Euler Hermes Economic Research

Country Report

United Kingdom

Volatility for the long run

General Information

GDP	USD2941.886bn (World ranking 5, World Bank 2014)
Population	64.51mn (World ranking 22, World Bank 2014)
Form of state	Constitutional Monarchy
Head of government	David CAMERON (Conservative Party) – incumbent, announced resignation June 2016
Next elections	2020, legislative

Strengths

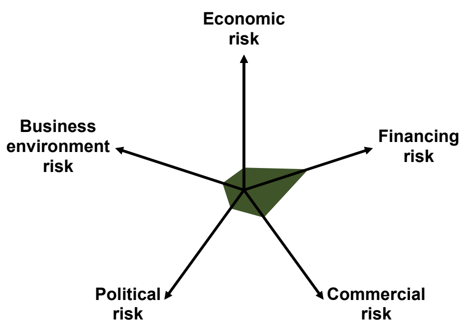
- Supportive economic and fiscal policies
- Accommodative financial conditions
- Healthy banking sector
- Diversified export structure
- Fiscal consolidation under way

Weaknesses

- High trade balance deficit
- 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, 2014)

Exports		Rank		Imports
United States	11%	1	17%	Germany
Germany	10%	2	8%	China
Netherlands	7%	3	8%	Netherlands
Switzerland	7%	4	7%	United States
France	6%	5	7%	Belgium

By product (% of total, 2014)

Exports		Rank		Imports
Cars And Cycles	9%	1	8%	Cars And Cycles
Non-Monetary Gold	8%	2	5%	Crude Oil
Pharmaceuticals	7%	3	5%	Pharmaceuticals
Aeronautics	6%	4	5%	Refined Petroleum Products
Crude Oil	5%	5	4%	Computer Equipment

Source: Chelem

Economic Overview

'Brexit aftermath': volatility for the long run

The citizens of the United Kingdom voted to leave the European Union in a referendum held on June 23, 2016, with 51.9% of the vote in favor of Brexit. In the morning of June 24 when the final results came in, the pound was down -10% against the USD (-8% against the EUR). Downside pressures could remain high in the near future - and so will volatility. Equity markets were also affected. The financial sector took the biggest hit. Yet the automotive, construction, and retail sectors have also suffered double-digit losses.

In order to protect the British banking system from increased uncertainty and instability, the Bank of England (BoE) announced it would inject GBP250bn worth of liquidity when needed – and stands ready to act further. We expect the BoE to remain very accommodative until 2017 as inflation will remain below 1%. It will also monitor inflation developments to be able to put a lid on upside pressures. Indeed, the depreciation of the sterling implies a higher inflation rate in 2017 (+2.7%).

Prolonged uncertainty will weigh on investment and private consumption will suffer from the sterling depreciation

The UK is expected to invoke after September Article 50 of the Treaty of the European Union, which would set a two-year clock ticking on exit negotiations.

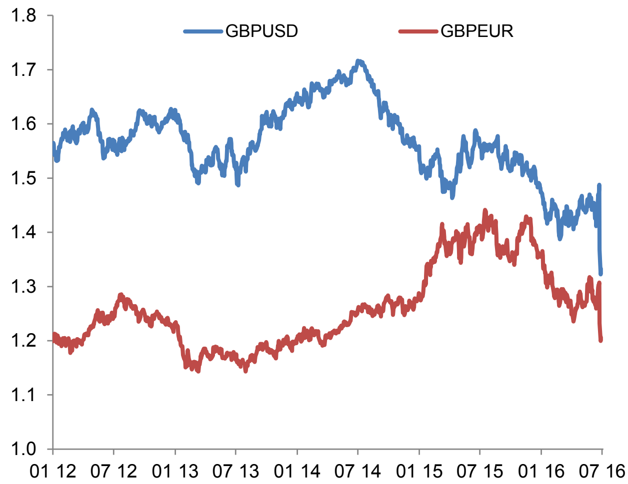
Although Britain's exit from the EU would require the repeal of legislation such as the European Communities Act, David Cameron has pledged to regard the referendum as binding. However, the timing of the official notice remains uncertain as Cameron chose to leave this to his successor.

The withdrawal process includes a 2-year negotiation period, beginning at the date of the official notification. If experience is anything to go by, the time frame is ambitious. For example, when Switzerland rejected EEA membership in 1992, negotiations on bilateral arrangements with the EU have dragged on for five years. It took another three for these to come into force. The complete trade agreement was finalized in 2010.

Thus, an interim agreement between Britain and the EU could be on the cards. The exit process might be defined. Yet the basis for the new relationship with the EU is not. The terms of trade and the regulatory environment might have to be negotiated in parallel.

Uncertainty, coupled with the loss of purchasing power, could shave half a percent off real GDP growth this year. 2016 growth may reach 1.3%, down from the +1.9% forecast. Resilient economic performance in the first two-quarters will be offset by a recession in the coming semester, with -0.2% q/q in Q3 and -0.1% q/q in Q4 2016 (forecasts). Import prices will increase considerably due to a weaker Pound. This is likely to impact companies' profitability as the UK has a very high goods trade balance deficit (see Figure 3), more than 60% of which is with the Eurozone.

Figure 1 – GBP vs USD and vs EUR



Sources: Bloomberg, Euler Hermes

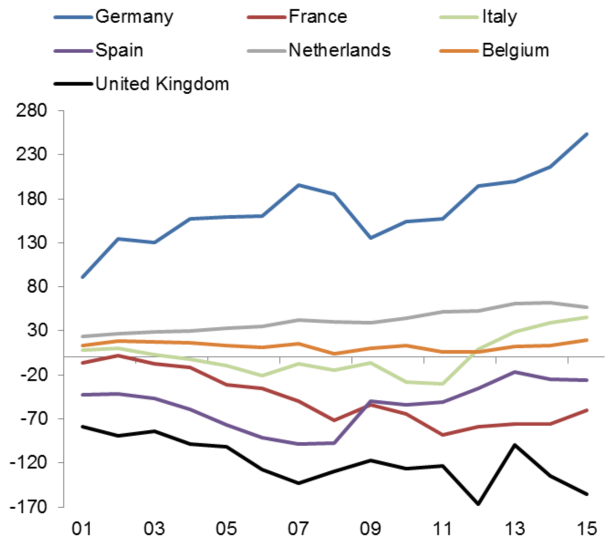
Figure 2 – Key economic forecasts

United Kingdom		Weight	2014	2015	2016	2017
GDP		100%	2.9	2.3	1.3	1.0
Consumer Spending		65%	2.5	2.7	2.2	1.6
Public Spending		20%	2.5	1.5	1.3	0.7
Investment		21%	6.4	4.1	-0.5	-1.1
Construction		9%	8.4	4.0	-0.7	-1.0
Equipment		10%	4.7	5.2	-0.2	-1.2
Stocks	*	-3%	-0.1	0.0	-0.1	-0.3
Exports		30%	1.2	5.1	1.2	2.5
Imports		33%	2.4	6.3	1.7	1.2
Net exports	*	-3%	-0.4	-0.5	-0.2	0.4
Current account	**		-92	-96	-103	-106
Current account (% of GDP)			-5.1	-5.2	-5.4	-5.5
Employment			2.4	1.3	2.2	1.4
Unemployment rate			5.7	5.1	5.1	5.1
Wages			1.8	3.6	3.0	2.5
Inflation			1.3	0.0	0.9	2.7
General government balance	**		-102	-82	-81	-80
General government balance (% of GDP)			-5.6	-4.4	-4.3	-4.2
Public debt (% of GDP)			88.2	89.2	88.0	88.0
Nominal GDP	**		1817	1865	1896	1920

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

Sources: National sources, IHS, Euler Hermes

Figure 3 – Trade balance, EURbn



Sources: IHS, Euler Hermes

Figure 4 – Impact of a Brexit on the United Kingdom (2017-2019)

	2017		2018		2019		
	Stay	*Leave*	*Stay*	*Leave*	*Stay*	*Soft Leave - exit with a FTA*	*Hard Leave - exit w.o. a FTA*
Real GDP growth	1.8%	**1.0%**	1.7%	**1.2%**	1.7%	**0.2%**	**-1.3%**
Nominal GDP growth	3.3%	**2.7%**	3.3%	**3.0%**	3.2%	**2.5%**	**1.2%**
Goods export gains (GBPbn)	35	**30**	25	**20**	20	**-9**	**-30**
Services export gains (GBPbn)	10	**6**	12	**4**	14	**-5**	**-11**
GBP trend	< 5% depreciation	**> 5% depreciation**	> 5% appreciation	**> 5% depreciation**	> 5% appreciation	**> 10% depreciation**	**> 20% depreciation**
Net investment from abroad (GBPbn)	> 50	**< 10**	> 50	**< 10**	> 50	**-60**	**-210**
Firms' turnover (annual growth)	3.5%	**2.0%**	4.0%	**1.5%**	4.0%	**1.2%**	**-1.0%**
Firms' margins (pp)	0.5	**-0.5**	1.0	**-0.8**	1.0	**-1.0**	**-2.0**
Business insolvencies	3.0%	**4.0%**	1.0%	**2.5%**	0.0%	**3.3%**	**4.4%**

Sources: Eurostat, ONS, IHS, Euler Hermes

FTA or no FTA post EU exit?

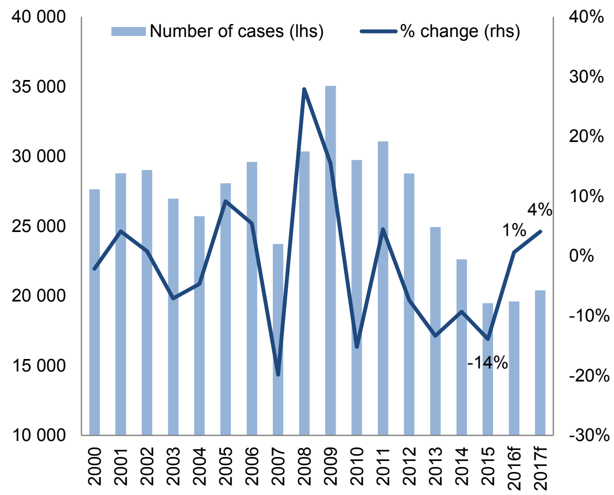
Negotiations with the EU are likely to be long. In practice, the UK would need to renegotiate not only a Free Trade Agreement (FTA) with its European counterpart. It might be forced to set terms for trade with up to 52 countries which have agreements with the EU in place.
By the time the exit is officially agreed, Britain will remain an EU member and all actual conditions (Four EU Freedoms) will continue to apply.

From then onwards two scenarios can unfold. If a Free Trade Agreement (FTA) is signed ("Soft Leave"), UK companies should benefit from lower tariffs but still lose export competitiveness (see Figure 4). If a deal on an FTA is not reached before Brexit takes effect ("Hard leave") trade would default to World Trade Organisation (WTO) rules. The impact will be stronger as the UK trade with the EU will be subjected to WTO Most Favored Nation defined tariffs (see report [Brexit: What does it mean for Europe?] for in depth analysis).

Insolvencies back on the rise

In 2016, business insolvencies are expected to increase by +1%, for the first time since 2012. The upward trend is forecast to accelerate in 2017 with insolvencies up by +4%. This U-turn is due to two main factors. First, the Brexit effect will weigh on companies payment behaviour as the sterling is depreciating and the domestic activity is slowing down. Retail, Trade, and Construction activities will continue to bear the brunt, accounting for 35% of total bankruptcies. Second, there are +9% more enterprises in the country in 2015 compared to 2013. Despite this increase, insolvencies will remain at low levels with 20,400 cases expected in 2017, i.e. -24% less than the 2003-2007 average.

Figure 5 – Business insolvencies



Sources: ONS, Euler Hermes

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Contact Euler Hermes Economic Research Team
research@eulerhermes.com

Last review: 2015-06-30
Country Risk Analyst:
Ana Boata, Thomas Cardiel
ana.boata@eulerhermes.com
thomas.cardiel@eulerhermes.com