www.davy.ie
Bloomberg: DAVY<GO>
Research: +353 1 6148997
Institutional Equity Sales: +353 1 6792816

Conall MacCoille
conall.maccoille@davy.ie / +353 1 6148997

Davy Research

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Research Report: Economy

UK economy

Prospects for UK net trade in 2011

Most macroeconomic projections for UK GDP growth in 2011 are conditional on a sharp turnaround in trade performance

- The outlook for UK growth remains highly uncertain. Most forecasts for 2011 GDP growth are based on a sharp improvement in UK trade performance next year.
- On average, forecasters expect net trade to make a 0.5% contribution to GDP growth in 2011 (having detracted from growth in 2010).
- The poor performance of UK net trade has been surprising given the competitive gain from the sharp sterling depreciation in 2007. Thus far, forecasters have provided little rationale for why this weakness should dissipate in 2011.

Net trade unlikely to pick up sufficiently strongly to offset fiscal adjustment; policy rates may remain at historic low for longer than expected

- The UK's specialisation in traded financial and business services, a poorly performing sector, is likely to continue to act as a drag on export growth next year.
- The Bank of England expects an improvement in UK net trade in 2011 in its central projections. But the November inflation report outlined the severe doubts of the Monetary Policy Committee (MPC) in this regard.
- If the MPC's projections for GDP growth based on a turnaround in net trade are not realised, short-term interest rates may remain on hold at their current historic low of 0.5% for longer than the market might currently expect.

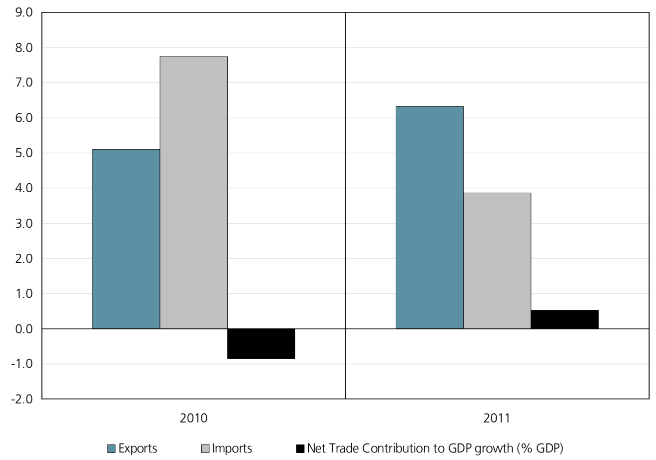
Introduction

Outlook for UK GDP growth remains highly uncertain; expectations may be overstated

- On average, forecasters expect the UK net trade deficit to make a 0.5% contribution to GDP growth in 2011

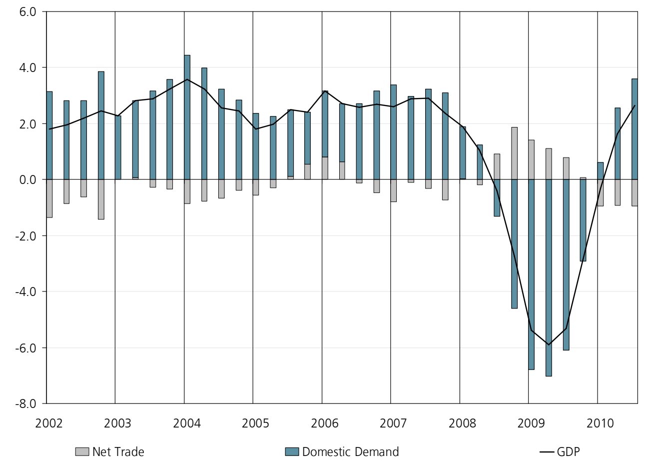
The outlook for UK growth remains highly uncertain. The majority of forecasts for GDP growth in 2011 are in the region of 1.5-2.5%. Figure 1 illustrates that these projections are based on a sharp turnaround in the net trade contribution to GDP growth in 2011. So projections for UK GDP growth expect foreign demand to compensate for the fiscal tightening scheduled for 2011. Indeed, only one projection in the Treasury December survey of 38 economic forecasts did not outline a sharp improvement in UK trade performance next year. On average, forecasters expect the UK net trade deficit to make a 0.5% contribution to GDP growth in 2011 (having detracted from growth in 2010).

Figure 1: UK exports, import growth and net trade contribution to GDP



Source: HM Treasury Forecasts for the UK Economy: a comparison of independent forecasts, December 2010

Figure 2: GDP growth and domestic demand, net trade contributions



Source: Office for National Statistics; Davy estimates

Net trade unlikely to pick up sufficiently strongly to offset fiscal adjustment

- The relatively weak performance of UK net trade in recent years has been surprising given the competitive gain from the sharp sterling depreciation in 2007

But can this rebalancing of demand away from government spending towards the export sector be achieved sufficiently quickly to realise relatively robust GDP forecasts for 2011? The weak performance of UK net trade in recent years has been surprising given the competitive gain from the sharp sterling depreciation in 2007. Thus far, explanations for this poor performance have been few and far between, and forecasters have provided little rationale for why this weakness should dissipate in 2011. This note suggests that a sharp turnaround in UK net trade is unlikely and that expectations for UK GDP growth in 2011 may therefore be overstated.

The Bank of England also expects an improvement in UK net trade in 2011. That said, the Bank's November inflation report spent some time outlining the severe doubts of the Monetary Policy Committee (MPC) that such an improvement would occur given the failure of UK net trade to contribute to growth following the sterling depreciation. The projections of the Office for Budgetary Responsibility (the Treasury) are also conditional on a sharp turnaround in UK net trade. So both the outlook for monetary policy and budgetary policy in the UK will depend on trade performance.

Reasons for the UK's poor net trade performance

This note explains why the UK's net trade performance has been surprisingly poor:

- UK exporters have taken the competitive boost from the sterling depreciation in the form of higher profit margins rather than attempting to gain market share. Until UK exporters begin to cut their prices, they are unlikely to gain export market share so net trade contributes positively to GDP growth.
- The UK's specialisation in financial services trade has had a negative impact on export prospects. Global financial market activity is unlikely to rise in the near future given that the deleveraging process is still underway and as consumers and non-financial companies continue to repair their balance sheets. If this is the case, services exports will continue to provide a drag on UK exports.

The strong turnaround in the UK trade contribution to GDP growth in 2011 that is being predicted by most economic forecasters may therefore not be realised.

Recent data flow on UK net trade has not been convincing

There has been little evidence that the UK trade deficit is beginning to narrow. The trade deficit was £4.1bn in November, considerably larger than the £3.6bn market expectation. The strong recovery in global trade, UK exports and UK imports has not led to an improvement in the UK's net trade performance. The consensus among forecasters that net trade would make a strong positive contribution to GDP growth next year followed the release of the Q3 2010 national accounts. The initial releases indicated that net trade had contributed 0.4pp to GDP growth of 0.8% in the quarter; however, the final quarterly national accounts revised away the positive net trade contribution to -0.1pp. So the recent negative data flow on UK trade does not bode well for 2011.

Consequences for asset prices

What might this mean for asset prices? Short-term interest rates in the UK are more likely to remain at 0.5% if the MPC's projections for GDP growth based on a turnaround in net trade are not realised. This turnaround in net trade performance implies that companies will be able to increase their earnings by expanding export volumes in foreign markets. If macroeconomic projections for UK trade in 2011 are too optimistic, the corresponding expectations for corporate earnings (particularly in the export-orientated sectors) will also be with obvious implications for asset prices.

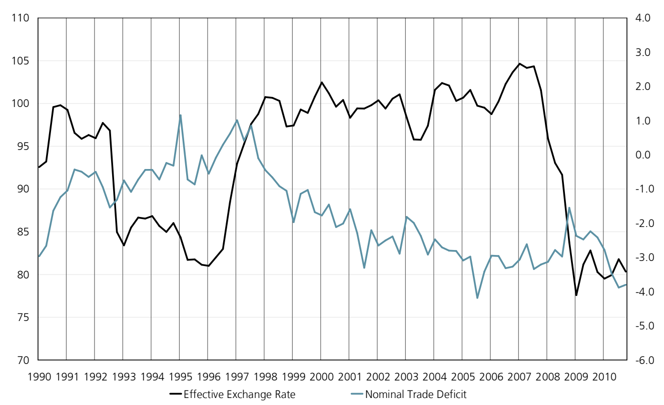
Why has UK trade performance been so poor?

- **Given that there had previously been a strong statistical relationship between the exchange rate and trade performance across many countries, the relatively poor performance of UK trade since 2007 is surprising**

The sharp depreciation of sterling, following the collapse of Northern Rock in 2007, had been expected to help reduce the UK's trade deficit. Figure 3 illustrates that in trade-weighted terms the depreciation in 2007 was even larger than in the period following the UK's exit from the European Exchange Rate Mechanism (ERM) in 1992. Peak to trough, the nominal effective exchange rate fell by 27% between 2007 and 2009 compared with a decline of around 20% from 1990-1995. Following the UK's exit from ERM, the trade deficit began to shrink, eventually moving into a small surplus in the mid-1990s. Conversely, the sharp appreciation of sterling from 1996 onwards led to a deterioration in the UK trade deficit. This time around, however, there has been little response with the trade deficit remaining close to 4% of GDP in the third quarter of 2010. Given that there had previously been a strong statistical relationship between the exchange rate and trade performance across many countries, the relatively poor performance of UK trade since 2007 is surprising.

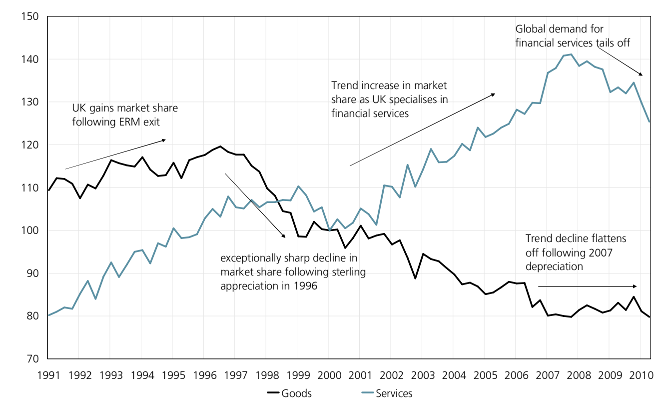
Figure 4 attempts to shed light on this weakness by illustrating UK exports of goods and services as a share of global demand. Over the past two decades, the UK's goods export market share has been in secular decline, mainly due to the emergence of new competitors such as Eastern European economies, China and other developing countries. Since 2007, however, this decline has stalled – providing some evidence that the sterling depreciation has had a positive impact on UK export growth. That said, in the period following the UK's depreciation in 1992, the UK gained market share in the traded goods market. So the sterling depreciation appears to have had less of a positive impact on the UK's goods export market share this time around. We discuss the reasons for this later on but first explain the exceptionally poor performance of UK services imports in the recent past.

Figure 3: UK nominal trade weighted exchange rate and nominal trade deficit



Source: Office for National Statistics; Bank of England

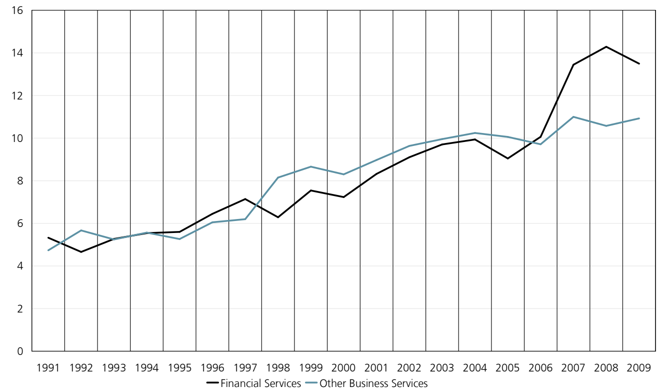
Figure 4: UK goods and services market shares



Source: Bank of England, November 2010 Inflation Report

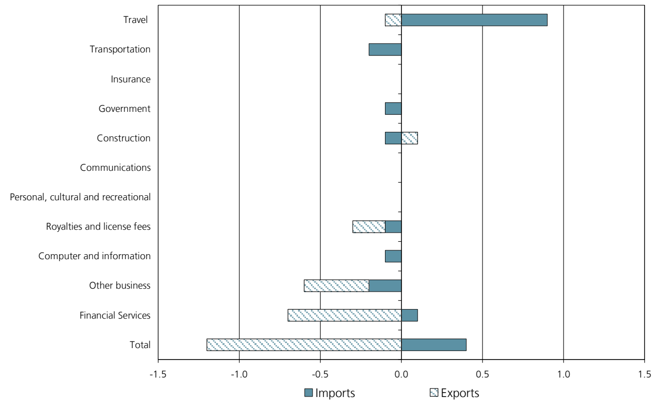
Traded services, comprising around 40% of total exports, are particularly important for the UK. Since 1990 the UK has gained market share in the global traded services market, but this trend went into sharp reverse in 2007 – severely hurting aggregate UK export prospects. The rising importance of the traded services sector for the UK economy has been accompanied by increasing specialisation in the financial and business services sectors. Figure 5 illustrates that these sectors have doubled their share of UK exports over the past two decades. Together, these sectors accounted for 7.3% of UK GDP in 2008 and 62% of UK services exports in nominal terms.

Figure 5: Financial and business services' shares of UK exports



Source: Office for National Statistics, The *Pink Book* 2010

Figure 6: Cumulative contributions of services trade to UK GDP growth since Q2 2007



Source: Bank of England, November 2010 Inflation Report

- **The global financial crisis and the deleveraging process have had a negative impact on UK financial services trade**
- **The traded services sector is likely to act as a drag on UK exports for some time**

Figure 6 illustrates the large negative contribution from financial services and other business services trade to UK GDP growth since Q2 2007. This confirms that the UK's specialisation in business and financial services has held back export growth. Clearly, the global financial crisis and the deleveraging process have had a negative impact on UK financial services trade. Activity in the financial sector is likely to remain muted as consumers and firms continue to repair their balance sheets and financial firms adapt to a stricter regulatory environment. The traded services sector is therefore likely to act as a drag on UK exports for some time.

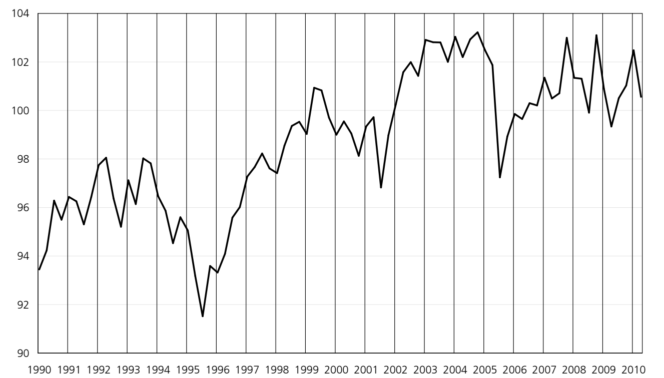
Why have UK goods exports not benefitted from the low level of sterling?

However, the weakness of the financial sector cannot directly explain the muted response of UK goods trade (which comprises two-thirds of UK exports) to the sterling depreciation. The adjustment of an economy's trade balance following exchange rate depreciation has been described as the 'J-curve' (i.e. the trade deficit may at first deteriorate following a currency depreciation but will eventually begin to narrow).

- **The UK terms of trade have been broadly flat since the depreciation of sterling. This suggests that we should not have expected an improvement in the UK's trade performance.**

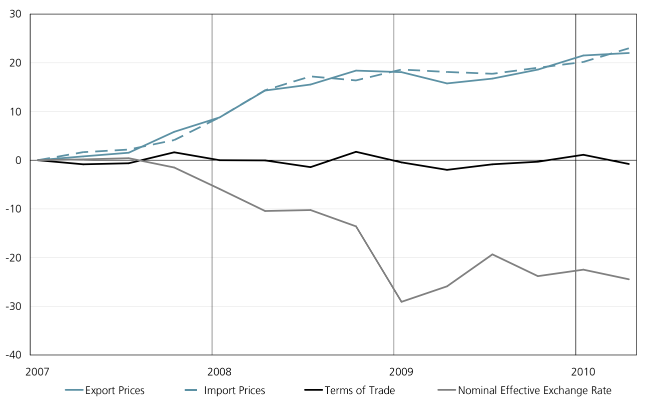
As the value of a currency falls, imports become more expensive as it becomes more costly to buy them from abroad. Also, exports become cheaper in foreign markets because the domestic currency is worth less. This means the terms of trade (the price of a country's exports relative to its imports) decline. Because it takes time for export volumes to rise (and import volumes to fall), the trade deficit may at first deteriorate given the decline in the terms of trade. But as trade volumes respond (to the fall in the terms of trade), the nominal trade deficit should eventually begin to narrow. So has there been an adjustment in the UK terms of trade? Figure 7 illustrates that the UK terms of trade have been broadly flat since the depreciation of sterling. This suggests that we should not have expected an improvement in the UK's trade performance.

Figure 7: UK terms of trade



Source: Office for National Statistics

Figure 8: Percentage changes in trade prices since Q1 2007



Source: Office for National Statistics; Davy estimates

- **UK export volumes are unlikely to rise sharply because companies have taken the competitive gain from the sterling depreciation in the form of higher profit margins rather than attempting to cut their foreign-denominated prices and gain export market share**

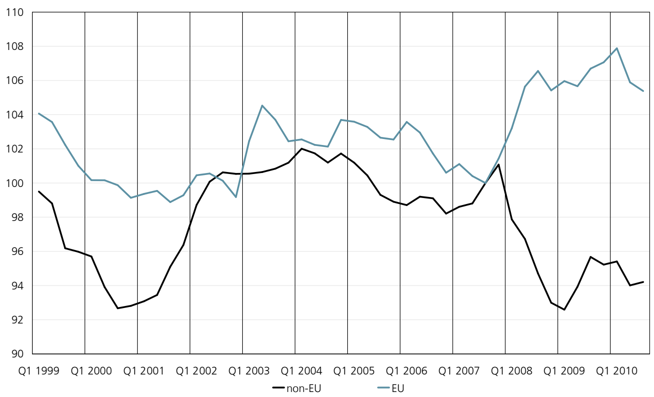
Figure 8 shows that UK import prices have increased by around 23% since 2007. Surprisingly, export prices (in sterling) have risen by approximately the same amount so that the UK terms of trade have been broadly flat. That is, UK exporters have increased the price of their exports in sterling, so that their prices in foreign currency terms (e.g. euro) have remained constant. UK export volumes are unlikely to rise sharply because companies have taken the competitive gain from the sterling depreciation in the form of higher profit margins rather than attempting to cut their foreign-denominated prices and gain export market share.

There are several reasons why UK firms may have decided not to cut their foreign-denominated export prices:

- The price elasticity of demand for UK exports may be low so that exporters have little to gain by cutting their foreign-denominated prices. This is more likely to be the case if UK exporters operate in niche or specialised markets, which may be more likely now than in the past given heightened competition in global markets for traded goods.
- UK firms have been faced with tighter credit conditions as banks have restrained lending. Higher profits will have allowed UK firms to pay down bank debt and improve their balance sheet position. Indeed, the data show that UK private non-financial companies have been paying down bank debt. So exporters may have been reluctant to reduce their profit margins in the short term by cutting their export prices in pursuit of higher profits in the medium to long term as their volumes pick up and they gain market share.
- It takes time for capital within an economy to be reallocated towards the export sector. This adjustment may have been even longer than usual because firms had limited access to credit. This effect may have prevented new firms from entering the export sector in pursuit of higher profit margins. Similarly, credit constraints may have stopped UK firms from competing with foreign firms importing goods into the UK which had received a competitive loss from the sterling depreciation.
- Companies may have judged that the depreciation of sterling is largely temporary and decided not to expand production sharply.

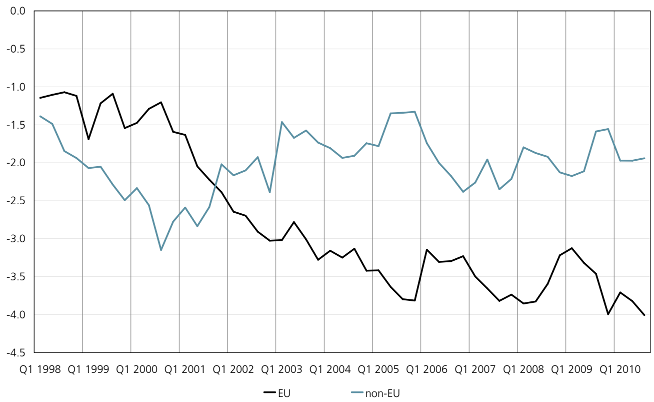
Analysing trade on a bilateral (rather than aggregate basis) can also help in understanding how the UK has adjusted to the sterling depreciation. Unfortunately, the Office for National Statistics provides only data on UK goods trade volumes split between the EU and non-EU countries. This means that we cannot compare UK trade performance across countries. However, there appears to have been considerably more price adjustment in the UK's trade with countries outside the EU. The goods terms of trade with non-EU countries has fallen, while it has increased with the EU countries (Figure 9).

Figure 9: UK terms of trade with EU and non-EU countries



Source: Office for National Statistics; Davy estimates

Figure 10: UK nominal trade in goods deficit with EU and non-EU countries



Source: Office for National Statistics; Davy estimates

- **Pricing by UK firms, particularly those that export goods to the EU, has delayed a positive contribution from net trade to UK GDP growth**

Commensurate with these relative price movements, the UK's trade performance with countries outside the EU has been far more favourable. Since the sterling depreciation, there has been a modest improvement in the UK's trade in goods balance with non-EU countries, which has narrowed to 0.5% of nominal GDP since the sterling depreciation (Figure 10). In contrast, the UK's nominal goods trade deficit with EU countries has expanded to 4% of nominal GDP. This means that pricing by UK firms, particularly those that export goods to the EU, has delayed a positive contribution from net trade to UK GDP growth.

Conclusion

In 2011 the key issue for the UK economy is how quickly private demand can pick up to offset the fiscal squeeze as the coalition government reins in spending. Most macroeconomic projections expect UK net trade to do a lot of the work, with exports picking up so that foreign demand helps the rebalancing of the UK economy away from government spending. In our view this adjustment process is not likely to be a smooth one with net trade and exports not expanding sufficiently quickly so that overall GDP growth falls below trend, with calendar year GDP growth slightly weaker than current consensus expectations.

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