Euler Hermes Economic Research

Country Report

United Kingdom

Slow down or inflection point?

General Information

GDP	USD2678.45 bn (World ranking 6, World Bank 2013)
Population	64.1 mn (World ranking 22, World Bank 2013)
Form of state	Constitutional Monarchy
Head of government	David CAMERON (conservative party)
Next elections	2020, legislative

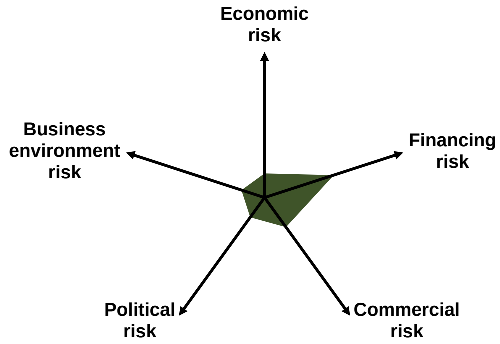
Strengths

- Strong business confidence
- Supportive economic policies
- Accommodative financial conditions
- Healthy banking sector
- Diversified export structure

Weaknesses

- Strong currency
- High current account balance deficit
- High fiscal deficit and public debt
- High external liabilities
- Decreasing long term per capita income
- Low productivity growth
- Political uncertainties due to the EU “in out” referendum

Country Rating AA1



Source: Euler Hermes

Trade structure

By destination / origin (% of total)

Exports		Rank		Imports
United States of America	13%	1	15%	Germany
Germany	10%	2	9%	China
Netherlands	7%	3	9%	United States of America
Switzerland	7%	4	7%	Netherlands
France	6%	5	6%	France

By product (% of total)

Exports		Rank		Imports
Machinery, nuclear reactors	14%	1	12%	Machinery, nuclear reactors
Mineral fuels, oils	11%	2	11%	Mineral fuels, oils
Vehicles	11%	3	11%	Vehicles
Pearls, precious stones, metals	11%	4	9%	Electrical, electronic equipment
Pharmaceutical products	7%	5	5%	Pearls, precious stones, metals

Source: ITC (2014)

Economic Overview

Slowing GDP growth, but still strong

After averaging 0.7% Q/Q growth during 2015, GDP growth slowed down in Q1 2015 to +0.3% q/q. Production in the manufacturing sector increased by a meagre +0.1% q/q while the construction sector contracted by -1.1%, the agriculture sector was a mildly disappointing -0.1% and the services sector stabilized. Domestic demand contributed by 1.2pp to GDP growth while net exports subtracted -0.9pp on the back of export contraction (-0.3% q/q) and strong import growth (+2.3% q/q).

Consumer spending as main driver for growth, but investment decisions could get postponed due the Brexit fears

All in all, we expect GDP growth at +2.2% in 2015 and +2.0% in 2016 (see Figure 1). The labour market improvement will continue to support private consumption and real wages are recovering. Consumers received a small boost from the lower oil prices while companies should see increasing profitability by year-end (+0.4pp in margins to 32% of value added).

Total investment has been impacted by (1) the contraction in the construction sector over the past two quarters; (2) the slowdown in equipment investment due to the uncertainty induced by the elections. Turnover growth is expected to slow down to 2% in 2015 on the back of downside price pressures (+3% expected in 2016 – see Figure 2).

Currency appreciation will limit export opportunities and export performance is already weak: -10% since end-2011 and +17% since 2008 (vs -4% and +20% respectively for imports). Prospects don't look bright given the weakening price competitiveness position compared to the European peers as they benefit from the lower euro – see Figure 3. This is particularly important as 45% of UK total exports go to the eurozone (vs 12% to the US).

Monetary policy to remain accomodative until mid-2016

With little evidence of a catalyst for aggressively higher oil prices, inflation will only increase gradually in the coming months and will remain unusually low (at +0.4% on average in 2015 and +1.5% in 2016) – markedly below the BoE 2% target also hindered by the strong GBP and contained wage increases despite the rapidly falling rate of unemployment (at 5.5% in Q1). We see little reason for the BoE to rush into beginning its monetary policy tightening cycle. Therefore we remain inclined to believe that the first rise in interest rates will come late in Q2 2016, with the potential for a delay if growth disappoints.

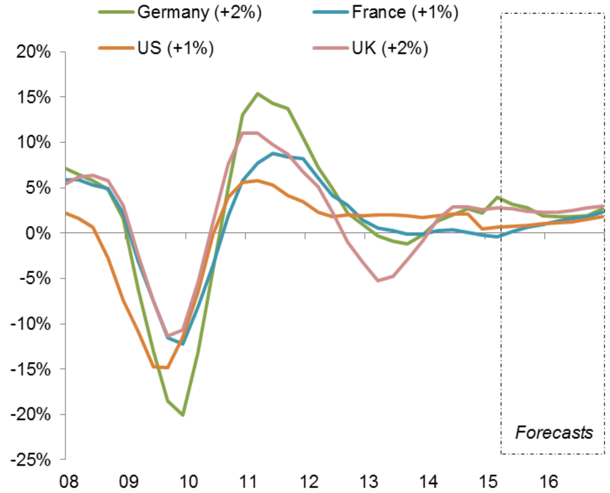
Figure 1 Economic indicators

United Kingdom		weight	2013	2014	2015	2016
GDP		100%	**1.7**	**2.8**	**2.2**	**2.0**
Consumer Spending		64%	**1.7**	**2.5**	**2.7**	**2.6**
Public Spending		21%	**-0.3**	**1.7**	**1.8**	**1.3**
Investment		16%	**3.4**	**7.8**	**2.7**	**3.4**
Stocks	*	0%	**0.1**	**0.1**	**0.3**	**0.2**
Exports		31%	**1.5**	**0.6**	**3.7**	**2.0**
Imports		32%	**1.4**	**2.2**	**5.5**	**4.1**
Net exports	*	-1%	**0.0**	**-0.5**	**-0.7**	**-0.8**
Current account	**		**-77**	**-101**	**-102**	**-102**
Current account (% of GDP)			*-4.5*	*-5.6*	*-5.5*	*-4.9*
Employment			**1.2**	**2.3**	**2.7**	**2.1**
Unemployment rate			**7.2**	**5.7**	**5.5**	**5.3**
Wages			**3.1**	**3.2**	**2.8**	**3.0**
Inflation			**2.6**	**1.3**	**0.3**	**1.4**
General government balance	**		**-94**	**-96**	**-90**	**-85**
General government balance (% of GDP)			*-5.7*	*-5.6*	*-4.8*	*-4.4*
Public debt (% of GDP)			*90.6*	*93.1*	*94.7*	*93.9*
Nominal GDP	**		1713	1791	1865	1946

Change over the period, unless otherwise indicated:
* contribution to GDP growth
** GBP bn

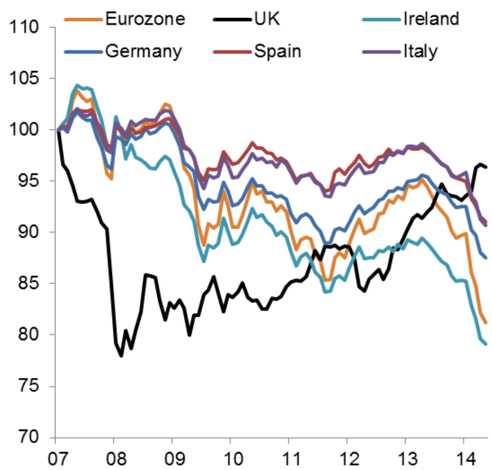
Sources: IHS, Euler Hermes

Figure 2: Turnovers' growth



Sources: Eurostat, Euler Hermes

Real effective exchange rate, Dec 2007 = 100



Sources: Bruegel, Euler Hermes

Business insolvencies to have reached a plateau

Business insolvencies are expected to fall for the 4th consecutive year in a row (-2% in 2015), but to increase in 2016 (+4% to 23,700 – see Figure 3) on the back of the monetary tightening, the slowdown in growth and the business demography (strong business creations since 2013).

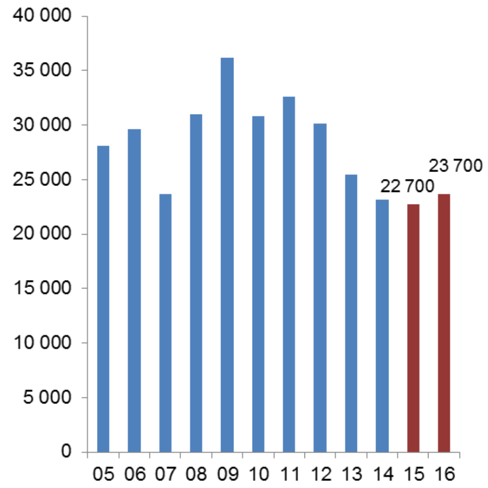
A tale risk, but still a risk – Brexit, what does this mean?

The Conservative Party won the UK elections for a second term, with a 12-seat majority and a slightly higher proportion of the vote than in the last election in 2010 (36.9% vs. 36.1% previously). Financial markets have reacted positively as a Conservative majority was viewed as the most business friendly outcome.

The continued fiscal consolidation should see a budget surplus by 2020. The corporate tax rate will remain unchanged at 20%, the lowest level within the G-20, with boosting financing for innovative start-ups a key aim. Another core Conservative election pledge was to hold a referendum on the UK's EU membership by the end of 2017 or earlier. We expect the UK government will try to negotiate with its counterparts in the rest of Europe to secure better terms for the UK within the EU (similar to what Scotland did with the UK last year), rather than exit from the EU. Greater support for free trade, reducing burdensome EU red tape and lower labor mobility being the main points for discussion.

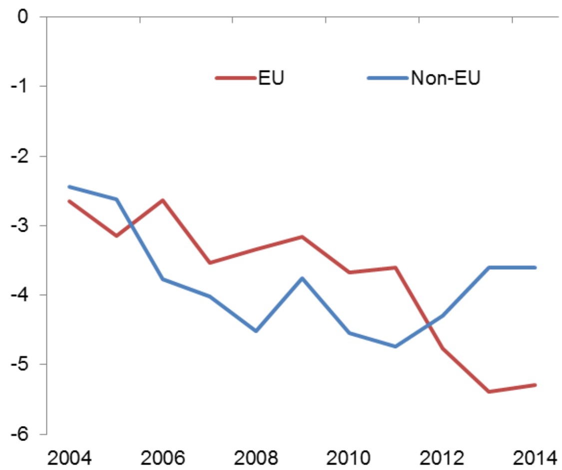
In our view it is not in UK's economic interest to exit the EU given the persistent and large trade deficit it has (see Figure 5). The Brexit (10% probability) would require the renegotiation of all EU free-trade agreements that the UK currently benefits from and would see corporates impacted by higher export and import prices with potential temporary disruption risk. Automotive, agri-food and the financial sectors would be the hardest hit, but chemicals and machinery would also suffer. Similarly the disruption to Foreign Direct Investment – the UK is currently largest beneficiary in the EU - would make the UK less productive. While it is easy to argue that the EU would lose more due to the importance of export earnings from the UK than vice-versa, the EU buys around 50% of the UK's exports while the UK only buys around 10% of the EU's exports. A Brexit would permanently reduce UK GDP by up to 2% due to lower FDI and trade flows.

Figure 4: Business insolvencies, number



Sources: National sources, Euler Hermes

Figure 5: Trade balance, GBP bn



Sources: National sources, Euler Hermes

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