UK Economic Outlook

European Economics

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UK Economy: The Great Decoupling (I)

UK growth since 2016 has been modest in historical as well as international comparison.

- UK was growth leader until 2016
- UK has fallen behind rivals after the EU referendum.
- Consumer spending came under pressure.

Sources: ONS, Destatis, BEA, Eurostat and Citi Research
UK Economy: The Great Decoupling (II)

Business investment in particular decoupled from the global investment cycle.

- Business investment decoupled markedly from the investment cycle elsewhere.
- Exports grew nicely as weak sterling helped benefit from global trade recovery.
- But import growth was also strong, offsetting some of the benefit to growth.

Sources: ONS, Destatis, BEA, Eurostat and Citi Research
After the referendum, most forecasters expected a quick hit to output and a swift recovery. The opposite happened. But 2018 GDP looks set to be almost exactly where forecasters expected.

- Brexit uncertainty did not have the immediate impact we and others anticipated.
- But effects unfolded later.
- Contrary to 2016, ‘no deal’ Brexit in 2019 would immediately change the economy (but also end uncertainty).
- We would consider reducing forecasts by a front-loaded 5% of GDP over 2-3 years.

Sources: ONS, Bank of England and Citi Research
UK Growth: Sustainable or Unsustainable? (I)

The sharp drop in household savings cries out for a correction...

- Resilience in UK consumer spending was helped by plunging household saving ratio.
- With saving rates at historic lows, the consumer might find it harder to ride to the rescue again in the event of a no deal Brexit.

Sources: ONS and Citi Research
UK Growth: Sustainable or Unsustainable? (II)

…but tentative signs of a productivity growth rebound could signal untapped potential.

- Most of UK output growth 2012-2017 came from more labour input.
- The lack of investment restricts labour productivity growth.
- But productivity growth has picked up. Are companies improving production processes?
- Sustained higher productivity growth would be important, e.g. for inflation and fiscal forecasts.

Sources: ONS and Citi Research
Outlook: “Smooth-but-hard” Brexit assumption

Key assumption is that the UK and the EU agree on a transition period preserving essentially the same relationship they have today.

- Brexit uncertainty and adjustment is likely to weigh on growth for the foreseeable future.
- In addition, most scenarios will see less free trade with Europe and lower immigration.
- No deal would likely to cause major disruption in the short-term.
- Long-term consequences of Brexit are difficult to predict as UK choices matter as well.
- “Global Brexit” vs. “Drawbridge Brexit”

2017 - 19

Brexit Negotiations

2019 – at least 2021

Transition

Step 1

- Withdrawal and transition treaty
- Status Quo Preserved
- Single Market and Customs Union
- No immigration control

2021 at the earliest

Final Model

Step 2

- Largely free goods trade
- Immigration controls
- Barriers to services trade

Uncertainty

Source: Citi Research
Lessons From and For Brexit Forecasting

As ‘no deal’ remains a risk less than 6 months before the Article 50 TEU deadline, the post-referendum forecasts provide some lessons for risk analysis.

Sources:
- ONS
- Bank of England
- Citi Research

- Business investment is key weak spot so far
- Consumers just kept spending
- Import substitution takes a lot of time
- Brexit has had virtually no impact on the rest of the world
- Long lags and policy supported residential construction investment
- The housing market is (partly) a Brexit victim
- If policy makers avoid errors, financial conditions can loosen
- Sterling’s pass-through to inflation was faster than expected
- This time would be different: no deal brings actual changes, not just uncertainty.

**UK components of GDP growth, 2016–18:** BoE forecast and actual

<table>
<thead>
<tr>
<th>Component</th>
<th>BoE Forecast</th>
<th>Actual/Current FC</th>
<th>Pre-Referendum</th>
<th>Post-Referendum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total GDP</td>
<td></td>
<td></td>
<td>+0.2p</td>
<td></td>
</tr>
<tr>
<td>Private Consumption</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business Investment</td>
<td></td>
<td></td>
<td>+1.3p</td>
<td></td>
</tr>
<tr>
<td>Residential Investment</td>
<td></td>
<td></td>
<td>+0.4p</td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td></td>
<td></td>
<td>+0.7p</td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td></td>
<td></td>
<td>+1.4p</td>
<td>-2.8pp</td>
</tr>
</tbody>
</table>

Sources: ONS, Bank of England and Citi Research
UK’s Global Success Story Challenged

The UK successfully specialised in Advanced Economy service provision, benefitting from immigration and capital inflows. Not just Brexit, but peak globalisation and a backlash against free trade and migration could keep the UK’s position in the global economy in suspense for years.

Also-ran in manufacturing generally
Large OECD Economies – Goods Trade Intensity (% of GDP), 1991-2017

<table>
<thead>
<tr>
<th>Year</th>
<th>UK</th>
<th>Max</th>
<th>Min</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
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<td></td>
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<td>1999</td>
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<td></td>
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<tr>
<td>2003</td>
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<td></td>
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<tr>
<td>2007</td>
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<td></td>
</tr>
<tr>
<td>2011</td>
<td></td>
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<tr>
<td>2015</td>
<td></td>
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</tr>
</tbody>
</table>

Unsustainable external imbalance
Selected Economies – Cyclically-adjusted Norm and Actual Current Account Balance (% of GDP), 2017

Sources: BoE, Markit, ONS, Lloyds, CBI, GfK, Royal Institution of Chartered Surveyors (RICS), Halifax, Nationwide and Citi Research

World leader in AE services
Large OECD Economies – Goods Trade Intensity (% of GDP), 1991-2017

Economic Recovery Reduces EU Mobility
UK, Germany – Employment of Foreign EU Citizens (YY %), 2007-2018Q1

Sources: BoE, Markit, ONS, Lloyds, CBI, GfK, Royal Institution of Chartered Surveyors (RICS), Halifax, Nationwide and Citi Research
Forecast overview: Medium-term Optimism

We expect growth to remain weak through the winter as Brexit uncertainty continues, but – assuming a long Brexit transition period – a growth rebound thereafter. Key risks are ‘no deal’ short transition and external risks.

<table>
<thead>
<tr>
<th>YY %</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>1.7</td>
<td>1.3</td>
<td>1.5</td>
<td>1.9</td>
<td>2.0</td>
<td>1.9</td>
</tr>
<tr>
<td>Private Consumption</td>
<td>1.8</td>
<td>1.1</td>
<td>1.4</td>
<td>1.5</td>
<td>1.6</td>
<td>1.6</td>
</tr>
<tr>
<td>Public Consumption</td>
<td>-0.1</td>
<td>1.3</td>
<td>1.8</td>
<td>1.2</td>
<td>0.9</td>
<td>0.9</td>
</tr>
<tr>
<td>Fixed Investment</td>
<td>3.4</td>
<td>0.4</td>
<td>0.5</td>
<td>3.2</td>
<td>2.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Business Investment</td>
<td>1.6</td>
<td>0.5</td>
<td>-0.2</td>
<td>3.2</td>
<td>2.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Construction Dwellings</td>
<td>9.6</td>
<td>6.3</td>
<td>-0.2</td>
<td>3.8</td>
<td>2.8</td>
<td>2.8</td>
</tr>
<tr>
<td>Exports</td>
<td>5.4</td>
<td>-0.7</td>
<td>2.0</td>
<td>2.8</td>
<td>3.1</td>
<td>2.6</td>
</tr>
<tr>
<td>Imports</td>
<td>3.2</td>
<td>-0.2</td>
<td>1.8</td>
<td>2.1</td>
<td>1.6</td>
<td>1.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other Forecasters (GDP only)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consensus (Bloomberg)</td>
</tr>
<tr>
<td>IMF</td>
</tr>
<tr>
<td>Bank of England</td>
</tr>
</tbody>
</table>

Sources: ONS and Citi Research
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