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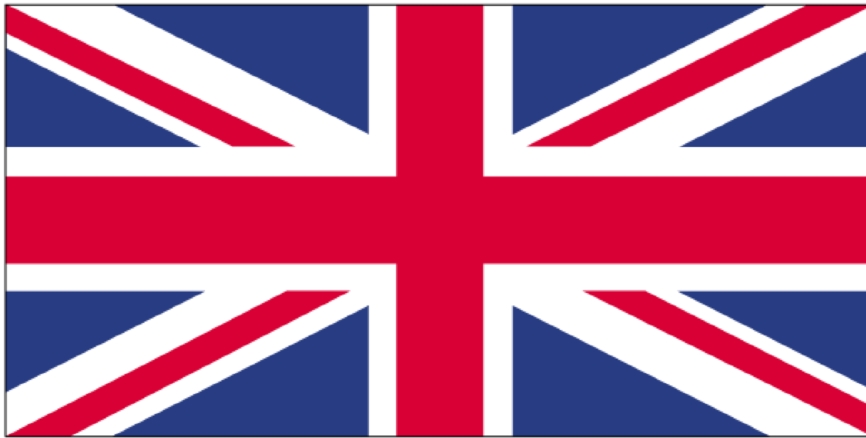
Country report **UNITED KINGDOM**



Summary

UK's economy has been stagnating since end-2010. Growth is expected to pick up during 2012 as falling inflation alleviates the squeeze on real incomes. The risks to this somewhat upbeat forecast are skewed to the downside, however. In part, these risks are the by-product of the harsh fiscal consolidation program and the ongoing parallel deleveraging process in both the household and financial sectors. What's more, the development of the eurozone debt crisis has significant implications for the UK in light of the substantial trade and financial links between the two. The good news is that the UK policymakers can still announce a credible plan B – slowing the pace of spending cuts or introducing temporary tax cuts – if debt metrics fail to improve due to significantly slower economic growth. The government has thus far decided to stick dogmatically to its fiscal austerity plan in order to retain its AAA-rating. What they fail to realise is that growth shortfalls are equally credit-negative.

Things to watch:

- Strength of economic growth in the face of public and private sector deleveraging
- Fiscal policy stance

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United Kingdom

National facts	
Type of government	Constitutional monarchy
Capital	London
Surface area (thousand sq km)	243
Population (millions)	62.3
Main languages	English
	Scots
Main religions	Christian (71.6%)
	Muslim (2.7%)
	Hindu (1%)
Head of State	Queen Elizabeth II
Head of Government (prime-minister)	David Cameron
Monetary unit	Pound (GBP)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	2439	3.54
Nominal GDP at PPP	2301	2.92
Export value of goods and services	783	3.57
IMF quotum (in mln SDR)	10739	4.94
Economic structure	*2011*	*5-year av.*
Real GDP growth	0.9	0.5
Agriculture (% of GDP)	1	1
Industry (% of GDP)	21	22
Services (% of GDP)	78	77
Standards of living	*USD*	*% world av.*
Nominal GDP per head	38887	361
Nominal GDP per head at PPP	36687	297
Real GDP per head	37636	463

Social and governance indicators	rank / total
Human Development Index (rank)	28 / 187
Ease of Doing Business Index (rank)	7 / 183
Index of Economic Freedom (rank)	14 / 179
Corruption Perceptions Index (rank)	16 / 183
Press Freedom Index (rank)	28 / 178
Gini index (income distribution)	35.9736847
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
US	10	Germany	13
Germany	10	US	9
France	8	China	7
Netherlands	7	Netherlands	6

Main export products (%)	
Machinery & transport equipment	34
Chemicals & related products	19
Mineral fuels, lubricants & related materials	13
Food, drinks & tobacco	6
Main import products (%)	
Machinery & transport equipment	35
Chemicals & related products	12
Food, drinks & tobacco	11
Mineral fuels, lubricants & related materials	9
Openness of the economy 2011	
Export value of G&S (% of GDP)	32
Import value of G&S (% of GDP)	34
Inward FDI (% of GDP)	2.6

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economy

The UK economic recovery, which commenced during the second half of 2009, has been extremely sluggish. Output has essentially stagnated since the fourth quarter of 2010 and has only grown by 3%-points since 09Q3 (half the speed the US experienced over the same period). This came as a surprise to the authorities since they believed their fiscal consolidation plan would not weigh too much on activity given that the UK has a floating exchange rate and an independent central bank. The idea was that activist monetary policy will support the economy, while currency flexibility can support economic rebalancing. As regards the former, the Bank of England's (BoE) recent quantitative easing (QE) measures[1] have not been successful in easing financial conditions. Meanwhile, the weaker pound also failed to rebalance the economy towards external demand. In the period 2008 – 2011, the sterling depreciated by 16% on a trade-weighted basis yet the UK's current account balance as a share of GDP worsened by 1.7%-points. This was simply due to the weakness in the UK's main export markets during the post-crisis period. Sadly, we cannot pin down our hopes on robust global demand growth going forward while the major trading partners are also going through a phase of fiscal austerity and private sector deleveraging. To be sure, the beleaguered peripheral eurozone countries, which are collectively as important an export

[1] On 9 February 2012, the BoE approved an additional GBP 50bn of gilt purchases as part of its QE program. This followed a GBP 275bn program (introduced from March 2009 to October 2011). Upon completion of the asset purchases, the BoE will hold around one-third of total outstanding public debt stock.

destination as the US (they accounted for roughly 12% of direct goods exports in January 2012 compared with 13% in the case of the US), will weigh on Britain's export performance for some time to come. Hence, we are not entirely convinced that the external sector will give the economy the support it needs to withstand the sharp fiscal squeeze that lies ahead.

The government's last hope can be that the private sector will step in to replace the withdrawal of public spending. Indeed, consumer spending may surprise on the upside as falling inflation continues to alleviate the squeeze on real incomes. But this does not imply that highly indebted households are now out of the woods. The labour and the housing market are still on a weakening trend, nominal wage growth is subdued and credit conditions remain tight. To make matters worse, the fiscal austerity measures will add to these strong headwinds. Thus, not much positive contribution to growth can be expected from household consumption. Private sector investment, on the other hand, may rise more than currently anticipated. Cash-rich companies are mostly delaying investment plans due to an uncertain macroeconomic backdrop. Should demand conditions improve, then a modest pickup in activity on the back of stronger private sector investment can be expected. However, this is unlikely to materially alter the outlook since fixed investment accounts for only 15% of GDP.

The simultaneous private and public sector deleveraging will, therefore, pose substantial downside risks to the economic outlook. But the government continues to believe that the economy is sufficiently flexible and robust to grow while facing these headwinds. This is the reason why the Chancellor of the Exchequer, George Osborne, decided to present a fiscally neutral budget in March 2012. The main giveaways – a rise in the personal tax allowance and an extra 1% cut in corporation tax – are to be paid for by higher taxes on the rich, including a new 7% rate of stamp duty and a crackdown on tax avoidance.

Sticking to the consolidation plan without taking its adverse impact on growth into account is unwise, in our view. The risk is that fiscal belt-tightening measures lead to a weaker recovery and this, in turn, forces the government's hands to carry out even further austerity to reach its 2016-17 fiscal target. Such macro policy can hurt the country's long-term growth rate as some workers who have lost their jobs for a prolonged period will eventually leave the labour market. To this end, it would be justifiable for the government to switch to plan 'B' by slowing down the pace of fiscal adjustment so that the recovery gets a chance to pick up some steam. This is particularly relevant when (i) the external environment remains weak and uncertain, (ii) the private sector is also busy repairing its balance sheet and (iii) the central bank's (un)conventional ammo fails to boost the recovery. To maintain debt sustainability, the government must opt for a back-loaded fiscal consolidation plan by offering credible medium-term fiscal targets. This will keep bond investors and the rating agencies at bay while giving the economy a chance to recover. The alternative can be either missing budget targets and thereby losing credibility or accepting the harsh consequences of even more restrictive fiscal policy on growth.

Banking Sector

There has been a gradual improvement in the health of UK banks in recent years as capital has increased. That said, there are still a number of weaknesses in the system worth mentioning. First, the elevated uncertainty about the UK economy and the resulting downside risks to asset quality remains a concern. We expect the challenging macroeconomic environment, combined with a high level of consumer indebtedness, to weigh on banks' asset quality. We should note that renewed price falls in the property market could trigger further losses in the banking sector. Moreover, the

high level of public sector indebtedness combined with the harsh austerity measures inflicted on the broader public means the political will for bailing out British banks in the future has diminished considerably. The UK government already bears the burden of its massive interventions in the banking sector. The major source of concern stems from the UK banks' relatively large exposure to the peripheral countries (Greece, Ireland, Italy Portugal, and Spain; GIIPS). The good news is that the direct exposure of the UK banking sector to the GIIPS sovereigns is limited. According to the recent estimate of Fitch, as of end 2011, the major banks (Lloyd, RBS, HSBC and Barclays) had around GBP 11.6bn in exposure (net of provisions) to the sovereign debt of GIIPS, accounting for just over 6% of core tier-1 capital or 0.8% of GDP. However, UK banks have significant exposures to the private sectors of the GIIPS, notably Ireland. Total exposure to the GIIPS amounted to GBP 202bn (13.2% of GDP) in 11Q3, of which 42% is only Ireland. Therefore, any escalation of the eurozone crisis or an Irish sovereign default, though not our base-case scenario, can have a strong negative impact on UK banks’ balance sheets.

United Kingdom

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	3.5	-1.1	-4.4	2.1	0.9	0.2	1.2
Consumer prices (average % change pa)	2.3	3.6	2.2	3.3	4.5	2.9	3.2
Current account balance (% of GDP)	-2.5	-1.5	-1.7	-3.3	-2.8	-2.4	-2.7
Economic growth							
GDP (% real change pa)	3.5	-1.1	-4.4	2.1	0.9	0.2	1.2
Gross fixed investment (% real change pa)	8.1	-4.8	-13.4	3.1	-2.6	-2.1	2.8
Private consumption (real % change pa)	2.7	-1.5	-3.5	1.2	-0.6	-0.2	1.0
Government consumption (% real change pa)	0.6	1.6	-0.1	1.5	1.0	0.2	-0.2
Exports of G&S (% real change pa)	-1.3	1.3	-9.5	7.4	4.9	1.5	4.7
Imports of G&S (% real change pa)	-0.9	-1.2	-12.2	8.6	0.4	0.2	4.0
Economic policy							
Budget balance (% of GDP)	-2.8	-5.0	-11.3	-10.1	-8.2	-7.6	-6.7
Public debt (% of GDP)	44	55	70	80	86	90	93
Money market interest rate (%)	6.0	5.5	1.2	0.7	0.9	1.3	1.6
M2 growth (% change pa)	12	16	5	6	-3	-1	2
Consumer prices (average % change pa)	2.3	3.6	2.2	3.3	4.5	2.9	3.2
Exchange rate LCU to USD (average)	0.5	0.5	0.6	0.6	0.6	0.6	0.6
Recorded unemployment (%)	5.3	5.6	7.6	7.8	8.1	8.7	8.7
Balance of payments (mln USD)							
Current account balance	-71080	-41160	-37050	-75230	-69400	-59400	-69600
Trade balance	-179740	-173460	-128560	-152460	-159300	-154100	-175800
Export value of goods	442280	468150	356350	410900	479900	484600	544800
Import value of goods	622010	641600	484900	563340	639200	638600	720500
Services balance	85530	84140	73640	88200	114300	124800	134600
Income balance	50250	74630	40650	20680	9600	3700	7600
Transfer balance	-27110	-26490	-22790	-31660	-34000	-33800	-36100
Net direct investment flows	-126020	-69630	30070	23240	-17030	8440	19710
External position (mln USD)							
International investment position	-647400	-148000	-492800	-561900	n.a.	n.a.	n.a.
Total assets	15519200	16007400	14056700	15501000	n.a.	n.a.	n.a.
Total liabilities	16166600	16155400	14549500	16062900	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-6.4	-6.5	-5.9	-6.7	-6.5	-6.3	-6.8
Current account balance (% of GDP)	-2.5	-1.5	-1.7	-3.3	-2.8	-2.4	-2.7
Inward FDI (% of GDP)	7.2	3.5	3.3	2.3	2.6	3.0	3.2
International investment position (% of GDP)	-23.0	-5.6	-22.6	-24.8	n.a.	n.a.	n.a.

Source: EIU

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