The biggest threat to Britain's credit rating is a possible exit from the EU

*In advance of David Cameron's now postponed speech on Europe, **Costas Milas** explores the ramifications which the prospect of an exit from the EU might hold for the UK's credit rating.*

Prime Minister David Cameron is preparing for a major speech in the Netherlands which is expected to shed some light on the future of Britain's relationship with our European partners. There is speculation that he will offer the public the prospect of an "in or out of the EU" referendum vote after renegotiating Britain's terms of EU membership.

The timing of a possible "Brexit" talk could hardly be any worse: although the UK economy has managed to come out of a double-dip recession, there is a high likelihood that next week's GDP figure release will signal the first leg of, yet another, (now triple-dip) recession. Worried that a policy U-turn might put Britain's prized AAA credit rating at risk, Britain's policymakers have decided to stick to austerity. With this in mind, it looks odd that David Cameron is willing to engage in a possible "Brexit" argument which risks jeopardising the country's AAA credit rating.

To understand why this is the case, let me discuss briefly how credit rating agencies decide on sovereign credit ratings scores. The three main credit rating agencies (Moody's, Standard&Poor's and Fitch) cite a number of factors (namely GDP growth rate developments and public finance trends) but provide little guidance as to the relative weights assigned to each factor. Yet, researchers have studied extensively the empirical models used by credit rating agencies to reach the following conclusions:

1. An increase in annual GDP growth by 1.3 percentage points improves a country's rating by about one-tenth of a notch.
2. An annual rise in (net) government debt by 2 percentage points of GDP justifies some two-tenths of a notch downgrade in a country's credit rating.
3. An annual drop in government deficit by 1 percentage point of GDP justifies a one-tenth of a notch upgrade in a country's credit rating.
4. European Union (EU) membership enjoys a 'premium' of as much as 2 notches. The idea is that EU membership improves credibility (as economic policy is restricted and monitored by other member states) and, at the same time, provides enormous economic benefits as it offers (trade) market access to a population of around 503 million.

According to the Office for Budgetary Responsibility (OBR) latest estimates, Britain's growth is expected to increase by 1.3 percentage points (from -0.1% in 2012 to 1.2% in 2013). Britain's net government debt is expected to rise by some 2 percentage points (from 74.7% of GDP in 2012 to 76.8% of GDP in 2013) and government deficit is projected to drop by 0.8 percentage points (from 6.9% of GDP in 2012 to 6.1% of GDP in 2013). Taken together, the growth and deficit "improvements" justify two-tenths of a notch upgrade which is offset by an equivalent downgrade due to the increase in the net debt. Unless these forecasts turn out to be spectacularly wrong, Britain's credit profile should remain stable, at least for now. In fact, a drop in Britain's AAA rating would involve lower growth, an increase (rather than a decrease) in the deficit and net debt approaching 80% of GDP in 2013.

That said, the biggest threat to Britain's credit rating comes from a possible decision (following a referendum) to drop EU membership. If Britain's policymakers decide to go this way, they will have to spell out in great detail what the economic benefits of an EU exit will be. Otherwise, a "Brexit" will look like a big jump into the unknown and therefore Britain's prized AAA credit rating will go fast whether or not fiscal and growth figures turn out to be worse than predicted.

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About the Author

Costas Milas *is Professor of Finance at University of Liverpool Management School.*

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