Credit ratings agency gives verdict on British economy

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The credit ratings agency Fitch warned that Britain, as the country requiring “the largest budget adjustment” among industrialized nations, was “potentially [the] most at risk” of all the major economies and could lose its prized AAA status as a sovereign borrower.

Fitch, like the IMF and other international institutions, is concerned about Britain’s ballooning budget deficit, which now looks set to reach at least £200 billion (US $334.5 billion) or 14 percent of GDP this financial year. This is more than 14 percent above the £175 billion anticipated by Alistair Darling, the Chancellor of the Exchequer, last April. Total government debt is expected to rise to nearly £1.4 trillion (US $2.34 trillion) in 2013-14, before falling back to normal levels of borrowing in 2017-18.

David Riley, head of sovereign ratings at Fitch, said, “Many credit profiles of major AAA sovereigns have been significantly weakened by the financial crisis and the subsequent recession. The already outsized budget deficits and the rise in government debt has reduced the ‘fiscal space’ for policy makers to respond to further adverse shocks.”

However, Fitch did not downgrade Britain’s rating because it anticipates the government will implement punishing budget cuts. Riley said, “Our stable rating outlook reflected our expectation that the UK government will articulate a stronger fiscal consolidation programme next year.”

Last May, Standard and Poor’s, another credit ratings agency, changed its outlook for the British economy from stable to negative and said it would wait to see what steps the government took to reduce the deficit before reviewing the rating again.

Any downgrading of Britain’s debt status would lead to a massive hike in interest rates, currently at a post-war low of 0.5 percent, to stem the flight out of sterling. This would in turn push up debt service costs for government, households and businesses, as well as lead to a further round of public expenditure cuts and mass unemployment.

Following the announcement, sterling declined slightly against both the dollar and the euro. The pound has now fallen 25 percent since the start of the financial crisis, with no corresponding increase in exports or reduction in imports. It only rallied after Prime Minister Gordon Brown stepped in to reassure the international money markets and reiterate his commitment to reduce public spending.

Brown said, “We have assured people that, as a result of our deficit reduction plan that we announced in our budget in April that we are taking the necessary action to cut our deficit by half…probably ahead of other countries. I think the ratings agencies will take into account that these are world issues that have got to be dealt with not just by one country, but many countries.”

Fitch’s announcement constitutes its verdict on Britain’s economy. It was a warning that its monetary and fiscal policy are unsustainable and that the government must slash public expenditure to enable the bank bailouts to continue. Moreover, international financial institutions and leading G20 governments, led by Washington, will brook no tax on financial transactions like the so-called Tobin tax, which was proposed by Brown to fund future rescues. Working people must be made to shoulder the burden.

The Labour government has declared that it will do “whatever it takes” to stabilise Britain’s banks and the financial system. It has thus far pledged an amount almost equal to Britain’s entire GDP in capital and liquidity injections, toxic asset purchases, loan guarantees and deposit insurance to the banks, proportionately far more than any other country. Only two weeks ago, the government announced another round of measures worth £39 billion (US $65.3 billion) aimed at shoring up the nationalised Royal Bank of Scotland (RBS) and the Lloyds Banking Group, making the rescue of RBS the world’s largest banking bailout.

But all international institutions have warned that the banks have declared less than half their likely losses on their speculative trading in sophisticated financial instruments. According to the IMF, British banks are expected to write down a further £1,500 billion (US $2.5 trillion) by the end of 2010, more than the entire UK GDP.

In other words, Britain’s moribund banks are set to make further calls for government aid. As such, the banks now pose the biggest risk to Britain’s solvency.

This picture was confirmed in a recent report by the Bank of England, aptly called *Banking on the State*, by Piergiorgio Alessandri and Andrew Haldane. They point out that while the state has always acted as lender of last resort to the banks via systems of liquidity, deposit and capital insurance, the risks to the state have risen astronomically in the last 35 years.

Whereas for nearly a century after 1880, the banks’ assets grew roughly in line with GDP and were about 50 percent of GDP, this changed in the 1970s. By the start of the 21st Century, bank assets were more than five times UK GDP, a tenfold increase, as lending and proprietary trading rose. Moreover, at the same time, the banks' capital and liquidity ratios fell by a factor of five, further increasing the risk to the state. By diversifying out of banking into other financial sectors, such as insurance and mortgage lending, the banks had increased systemic risk.

The corollary of rising risk has been a dramatic increase in returns to shareholders. Between 1920 and 1970, shareholders' returns were less than 10 percent, roughly in line with non-financial companies. This changed in the 1970s when returns started to rise and have since averaged 20 percent. Immediately prior to the financial crisis, returns were close to 30 percent as the banks' capital ratios fell.

However, as limited liability companies, the banks and their shareholders face zero losses. While the profits were privatised, the risks and losses have been socialised—i.e., borne by the taxpayers.

The report lists speculative strategies whereby the banks boosted their profits and "whether by accident or design, game[d] the state." It notes that while the authorities may say "never again," the very cost of the crisis "means that such a statement lacks credibility. The document continued, "*Knowing this, the rational response of market participants is to double their bets*. This adds to the cost of future crises. And the larger these costs, the lower the credibility of 'never again' announcements. This is a doom loop [emphasis added]."

While the government has presented the bailouts as necessary to safeguard jobs and living standards, this is entirely fraudulent. What was in fact a massive diversion of public funds to protect the wealth of the financial elite is being further used to press forward with a fundamental restructuring of British capitalism through the impoverishment of the working class.

The economic situation is far worse than any of the political and economic commentators admit. Indeed, the revelation that Britain's economy contracted by 0.4 percent in the third quarter of 2009 confounded all the pundits' expectations. With Britain's economy contracting for six consecutive quarters, GDP has now fallen by 5.9 percent since early 2008, in what is now the longest and deepest recession since the war.

This is in contrast to the rest of Europe, where the 16 Eurozone countries grew collectively by 0.4 percent in the third quarter, after shrinking by 0.2 percent between April and June. The French and German economies grew for a second consecutive quarter, while the US economy grew in the third quarter.

GDP has fallen despite the government's unprecedented economic stimulus package and quantitative easing, whereby the Bank of England essentially prints money by buying up the banks' assets in the form of government and corporate bonds. The total amount of quantitative easing, ostensibly set to ensure banking lending to business and make good the fall in GDP, has now been increased this last week by £25 billion. At 14 percent of GDP, this is far greater than the fall in economic output.

With bank lending at rock bottom, quantitative easing has had demonstrably little effect other than to allow business as usual for the financial oligarchy. The bank's Monetary Policy Committee admitted as much when it said that the asset purchases had "helped to boost asset prices and improve access to capital markets."

The Bank of England has signalled that this is the last tranche of quantitative easing and that interest rates are likely to rise next year—in effect that the government had played its last card to stimulate the economy.

However, conditions facing the working class have not improved and indeed, are expected to further deteriorate. 7.8 percent of the workforce, up from 5.9 percent a year ago, is now unemployed. Young people have been particularly hard hit, with 946,000 or 20 percent of those between the ages of 16 and 24 not in work, education and training. This is the highest since records began in 1992.

While the overall increase in unemployment was less than expected, this is attributed to Britain's "flexible labour market"; employers have, with the complicity of the trade unions, cut wages and shortened working hours.

More job losses are on the way. Lloyds Banking Group has announced another round of 5,000 job cuts, on top of the 8,000 already eliminated, taking the total job losses among the leading high street banks in the last twelve months to 42,000. Unemployment is expected to reach 3 million next year, which will make it a major election issue. At the same time, the number of first time voters without a job will be the highest for at least four elections.

Research from Resolution Foundation shows the impact this is having on low income households. It says that Britain's 14.3 million low earners—nearly half the workforce—are in danger of being sucked into a whirlpool of poverty. One quarter of low income households, those with an average of £15,800 (US $26,425) at their disposal, spend more than 24 percent of their monthly income on debt, twice the number of three years ago. They are particularly vulnerable to homelessness should they lose their job, as one third of low income households have high loan to value mortgages and are in negative equity.

The author recommends:

British government mounts world's largest bank bailout
[9 November 2009]

Britain: Deepening recession fuels concern over corporate bonuses and bailouts
[30 October 2009]