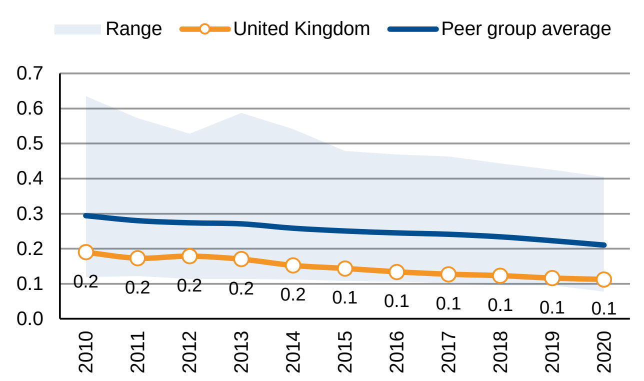
ESG Risks

- **Environment:** The UK committed to reach net zero carbon emissions by 2050. According to the Department for Business, Energy and Industrial Strategy, greenhouse gas emissions decreased by 48.8% between 1990 and 2020, while 43.1% of total electricity was generated from renewable energies in 2020. Further investments are needed in the electrification of the railway system to reduce transport-sector emissions, as well as in the renewal of the UK housing stock with a view of improving energy-efficiency. In terms of domestic energy efficiency, the Government set a new target in 2021, aiming to reduce domestic CO2 consumption by 75-80% compared to current levels by 2025. The UK is vulnerable to the effects of climate change, and specifically flooding and risks to health from high temperatures (economic losses due to climate-related natural disasters was estimated at GBP 54bn over 1980-2019).
- **Social:** The UK compares favourably to most other countries on the basis of high labour force participation (around 79% of the active labour force). Challenges relate to moderate levels of income inequality and an ageing society, with the UK's old-age dependency dynamics comparing poorly internationally although favourably compared to many EU member countries.
- **Governance:** The UK benefits from mature institutions under parliamentary democracy, although its governance quality has weakened since the 2016 EU referendum with regulatory policies being subject to increased uncertainty outside the EU. International and domestic political tensions related to Brexit are likely to persist.

Overview of Scope's qualitative assessments for United Kingdom's *ESG Risks*

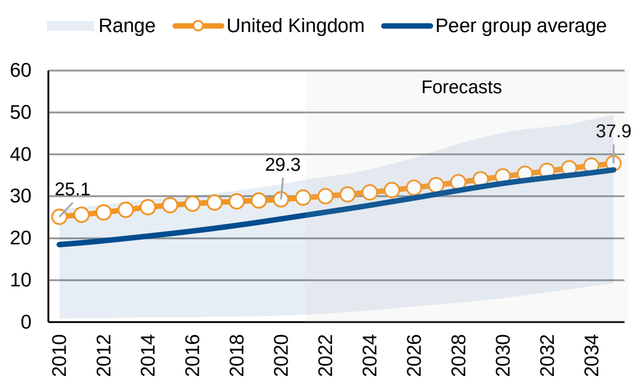
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Environmental risks	Neutral	0	Ambitious commitment to carbon neutrality by 2050
	Social risks	Neutral	0	Relatively favourable demographics; challenges include income inequality and the risk of social exclusion
	Institutional and political risks	Neutral	0	Resilient institutional framework, but ongoing domestic and international Brexit-related challenges

CO2 emissions per GDP, mtCO2e



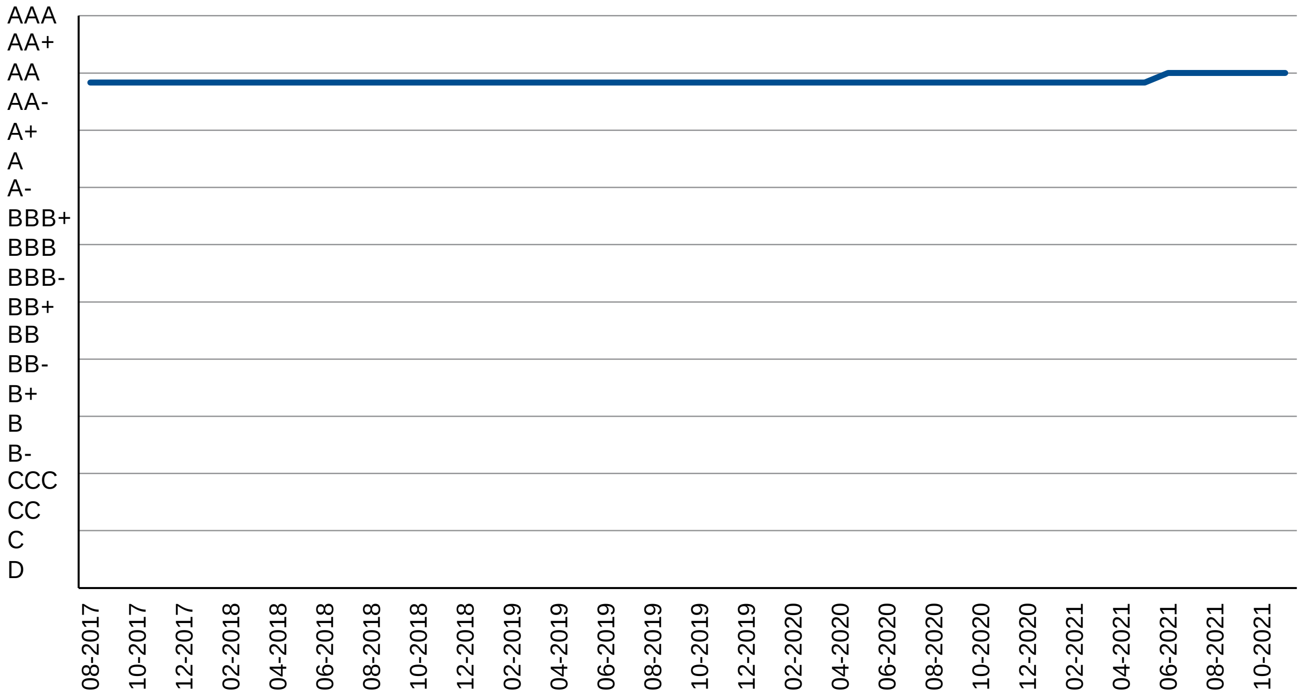
Source: European Commission, Scope Ratings GmbH

Old Age Dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per our Core Variable Scorecard (CVS).

Peer group
Belgium
Czech Republic
Estonia
Latvia
Lithuania
Poland
Slovenia
United States

Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators[1]

	2016	2017	2018	2019	2020	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD 000s'	41.2	40.3	43.1	42.4	40.4	46.2	50.9
Nominal GDP, USD bn	2703.2	2664.7	2861.0	2833.3	2709.7	3108.4	3442.2
Real growth, %[1]	1.7	1.7	1.3	1.4	-9.8	6.8	4.6
CPI inflation, %	0.7	2.7	2.5	1.8	0.9	2.2	2.6
Unemployment rate, %[1]	4.9	4.4	4.1	3.8	4.5	4.6	4.2
Public Finance Risk							
Public debt, % of GDP[1]	86.8	86.3	85.8	85.2	104.5	108.5	107.5
Interest payment, % of government revenue	4.4	4.9	4.5	3.8	3.0	3.2	2.7
Primary balance, % of GDP[1]	-1.7	-0.6	-0.6	-0.9	-11.4	-10.8	-4.6
External Economic Risk							
Current account balance, % of GDP	-5.4	-3.8	-3.7	-3.1	-3.7	-3.4	-3.4
Total reserves, months of imports	1.5	1.6	1.7	1.7	2.2	-	-
NIIP, % of GDP	-1.7	-14.6	-14.4	-29.5	-31.6	-	-
Financial Stability Risk							
NPL ratio, % of total loans	0.9	0.7	1.1	1.1	1.2	-	-
Tier 1 ratio, % of risk weighted assets	16.9	17.1	17.9	17.9	18.5	-	-
Credit to private sector, % of GDP	132.1	134.2	134.6	133.5	146.4	-	-
ESG Risk							
CO² per EUR 1,000 of GDP, mtCO²e	133.9	127.1	123.0	115.9	112.1	-	-
Income quintile share ratio (S80/S20), x	5.9	6.2	-	-	-	-	-
Labour force participation rate, %	77.2	77.4	77.7	78.0	-	-	-
Old age dependency ratio, %	28.3	28.5	28.8	29.0	29.3	29.7	30.0
Composite governance indicator[2]	1.4	1.4	1.4	1.4	1.3	-	-

* Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, UN, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 10 December 2021	10.1

[1] This table presents a selection of the indicators (24 out of 29) used in our quantitative model, the Core Variable Scorecard.

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