Euler Hermes Economic Research

Country Report

United Kingdom

Softer Brexit does not rule out economic slowdown

General Information

GDP	USD2861.0907bn (World ranking 5, World Bank 2015)
Population	65.14mn (World ranking 22, World Bank 2015)
Form of state	Constitutional Monarchy
Head of government	Theresa MAY (Conservative Party)
Next elections	2022, legislative

Strengths

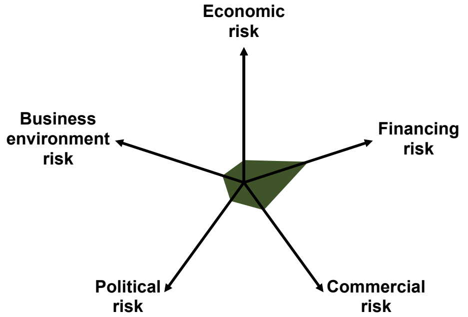
- Supportive economic and fiscal policies
- High trade balance surplus on services
- Healthy banking sector
- Diversified export structure
- Very friendly business environment

Weaknesses

- High trade balance deficit on goods
- High current account balance deficit
- Uncertainty surrounding Brexit
- Decreasing long term per capita income
- Low productivity growth

Country Rating

AA1



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
United States	14%	1	17%	Germany
Germany	10%	2	9%	China
Switzerland	7%	3	8%	United States
Miscellaneous	6%	4	8%	Netherlands
China	6%	5	7%	Belgium

By product (% of total)

Exports		Rank		Imports
Cars And Cycles	9%	1	9%	Cars And Cycles
Non-Monetary Gold	8%	2	6%	Pharmaceuticals
Pharmaceuticals	7%	3	3%	Telecommunications Equipment
Aeronautics	7%	4	3%	Non-Monetary Gold
Jewellery, Works Of Art	4%	5	3%	Electrical Apparatus

Source: Chelem (2015)

Economic Overview

The slowdown in GDP growth should accelerate in 2017

In 2016, in the aftermath of the Brexit vote, the UK economy managed to maintain its solid momentum. Indeed, political uncertainty was contained; the monetary policy response was proactive and fiscal policy was supportive; business and consumer confidence remained resilient; the stock markets were boosted by a weaker pound and the services sector continued growing.

Yet, growth tumbled in Q1 2017, with GDP growing by +0.2% q/q (-0.7% excluding stocks) against an average of +0.6% q/q in H2 2016. The drag came from private consumption which slowed down significantly to +0.3% q/q after +0.7% in Q4 (its slowest pace since Q4 2014). Net trade contributed negatively to GDP growth by -1.4pp as exports fell while imports rose.

Output in the services sector decelerated: +0.2% (against +0.8% in Q4 2016), recording its lowest figure since Q1 2015. Looking ahead, we expect UK GDP growth to slow down to +1.4% in 2017 from +1.8% in 2016 and to +1.0% in 2018.

In 2016, business insolvencies reflected the economy's post-Brexit resilience, decreasing by -1% compared to 2015. However, they have been on the rise for two consecutive quarters: +3.6% y/y in Q1 2017. We thus expect an increase of +5% in insolvencies for 2017 and +6% in 2018 (see Figure 2).

The main culprits are the expected slowdown in GDP growth and pressures on margins which are linked to the rise in input costs. These are due to the sterling depreciation, in the context of high indebtedness.

As post-Brexit vote resilience is being tested, the election yielded surprises…

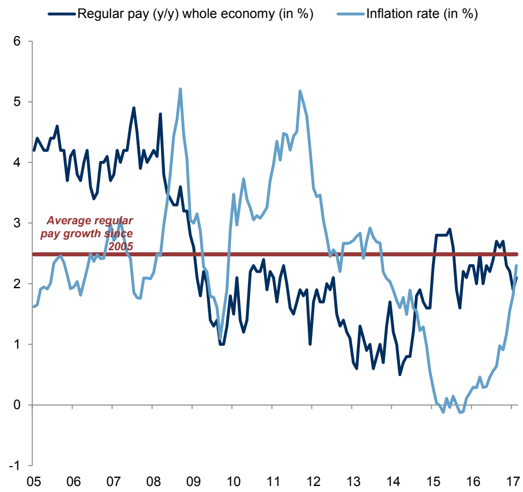
Though polls predicted a clear victory for the Conservative party, it won 317 seats, 9 seats short of a majority (and -13 seats less compared to 2015). Labour strengthened its position by winning 262 seats (+30 seats).

Despite overall resilience, several pain points could account for a retaliation vote (see Figure 3). (i) Since the Brexit vote, the sterling has strongly depreciated: -13% vs. the EUR and by -12% vs. the USD; (ii) inflation rose from +0.3% y/y in May 2016 to +2.9% y/y in May 2017; (iii) real wages have been contracting since February 2017 (-0.2% y/y against a rise of +1.7% last year); (iv) the savings rate reached its lowest level in more than half a century; (v) the 'wait-and-see' attitude from foreign investors had a negative impact on M&A deals: pending deals increased by more than 80%. The total value of completed cross-border M&A deals fell by -35% while the number of deals increased by +6%.

Hence, this situation led voters to demand policy solutions and guarantees that the government would not exclusively focus on Brexit negotiations. The Labour party is deemed to have heeded the people while PM May focused on her "Hard Brexit" stance.

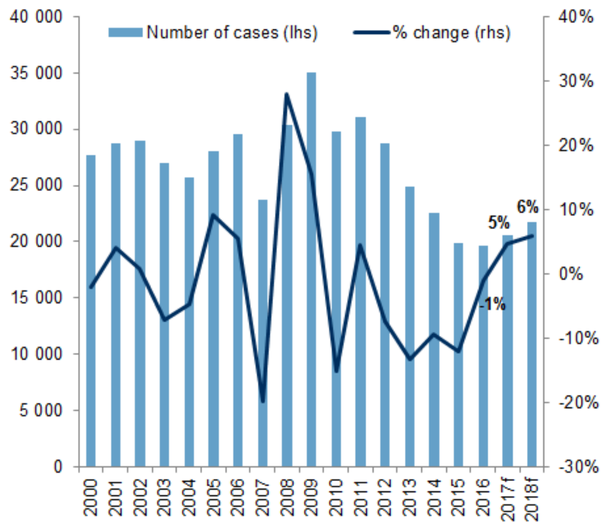
The Tories struck a coalition deal with the Democratic Unionist Party (DUP) of Northern Ireland. We expect it to last at least 12 months despite its fragility, as the UK government cannot afford to waste precious time for negotiations.

Figure 1 - Inflation and wage growth rates, y/y



Sources: National statistics, IHS, Euler Hermes

Figure 2 - Business insolvencies



Sources: ONS, Euler Hermes

Figure 3 – Brexit: What a difference a year makes

	1 year before	Current	%
Households			
Inflation (y/y)	0.3	2.9	
Unemployment rate	5.0%	4.6%	
Real w ages (y/y)	1.7	-0.2	
Saving rate (% of gross disposable income)	6.1	3.3	
GfK Consumer Confidence	-1.0	-5.0	
Retail sales (nominal terms, y/y)	4.3%	2.1%	
Residential prices (y/y)	8.7%	5.8%	
Companies			
Value of completed M&A deals (cross-border, 12M)	254	164	-35%
Number of completed M&A deals (cross-border, 12M)	625	665	6%
Pending M&A deals (12M sum)	85	147	73%
Turnover grow th (12m/12m)			
Manufacturing sector	0.4%	5.3%	
Services sector	-2.1%	8.7%	
Profitability indicators (selling prices minus input prices, Manufacturing PMI Index)	7	-3	
Business insolvencies (3M sum, y/y)	5096	5278	4%
Financial data			
GBPEUR	1.31	1.14	-13%
GBPUSD	1.45	1.27	-12%
Stock market (FTSE 100)	6231	7438	19%

Sources: Bloomberg, ONS, Eurostat, Gfk, Markit, Euler Hermes

Figure 4 – Impact of Brexit on the United Kingdom

				Step 1: EU exit			Step 2: Finalized trade deal with the EU		
	2016	2017	2018	2019		...	2021		
	Pro-Brexit vote in June	EU exit negotiations with EU	EU exit negotiations with EU	Transition deal (80%)	No transition, WTO rules (20%)		Extensive FTA (25%)	Limited FTA (55%)	No FTA, WTO rules (20%)
Real GDP (y/y)	1.8%	1.4%	1.0%	0.9%	-1.2%		0.7%	0.3%	-0.4%
Real private consumption (y/y)	2.8%	1.9%	1.2%	1.2%	-1.0%		1.0%	0.8%	-0.3%
Real business investment (y/y)	-1.5%	-0.7%	-2.5%	-2.5%	-8.0%		-1.5%	-4.0%	-2.5%
Real total exports (y/y)	1.8%	1.5%	2.0%	1.6%	-6.0%		-1.0%	-2.5%	-3.0%
Inflation (CPI, y/y)	0.7%	2.7%	2.6%	2.4%	3.5%		2.3%	2.7%	3.0%
BoE benchmark interest rate	0.25%	0.50%	0.75%	1.00%	0.75%		1.00%	1.00%	1.00%
GBP/EUR (eop)	1.17	1.12 - 1.15	1.05 - 1.10	1.04 - 1.08	0.84 - 0.87		1.07- 1.12	0.97 - 0.98	0.79 - 0.81
Manufacturing firms' turnover (y/y)	2.7%	4.0%	3.5%	3.0%	-1.0%		1.3%	1.2%	-0.8%
Non-financial corporations firms' margins (pp)	-0.5	-0.8	-0.7	-0.5	-2.0		-0.3	-1.0	-1.5
Business insolvencies (y/y)	-1.0%	5.0%	6.0%	3.0%	15.0%		1.0%	8.0%	5.0%

NB:
Transition deal = Bridge solution which allows the UK to obtain equivalence for financial services and have no tariffs and non-tariffs barriers on goods and services in exchange of contributions to EU, maintenance of EU regulations and no control on migration
Extensive FTA = Most goods (notably in strategic sectors: automotive, energy, chemicals, pharmaceuticals, agri-food) will be duty-free (weighted average tariffs below 1%), substantial services sector add-ons
Limited FTA = Selective sectors will be duty-free, others will be subject to tariffs. The weighted average tariffs could be 2 to 3% on goods, few services sector add-ons (tariff equivalent additional costs of 10% tariffs on average)
No FTA = WTO, Most Favored Nation principle will apply (equiv. to more than 5% weighted average on goods, 20% to 30% additional costs for trade in services)

This poses downside risks to our economic forecast as consumer spending growth could be even weaker. In the medium-run, a softer Brexit could be an upside risk to our forecasts (smaller nominal shock).

… which point towards a softer Brexit

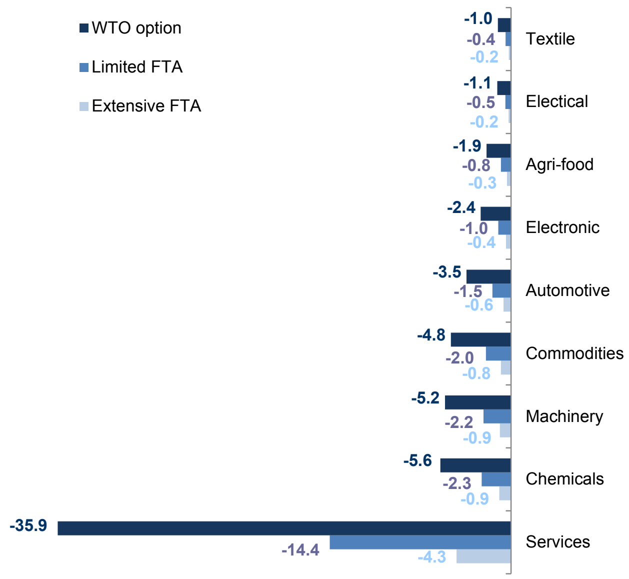
The need for political stability is acknowledged by all parties. Negotiations with the EU should be more or less in line with the schedule given the short timeframe.

Unless all EU member states unanimously decide to prolong the overall process, the UK will need to exit the EU by the end of March 2019. The Hard Brexit stance ("no deal is better than a bad deal") seems to be less plausible now as the Tories' sole political partner, the DUP expressed the need of a "workable plan to leave the EU" while a significant number of MPs either supported Bremain or a Soft Brexit. The EU-driven sequence should be accepted by both sides, leading to a transition deal in 2019 and, eventually, a limited Free Trade Agreement (FTA) as detailed in our previous Brexit Report and Figure 4.

In 2021 we expect selective sectors to be duty-free, others to be subject to non-prohibitive tariffs. The weighted average tariff would reach 2 to 3% on goods and few services sector add-ons are likely (tariff equivalent additional costs of 10% on average). A total loss of GBP12bn in exports of goods with the EU is expected in 2021 and GBP14.4bn on the services side (see Figure 5). Customs procedures would be established at the border while the existing standards in terms of packaging, labelling etc. between both countries would help make non-tariffs barriers less burdensome. The UK would retain its ISO and IEC membership after exiting the EU while working closely with the European Standards Organization to ensure compliance with EU product laws. As for services, we would expect non-tariff barriers (licensing, administrative costs etc.) to represent additional costs.

The downside risk of a cliff-edge Brexit remains unlikely as it requires three conditions: a stronger Tories leader, a breakup of the coalition, and prolonged political turmoil.

Figure 5 – Export losses by scenario



Sources: National statistics, Euler Hermes

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