Research Paper

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Increasingly Apart

Post-Crisis Growth Trajectories in the UK and Eurozone

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Contents

Summary

- The UK's economy has performed considerably better than that of the eurozone since the 2008–09 financial crisis. Between 2010 and 2015, real GDP growth in the UK averaged 2 per cent, slightly above the G7 average. Real GDP growth in the eurozone, in contrast, averaged 0.9 per cent. This paper examines why the UK has followed such a different trajectory.
- We argue that the divergence reflects the relatively rapid process of banking resolution that occurred in the UK. This helped the economy to return to its pre-crisis growth model, which favoured household consumption over savings. In the eurozone the adjustment has taken longer. Deleveraging – that is, reducing indebtedness so that more normal rates of growth can resume – was further impeded by the sovereign debt crisis in 2010–12 exacerbating structural problems in the banking sector. The result has been a significant contraction in credit, domestic consumption and investment in the eurozone.
- The UK's much more aggressive and more sustained monetary and fiscal policy easing in the aftermath of the financial crisis has been another key factor in the economy's ability to rebound from the recession. In contrast, conflicting views among creditor and debtor countries in the currency union prevented decisive moves towards the establishment of a common fiscal policy. As a result, debtor countries have had to bear the brunt of the burden of fiscal adjustment, exacerbating downturns in these economies. Monetary policy, as well, has been hostage to ideological divergences among member countries, slowing down the eurozone response until deflation became a real threat.
- A further problem for the eurozone is that those economies most in need of stimulus were also unable to adjust to the constraints imposed by the monetary union. This inhibited economic convergence inside the monetary union, further complicating the political environment for policymaking. Sluggish economic growth and high youth unemployment in these countries have become a major source of discontent, eroding popular support for the currency union and muting business sentiment. This contrasts sharply with the UK, where employers were able to shed jobs quickly in response to the events of 2008–09, but also started hiring quickly once a basic level of consumer and industrial confidence had been restored.
- Controversially given the current political climate, however, the UK's economic success partly seems to reflect its openness to inflows of foreign capital and labour. Annual net migration to the UK quadrupled between 1994 and 2014, rising from 78,000 to 313,000. Although the 'Brexit' campaign reflected popular antipathy towards immigrants and the perception that uncontrolled immigration was bad for the economy, we argue that in fact this substantial import of human capital has led to faster output growth.
- However, inflows of foreign capital and labour into the UK may decrease in the future as a result of the country's June 2016 vote to leave the EU. In effect, the 'Leave' vote threatens to undermine the very consumption-centric economic model that has enabled the UK to outperform the eurozone.
- As if the challenges of managing the economic impacts of 'Brexit' weren't enough, the UK's growth prospects face additional challenges. Limited rises in productivity growth and persistently high household debt, now compounded by a higher public debt burden, also pose significant constraints for the country's consumption-led growth model.

1. Introduction

In the past six years, the economic performance of the UK has diverged notably from that of the rest of the EU, and in particular from that of the eurozone. Growth has been consistently slow across the eurozone, with the exception of the rebound recently seen in Spain and Ireland. In contrast, the rate of GDP growth in the UK has been among the fastest among advanced economies, and similar to the relatively strong growth trajectory seen in the US.

We argue in this paper that this divergence is due to the much more aggressive policy stimulus in the UK from the outset, and the fact that – partly as a result of rapid government intervention in the banking sector – the crisis-resolution period following the 2008–09 downturn was shorter in the UK than in the eurozone. The UK's relatively short, sharp adjustment helped the economy to switch back to its pre-crisis model of growth, one that favours consumption over savings. In the eurozone deleveraging has taken longer – partly due to the complication of the 2010–12 sovereign debt crisis and neglect of structural problems in the banking sector. This has resulted in a significant contraction in domestic consumption and investment.

The greater resilience of the UK economy has proved attractive to both foreign investors and foreign workers. The economy's integration into the EU single market and its openness to both capital and labour have facilitated and expanded financial inflows and inflows of workers. Since the early 2000s, and especially in the years after the global financial crisis, the UK economy increased its stock of overseas capital and labour. Net foreign direct investment (FDI) flows shifted in the UK's favour, from a net outflow equivalent to 5 per cent of GDP in 2007 to a net inflow worth 4 per cent of GDP in 2015.[1] Net immigration also quadrupled in the two decades between 1994 and 2014, rising from 78,000 a year to 313,000 a year. Currently the number of immigrants from EU countries is almost equal to the number of non-EU immigrants.[2]

Not only is the UK an attractive market for both foreign investors and foreign workers, but – contrary to some popular perceptions – its economy has been able to absorb these inflows smoothly. Its domestic demand-driven model of growth, characterized by plentiful cheap capital, low labour costs, flexible employment conditions and a large supply of workers, has proven effective. Real GDP grew at an average rate of 2.1 per cent per year during the period 2012–15.[3] Moreover, since the onset of the financial crisis the UK has been an overall contributor to global aggregate demand – so its domestic recovery has helped the world economy to grow. In contrast, the eurozone has been a major drag on global growth – running a persistent current-account surplus and therefore importing less than it exports.

The UK's successful economic performance is not without flaws. In this paper we argue that limited productivity growth and still-high household debt, now compounded by a higher public debt burden, present significant constraints for a growth model driven by consumption. Up to now, inflows of financial and human capital have helped overcome these constraints. However, the effects of the

[1] This was mainly due to repatriation of funds. Codogno, L. (2016), 'Brexit poses serious political ramifications for the rest of the EU', LSE Brexit Blog, 5 May 2016, http://blogs.lse.ac.uk/brexit/2016/05/05/brexit-poses-serious-political-ramifications-for-the-rest-of-the-eu/ (accessed 21 Sep. 2016).
[2] Office for National Statistics (2016), 'Migration Statistics Quarterly Report: August 2016', 25 August 2016, http://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/internationalmigration/bulletins/migrationstatisticsquarterlyreport/august2016 (accessed 21 Sep. 2016).
[3] OECD.Stat (2016), 'Gross domestic product (GDP)', https://stats.oecd.org/index.aspx?queryid=60702 (accessed 5 Oct. 2016).

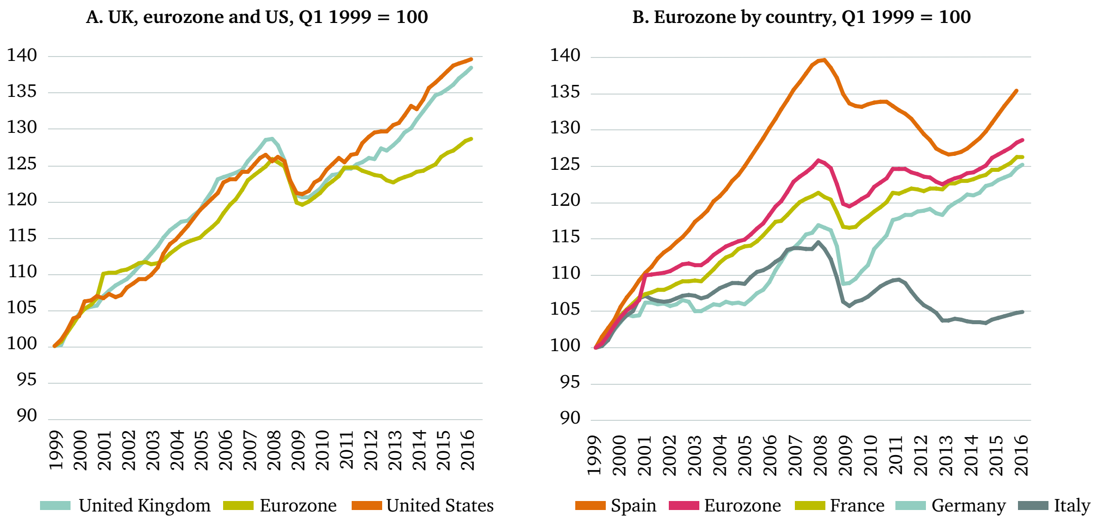
June 2016 referendum on EU membership could cause these inflows to decrease in the future, as more isolationist British policies and, potentially, retaliatory measures by the EU could increase the barriers to free movement of people, goods, services and money. In light of 'Brexit', does the UK therefore need to reconsider its model of growth? Will the current model, which relies on attracting and absorbing high levels of foreign capital and labour, be sustainable in the event of a new relationship with the EU that reduces market openness and integration?

2. Gauging the UK/Eurozone Divide

The UK, together with the US, was one of the countries most severely hit by the 2008–09 crisis because of the size of its financial sector, which accounted for approximately 9 per cent of total output in 2008.[4] Yet it has recovered relatively quickly (see Figure 1, Panel A). Between 2010 and 2015, real GDP growth in the UK averaged 2 per cent, slightly above the average rate of growth for the G7 as a whole.[5] In contrast, real GDP growth in the eurozone averaged 0.9 per cent over the same period.[6]

This year the IMF expects the UK to grow at a slower pace of 1.8 per cent, down from 2.2 per cent in 2015, because of the impact of Brexit. Even so, that would still be broadly on a par with an expected expansion of 1.7 per cent in the eurozone (down from 2 per cent last year).

Figure 1: Real GDP



Sources: (A) US Bureau of Economic Analysis and Eurostat; (B) Eurostat.

Although our focus is not to examine in detail the causes of slow growth in the eurozone, it should be stressed that the performances of the currency union's major economies have varied (see Figure 1, Panel B). Indeed, this has been one of the causes of the political deadlock between creditor and debtor countries, which prevented more accommodative macroeconomic policies from the outset. It also delayed sorely needed moves towards a more complete monetary union (for instance, the establishment of a common treasury and fiscal policy). A short discussion of these divergences is contained in Box 1.

[4] Ibid.
[5] IMF (2016), World Economic Outlook Database, October 2016, http://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weorept.aspx?pr.x=67&pr.y=11&sy=2008&ey=2016&scsm=1&ssd=1&sort=country&ds=.&br=1&c=112&s=NGDP_RPCH&grp=0&a= (accessed 7 Oct. 2016).
[6] IMF (2016), World Economic Outlook Database, October 2016, http://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weorept.aspx?sy=2008&ey=2016&scsm=1&ssd=1&sort=country&ds=.&br=1&pr1.x=48&pr1.y=4&c=163&s=NGDP_RPCH&grp=1&a=1 (accessed 7 Oct. 2016).

Box 1: Divergences in the eurozone

The global financial crisis and its aftermath – the 2010–12 sovereign debt crisis in Europe – exacerbated existing structural weaknesses in Europe's currency union and exposed deep policy mistakes, the correction of which required painful adjustments that adversely affected GDP growth and employment. For example, the convergence of interest rates across the eurozone in the pre-crisis years resulted in too accommodative monetary conditions in some eurozone countries, leading to unsustainable credit growth and excessive indebtedness. In Spain, for example, the household gross debt-to-income ratio peaked at 134 per cent in 2007,[7] with the bulk of this debt ultimately financed abroad as the country had been running large current-account deficits. While this supported high levels of consumption, investment and government spending – and ultimately strong GDP growth – in the years before 2008, it also meant that Spain needed to go through a painful process of deleveraging after the financial crisis hit. This was reflected in a massive decline in (mostly residential) investment and a sharp drop in gross imports (see Table 1).

Italy's comparatively weak output has a longer history, mostly because potential growth was (and still is) anaemic as a result of many factors, including structural rigidities in product markets and poor governance in banks and local governments. Although the country was never exposed to an acute real estate and banking crisis on a par with that of Spain, slow or absent growth has meant that the economy has been in decline ever since the crisis hit. As a result, consumer and business confidence has been low and domestic demand – both household consumption and business investment – persistently weak. Export growth has failed to compensate, in part because Italy has missed globalization opportunities. Although the country's current account is currently in surplus,[8] this partly reflects the drop in imports associated with weak domestic demand, as well as some export resilience.

Germany, by contrast, has been able to benefit from growth in both domestic and external demand. This reflects the fact that, when the crisis hit, its economy was not overleveraged (having just worked off the excesses of its post-unification boom) and had become more competitive as a result of labour market reforms.[9] The economy's production structure was also well placed to benefit from growing demand in emerging markets.

France is somewhere between these extremes: domestic demand held up relatively well after the crisis, helped by comparatively supportive financial conditions (as France escaped the sovereign debt crisis despite persistent fiscal deficits) and thus a comparatively less severe fiscal policy.

Table 1: Post-crisis recovery by GDP component (Cumulative changes between 2008 and 2015 as a percentage of 2008 levels, at 2010 constant prices)

	GDP	Household consumption	Government consumption	Gross fixed capital formation	Gross exports of goods and services	Gross imports of goods and services
UK	7.7%	4.7%	7.3%	5.6%	10.4%	14.3%
Eurozone	0.9%	-1.6%	5.2%	-11.9%	18.7%	12.8%
Germany	6.3%	6.5%	6.5%	4.9%	13.2%	23.5%
France	3.7%	4.7%	10.8%	-5.2%	18.5%	20.4%
Italy	-7.3%	-5.3%	-4.2%	-27.5%	6.7%	-3.4%
Spain	-4.4%	-8.2%	0.4%	-26.6%	22.1%	-7.4%

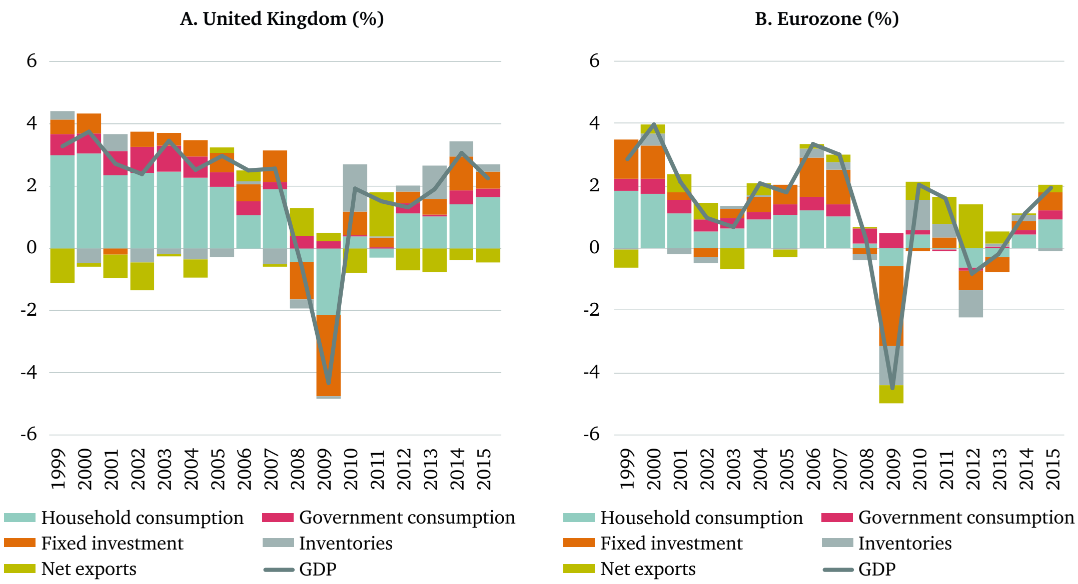
Source: OECD.Stat (2016), 'Gross domestic product (GDP)', https://stats.oecd.org/index.aspx?queryid=60702 (accessed 5 Oct. 2016).

[7] Eurostat (2016), 'Household Debt to Income Ratio', http://ec.europa.eu/eurostat/about/overview (accessed 5 Oct. 2016).
[8] Bank of Italy (2016), 'Current Account, Balance', https://www.bancaditalia.it/statistiche/index.html (accessed 5 Oct. 2016).
[9] The Hartz reforms were enacted between January 2003 and January 2005. Named after Peter Hartz, the chair of the Committee for Modern Services in the Labour Market, they cut welfare and unemployment benefits and introduced new programmes aimed at getting the unemployed into work. Gaskarth, G. (2014), *The Hartz Reforms … and their lessons for the UK*, London: Centre for Policy Studies, https://www.cps.org.uk/files/reports/original/141024133732-TheHartzReforms.pdf (accessed 5 Oct. 2016).

A breakdown of GDP growth by expenditure component (Figure 2) underlines the differences between the UK and the eurozone. In the period before the financial crisis private consumption contributed more to total output growth in the UK than it did in the eurozone.[10] This remained broadly the case after the crisis, notwithstanding a sharp correction in UK household consumption in 2009 in particular.

That private consumption has been, and continues to be, a more powerful driver of GDP growth in the UK than in the eurozone is also reflected in much faster growth in services activity (10.3 per cent since 2011 in the UK, versus 2.8 per cent in the eurozone).[11] As can be inferred from Figure 2, between 2000 and 2008 increases in the consumption component of UK GDP accounted for over two-thirds of the country's total GDP growth in every year but one. Equally striking is how much the decline in household consumption contributed to the UK's downturn in 2008–09 – a result of rapid household deleveraging, as we will see below. Coming out of the crisis, it took some time for consumption to resume its role of growth driver, but since 2012 it has clearly done so.

Figure 2: Contribution to real GDP growth by spending category



Source: Eurostat.

The picture is somewhat different for investment. In the eurozone before 2008, fixed capital formation (i.e. investment in assets such as factories or equipment) exhibited a somewhat stronger contribution to growth than it did in the UK. However, the situation was reversed after the global financial crisis – in part as heightened economic uncertainty and credit crunches in eurozone countries during the subsequent sovereign debt crisis discouraged investment (see Figure 2 and Box 1). The rebound in investment in the UK has been striking, and much more powerful than in the eurozone. Capital spending on fixed assets grew twice as fast in the UK in 2014 as it did in 2006. In contrast, such investment has been much slower to recover in the eurozone, and so far its growth has failed to return to its pre-crisis trend.

[10] Of course, a breakdown by country would show differences in the growth of consumer demand in the main eurozone economies – differences due more to cyclical factors such as low interest rates and credit growth (e.g. in Spain) than to structural factors.
[11] OECD.Stat (2016), 'Gross domestic product (GDP)', https://stats.oecd.org/index.aspx?queryid=60702 (accessed 5 Oct. 2016).

The domestically driven pattern of growth in the UK is also illustrated by the fact that net exports of goods and services mostly made a negative contribution to overall GDP growth throughout the pre- and post-crisis periods (the exception being during the crisis itself). In contrast, net exports in the eurozone have on balance made a positive contribution to growth throughout the past 16 years. This was especially evident during the 2010–12 sovereign debt crisis, when imports collapsed in the most severely affected euro member economies.

In sum, while household consumption was the UK's prime growth driver pre-crisis, both investment and consumption played important parts in the post-crisis recovery. Net exports, meanwhile, have continued to subtract from real GDP growth, as was also largely the case before 2008. Only during the crisis period and its initial aftermath did external trade significantly drive UK growth, probably due to the scale of the consumption crunch that occurred at the same time.

3. Divergent Policy Stances

The UK's model of growth is often seen as intrinsically different from the 'continental' one and more similar to that of the US. This model is characterized by comparatively sharp fluctuations in household demand that are driven by the credit cycle, with subsequent waves of leveraging and deleveraging (or 'boom' and 'bust'). It can only be sustained if labour markets are sufficiently flexible, as this strengthens incentives for employers to hire staff quickly and for workers to seek jobs instead of claiming unemployment benefits.

The 'continental' model in some ways would be its opposite, with consumption driven more by income than by credit conditions, as saving rates are high and stable. As a result, individuals attach more importance to stability of employment and income (as opposed to the level of income). Comparatively rigid labour market regulations, in turn, tend to discourage job creation and limit employment growth, so resulting in higher 'non-frictional' unemployment rates (defined as excluding people in transition between jobs).

The extent to which these perceived differences between the British and continental growth models have enabled or impeded economic recovery is somewhat of an open question for us, which we will examine below. However, as will become clear, this is but one of several factors that explain the growth gap between the UK and eurozone, differences in macroeconomic policy stances being particularly prominent among them.

Indeed, monetary and fiscal policies were more accommodative in the initial stages of the recovery in the UK than in the eurozone. As well, the UK tackled the resolution of insolvent financial institutions up front whereas the eurozone left this largely unaddressed, contributing to a credit crunch and exposing sovereign risk. Could this have made it harder for the latter to attain 'escape velocity' and keep growing strongly once policy support is withdrawn?[12]

Monetary policy

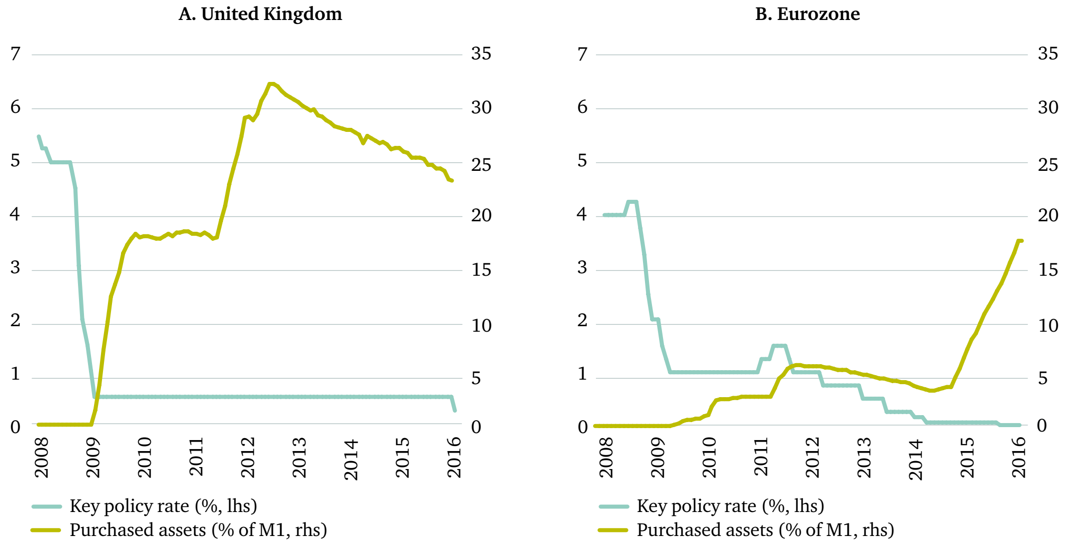
As shown in Figure 3, the initial cuts in official interest rates in 2008 and 2009 were larger in the UK than in the eurozone. What is more, the response of the European Central Bank (ECB) was impeded by having to reverse policy tightening, as the bank had initially hiked rates at the start of the crisis in 2008 and then did so again twice in 2011. With hindsight these rate hikes were premature. They probably damaged the ECB's credibility and may have rendered subsequent action less effective than it would otherwise have been. The ECB also started unorthodox asset purchases much later than the Bank of England did, and its 'quantitative easing' (QE) still has a long way to go before matching that of the UK in relative terms. QE is generally thought to stimulate economic activity through a range of channels, for example by encouraging investors to rebalance their portfolios towards alternative assets (stocks, corporate bonds, foreign assets). It was developed as a means of easing financial conditions when official interest rates are at or near zero – when the scope for conventional monetary policy easing is therefore constrained by what economists call the 'zero lower bound'. Figure 3 suggests

[12] This is even aside from the effects of the 2010–12 debt crisis in the eurozone, which entailed a comparatively large fiscal contraction that has also been counterproductive to prospects for cyclical recovery.

that the ECB has only now reached the same scale of asset purchases that the Bank of England achieved in 2011. At its current pace of asset purchases, €80 billion per month, the ECB would have to continue QE for at least another year in order to match the scale of balance sheet expansion in the UK.

The reasons why the ECB has been slow to respond are manifold and largely political. By design the ECB is a central bank without a single sovereign. As asset purchases potentially have far-reaching cross-country distributional effects, national politicians – and arguably some central bankers – are understandably wary of their use in the eurozone. Without dwelling too much on these political economy aspects, the conclusion is clear: monetary policy in the UK was more responsive at an early stage, which facilitated quick and smooth deleveraging while avoiding a debt crisis (as the cost of capital fell more quickly and asset prices held up better). This then set the scene for a quicker recovery.

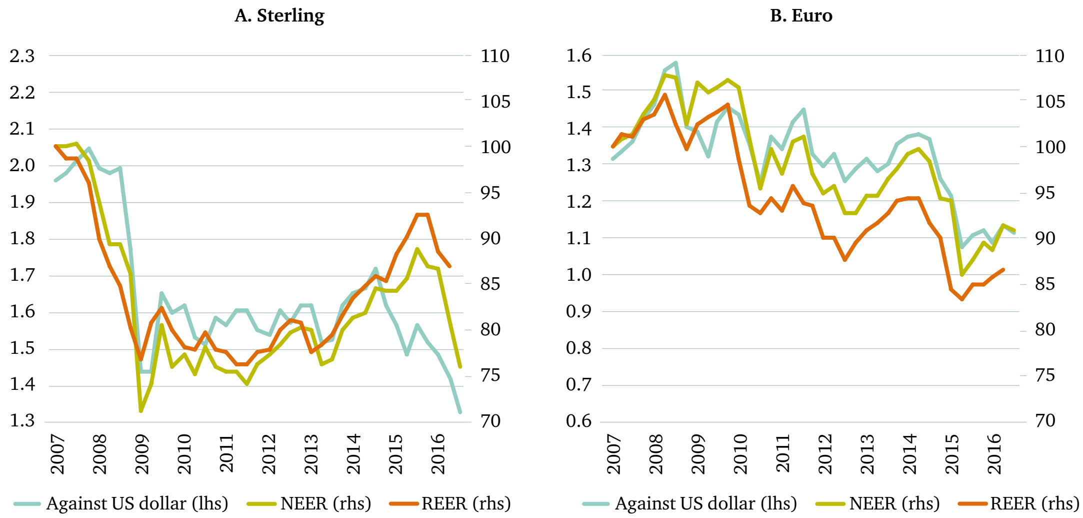
Figure 3: Monetary policy indicators



Sources: (A) Bank of England; (B) European Central Bank.

The impact of the UK's faster monetary policy response is also reflected in the movement of exchange rates. On all measures, sterling declined steeply in the aftermath of the financial crisis (see Figure 4) – which would be consistent with the Bank of England's earlier and larger policy easing measures. Depending on how the exchange rate is measured, the euro depreciated more modestly than sterling or continued to appreciate in the early stages of the crisis. It was only when the ECB launched QE in early 2015 that the depreciation in the euro, in trade-weighted terms, equalled the decline in sterling. But even this closing of the gap was temporary, as the UK saw another sharp depreciation in sterling after the June 2016 referendum on EU membership. Taking the period since the financial crisis as a whole, sterling's real effective exchange rate (REER) has fallen by about the same amount as that of the euro. However, in terms of the nominal effective exchange rate (NEER), sterling has fallen much further than the euro since the crisis. This has surely helped the Bank of England to push up inflation, which in turn has facilitated deleveraging in the UK as the real value of debt – fixed in nominal terms – has fallen as a result.

Figure 4: Exchange rates



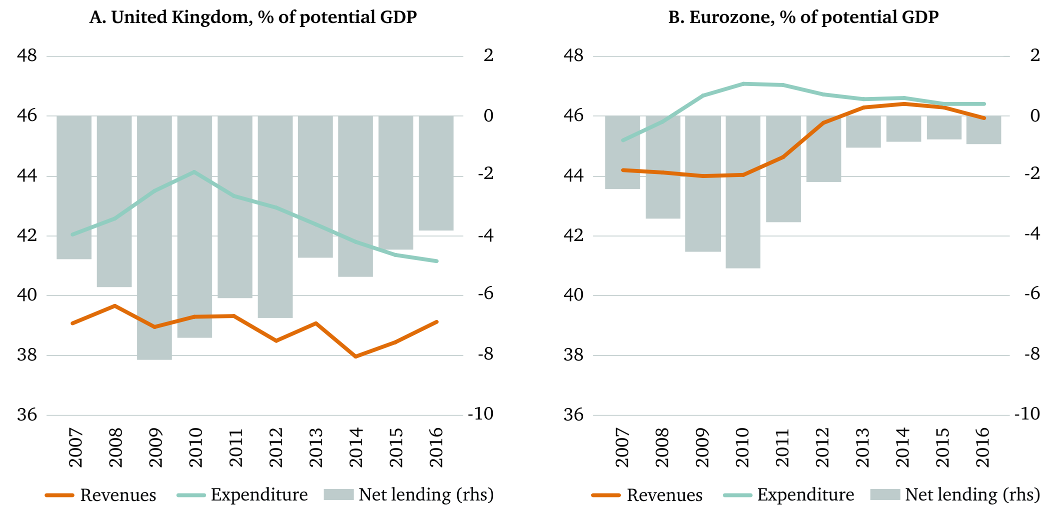
Sources: (A) Bank of England, JP Morgan; (B) European Central Bank, JP Morgan.

Fiscal policy

Fiscal policy was also much more accommodative in the UK than in the eurozone in the early years after the crisis. The UK's fiscal stimulus in 2009 was much larger than that in the eurozone (see Figure 5). And while the UK started fiscal consolidation earlier than the eurozone (in 2010, as opposed to 2011), the effects of austerity proved much more brutal in the eurozone, where governments adopted a contractionary policy stance in the midst of the recession in 2012–13. Moreover, the UK's fiscal consolidation was driven more by expenditure restraint than by tax increases. This mitigated the immediate impact on disposable income and consumption, whereas the tax hikes that predominated in euro member states – from levels that were already comparatively high – likely helped to subdue domestic demand.

If, in the aftermath of the financial crisis, private debt fell more rapidly in the UK than in the eurozone, albeit from higher starting levels (see below), it was counteracted by rapid leveraging of the public sector. Expansionary fiscal policy was therefore a major driver of the UK recovery in the years immediately after the crisis. In the eurozone, fiscal expansion in response to the crisis was more limited, which again explains in part the more muted recovery there compared with in the UK. While the subsequent reversal of fiscal easing has been brutal in both economies, the UK proved much more resilient to it than the eurozone.

Figure 5: Cyclically adjusted fiscal indicators



Note: 2016 data are projections.
Source: OECD.

Crisis resolution

The initial shock stemming from the financial crisis was much larger, relative to GDP, in the UK than in the eurozone. However, it took the latter much longer to restore the balance sheets of its banks – again reflecting opposing views and conflicts of interest among the debtor and creditor nations inside the single currency area. These different approaches are reflected in the evolution in debt and bank lending, which in turn helps to explain the divergent growth performances of the UK and eurozone economies.

The strong growth of consumption in the UK before the crisis was financed in large part through access to credit. This can be seen in the fact that households' net lending – in effect, the difference between savings and (debt-financed) investment – turned negative in the five years leading up to the crisis (see Figure 6). Gross household debt, already high in comparison with the eurozone, had also soared as a percentage of GDP over the preceding decade (see Table 2).

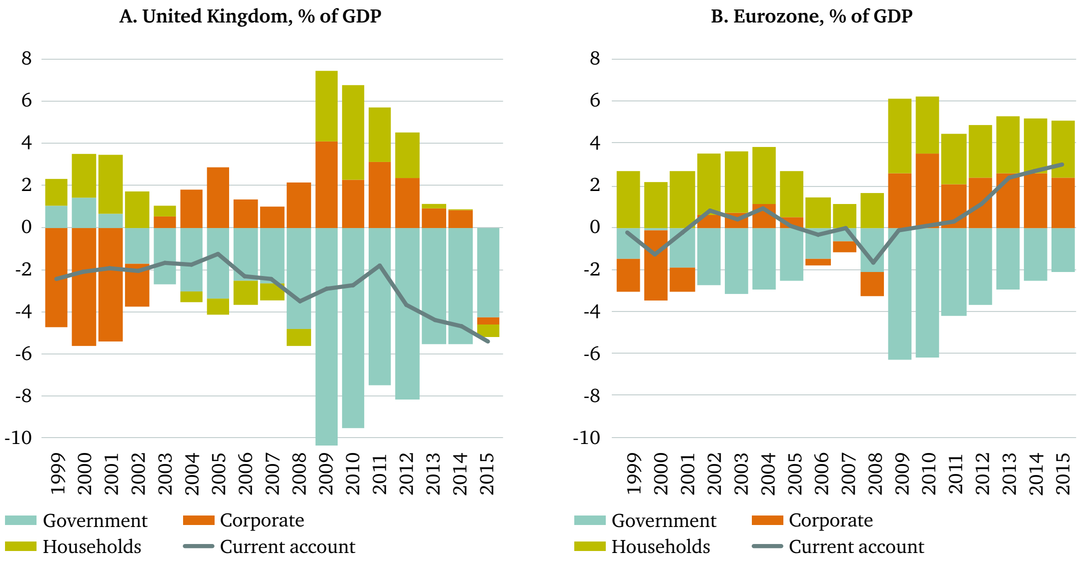
By contrast, households in the eurozone remained net lenders and the increases in their gross debt were much less pronounced than in the UK. This was reflected in the different current-account positions of the UK and the eurozone respectively: in the run-up to the crisis of 2008–09 the UK ran a deficit in the range of 2–4 per cent of GDP, while the eurozone's current account was broadly in balance (see Figure 6). Domestic household net lending in the eurozone was sufficient to finance government deficits even as the corporate sector maintained a net lending position close enough to balance.

The fact that gross debt-to-GDP ratios in the eurozone nonetheless rose during this period is a reflection of the core/periphery divide, with companies and households in periphery countries assuming more debt, ultimately financed by net saving in Germany. This imbalance subsequently contributed to the 2010–12 debt crisis, as did the 'one-size-fits-all' monetary policy of the ECB, market rigidities in the periphery countries, and the idiosyncratic problems of Greece and Cyprus.

If these were broadly the dynamics leading up to 2009, the situation changed after the financial crisis as UK households initially reversed their behaviour – deleveraging to become large net lenders (see Figure 6). As a result, household debt began to fall sharply. The belt-tightening didn't last, however, as UK households soon began to borrow and spend more freely again, reducing their net savings. By 2015 they had reverted to net dissaving – the same pattern observed in 2004–08 in the run-up to the financial crisis – and this was reflected in a small increase in the household debt ratio from a low of 85.7 per cent of GDP in mid-2015 to 87.4 per cent of GDP in the first quarter of this year.[13]

Eurozone households have continued to be net savers even if the ratio of household net lending to GDP has not quite recovered from the drop in 2010 – this despite consumption spending and housing purchases having fallen in countries hit by the debt crisis. There is a similar contrast between Britain and Europe in the corporate sector. Corporates in the UK, after an initial surge in net lending post-financial crisis, reverted to net dissaving in 2015, whereas eurozone corporates have remained net savers since 2009. However, this has not reduced gross corporate indebtedness in the eurozone (see Table 2), as massive retained profits in Germany are no longer recycled in the eurozone and as corporates in the rest of Europe continue to struggle to pay back their bank loans. The latter situation is reflected in the large number of non-performing loans held by banks in Europe, which helps to explain the weak recovery of both bank credit and investment.

Figure 6: Sector net lending balances



Sources: (A) Office for National Statistics; (B) Eurostat.

Table 2: Gross debt as a percentage of GDP

	United Kingdom			Eurozone		
	Q4 1999	Q4 2008	Q1 2016	Q4 1999	Q4 2008	Q1 2016
Gross debt[1]						
Non-financial corporate	65.7	93.9	70.8	76.0	98.5	105.0
Households	63.0	94.4	87.4	46.8	60.0	59.0
Central government	42.9	54.9	107.9	73.8	71.8	106.7

[1.] Debt securities and loans, non-consolidated.
Source: Bank for International Settlements (2016), 'Credit to the non-financial sector', http://www.bis.org/statistics/totcredit.htm?m=6%7C326 (accessed 5 Oct. 2016).

[13] Bank for International Settlements (2016), 'Credit to the non-financial sector', http://www.bis.org/statistics/totcredit.htm?m=6%7C326 (accessed 5 Oct. 2016).

4. Structural Factors

If macroeconomic and crisis resolution policies have been more favourable to recovery in the UK than in the eurozone, to what extent has the eurozone's very mixed record on liberalizing labour and product markets made a difference to its growth outlook? Another potential factor to consider is the interaction of both economies with the rest of the world, namely the extent to which each has been able to draw on the import of human and financial capital to kick-start and sustain its recovery. This is of particular importance to the UK, not least in the light of the 'Brexit' vote, which may make it more difficult to rely on external sources of potential growth in future.

The responsiveness of the labour market

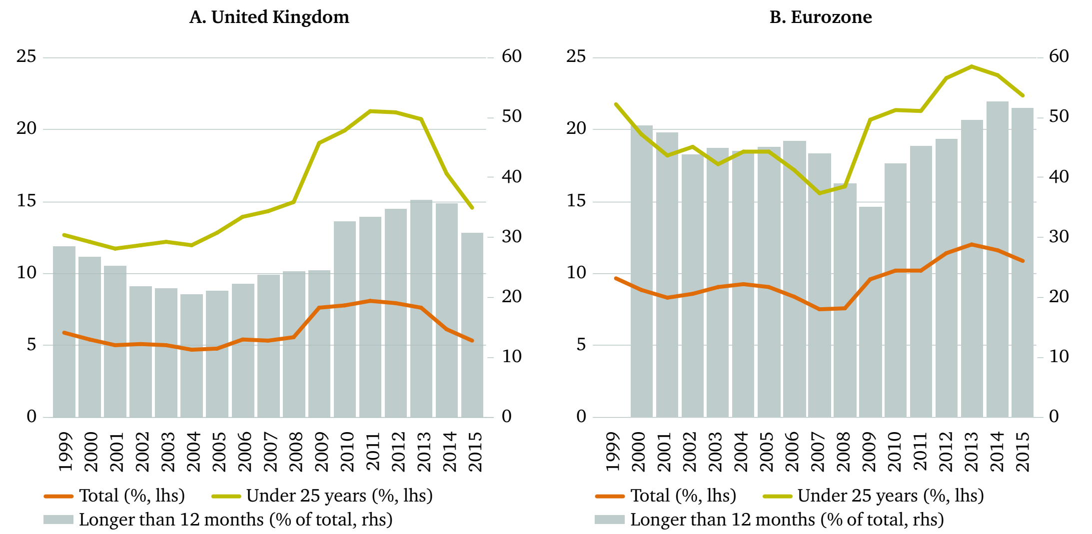
If the recovery in the UK has been brisker than in the eurozone, the question arises as to how the supply side has been able to accommodate this smoothly. We have already seen that investment in the UK has been one of the drivers of the recovery, and this has helped the capital stock – machinery, tools, etc. – to adjust to the rebound in activity. As regards the labour market, we have already mentioned the greater flexibility of labour supply in the UK than in the eurozone. This both helps the economy to respond to increased demand for labour and enhances consumer confidence, which in turn feeds back into more buoyant demand.

As Figure 7 shows, unemployment in the UK is structurally lower than in the eurozone. Perhaps more importantly, so is the share of long-duration unemployment relative to total unemployment. Put another way, there are proportionately more long-term unemployed people in the eurozone than in the UK. It is well documented that long-duration unemployment erodes skills (and human capital more broadly), and as such jeopardizes the re-employability of the jobless.[14] UK labour laws provide for greater contractual flexibility, and so the country has proportionately fewer people who remain unemployed for more than 12 months, than the eurozone. That said, the UK's long-term rate of unemployment has risen since 2008 (see Figure 7), notwithstanding some improvement in the past two years.

Greater labour flexibility meant that the UK's unemployment rate fell faster than the eurozone rate after the 2008–09 crisis.[15] In the eurozone the 'stickier' labour market, which makes it harder to shed workers, has constrained job creation. Amid weak business confidence and sluggish economic growth, firms have been careful about hiring too rapidly in order to avoid being saddled with excess workers should the European economy not fully recover.

[14] Blanchard, O. and Summers L. H. (1986), 'Hysteresis and the European Unemployment Problem', in Fischer, S. (ed.) (1986), *NBER Macroeconomics Annual*, Vol. 1, Cambridge: MIT Press, pp. 15–78.
[15] OECD (2016), 'Unemployment rate (indicator)', doi: 10.1787/997c8750-en (accessed 8 Sep. 2016).

Figure 7: Unemployment rates in the UK and eurozone



Source: Eurostat.

Comparatively higher rates of economic growth in the UK before the crisis – averaging 2.9 per cent a year in 1999–2007, versus 2.3 per cent in the eurozone – were associated with comparatively rapid growth in labour productivity (1.9 per cent a year in the UK, versus 0.9 per cent a year in the eurozone).[16] The economy's success also coincided with increased labour market participation during this period: the working-age population grew by an average of 0.8 per cent a year in the UK, compared with 0.4 per cent a year in the eurozone.[17] The differences in both indicators reflect the UK's more dynamic demographics, including high net immigration. Higher productivity in the workforce may directly reflect migration inflows if these raise the quality as well as the quantity of available labour.

Yet the durability of the UK's productivity advantage *vis-à-vis* Europe is by no means clear. During the global financial crisis, the loss in employment and output per worker was quite similar for both the UK and the eurozone.[18] However, the initial rebound in output in 2010–11 relied heavily on a surge in output per worker in the latter, whereas in the UK the recovery was more a reflection simply of greater numbers of people taking up work. Moreover, labour productivity growth in the UK has not reverted to the rates that were normal pre-crisis; in 2015 productivity grew by only a tenth more than in the eurozone.

If stronger fiscal consolidation and a weaker monetary policy response in the eurozone had been offset by structural reform, the outcome could have been positive for growth. Unfortunately, progress has been limited, as illustrated by the charts in Figure 8. These two charts display indexes of labour- and product-market rigidity in different policy fields in 1998, 2007 and the most recent post-crisis observations (depending on the indicator, 2012, 2013 or 2014) obtained from the OECD.[19] In all areas, the UK is characterized by the highest market flexibility and, despite progress towards flexible markets

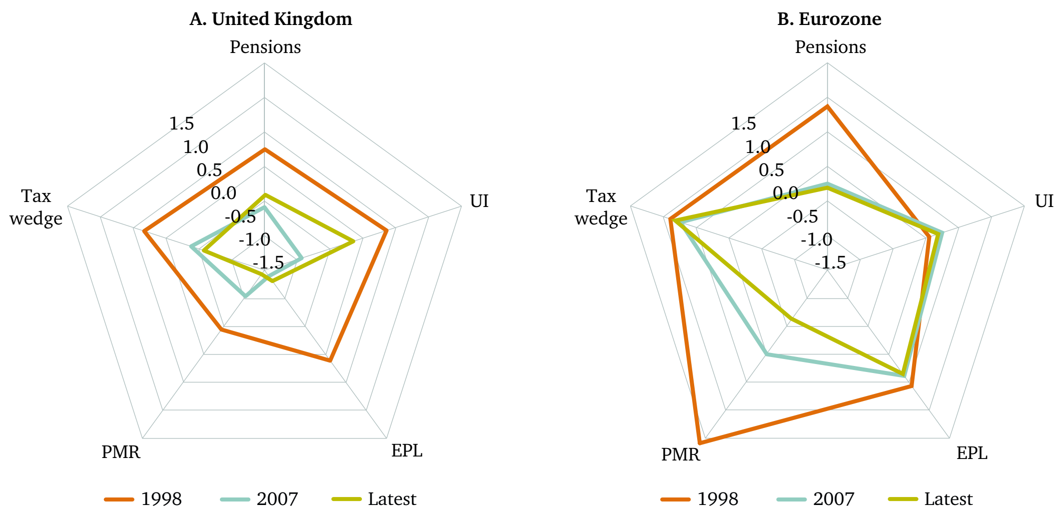
[16] OECD.Stat (2016), 'Gross domestic product (GDP)', https://stats.oecd.org/index.aspx?queryid=60702 (accessed 6 Oct. 2016); and Eurostat (2016), 'Real Labour Productivity', http://ec.europa.eu/eurostat/ (accessed 6 Oct. 2016).
[17] European Commission, AMECO.
[18] OECD.Stat (2016), 'Unemployment rate' and 'Level of GDP per capita and productivity', https://stat.oecd.org/(accessed 6 Oct. 2016).
[19] OECD (2016), 'Chapter 4: Structural Policy Indicators', in *Economic Policy Reforms 2016: Going for Growth Interim Report*, Paris: OECD Publishing, http://dx.doi.org/10.1787/growth-2016-en (accessed 8 Sep. 2016).

in the eurozone, the UK has preserved this advantage over time. The eurozone has taken major strides in liberalizing product market regulation (PMR) and early-retirement pensions. But there has been no progress on reforming unemployment insurance (UI), easing employment protection legislation (EPL), or reducing the tax 'wedge' so that low wage earners are less costly to employ – all policy areas that are particularly important for job-creation incentives. Again, had the eurozone achieved more progress in these policy domains, employment growth could have been stronger.

A further problem for the eurozone is that market rigidity tends to be most severe in the southern European economies such as Greece, Spain, Portugal and Italy. So even though austerity was not uniform across the currency union – Figure 5 shows averages for the eurozone as whole, but there were distinct differences between countries – those economies most in need of stimulus were also generally weak on policy reform. This paradox inhibited economic convergence inside the monetary union, and it continues to complicate convergence to this day. This is especially the case in France and Italy, which are the most reluctant to embark on structural reform and currently act as a drag on economic growth in the eurozone as a whole.[20] As long as unemployment in France and Italy is persistent or increasing, household and corporate spending will remain tepid. This also complicates the political environment for policymaking. Sluggish economic growth and limited job opportunities, particularly for young people, have become a major source of discontent that anti-euro parties and movements have been quick to exploit.

If private consumption and investment remain suppressed, other drivers of GDP growth, such as exports or government spending, must pick up the slack. Boosting export growth was the approach successfully taken by Germany, while France took the route of increasing government spending, albeit with less success. Not surprisingly, the ECB keeps stressing that there is only so much it can do to stimulate growth, and that structural reforms to reduce market rigidities need to be strengthened as well.

Figure 8: Structural reform indicators



Note: Positive number = more rigid market.
Source: OECD.

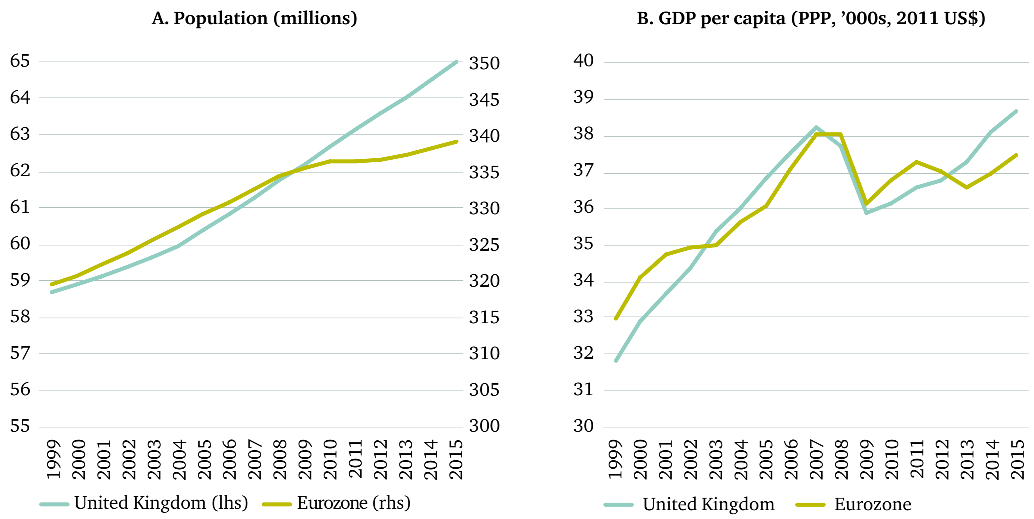
[20] In Italy the Job Act, the labour market reform, was implemented in 2014.

Immigration and demographics

The differences in growth rates between the UK and eurozone economies are significant, but to what extent is this explained by demographic developments? Figure 9 tells us the following story: (i) the divergence in economic growth between the two economies since the financial crisis has coincided with a sudden drop in population growth in the eurozone that has not been replicated in the UK; and (ii) in per capita terms real GDP growth has diverged *much less* than real GDP growth *per se* since the onset of the financial crisis (indeed whatever divergence there may have been occurred basically in 2014 and 2015). To complete the analysis, however, we need to look at the sources of faster population growth in the UK, as reported in Table 3. This table shows that the more dynamic demographics in the UK since the onset of the financial crisis can be traced not only to a higher natural rate of population growth (i.e. births and deaths) – on this measure Britain was in any case more dynamic than the eurozone before the crisis – but also to a considerably larger contribution from net migration.

Our interpretation of this phenomenon is that, to a considerable extent, faster output growth in the UK relative to the eurozone post-crisis has been possible owing to substantial imports of human capital. It seems that immigration has been one of the major factors that allowed the UK to recover more quickly from the Great Recession than the eurozone. This is not only because proportionately greater numbers of workers have entered the country, but also because more of them are of working age and because their employment rates tend to be higher than those of the indigenous workforce.[21] Moreover, in the eurozone the spikes in migration inflows in 2013 and 2015 were mostly associated with arrivals of refugees who could hardly be expected (or in many cases were not legally allowed) to enter the active labour force in large numbers quickly.

Figure 9: Demographics and economic growth



Sources: (A) Eurostat; (B) World Bank.

[21] Migration Advisory Committee (2014), *Migrants in low-skilled work: The growth of EU and non-EU labour in low-skilled jobs and its impact on the UK*, London: Home Office, p. 73, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/333083/MAC-Migrants_in_low-skilled_work__Full_report_2014.pdf (accessed 10 Oct. 2016).

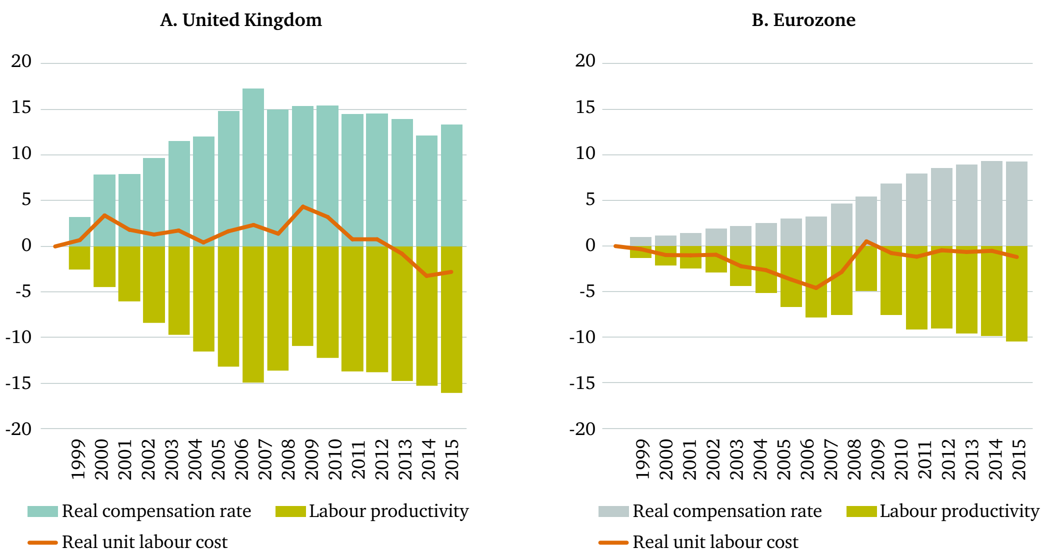
Table 3: Sources of population growth

	1999–2007		2008–12		2013		2014		2015	
	'000s	% of pop.	'000s	% of pop.	'000s	% of pop.	'000s	% of pop.	'000s	% of pop.
United Kingdom										
Natural	111	0.2	238	0.4	203	0.3	207	0.3	174	0.3
Net migration	221	0.4	229	0.4	242	0.4	209	0.3	400	0.6
of which EU			*72*	*0.1*	*123*	*0.2*	*174*	*0.3*	*184*	*0.3*
Total	332	0.6	467	0.7	446	0.7	416	0.6	574	0.9
Eurozone										
Natural	299	0.1	268	0.1	22	0.0	96	0.0	-137	0.0
Net migration	1,228	0.4	618	0.2	1,403	0.4	681	0.2	1,416	0.4
Total	1,526	0.5	886	0.3	1,425	0.4	777	0.2	1,279	0.4

Sources: Eurostat and Office for National Statistics, annual averages.

Obviously the migration of workers into the UK has further consequences, not least for real wages and labour productivity. Figure 10 shows that as the UK recovered from the financial crisis, the average real wage fell. While labour productivity growth has also slowed, on balance the real unit labour cost – a measure of profitability and international cost competiveness – has fallen, to the benefit of businesses. It is plausible, although hard to prove empirically, that the large inflow of workers from the EU played a role in creating this dynamic by increasing competition in the UK labour market. By stark contrast, average real wages continued to grow after the financial crisis in the eurozone – albeit more slowly than before. As labour productivity growth slowed roughly as much as real wage growth, real unit labour costs levelled off.

Figure 10: Labour cost and labour productivity (cumulative changes since 1999, %)



Source: European Commission AMECO Database.

Capital movements

Financial capital flows into the UK have been another factor enabling the comparatively brisk recovery. Table 4 shows the net inflows of foreign direct and portfolio investment against the current-account balances of the UK and the eurozone respectively.

What we observed in the aftermath of the crisis was FDI flowing out of both economies and portfolio investments flowing in. On balance capital inflows during this period were positive, broadly matching the UK's and eurozone's current-account deficits. This turned around completely in 2012–14, when the eurozone started to run a current-account surplus, with the offsetting financial outflow not invested in securities or channelled into FDI, but rather placed into bank deposits abroad – i.e. deposit flight. The UK, meanwhile, saw a large net financial inflow (other than FDI and portfolio investment) in this period – presumably from the eurozone to a large extent – well exceeding its current-account deficit. In 2015 these patterns diverged again, with massive portfolio investment and FDI flowing into the UK, well in excess of its current-account deficit, so its basic balance turned positive. (The basic balance is the difference between the current-account position and the net outflow of portfolio investment and FDI.) The eurozone situation was a mirror image of that in the UK, with net portfolio investment and FDI flowing out massively.

Table 4: Current and financial account (annual averages)

	2009–11	2012–14	2015
United Kingdom (US$ bn)			
Net FDI inflow	-36	-2	183
Net portfolio inflow	144	-91	194
Basic balance	41	-216	220
Current account	-67	-123	-156
Eurozone (US$ bn)			
Net FDI inflow	-147	-6	-132
Net portfolio inflow	303	15	-245
Basic balance	76	280	23
Current account	-80	271	401

Note: The basic balance is defined as the sum of the current-account balance and the net inflow of capital.
Sources: European Central Bank, UK Office for National Statistics.

Table 4 clearly shows that the UK is a much more popular investment destination than the eurozone. This has helped the UK to finance its current-account deficit – currently over 5 per cent of GDP[22] (see Figure 6) – on favourable terms. As to the reasons why this has happened, we can only speculate, but two potential factors stand out: (i) in the eurozone, growing concerns over the viability of the single currency (in the face of the refugees crisis, growing populism, and conflicts between creditor and debtor countries in the wake of the debt crisis) have resulted in capital outflows; and (ii) in the UK, the more flexible economy (see the structural reform discussion above) and the more mature macroeconomic policy framework have driven inflows. In the absence of these two factors, the UK's economic growth would likely have been weaker and the eurozone's stronger.

[22] Ecowin (see Figure 6).

5. Conclusions

The UK economy has recovered more strongly and more quickly from the financial crisis, and generally has been doing better than the eurozone. While some external factors worked in the UK's favour – it was not as badly affected as some peripheral euro economies by the global financial crisis – both the magnitude of its growth and the consistently slow growth seen across the eurozone suggest that the UK's comparative success has deeper causes.

In this paper, we have argued that the primary cause of this divergence was the UK's more aggressive macroeconomic policy stance at an early stage in the crisis, and more rapid intervention by the government in the financial sector. This helped to kick-start the recovery and enabled it to reach the necessary 'escape velocity' for self-sustained, demand-led growth. Moreover, a flexible labour market allowed employers to both shed jobs quickly and hire workers quickly once confidence returned. Eurozone economies have less flexible labour markets – and those that have reformed their labour markets most effectively are now more successful than those that have not – and rely more heavily on capital formation to drive GDP growth. In these economies, households, firms and governments draw down on their savings in times of low economic growth, which dampens consumption- and investment-led growth. Labour market inflexibility also means that workers who lose their jobs are more likely to remain outside the labour pool for longer, thus saving and consuming less.

This ties in with evidence that slower post-crisis growth in consumption in the eurozone can be attributed to the lag in recovery in employment. If a large percentage of the population is out of work, those people are less likely to make significant spending decisions. Countries such as Germany and the UK, which are back to their pre-crisis levels of household spending,[23] have benefited from a faster rebound in consumption than countries such as Italy and Spain with high unemployment.[24] The prevalence of high levels of long-term and very long-term unemployment, especially in Spain and Italy,[25] will exacerbate the problem of weak consumption if labour markets cannot reintegrate the jobless.

This is not to say that the UK model is without flaws. Despite having deleveraged throughout the crisis, the UK remains significantly leveraged, especially at the household level, and its public sector has taken on a large portion of debt. High indebtedness will limit the country's ability to maintain consumption-led growth indefinitely unless foreign investors are willing to finance the current-account deficit on favourable terms. In addition, the UK's lack of worker productivity growth, which has been mitigated by inflows of foreign workers and the drop in the real unit labour cost, will undermine competitiveness and so GDP growth unless the exchange rate stays low or depreciates further.

As the UK government is considering all the possible options that arise from the decision to leave the EU, these findings need to be factored in. The key question is whether the current model, which relies on attracting and absorbing high levels of foreign capital and labour, will be sustainable in the event of a new relationship with the EU that reduces market openness and integration.

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[23] Office for National Statistics (2016), 'Household spending', https://www.ons.gov.uk/ (accessed 6 Oct. 2016); and Federal Statistical Office, Germany (2016), 'Final Consumption Expenditure', https://www.destatis.de/EN/Homepage.html (accessed 6 Oct. 2016).
[24] OECD.Stat (2016), 'Gross domestic product (GDP)', https://stats.oecd.org/index.aspx?queryid=60702 (accessed 6 Oct. 2016).
[25] Eurostat (2016), 'Unemployment by duration', http://ec.europa.eu/eurostat/ (accessed 6 Oct. 2016).

The sustainability of the UK model post-Brexit relies on both economic and political dimensions. In terms of the former, it is critical to maintain the confidence of international investors. A more constraining relationship with the EU and limited access to Europe's single market would affect investors' confidence. If the UK becomes less attractive as an investment destination, and stricter immigration policy causes the labour force to shrink, then it may find it difficult to attract the quantity of foreign capital and labour necessary to keep a domestic demand-driven economy dependent on foreign capital and labour in balance. If net FDI and other capital inflows to the UK shrink, then the impact on the sterling exchange rate will be even more severe than has so far become apparent in the aftermath of the Brexit vote. On the one hand this would help reduce the current-account deficit and cushion the adverse impact of Brexit on real GDP growth via the export channel. On the other hand, this would be accompanied by deleveraging and a slowdown in domestic demand.

Stalling (or reversing) labour inflows, meanwhile, could produce a fall in potential output and employment, which in turn would feed into weaker household consumption. If the UK were to partially lose access to the EU's internal market – which would be particularly damaging for its financial services industry – this would have a negative impact on potential output and jobs.

This brings us to the political dimension: how much EU internal market access will the UK be willing to sacrifice, and in return for what degree of control over immigration? The Brexit vote reflects the disparity between the 'winners' and 'losers' from globalization inside the UK. The 'losers' expect the political establishment to offer more 'protection' against globalization, notably by restricting immigration. If the leadership doesn't deliver on that desire, a political backlash could ensue. At worst, the UK economy could fall prey to protectionism and would suffer as a result. Obviously the UK leadership will want to avoid this, but it finds itself between a rock and a hard place. A lot of political talent will be needed to navigate past this.

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Paola Subacchi is director of the International Economics Department at Chatham House. She is an expert on the functioning and governance of the international financial and monetary systems, and advises governments, international organizations, non-profits and corporations.

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Paul van den Noord contributed to this paper in a personal capacity and any views herein solely belong to him or the co-author.

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