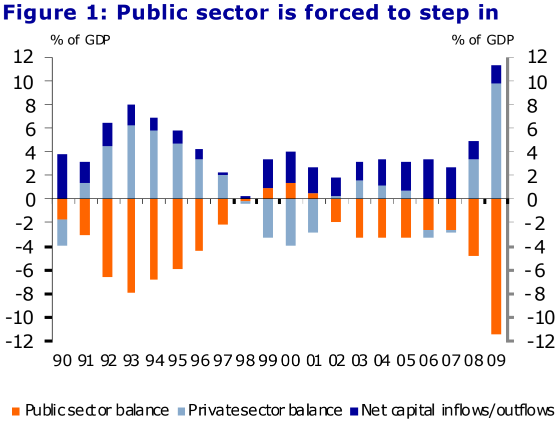
Is Britain the next Greece?

In our view, there are ten reasons why the UK will not go down the 'Greek path' anytime soon. But the new government must plug in its fiscal black hole if it wishes to retain its debt sustainability and its cherished AAA rating.

Private sector's frugality

There have been various versions of the 'Britain is the next Greece!' story out there. After all, the government's budget balance in 2009 (11.5% of GDP) was of a very similar magnitude to that of Greece (13.6% of GDP) and the public sector borrowing is clearly on an unsustainable path – the government borrows a pound for every four it spends. The reason for the massive deterioration in the UK's public finances is mainly due to the retrenchment in the private sector. Between 2007 and 2009, net saving –the gap between income and expenditure– of the UK private sector jumped by a massive 9.8% of GDP (see figure 1).

Figure 1: Public sector is forced to step in



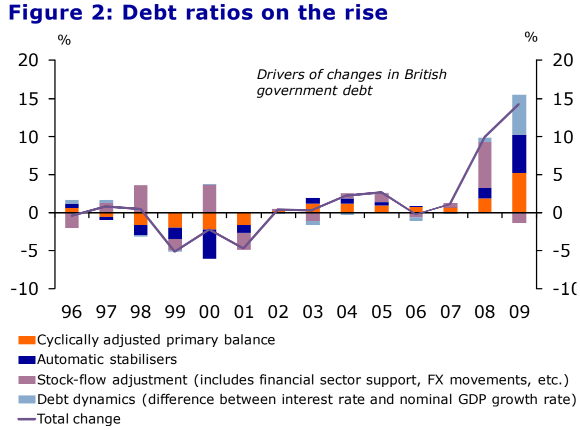
Source: Rabobank, Reuters EcoWin

Households were under immense pressure to repair their balance sheets in the aftermath of tighter credit conditions and the bursting of the housing bubble. And the resulting drop in gross operating income of non-financial companies (almost 9% in 2009) made British companies equally hesitant to spend/invest.

…led to profligacy in the public sector

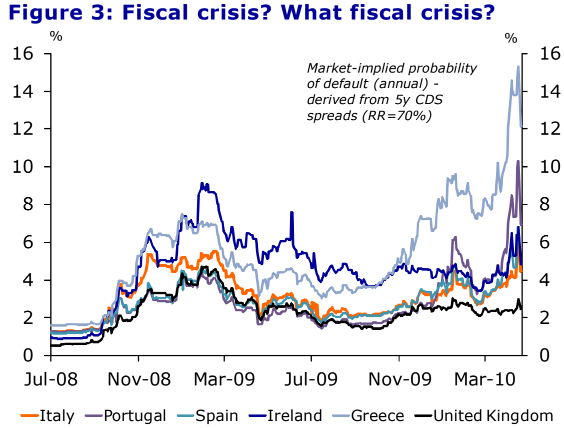
Since the net inflow of capital from abroad fell little, the principal offset to this shift towards frugality was the government's towards profligacy. Net government borrowing jumped by 8.6% of GDP between 2007 and last year. Quite understandably, the plethora of government measures alongside the operation of automatic stabilisers resulted in the spiralling of the public sector's debt ratio (see figure 2). And the pallid recovery going forward is bound to push the public sector debt ratio even higher in the coming years.

Figure 2: Debt ratios on the rise



Source: Rabobank, OECD

Figure 3: Fiscal crisis? What fiscal crisis?



Source: Rabobank, Reuters EcoWin

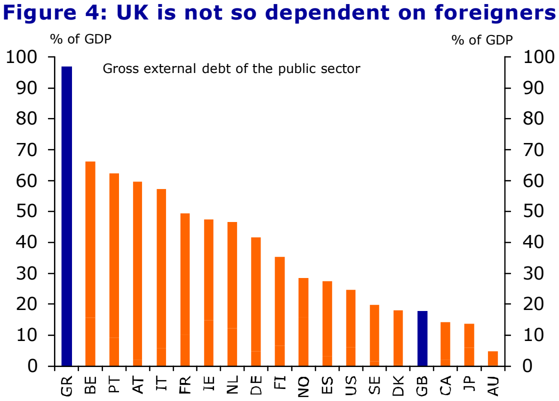
So it is somewhat surprising for many that the financial markets are still not expecting UK PLC to face difficulties in servicing its debt. The country has remained strikingly untouched by the contagion effects hitting the periphery (see figure 3). The question is, therefore, whether we should believe the markets (i.e. the UK will face no difficulty in repaying its debt) or must we start worrying that the UK could eventually go the way of Greece? We believe the markets are right if one focuses on the short run.

Nowhere near Greece, yet

More concretely, we believe there are ten reasons why the country is less likely to share the same as fate as Greece. The UK:

1. ***need not rely as much on the 'footloose' foreign investors for financing its debt obligations.*** External debt accounts for 18% of GDP compared to 97% in Greece (see figure 4).

Figure 4: UK is not so dependent on foreigners

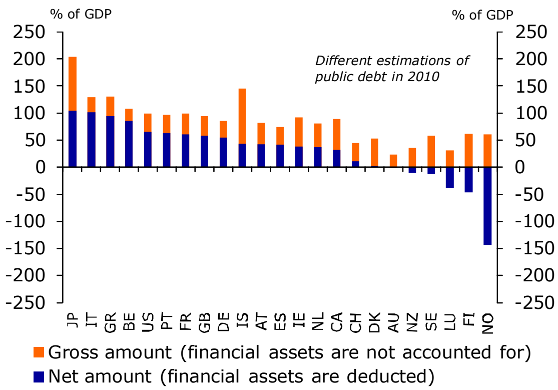


Source: OECD, WB, IMF, BIS

2. ***will not immediately run into difficulties in rolling over its debt.*** First, the weighted average maturity of the UK public debt is nearly 13½ years, compared with 8 for Greece at the end of last year. Second, demand for gilts remains strong because they are still deemed as a safe and liquid asset class. Indeed, sterling assets still *benefit* along with the core eurozone countries from safe-haven flows amid return of risk aversion in the financial markets.
3. ***will face fewer problems in servicing its debt.*** Public debt is more affordable in the UK because net interest payments account for less than 5% of total budget revenue – as opposed to over 9% in Greece. As such, only a sharp rise in gilt yields for a prolonged period will bring the costs of debt servicing close to that of Greece.
4. ***has credible budget statistics.*** As opposed to the Greek government that suffers from a 'credibility deficit', the financial markets do not question the official figures in the UK.
5. ***is not facing massive ageing-related expenditures.*** According to the project-tions of the European Commission (EC), the ageing-related expenses for the UK will be much less (20.3% of GDP) than Greece (25.2% of GDP) within 10 years.
6. ***has a better track record.*** The country has shown throughout history that it is highly reluctant to opt for the default option. The last time the government de-faulted on its external debt was in 1594. Its status as the *de facto* financial centre of Europe will also make it think twice before pushing the default button given that the reputational cost far outweighs the benefits of not repaying the creditors. The last thing the UK government wants is an exodus of bankers towards Paris or Frankfurt. Greece, on the other hand, has less reasons to go through the painful austerity measures and its poor track record –defaulting five times over the past two centuries on its external debt alone– is not comforting the markets.
7. ***is far less indebted.*** Net financial liabilities of UK's public sector (47% of GDP), which is an indeed a better measure of a country's indebtedness than gross debt because financial assets are accounted for, is still a far cry from Greece's (86.1% of GDP). Even if we look at gross debt ratio, the UK's fiscal position looks in better shape (see figure 5). Mind you that much of the rise in UK's debt ratio was support for the financial sector, which will eventually be largely repaid

by banks. However, in the case of Greece, the increase in the debt stock is entirely attributed to falling GDP growth, rising interest rates and budget deficits.

Figure 5: Greece's debt is just too large



Source: Rabobank, OECD

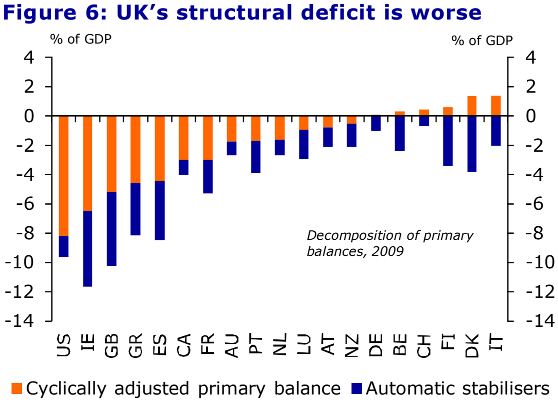
8. ***can benefit from having an independent central bank.*** Monetisation of public debt is risky because it will eventually undermine the central bank's independence and inflation fighting credibility. But as the saying goes, desperate times require desperate measures. Amid market panic and drying up of liquidity, a central bank may resort to money printing in order to act as a buyer-of-last-resort. The opportunity to carry out quantitative easing may have a positive confidence effect on the markets. As the former U.S. Treasury Secretary, Hank Paulson, famously said: *"If you have a bazooka in your pocket and people know it, you probably won't have to use it*''. In this regard, market participants will ask for lower interest rates if they know such 'nuclear' option is on the table. Indeed, the Bank of England (BoE) has so far purchased roughly GBP 200bn worth of the British government bonds, accounting for almost a 25% of debt outstanding. The ECB, which until recently remained reluctant to follow suit, also decided to purchase government bonds. But it may be *unwilling* to purchase a quarter of Greek government debt (amounting to EUR 80bn) since it might be forced to do the same for the rest of the periphery countries, which would increase the total potential purchase to an eye watering EUR 760bn.
9. ***can benefit from the depreciation of the exchange rate.*** The fact that the UK has its own exchange rate is actually a blessing for the government during these tough times. Remember, much of the Greek government woes stem from the loss of competitiveness in the global marketplace. Unit labour cost (ULC) in the country rose by 50.3% over the past decade amid a rapid growth in real wages while Britain's ULC increased by around 20%. Given that Greece is in the euro straitjacket, it can only regain competitiveness by going through a very painful internal devaluation – real wages and prices have to drop – while UK's exporters can benefit from sterling's strong depreciation. Since January 2008, UK's trade-weighted exchange rate (adjusted for inflation) has depreciated by 17.6% – predominantly via sterling depreciation – even though Greece's appreciated by 2%. The floating exchange rate regime will also help the UK to keep deflation at bay. This is extremely favourable for the country because it lowers the risk of falling into a debt-deflation spiral.
10. ***will benefit from favourable stronger GDP growth***. After seeing GDP contract for six quarters in a row and decline 4.9% in 2009, the UK finally pulled itself out of recession in 09Q4. And we expect it to gain momentum in the coming months as exporters, spurred by a weak pound, hit their stride. Higher growth will reduce the fiscal adjustment pain for the UK because it leads to (i) an automatic increase in tax revenues and a drop in social security payments (ii) an improvement in asset quality in

the banks' balance sheets, which allows the UK authorities to remove the financial sector support measures that previously added to the debt ratio. Things will not look as rosy for Greece because the country needs to frontload fiscal consolidation in order to restore public confidence. This means GDP, which has already contracted by 2% in 2009, will drop further by 4% this year and 2½ % next year, according to the IMF.

But complacency won't be tolerated

So far, the financial markets have been prepared to give the UK the benefit of doubt because of the reasons outlined above. But the experiences of the periphery shows that the new coalition must not attempt to test European market patience nor that of the rating agencies. The large cyclically adjusted primary deficit of UK's public sector (5.2% of GDP in 2009), which surpasses that of Greece (4.5%), implies that the economic recovery will only go some way towards addressing the fiscal imbalance (see figure 6). The rest of the correction has to come from tax hikes and spending cuts.

Figure 6: UK's structural deficit is worse



Source: Rabobank, OECD

More worryingly, the projected halving of the deficit over the next four years relies on an such an optimistic economic outlook that even Mr. Cameron called it a "work of fiction". The UK Treasury forecasts a 3¼% growth of real GDP in 2011 and 3½% for the years after because it excludes the effects of the as-yet unspecified fiscal tightening that is expected to kick in the coming quarters. In our view, there are even more reasons why the economy cannot grow as rapidly as the current fiscal arithmetic assumes. First, the deleveraging process in the private sector will keep domestic demand weak for some time to come. That said, no one can expect households and firms to spend 9.8% of GDP less than their income in perpetuity. Second, the recovery has been primarily dependent on the temporary inventory cycle. Third, the depreciation of the currency will only help up to a certain point because the economic woes in the eurozone, which is Britain's biggest trading partner (buying nearly half of its exports), can lead to a weakening of external demand. Moreover, we should not get over-excited about an industry-led economic recovery because industry only accounts for 17% of the economy.

Conclusion

Thus, the Lib-Con alliance will face a twofold challenge: cleaning up public finances without strangling the incipient economic recovery at birth. Getting the timing of the exit right is certainly difficult, but they can increase their chances of success by pursuing policies that will lead to the rebalancing of the economy towards higher exports and away from consumption. Additionally, spending cuts must take the leading role in the fiscal consolidation plan because it is less harmful for economic growth (see our Special: Demystifying the paths toward debt sustainability). Lastly, the BoE can give the government a helping hand by simply keeping the interest rate low for an extended period.

May 2010
Shahin Kamalodin (+31 30 2131106)
S.A.Kamalodin@rn.rabobank.nl

www.rabobank.com/kennisbank