

UK Economics Weekly

How Vulnerable Is the UK to EM Strains?

- The UK continues to grow strongly, with solid gains in IP, car sales and house prices. However, with recent strains in a range of emerging markets (EM), this note aims to assess the extent to which the UK is vulnerable to potential EM weakness.
- The UK economy is very globalized, but the UK's direct export exposure to EM is relatively low. Indeed, even with the UK's relatively high level of services exports, the UK's goods and services exports to EM are the smallest (as a share of GDP) among the EU15 countries. UK banks have sizeable EM exposure, but the bulk of the UK's inward and outward FDI is to/from advanced economies rather than EM. Moreover, the EM slowdown has some positive side-effects for the UK, in that falling import prices will probably help pull UK inflation below target in coming months, raising the chance that real wages start to rise by year-end. Recent experience suggests that – provided prospects for US and EMU growth do not deteriorate markedly – further steady EM downgrades will not derail the UK's recovery.

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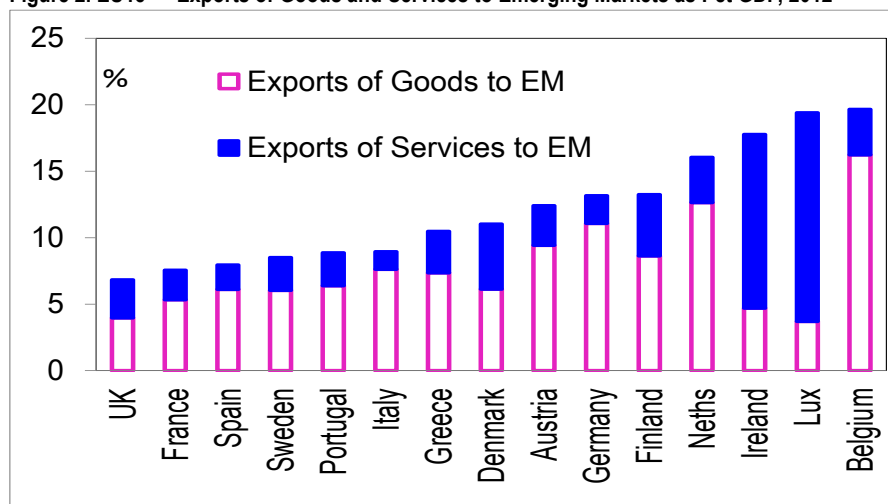
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Figure 1. Citi Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs. Bunds	\$/£	£/€
End 2014	0.75	£362bn	3.60	183bp	1.76	0.80
Mid 2015	1.50	£358bn	3.80	194bp	1.77	0.79

Source: Citi Research

Figure 2. EU15 — Exports of Goods and Services to Emerging Markets as Pct GDP, 2012



Note: Emerging markets measured using the IMF "developing countries" definition.
Sources: IMF, Eurostat and Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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How Vulnerable Is the UK to EM Strains?

This note aims to assess the UK's vulnerabilities to possible EM weakness

The UK's exports of goods to emerging markets have risen quite rapidly in recent years...

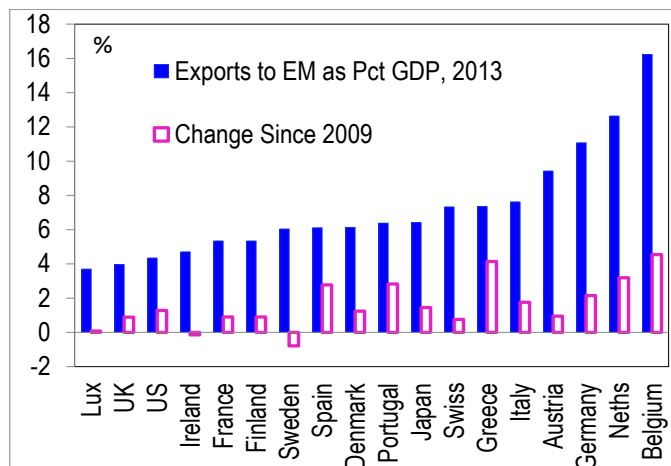
...but, as a share of GDP, remain relatively low by EU standards

The latest data suggest that the UK continues to grow strongly, with the PMI indices well above average, plus ongoing solid growth in IP, car sales and house prices. Monetary policy is loose, headwinds have reduced from private deleveraging, balance sheet repair, and fiscal drag, and we suspect that domestic risks to growth are to the upside. However, with the recent strains in a range of emerging markets, some investors worry that the UK recovery will be short-circuited by external weakness. To be sure, we have been cutting EM growth forecasts for a while, and there may still be downside risks to a number of countries. This note aims to assess the extent to which the UK is vulnerable to potential EM weakness.

Exports of goods to emerging markets have risen quite rapidly in recent years: in USD terms, the UK's exports of goods to EM have risen by 108% over the last 10 years, more than twice the growth in exports to advanced economies (52%)¹. Exports of goods to EM are up from 2.3% of UK GDP in 2002 to 4.0% of GDP in 2013 (annualizing data for Jan-Sep 2013). This ratio now is the highest since 1984.

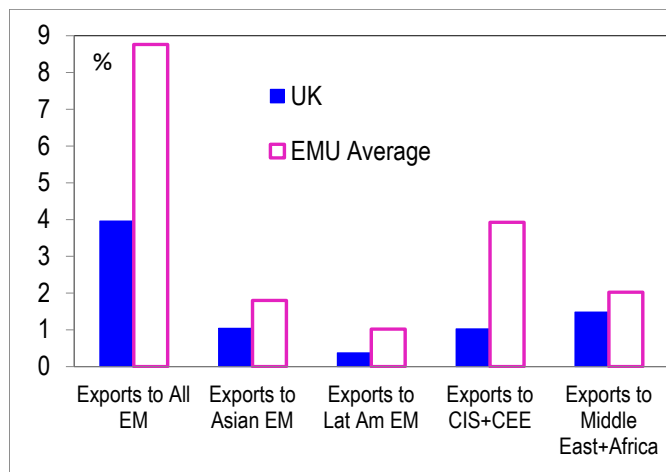
However, the expansion in exports to EM is not spectacular compared with other countries and comes from a low base. The UK's direct export exposure to emerging markets remains relatively low. Exports of goods from the EMU countries to emerging markets have surged by 158% over the last 10 years (in USD terms), with even more spectacular gains in exports to EM from Spain (216%), Greece (299%) and Portugal (382%). As a share of GDP, the UK's exports of goods to EM are the lowest among the EU15 countries apart from Luxembourg (exports of goods to EM are 3.7% of GDP). For EMU as a whole, exports of goods to EM are 8.8% of GDP and >9% of GDP for Austria, Germany, the Netherlands and Belgium (the data for the latter two may include the re-export of goods from neighbouring EMU countries).

Figure 3. EU15, US and Japan – Exports of Goods to Emerging Markets as Pct GDP, 2009-13



Sources: IMF and Citi Research

Figure 4. UK and EMU Average -- Exports of Goods to Emerging Markets as Pct of GDP, 2013



Sources: IMF and Citi Research

The UK has lost market share in EM countries over recent years

Even after the EM boom of the last 10 years, only 20% of the UK's exports of goods go to emerging markets. And the UK's share in aggregate EM imports (of goods) has fallen steadily from 5.1% in 1981 to 2.7% in 2000 and just 1.6% in 2013. The economies of France and Italy are, in nominal terms, similar to the UK, but both export about 50% more to emerging markets than the UK does. The UK's export exposure is relatively low for all major EM regions other than the Middle East.

¹ Figures based on the IMF DOTS data, using the IMF's definition of emerging markets.

The UK is a major exporter of services, especially financial services, but most of these go to other advanced economies...

Of course, the UK is also a major services exporter, and services account for 37% of the UK's total exports (whereas services account for only 24% of exports for euro area countries)². However, only 24% of the UK's exports of services go to emerging markets (2012 data), and this ratio is rising only slowly (having been 20% in 2004). In particular, the UK's services exports are strongly oriented to financial and business services, and world trade in these is largely between advanced economies. EM countries' imports account for about 36% of total global imports of services (similar to their share in global imports of goods) but only 18% of global imports of financial services. Many EM countries have relatively closed capital accounts, or other limitations on the role of foreign financial services firms. Trade openness is generally much greater for goods than for financial services.

...exports of services to EM are only about 3% of UK GDP...

■ In 2012, the UK's exports of services to emerging markets totalled 2.9% of UK GDP (£55.5bn), slightly ahead of the EU15 average (2.5% of GDP) but roughly in the middle of the pack for European economies.

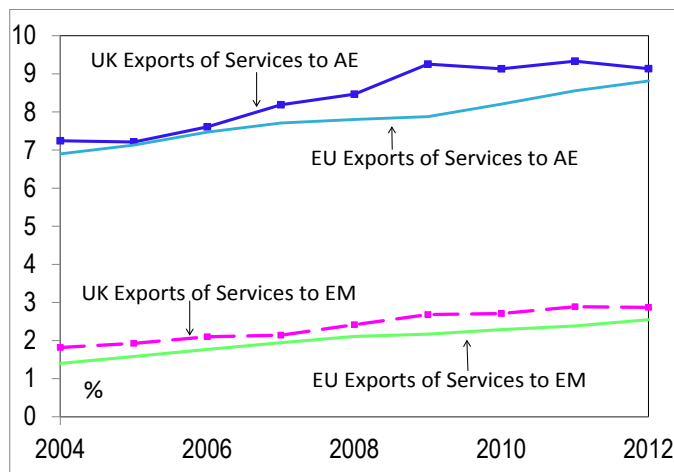
...which is similar to exports of services to North America...

■ The UK's exports of services to the US and Canada (£55.2bn in 2012, 2.9% of GDP) are similar to the UK's services exports to all emerging markets.

...and well below the UK's exports of services to EU countries

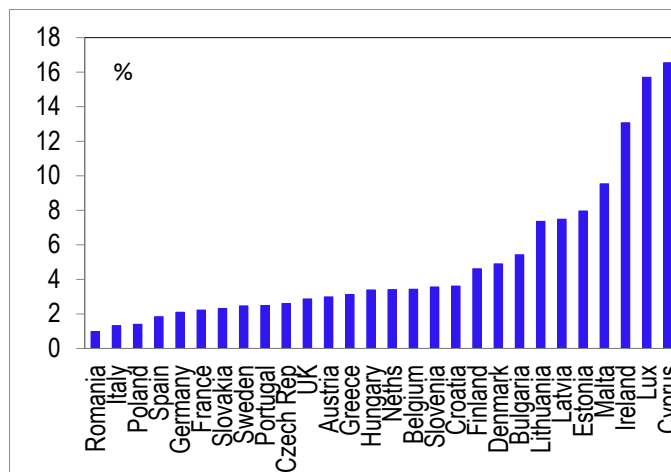
■ The UK's exports of services to the EMU countries (£72.2bn, 3.7% of UK GDP in 2012) are substantially greater than the UK's services exports to all EM countries.

Figure 5. UK and EU Average – Exports of Services to Advanced Economies (AE) and Emerging Markets (EM) as Pct GDP, 2004-12



Sources: Eurostat and Citi Research

Figure 6. EU Countries – Exports of Services to Emerging Markets as Pct GDP, 2012



Sources: Eurostat and Citi Research

The UK's overall export exposure to EM countries, as a share of GDP, is the lowest among the EU15 countries

In total, we calculate that the UK's overall exports (good and services) to emerging markets are about 6.8% of GDP (2012 data) – the lowest among the EU15 countries – whereas exports to EM are 7.6% of GDP for France, 7.9% of GDP for Spain, 8.9% of GDP for Italy and 13.2% of GDP for Germany (see Figure 2, front page). The UK's exports are overwhelmingly AE-oriented. The UK's relatively low export exposure to emerging markets means that the direct boost to UK exports from the long EM boom has been modest compared with that for many other European countries: but the flipside is that the direct drag on UK exports from an EM slowdown is also likely to be relatively modest unless the UK's key export markets of the EU and North America weaken markedly.

² Note that this 24% figure includes exports from one euro area country to another.

UK banks have sizeable exposure to EM countries...

...and this has risen sharply in recent years...

...to a level far above the norm in advanced economies

UK banks have relatively high exposure to Asian EM, Lat Am and Middle East/Africa

Of course, the UK's EM links are wider than purely through exports. In particular, UK banks have substantial – and rapidly rising – exposure to emerging markets.

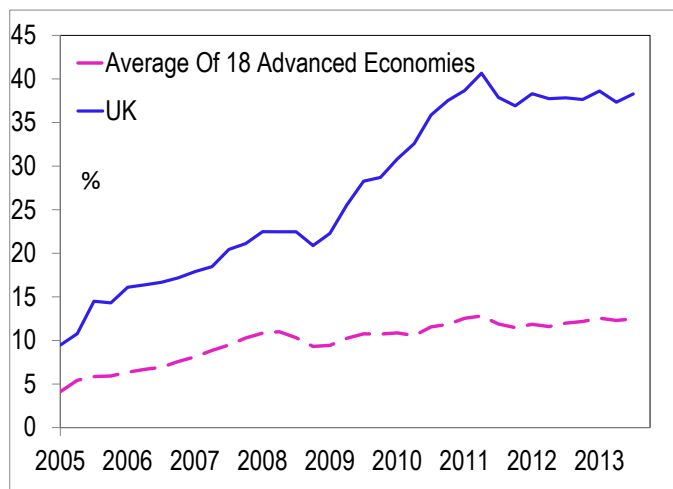
■ Using BoE data, the claims of UK-owned banks on developing countries (on an ultimate risk basis) have soared from £194bn in Q4-04 (8.4% of annual UK GDP) to £636bn (27.1% of GDP) in Q4-09 and to £960bn (38% of GDP) in Q3-13³. Over the last five years (ie from Q3-08 to Q3-13), UK-owned banks cut their total foreign assets by 10%, with a 28% drop in assets in other developed countries (and a 23% drop in exposure to developed Europe). But, UK-owned banks have compensated by increasing their claims in emerging markets by 48% over the last five years, with increases of 36% for Latin America, 58% for EM Europe and 79% for EM Asia.

■ As a share of GDP, the level of UK-owned banks' claims on EM countries (38% of GDP) is roughly three times the average among 18 major advanced economies (12% of GDP using BIS data) – and this ratio is below 10% of GDP for German banks and US banks. The only major AEs with higher banking sector exposure to EM are Austria (58% of annual GDP, concentrated in EM Europe) and Spain (41% of GDP, concentrated in Lat Am), although banks' exposure to EM is also relatively high for Greece (34% of GDP), the Netherlands (23% of GDP) and Switzerland (22% of GDP).

■ Among EM countries, the exposure of UK banks is relatively high to Asian EM, Lat-Am and Middle East/Africa, but relatively low (although rising rapidly) for Emerging Europe. Note that these data for UK banks' exposure to EM exclude exposure to offshore financial centers, which totalled a further £572bn (23% of UK GDP) in Q3-13, the highest as a share of GDP among advanced economies.

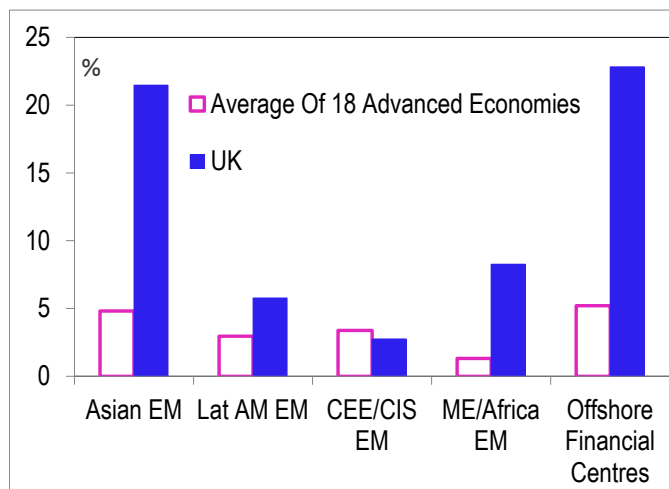
Note that the biggest companies in the UK equity indices generally also have relatively high EM exposure, through the major weighting of financial and resource-oriented firms. Hence, corporate profits of major quoted companies in aggregate probably are more EM-sensitive than the UK economy as a whole (see Figure 12).

Figure 7. Selected Countries – Exposure of Domestically Owned Banks to Emerging Markets as Pct GDP, 2005-13



Sources: BIS, Eurostat, DataStream and Citi Research

Figure 8. Selected Countries – Exposure of Domestically Owned Banks to Emerging Markets and Offshore Financial Centers as Pct GDP, 2013



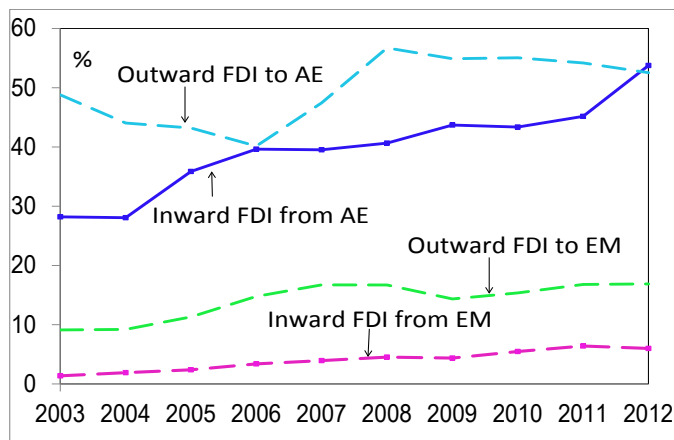
Source: Citi Research

³ Of course, these data do not tell us whether the riskiness of these assets has risen or fallen.

The UK is also highly globalized via FDI, but the bulk of inward and outward FDI is with other advanced economies

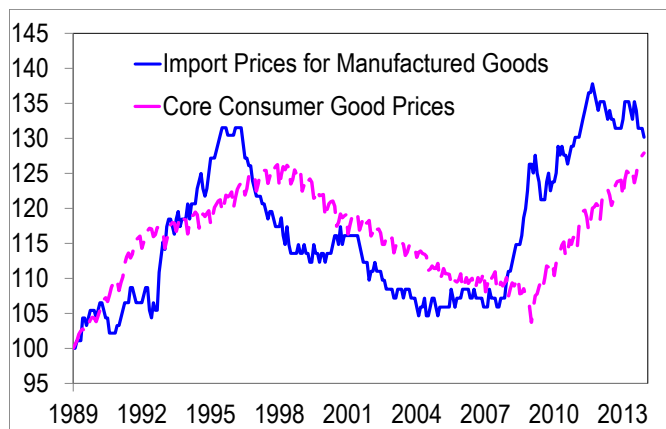
In addition, the UK economy is also highly globalized via elevated levels of inward and outward FDI. The levels of inward FDI (54% of annual GDP in 2012) and outward FDI (74% of annual GDP) are far above the averages for developed countries (33% of GDP for inward FDI, 43% of GDP for outward FDI) and on both measures the UK ranks the highest in the G7. However, while FDI flows to and from EM have risen sharply in recent years, only 10% of the stock of inward FDI is from emerging markets and only 24% of the stock of outward FDI is in emerging markets. The stock of outward FDI by UK-owned firms in other EU countries, £513bn in 2012, is far greater than the stock of FDI in all emerging markets combined (£264bn). Of course, even some FDI in AEs may be EM-oriented. But, while FDI channels probably increase the UK's sensitivity to EM tremors above the export channel alone, again the UK's key links are to advanced economies rather than EM.

Figure 9. UK – Level of Inward and Outward FDI from/to Advanced Economies and Emerging Markets, as Pct UK GDP, 2003-12



Note: Advanced economies defined here as the EU, EFTA, US, Canada, Japan, Australia, New Zealand. EM defined as the rest. Sources: ONS and Citi Research

Figure 10. UK – Import Prices and Core Consumer Goods Prices, Indexed to Jan 1989 = 100, 1989-2013



Note: Core consumer goods prices are goods excluding food, drink, tobacco and energy products. Sources: ONS and Citi Research

An EM slowdown could have some positive side-effects for the UK

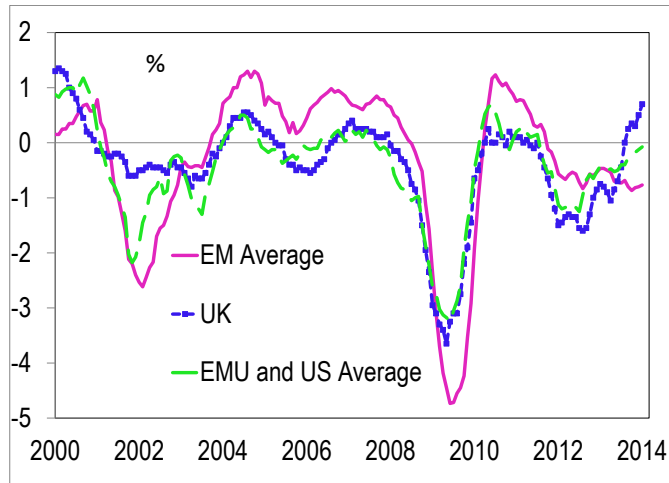
Indeed, in some cases, downside risks to EM may even help UK growth. For example, UK firms – whose liquidity position is very high⁴ – may emphasize investment in the UK rather than externally. Likewise, EM strains may also increase the exodus of capital to the top end of the central London housing market. Moreover, EM weakness has helped pull global commodity prices lower (and marginally lift the trade-weighted pound), hence pushing down import prices and cutting UK inflation – delivering a boost to UK consumers' real incomes. UK import prices fell 1.7% QoQ in Q4, the second-biggest drop of the last 10 years, and this should help pull UK inflation below target during this year. EM strains probably make it more likely that UK real wages will start rising by year-end.

Provided US and EMU growth prospects are not derailed, the UK's recovery probably can withstand further EM downgrades

Overall, however, the UK's economic prospects appear to be tied far more to domestic conditions plus prospects for the US and EMU than to emerging markets. As evident in Figure 11, revisions to consensus forecasts for UK growth are far more closely linked to changes in the consensus for the US and EMU growth than to changes in the consensus for emerging markets. The last year has seen repeated downgrades to consensus EM growth forecasts with large upgrades to consensus UK growth forecasts. Clearly, UK growth prospects probably will suffer if EM strains worsen very sharply. But recent experience suggests that – provided prospects for US and EMU growth do not deteriorate markedly – further steady EM downgrades will not derail the UK's recovery.

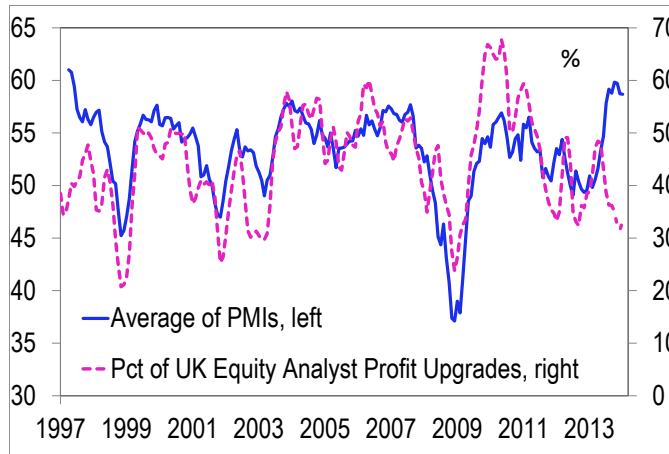
⁴ See "Is Growth Credit-Led?", Michael Saunders, UK Economics Weekly, 7 February 2014, Citi.

Figure 11. Selected Countries – 12-Month Sum of Revisions to Consensus Growth Forecasts for Current and Next Year, 2000-14



Note: EM average is unweighted average for Asian EM, Latin America and Eastern Europe, Sources: Consensus Economics and Citi Research

Figure 12. UK – PMI Surveys and Pct of Equity Analyst Profit Upgrades, 1997-14



Note: PMIs weighted 50% services, 35% manufacturing, 15% construction. Pct of equity analyst upgrades is shown as a 3-month average. Sources: DataStream and Citi Research

Economic Indicators

Tue	Consumer Prices (Jan)	Forecast: -0.4% MoM, 2.1% YoY	Prior: 0.4% MoM, 2.0% YoY
18 Feb	CPI Ex Food, Drink, Tobacco, Energy (Jan)	Forecast: -0.6% MoM, 1.9% YoY	Prior: 0.1% MoM, 1.7% YoY
	Retail Prices (Jan)	Forecast: -0.4% MoM, 2.6% YoY	Prior: 0.5% MoM, 2.7% YoY
	RPIX – Excludes Mortgages (Jan)	Forecast: -0.4% MoM, 2.7% YoY	Prior: 0.5% MoM, 2.8% YoY

We expect CPI inflation will stay around the 2% target in these figures, although base effects from a fairly weak core CPI reading a year ago may prevent the YoY rate from slipping further. Food price inflation may well slow further, but we factor in a small rise in household gas and electricity prices this month. Looking forward, CPI inflation is likely to remain around the 2% target in coming months, averaging perhaps a little below 2% over the year as a whole.

Tue	Producer Input Prices (Jan)	Forecast: -0.6% MoM, -2.9% YoY	Prior: 0.1% MoM, -1.2% YoY
18 Feb			

With the stronger pound and slightly weaker commodity prices, we expect to see another decline in input prices (the eighth in the past 10 months), producing the sharpest YoY decline in input prices since 2009. This disinflationary backdrop will, we expect, help cap CPI inflation in the next year or two.

Tue	Producer Output Prices (Jan)	Forecast: 0.2% MoM, 0.8% YoY	Prior: 0.0% MoM, 1.0% YoY
18 Feb	Output Prices Ex Tax (Jan)	Forecast: 0.2% MoM, 0.9% YoY	Prior: -0.1% MoM, 1.1% YoY
	Excluding Food, Drink, Tobacco, Energy (Jan)	Forecast: 0.1% MoM, 0.8% YoY	Prior: 0.1% MoM, 1.0% YoY

The output price data are not seasonally adjusted and often record a relatively high gain in January on start-of-year price hikes. So we would focus more on the YoY change than the MoM change as a guide to the trend and expect that base effects from the 0.4% MoM gain seen a year ago will bring the YoY rate a little lower this month.

Wed	LFS Unemployment (Oct-Dec)	Forecast: -194,000 QoQ, 7.0% Rate	Prior: -167,000 QoQ, 7.1% Rate
19 Feb	Claimant Count Unemployment (Jan)	Forecast: -30,000 MoM, 3.6% Rate	Prior: -24,000 MoM, 3.7% Rate

We expect this release will show the jobless rate falling to the MPC's 7% threshold, with the single month LFS figure for December falling well below 7%. The single month figure for September already fell to 7.1% and, with the LFS based on a rolling 3-month sample, the people surveyed in December will be largely the same as those surveyed in September. Hence, with rapid job growth (Q4 is likely to see record job growth of about 280K QoQ), we expect the single month figure to be down to about 6.7%. The 3-month average is likely to fall below 7% soon.

Thu	CBI Industrial Trends Survey (Feb)		
20 Feb	Monthly Output Expectations Net Balance (Feb)	Forecast: +24%	Prior: +23%
	Monthly Order Books Net Balance (Feb)	Forecast: +6%	Prior: -2%
	Monthly Selling Prices Net Balance (Feb)	Forecast: +10%	Prior: +20%

This year, as often happens, the January survey showed a dip in order books but price expectations rising. We expect these trends – which seem to be a seasonal norm – to unwind a bit in the February survey. A reading in line with our expectations would put both output expectations and order books about one standard deviation above average, and hence would be consistent with continued rapid output growth.

Fri	Retail Sales Volumes (Jan)	Forecast: -2.0% MoM, 4.0% YoY	Prior: 2.6% MoM, 5.3% YoY
21 Feb			

The January retail sales data are often quite volatile, producing either a gain of more than 1% MoM, or a decline, in 13 of the last 15 years (the most of any month and compared to an average of seven such readings across all other months). For this year, we expect the January figures to show a large drop, largely reversing the erratic gain in December, although leaving volumes in the last three months up by 0.9% from the prior three months.

Economic Calendar, 3 February — 21 February 2014

3 February	4 February	5 February	6 February	7 February
Manufacturing PMI (Jan) Dec 57.3 Jan 56.7		Services PMI (Jan) Dec 58.8 Jan 58.3	Halifax House Prices (Jan) Dec -0.5% MoM, 5.8% YoY Jan 1.1% MoM, 7.8% YoY	Trade Balance – Goods & Services (Dec) Nov £-3.6bn Dec £-1.0bn
		MPC Meeting Starts	MPC Meeting Ends: Rate Unchanged at 0.5% QE Unchanged at £375bn	Industrial Production (Dec) Nov -0.1% MoM, 2.1% YoY Dec 0.4% MoM, 1.8% YoY
			ECB Meeting: Refi Rate Unchanged at 0.25%	Manufacturing Output (Dec) Nov -0.1% MoM, 2.2% YoY Dec 0.3% MoM, 1.5% YoY
10 February	11 February	12 February	13 February	14 February
		BoE Inflation Report (10:30)	RICS House Price Survey (Jan, 00:01)	Construction Output (Dec)
			Riksbank Monetary Policy Outcome (08:30)	
17 February	18 February	19 February	20 February	21 February
	Consumer Prices (Jan) Dec 0.4% MoM, 2.0% YoY JanE -0.4% MoM, 2.1% YoY CPI Ex F, D, T, E (Jan) Dec 0.1% MoM, 1.7% YoY JanE -0.6% MoM, 1.9% YoY Retail Prices (Jan) Dec 0.5% MoM, 2.7% YoY JanE -0.4% MoM, 2.6% YoY RPIX – Ex Mortgages (Jan) Dec 0.5% MoM, 2.8% YoY JanE -0.4% MoM, 2.7% YoY Producer Input Prices (Jan) Dec 0.1% MoM, -1.2% YoY JanE -0.6% MoM, -2.9% YoY Prod. Output Prices (Jan) Dec 0.0% MoM, 1.0% YoY JanE 0.2% MoM, 0.8% YoY Ex F, D, T, E (Jan) Dec 0.1% MoM, 1.0% YoY JanE 0.1% MoM, 0.8% YoY	LFS Unemployment (Oct-Dec) <div><div>QoQ</div><div>Rate</div></div> <div>Sep-Nov -167K 7.1%</div> <div>Oct-DecE -194K 7.0%</div> <div>Claimant Count</div> <div>Unemployment (Jan)</div> <div><div>MoM</div><div>Rate</div></div> <div>Dec -24K 3.7%</div> <div>JanE -30K 3.6%</div> <div>MPC Minutes</div> <div>BoE Agents' Summary of Business Conditions (Feb)</div>	CBI Industrial Trends Survey (Feb, 11:00) Output Expectations (Feb) Jan +23% FebE +24% Order Books (Feb) Jan -2% FebE +6% Selling Prices (Feb) Jan +20% FebE +10%	Retail Sales Volumes (Jan) Dec 2.6% MoM, 5.3% YoY JanE -2.0% MoM, 4.0% YoY <div>Public Sector Net Borrowing (Jan)</div>
Eurogroup Meeting (Brussels, Afternoon)	EcoFin Meeting (Brussels)			

E Citi estimate. B Billion. P Provisional. R Revised. Note: All data are released at 9.30 a.m., except those marked otherwise.

Sources: BoE, CBI, ONS, national sources and Citi Research.

Appendix A-1

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