Sovereign Outlook 2017: Turbulent Politics and Troubled Public Finances

Scope Ratings

Scope Ratings' outlook for 2017 for large EU sovereigns, which includes Germany, France, Italy, Spain and the UK, reflects the common challenges these countries are facing. Except for Germany, there is a lack of deleveraging in the public sector. Furthermore, subdued and non-inclusive economic growth, and political movements that are simultaneously populist, anti-austerity, anti-establishment, anti-immigrant and anti-EU, are pushing established political parties towards anti-reformist and nationalist policies. This makes progress in structural reforms, which are necessary at national level, within the EU and among euro area institutions, increasingly uncertain. Scope expects that policy response will remain mostly confined to monetary policy, and aid from the fiscal side will be marginal. This leaves the large EU sovereigns, except for Germany, ill-prepared for the next downturn, as their capacity to stimulate the economy during the next crisis is significantly impaired.

Outside Germany, deleveraging in the public sector has stalled

In the eighth year after the economic crisis, larger EU economies still see public debt rising (Figure 1). By the end of 2016, we expect the average public-debt-to-GDP ratio for France, Italy, Spain and the UK be at 105.5% up from only 60.4% at the end of 2007. We see no reasons to expect improvement in 2017: on the contrary, we estimate that public debt on average will climb to 106% of GDP by the end of the year.

The larger EU economies will continue to run budget deficits in 2017, with headline budget deficits falling behind the targets set in the 2016 medium-term stability programmes (Figure 2). The gap, though, differs from 0.2% in France to 0.9% in Spain. Large EU countries find it hard to cut welfare-related expenditures, both at the sovereign and sub-sovereign levels. A gap similar to that of Spain is shown by the UK. We expect the UK, which has been successfully reducing its large budget deficit in the post-crisis years, to reverse its course in order to provide a fiscal stimulus and to offset the likely slowing of the economy that should be hampered by uncertainties associated with the country's withdrawal from the EU.

Germany stands out among the larger EU economies. It is the only country that has been able to reverse its public debt trend and make it go downwards despite subdued GDP growth. The main reason is the balanced budget policy that the country has been pursuing since 2014. Continuous German divergence from the other large EU economies in terms of public debt could, in our opinion, contribute to Germany taking a tougher stance regarding monetary union member states that are not compliant with the EA fiscal rules, as well as towards the current set of ECB monetary policies.

Moreover, excluding Germany, the reality that there will be no deleveraging of public balance sheets in the eighth year after the financial crisis shows that the sovereigns are at best ill-prepared for the next downturn. Their capacity to stimulate the economy during the next crisis will be significantly be impaired as a result.

Analysts

Dr Ilona Dmitrieva (author)
+44 20 34570 445
i.dmitrieva@scoperatings.com

John Francis Opie
+49 69 97944 752
jf.opie@scoperatings.com

Alexandre Jeanjean-Récamier
+44 20 34504 444
a.jeanjean-recamier@scoperatings.com

Head of sovereigns

Dr Stefan Bund
+49 30 27891 258
s.bund@scoperatings.com

Investor Outreach

Michael Pinkus
+49 30 27891 146
m.pinkus@scoperatings.com

Scope Ratings AG

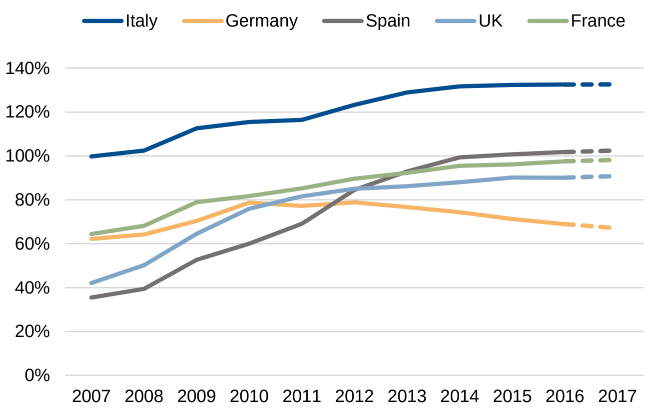
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

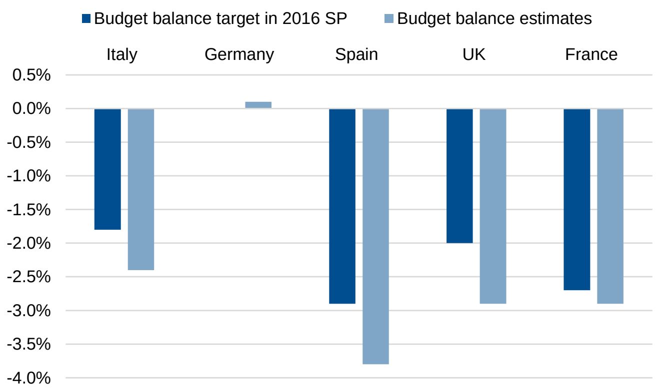
Bloomberg: SCOP

Figure 1: Evolution of public debt in some EU countries (gross general government debt/GDP, %)



Source: Eurostat, Scope estimations

Figure 2: Estimated budget balances for 2017 vs targets in 2016 stability programmes



Source: Eurostat, EC forecasts, Scope estimates. The UK data comes from the 2016 convergence programme

Subdued and non-inclusive economic growth

We see 2017 as another year of subdued economic growth. Among larger EU economies, Spain is likely to continue to be the best performer in terms of GDP growth. We expect its GDP to grow at 2.2% in 2017 vs around 1.1% on average for France, Germany, Italy and UK. In the past, Spain's higher performance was mostly the result of the relatively quick repair of bank balance sheets, significant deleveraging of the private sector and sharp downward adjustment of wages and salaries, which boosted the country's competiveness on world markets. The effect of these factors is fading now, with GDP growth slowing as a result. The UK had grown robustly (albeit only in comparison to other advanced economies) in 2014-2015 and is still expected to show a growth rate of around 2% in 2016. However, its growth is likely to dive to just 1% in 2017 because of Brexit-related uncertainties.

Subdued economic growth is a result of both common and country-specific structural issues

The subdued growth we are seeing in these countries is due to common structural problems, such as population ageing, unsatisfactory labour productivity and inequality in both income and wealth, as well as various country-specific factors. For instance, Germany, one of the most open economies in the broader EU, feels the elevated geopolitical risks endangering the back bone of its economy, export industries. In contrast, France, Italy and Spain are struggling to tackle rigidities in their labour markets and services sectors. Deleveraging in the private sector in the UK and Spain has made good but insufficient progress in the post-crisis years and can still weigh on their GDP growth. The UK's vote to leave the EU exposes its economy to distinctly high uncertainty about future trade arrangements with EU countries, which will weigh heavily on household and business confidence in 2017, resulting in lower growth in consumption and investment.

We see this trend of subdued economic growth extending far beyond next year and are increasingly considering it as the 'new norm'. Despite a long-term trend of subdued economic growth, certain temporary factors, such as falling energy costs, can provide a boost to economic growth. This happened in 2015 and remained so, albeit to lesser extent, in 2016. In 2017, however, we expect a gradual fading of the positive impact of low energy prices (which have recently firmed up and are starting to edge up again, albeit not to recent highs) and of the weaker euro (which has helped European exporters in the past). However, factors supporting growth in 2017 are set to include the continued accommodative monetary policies of the ECB as well as a de facto slightly expansionary

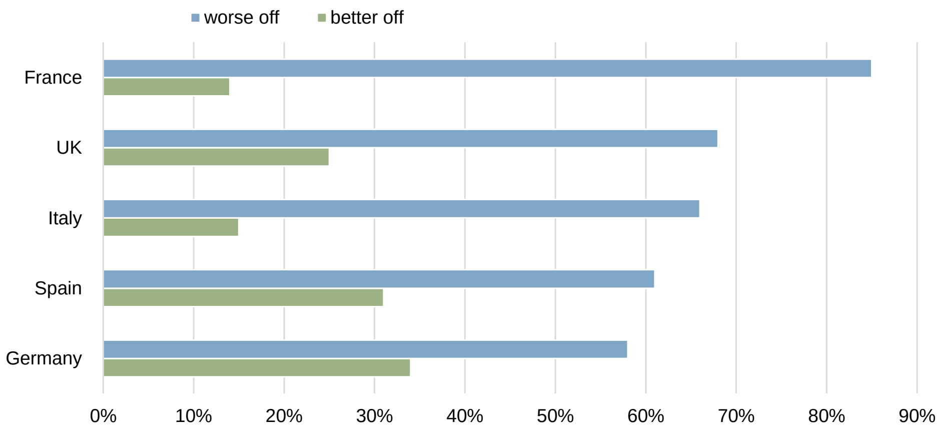
Table of Content

fiscal stance in the EA due to the fact that a number of Mediterranean countries are either avoiding or disregarding budgetary rules.

Low economic growth is combined with rising inequality

We note that subdued economic growth is accompanied by rising inequality in both income and wealth distribution, or, in other words, economic growth has become less inclusive for a significant part of population, who have not seen any real improvement in their living standards. This development is common to all larger EU economies. Even if one were to discount any hard data on the evolution of Gini coefficients[1] in each country (which often lags the current data by several years), soft data, capturing peoples' perception of how their wellbeing is evolving, tells a compelling story. According to the Pew Research Center, a Washington-based think-tank conducting opinion polls and demographic research, 56% of parents in Germany and 62% of parents in Spain believe that their children will be financially worse-off during their lifetimes. France leads the league with the overwhelming majority being pessimistic about the future of their children (Figure 3). Subdued and non-inclusive economic growth has become a feature of post-crisis development, which, in our view, is going to be more marked from 2017 onwards.

Figure 3: Perception of future living standards in selected EU countries, %



Source: PEW

Structural reforms and stability of the EA institutions are challenged by political dynamics

We see a strong link between low and non-inclusive economic growth and elevated political risk, which manifests itself in two trends: (i) rising popular support for euro-sceptic, anti-immigrant, anti-austerity and anti-establishment parties, and (ii) a policy shift of established and more centrist parties aimed at capturing voters who share some of this sentiment. This trend bodes ill for the pace of structural reforms that are vital for the majority of large EU economies and the stability of the EU and especially EA institutions.

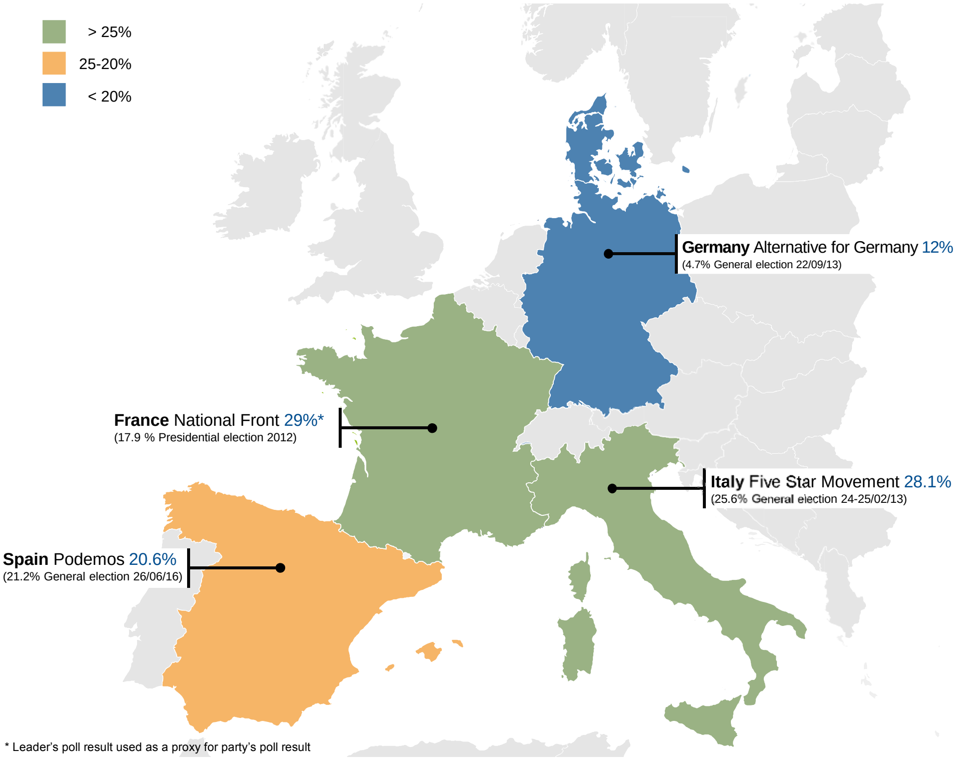
Rising voter support for populist parties

We note an increased probability of radical changes to the political makeup in Europe, with fringe political parties now apparently at the cusp of gaining significant success at elections and hence gaining electoral representation or mandates that bring them closer to power in 2017. Specifically, national elections in France and Germany are likely be confronted with this development. In France, the National Front's candidate for the presidency, Marine Le Pen, looks increasingly likely to reach the second round of the election in May. In Germany, the elections in October 2017 for the Bundestag seem at this point set to provide the Alternative for Deutschland (AfD), a right-wing and anti-

1 Gini coefficients measure statistical dispersion intended to represent the income or wealth distribution of a nation's residents. They are the most commonly used measure of inequality. A Gini coefficient of zero expresses perfect equality, while a coefficient of 1 (or 100%) expresses maximal inequality. Scholars have devised over a dozen variants of the Gini coefficient.

immigrant party, with enough seats to at least demand to be included in talks to form a governing coalition. In all these cases, these fringe parties have in common a fundamental questioning of the basic tenets and freedoms on which the EU is based (particularly the free movement of labour), as well as a sceptical attitude towards the euro.

Figure 4: Support for populist parties



Source: electograph.com, NC Report, Emnid, Ifop, Fiducial, Ixe
Notes: Polling timing: France 17/11/16, Spain 19/11/16, Germany 26/10/16, Italy 21/09/16
Sample size: around 1000 except for Germany: 1840

The minority government in Spain could soon face problems with opposition parties, which the government relies on in a case-by-case manner, to agree to the continuation of structural reforms. Should a political impasse evolve and remain, early parliamentary elections could no longer be ruled out, with the populist party Podemos and regional separatist parties potentially gaining strength. The 'no' vote in the upcoming Italian referendum on constitutional changes scheduled for the 4 December 2016, could well lead to a caretaker government until the 2018 elections. The 2018 elections, which are likely to be held under the new election law that gives an outright victory to the party with the largest number of votes (but not less than 40%), could bring the Five Star movement, a clearly anti-establishment party, to power.

.. while centrist parties shift their policies

The shift of a centrist, established political party towards policies formerly seen as belonging to the fringe is already evident in the UK. Anti-immigrant and euro-sceptic stances are now key components of the political platform of the ruling Conservative party, which is navigating the withdrawal of the country from the EU after the Brexit vote. The negotiations between the UK and the EU for this exit, which are expected to start next year, could work as a catalyst for calls for a revision of EU and EA institutions. In fact, calls for a re-invention of the EU, either via a new treaty or new treaty chapters, are coming already from the French centre-right Republican party, which is currently the front-runner for the 2017 presidential elections. Leaders of the EU bodies have taken a very defensive stance against any calls for change and the demands of the UK, but this stance may not be sustainable.

EA fiscal policy: supportive short-term, but not accommodative enough in the longer term

We expect that the broadly neutral or even slightly expansionary fiscal policy in EA in 2017 will support the economic recovery, rather than restrict it, as occurred from 2011 to 2014. However, we do not consider changes in fiscal policy to be of sufficient magnitude to remove reliance on monetary policy to revive EA-wide aggregate demand for next year and beyond. The aggregate fiscal stance hides significant differences between countries: it is expansionary for countries with high and rising debt (which is a de facto breach of prior commitments), but is neutral or even slightly contractionary for countries with declining debt. As a result, expanding EA aggregate demand is being undertaken by those countries with tighter fiscal space, resulting in an absence of deleveraging of their public sectors, with far-reaching negative consequences for their sovereign creditworthiness.

EA fiscal framework contributes to the lack of public sector deleveraging

In our view, the main problem is the current design of the EA fiscal framework. It rests on a set of complicated rules with limited scope to promote fiscal stabilisation, especially at the EA level, calling their efficiency into question. The complexity of the rules comes from the dual definition of the budget balance.

The first definition is the one prescribed in the Maastricht treaty: the budget deficit must be below 3% of GDP. The second is a structural budget balance, which excludes the impact of the economic cycle and one-off fiscal measures from the headline budget balance. Other rules include a 60% threshold on gross public debt and a set of regulations prescribing the way non-compliant countries should balance their budgets to achieve both debt and budget-balance thresholds.

In our view, the efficiency of these rules is questionable because they rely heavily on structural balance calculations, which are estimated by the IMF, the OECD and the European Commission with a noticeable degree of variation, evidencing drawbacks in their methodologies. Moreover, structural budget calculations for previous years are at times subject to major revisions as time passes, undermining both the accuracy and relevance of recommendations on fiscal policy issued by the European Commission. Finally, and most importantly, these strict rules are meant to be imposed on individual EA member countries with no view of aggregate fiscal balances and aggregate demand in the EA as a whole, with no formal mechanism of obligation to examine the possibility of any room for some deficit expansion above limits in one or more countries to offset near-zero deficits or even surpluses in other countries (for further discussion on this topic, see 'Can Fiscal Policy Revive Economic Growth in the Euro Area?')

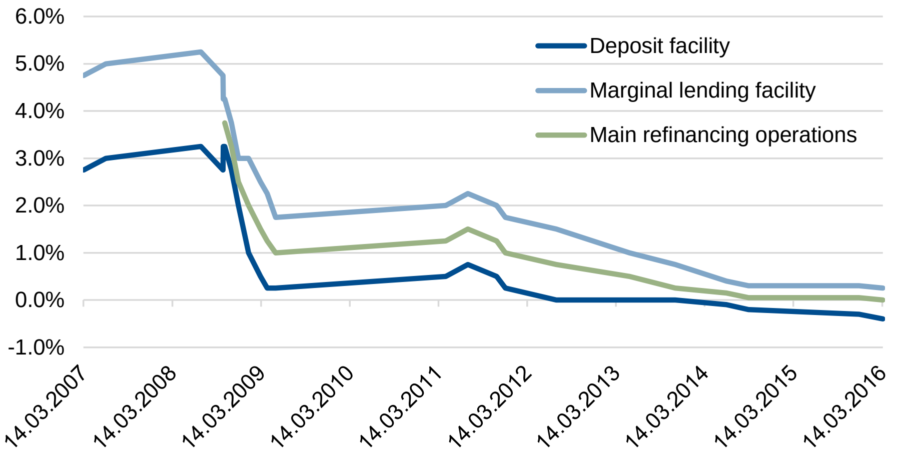
Overstretched monetary policy brings additional risks

With the risk that the pace of various structural reforms in larger EU countries will become slower and that there will be effectively very limited support from fiscal policy, we see little alternative to the continuation of ultra-accommodative monetary policy in 2017 and beyond. The problem here is that such monetary policies are running increasingly at the limits of their effectiveness and have negative consequences for the credit risks of sovereigns.

The ECB monetary policy is close to its limits

Key policy interest rates in the EA, some neighbouring countries, and Japan have undercut the zero rate that was previously thought of as an absolute lower-bound (Figure 4). Further, a number of market commentators believe even deeper negative rates are acceptable. Our view, however, is that there is a limit to monetary policy and its limit increasingly seems to have been reached, putting the efficacy of such policies into question. In an attempt to effectively influence markets, the ECB has had to keep widening the scope of asset purchase programmes to include many different types of securities, and is now contemplating moves that may incur significant moral hazard, such as buying debt securities issued by banks that are supervised by its regulatory branch.

Figure 5: Change in European Central Bank policy rates



Source: ECB

The ECB's accommodative policy has mixed results

In any case, ultra-accommodative monetary policies have had, at best, mixed results in the larger EA economies. On the one hand, by suppressing yields on sovereign bonds through such asset purchase programmes, those policies have widened the EA sovereigns' 'fiscal space', i.e. their ability to increase expenditure or reduce revenues without undermining fiscal sustainability or bond market access. Indeed, EA sovereigns were able to launch some growth-friendly measures, such as tax credits for business in France and Italy, as these sovereigns enjoy rapidly diminishing costs of servicing their rising debt levels. On the other hand, the ECB's policy exposes governments and long-established private corporations to risks associated with rising pension obligations, with risks rising largely due to the defined benefit principle, where pension providers are taking the interest rate risk. Other risks arise from the weak profitability of the banking sector and the negative impact on banks' ability to lend, which eventually could backfire on the EA sovereign's credits (for discussion on the outlook on the banking sector, see 'European Banking Outlook for 2017 and Beyond: Balance Sheet Safety vs Profitability Challenges'). Thus, there are now important reasons to raise serious questions about the effectiveness of current monetary policies.

Nevertheless, there are major reasons for the likely continuation of current monetary policies, including an extension of the asset purchase programme (that was set to taper from March 2017). These are the continuation of very low inflation rates, which significantly undershoot the ECB's target of 2%, and of market volatility. In turn, the sources of market volatility include political components. Those could be policy surprises following the US presidential election and developments that could derail any necessary reforms, such as post-referendum disruptions in Italy, teetering of governments in Spain, and electoral outcomes in France and Germany.

Germany

In Scope's view, Germany will continue to exhibit exceptionally strong sovereign credit in 2017. This assessment is based on a wealthy and well-diversified economy, the biggest in the EA and fourth in the world. The country's net creditor position with one of the highest current account surpluses worlwide also indicates its relative indepedendence from external financing and market sentiments. We expect Germany's net creditor position to strenghten further next year, thanks to a continuously high current account surplus.

Exceptionally strong credit that could be negatively affected by the political sphere

Compared to similar advanced economies, the sovereign has moderate levels of public debt, which we expect to fall to about 67% of GDP by YE 2017, compared to 71% at YE 2015. The debt ratio improvement is due to a budget that the government has preliminarily approved in 2017, complying with the national 'debt brake' rule. The rule prescribes to keep the federal budget deficit no higher than 0.35% of GDP and run balanced budgets for German Laender starting from 2020 (all in structural terms). The government's expectations of budget balancing are credible, given conservative assumptions both for GDP and inflation for 2017. Germany enjoys one of the lowest funding costs and its long-term debt obligations are trading at negative rates.

Next year's GDP is likely to perform at the EA average level; although, compared to the previous year, it is expected to ease slightly, being affected by a weak external demand of the country's main trade partners (China, the UK, EA countries). Among the larger EU economies, Germany's economy is the most vulnerable to any slowing of global trade trends. We note that the slowdown in economic growth is a medium-to-long term trend driven by worsening demographics, sluggish investment and productivity trends. In sharp contrast to other larger EU economies, the economic slowdown will not prevent the country from reducing further its public debt.

The country's strong fundamentals could however be negatively affected by the political sphere. The general elections scheduled for the second half of 2017 will be held in the face of declining support for the ruling coalition and rising support – as shown by recent elections in a number of regional parliaments – for the Alternative for Deutschland (AfD) party. Based on recent polls, AfD is highly unlikely to take power in the 2017 national elections, but any participation in the coalition could make growth-oriented reforms in Germany, as well as EA-wide reforms more difficult to design and implement.

France

In Scope's view, France will continue having a very strong sovereign credit in 2017. This assessment is supported by a wealthy and a highly diversified economy, moderate levels of private indebtedness, limited external vulnerability and healthy demographics with a growing labour force. The latter distinguishes France from other major EA economies. France enjoys one of the lowest cost of debt funding and its long-term debt obligations are trading at negative rates. The strength of the sovereign is, however, weakened by relatively rigid markets for labour, goods and services, an overextended public sector, which has generated high and growing debt, as well as by institutional and political hurdles in implementing structural reforms.

Very strong credit with no improvement in public debt levels next year

We do not expect improvement in the country's public debt next year. On the contrary, its public debt-to-GDP is likely to increase to around 98% as a result of a budget deficit (of almost 3%), stubbornly low inflation and modest GDP growth, which is unlikely to surpass the 2016 level. We attribute low economic growth to a mix of structural problems, in particular: i) an overregulated service sector, ii) high tax burdens, and iii) inflexible labour markets. Insufficient restructuring of the latter manifests itself in modest job creation and a historically high employment rate, which we expect to remain at 10% or more next year.

Following the parliamentary adoption in 2016 of the French labour code reform, which should contribute to more labour market flexibility, we do not expect any major reforms before the upcoming presidential elections scheduled for May 2017. However, a possibility of continued reforms exits, should a presidential candidate from the centre-right party Les Républicains, who currently leads the polls, win next year. The Républicains are calling for higher pension age, more flexible labour market (beyond the recently adopted labour code) and a sharp reduction in public spending.

The upcoming presidential elections will determine the future of structural reforms

Although this set of reforms would be highly beneficial for the French economy, reform implementation risks should not be underestimated. Indeed, the ruling Socialist party had to rely no less than three times on Article 49-3 of the French Constitution, which allows the government to pass a bill through the parliament without a vote. The Républicains are also calling for a re-invention of the EU, either through a new treaty or through new treaty chapters, which, among other things, could reduce the compentencies of the EU. The far-right National Front, with its political agenda based on trade barriers, abolishing of the euro and large-scale public intervention, is polling strongly at present, making its leader a realistic presidential candidate. Her chances of winning in the second round (her strong polling still does not guarantee victory in the first) could be limited, though not negligible.

Italy

We believe that Italy will continue to be a good quality sovereign credit in 2017. This assessment is supported by a large, wealthy and diversified economy, relatively low private indebtedness with high saving rates, especially for households, and limited external vulnerabilities. Italy enjoys low funding costs and its long-term debt is trading at negative rates. The sovereign credit is, however, weakened by very high levels of public debt; a banking sector overburdened with non-performing loans; overregulation in the labour market; and in the markets for goods and services, less vigorous economic competitiveness as well as government institutions still prone to political instability and worsening demographics.

Good quality sovereign credit is weakened by a very high public debt

We do not expect meaningful improvement in 2017 of the country's major area of weakness – very high public debt. It is likely to stay at around 132% of GDP, almost unchanged compared to our estimates at YE 2016. One of the reasons for this is the 2017 draft budget which would result in a budget deficit of 2.4%, again unchanged compared to 2016. This is an upward revision of the budget deficit target, set at 1.8% by the government's medium-term stability programme in April 2016. The revision is driven by cancellation of VAT hikes, which are supposed to cover growth-friendly budgetary measures, such as a cut in corporate income tax to 24.0% (from 27.5%) and additional spending on pensions for low-income retirees. Extra spending on refugees and post-earthquake reconstruction is another reason for a hike in the budget deficit. Other factors, in particular real GDP growth and inflation, which we expect to continue to be weak in 2017 compared to 2016, will provide little help in improving Italy's public debt level.

Whether Italy's new budget deficit target will pass remains unclear and depends on the negotiations between the government and the European Commission. However, the fact that the country had already been granted considerable flexibility on budget deficit targets in 2016 bodes ill for the government's position.

Italy is fairly unique in that the country runs a budget deficit despite a primary budget surplus, a rare achievement for any major EA economy (with the exception of Germany). Italy's budget deficit is a function of exceptionally high debt service payments on substantial levels of public debt that have accumulated over many years. The country's budget deficit is very dependent on the continuation of the ultra-accommodative policy of the ECB, which has helped to substantially improve the country's debt affordability metrics.

Continuation of structural reforms will depend on the results of the constitutional referendum

In our view, the continuation of vitally important structural reforms, which have made progress in labour-market and judicial-system reforms, will depend on results of the constitutional referendum scheduled for 4 December 2016. A 'yes' vote would speed up legislative processes and therefore contribute positively to both the adoption and implementation of structural reforms. Taking into account recent polling results, however, the 'yes' result is far from guaranteed. A 'no' vote would likely lead to a caretaker government until the 2018 elections, which would have low appetite to launch radical reforms before the elections.

Finally, there are some signs of improvement in the balance sheets of Italian banks from the cleaning up of a significant amount of impaired loans, aided by i) economic recovery over the last two years, ii) judicial reforms, especially related to bankruptcy and foreclosure processes, iii) institutional measures such as guarantees on senior tranches of securitised bad loans and iv) the establishment of the banks rescue fund, Atlante. The continuation of economic recovery in 2017, coupled with institutional reforms, should contribute to further improvement in the banking sector balance sheet repairs unless market volatility negatively affects the sector, as happened in 2016.

Spain

In Scope's view, Spain will continue to be a good quality sovereign credit in 2017. This assessment is supported by a relatively wealthy economy, strong post–crisis economic performance and successful re-balancing of the economy away from the real estate sector, as well as a good track record of private sector deleveraging, labour market reforms and the repair of banking sector balance sheets. Spain enjoys a low cost of debt funding and its long-term debt is trading at negative rates. The sovereign position, however, is weakened by high levels of both public and private sector debt, persistently high budget deficits, a weak external position, stubbornly high unemployment rates with significant structural component, an overregulated professional services market, as well as government institutions prone to political instability and, finally, worsening demographics.

Good quality credit with best performing economy but still rising public debt

We do not expect improvement in the public debt level in 2017, which is likely to reach as high as 102% of GDP by YE 2017. This is in spite of a strong pick-up in economic growth since 2014, which is expected to continue in 2017, albeit at a slower pace than in 2016, largely due to slowing domestic demand and weak external demand. GDP growth in 2017, however, is still going to be one of the strongest in the EA. The main reason for a debt increase is a persistently high budget deficit, which exceeds the country's GDP growth rate. Despite a two-year extension granted by the European Commission last year to meet the Maastricht 3% budget deficit threshold and the low cost of funding of sovereign debt, doubts remain that Spain will meet the revised target of 4.6% of GDP in 2016, mainly due to some regions' slippage in keeping budget balances.

A minority government does not bode well with the continuation of structural reforms

Another reason for the relative lack of budgetary discipline is political: Spain went through almost 10 months of political turmoil and two inconclusive elections, ending in the re-appointment of the People's Party leader, Mariano Rajoy, as prime minister at the beginning of November 2016. He heads a minority government made up of the centre-right People's Party and the centrist Ciudadanos party. The coalition is seven seats short of a majority, which could prove difficult for the new government when it continues essential structural reforms. The opposition has already declared that its future initiatives, among other things, will include an unwinding of 2012 labour reforms approved by the People's Party, as well as changes to the budget stability law. Under these circumstances, it will be challenging for the government to keep up with 3.1% budget deficit target agreed with the European Commission for 2017, especially in the face of an economic slowdown and low inflation expected for next year. We cannot exclude that the minority government will fail to survive the full term.

United Kingdom

In Scope's view, the United Kingdom will keep its position as a very strong sovereign credit in 2017, but with softening trends. This assessment is supported by a dynamic, wealthy and diversified economy, flexible labour markets, a deep domestic capital market and the status of the sterling as a reserve currency. The sovereign credit, however, is weakened by a high, albeit diminished over the last several years, budget deficit leading to rising public debt levels, large current account deficits exposing the sovereign to risks related to continuous funding of the deficit, weak labour productivity and the compromised predictability of the government's policies following the Brexit referendum.

Very strong credit with softening trends triggered by the Brexit decision

Softening trends include an expected economic slowdown, potentially weaker public finances, as well as risks related to the continuous demand for funding of the country's large negative current account. We expect a softening of economic growth next year, driven by uncertainties for business and household confidence arising from implications for spending in the face of the still unclear and ill-defined path of the withdrawal from the EU. In our view, the depth of the economic slowdown will be determined by the nature and magnitude of future restrictions on access the EU single market, especially in regard to financial services, one of the main UK export industries. Failure to secure free access to the single market could lead to lengthy and unpredictable re-negotiations of trade agreements with EU partners, with a potentially negative impact on businesses and jobs.

According to the 2016 Autumn statement, the fiscal consolidation programme of the previous government, aimed at balancing the budget by 2020 is no longer on the agenda. Instead it was indicated that public finances would return to balance as early as possible. The current government plans to substantially raise public investment in transport and digital infrastructure and reduce corporate tax rates to support growth. These expenditure-rising measures are expected to be partially counterbalanced by additional revenue coming from a crackdown on tax avoidance and savings through the efficiency review announced at the 2016 budget. These measures are expected to result in a moderate reduction of the budget deficit in 2017 compared to the previous year. Budget deficit in 2017 combined with a slowdown in GDP will bring public debt to near 90% of GDP at YE 2017.

Difficulty in funding the country's large current account deficit, which we expect to be around 5.1% of GDP next year, could arise from further downward pressure on the British pound and foreign direct investment outflow. The former has depreciated sharply against the dollar and euro within just four months following the referendum. The latter could be triggered by diminishing investments in the UK financial sector, which until now has been one of the main sectors for foreign investors in the UK economy.

Scope Ratings AG

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Rüsterstraße 1
D-60325 Frankfurt

Phone +49 69 97944 754

Paris
21, Boulevard Haussmann
F-75009 Paris

Phone +33 1 53 43 29 89

London
Suite 407
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

info@scoperatings.com
www.scoperatings.com

Disclaimer