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United Kingdom – "political construction sites" create uncertainty

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After securing victory at the parliamentary elections in May 2015, the Conservative Party is now getting down to business with the promised referendum on the United Kingdom's EU membership, which is to be held by 2017 at the latest. The United Kingdom is now entering a prolonged phase of political uncertainty fraught with considerable economic risks.

Good short-term growth prospects ...

With the exception of these political imponderables, the UK's economy has recently been in a healthy state. With price-adjusted GDP growth of 2.8 % on the previous year, the UK was at the top of the G7 countries' growth leaderboard in 2014. The unemployment rate has fallen continuously to 5.5 % and is now close to pre-crisis lows.

However, the economy of the United Kingdom lost momentum in the first quarter of this year. The rate of growth halved to 0.3 % on the previous quarter. Despite a dip in April / May, which may have resulted from the general elections, sentiment indicators show that momentum is picking up again. Not least because of the soft start to the year, the overall economic expansion rate will slow to approximately 2¼ % in 2015. Domestic demand will continue to be the main driver of growth.

... but economic weaknesses remain

- The United Kingdom has hardly come any closer to achieving the target of a more balanced growth model which the Conservative Party postulated when it came to power in 2010. The fate of the UK economy still mainly depends on credit-financed private consumption and the upswing on the residential property markets. The share of manufacturing in total real gross value added on has stagnated at around 10 %.

- The twin deficits in the national budget and the current account balance, which were approx. 5.5 % of GDP each in 2014, have also proven to be persistent. Both are expected to fall only moderately to between 4½ and 5 % this year.

- Wage and productivity developments also remain unsatisfactory. Across the economy, labour productivity per hour worked has virtually stalled since the outbreak of the financial crisis. This has gone hand-in-hand with weak wage growth. Only recently have there been growing signs that the increasing labour shortage is creating stronger wage dynamics.

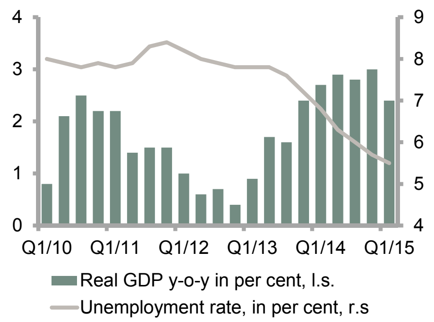
High risks

After a marked upturn since the end of 2012, residential property prices have now returned to pre-crisis levels. They are deemed to be around 40 % overvalued in relation to long-term income and rental trends. A correction is being predicted, especially in case of a major interest rate rise. This could be triggered by the key interest rate trend reversal which is generally expected for 2016.

Fiscal policy also has the potential to derail economic growth. The new government aims to balance the budget by 2018/19. Recently, the Chancellor of the Exchequer even flagged the possibility of a UK version of the debt brake by challenging the government to record a balanced budget when the economy runs normally. Thus, further consolidation measures with corresponding negative growth impacts will be inevitable.

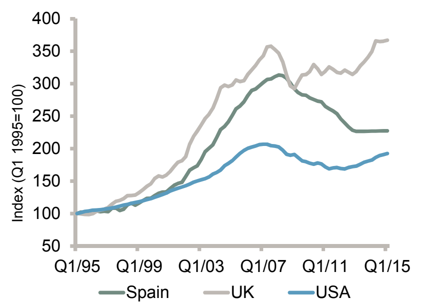
The biggest risk, however, is the "Brexit" scenario. The uncertainty it creates is likely to dampen investment appetite even before the referendum. Several enterprises, primarily from the financial industry, have already signalled that they will consider moving to a different location should the UK leave the EU. A Brexit could severely affect UK trade as well, since it is strongly oriented to the EU, which accounted for 47 % of UK exports and 53 % of imports in 2014. In order to shorten the phase of uncertainty, the UK government should hold the referendum as soon as possible. ■

Figure 1: Growth and labour market



Source: Bloomberg

Figure 2: Comparison of UK house prices



Source: Feri, Bloomberg