

1. Global outlook: forward to the past

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Key findings

- **The UK has adapted well to globalisation opportunities.** Over the past 25 years, it has been a world leader in advanced-economy service provision and some manufacturing industries. The UK imports consumer and industrial goods. UK manufacturing has high shares of imported goods in its value added by international standards, making it especially vulnerable to increased trade barriers.
- **Services trade as a fraction of national income is higher in the UK than in many other major economies and has grown substantially over the last two decades.** This increase has in part been helped by the establishment, extension and deepening of the EU Single Market. The UK has a trade surplus in services of 5.5% of national income, three-quarters of which came from financial and professional services. Trade in these highly regulated industries depends particularly on trust and cooperation between jurisdictions.
- **The UK depends on global capital and migrant labour, and has been successful in attracting both.** It has become a destination of choice for direct investment and internationally mobile workers. The UK depends on both to fund its large current account deficit and to close skills gaps.
- **Working-age immigrants from the EU are substantially more likely to be in paid work than either those born in the UK or immigrants from the rest of the world.** Foreigners accounted for more than half of UK employment growth in the last two decades, but the contribution from EU citizens has recently fallen sharply. Should this persist, the direct effect would be to halve trend UK GDP growth.
- **Even leaving Brexit aside, the business models of many globalised economies are being challenged.** First, as labour cost differentials diminish, the rush to offshore production may have peaked. Second, there is the US-forced reordering of international trade relations, with a risk of sustained alienation between the US and China in particular. Third, there is a rising aversion to immigration in many advanced economies.
- **The global outlook is for strong growth but with growing discrepancies.** The fiscal-stimulus-fuelled US economy is firing on all cylinders and Europe is still growing nicely, but the synchronised upswing of 2017 is past and risks are emerging.

1.1 Introduction

Over the last 25 years, the UK has embraced globalisation as well as the establishment, extension and constant deepening of the European Single Market more than many other advanced economies. The UK economy has substantially adjusted its business model to exploit its comparative advantages in a globalised economy. The UK is a world leader in advanced economy service provision and some specific manufacturing industries and has been more successful than most in attracting international capital and workers to produce these goods and services. This successful specialisation drive has coincided with the UK economy mostly outperforming its G7 rivals.

In this context, however, the UK is now facing challenges, including both the UK's vote to leave the EU and challenges to globalisation more generally. This latter group of challenges includes the unprecedented attempt to reorder international trade in the perceived favour of the US by American President Donald Trump and signs that globalisation is slowing due to structural factors but also due to a political backlash against globalisation, especially migration of workers.

In this part of Citi's contribution to the Green Budget, we take a prospective look at the international environment for the UK economy. This includes an assessment of the near-term growth outlook of the UK's major trade partners. But more importantly, it includes a discussion of the UK's vulnerability to a reversal of economic and financial integration, be it at the global level (reversal of globalisation) or at a regional level (in the form of the UK's exit from the European Union). In this chapter, we anatomise the UK's growing exposure to globalisation over the past 25 years. In keeping with the four freedoms of the European Single Market, we scan goods and services trade (Section 1.2) as well as the cross-border exchange of labour and capital (Sections 1.3 and 1.4). We take a stab at potential success factors for post-Brexit Britain (Section 1.5) and provide Citi's global growth forecasts up until 2022 (Section 1.6). Section 1.7 concludes this chapter, while Chapter 2 revisits more specifically the impact of Brexit.

1.2 UK specialisation in the global economy

Lagging in goods trade, leading in services trade

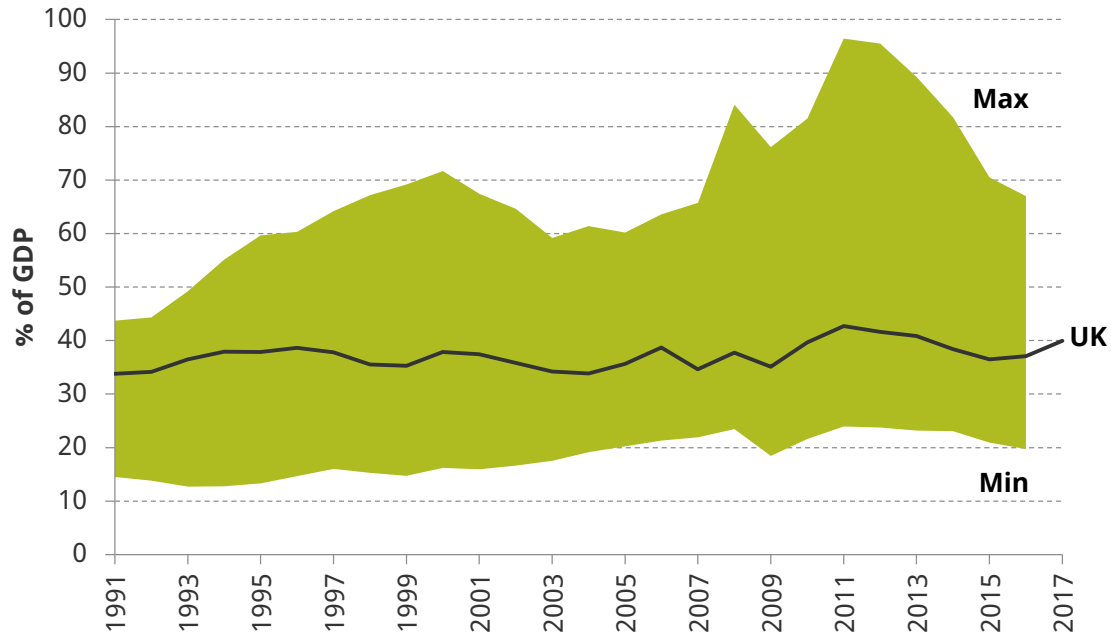
The UK is one of the leading trading nations in the world. According to OECD data, in 2017 the UK accounted for 3.6% of global exports (fifth after China, the US, Germany and Japan) and 3.8% of global imports (joint fourth with France, ahead of Japan).¹ However, adjusted for the size of the economy (dividing the sum of exports and imports by GDP), the UK becomes more middle of the road among advanced economies. On that measure, UK trade intensity was 58% of GDP in 2016, lower than in Germany (84%) or South Korea (77%), but still double that in the US (27%) or Japan (31%).

UK trade intensity differs markedly between the goods sector and the services sector. *Goods* exports and imports equalled 40% of GDP, which Figure 1.1 shows is average among the largest industrialised economies. In 2016, for example, Germany's goods trade intensity was 67% of GDP. Over the past 25 years, the UK has fallen further behind the global leaders on this measure.

¹ <http://www.oecd.org/eco/outlook/economic-outlook/>.

By contrast, Britain leads the large economies in *services* trade intensity. As Figure 1.2 shows, it has been top of the pack in every year but one since 1991. In addition, the UK has grown its involvement more than any other industrialised economy. According to OECD

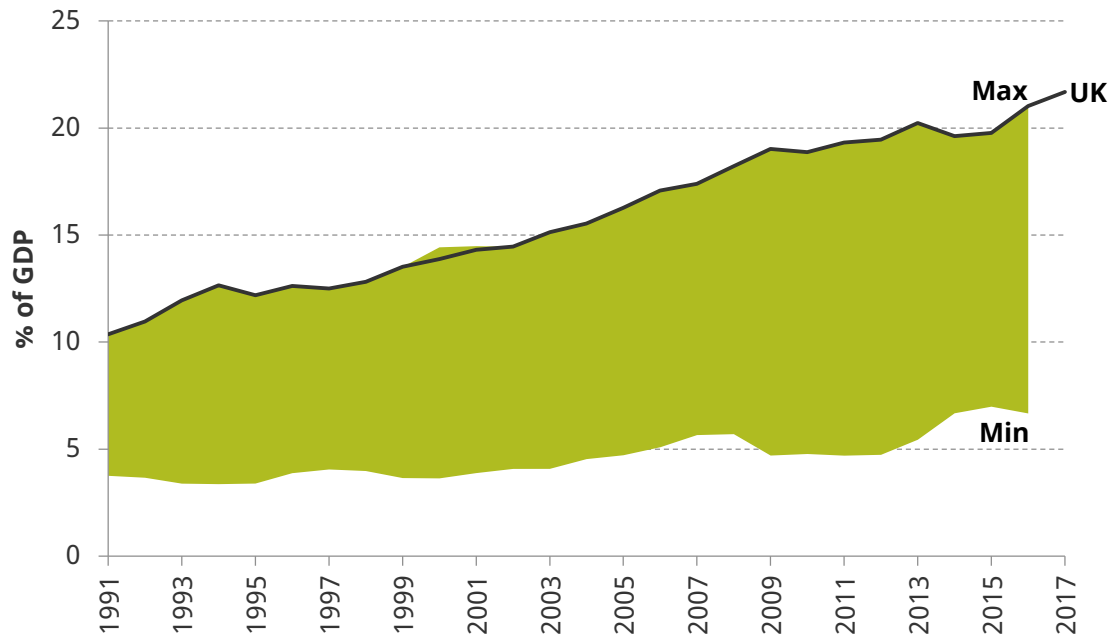
Figure 1.1. Goods trade intensity of selected large OECD economies



Note: Exports + Imports divided by GDP. UK, US, Germany, France, Italy, Spain, Canada, Japan and South Korea.

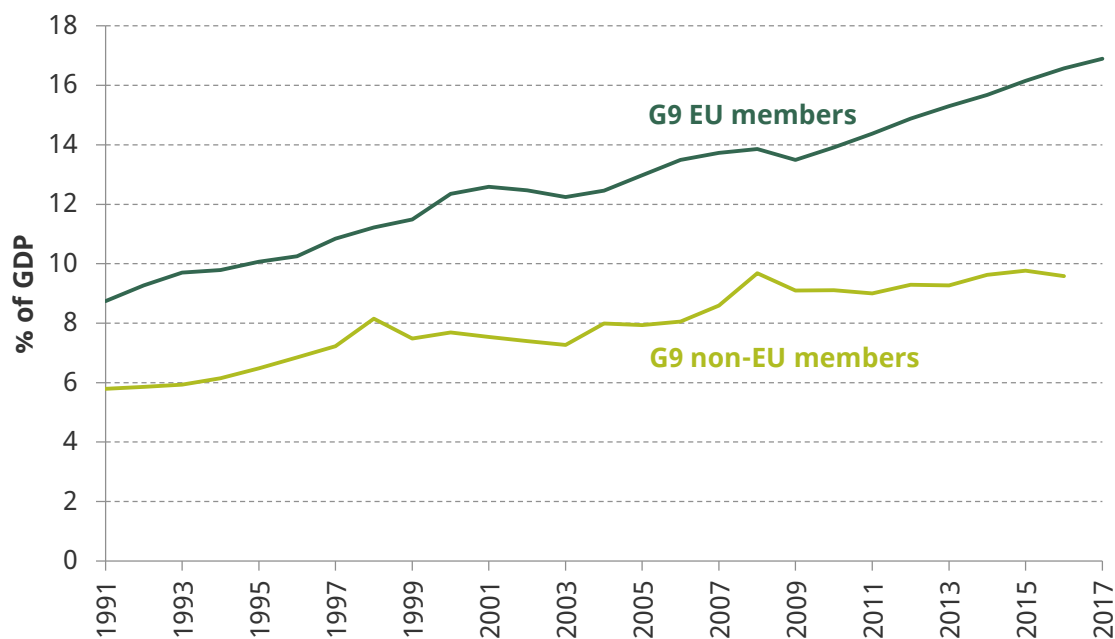
Source: OECD and Citi Research.

Figure 1.2. Services trade intensity of selected large OECD economies



Note: Exports + Imports divided by GDP. UK, US, Germany, France, Italy, Spain, Canada, Japan and South Korea.

Source: OECD and Citi Research.

Figure 1.3. Services trade intensity of G9 economies, by EU membership

Note: Exports + Imports divided by GDP. UK, US, Germany, France, Italy, Spain, Canada, Japan and South Korea.

Source: OECD and Citi Research.

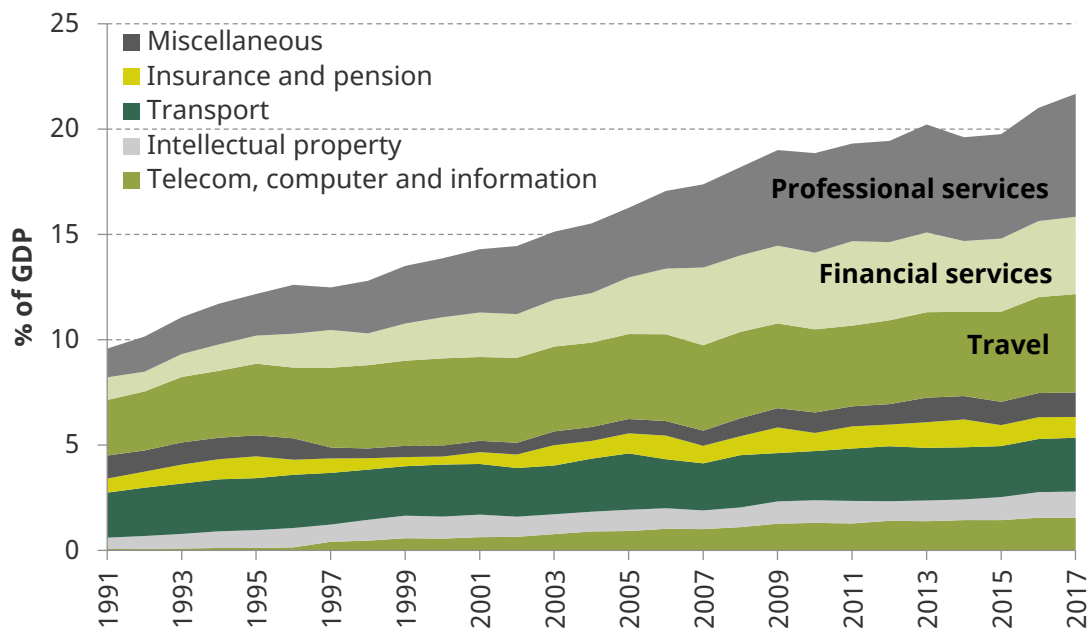
data, in 2017 the sum of UK services exports and imports as a share of GDP was 22%, ahead of France (18%) and Germany (17%). And contrary to the stable trade intensity in goods trade, the UK's trade intensity in services has almost constantly risen over the last 25 years, from just over 10% of GDP in 1991.

At least in part, this is due to the successful EU Single Market: as Figure 1.3 shows, the services trade intensity of non-EU large economies such as the US (7% of GDP in 2016), Canada (12% in 2017), Japan (7% in 2016) and Korea (12% in 2017) is notably lower than that of EU members and has grown more slowly than among large EU economies including the UK. While the level of services trade integration might just be a result of geographical proximity (and sharing a time zone), the dynamics also highlight the unique integration of services trade in the EU's Single Market. This will become important in Chapter 2, when we discuss the potential long-term consequences of Brexit.

Specialisation in financial and professional services

As Figure 1.4 shows, the majority of growth in services trade intensity has come from financial and professional services activity. Trade in these sectors has quadrupled, from 2.4% of GDP in 1991 to 9.5% of GDP in 2017. In addition, travel and franchising services have also contributed significantly to the intensification of services trade. The UK clearly has developed a significant competitive advantage in service provision, which shows in the fact that it ran a 5.5% of GDP services trade surplus in 2017, three-quarters of which came from financial and professional services. This specialisation is important in our context because it has occurred in relatively highly regulated sectors (contrary to, say, tourism or transport services) and is thus more dependent on cooperation between different jurisdictions and vulnerable to the deterioration thereof.

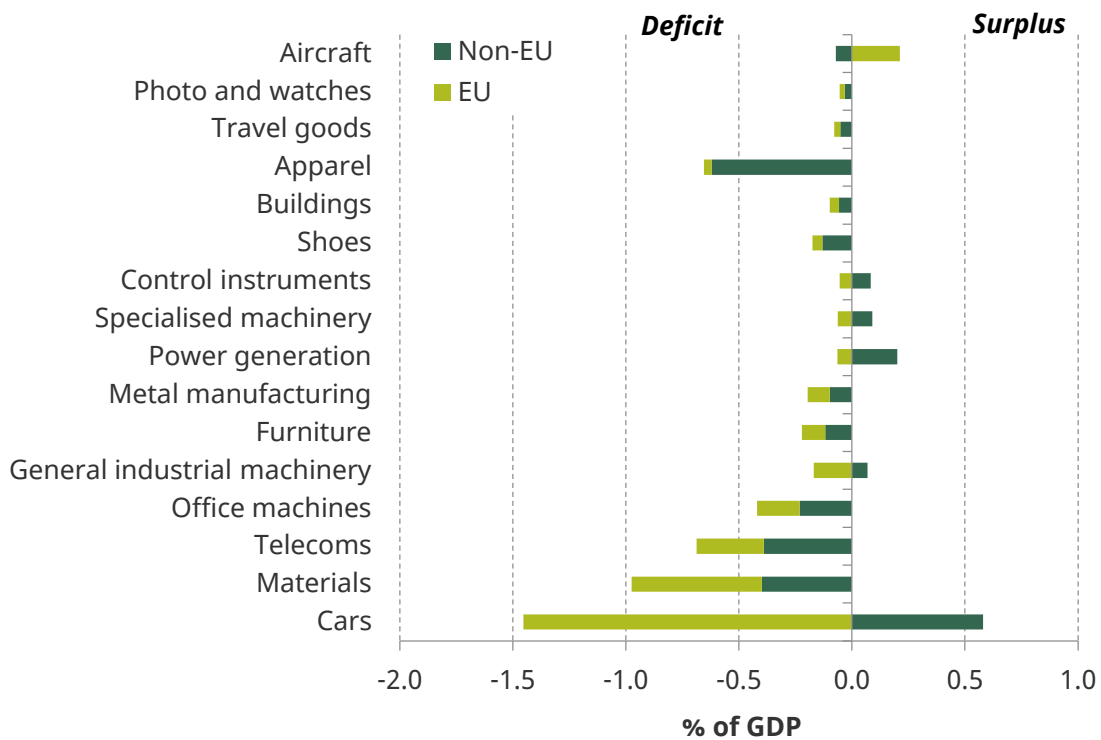
Figure 1.4. UK trade intensity by service sector



Note: Exports + Imports divided by GDP.

Source: ONS and Citi Research.

Figure 1.5. UK trade balance by manufacturing sector, 2015–17 average



Source: ONS and Citi Research.

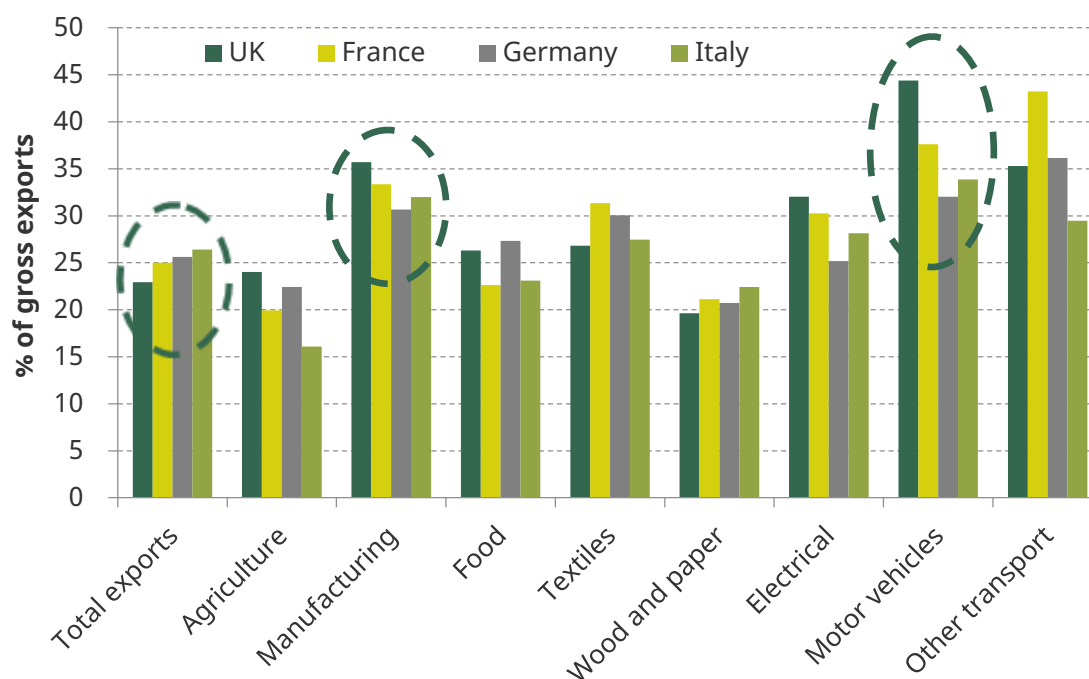
Specialisation in goods production

Naturally, specialisation has not only occurred within the services sector. Despite the general UK underperformance relative to other major economies in the goods production sector, there are pockets of highly competitive manufacturing industry in Britain. Trade surpluses are not comprehensive evidence of competitiveness (export growth and market shares, for example, are also important), but they can give some guidance: the UK remains a powerhouse in aircraft production, with a 0.2% of GDP trade surplus in the sector with the EU (more than offsetting the 0.1% of GDP deficit with the rest of the world), as well as in power generation devices (see Figure 1.5). In highly specialised machinery and control instruments, Britain has also produced more than it needed at home in recent years. In addition, Britain now runs a sizeable surplus in car exports with non-EU economies (0.6% of GDP on average over 2015–17, up from only 0.1% of GDP 20 years ago) as it seems to have become a hub for EU-based and other car manufacturers exporting to the rest of the world.

UK manufacturing has deeper international supply chains than rivals

In today’s globalised economy, trade in finished goods is no longer the key yardstick of integration; the integration of supply chains also matters. In some parts of manufacturing, production processes span several countries, sometimes several times, with lorries becoming mobile warehouses of unfinished stock in just-in-time delivery processes. Across developed economies, according to the OECD TiVA (trade in value added) database, the total foreign value-added share in gross exports rose from 18% to 24% between 2000 and 2011 (latest data available). In the most highly integrated trading areas, such as the EU-28, it reached 28% in 2011.

Figure 1.6. Foreign value added as a share of gross exports, 2011



Note: Exports of goods and services.

Source: OECD and Citi Research.

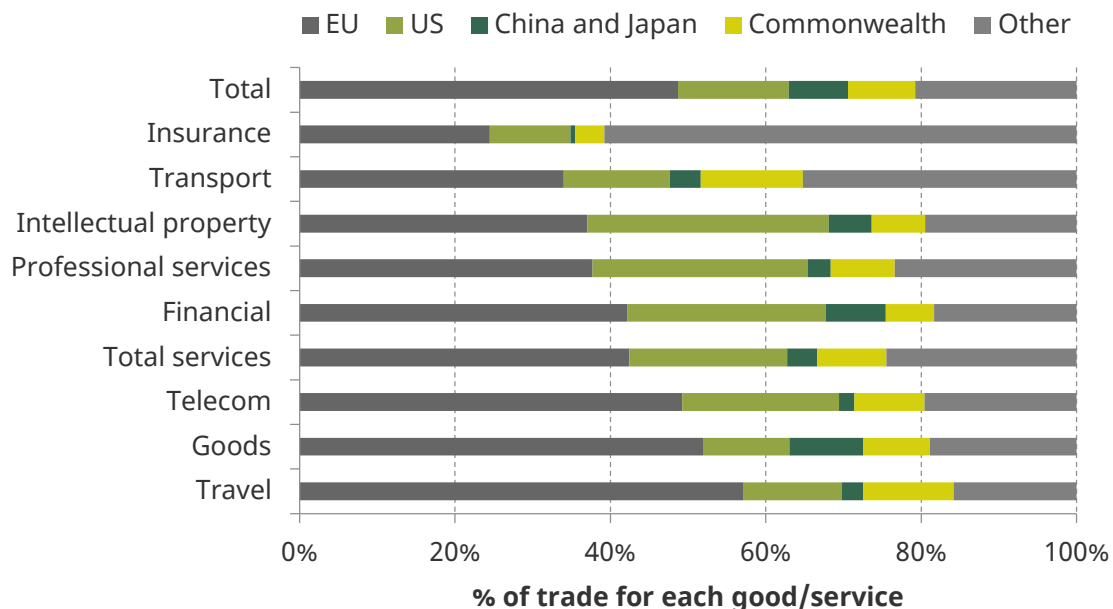
The UK has a lower share of foreign input in its exports (23% in 2011) than key European competitors such as France (25%), Germany (26%) or Italy (26%). That would point to a lower degree of specialisation along the production process (see Figure 1.6). However, that is distorted by the UK's high share of services exports, where supply chains are less long and integrated than in goods production. Focusing on manufacturing only, the picture changes: 36% of the value added in UK gross exports in 2011 was foreign (OECD average 31%), rising to 44% in car manufacturing (compared with only 32% in Germany and 33% on the OECD average). These above-average degrees of specialisation within the European manufacturing value chain make the UK more vulnerable to new and higher customs and regulatory borders, whether that is within the EU or beyond. The exposure of different industries and workers to increased trade barriers between the UK and the EU is discussed in Chapter 10.

EU and US remain most important UK trade partners

A static view of UK trade relations yields a clear picture of which part of the world matters most for UK trade. In 2017, the EU was the destination of 44% of UK goods and services exports and the source of 53% of UK imports. The US accounted for 18% of exports and 11% of imports, China for 4% of exports and 7% of imports and the rest of the world for 35% of exports and 29% of imports. The shares in trade can vary widely by sector: the EU accounts for more than half of the UK's goods and travel services trade, but less than a quarter of the (admittedly relatively small) insurance services trade (see Figure 1.7).

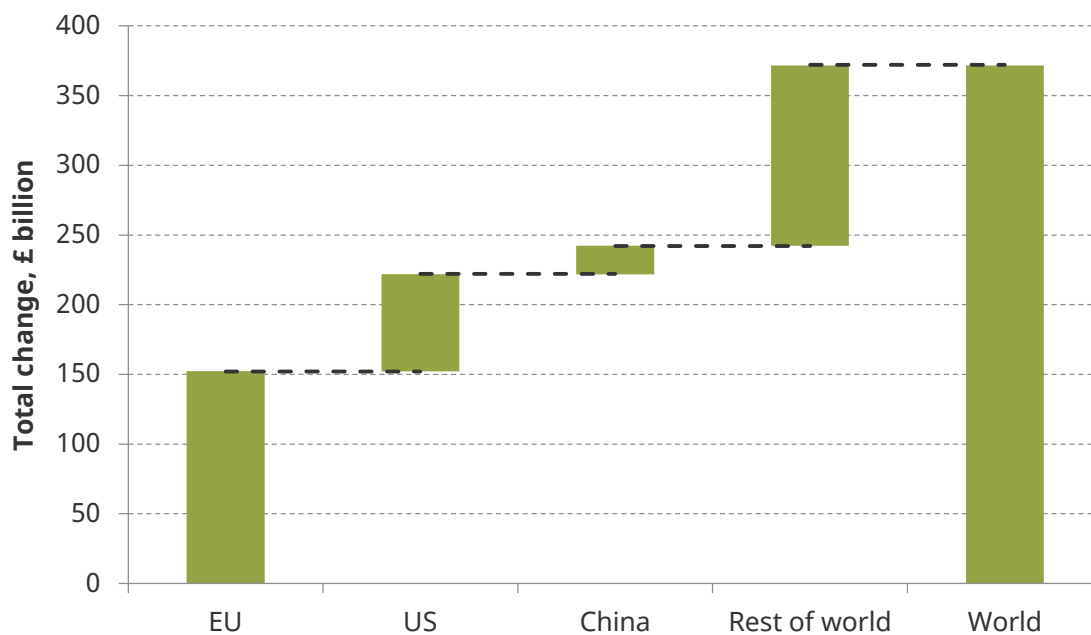
Over time, the EU has become a bit less dominant in UK trade. The share of exports to the EU in total UK exports has shrunk from 55% in 1999 to 44% in 2017, while the share of exports to the US was stable at 18% and that of exports to China quadrupled from 1% to 4%. The rest of the world was up 5 percentage points (ppts) over this period to 31%. On

Figure 1.7. UK trade partners by good or service, 2017



Note: Exports + Imports. Countries that are members of both the EU and the Commonwealth are included in the EU total.

Source: ONS and Citi Research.

Figure 1.8. Change in UK nominal exports of goods and services, 1999–2017

Source: ONS and Citi Research.

the import side, shares have been more stable, with the EU and the US merely losing 2–3ppt shares in UK imports each (to 53% and 11%, respectively, in 2017) to the benefit of China (7% of UK imports in 2017), while the rest of the world’s share was unchanged (at 26%).

Although they underperformed the UK’s emerging export markets in terms of absolute economic growth, advanced economies still made a greater contribution to UK trade growth than their fast-growing rivals. EU markets accounted for 41% of UK export growth from 1999 to 2017, the US for 19% (see Figure 1.8). On the import side, the EU accounted for 55% of the growth and the US for 9%, so in total almost two-thirds of UK import growth. In both cases, the contribution to trade growth for the UK was roughly in line with each economy’s respective trade shares. Advanced economies, in particular the EU, made up for their growth underperformance relative to emerging markets with their greater trade intensification.

1.3 Labour and immigration

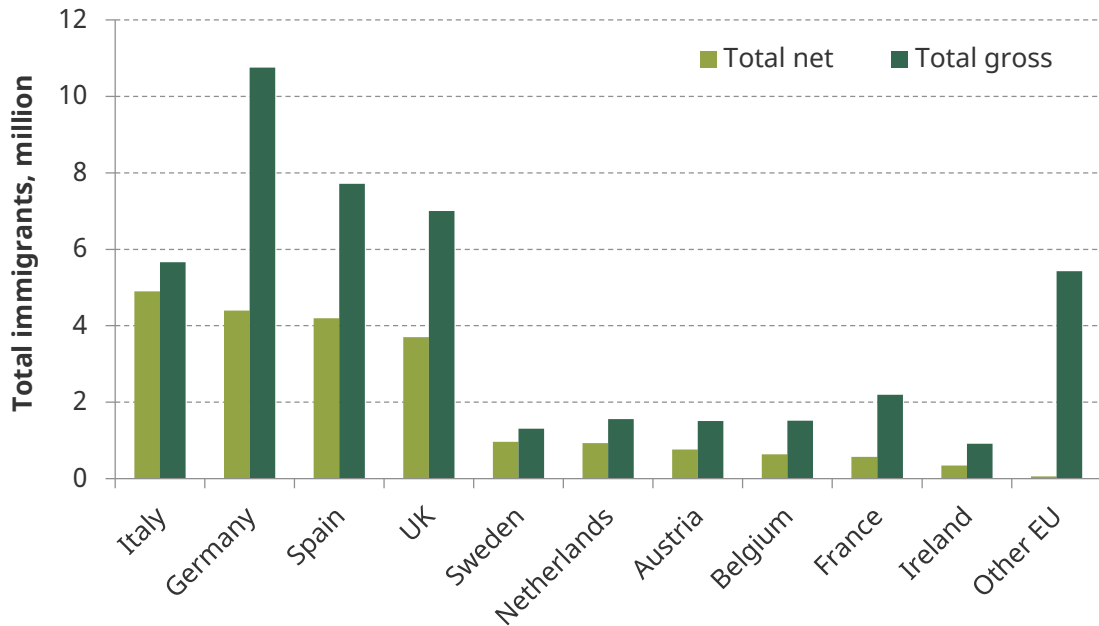
As mentioned in the introduction, economic exchange between countries does not only consist of trading the output of the production process. The freedom of production inputs (capital and labour) to move across borders to increase their effectiveness is equally conducive to exploiting the advantages of globalisation. Here, the UK has traditionally been a successful player as well.

Popular immigration destination, especially for EU citizens

The UK’s flexible labour market, its welcoming environment for immigrants and its accessible language have made it one of the most successful advanced economies in attracting foreign talent. According to Eurostat data, a net 3.7 million foreign passport

holders immigrated to the UK in 2000–16 (in gross terms, 7.0 million), one of the highest numbers in the EU (see Figure 1.9).

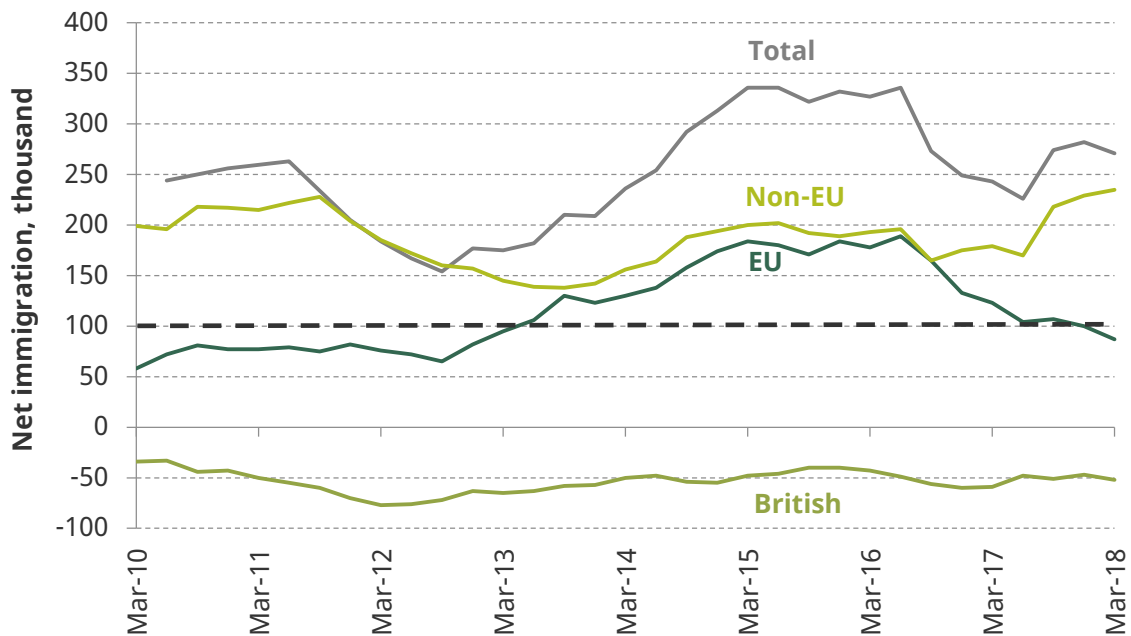
Figure 1.9. Total immigration to EU countries between 2000 and 2016



Note: Immigration (net: minus emigration) other than holders of reporting country citizenship.

Source: Eurostat and Citi Research.

Figure 1.10. UK net immigration (total over four quarters)



Note: Immigration less emigration. In 2010, the government announced a target to have net total migration in the ‘tens of thousands’.

Source: ONS and Citi Research.

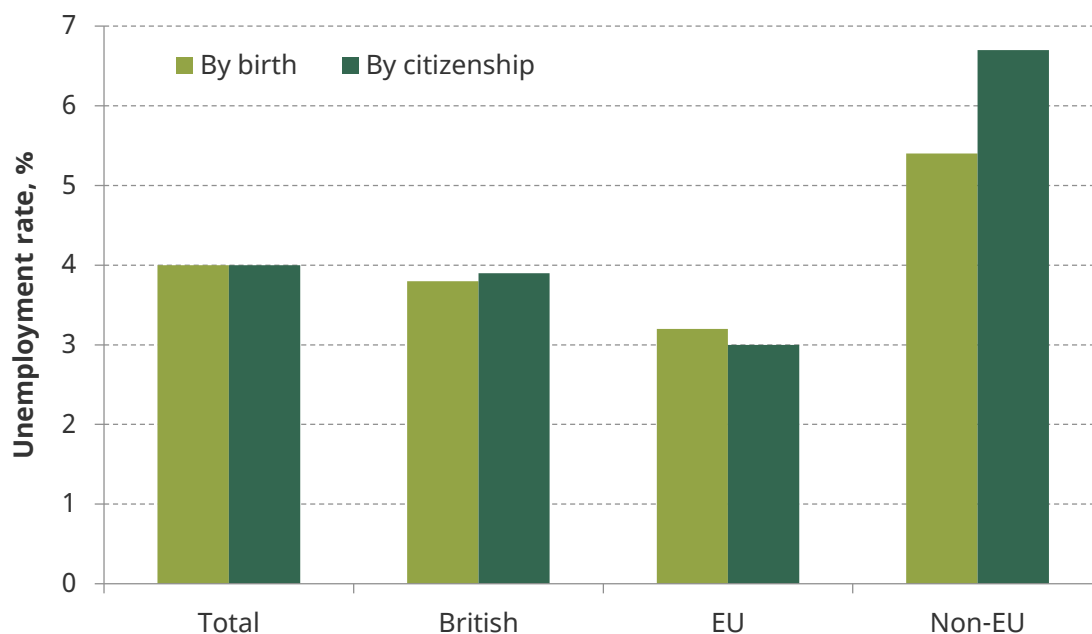
Most of the UK’s immigration over this period came from outside the EU (see Figure 1.10). However, for a period following the eurozone debt crisis, immigration from other EU member states was as high as that from the rest of the world. Since the EU referendum and the fall in the value of the pound relative to the euro, immigration from EU countries has fallen, even though it still remains above the pre-euro-crisis levels, at least until end-2017. By contrast, immigration from non-EU states has increased the most recently, meaning total net immigration has not dropped by very much and remains well above the government’s official target of ‘the tens of thousands’.

Immigrants from the EU more likely to work than UK natives

Immigrants have strongly benefited the UK economy, accounting for more than half of the employment growth in recent years and alleviating skills shortages across the economy. Many studies find positive effects of immigration on the economy on an aggregate, per-capita and per-worker basis, though the associated distributional effects of this may be uneven and side effects have to be assessed. For example, Citi’s latest GPS (Global Perspectives and Solutions) report² found that while migration added 8% to UK population between 1990 and 2016, it drove a 16.6% increase in GDP. The recent report by the UK’s Migration Advisory Committee also found a positive impact of immigration on productivity and innovation, especially from highly skilled workers.³

However, some immigrant groups have been more successful in the economy than others, with (non-UK) EU citizens outperforming not just other immigrants but also

Figure 1.11. UK unemployment rate by birthplace and citizenship, second quarter of 2018



Note: Citizenship as stated by respondents in the Labour Force Survey.

Source: ONS and Citi Research.

² *Migration and the Economy: Economic Realities, Social Impacts and Political Choices*, Citi GPS (Global Perspectives and Solutions), September 2018.

³ Migration Advisory Committee, *EEA Migration in the UK: Final Report*, September 2018.

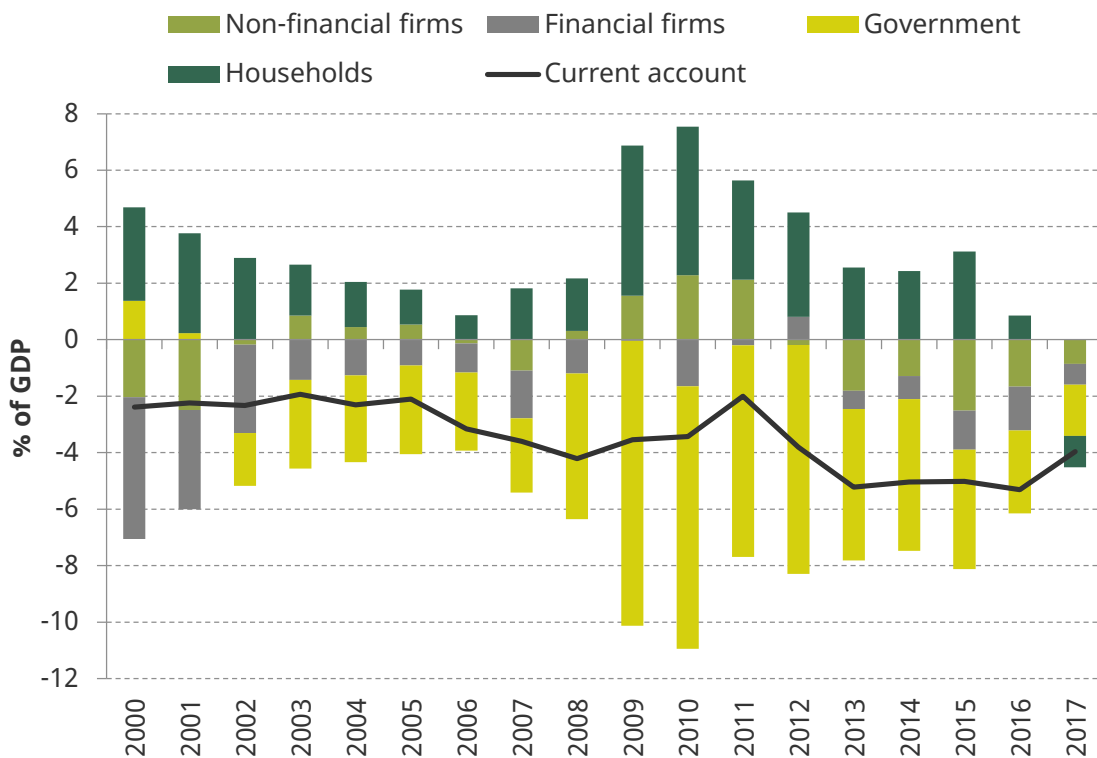
natives on four measures. First, EU citizens took up about half of all newly created jobs in the period from 2014 up until the EU referendum, while non-EU foreigners struggled to enter the labour market in this period. Second, EU citizens in the UK have been more available to the labour market, with an activity rate of 83% among 15- to 64-year-olds in 2017 according to Eurostat data, well above that of non-EU citizens' activity rate (66%) and even above that of British citizens (78%). Third, EU citizens are more likely to hold a job, with an employment rate of 80% in 2017 according to Eurostat, above the 74% employment rate of UK citizens and the 61% employment rate of non-EU citizens. The UK has the highest employment rate of non-native EU citizens among EU-15 member states. And fourth, as a result, the unemployment rate of EU citizens at 3.0% is lower than British citizens' at 3.9% and non-EU citizens' at 6.7% (see Figure 1.11) according to ONS data. At least for British and EU citizens, these results do not differ much when looking at birthplace rather than citizenship.

1.4 A hub for global investment

The UK has long depended on international investors to fund firms' and government's spending and investment and, since last year, even household spending. All domestic sectors of the economy have become net borrowers as of 2017 (see Figure 1.12).

As the UK became a destination of choice for increasingly globalised investment flows, this dependence on foreign funding was not a problem. London's role as a global financial centre, its track record of above-average growth for advanced economies, strong property rights and solid public finances secured sustained funding inflows. Conversely, depending

Figure 1.12. UK net lending/borrowing by sector



Source: ONS and Citi Research.

on foreign capital inflows has become a typical feature of the UK economy: the last current account surplus in a single year dates back to 1983!

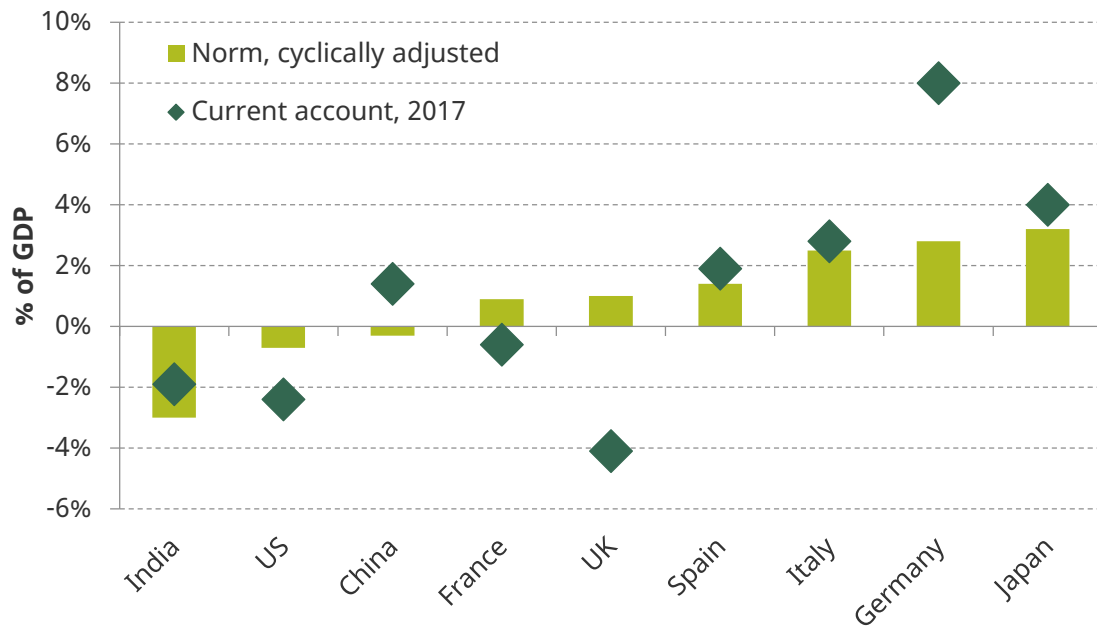
In 2017, the current account deficit amounted to 3.9% of GDP, down from 5.2% in 2016 and the lowest since 2012. The current account deficit is made up of three components: the goods and services account (which measures the overall trade balance), the primary income account (which includes income from investments abroad as well as payments to UK residents employed overseas) and the secondary income account (which covers transfers between countries, such as overseas aid or payments to the EU). In 2017, the overall current account deficit combined:

- A **trade deficit** on the goods and services account of 1.3% of GDP, which in turn was the result of a goods trade deficit of 6.7% of GDP and a services trade surplus of 5.5% of GDP.
- A **primary income deficit** of 1.6% of GDP. This largely results from higher outflows of income on foreign investors' UK assets than inflows of incomes on UK investments abroad. It reflects both a difference in the amount of underlying assets (foreigners owned more UK assets than UK residents owned foreign assets – a negative international investment position) of £165 billion or 8.1% of GDP at the end of 2017 and a difference in the rates of return on these assets (rates of return on UK investments abroad, at 2.0% in 2017, were lower than foreign investors' returns on UK assets at 2.3%). The negative international investment position is set to get bigger, rising to £262 billion, or 13% of GDP, in 2018 Q1.
- A **secondary income deficit** of 1.0% of GDP, about half of which reflects net payments to EU institutions (£9 billion in 2017) and the rest other government transfers (such as development aid) and non-government transfers (such as net remittances).

However, large current account deficits can also become serious macroeconomic vulnerabilities, as some emerging economies are currently reminding us. The size and persistence of the UK's current account deficit has become a concern for many economists, even though it has so far not triggered any violent adjustment. While the UK is able to sustain a less favourable current account balance than other G7 countries, as long as it maintains its higher trend growth rate and a less worrying demographic outlook, the negative net international investment position as well as declining oil and gas reserves should be set against that. The IMF calculates that, based on these structural factors, the UK should actually be running a current account surplus of 1.0% of GDP through the cycle, similar to France or Spain.⁴ That means the UK would have to adjust its current account balance by 5% of GDP, the largest necessary upward adjustment of any of the economies analysed by the IMF (see Figure 1.13). In addition, the UK's norm current account surplus may have risen further since the EU referendum due to lower expected growth and less immigration more than offsetting any potential savings on EU budget contributions.

⁴ See International Monetary Fund, 'EBA [external balance assessment] estimates: analysis of 2017 current accounts and real effective exchange rates', <https://www.imf.org/external/np/res/eba/data/EBAEstimates-2017.pdf>.

Figure 1.13. Cyclically adjusted norm and actual current account balance as % of GDP for selected countries, 2017



Source: IMF and Citi Research.

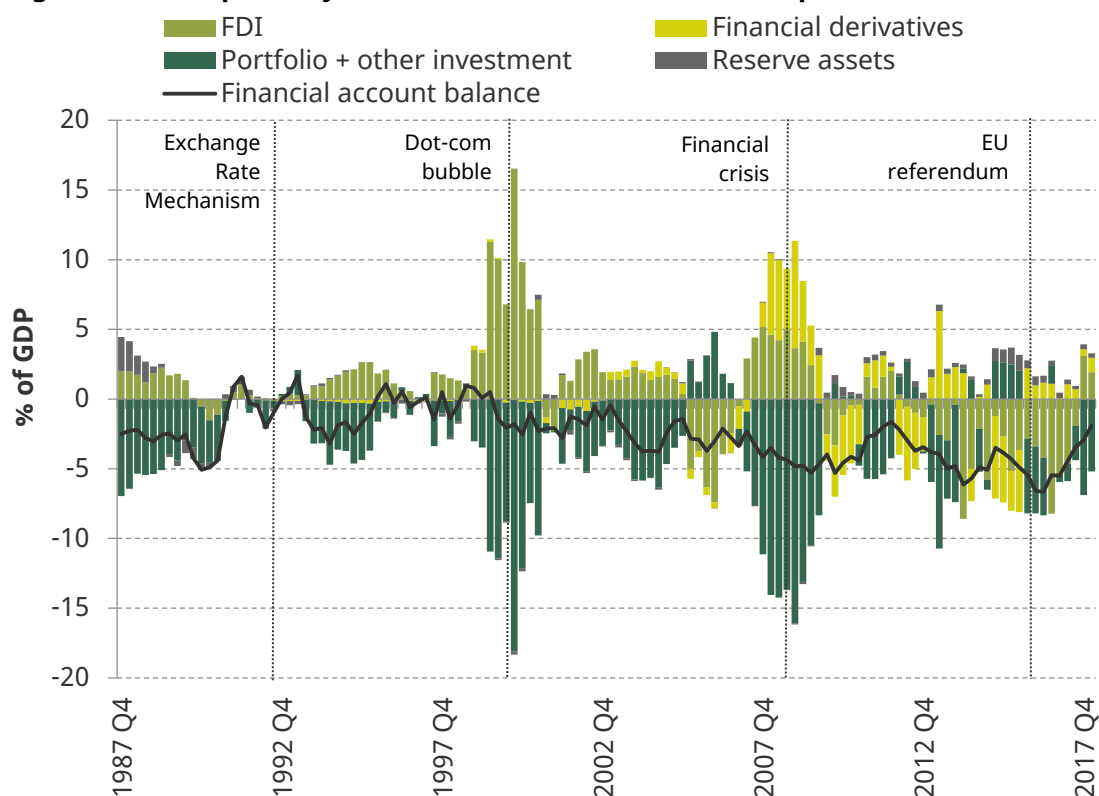
How does the UK fund its current account deficit?

Broadly speaking, the position of the current account should be balanced by the financial account, which covers international flows of capital. There are several different types of capital flow, including foreign direct investment (where the investor has some control over the enterprise they are investing in), portfolio or loans investments (financial investments such as buying shares or bonds where the investor does not get any control) and reserve assets (which are foreign financial assets owned by monetary policy authorities – in the UK, the Bank of England).

In 2017, the UK financial account saw inflows of 3.0% of GDP, made up of the following components:

- A 3.1% of GDP net outflow of **foreign direct investment (FDI)**. Net FDI outflows are unusual in the UK: last year's was the first since 2011 and the depth of the global financial crisis. From 2012 to 2016, the UK had experienced inflows, peaking at 8.2% of GDP in 2016. FDI outflows are not always associated with crises, however. They are often accompanied by inflows of other types of investment; for example, during boom periods in equity and bond markets, the City of London collects funds from around the world and channels them back into investments abroad. Last year's outflow could, however, reflect current and expected growth differentials between the UK and the rest of the world, which have reversed since 2016 due to the EU referendum.
- An inflow of **portfolio investment** (mostly into debt securities of UK residents) and **other investment** (mostly into loans to UK residents) worth 6.9% of GDP. Data on these categories and their composition are very volatile, but most of the net inflows have been into long-term debt securities (portfolio investment), often fluctuating with inflows via loans (other investment).

Figure 1.14. UK quarterly net financial account and net component flows



Note: Net foreign direct investment (FDI, mainly purchases of equity stakes $\geq 10\%$); net portfolio and other investment (mainly purchases of equity stakes $< 10\%$, debt securities and loans); net financial derivatives (financial instruments dependent on other assets); net reserve assets. All quarterly as a percentage of nominal GDP.

Source: ONS and Citi Research.

- A small outflow of **net reserves** worth 0.3% of GDP. Outflows of reserves have been consistently 0–1% of GDP per year since the financial crisis.

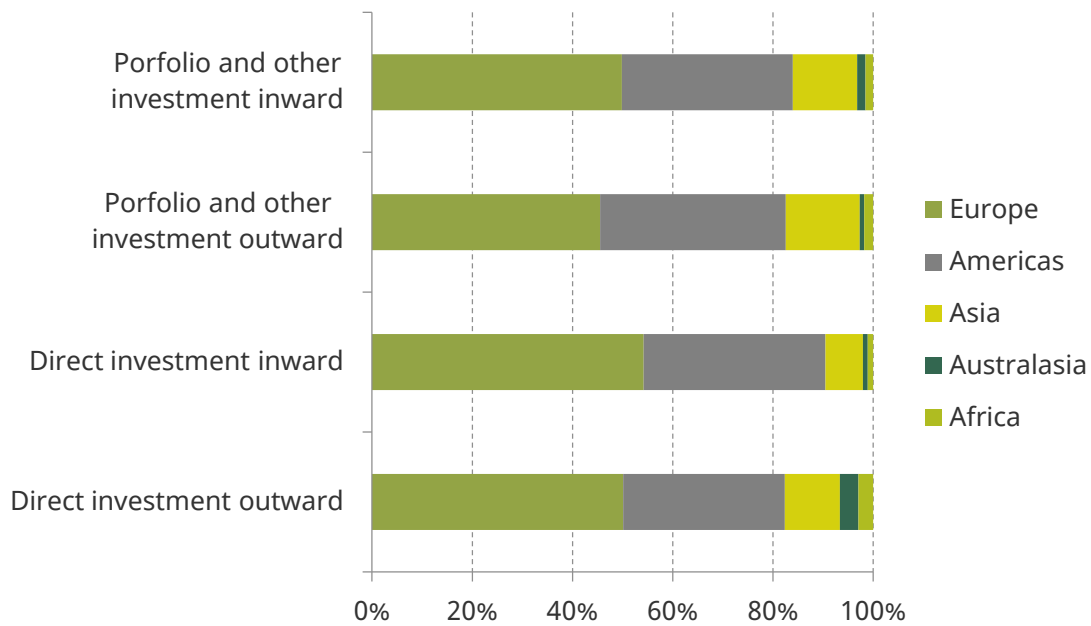
Where does the funding come from? Advanced economy sources, especially the EU and the US, dominate investment from and into the UK, both in terms of direct investment and portfolio investment.⁵ For example, EU and other European economies currently account for more than half of the UK’s inward and outward stock of foreign direct investment and nearly half of the portfolio (and other) investment as well; the Americas account for another third in total (see Figure 1.15).

However, there have been notable shifts between regions in the funding flows, in particular the destination of UK foreign direct investment. UK foreign investment into Asia accounted for only 4% of British FDI stocks in 2000, but has risen to an 11% share since 2010. Over the same period, the Americas’ share has risen by 4ppts to 32%, while Europe’s has fallen by 13ppts to 50%. By contrast, the shares in inward FDI were more or less stable over this period. On the portfolio and other investment side, the share of Europe in the UK outward stock of investment has dropped from 56% in 2000 to 46% in 2016, matched by an

⁵ We combine portfolio and other investment, which is mostly loans, as the two often replace each other from one quarter to the next and we can reduce the volatility in the data by netting them.

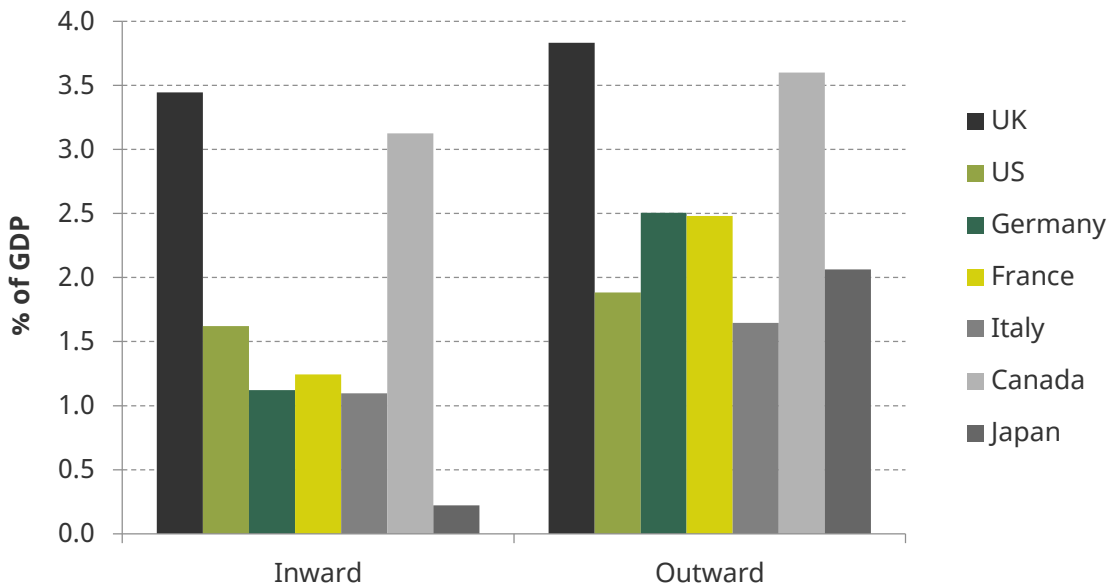
equivalent rise from 27% to 37% for the Americas, the rest being stable. On the liability side, Europe’s share in UK inward investments has been roughly stable, but the Americas gained 8ppts mostly at the expense of Asian investors. Overall, it is clear that Europe has become a less important destination for UK outward investment (while the US and Asia have gained), while the UK continues to depend on European investors for incoming investments.

Figure 1.15. UK stock of inward and outward investment in 2016, by region



Source: ONS and Citi Research.

Figure 1.16. Average foreign direct investment between 2005 and 2017 as a share of GDP for the G7 economies



Source: OECD and Citi Research.

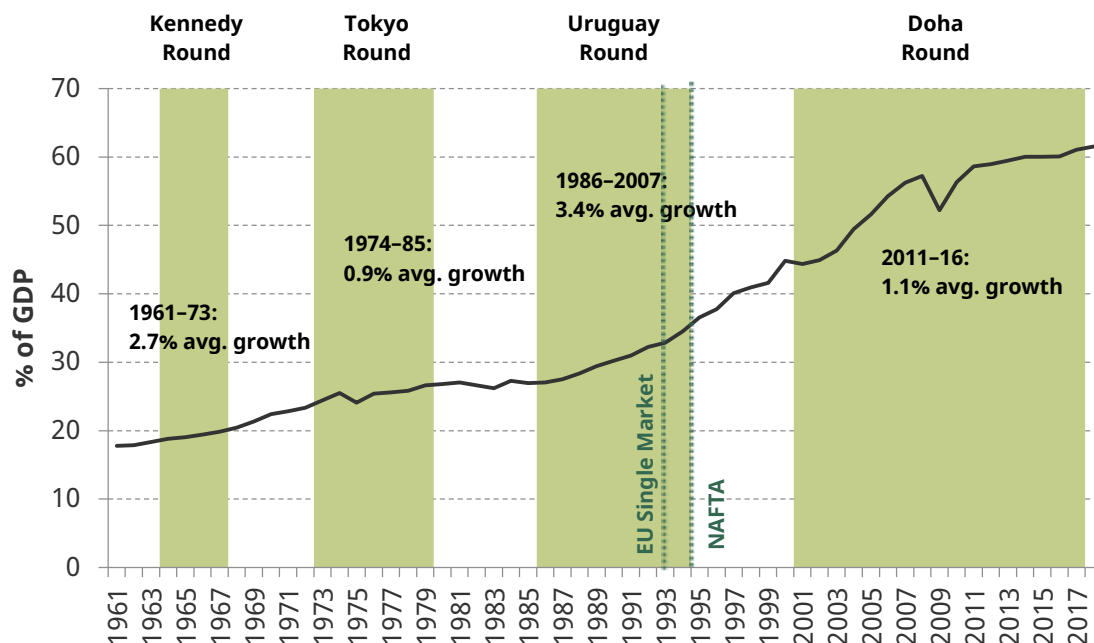
Finally, the UK has been more successful than other OECD economies in attracting foreign direct investment. According to OECD data, over the past 12 years, the UK has on average attracted investment worth 3.4% of GDP per year, more than double or even three times the amount relative to GDP in its major European rivals, the US and Japan. Only Canada in the G7 comes close to the UK on this statistic (see Figure 1.16). The UK has also been more active than its G7 rivals in terms of outward FDI over this period, but there the lead is not quite as impressive (and likely the result of the UK’s role as Europe’s financial centre, channelling European investments elsewhere).

In sum, the UK has immersed itself in globalisation by specialising in some outputs such as some parts of **manufacturing** and **services**, but also by drawing more than rival economies on global production factors in the form of **immigration** of workers and depending on international **investment**. In the following section, we highlight how globalisation is challenged, which affects the UK on all four fronts.

1.5 Challenges to the UK’s globalisation model

The UK’s specialisation approach to globalisation has been a key to its economic success over the last 25 years, as demonstrated above. Last year, coinciding with the immediate aftermath of the EU referendum, globalisation looked reinvigorated after a softer period: growth in trade volumes was increasing towards its historical relationship of about twice GDP growth and global trade intensity was rising at rates closer to historical averages. However, that recovery seems to have been short-lived: since the beginning of 2018, volumes have retreated again. The soft patch in global integration is not over (see Figure 1.17) for the time being.

Figure 1.17. Global trade intensity (exports + imports as a share of GDP)



Note: The labelled ‘rounds’ were periods of multilateral trade negotiations.

Source: OECD and Citi Research.

However, even if the current soft patch for global trade eventually proves to be partly cyclical, the UK's globalisation success story is facing serious challenges, some potentially transient, others likely permanent: (i) peak globalisation; (ii) trade wars; (iii) populism and opposition to immigration; and (iv) EU exit. Before moving on to global and regional economic forecasts, we highlight how global threats to the free movement of economic outputs and inputs can impact a highly globalised UK economy more than others, before turning to the UK economy and self-imposed threats to globalisation in Chapter 2.

Peak trade in goods and services: cost differences diminish

As we showed above, globalisation has been driven to a large degree by deepening trade across more economies. There is surely a lot more room for that process to continue, in particular if countries continue to work on lowering barriers to trade. However, to the degree that globalisation was driven by large differentials in production costs, in particular labour costs, these differences might be diminishing.

For example, Citi analysts have pointed out that average wages in China (in yuan terms) in the manufacturing sector have tripled in the last 10 years,⁶ while they have risen by less than a third in Germany over the same period according to the German federal statistical office. Non-wage costs are also rising, with industrial leases in China now 10 times higher than in Mexico. It is possible and indeed likely that other, even cheaper locations are taking over as destinations for offshoring, as the attractiveness of China on a pure labour cost motivation wanes. But it is also conceivable in our view that cost-based globalisation growth has reached its peak and could give way to a stronger trend of re-onshoring of production to the places of consumption, in particular the US and Europe. This process might accelerate if the political backlash against globalisation in the West, which manifests itself most clearly in the trade wars of US President Trump against China, continues.

OECD work shows that the integration of global value chains across borders has been receding in the period 2011–16, following two decades of rising integration.⁷ Global value chains have been a source of technological knowledge transfer, economies of scale, and cluster economies, all supporting productivity growth. To some degree, this lack of further cross-border integration may be the result of hitting limits of specialisation, but it may also reflect growing concerns about the vulnerability of cross-border supply chains and the lack of prospect for further trade integration.

Outside goods trade, the evidence is less clear-cut. However, there is evidence that cross-border financial exposures have been shrinking since the global financial crisis. The sum of global external assets and liabilities as a share of global GDP is shrinking among advanced economies (from 250% of GDP in 2007 to 200% of GDP in 2016) and has stopped growing among emerging economies. This is likely to be the result of post-crisis deleveraging and also partly a result of regulation to make the global financial system safer by reducing the potential for cross-border contagion. However, it also affects a sustained decline in global financial integration, which could become a worrying trend for global financial centres such as London if it reflects a lack of trust between jurisdictions.

⁶ See 'European freight forwarding – tides of change, sea freight facing structural headwinds', <https://www.citivelocity.com/t/r/eppublic/1TDHr>.

⁷ OECD, *Cardiac Arrest or Dizzy Spell: Why is World Trade So Weak and What Can Policy Do About It?*, Economic Policy Paper 18, 2016.

Trade wars as a backlash against globalisation

Even before President Trump started his trade wars this year, there was clear evidence that the appetite for further trade integration had stalled around much of the world. Multilateral trade negotiations made little progress for many years and were – and still are – increasingly being replaced by bilateral and plurilateral trade agreements. These tend to focus less on opening markets for growing categories of consumption and trade such as services, instead emphasising lowering the remaining barriers to goods trade, such as tariffs, and addressing mutual recognition of standards and regulations. Outside these limited advances, there was ample evidence of rising barriers to trade even before Trump.⁸

But with the arrival of US President Trump, the risk of an unravelling of the global trade system has clearly increased dramatically. Having withdrawn the US from the Trans-Pacific Partnership agreement as one of his first acts upon becoming President in January 2017 and launching renegotiations of the US's existing free trade deals such as NAFTA with Canada and Mexico and KORUS with South Korea, Trump focused on domestic tax and entitlement reform in 2017, but then returned to the trade agenda earlier this year. On 1 March, the US administration announced a 25% tariff on steel imports and a 10% tariff on aluminium imports, nominally on the grounds of national security concerns. Trump initially suspended the tariffs for a number of trade partners, including the EU and thus Britain. However, since June, the tariffs have been in place and have led to EU retaliation against the US. Note that the US tariffs automatically also led to second-round barriers, with the EU imposing 'safeguard tariffs' against a surge in steel imports from other economies affected by the US steel tariffs. The EU has joined the World Trade Organisation (WTO) complaints against the US tariffs.

While the US government designed the steel tariffs to please a specific voter constituency at home, attention quickly turned to broader US trade imbalances, in particular with China. In late March this year, the Trump administration announced 25% tariffs on Chinese imports worth \$50 billion per year under section 301 of the US Trade Representative, which eventually came into effect on 6 July and triggered like-for-like Chinese retaliation. In September, the Trump administration announced additional 10% tariffs on a further \$200 billion of imports from China, which will rise to 25% if the Chinese authorities do not address American concerns. China has retaliated with new tariffs on \$60 billion of US goods and has vowed to keep retaliating, but since its imports from the US are far smaller than vice versa, it will increasingly respond asymmetrically – for example, by offsetting US tariffs with domestic cost cuts for firms or devaluing its currency. The impact of these tariffs on global growth could quickly become significant: while Citi Global Economics estimates the 10% US tariff on \$200 billion worth of Chinese imports to reduce global GDP growth by 0.1ppt over a year (current forecast 3.3% in 2019), this could rise to 0.3ppt if the tariff rises to 25%, considering all the linkages, spillovers and spillbacks.⁹

The outcome of the US–China confrontation is open, with some talks still ongoing, and so are the consequences for the UK economy. A slowdown or even recession in the US and China during the trade wars would be detrimental to the global economy and thus to the UK (although Britain is far less exposed to trading with China than, say, Germany). On the

⁸ See Global Trade Alerts, https://www.globaltradealert.org/global_dynamics/day-to_0914.

⁹ See Citi Research, *Global Economic Outlook & Strategy: Mind the Gaps*, September 2018.

positive side, British companies may be able to benefit in the Chinese markets at the expense of American rivals – for example, in aviation technology – and at the expense of Chinese rivals in the US.¹⁰

In the long term, if the US (which is joined in a WTO complaint against Chinese trade practices by the EU and Japan) is successful in breaking down Chinese barriers to trade, UK companies may benefit as well. If, however, the trade wars lead to a permanent alienation between a China-dominated sphere and the West, the UK could become even more dependent on advanced economy trade, having just left the largest trade bloc within that space. In this context, it is particularly worrying for Britain after Brexit that the US administration seems to be undermining the WTO by blocking the appointment of officials to complete its dispute resolution bodies.

So far, a direct trade confrontation between the EU (and thus, for now, the UK) and the US has been largely avoided after US President Trump and EU Commission President Jean-Claude Juncker agreed to hold off any further tariffs while the two sides are negotiating lower industrial tariffs, regulatory cooperation, increased EU soybean and liquid natural gas imports from the US, and a reform of the WTO.

However, President Trump has ordered investigations into tariffs on car imports, and an announcement could be imminent. While tariffs would likely be suspended for the EU while trade talks continue, they will hang like a sword of Damocles over European car exports to the US. The UK is Europe's second-largest car exporter to the US after Germany in absolute terms, with 0.3% of GDP worth of exports potentially affected. If a 25% tariff is passed fully on to US consumers and triggers an equivalent volume reduction, US car tariffs could shave up to 0.1% off UK GDP in 2019. This is probably an upper-end estimate, given that the price elasticity of demand may be lower and manufacturers might take some of the hit within their profit margins. However, the effect could also be amplified by other second-round effects such as reduced investment or lower wages.

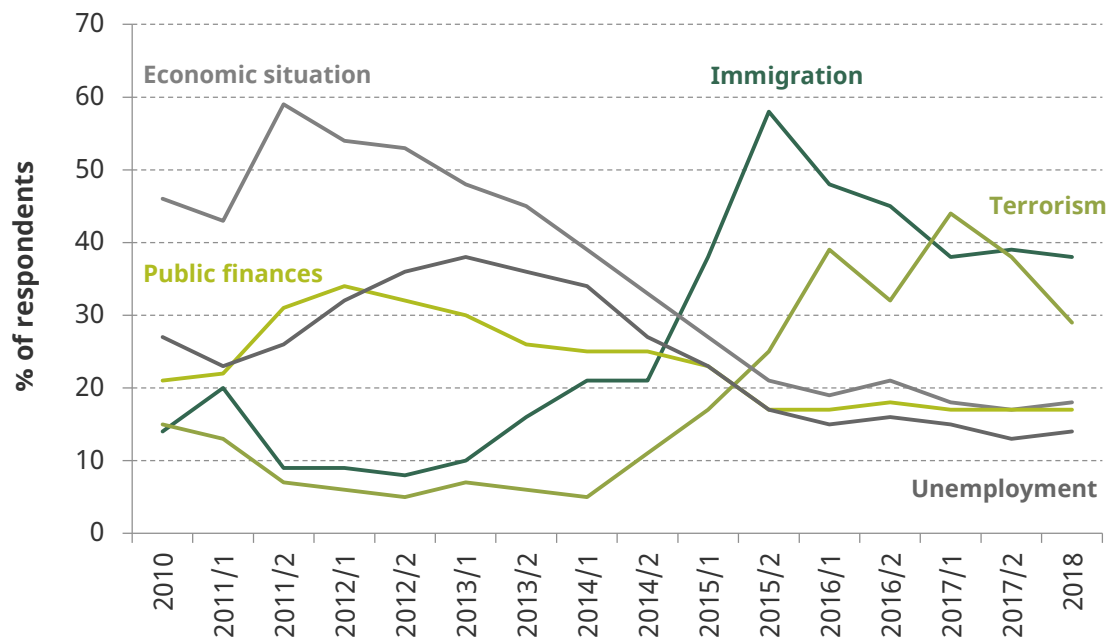
Improved trade relations with the US remain a potential benefit of leaving the EU for Britain. While the EU and the US have repeatedly failed to agree an ambitious removal of barriers to trade due to economically small but politically highly charged areas such as food regulations and public procurement, the UK might be able to make more concessions and build on its traditional special relationship with the US. The process of negotiating a new access to the US is likely to take time and could well extend beyond President Trump's tenure. But expecting a comprehensive and balanced trade deal with the current US administration requires a great optimism, in our view.

Rising aversion to migration

Not only the further global integration of goods and services trade and the mobility of capital are under threat from structural and policy or political forces, but also the mobility of labour. Especially since the 2015/2016 European refugee crisis, fewer and fewer countries can politically afford a liberal stance on immigration for fear of failing to manage inflows successfully. In this sense, the refugee crisis continues to reverberate and influence attitudes to immigration well beyond European borders, including the UK.

¹⁰ See Citi Research, *Trump's Trade Wars: EU Risks and Opportunities*, June 2018.

Figure 1.18. European public opinion on the two most important issues facing the EU at the moment



Source: EU Commission and Citi Research.

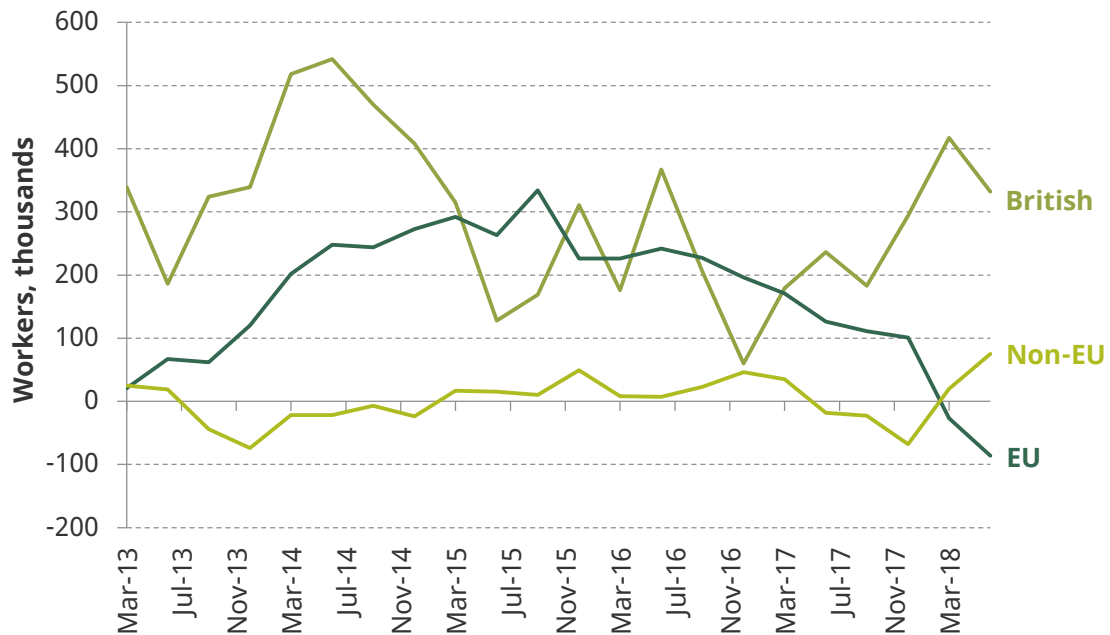
In the UK, many observers agree that a desire to control and reduce immigration was one key driver of the vote to leave the EU just a few months after the peak of the refugee crisis. And although the peak of the refugee crisis passed three years ago and the number of asylum seekers has returned to more normal levels in most countries, Figure 1.18 shows that citizens across the EU cite immigration as the single most important issue facing the continent, with a share of 38% mentioning it as one of the two top issues across the EU and 29% in the UK. These figures are down from peaks of 58% in the EU and 61% in the UK since November 2015, but still very elevated. For comparison, the poll shows that it took seven years for the share of people concerned about the economic situation to drop below 20%, having peaked at a similar level to immigration fear amid the euro crisis in 2011.

Voter aversion to immigration poses an economic challenge for many countries, but especially the UK. With the economy nearing full employment and at least anecdotes of skills shortages becoming more frequent, the case for promoting immigration to the UK is strong from an economic perspective, but likely to prove challenging politically. This could be true especially if the government’s commitment to end EU free mobility of labour leads to greater dependence on migrants from further afield.

EU citizens leaving the labour market, but not just because of Brexit

In fact, the immigration tide may have turned already, especially when it comes to EU citizens, and probably not just because of Brexit (see above). This may already be affecting the labour market: as Figure 1.19 shows, year-on-year growth in employment of (non-UK) EU citizens has fallen from 334,000 at the peak in the third quarter of 2015 to solidly negative figures in the first two quarters this year. While the Office for National Statistics

Figure 1.19. UK employment growth 2013–18, by citizenship (thousands, year-on-year)



Source: ONS and Citi Research.

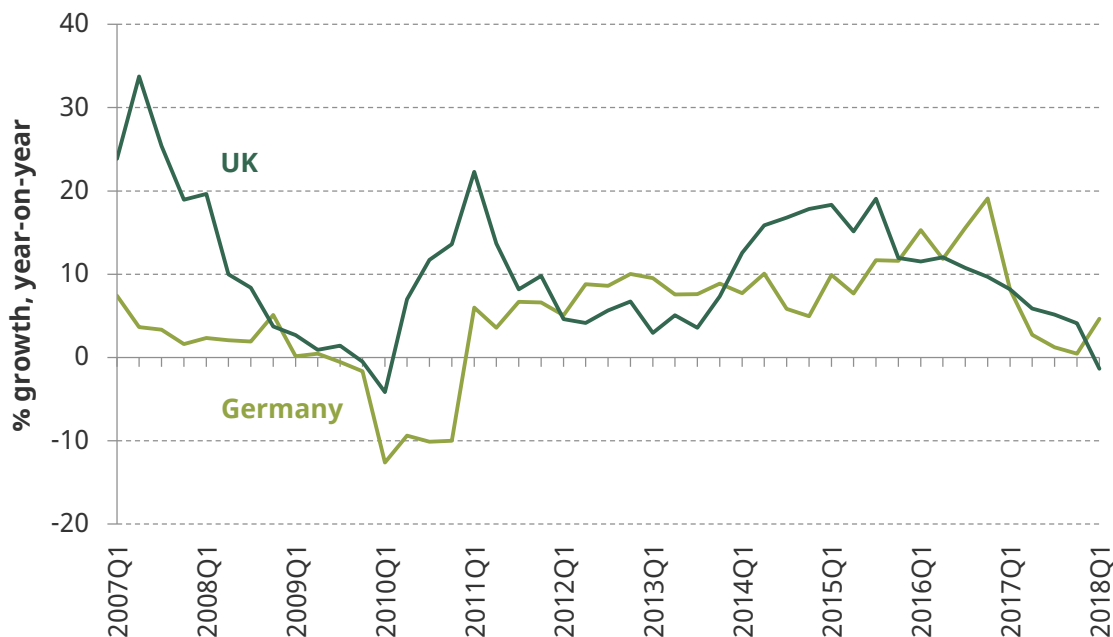
warns against comparing migration and labour market data,¹¹ the decline in net immigration from the rest of the EU and the net employment decline are unlikely to be coincidence. The EU referendum has raised uncertainty for would-be migrants about the economic outlook of the UK and probably also their personal status as immigrants after Brexit. In addition, sterling's depreciation means pay in the UK looks less attractive in terms of their home currency compared with pay in rival EU economies such as Germany or the Benelux countries.

Brexit and potentially tougher new immigration rules in the UK could hamper the UK's attractiveness just at the point when competition for talent intensifies. For example, EU citizens' mobility may have dropped off more widely as a result of the broadening economic recovery. According to Eurostat data, Germany – despite no currency devaluation or EU exit worries – has also experienced a sharp growth slowdown in the employment of EU citizens (see Figure 1.20). The economic recovery of southern Europe after the eurozone sovereign debt crisis in 2011–12 and the convergence of living standards between the EU's east and west reduce the incentives to leave home even to countries where the pull factor remains strong.

In conclusion, migration in general and from the EU in particular has benefited the UK economy in the past. Foreigners accounted for more than half of UK employment growth in the last two decades. If the newcomers raised productivity as well – as studies suggest – they accounted for an even greater share of UK output growth, boosting per-capita GDP. As competition for talent is becoming harder due to economic convergence, the UK is hampered by Brexit uncertainty and weak sterling (and, in the future, potentially restrictive immigration rules). A lot is at stake: if the 1ppt decline in the contribution of EU

¹¹ Office for National Statistics, 'UK and non-UK people in the labour market: August 2018', 14 August 2018.

Figure 1.20. Employment of foreign EU citizens in the UK and Germany (% growth, year-on-year)



Source: Eurostat and Citi Research.

citizens to UK employment growth since the EU referendum is sustained, it would halve trend UK GDP growth even without any additional impact on productivity.

1.6 The current global economic outlook

Global economy

The trends and risks we have highlighted above constitute potentially severe medium-term headwinds for the UK economy. However, they overlay a cyclical outlook that is, on the whole, reasonably positive, at least in the near term. In this section, we present Citi’s expectations for growth in the UK’s main trade partners: the euro area, the US and China.

Despite policy-induced risks for global trade, Citi Global Economics currently expect global real GDP at market exchange rates to grow by a very solid 3.3% in 2018 and 3.2% 2019, before slowing back towards the long-run average close to 3.0% in the remainder of the forecasting horizon until 2022. In purchasing-power-parity-weighted terms, this equates to 3.9% GDP growth this year and next year, followed by 3.7% in 2019 and 3.8% in 2020. At the global level, these forecasts are in line with the latest IMF forecasts and have been stable for a while. Citi have, however, noted in recent months that incoming data and policy actions present an increasingly heterogeneous picture. Accordingly, whereas our projections for global growth have looked stable throughout the year, there has been greater uncertainty around the central tendency for 2018 as the year has progressed.

Importantly when it comes to the above-mentioned trade wars, the tariffs implemented so far cover only a fraction of global trade. Yet, for some products, the threat of tariffs has already affected trade patterns, such as in agriculture where US exports of soybeans surged in advance of the threat (implemented in fact) of the tariff. Citi research on the

potential costs to the individual economies of the announced (and applied) tariffs estimates that just direct effects would subtract 0.54ppt from China's GDP growth (0.21ppt from \$50 billion tariffs, 0.33ppt from \$200 billion tariffs), 0.57–0.67ppt for Japan (0.27ppt from \$50 billion tariffs, 0.30–0.40ppt from autos) and 0.20ppt for the euro area (from autos tariffs). The effect of just these three shocks in isolation, without considering spillovers, is a slowdown of around 0.15ppt on global growth (although we estimate that a 0.5ppt decline in Chinese growth per se could lower global growth by 0.2ppt), suggesting material downside risk to Citi's estimates ahead. We now turn to the most important advanced economies and emerging markets.

Eurozone

Last year, the eurozone boomed, at least by its moderate standards, with GDP expanding by 2.5%. Unfortunately, that was short-lived: the first half of 2018 has been marked by a significant slowdown in growth momentum largely due to fading export growth and a weakening in export-oriented manufacturing confidence. The pace of decline in sentiment slowed over the summer and we observe signs of resilience, especially in domestic demand. Notwithstanding (major) risks in individual countries – in particular Italy's political and policy risks – ample monetary policy support from the European Central Bank and a moderately accommodative fiscal stance should sustain output growth at robust levels for the rest of this year and next.

Growing employment and accelerating wage growth, paired with moderate inflation, should support consumer spending, while supply chain bottlenecks, low borrowing costs and a long period of previous underinvestment should trigger a further strong recovery in business investment. On the external side, positive spillover effects from strong US growth, amplified by the depreciation of the dollar against the euro, should help limit the downside from emerging-market wobbles.

On balance, Citi economists currently expect eurozone GDP to rise by 1.9% in 2018 and 1.7% in 2019. We expect growth to stay slightly above the trend corridor of 1–1.5% in subsequent years. With the exception of Italian political and policy developments, the

Table 1.1. Summary of international GDP forecasts (% growth, year-on-year)

	2017	2018	2019	2020	2021	2022
World	3.3	3.3	3.2	3.1	3.0	3.0
Advanced economies	2.2	2.3	2.2	1.7	1.7	1.6
US	2.2	2.9	2.8	1.8	1.8	1.8
Eurozone	2.5	1.9	1.7	1.7	1.6	1.6
UK	1.7	1.3	1.5	1.9	2.0	1.9
Emerging markets	4.7	4.7	4.6	4.9	4.7	4.7
China	6.9	6.6	6.4	6.3	5.8	5.6

Note: Advanced economies include the US, Canada, Japan, Australia, New Zealand, the eurozone, the UK, Sweden, Norway and Switzerland. Emerging markets include the rest of the world. Aggregates weigh GDP growth by nominal GDP at current market exchange rates.

Source: Citi Research, *Global Economic Outlook & Strategy: Mind the Gaps*, September 2018.

main risks for eurozone growth are external. Large EU economies such as Germany and Italy are more exposed to international (goods) trade than the US, Japan or indeed the UK and thus more vulnerable to fluctuations in demand in other parts of the world.

Citi's eurozone growth estimates are currently a bit below those of other forecasters. The IMF's latest projection is for 2.2% GDP growth this year and 1.9% in 2019, OECD's was even higher at 2.2% in 2018 and 2.1% in 2019. Finally, the Bank of England forecast 2¼% growth in the eurozone in 2018 and 1¾% in 2019.

US

Citi economists expect the US economy to expand by a very strong 2.9% this year, egged on by wholesale tax cuts and infrastructure investment. Fiscal stimulus and buoyant equity markets should continue to boost growth through the rest of 2018 and 2019 and push the unemployment rate further below 4%. Other forecasters are similarly optimistic on the short-term prospects for the US economy. The Bank of England expects 3.0% GDP growth this year, followed by 2.5% in 2019. The IMF expects 2.9% in 2018 and 2.8% in 2019, the OECD the same. Inflation remains subdued, but we expect three more 25 basis point policy rate hikes from the Federal Reserve to a terminal Federal Funds rate of 2.75–3.00% for this cycle in mid 2019.

2020 could be an inflection point for the US economy, where the impact of the fiscal stimulus fades and tighter monetary policy may start to bite. We (and most other forecasters like the Bank of England) expect GDP growth to converge with its trend rate of just under 2%. The big risk for the US and the global economy is that just at the point where the fiscal stimulus fades, monetary policy proves too tight. In that case, the Federal Reserve might trigger a sharper slowdown or even a recession. Citi's US economists – and presumably most other forecasters – expect the Fed to avoid that fate and hit just the right stance to keep growth at potential, inflation at target and extend the cycle. But this is clearly a fine line. Citi economists have also highlighted that the US fiscal path could change after the mid-term elections, with a significant chance that the next Congress will legislate away the 2020 'fiscal cliff', in particular as that will be an election year.

China

China has been the largest contributor to global demand growth for many years, but indicators point to a significant loss of momentum due to the pain of policy tightening to address growing imbalances such as over-indebtedness and environmental pollution. Retail sales and fixed asset investment in particular slowed sharply in the first half of 2018.

To a large degree, the investment weakness reflects policy choices and is thus not in itself a worry for China's underlying fundamentals. However, Citi's China economists do believe that the consumption growth slowdown in part reflects deteriorating fundamentals such as lagging disposable income growth, rising household debt and the collapse in equity prices.

Citi forecast Chinese GDP growth to slow gradually from 6.9% in 2017 to 6.6% in 2018 and 6.4% in 2019. While this may sound optimistic relative to much of the tone of economic commentary on China, it is based on a myriad of fiscal and monetary measures designed to arrest the slowdown and it is similar to those of other forecasters: the OECD expects GDP growth of 6.7% this year and 6.4% next and the IMF 6.6% this year and 6.4% next.

China is facing significant challenges ahead. Besides the US trade wars, there are some signs of growing capital outflows, which have triggered trouble before, despite China's still-high foreign exchange reserves. A deterioration of the economic fundamentals, along with headwinds from the trade dispute with the US, could aggravate these capital outflow pressures and limit the Chinese authorities' room for policy easing.

1.7 Conclusion

The global economy is projected to grow at solid rates this year and next. It is carried by US fiscal stimulus and the ongoing recovery in Europe, supported by accommodative monetary policy. It should be resilient enough to withstand US trade wars and structural challenges in China and other emerging markets. However, fragilities tend to increase as the cycle matures. Financial market turbulences and policy errors, amplified by still-large debt overhangs in many economies, could slow growth sharply. In 2020, the question about the sustainability of the US growth momentum could become pressing and downside risks to global growth could become material. At this point, monetary policy may not have as much firepower to counter a slowdown as in the past, with policy rates near the effective lower bound and asset purchases maxed out. Fiscal policy might also still be constrained as most advanced economies still struggle to bring down legacy debt ratios meaningfully. The next downturn could be deeper and longer than usual.

Beyond these cyclical worries, we have highlighted structural concerns. The integration of global supply chains may have peaked and could even partly reverse. Temporary phenomena such as the trade wars may trigger a wave of re-onshoring of production, which may increase the dependence on regional markets rather than those further afield, just when the UK has chosen to cut or water down its ties with its regional market. Factors such as the 2015/2016 refugee crisis may have increased voter aversion to immigration, which could reduce immigration flows just when skills shortages are beginning to bite.

These developments are particularly concerning for the UK, which has so successfully specialised within the global supply chain on financial services and selective manufacturing industries such as car manufacturing and aviation. It has an impressive track record of attracting and integrating talent into its workforce. As it leaves the European Union, the basis of much of its success in services trade and the source of its most successful group of immigrants, the global economy could prove to be a much more challenging environment than it has been for many years.