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CAPTURING VALUE WORLDWIDE<sup>SM</sup>



## Country Profile: United Kingdom

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*It has never been more important for you to understand what is occurring in the world beyond your country's borders. Whether you realize it or not, we are now all fellow citizens...Global Citizens.*

*The Thomas White organization was founded in 1992 with the goal of bringing the benefits of globalization to investors around the world. We believed that once investors understood that globalization was a positive force, they would also see the advantages of adding international equities to their portfolios. It only makes common sense that professional investors would begin searching the globe for the most attractive opportunities. Researching a wider universe of companies should improve long-term performance. Moreover, broad diversification typically lowers return volatility. Multinational corporations have been using this global strategy for years; why shouldn't investors do the same?*

*Now 15 years later, our firm growth and strong subsequent portfolio performance has confirmed our investment premise. Currently, Thomas White professionals are performing research and managing over one billion dollars in close to 50 countries. We believe one reason for our success is that the nationalities of these analysts are as globally diverse as our portfolios.*

A handwritten signature in black ink that reads "John S. White, Jr." The signature is written in a cursive, flowing style.

# The United Kingdom: From Empire to Global Financial Center



Victoria Memorial Buckingham Palace. The British Empire reached its peak during Queen Victoria's long reign in the 19<sup>th</sup> century. The period also saw unprecedented economic progress as the Industrial Revolution reached its zenith.

Future historians may find it improbable that a small island nation in the North Atlantic once ruled over a fourth of the globe, gifted parliamentary democracy to the world, and was the cradle of Industrial Revolution which transformed the global economic landscape. From the greatest empire ever to a modern developed economy, the United Kingdom has been the dominant force or a key player in the global arena for nearly three centuries now. No other nation has had such a profound influence on modern history as the U.K.

## **Pax Britannica**

The United Kingdom of Great Britain and Northern Ireland, as the U.K. is officially known, first came into global prominence in the 17<sup>th</sup> century when its sailors went to distant shores in search of resources and trading opportunities. The early forays into unknown territories were mostly for trade, and political domination was an afterthought. Britain was outpaced by its European neighbors in the early rush to acquire overseas territories. Through superior political strategies and naval might, the country gradually pushed out other colonial forces and soon became the unchallenged global superpower.

While the true legacy of colonization is debatable, the process led to opening up of trade routes at an unprecedented scale, and Britain was at the forefront of it. British textile mills sourced raw material from different locations, processed them at manufacturing units in England, and sold finished goods to consumers in many markets. These were the early attempts at globalization, though the process took a couple of centuries to gain currency and become the force that it is today. The increased trade relations between the industrially developed nations and their

overseas colonies led to gradual spread of industrialization to other parts of the world and brought economic prosperity.

**Loss of empire and the shift to a modern, developed economy**

Ironically, it was Britain’s unwillingness to practice its own democratic ideals at the colonial level and the attempts to impose monopolistic control over trade, which led to the Empire’s first major loss of territory. The formation of the U.S., the first major nation to gain independence from the British Empire, was a result of the discontentment of American colonists over denial of voting rights and the preferential rights bestowed upon the British East India Company for tea exports to American colonies. Canada and Australia, two of the largest British colonies, became independent towards the end of 19th century and early 20<sup>th</sup> century.

During the first half of the 20<sup>th</sup> century, the heavy costs of the two World Wars further weakened the British Empire. As government attention was focused on the

war effort and the post-war rebuilding, struggles for independence gained strength in many colonies. Gradually, within two decades after the Second World War, Britain lost control over most of its overseas territories.

However, unlike many dominant empires before it, the U.K. did not fall into oblivion after losing its territorial limbs. The country, along with the U.S., played a major role in shaping a new world order in the post-war era. As a permanent member of the United Nations Security Council and a founding member of the NATO strategic alliance, the U.K. retained influence over global affairs without even having to allude to its past glories.

The U.K. and the World	
Nominal GDP (\$)	2.67 trillion
GDP Rank	6/191
Per Capita GNI (\$)	46,040
Per Capita GNI Rank	18/210
Population Rank	22/227
Geographical Area Rank	79/250
Global Competitiveness Rank	13/133
Economic Freedom Index Rank	11/179
Human Development Index Rank	21/182
Major Industries	Financial Services, Tourism, Defense and Aerospace, Pharmaceuticals.

More than two centuries of primacy over global trade had made London a major center of international commerce, banking, and finance in the 20<sup>th</sup> century. These became major competitive advantages, as the country set about rebuilding itself in the post-war period.

Though the U.K. went through a period of economic weakness in the 70s, restructuring of the economy in the 80s with large scale privatization of state-owned enterprises led to prolonged economic growth.

The steady influx of migrants, mostly from former colonies, in the post-war period added many more hues to the country's cultural diversity. Now, the U.K arguably ranks just below the U.S. in ethnic diversity, and it is estimated that the native British will be a minority within a couple of decades.

The huge army of migrants, who were young and often highly skilled, has made the U.K economy more energetic and has given the nation a more varied demographic profile than its European neighbors. The country's colonial past is partly behind the steady growth in the tourism industry which now employs nearly two million. Nearly 35 million foreign tourists visit Britain annually and spend close to \$35 billion in the country.

### **The lingua franca that unifies the world**

Along with the British Empire, the English language spread far and wide. English became the first language of many large colonies, like the U.S., Canada, and Australia, which later became independent countries, while many other former colonies adopted it as a second language. English is now the official language in 53 countries and it is estimated that as many as 1.8 billion people can speak the basic language, or the many regional versions of it.

More than the large number of people using the language, English owes its primacy to the fact that it is the language of choice for global business. Global economic leadership has remained with English-speaking nations for well over two centuries now. It was only natural that English became the preferred language of communication for business and commerce.



Leather-bound books line the shelves at Wren library, Cambridge University. The English language has become a truly global unifier and a major factor behind the spread of globalization.

English is the first truly global language, as it is probably the only language that has gained almost equal importance as the local languages in many countries across the world. Various regional influences have enriched the language to a great extent and have made it all the more vibrant. Many words and phrases from other languages are accepted into modern English vocabulary every year, a process which further increases the acceptance and popularity of the language. These diverse cultural influences are most visible in English literature where the literary works of non-native English speakers now

dominate.

Globalization has only accelerated the spread of the English language as more countries open up trade, and global businesses expand their operations across geographies. Millions of people in large emerging economies like China and India are mastering the language, as English proficiency is seen as a distinct competitive advantage in a globalized world. It may even be argued that, if not for the ease of communication facilitated by the global acceptance of English, the process of globalization would not have spread so fast. It is no surprise that English is now the most significant factor unifying people from diverse cultures and geographies, more than ever.

## **Center of learning**

More than anything else, it was the advances in science and technology that made the Industrial Revolution possible. The technological innovations introduced in textile manufacture, mining, steam power, metallurgy, and chemicals would not have been possible without the many institutions of higher learning that thrived in 18th century Britain. By then, the Universities of Oxford and Cambridge were well established as the world's premier centers of learning and attracted the best scholars. Helped by this conducive environment, Britain was at the forefront of scientific research.

However, higher learning was accessible only to the elite until it was opened for all in the early 19<sup>th</sup> century through the establishment of institutions like the Royal Institution. This

democratization of scientific research led to the emergence of eminent scientists who were behind many significant discoveries and inventions. Emphasis on intellectual ability and meritocracy in the education system eventually led to the disappearance of class-structure in society.

More significantly, the British system of higher learning became a model for other countries to replicate. Institutions of excellence modeled on British universities have played a significant role in the advancement of education and research in other countries, and the creation of progressive classless societies. This is most visible in the U.S. where many universities emerged and established themselves as the new Oxfords and Cambridges of the world. Without this radical shift in social structure, the dramatic economic changes brought about by industrialization over the last two centuries would not have been possible.

Even today, the U.K. retains its status as a center of excellence in higher learning. As many as 2.3 million students are currently studying at the country's 170 universities, with 650,000 students graduating annually. With many consistently ranking high on the lists of best global universities, these institutions of higher learning continue to sustain the country's strong skill base, and embolden the competitive strength of local businesses.

## **Hesitant embrace of the mainland**

Britain's embrace of European integration has so far been less enthusiastic than its continental neighbors, though the country joined the European Communities in 1973 and is a prominent member of its successor, the European Union. Concerns about loss of sovereignty and other political issues made the country opt out of the common European currency, the euro. While public wariness over closer

European unity had been somewhat waning overtime, the financial crisis and its adverse impact on the euro has raised caution once again in Britain.



European Parliament Strasbourg France. With the advent of the Greek debt crisis as well as the uncertainty surrounding the impact of the economic slowdown on the future of the euro, the opinion on adopting the euro remains divided in Britain.

Though support for political integration remains hesitant, the U.K. has reaped the benefits of increased economic integration within Europe. British exports to other EU countries, which have crossed \$300 billion annually, support nearly three million domestic jobs. While further cooperation would make cross-border trade in goods and services easier and bring down transaction costs, the Greek debt crisis, as well as the vulnerabilities of other weaker Euro-zone members, have exposed the flip-side of becoming a Euro-zone member.

### **Financial center of the world, buffeted by the global crisis**

For many decades, London, together with New York, has been a truly global financial center where institutions and investors from all over the world transact business. The city is perfectly positioned to attract business from the mature European economies as well as the fast growing economies of Asia. The major portion of the capital outflows from the big oil exporters in the Middle East and Russia are managed in London. Old colonial links, which bestowed familiarity, also helped London in attracting business from emerging countries.

The growth of equity, commodities, and derivative exchanges and the development of sophisticated trade settlement and control systems led to a rapid rise in trading activity and related financial services businesses, out of London. The city now has a major share of trading in currency futures, energy futures and Eurobonds. The Alternative Investments Market of the London Stock Exchange continues to attract a large number of companies from emerging economies.

London's long history as a major trading and financial center led to the development of financial business clusters where resources and talent are concentrated. These clusters have made it attractive for over 300 global banks and other institutions to locate their offices in London. Even American banks manage their non-U.S. global operations out of London. While it is possible that some of the people-intensive back office processes have moved to low-cost locations, centers like London have retained the high-end, value-added businesses.

The city is also home to one of the largest insurance markets in the world, helped by a long tradition of transparent legal culture. Besides banking, insurance, and investment services, London has clusters of large accounting, legal, and business consultancy service firms which add to the city's attractions as a major commercial center. More than a fifth of Europe's top 500 industrial firms have their headquarters in London.

All these factors have made London a major driver of economic growth in the U.K. With a total workforce nearing 5 million, the city now accounts for nearly 19% of the country's economic

output. In fact, London's economy exceeds that of many European countries like Austria and Denmark in size.

Yet the global financial crisis subdued London's financial district. The erosion in confidence led to a credit market freeze and a sharp decline in business transactions. Along with the steep fall in the value of their investment holdings, these adverse developments pushed many banks and financial firms to scale down their operations and cut jobs. For the city's economy, which employed more than 340,000 in the financial services industry just before the market upheaval, the crisis ushered in a phase of uncertainty and subdued growth.

Though the traditional banks based out of London were relatively unaffected during the early days of the global credit crisis, their fortunes worsened as the crisis escalated. Major European governments, the European Central Bank, and the Bank of England were forced to take exceptional initiatives to improve liquidity, provide additional capital, arrest the market decline, and rebuild confidence. Like their counterparts in the rest of Europe and the U.S., many prominent British banks were forced to accept large capital infusions from the government to strengthen their financial position. Yet, it is also true that London is better equipped than most other financial centers to weather the crisis. Not only does it boast well-established institutions nurtured over many decades, London has a more accommodating regulatory structure for businesses seeking to raise capital. The financial hub is also not exposed to any single large economy, as the firms based in the city, especially the large banks, have extensive global operations. It shouldn't surprise anyone if London emerges stronger, once the dust settles after the global financial crisis.



The London financial district as seen from across the Thames River. The financial services industry dominates the city's economy and as a global financial center, London is outranked only by New York.

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## **Weathering the downturn**

After remaining in the firm grip of recession for six consecutive quarters, the worst in the last 70 years, the U.K finally reverted to growth in the last quarter of 2009 at a higher than expected quarterly growth rate of 0.4%. Services, which constitute over 75% of the nation's GDP, powered the rebound for the EU's third largest economy. Among Europe's developed nations,

Britain's economy was one of the hardest hit by the global financial crisis. As a well-recognized global financial hub, London's financial services sector had been growing at four times the rate of the economy over the three years preceding the crisis. But with one out of every five Britons employed in the financial sector, the economic slump took a heavy toll on the country's employment scenario. Unemployment soared to about 8% in the beginning of 2010, from 6.5% recorded at the end of 2008. This was the highest unemployment level in 14 years, taking the number of jobless to over 2.5 million. Unemployment levels are expected to breach the 3 million mark by 2010.

The U.K. economy entered into recession for the first time since 1991 in the fourth quarter of 2008, with its GDP shrinking a hefty 1.5%. As the global financial services hub reeled under the repercussions of the global financial crisis, the economy contracted substantially by 5% in 2009 after recording a 0.7% expansion in 2008.

The recession resulted in a major political upheaval in the U.K., as the ruling Labor Party led by Gordon Brown was trounced in the May elections. With the opposition Conservatives not securing a clear majority, the stage is now set for the country to be ruled by its first coalition government in nearly 70 years. David Cameron, the leader of the Conservatives has assumed power as the new Prime Minister, and will join coalition partner Nick Clegg, the leader of the Liberal Democrats, who will be the Deputy Prime Minister.

## **Housing sector in turmoil**

When U.S. housing prices started declining in 2006, the U.K. housing market remained firm and it was not until the end of 2007 that the global credit crisis forced British home prices down. The preceding decade, spanning 1996-2007, witnessed a spectacular 200% spike in home prices in the U.K. Having peaked in August 2007, the economic crisis caused them to plummet. Early signs of the impending implosion came when one of the largest mortgage lenders in the U.K. faced a bank run and was subsequently nationalized. Even then, it was hoped that the downside to the broader economy would be limited, and in any case, not be as severe as in the U.S. Such hopes soon vanished as the financial turmoil gripped Europe and the pain was felt in London as well.

The manufacturing and construction sector, which contributes to about 20% of the U.K.'s GDP virtually stalled as a result of the housing sector collapse. According to the building society Nationwide, home prices in the U.K. declined by almost 16% in 2008, clocking the largest fall on record. After reaching a trough in April 2009, housing prices started recovering gradually, largely due to a stamp duty and a land tax holiday introduced by the government as well as a

drop in the supply of new properties. Low interest rates also facilitated this earlier than expected recovery, and home prices increased by about 1.1% through 2009. However, prospects for the housing sector in 2010 will depend upon the momentum of the economic recovery in Britain and whether there are a large number of homes available for sale in 2010.

## Stimulus measures inflate the budget deficit

In order to counter the severe slowdown, the country implemented a series of measures as a part of its monetary and fiscal stimulus. Between October 2008 and March 2009, the Bank of England (BoE) embarked on an aggressive rate-cutting spree, bringing down its benchmark to a record low of 0.5%. A systematic quantitative easing policy was embraced by the central bank to revive lending and unfreeze credit markets. The government also announced a fiscal stimulus of \$29.73 billion in November, in addition to the \$859.6 billion financial sector rescue package in October. Inflation remained below 2% through 2009 due to relatively low fuel prices and ebbing demand, as well as the VAT cuts introduced by the end of 2008 to spur spending. Inflation has started inching up since the beginning of 2010, with the withdrawal of the temporary reprieve from VAT, as well as the gradual recovery in fuel prices. The effects of the economic slowdown are expected to contain the inflation levels within limits for some time at least.

Another key concern for the British economy is its spiraling budget deficit in the face of declining tax revenues and higher government spending. The deficit, which was within reasonable limits at 2.4% of GDP in 2007-2008, ballooned to over 11.5% in 2009, as stimulus measures took a toll on government finances. The deficit is further likely to swell to over 12% of GDP in 2010. The new coalition government headed by Prime Minister David Cameron recognizes the spiraling deficit as a key concern and has planned spending cuts worth £6 billion (\$8.56 billion) in 2010.



Expressway lit-up in the night, near Devon, England. The U.K. government's public spending in large infrastructure projects is intended to shield the economy from the adverse effects of the economic downturn to some extent.

## The future will remain all about services

When the focus of global manufacturing shifted to low-cost locations during the last quarter of the 20th century, British manufacturing also declined. While political pressure to protect the remnants of a glorious industrial past will continue, the road ahead for traditional industries in much of the developed world is likely to be one of consolidation and preservation, rather than rapid growth.

Over the years, Britain has become a major international tourist destination, favored for its heritage sites and pleasant countryside. Of late, the country's vibrant and cosmopolitan cities are attracting even younger tourists. The estimated 31 million tourists who visit the U.K. annually spend over \$37 billion, providing a major fillip to the economy. While the strong dollar may lead to an increase in the number Americans visiting Britain in the short term, the global economic uncertainties may lead to a slowdown in tourist arrivals and their average spending over the next one or two years. However, tourist arrivals are bound to increase subsequently as the country gets ready to host the Olympic Games in 2012.

The shift to high-end services, in sectors as varied as life sciences, information technology, and



As London gears for the 2012 Olympics, preparations for the global sporting extravaganza are in full-swing. While infrastructure projects like the one seen here beyond the Stratford train station are expected to give a fillip to the construction sector, the Olympics are also expected to boost the economy's tourism sector. This augurs well for the economy's employment scenario, especially after having weathered the severe slump.

financial services, has held the U.K. economy in good stead in recent decades. The strong demand growth for such services, stoked by globalization, has accentuated this structural shift in the country's economy. The country is now the second largest exporter and third largest importer of commercial services. Relative openness to immigration has enabled the country to attract skilled professionals essential for the service industry. Government estimates indicate that the economy gains over \$10 billion every year from immigration, mostly from the skills brought by the migrants and also through

increased economic linkages to their countries of origin. However, the opposition to ease the immigration policy continues, which may hinder the services sector growth.

In recent years, the U.K. has emerged as a strong center of research and innovation. The country is now ranked as having the second best research base in the world, helped by the research ecosystems developed around its major universities. Currently, the U.K. is one of the top three centers for pharmaceutical research and accounts for 40% of biotechnology products in the pipeline by European companies. Many specialist companies in the U.K. are now focusing on cutting-edge research areas like nanotechnology. Creative industries, including digital entertainment, advertising, digital game development, and design services, are also gathering steam.

Rather than revive traditional manufacturing, Britain's emphasis on the services sector with its high paying jobs has become an attractive option. Like its enterprising sailors of yore who opened up trade routes that brought prosperity, the service businesses in modern Britain have been early riders on the wave of globalization. The U.K. will thrive on its strength in services, as the globalization tide swells to reach even farther shores. 🌐

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