

UK ahead of elections: political uncertainties, long-term challenges

Second Quarter 2015

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Main messages

- 1 **All parties are polling well short of a majority**
- 2 **The mix of fiscal and monetary policy could not be very different** under alternative governments...
- 3 **... and will progressively tighten** over the next parliament
- 4 **Strong but slowing growth in 2015-16**, but increasing concerns on the impact of political uncertainties on activity
- 5 **Several issues will shape the UK economy in the long term:** The status in EU, policies to increase productivity growth and competitiveness and policy towards immigration

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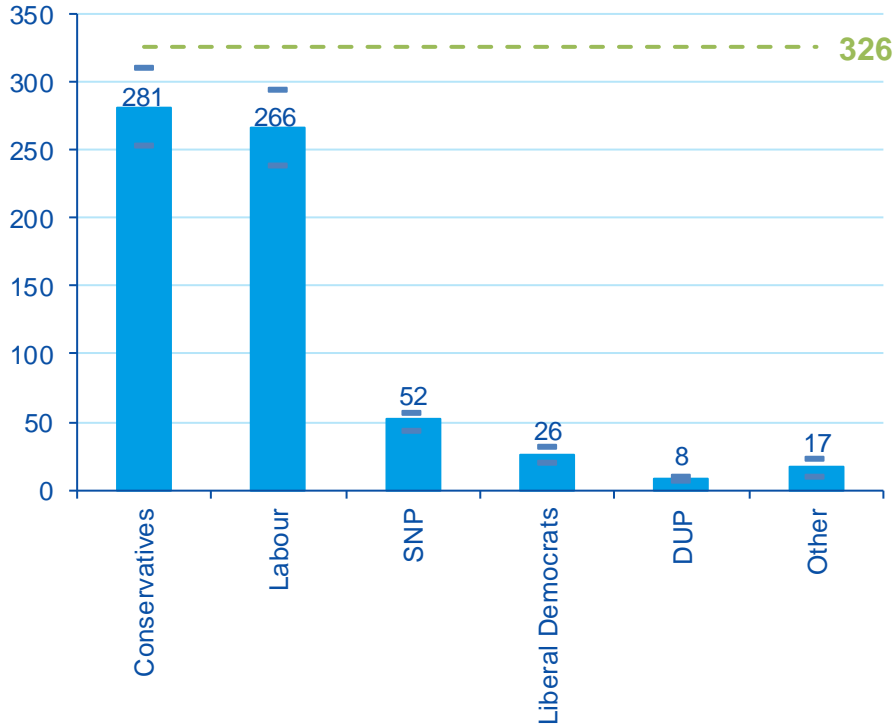
All parties are polling well short of a majority

Even natural coalitions (Con+LibDem or Lab+SNP) could fall short of a majority

A distinct possibility is minority government with bills passed on case-by-case basis

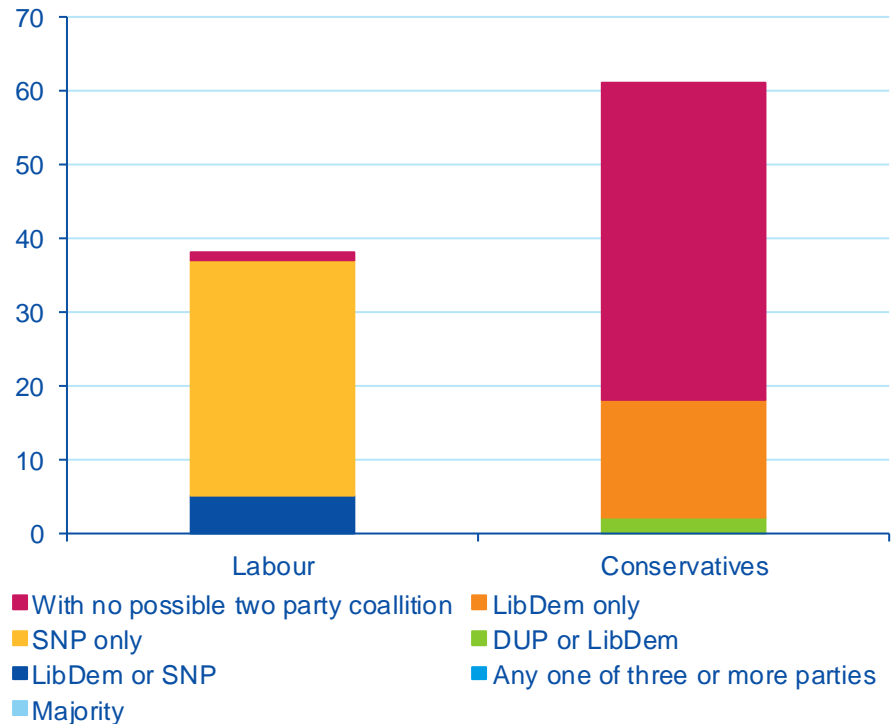
Parliament election forecast: Projected number of seats, low and high

Source: www.electionforecast.co.uk; 6 May 2015



Probability of governments after election

Source: www.electionforecast.co.uk; 6 May 2015



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Election prospects

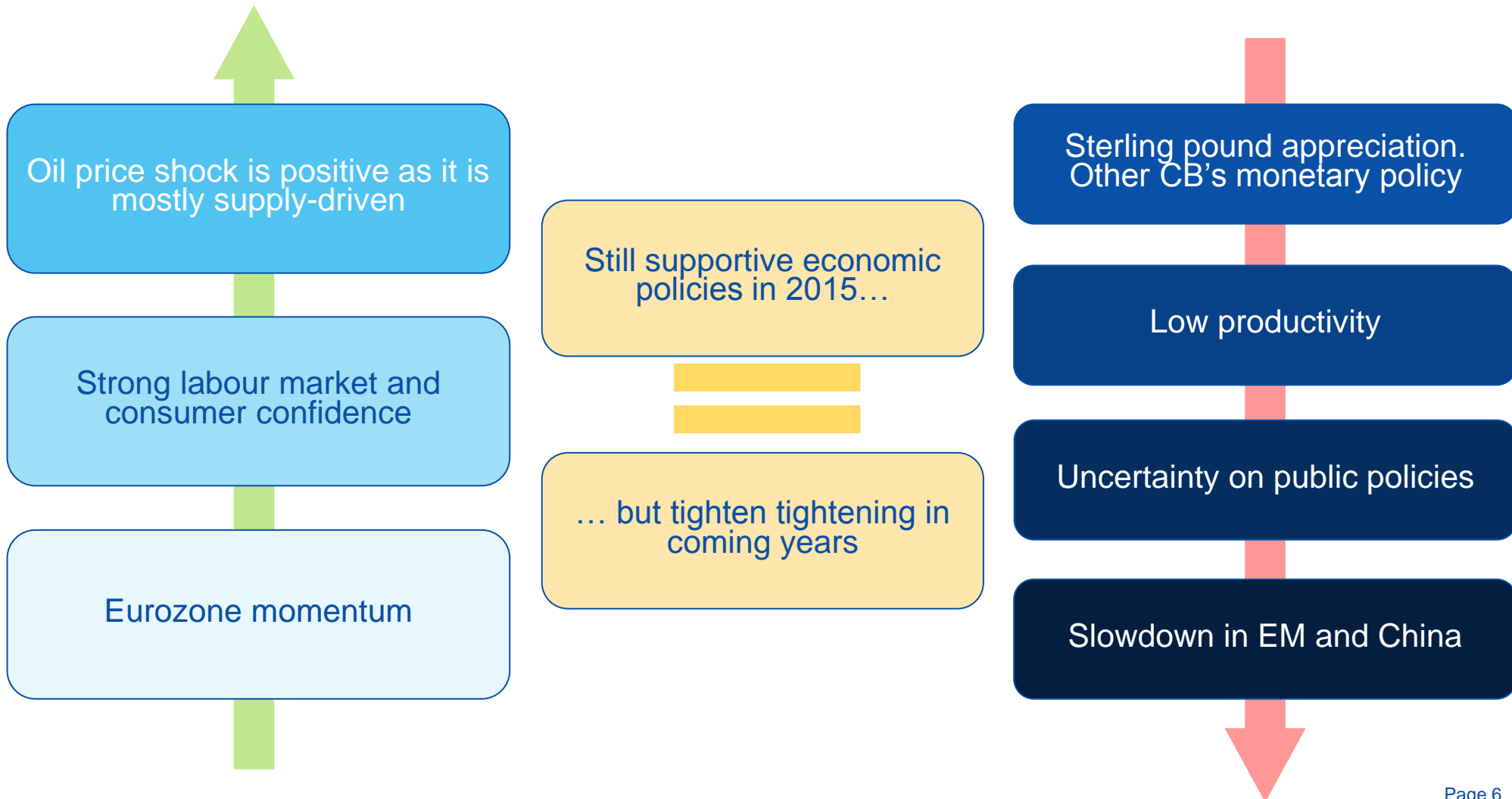
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Drivers of growth

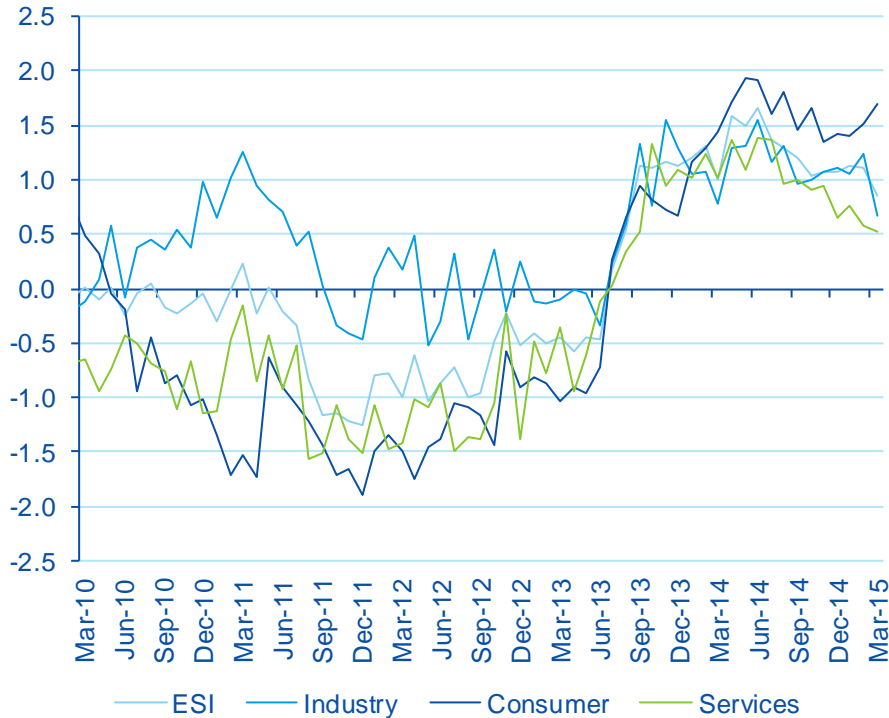


The economic momentum is easing somewhat

Confidence indicators provide mixed signals (strong PMI's, but EC confidence is slowing)

European Commission confidence survey (standardised)

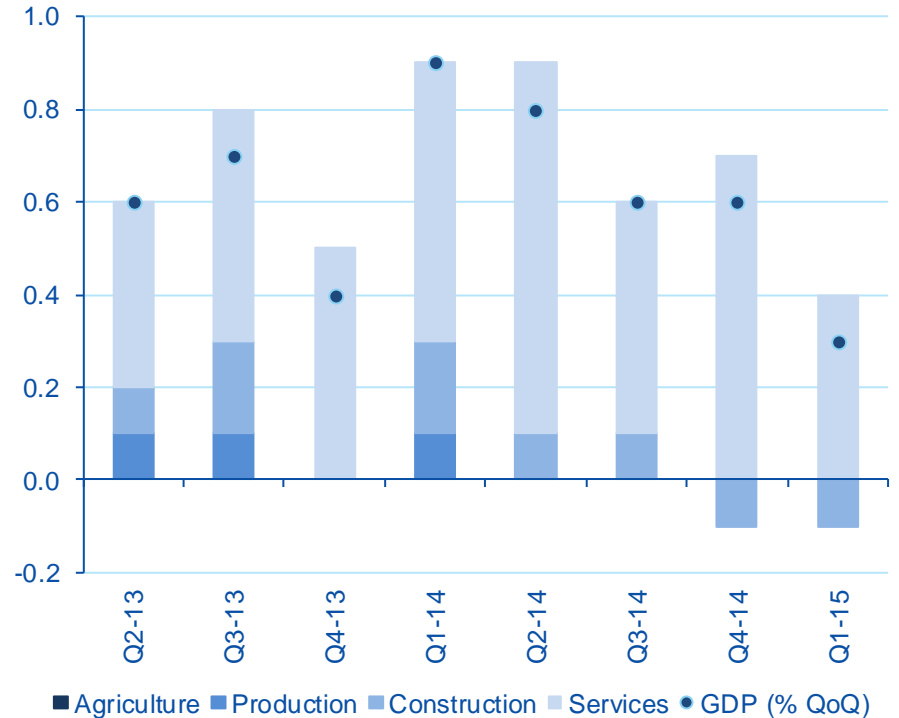
Source: Euroean Commission and BBVA Research



GDP growth in 1Q15 slows sharply to 0.3% QoQ, driven by weak services

GDP contributions to the QoQ percentage change

Source: ONS and BBVA Research



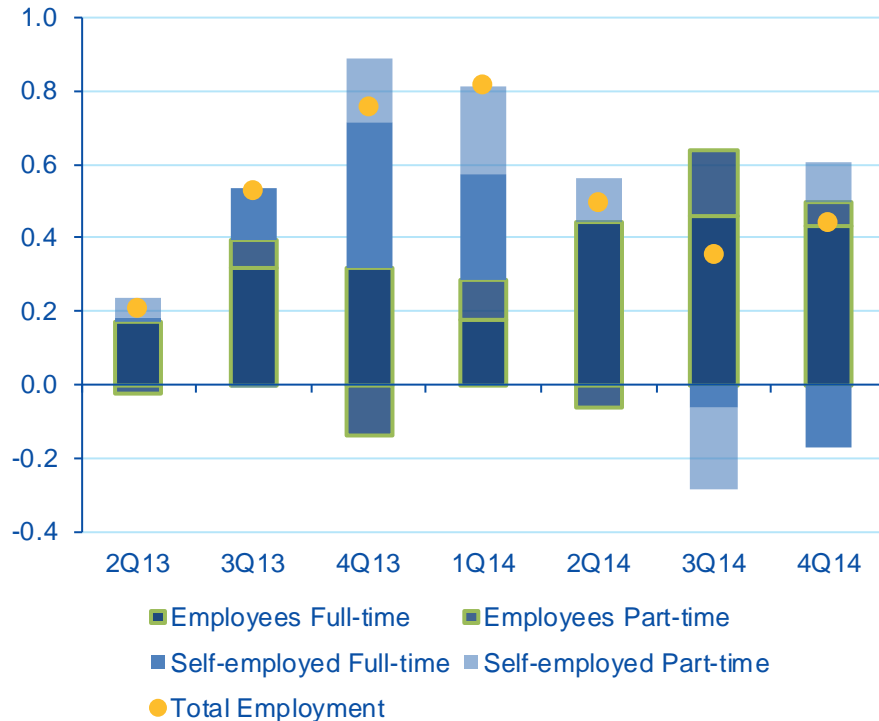
Strong job creation and incipient wage increases...

Job creation relatively strong, with composition changes towards more productive workers

Incipient signs of wage increases, and upward pressures in the pipeline

Employment (% QoQ)

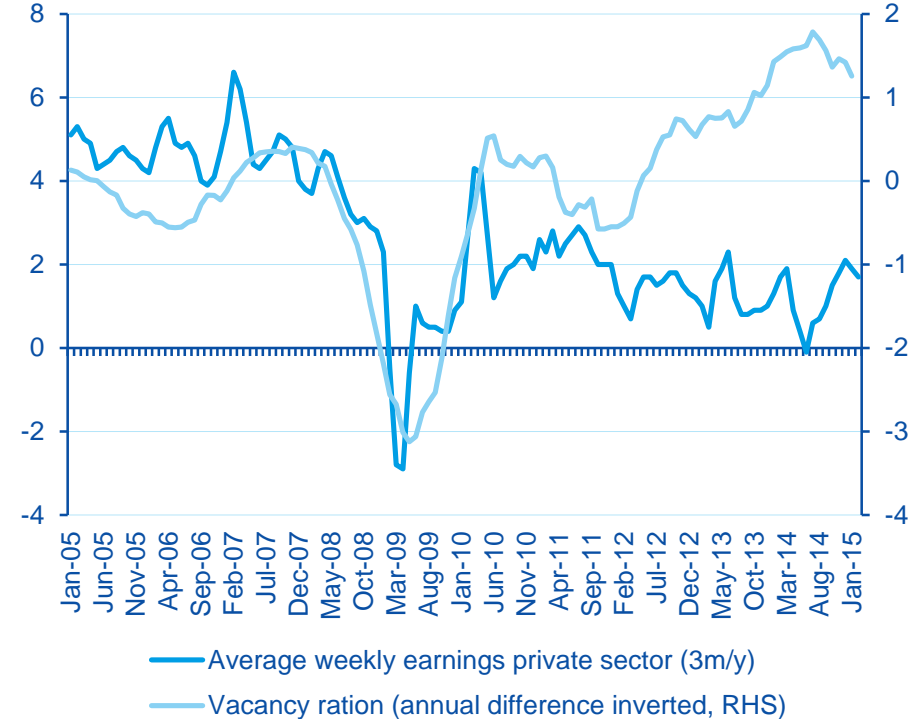
Source: Euroean Commission and BBVA Research



Earnings growth and vacancy ratio

Vacancy ratio: number of unemployed people per vacancy

Source: ONS and BBVA Research



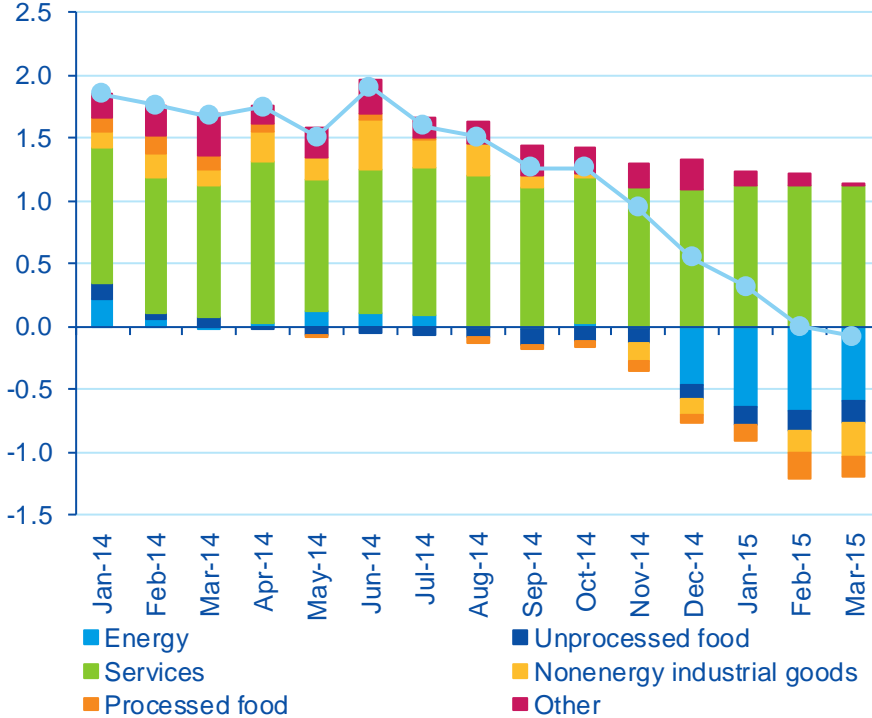
... along with very low inflation that should boost household's real incomes

Sharp decline in inflation due to the fall in oil prices and the appreciation of the pound

Households' disposable income is increasing, while strong confidence results in a low saving ratio

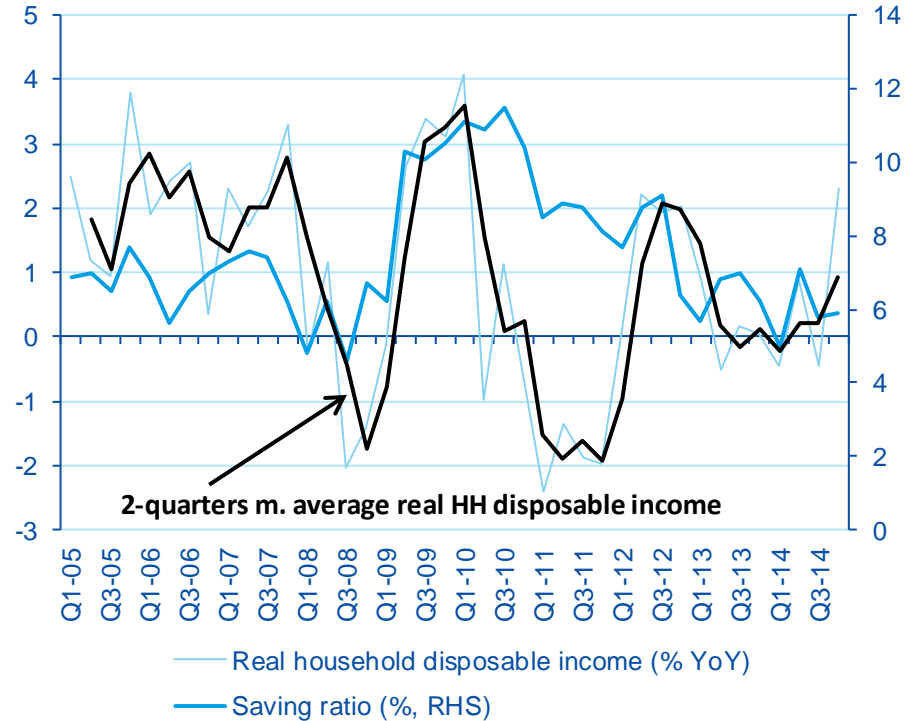
Inflation and its components (y-o-y)

Source: ONS and BBVA Research



Households' disposable income and savings

Source: ONS and BBVA Research



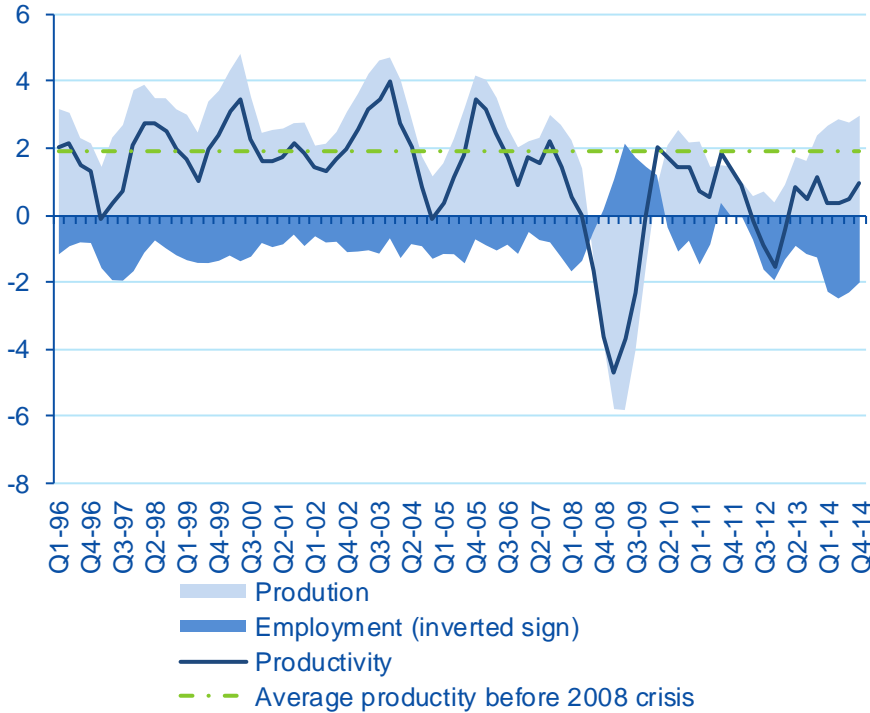
Productivity remains very low, increasing BoE's concerns about future price pressures

Productivity fails to take off...

... while spare capacity is being absorbed

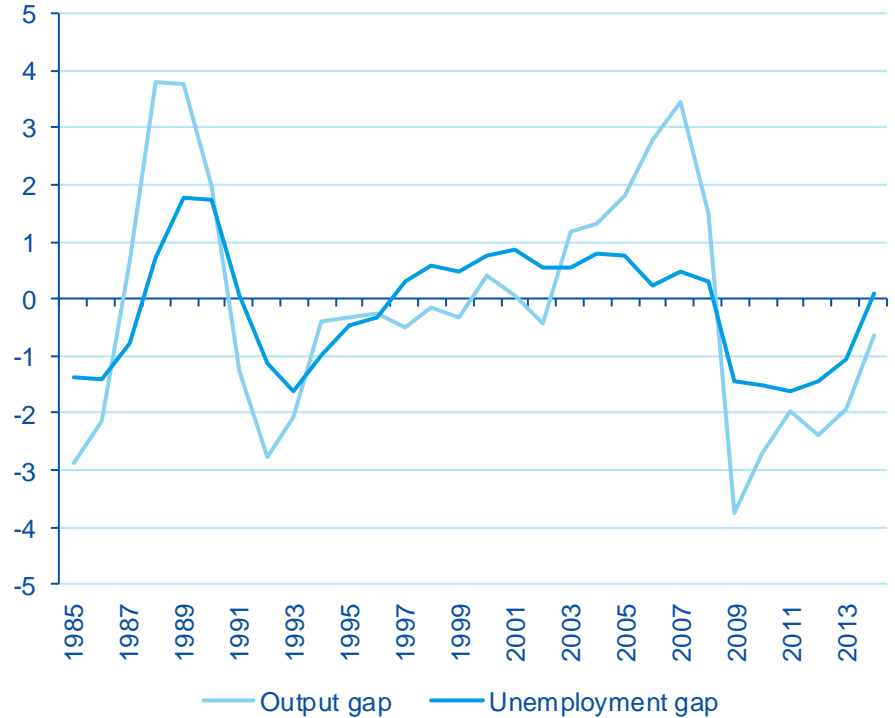
Productivity (% YoY)

Source: ONS and BBVA Research



Output and unemployment gap (%)

Source: OECD



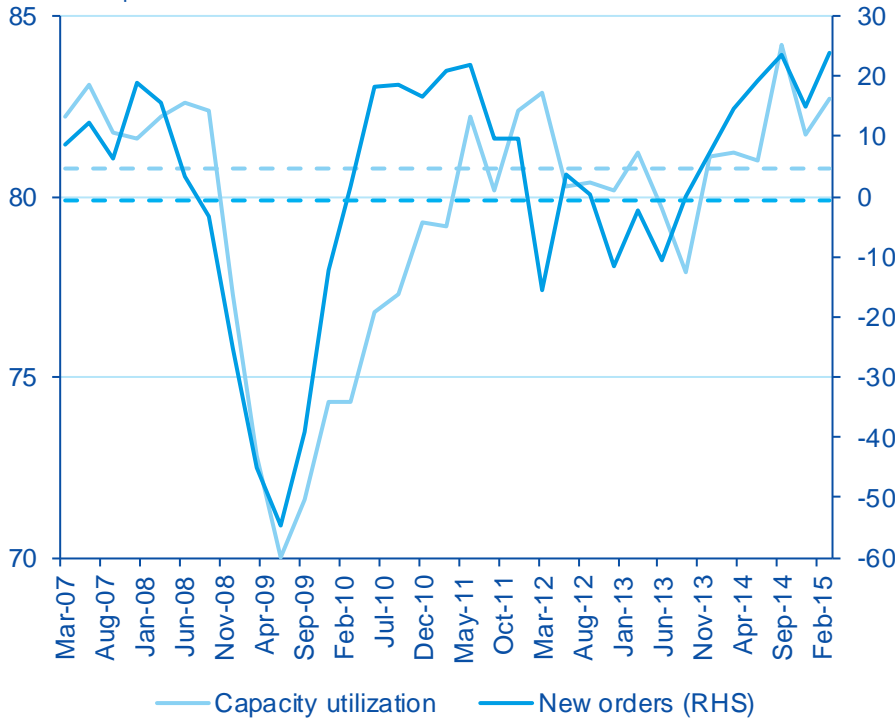
Demand prospects, reducing spare capacity, along with easing financial conditions should boost investment

Capacity utilization above historical average, while new orders increase

Very low interest rates support credit demand, but deleveraging continues

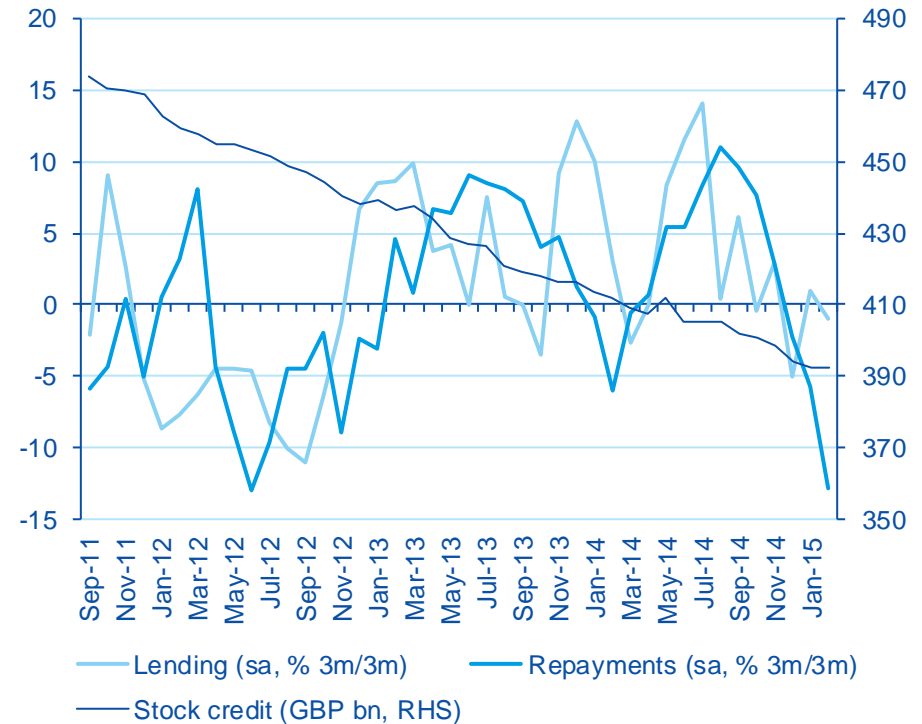
Capacity utilization and new orders

Source: European Commission and BBVA Research



Non-financial corporations: lending, repayments and credit stock

Source: BoE and BBVA Research



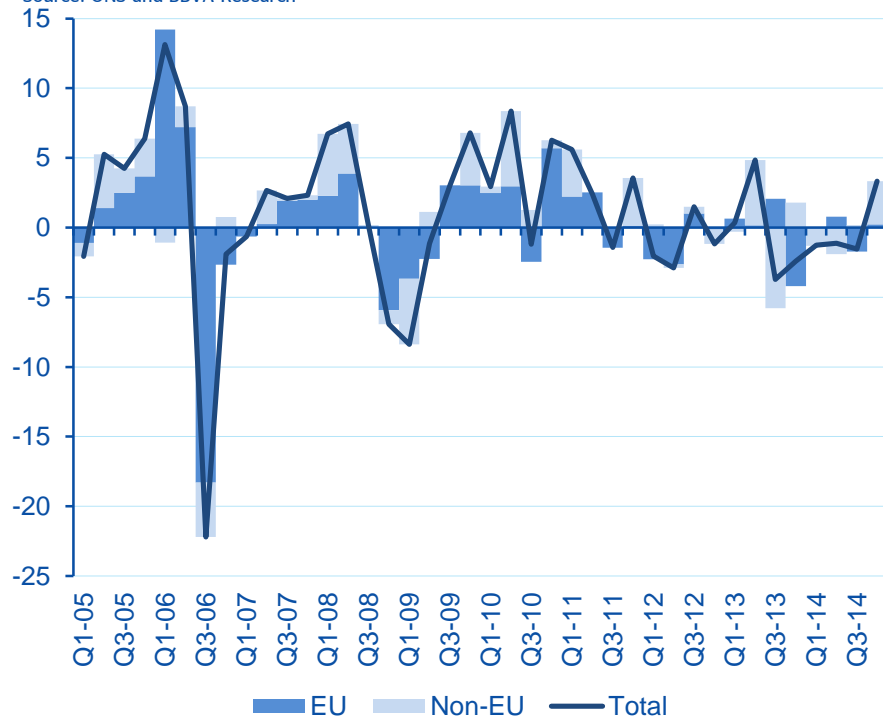
Export prospects improve despite the sharp appreciation of the pound

The eurozone recovery more than offsets slowing growth in emerging countries

Real appreciation of the pound despite depreciation vs de the USD

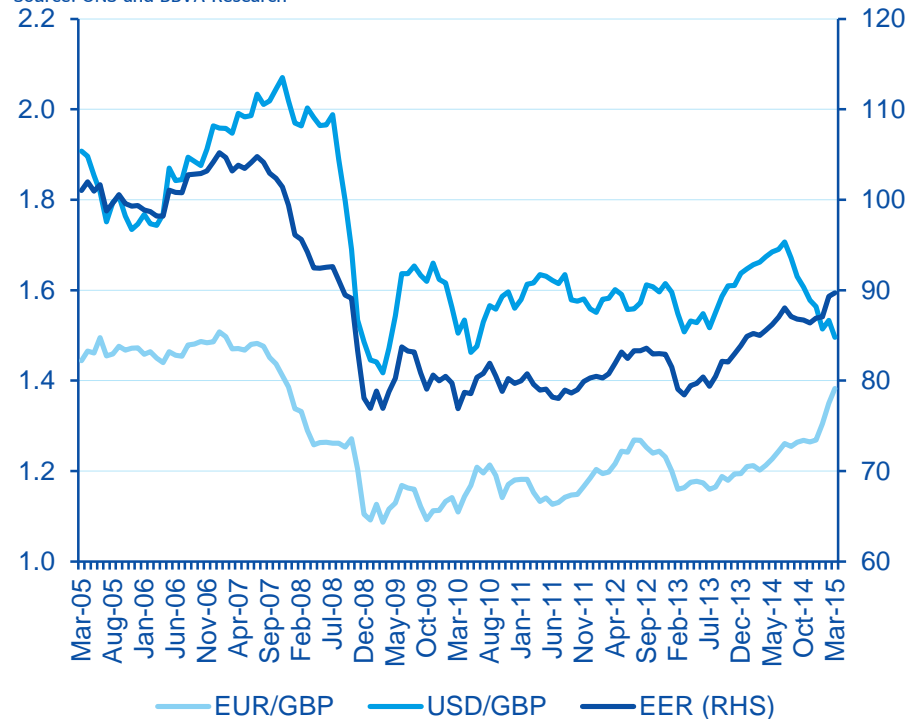
Exports to EU and non-EU countries (% QoQ)

Source: ONS and BBVA Research



Exchange rates

Source: ONS and BBVA Research



Projections: Strong growth in 2015-16, but slowing due to lower support from fiscal and monetary policy

Projections of main variables (%)

Source: BBVA Research

	2013	2014	2015 (f)	2016 (f)
Activity				
REAL GDP (% YoY)	1.7	2.8	2.5	2.3
Private consumption	1.7	2.5	2.4	2.2
Public consumption	-0.3	1.7	0.2	-0.4
Investment	3.4	7.8	4.5	5.6
Domestic demand (contr. %)	1.7	3.3	2.3	2.2
Exports	1.5	0.6	4.9	5.0
Imports	1.4	2.2	4.0	4.4
Net exports (contr. %)	0.0	-0.5	0.2	0.1
External sector				
Current account balance (% GDP)	-4.5	-5.5	-5.1	-4.8
Public finances				
General Govt. Balance (% GDP)	-5.7	-5.7	-4.4	-3.4
Prices				
CPI, % avg.	2.6	1.5	0.3	1.7

Strong domestic demand will continue to be the main support for growth...

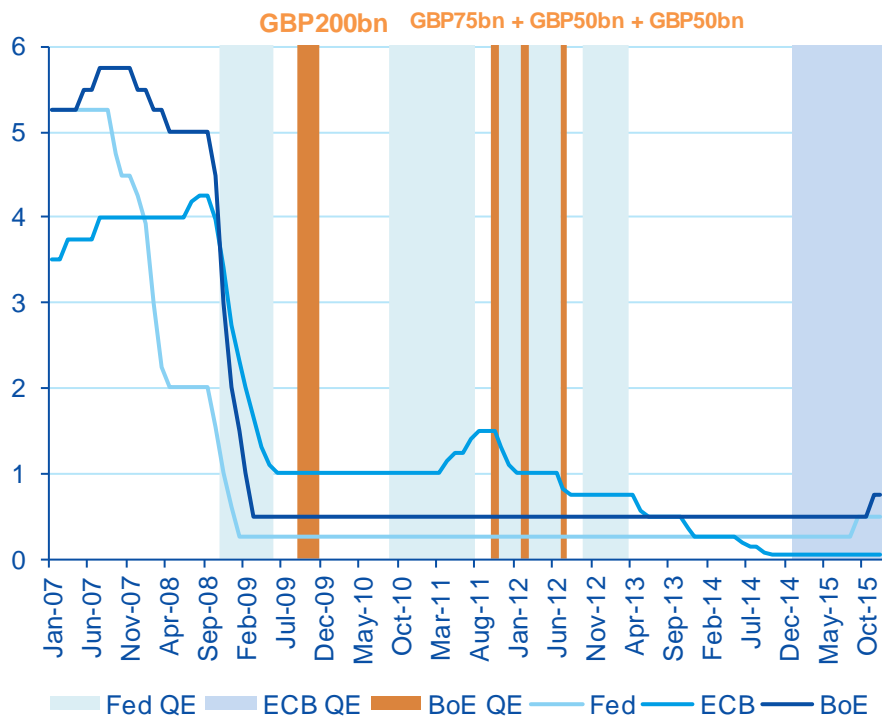
... while net exports will again make a small positive contribution

Domestic demand, the pace of inflation and the impact of Fed decisions on the pound will determine the date of the first hike of BoE Bank Rate (we expect 1Q16)

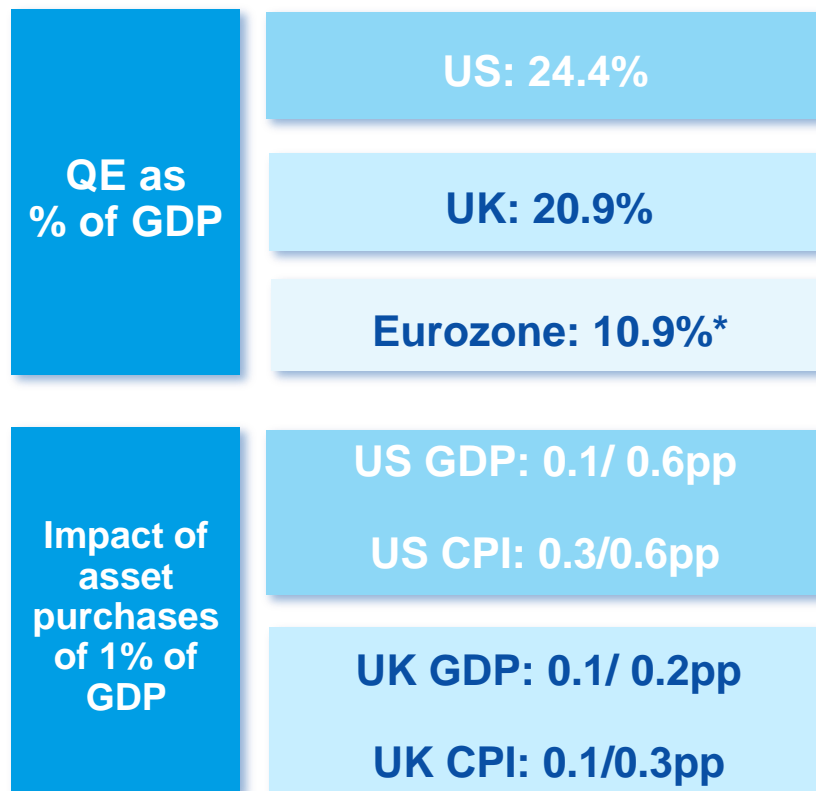
Accommodative monetary policy, but a slow tightening cycle is in the pipeline

Monetary policy stance: official interest rate and QE programmes

Source: OECD and BBVA Research



QE size and its impact on growth and inflation

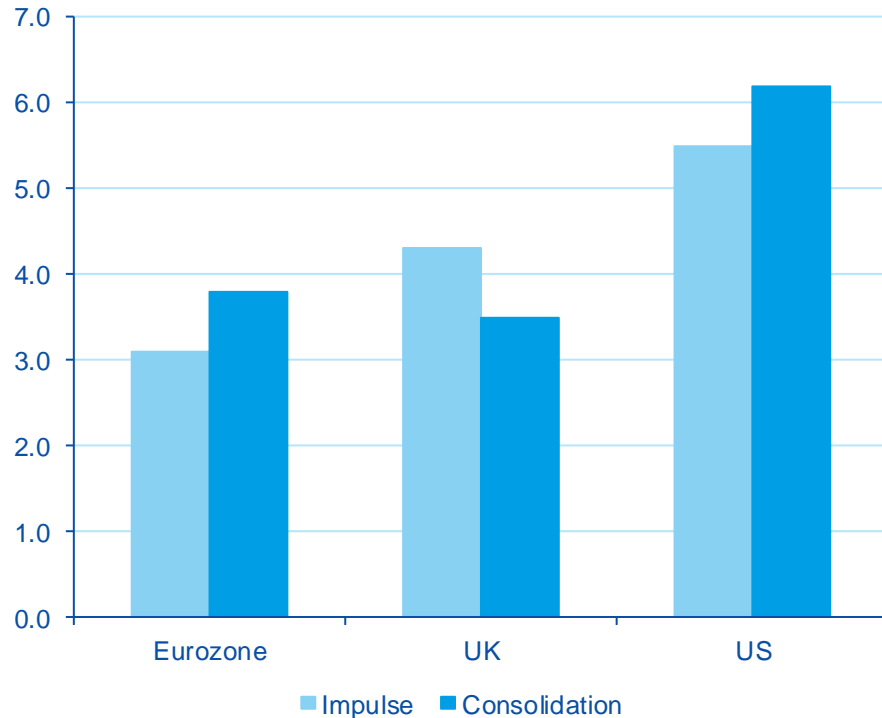


* Full implementation
Source: ECB, Weale et al. March 2015, and BBVA Research

Soft and gradual fiscal consolidation after the strong fiscal impulse over the 2008 crisis

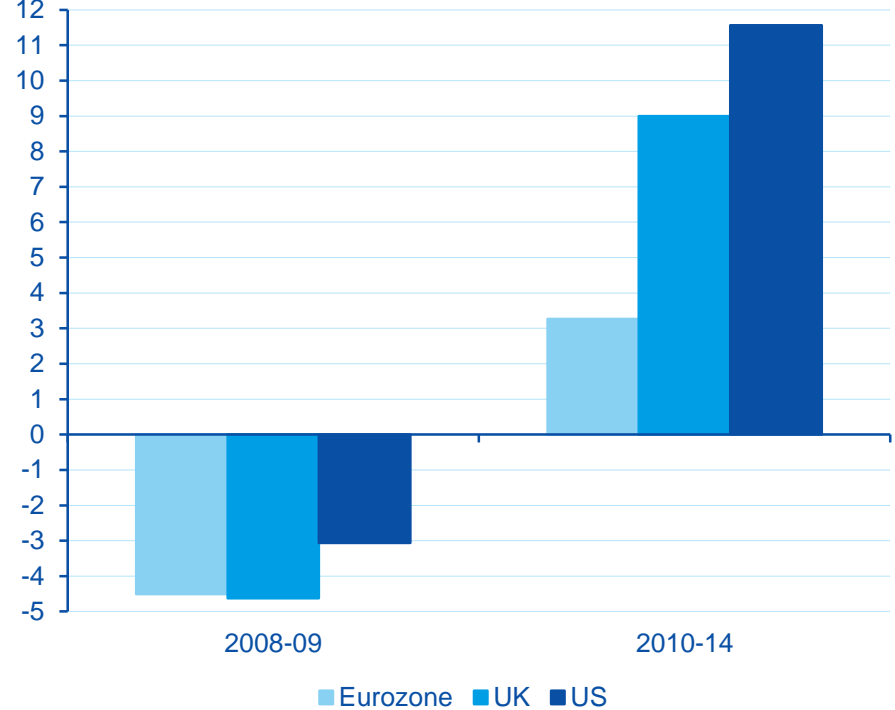
Fiscal impulse in 2008-9 and consolidation upto 2014 (pp)

Source: OECD and BBVA Research



Cumulated GDP change (%)

Source: Eurostat, ONS, BEA and BBVA Research



All parties plan further austerity...

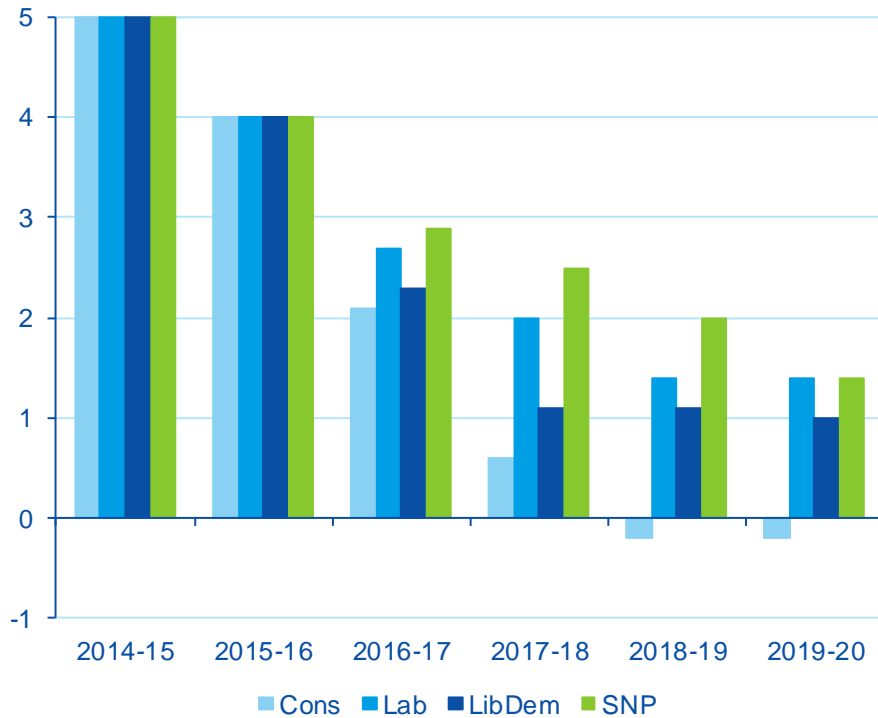
	Conservative	Labour	LibDem
Fiscal rules	Overall budget surplus by the end of next parliament	Surplus on current budget (excluding capital account) by the end of next parliament	Surplus on cyclical-adjusted current budget by 2017-18
Personal taxes	Raise personal tax free allowance to £12,500 by 2020-21 and ensure no-one earning less than £50,000 is paying tax at the 40% rate	Reintroduce 10% starting rate of income tax Increase top rate from 45% to 50% Abolish married couple's tax allowance	Raise personal tax free allowance to £12,500 by 2020-21 Increase capital gains tax
Wealth taxes	Raise inheritance tax threshold to ensure inheritance tax only paid by "rich"	Introduce a "mansion tax" on homes valued above £2m (aiming to raise £1.2bn)	Introduce a "mansion tax" on homes valued above £2m, collected through additional tax layers (aiming to raise £1.7bn)
Corporate taxes	Clampdown on tax avoidance (aiming at raising £5bn)	Reverse cut in corporation tax from 21% to 20%. Use proceeds to reverse rise in business rates planned for April 2015 and freeze rates in 2016	Clampdown on tax avoidance (aiming at raising £6bn)
Government spending	Raise £1.2bn through welfare savings, meaning smaller departmental cuts than those currently assumed	Increase spending on the NHS	Spend £8bn a year on NHS

Source: Oxford Economics

... especially next year to meet the fiscal mandate (zero deficit in 2017-18 or 2018-19); but at different paths

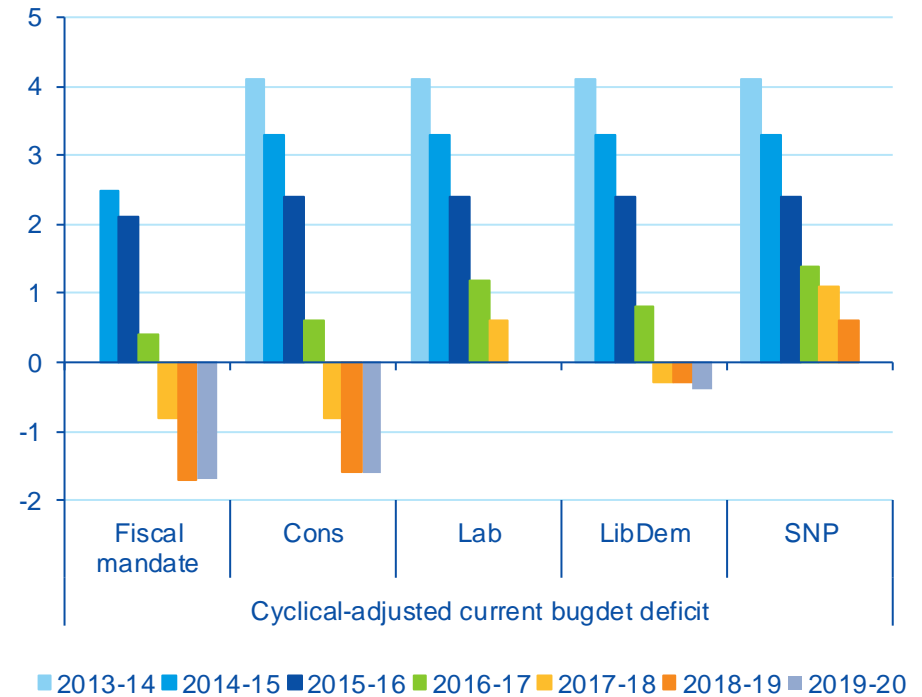
Public deficit plans including net investment (%GDP)

Source: IFS and BBVA Research



Cyclically-adjusted current budget deficit plans

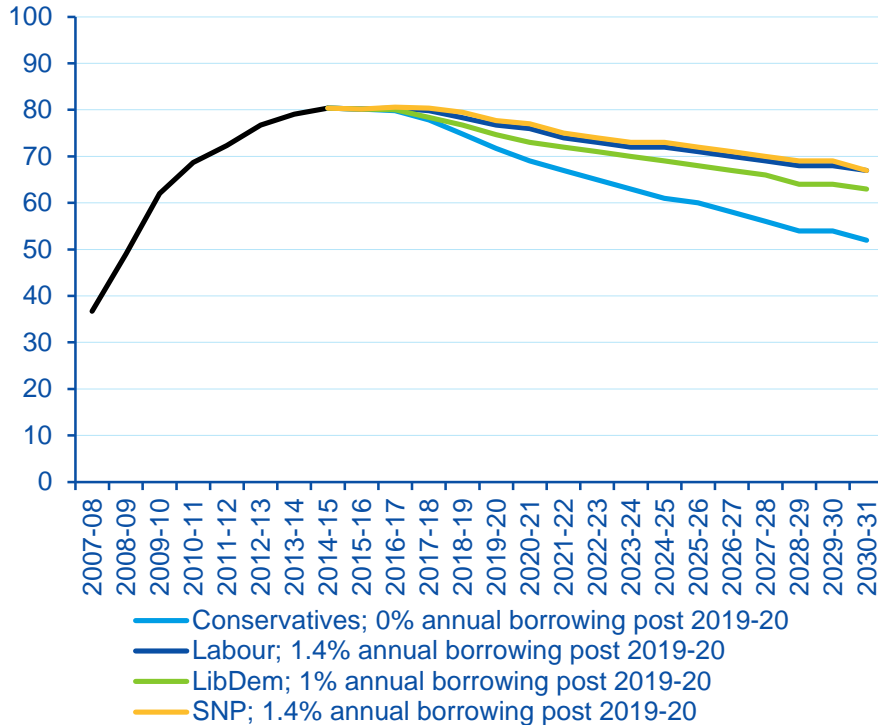
Source: IFS and BBVA Research



Public debt reduction, as the commitment to the supplementary target puts a brake on investment spending

Public sector net debt (% of GDP)

Source: IFS



Public sector net investment at around 1.5% of GDP under all parties' plans

Differences stem from how to finance public investment, or Conservatives want to have no borrowing at all

All-time low bond yields could be used to finance public investment (long-run effects)

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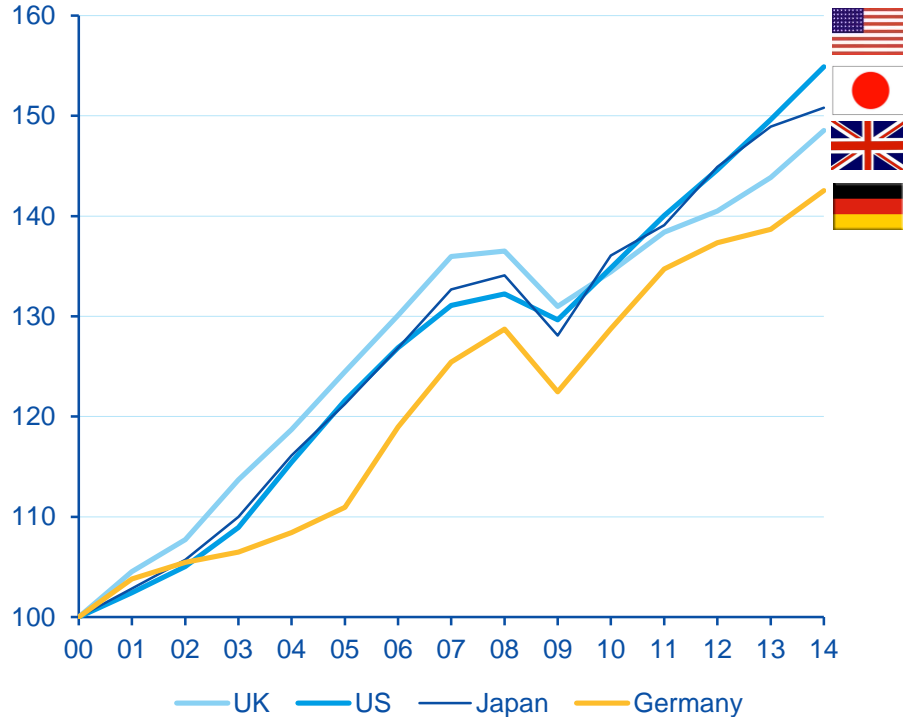
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Long term issues and policies

Looking beyond the crisis: the recovery has been poor in productivity growth

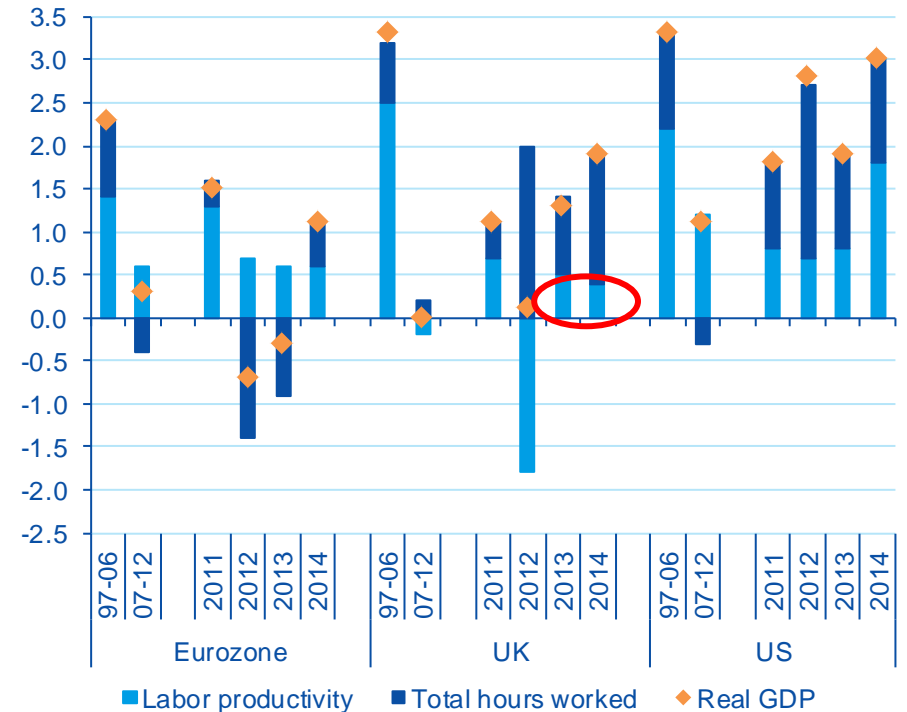
GDP per working age population (2000=100)

Source: IMF, OECD and BBVA Research

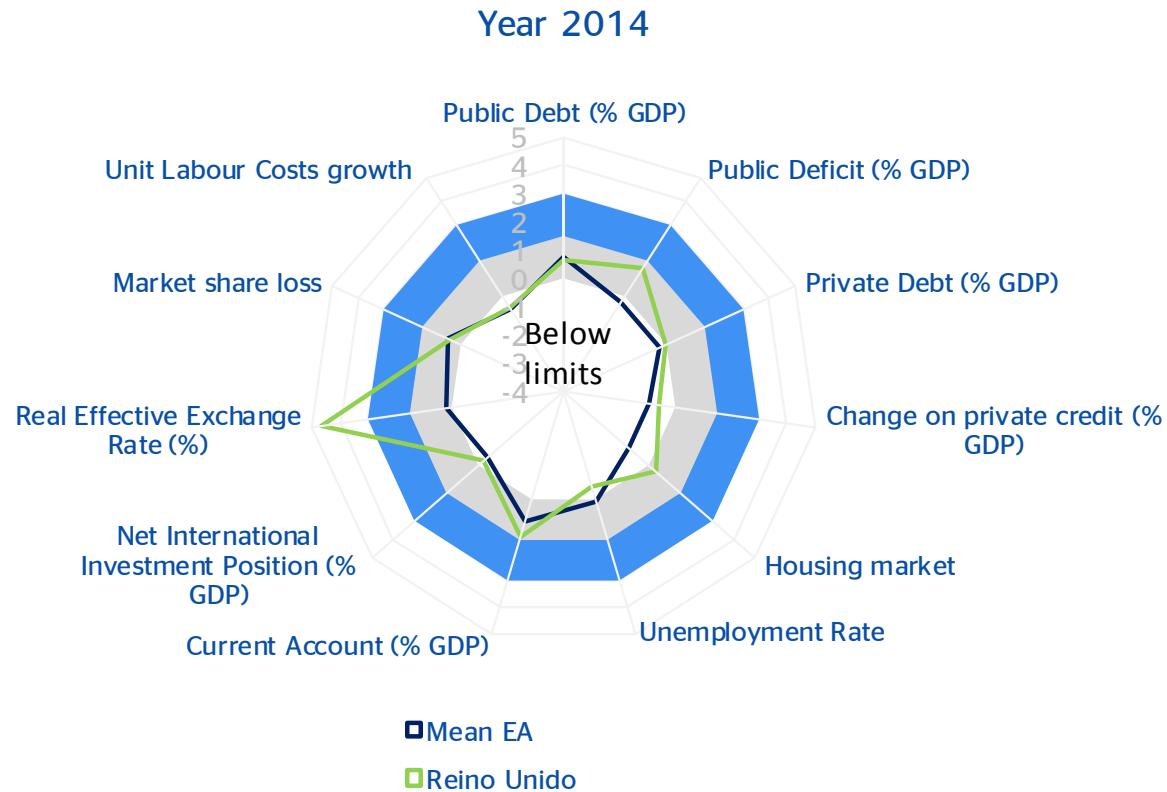


Growth of Labour productivity, real GDP and total hours worked, 1997-2014

Source: The Conference Board Total Economy Database and BBVA Research



Imbalances have yet to be corrected: appreciated currency, high current account and public deficits



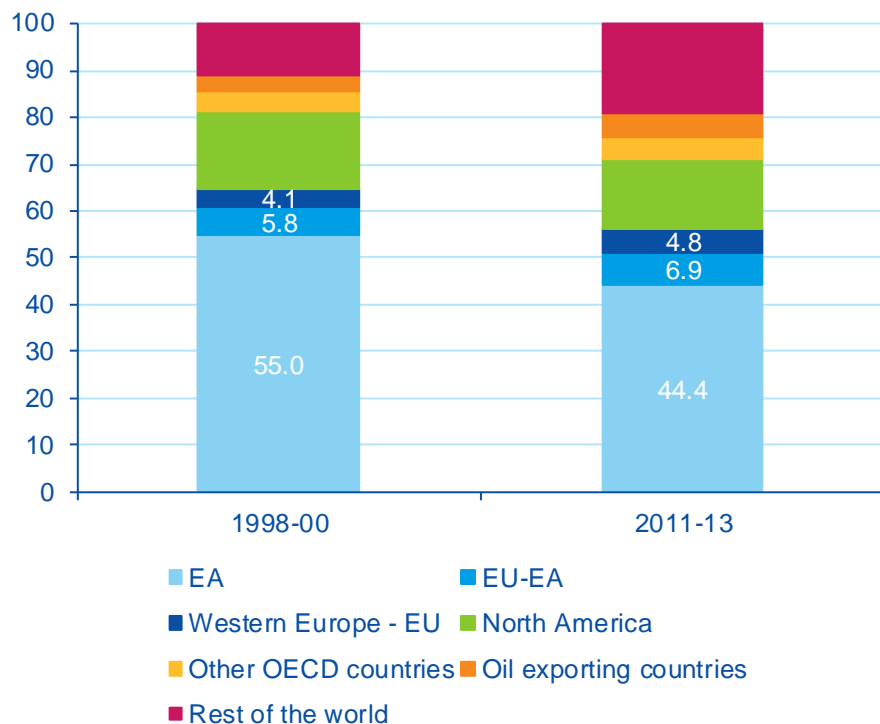
Different policies on three key long-term issues

	Conservative	Labour	LibDem
Employment	<p>Create two million new jobs in order to achieve full employment.</p> <p>Provide three million new apprenticeship positions.</p> <p>Improve tax competitiveness.</p>	<p>Create one million “green” jobs by 2030.</p> <p>Raise national minimum wage to £8 per hour.</p> <p>Ban “exploitative” zero hours contracts. Create more public sector apprenticeships.</p>	<p>Expand apprenticeships and develop national colleges for vocational skills.</p>
EU	<p>Hold referendum on Britain’s renegotiated EU membership by end of 2017</p>	<p>Enhance the UK’s influence in a reformed Europe.</p> <p>Reform of the EU budget, and a shift away from agriculture spending.</p>	<p>Remain in the EU.</p> <p>Hold an in/out referendum if there is a plan for “material transfer of sovereignty” from the UK.</p>
Immigration	<p>Migrants to wait four years before they can claim certain benefits or social housing. No out-of-work benefits for migrants or child benefit for dependants living outside UK</p> <p>Negotiate reform of EU freedom of movement rules.</p>	<p>Reintroduce exit checks to count cross-border flows. Longer waiting periods for out-of-work benefits.</p> <p>Make welfare system more contribution based.</p> <p>Stop Child Benefit from being sent abroad</p>	<p>Restore full entry and exit border checks.</p> <p>End indefinite detention for immigration purposes.</p> <p>Phase out child benefit for children living outside the UK</p>

The EU referendum threatens to change the relationship with Europe (and the rest of world)

Exports share by region

Source: ONS and BBVA Research



The EU remains as the main trading partner

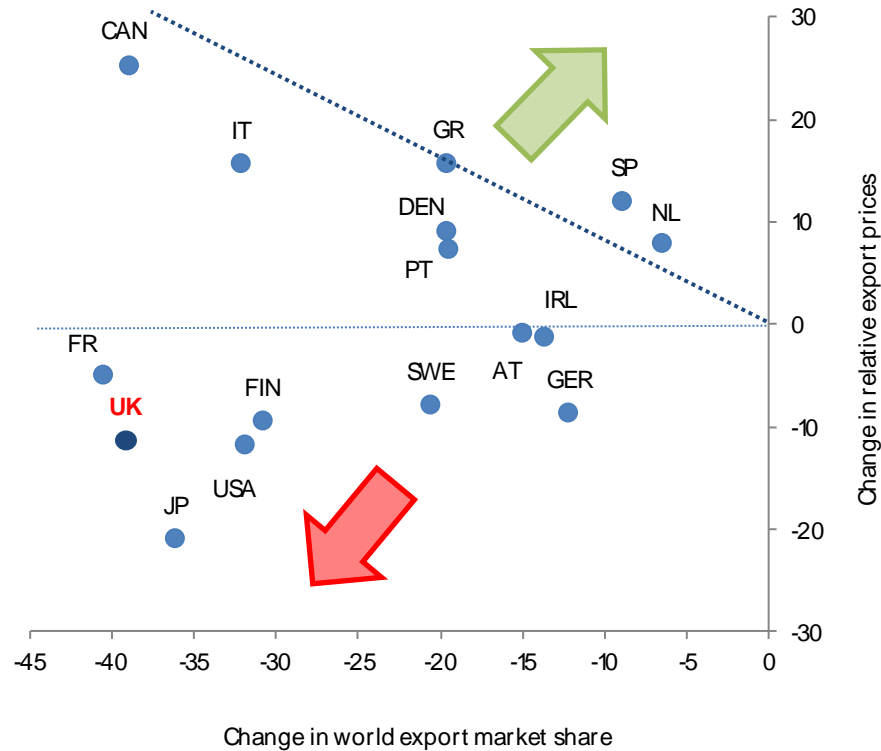
In a context of loss competitiveness

The UK has lost a large market share over the first decade of the century

The current account has deteriorated recently due to the reversal of the income account

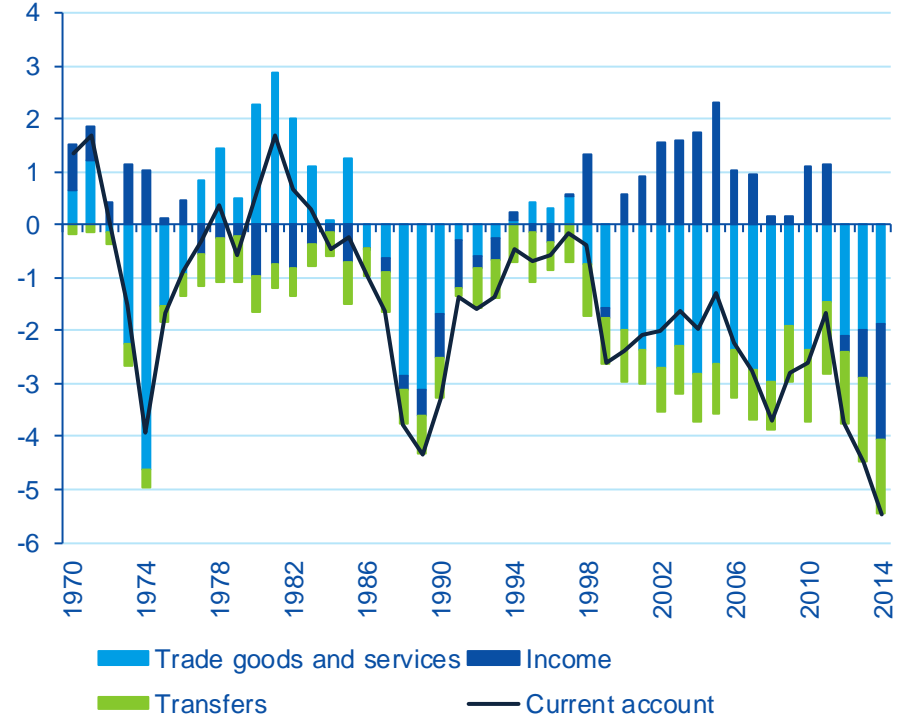
World export shares and REERs (% 1999-2011)

Source: Correa-López and Doménech (2012)



Current account (% of GDP)

Source: ONS and BBVA Research



Reversing open attitude towards immigration would reduce potential output growth

More than a half (54%) of the increase of population in 1991-2012 was due to the direct contribution of migration

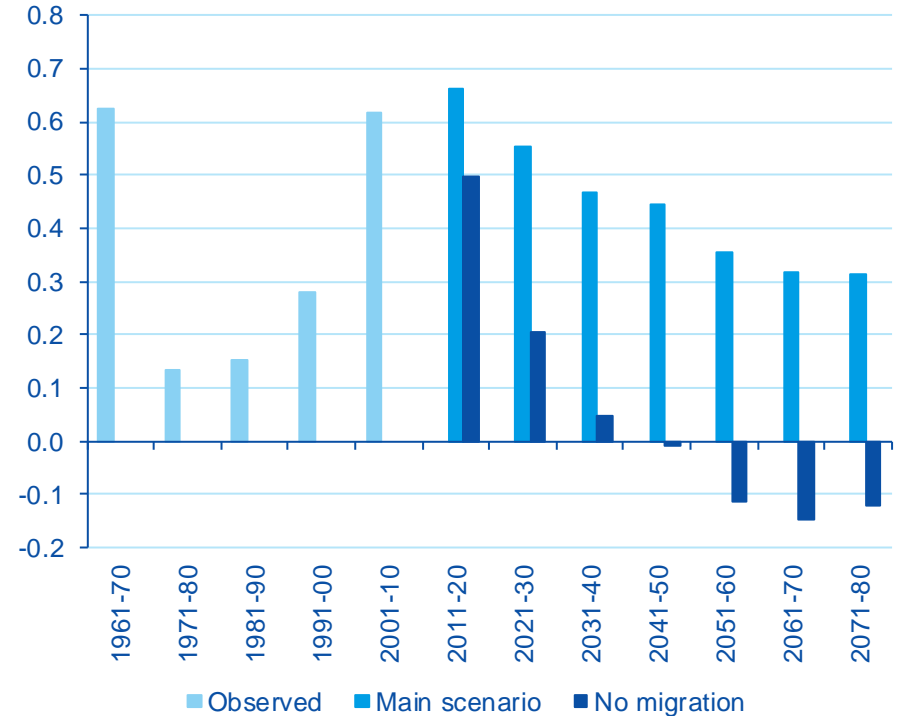
Any declines in the wages and employment of UK-born workers in the short run can be offset by rising wages and employment in the long run

The fiscal impact of migration in 2007-2009 was positive (+0.46% of GDP, according to the OECD, above the average)

Source: The Migration Observatory at the University of Oxford and OECD

Projected population (% YoY)

Source: Eurostat and BBVA Research



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