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GLOBAL MACRO RESEARCH — THE FUTURE OF THE UK

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THE UNITED KINGDOM FACES A SERIES OF CHALLENGES, SOME OF WHICH ARE GLOBAL AND SOME OF ITS OWN MAKING. AT THE SAME TIME, GEOPOLITICAL RISK HAS RETURNED WITH THE RUSSIAN INVASION OF UKRAINE, AND THE SECONDARY IMPACT FROM SPIKES IN FOOD AND ENERGY PRICES HAVE THEIR OWN RAMIFICATIONS. WE CONSIDER THE FUTURE THAT MAY LAY AHEAD FOR THE UK. IN PARTICULAR, WE COVER THE AFTERMATH OF BREXIT AND WHAT THAT MEANS, WHETHER THE UNITED KINGDOM STAYS UNITED AND THE PROBLEMS THAT STEM FROM STRUCTURALLY WEAK PRODUCTIVITY.

EXECUTIVE SUMMARY

1

Recent events have been a reality check for the UK, making fiscal responsibility a key issue for politicians in the years ahead

2

Brexit is a headwind: the UK's terms of trade have deteriorated, but there is little political appetite to reignite the debate

3

A fragmentation of the United Kingdom seems almost certain, continuing the gradual diminishing of the UK's global standing

4

The productivity conundrum is solvable but will need a clear plan and sufficient funding. Widespread deregulation is unlikely to be the solution.

RECENT EVENTS HAVE BEEN A REALITY CHECK

SELF-INFLICTED POLITICAL TURMOIL HIGHLIGHTED KEY VULNERABILITIES

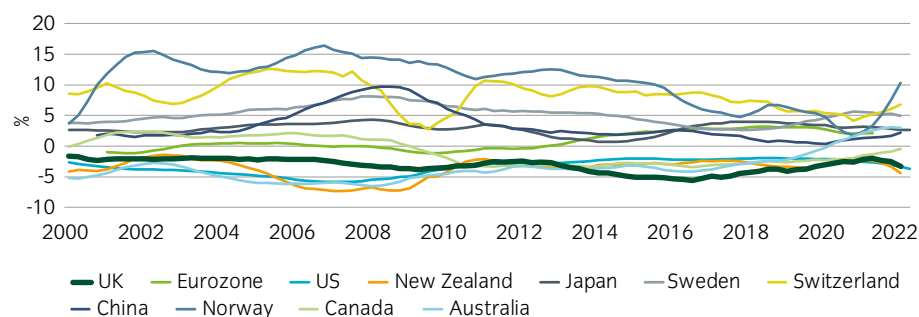
The September 2022 ‘mini budget’ saw new Prime Minister Liz Truss and Chancellor Kwasi Kwarteng attempt to implement a radical fiscal easing. With the economy facing severe headwinds from spiralling energy costs, a two-year energy price cap was introduced, at an estimated cost at the time of £120bn per annum, or around 5.5% of GDP. At the same time, the Chancellor announced the largest package of tax cuts since 1972, in aggregate amounting to around 2% of GDP. This was done after removing the most senior civil servant in the Treasury and deliberately bypassing the Office for Budgetary Responsibility (OBR).

Faced with a massive unfunded fiscal expansion, and legitimate concerns about the strength of the institutional framework, markets reacted negatively, and gilt yields spiked higher. Shortly after the budget, Kwasi Kwarteng was forced to resign, followed by Liz Truss. Many of the policies introduced in the mini budget were reversed to return stability to markets, and Rishi Sunak took over as Prime Minister.

FISCAL RESPONSIBILITY IS NOW A POLITICAL NECESSITY

Although UK debt to GDP is below some other major economies, the UK is heavily reliant on foreign funding. This makes excess debt particularly problematic for the United Kingdom – Mark Carney when he was governor of the Bank of England described this as “relying on the kindness of strangers”. After running a persistent current account deficit that has been amongst the worst in developed markets over the last twenty years (see Figure 1), around one third of gilts are now foreign owned. A large current account deficit, combined with, until recently, some of the lowest real yields in the world, was always going to make the UK vulnerable. Recent events are perhaps a foretaste of what a future funding crisis could look like, where foreign investors flee UK markets and cause financial instability.

Figure 1: The UK’s persistent current account deficit is a problem¹



¹ Source: OECD as at 1 April 2022. Two year moving average.

ENERGY PRICES COULD BE KEY IN THE SHORT TERM

The spike in energy prices since the Russian invasion has impacted all of Europe. Natural gas is critical as the marginal generator of electricity. When all else fails – the wind isn't strong enough or the sun isn't shining – you turn to natural gas to generate energy quickly to fill the shortfall. That makes the link between natural gas prices and electricity difficult to break.

Although the energy price cap has been limited to only last until April 2023, it is effectively a call option that leaves the UK government heavily exposed to natural gas prices. A combination of mild weather and full storage across Europe has caused prices to trend downwards, but if this reverses, it could leave the Treasury exposed. This highlights the need for a more coherent long-term energy strategy in the UK. Although the UK is relatively well placed in terms of both liquefied natural gas (LNG) terminals and regasification plants, previous governments have allowed storage facilities to become obsolete. This leaves the UK unable to store energy during the summer, and instead reexporting it to the rest of Europe. The UK's energy plan for cold winters is to reimport that gas stored on the continent, and to import electricity from France. The UK's fiscal and growth outlook in the months ahead has become highly dependent on the whims of the weather.

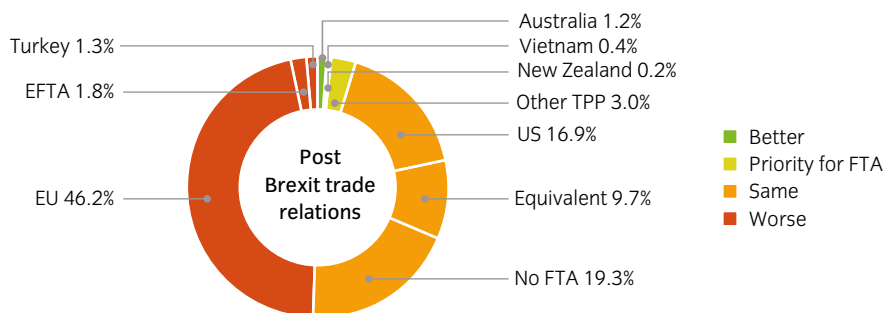
TRADE RELATIONS

IN AGGREGATE, UK TERMS OF TRADE HAVE DETERIORATED POST BREXIT

In the years following Brexit, the department for international trade was extraordinarily busy, signing over 40 trade deals with various countries and trading blocs. The problem was that most of these essentially replicated agreements that were already in place as part of the UK's membership of the EU. Only three were genuine improvements in the UK's terms of trade; those made with Australia, New Zealand and Vietnam. In aggregate those three deals represent just 1.8% of UK trade, which does little to compensate for the deterioration in the UK's terms of trade with its European neighbours, which represent around 50% of UK trade.

A stated priority for the UK government has been to join the Trans-Pacific Partnership, and negotiations are ongoing. China and Taiwan have also applied for membership. The election of President Biden in the US has removed the potential for a trade deal with the United States.

Figure 2: Only a tiny proportion of trade deals have resulted in better terms of trade for the UK²



² Source: UK Government and Insight as at September 2022.

THE FUTURE RELATIONSHIP BETWEEN THE UK AND EU

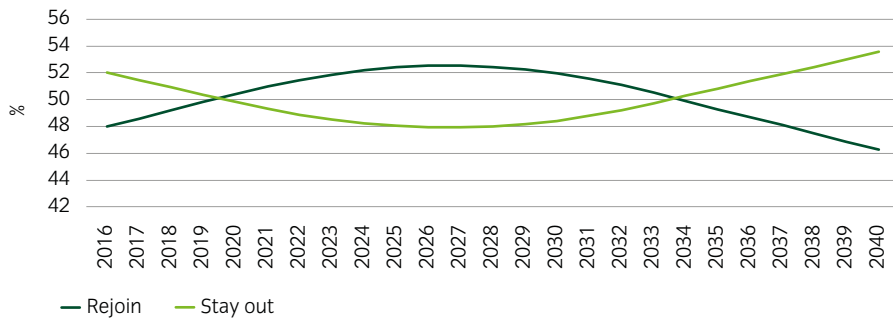
Brexit may not have been as bad as some of the worst fears put forward in a no-deal scenario, but it does have some genuine economic costs. Problems have ranged from trading across the Irish sea with Northern Ireland to not being granted equivalence in financial services. Economic geography will keep the relationship between the UK and EU at the heart of many issues and complex negotiations are likely to be ongoing without end. Brexit has in effect become Breternity, with a return to EU membership the only way to bring never ending negotiations to a close.

For voters, opinion polls suggest that most of those who voted in the 2016 referendum haven't really changed their mind. However, there is a demographic impact, and we can build a hypothetical model to estimate this over time. In the short term, the balance appears to have shifted towards a more pro-EU position. Teenagers at the time of the referendum are now able to vote and would be likely to support a pro-EU position in any future referendum. At the other end of the spectrum, the natural attrition of older voters will have reduced the pro-Brexit voting base. Taken together, a pro-EU demographic peak should occur around 2027 (see Figure 3).

Beyond that, much will depend on the attitudes of those who were young children in 2016. As they become voters, they will have few memories of being in the EU, other than vague arguments from their childhood, and it may mean very little to them. EU membership may be of little interest to that generation and the demographic trend may start to swing back.

Barring a significant change in voter preferences, the political will to reignite the debate simply doesn't exist. Even in the Labour party, the divisions between metropolitan liberals and post-industrial heartlands are too painful to reopen.

Figure 3: Demographic support for re-joining the EU peaks in around 2027³



³ Source: Insight, for illustrative purposes only.



AN UN-UNITED KINGDOM

HISTORY MAY PROVIDE THE BEST CLUES FOR THE FUTURE

To look at what the future may hold for the makeup of the United Kingdom, it's possible that we may be able to find clues in the past. In the general election of 1874, the UK held its first secret ballot. People could vote without their neighbours and more importantly their landlords knowing how they voted. At that point in history, Ireland was still part of the UK and, in every previous election, Irish votes had always gone to the standard UK parties – Conservatives and Liberals. In 1874, that changed dramatically. Irish Nationalist parties swept up Irish seats, ultimately leading to independence 47 years later. Before independence, the block of Irish MPs sitting in Westminster significantly changed the dynamics of British politics.

SCOTTISH AND IRISH REFERENDUMS NOW APPEAR TO BE INEVITABLE

Turning to Scotland and another UK election – 2015. Although only a year after the referendum on independence, in which 55% voted to remain part of the UK, the Scottish National Party (SNP) won all but three of the Scottish seats in Westminster. The SNP have since maintained a clear majority of Scottish MPs and control of the Scottish Parliament. With Brexit being cited as a key constitutional change, the SNP and Scottish Greens now believe that there is a mandate for a second referendum, and the UK Supreme Court has been asked to rule on the need for consent from Westminster.

If a second referendum does occur, there is little clarity to how it would play out. Opinion polls suggest that current support for Scottish independence is evenly split, but various factors will come into play. It will depend on who is in government in Westminster at the time, how popular they are, and both the domestic and European wide economic outlook. If the outcome is once again to remain within the UK, then the issue is likely closed. In Quebec, a move for independence from Canada in the 1980s and 1990s faded away following a second referendum, despite it being only a narrow victory for unionists. Until independence occurs, however, there will likely be a large block of Nationalist Scottish MPs in Westminster in the same way that there was a block of Irish MPs. This means a second referendum is likely to occur, even if it is some time away.

A third historic election occurred in 2019, with Irish Nationalists winning a majority for the first time in Northern Ireland. Under the terms of the Good Friday Agreement, when a majority of people in both Northern Ireland and the Republic want to unify, the Secretary of State for Northern Ireland should call a border poll, or referendum. Although polls are not quite there yet, the demographics are clear. Census data shows the Catholic population is overtaking the Protestant population in Northern Ireland. It may take longer for Northern Ireland to get its referendum than Scotland, but the outcome appears easier to predict, with a vote for unification the most likely result. If that were to occur, Northern Ireland would automatically rejoin the EU, just as East Germany automatically joined the European Community when it unified with West Germany in 1990.

IN ENGLAND, LEVELLING UP IS KEY

The 2019 election was, of course, about more than just Northern Ireland. It was principally about getting Brexit done. Boris Johnson the prime minister at the time, campaigned for and won seats in Northern England, the Labour heartlands. If the Conservatives have any chance of keeping a majority, then delivering on promises to level up the country (reducing economic imbalances between areas and social groups across the UK) will be key. Growth in London has been consistently around double other regions over the last 20 years and this regional divide has been most felt in Northern England (see Figure 4). Underlying this regional growth divide is a productivity problem.

Figure 4: Average growth by region over the last 20 years⁴



THE PRODUCTIVITY CONUNDRUM

LOW PRODUCTIVITY HAS SUPPRESSED WAGE GROWTH FOR OVER A DECADE

In some ways, low productivity growth has been a global phenomenon, but the UK has underperformed many of its peers. From the 1970s through to just before the financial crisis, the UK economy grew at a respectable 2.3% per annum; but since the financial crisis economic growth has dropped to an annual rate of just 0.6% (see Figure 5). This has caused problems for corporate profitability, but the most meaningful impact has been on wages.

Mean real wages in the UK historically grew at around 2% per annum, but since the financial crisis that's decreased to zero. A considerable gap has now grown between the current level of wages and the historic trend (see Figure 6). Although nominal wages have started to rise more recently, inflation has risen even faster, compounding the decline in real wages. Increasing levels of inequality mean that median wages were falling even before the cost-of-living crisis.

This has been at the root of the political turbulence that the UK has experienced since the financial crisis and ongoing political turbulence is likely to continue until a solution is found.

⁴ Source: Office for National Statistics (ONS), Insight calculations as at May 2021.

Figure 5: UK productivity has flatlined⁵

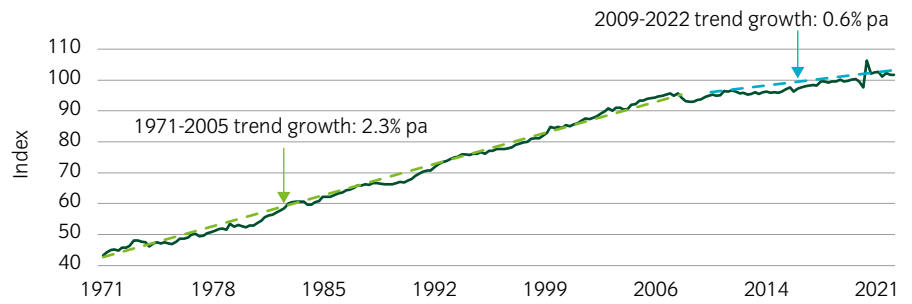
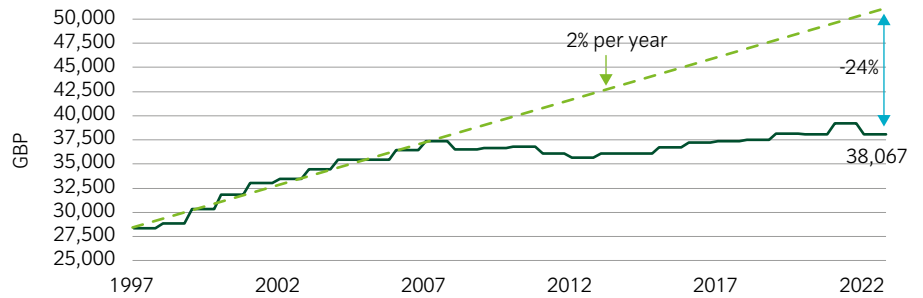


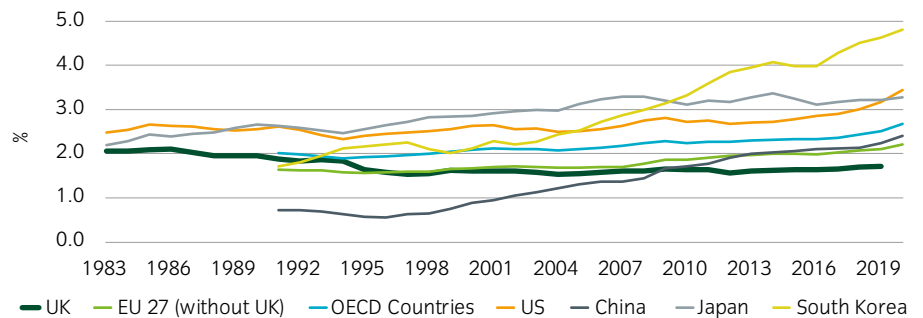
Figure 6: Low productivity has suppressed wage growth⁶



POTENTIAL SOLUTIONS TO RAISE PRODUCTIVITY

Although it's not yet clear if this will be taken forward, one plan proposed to solve the productivity conundrum has been low-regulation investment zones. Deregulation can be effective if undertaken in the right way, but a more consistent method to raise productivity is investing in research and development (R&D). Since the 1980s UK R&D as a percentage of Gross Domestic Product has declined, and now lags severely behind many of the UK's peers (see Figure 7).

Figure 7: UK R&D spending has failed to keep up⁷



The government planned to try to raise this back to around 2.4% per annum on a five-year time horizon, but cuts to science funding linked to the EU Horizons Programme are going to make that difficult. Given recent political turmoil, it is unclear what funding will be available to make this happen, but the new Advanced Research and Invention Agency⁸ is due to launch soon. This independent agency will use venture seed capital to fund high risk, high reward science opportunities.

There are some hopeful signs that a new industrial policy, targeting specific sectors and making use of industrial zone, could be successful in building the industries of the future.

⁵ Source: ONS as at 1 April 2022.

⁶ Source: Organisation for Economic Cooperation and Development (OECD) as at 1 October 2022.

⁷ Source: Organisation for Economic Cooperation and Development (OECD) as at August 2022.

SINGAPORE ON THAMES IS NOT A VIABLE OPTION

One vision of the future that was promoted by more right-wing libertarian Brexiters was that of Singapore on Thames. Lower taxes and reduce regulations outside the EU to create a high growth, low tax model. To assess the potential of such a model in the UK, it is worth considering how Singapore achieved its success.

The first step was to ditch the hinterland – Singapore left Malaysia in 1965 to become an independent city state. Although London could potentially follow such a model, possibly alongside a small part of the country including Oxford and Cambridge, it is impossible for the UK in aggregate. The second step was to pursue a highly interventionist economic policy agenda, actively using the state to direct economic development. The majority of housing stock was built by the state, and strict ethnic integration was used to develop national identity. This was then underpinned by a well-funded and meritocratic state education system and an active role in the Association of Southeast Asian Nations (ASEAN) trading block, which is the regional equivalent of the EU.

It would be impossible to find the political will to implement similar strategies to the ones that created the Singapore we know today, and as such Singapore on Thames is not, and never has been, a viable option.

DEREGULATION CAN ALSO INCREASE THE RISK OF CRISIS

The argument for deregulation is that regulation creates friction within an economy. People are forced to spend money on ensuring they comply with rules, and governments often get the regulations wrong, meaning that spending is wasted. All of this slows productive economic activity and leads to slower growth. Although it may be true that growth may be a little slower in the long term, regulation also helps to prevent the crashes that are a natural part of capitalism. If you deregulate, you are more likely to get deeper periodic crashes, which may be more negative over long time horizons than the impact of regulation.

⁸ <https://www.gov.uk/government/organisations/advanced-research-and-invention-agency>



CONCLUSION

One thing that Coronavirus and energy crisis has brought back is big government. Neoliberal policies have run their course and, when the chips are down, only governments have the scale to correct market failures. Increasing government involvement in scientific and economic development isn't necessarily a bad thing. As the production of the Oxford AstraZeneca vaccination showed, Britain does retain some genuinely world-class research facilities. With the right policy framework and proper funding, innovation will remain one of the UK's key strengths across a range of industries, from FinTech to green power, and specialised engineering.

Further good news comes from the fact that the British Isles are relatively well off in terms of direct climate change risks compared many other parts of the world. Greening the economy could provide a number of further opportunities.

However, it is hard to see a scenario where the UK remains as a United Kingdom over the longer term. Scotland appears more likely than not to become independent at some point, and for Northern Ireland it appears to just be a matter of time. If Scotland and Northern Ireland leave the UK, pressure could grow for Wales to follow. All of this will naturally diminish the UK's global standing, a trend that has been in place for the last century.

Unless careful control is kept of UK finances, the country will also become increasingly vulnerable to a funding crisis over time. The trigger for that crisis may be domestic, but it could equally be via contagion from some other part of the world. Recent events were a clear warning shot to politicians.

Navigating this future involves dealing with multiple challenges. Both crisis management and detailed long-term planning. It can be done – but it will need strong leadership and well thought out plans.

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