Euler Hermes Economic Research

Country Report

United Kingdom

Taking advantage from a reactive policy-mix

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Executive summary

- EH revised its 2014 GDP growth forecast slightly upwards: +0.1pp to 2.6% and left unchanged the outlook for 2015: +2.5%. Growth will continue to be driven by domestic demand with investment expected to recover.
- Monetary policy should remain accommodative until at least Q1-Q2 2015 but risks of a sooner-than-expected exit strategy prevail given the strength of the economic recovery and the latest developments in the housing market.
- Supporting measures for the UK corporates proved to be numerous over the past years and increasingly active.
- Business insolvencies are expected to remain on a declining trend, but falls are expected to soften in the coming years: -7% in 2014 and -5% in 2015 against -15% in 2013.

Positive surprises in 2013

In 2013, GDP increased by +1.7%, the highest rate since 2007. The main driver for growth was household consumption (+1.5pps contribution to GDP growth) while total investment continued to fall (-0.1pps) – see Chart 1. Net exports contributed by a meagre +0.2pps to GDP growth as export performance slowed down on the back of the GBP appreciation.

The UK will remain one of the best performers of the region

Q1 UK GDP growth was driven by domestic demand with both private consumption and total investment up by 0.7% q/q. Net exports had a nil contribution to GDP growth with exports down by 1% q/q given the appreciation of the GBP. Unemployment rate reached the lowest level since Q1 2009 (at 6.8% in Q1 2014 - see Chart 2) while real wages rose by 0.7% q/q. Capacity utilization rates are at high levels (81%) and financial conditions remain accommodative.

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Monetary policy should remain accommodative until at least Q1-Q2 2015

Inflation rate reached 1.5% y/y in May 2014, the lowest level over the past 4 years and a half and it is expected to remain below or close to 2% until 2015.

Table 1: Key economic forecasts

United Kingdom		weight	2012	2013	2014	2015
GDP		100%	0.3	1.7	2.6	2.5
Consumer Spending		64%	1.4	2.2	2.3	3.0
Public Spending		22%	1.6	0.7	0.9	0.7
Investment		14%	1.2	-0.7	4.5	2.5
Stocks	*	1%	-0.6	0.0	0.2	0.1
Exports		31%	1.7	1.0	1.4	2.7
Imports		32%	3.4	0.5	0.9	2.8
Net exports	*	-1%	-0.5	0.2	0.1	-0.1
Current account	**		-60	-71	-61	-54
Current account (% of GDP)			-3.8	-4.4	-3.6	-3.0
Employment			1.2	0.7	0.6	1.2
Unemployment rate			8.0	7.8	7.5	6.7
Wages			2.4	3.2	3.3	3.4
Inflation			2.7	2.6	1.8	2.0
General government balance	**		-94	-90	-82	-73
General government balance (% of GDP)			-6.1	-5.8	-5.1	-4.3
Public debt (% of GDP)			89.1	90.6	92.6	92.7
Nominal GDP	**		1558	1613	1690	1771

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

Sources: IHS Global Insight, Euler Hermes forecasts

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Indeed, inflationary pressures are expected to remain low on the back of (i) weak external price pressure, notably from the eurozone where inflation is expected to remain below or close to 1% until 2015; (ii) sterling appreciation; (iii) moderate wage growth in the short-term in line with the state of the labour market. Corporate margins remain low (32% of the value added, the lowest level since 2007, see Chart 3), but they should start to progressively recover in line with the rise in productivity. Interest rates should remain at record low levels at least until Q1-Q2 2015 given that the BoE Governor, Mark Carney, has suggested that the recovery has to be balanced, especially considering the fears of a bubble in the housing market.

A clear strategy for reindustrialization

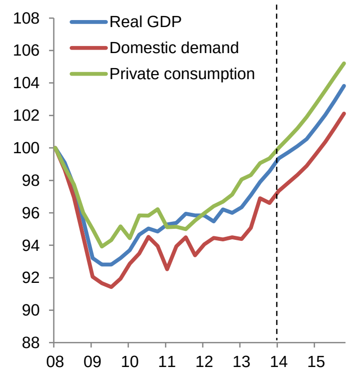
UK's manufacturing costs are lower than European peers, France and Germany, and have also registered slower growth over the past years. UK corporates benefit from a very strong business environment - see Chart 4. Supporting measures for UK corporates proved to be numerous over the past years and increasingly active: (i) fiscal burden is less restraining when compared to the other European countries, (ii) the BoE credit policy implemented in mid-2012 (Funding for Lending Scheme) worked well and (iii) business confidence is strong on the back of positive upcoming fiscal measures of which the most significant are corporate rate tax cuts in 2014 and 2015 (to the lowest level within the G20 group of countries), measures to target bank lending to SMEs, an increase in infrastructure spending and the new shale gas field allowance.

Further, Chancellor George Osborne announced new measures to help exporters raise financing. The changes will allow banks to use export credit notes guaranteed by the government's trade promotion agency as collateral at the BoE that should incentivize banks to lend extra-money to exporting British firms. The Finance ministry said that this measure should help reduce the cost of private-sector export finance loans by 5 to 10bp. In addition, the government's direct-lending programme through the UK Export Finance aiming to finance exporters would be doubled in size (to GBP3bn) and reduce interest rates. The government targets doubling exports by 2020. These measures are positive and should reinforce business confidence.

The falls in business insolvencies are expected to soften

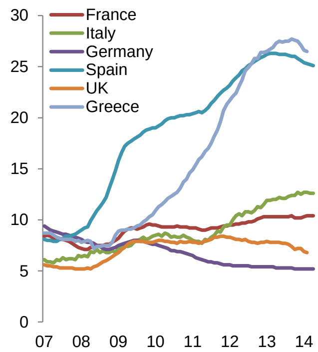
The total number of business insolvencies has indeed declined significantly in 2013 (-15%, for the second consecutive year), and even fell back just under the pre-crisis level (27,000 cases for the yearly average between 1997 and 2007). The economic recovery spread well across sectors, even if divergence still prevails. That said, business demographics and a less accommodative monetary policy stance would limit the pace of reduction in business insolvencies in 2014 (-7%) and 2015 (-5%).

Chart 1: Real GDP and components, index 100 = Q1 2008



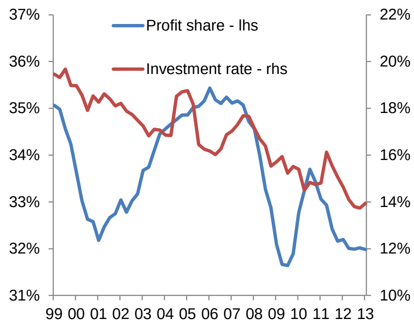
Sources: ONS, Euler Hermes

Chart 2: Unemployment rate, %



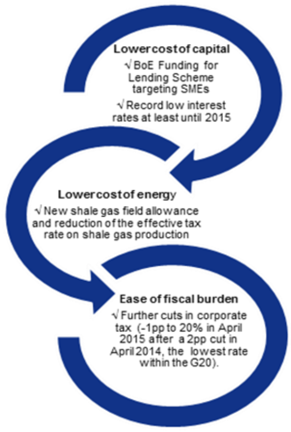
Sources: National sources, Euler Hermes

Chart 3: Non-financial corporations' margins vs investment rate, % of value added



Sources: Eurostat, Euler Hermes

Chart 4: Economic policies announced by the government and the monetary policies over the past years



Source: Euler Hermes

General Information

GDP	USD2435.174bn (World ranking 6, World Bank 2012)
Population	63.23 million (World ranking 22, World Bank 2012)
Form of state	Constitutional Monarchy
Head of government	David CAMERON (conservative party)
Next elections	2015, legislative

Strengths

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

Weaknesses

- Strong GBP.
- High current account balance deficit.
- High fiscal deficit and public debt.
- High external liabilities.
- Decreasing long term per capita income.
- Political uncertainties due to the rise in euroscepticism.

Trade structure

By destination / origin

Exports		Rank		Imports
Germany	12%	1	14%	Germany
United States	12%	2	8%	Netherlands
France	8%	3	8%	United States
Belgium	7%	4	8%	China
Netherlands	6%	5	7%	Norway

Source: Chelem

By product

Exports		Rank		Imports
Pharmaceuticals	7%	1	7%	Crude Oil
Cars And Cycles	7%	2	6%	Cars And Cycles
Refined Petroleum Products	6%	3	5%	Non-Monetary Gold
Crude Oil	5%	4	4%	Pharmaceuticals
Engines	4%	5	4%	Refined Petroleum Products

Source: Chelem

Risk Dimensions

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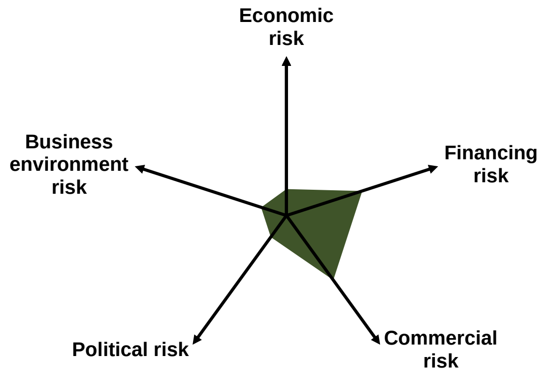

Source: Euler Hermes

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