Increasingly apart: the Euro area and the UK

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Introduction

In the last two years, the economic fortunes of the United Kingdom have diverged notably from the rest of the European Union, in particular the large economies of the Eurozone. While slow growth has been constant across the Eurozone, with the exception of the catch-up growth now being seen in Spain, growth in the UK has been among the fastest among advanced economies, more similar to the robust growth trajectory of the US than the slower growth of the EU.

We argue in this paper that this divergence is due to fundamental differences between the economy of the UK and the economies more prevalent in the Eurozone. Specifically, we argue that the UK's economy has followed a very different model of growth than most EU countries, reliant on favouring consumption over savings, and a more flexible labour market that allows unemployment to rebound from economic shocks more quickly and fully than Eurozone economies. This model produces a highly leveraged economy with low levels of capital formation. However, many of the excesses of this system have been resolved through policy reforms and consumer behavioural change, while the economies of the Eurozone have largely yet to address the problems inherent in their growth models – namely low labour market flexibility and an overreliance on government spending and exports instead of domestic consumption.

Part 1: The outlook for growth

After a promising beginning of the year, the pace of growth of the world economy is due to slow down this year. – according to the IMF, the world economy is forecast to grow at only 3.1% this year and at 3.6% in 2016,[1] in contrast to IMF predictions made last year that global growth would rise to 3.9% in 2015 and 4.0% in 2016.[2] The latest predictions have taken into account slowdown in the emerging markets economies – notably China – but expect growth in advanced economies to drive a rebound in growth in 2016.

Since 2012, the pace of economic growth worldwide has been remarkably stable, with GDP expanding at 3.4%, 3.3% and 3.4% in 2012, 2013 and 2014 respectively. The contribution to growth from the advanced economies, especially the US, has been significant and in stark contrast with the years immediately after the global financial crisis, when China and other emerging market economies were much more significant contributors to global growth. Growth in emerging markets is has been slowing since 2012, in large part due to China's slower growth, but also due to the decline in commodity prices and the tapering of quantitative easing by the Fed. Despite this decline, global growth has remained relatively constant during this period primarily because advanced

[1] IMF, World Economic Outlook, October 2015
[2] IMF World Economic Outlook, October 2014

economies have slowly been rebounding from their low growth rates after the 2008 financial crisis, and the 2012 Eurozone crisis. Advanced economies have grown from 1.2% in 2012 to 2.4% in 2015 (See Table 1). Previously, after briefly bouncing back from the financial crisis in 2010, growth in advanced economies had remained below 2% for four years, and is only expected to return to 2% this year. However, most of this growth has come from the United States, while it has been much more modest in the EU. In 2014, the real GDP of the EU as a whole grew only 1.5%, compared with growth of 2.4% for the US and 3.4% globally. The IMF predicts this trend of slower growth compared to the US to continue through the remainder of 2015 and 2016.

Table 1: Worldwide Real GDP growth rates through 2016

Real GDP Growth (%)	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015***	**2016***
World	0.0	5.4	4.2	3.4	3.3	3.4	3.1	3.6
Advanced economies	**-3.4**	**3.1**	**1.7**	**1.2**	**1.1**	**1.8**	**2.0**	**2.2**
European Union	-4.5	2.1	1.8	-0.4	0.2	1.5	1.9	1.9
United States	-2.8	2.5	1.6	2.2	1.5	2.4	2.6	2.8
Emerging markets	**3.1**	**7.4**	**6.3**	**5.2**	**5.0**	**4.6**	**4.0**	**4.5**
China	9.2	10.6	9.5	7.7	7.7	7.3	6.8	6.3

*projected

Source: IMF World Economic Outlook October 2015

Within the EU, there is significant divergence. The GDP of Germany and France are expected to grow at 1.5% and 1.2% respectively this year with a slighly better growth in 2016 (more for France than for Germany, Table 2). This year's strongest performer is Spain which, having been significantly hit by the crisis, strongly bounced back in 2014 and is due to grow at 3.1% this year and to slowdown to 2.5% in 2016 – in both cases Spain's GDP growth is well above the average for the EU (Table 1). Despite this strong performance, Spain, like all the other countries that were severely affected by the crisis, has not yet recovered the losses (Chart 1), Italy continues to lag behind; this year's modest GDP growth of 0.8% comes after a long recession, and 2016 should consolidate on the current recovery. The only peripheral country to completely rebound from the sovereign debt crisis and retain high levels of growth is Ireland, which has grown at 5.2% in 2014, and is expected to grow at 4.8% in 2015.

Among Europe's largest economies, the UK is the best performing although with a significant deceleration since 2014. For instance, the UK has had a stronger recovery, reaching six percentage points above its pre-crisis peak, although it still lags behind the United States, which has reached 10 percentage points above of its precrisis peak. Meanwhile, Germany and France, Europe's largest economies, experienced signficant economic contraction in 2009, and have been hampered by slow growth rates. Chart 1 shows that these economies have modestly recovered from the losses caused by the crisis, although in real terms they are just a few percentage points above pre-2008 levels (4 percentage points for Germany and 2 percentage points for France).

the other large economies of Italy and Spain are still below their pre-2008 levels. This is because they experienced a much more harmful 'double dip' recession, undergoing through negative growth after the financial crisis, bouncing back in 2010, and returning to a decline with the onset of the Eurozone crisis. While Italy has just returned to growth in 2015 and is due to grow below the EU average, Spain has experienced substantial growth.

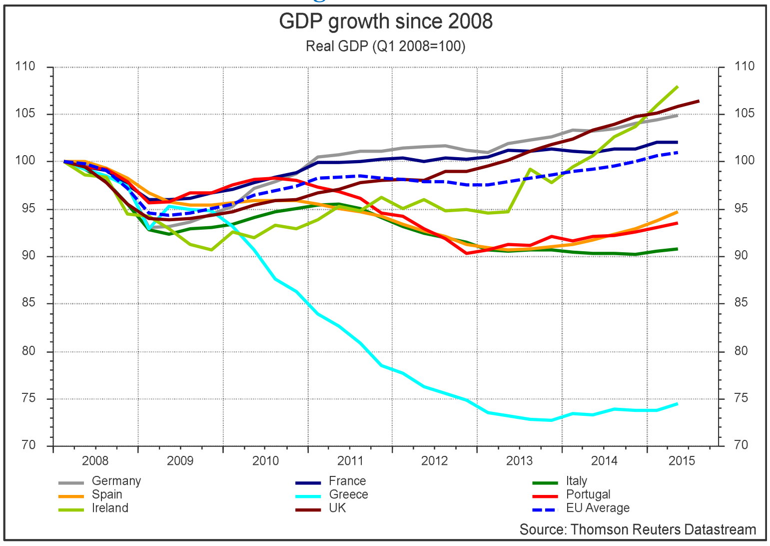
Table 2: Real GDP growth of the largest EU economies

Real GDP growth	2009	2010	2011	2012	2013	2014	2015 est.	2016 est.
France	-2.9%	2.0%	0.2%	0.7%	0.2%	0.2%	1.2%	1.5%
Germany	-5.7%	3.9%	3.7%	0.6%	0.4%	1.6%	1.5%	1.6%
Italy	-5.5%	1.7%	0.6%	-2.8%	-1.7%	-0.4%	0.8%	1.3%
Spain	-3.6%	0.0%	-0.6%	-2.1%	-1.2%	1.4%	3.1%	2.5%
UK	-2.8%	2.5%	1.6%	2.2%	1.5%	3.0%	2.5%	2.2%

Source: IMF world economic outlook October 2015

Due to the long periods of stagnation in the periphery and slow growth in the core, the EU as a whole only passed its 2008 peak level of GDP in late 2014, whereas the US' real GDP had rebounded to its pre-crisis peak in 2011. Although the UK was slow to return to growth, it has been the fastest growing large economy in Europe since 2012, and is currenly the European country to have grown highest above its precrisis peak, at 6 points above its 2008 GDP (Chart 1).

Chart 1: Growth of the largest EU economies since 2008

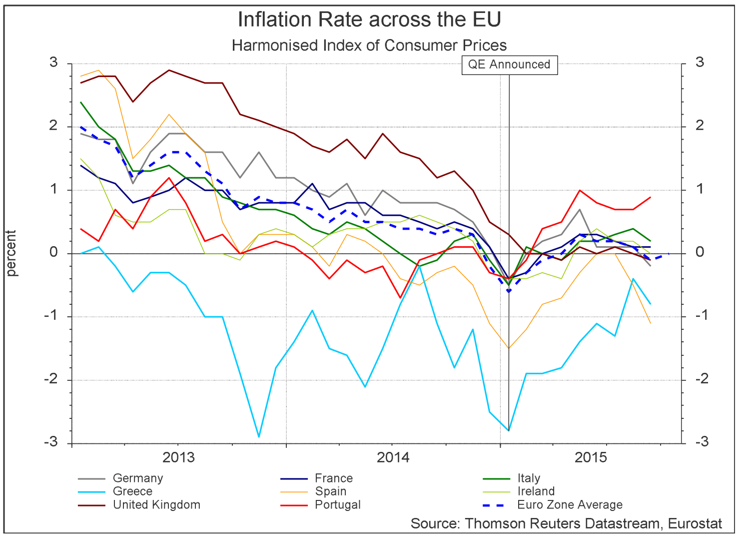


Source: Thomson Reuters Datastream

Globally, there are some down-side risks within the global economic outlook, which could result in lower than expected GDP growth in Europe or worldwide. These are risks posed by a variety of potential economic shocks that may affect growth, both globally and within Europe. First, the pending decision by the Federal Reserve to raise interest rates may affect GDP growth worldwide, especially in the emerging markets. Second, the continued low costs of commodities, especially petroleum, would continue to provide an advantage to industry in advanced economies. However, many large economies, such as Brazil, Indonesia, Russia and Turkey – the last two being significant trading partners for the EU – would be negatively affected by low commodity prices which may slow growth globally. A final additional risk comes from China. Chinese growth is expected to continue to slow to 6.3% in 2016, however, if the Chinese growth rate declines faster than anticipated, it could have knock-on effects on the global economy, through supply chain disruption, knock-on effects in Asia, and by exporting deflationary pressure. Strong spill-over effects from any of these risks would threaten Europe's already fragile recovery.

As for Europe specifically, there are two specific downside risks. First, there is the risk of deflation. Inflation rates in the Eurozone have declined from 2% in January 2013 to -0.2% in December 2014. Individual peripheral economies including Spain, Greece, and briefly Italy experienced negative inflation during much of 2014 (Chart 2). In January, the announcement of Quantitative Easing by the ECB led to an increase in inflation peaking at 0.3% in May. However, EU inflation has since returned to negative territory, with inflation in September measured at -0.1%. Inflation in the UK has also been moving steadily downwards and has also been at or below zero for most of 2015. The potential for continued low commodity prices and slower worldwide growth suggest that this will continue into 2016.

Chart 2: Inflation rate decreasing since 2013



Source: Thomson Reuters Datastream, Eurostat

Secondly, the debt overhang which has been exacerbated by the Euro crisis will continue to act as a drag on many economies, and will do so unevenly. Significant peripheral countries such as Italy and Portugal have debt burdens of approximately 130% of GDP while in the case of Greece it is now 177% of GDP – up from 102% in 2007. Even countries such as Ireland and Spain that had low debt to GDP ratio before the crisis – respectively 41.4% and 39.3% in 2008 - retain debt burdens of 105.6% and 97.7% of GDP respectively (Table 3). The risk of deflation is also likely to exacerbate the burden of the existing debt.

Table 3: Debt overhang of selected countries 2014

Country	Debt/GDP Ratio
Netherlands	67.9%
Germany	74.6%
United Kingdom	89.4%
France	92.3%
Spain	92.1%
Belgium	105.6%
Ireland	107.6%
Portugal	130.2%
Italy	132.1%
Greece	177.1%
United States (for comparison)	104.8%

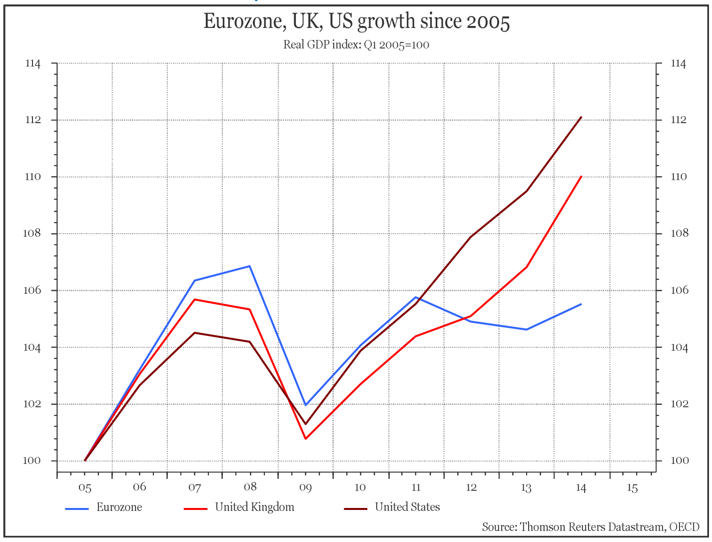
Source: IMF – World Economic outlook October 2015

Part 2: The UK and the Euro area: the tale of two economies

2.1 Overview

The United Kingdom is expected to grow at 2.5% this year, significantly higher than the Eurozone average expected growth rate of 1.5% and similar to the US' expected growth rate of 2.6%. This is following strong GDP growth in 2014 that at 3% was faster than any large advanced economy and outpaced the Eurozone which grew at only 0.9%. There are deep structural causes that affect how and why the UK and the Eurozone behave differently. The United Kingdom's model for growth has been intrinsically different from the 'continental' one for some time. To some extents it is similar to that of the United States, low fixed investment, strong private consumption, and low household savings. As a result, GDP growth rates in both the UK and US resumed at a similar time, and have been growing at similarly fast rates, although the UK lags slightly behind the US (Chart 3).

Chart 3: Growth comparisons



Source: Thomson Reuters Datastream, OECD

The growth and savings patterns currently experienced by both the UK and the Eurozone have changed markedly since the financial crisis in several ways. As mentioned before, growth rates, especially in the Eurozone, have been slower than before the crisis while the UK's growth rate has rebounded. For both the UK and Eurozone, declines in consumption have occurred, although more so in the Eurozone. Drivers of this uneven rebound in both consumption and overall growth include the lower unemployment levels in the UK, both short- and long-term, and the signficant deleveraging of households in the UK, down to 126.6% of GDP from 142.5% of GDP (Table 4 examines these trends in more detail).

Table 4: Changes since 2007 – UK versus Eurozone

	UK 2007	UK 2014	Eurozone 2007	Eurozone 2014
GDP Growth	2.6%	2.9%	3.0%	0.9%
Consumption Growth	1.9%	1.7%	1.0%	0.5%
Unemployment	5.5%	5.5%	7.8%	11.4%
24+ mo Unemployment	0.9%	1.1%	2.2%	3.9%
Public Debt/GDP	43.6%	89.4%	65.1%	94.2%
HH Debt/GDP	142.5%	126.6%	94.6%	95.7%

Source: Eurostat, IMF WEO October 2015, Thomson Reuters Datastream, OECD

2.2 GDP components and growth

In this section we look at how the various components of GDP components contribute to further growth in the UK economy, and how it differs from the Eurozone.

By examining the breakdown of GDP by component (Table 5), we can see that in periods before, during and after the crisis, the contribution of private consumption to GDP growth is higher for the UK and the US economies than for the Eurozone economy. Also for both the UK and the US the contribution to growth from net exports is negative. As for fixed capital formation, both the US and the Eurozone show similar contributions while the UK stands out both in terms of share of GDP and the long-term trend. Only in the government consumption component is the UK more similar to a Eurozone country, government consumption contributing roughly 20% of GDP to both the Eurozone and the UK economy, while the US has lower stake, remaining nearer to 15%.

Table 5: GDP growth by component: UK

		1994-99	2000-04	2005-09	2010-14
Private Consumption	**UK**	62.9%	64.6%	64.0%	64.8%
	Eurozone	56.6%	56.4%	55.9%	56.1%
	US	65.0%	67.0%	67.6%	68.4%
Capital Formation/Investment	**UK**	20.0%	19.1%	17.9%	16.6%
	Eurozone	21.6%	22.0%	22.4%	20.1%
	US	22.3%	22.3%	21.4%	19.2%
Government Consumption	**UK**	17.4%	18.8%	20.7%	20.6%
	Eurozone	19.6%	19.6%	20.1%	21.1%
	US	14.3%	14.8%	15.7%	15.8%
Net Exports	**UK**	-0.3%	-2.5%	-2.7%	-2.1%
	Eurozone	1.7%	1.7%	1.3%	2.6%
	US	-1.6%	-4.1%	-4.7%	-3.4%

Source: OECD

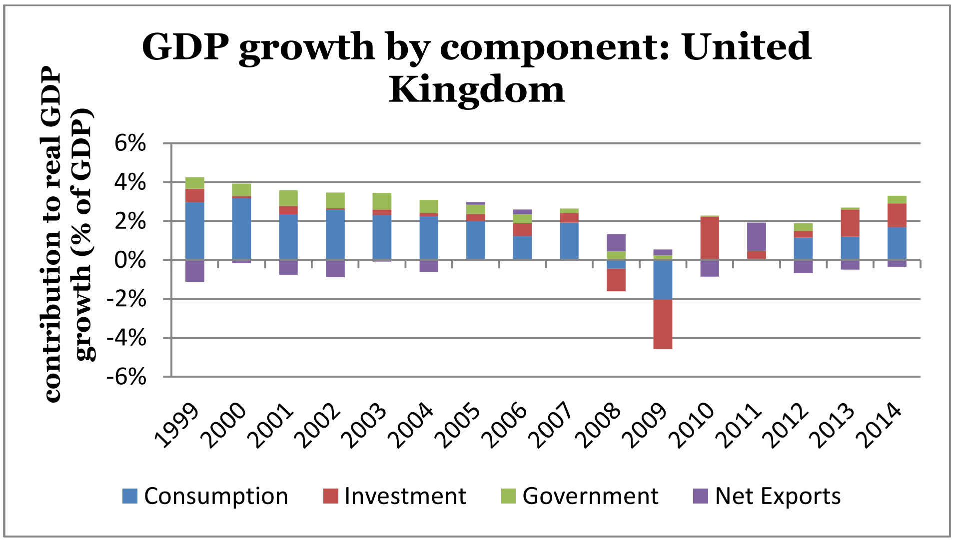
Private consumption also continues to be the most significant driver of UK's GDP growth, especially in comparison to the Eurozone (Charts 4a and 4b). Increases in UK GDP over the last 15 years have primarily come from growth in consumption and have maintained the UK's existing preponderance of consumption-based GDP. Before the financial crisis, UK increases in the consumption component of GDP accounted for over two thirds of total GDP growth in every year but one between 2000 and 2008 contributing an average of 2.2% to real GDP growth alone. Since the UK returned to growth in 2012, the share of GDP growth that has gone into investment has increased while the consumption component of GDP growth has declined in absolute terms – representing only an annual increase of 1.4% in GDP on average between 2012 and 2014.

Government spending and exports make up a smaller contribution to GDP growth in the UK. The UK has run a modest trade deficit most years, with the exception of years in which imports were supressed due to the crisis. Growth in government spending contributed an average of 0.62% of GDP to growth from 2000 to 2007, but has contributed an average of only 0.19% to GDP growth since 2010 when austerity policies were first implemented.

The one area where the UK's economic pattern post-crisis differs most from pre-crisis, at least for now, is capital formation the contribution of which to real GDP growth was 1.4% of in 2013 and 1.2% in 2014, accounting for almost half of the UK's total GDP growth in those two years (Chart 4.a).

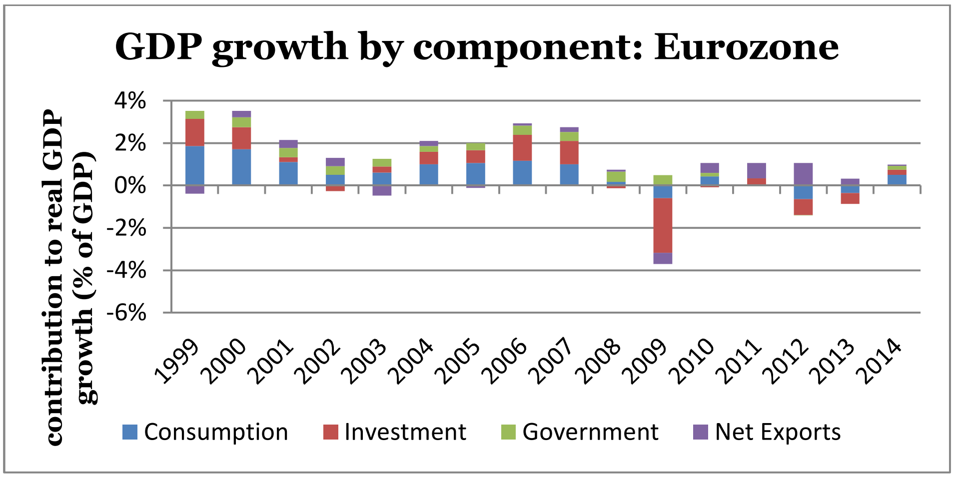
This contrasts with the Eurozone, where a greater portion of GDP growth driven by investment and government spending while private consumption provided just 1% annually on average to GDP growth between 2000 and 2008, with (Chart 4.b).

Chart 4.a: GDP growth by component: UK



Source: OECD

Chart 4.b: GDP growth by component: Eurozone



Source: OECD

As a result the recovery from the financial crisis has been very uneven across sectors of the economy. Tables 6.a and 6.b illustrate this point. Consumption levels have returned to pre-crisis levels in both the UK and the 'core' Eurozone economies, while the 'peripheral' Eurozone economies have not yet recovered to precrisis levels of consumption. Currently UK consumption is currently at a higher level compared to its precrisis peak than Germany or France and is growing faster. However, at the moment, the difference between the UK and the Eurozone average in consumption is due primarily to the supressed consumption in peripheral economies such as Spain and Italy.

The outlook for total government consumption is similar, except that France and Germany's government consumption have actually grown slightly faster than the UK. Net exports fluctuate signficantly from year to year, but the UK has still run trade deficits most years, while the Eurozone runs a trade surplus largely driven by German exports.

Again, what is most divergent in the recoveries of the UK versus the Eurozone economies is the rebound of investment. Investment in the UK is growing twice as fast in the UK in 2014 as it has been in 2007, while in the Eurozone, it is growing at less than a quarter of its precrisis rate. As a consequence, UK investment levels are at 118% of their precrisis levels, while the Eurozone is growing at 85.4%, and even core countries such as France and Germany have not recovered their pre-crisis investment levels.

Table 6.a: GDP growth by component

2007	UK	Eurozone	France	Germany	Italy	Spain
Consumption	1.9%	1.0%	1.4%	0.0%	0.7%	1.9%
Investment	0.5%	1.1%	1.4%	1.4%	0.6%	1.3%
Government	0.2%	0.4%	0.4%	0.3%	0.1%	1.1%
Net Exports	-0.1%	0.2%	-0.8%	1.5%	0.2%	-0.6%
Total Real GDP Growth	**2.6%**	**3.0%**	**2.4%**	**3.3%**	**1.5%**	**3.8%**
2014						
Consumption	1.7%	0.5%	0.3%	0.5%	0.2%	0.6%
Investment	1.2%	0.2%	-0.1%	0.4%	-0.7%	1.0%
Government	0.4%	0.2%	0.4%	0.3%	-0.1%	0.0%
Net Exports	-0.3%	0.1%	-0.5%	0.4%	0.2%	-0.1%
Total Real GDP Growth	**2.9%**	**0.9%**	**0.2%**	**1.6%**	**-0.4%**	**1.4%**

note: numbers may not add up to total due to rounding

Source: OECD

Table 6.b: 2014 Real GDP recovery by component

% of 2008 GDP	UK	Eurozone	France	Germany	Italy	Spain
Total GDP	105.6%	98.8%	102.1%	104.2%	91.9%	92.7%
Consumption	103.2%	98.7%	103.4%	104.5%	93.5%	89.3%
Investment	118.2%	85.4%	93.4%	96.8%	68.3%	68.6%
Government	105.8%	104.0%	109.9%	109.3%	96.9%	97.8%
Net Exports	127.0%	242.0%	131.8%	110.8%	-1249.3%	-86.5%

note: numbers may not add up to total due to rounding

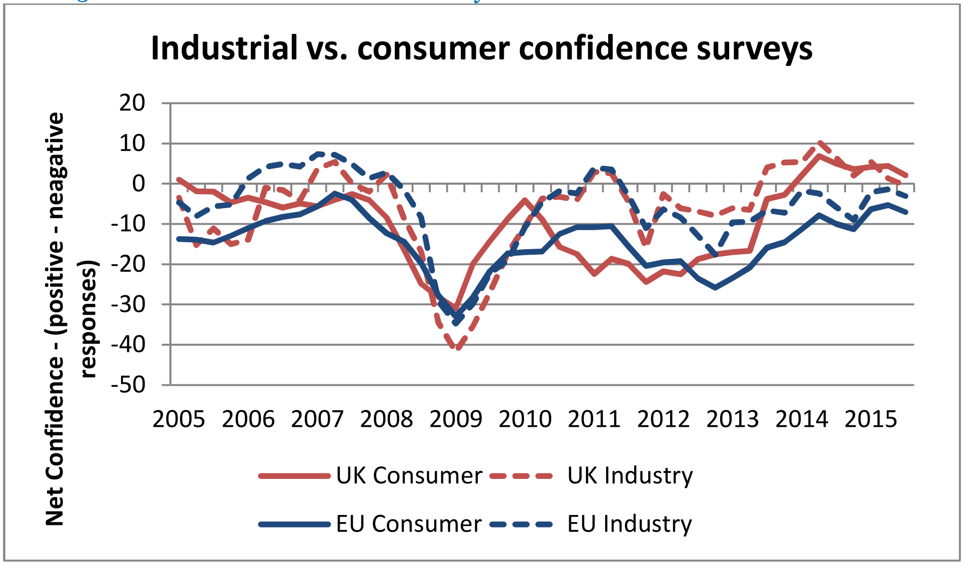
Source: OECD

2.3 A matter of confidence?

The channel by which the macroeconomic conditions have affected consumption and investment decisions in the UK can be seen in consumer and industrial confidence surveys, both in the UK and Europe (chart 5). The crisis caused consumer confidence to sink to extreme lows. Among individuals, both Eurozone and British publics had a low level of confidence through 2012. However, in late 2013 British consumer confidence began to increase much more rapidly than in the EU.

Industrial confidence, both within the UK and EU had already bounced back relatively quickly after the crisis – as did GDP – only to descend again in 2011 during the Euro crisis. Until the Euro crisis, EU and UK business confidence had moved roughly in tandem, while after that point, European businesses became increasingly pessimistic, suggesting that the Euro crisis did damage industry's assessment of the Eurozone's prospects. Here we have a vicious circle. Fear over the euro crisis in industry reduced industry confidence, leading to slower growth both in GDP and employment, further reducing consumer confidence. Since then EU consumer confidence has lagged behind the UK.

Chart 5: UK versus EU confidence surveys



Source: EU directorate general for economic and financial affairs

Meanwhile, the higher level of industrial confidence in the UK created a more virtuous circle. Increased industrial confidence translated into gains in specific macroeconomic indicators that in turn led to greater consumer confidence. Mid-2013 in particular saw a coincidence of a number of these positive economic indicators, including the FTSE100 returning to its pre-crisis peak in May 2013, and house prices recovering to their pre-crisis levels in August 2013.[3] This, combined with over a year of wage growth near 2% (Chart 6) began to positively affect the UK employment rates, creating a virtuous circle where more people employed created more confidence which created more consumption and faster growth and employment.

Chart 6: UK wage growth

Source: ONS, Thomson Reuters Datastream

[3] Source: ONS house price index

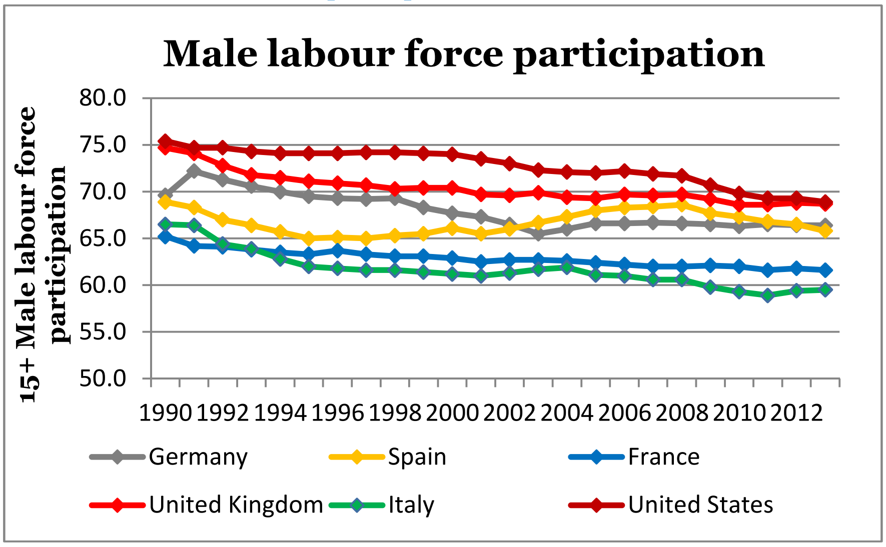
2.4 The labour market

Labour market conditions explain consumer confidence performance. In Britain, the labour market, being more flexible, tends to recover after a crisis faster and stronger than in the Eurozone. The high labour force participation rate and high levels of consumption mean that a significant portion of the UK's GDP growth will be tied to the growth of purchasing power across the population. In the UK before 2012, employment figures lagged both GDP and wage growth figures while UK wage growth had also been slow and did not consistently move above 1% until late 2012 (Chart 6). Although the UK returned to growth fairly quickly in 2010, the gains of the initially weak recovery did not feed through the labour market until wage growth returned and unemployment began to decline. When the UK returned to pre-crisis GDP levels occurred in late 2012, the UK remained above its pre-crisis unemployment low of 5.2% is not yet back to that level.

In the Euro area, the labour market recovery was been less robust. This is a result of two factors. First, the EU suffered a 'double dip' recession in 2011 at the advent of the Euro crisis. This suppressed industrial confidence, leading to lower hiring and lower consumer confidence. While the UK GDP growth slowed and consumer confidence lagged slightly, it was not nearly as severe as in the Eurozone. Additionally, labour markets in many Eurozone countries have 'stickier' labour markets. Even as growth returns, some potential workers will not be able to successfully reintegrate into the labour force. This is distinct from the normal 'churn' in the labour force that short-term unemployment represents and leads to more people staying unemployed for longer. The UK labour laws allow for more flexibility in hiring, and so the UK has seen fewer people unemployed for over two years, as well as a lower long-term unemployment level than in the Eurozone, even as it has risen since 2008. Countries such as Italy and Spain which were hit with high unemployment spikes have seen the unemployment rate rise from 9% at the start of 2008 to over 26% at its peak in 2013 – and the very-long-term unemployed rise to 4.9% and 7.8% of the total active population respectively (compare Charts 9.a and 9.b).

The UK has a much higher percentage of its adult population in the labour force (Chart 7). It is consistently the European country with the highest male labour force participation, and has labour force participation rates approaching the United States. While the UK remains an outlier, the Eurozone countries also fall into two groups. Instead of the familiar core/periphery dichotomy, Germany and Spain have significantly higher labour force participation, while France and Italy lag roughly 5 percentage points behind.

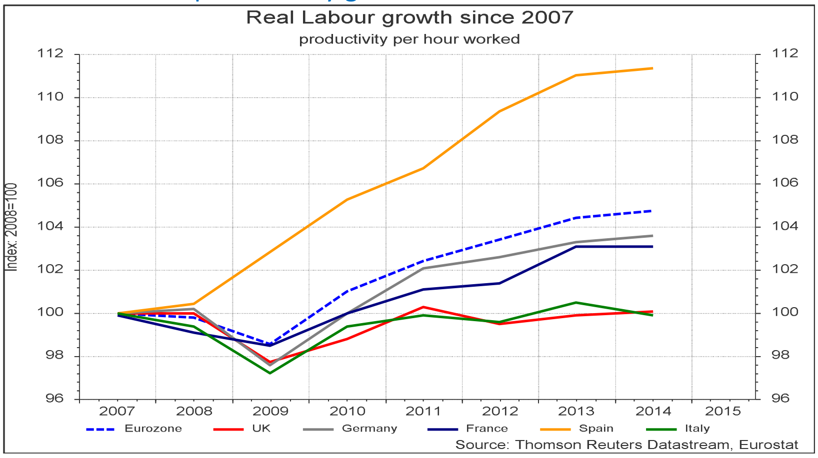
Chart 7: Male Labour force participation



Source: World Bank WDI

One notable change that did not occur in this downturn was an increase in worker productivity – almost alone among the European economies, British workers did not see a significant increase in worker productivity through the crisis. This is in contrast to other European countries, including France, Germany, and most notably Spain, whose productivity increased as the crisis went on.

Chart 8: Labour productivity growth since 2007

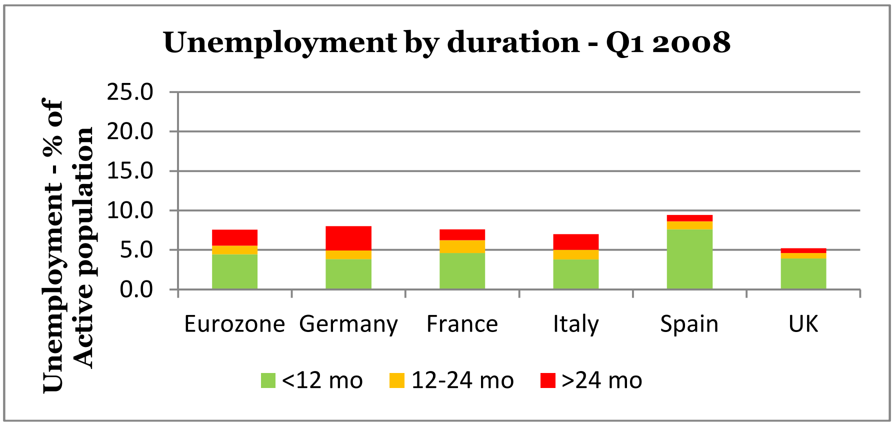


Source: Thomson Reuters Datastream, Eurostat

Due in part to high unemployment rates in the Eurozone, the workers who have remained in the labour force have become more productive (Chart 8). This comes from a variety of factors, including efficiency gains by companies facing cost pressure, layoffs of less productive employees, and increased labour competition requiring greater skill sets for employees. This is especially the case in Spain, whose high unemployment has required existing employees to become much more productive. The UK, meanwhile, has seen labour productivity remain essentially static.

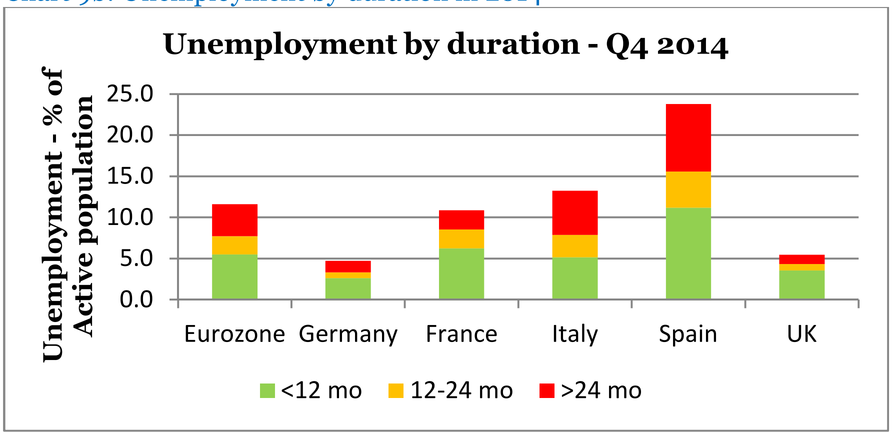
It is notable that it is possible to reverse labour market hysteresis, as can be seen most notably in the case of Germany. In late 2004, Germany had the highest unemployment level in Europe, over 50% of which was made up of the long-term unemployed (see charts 9.c. and 9.d). It's very-long-term (24+ mo) unemployment rate was at 4.2%, compared to Eurozone average of 2.7%. This 1.5 percentage point gap represented a more than the entire gap between the German unemployment level, 10.6% in Q4 2004 and the Eurozone average unemployment level – 9.2% (compare charts 9.c. and 9.e). However, in order to reverse this, the government at the time under Chancellor Gerhard Schröder implemented politically unpopular labour market reforms which allowed for easier hiring and firing of workers and subsequently lost power in the next election, making similar reforms elsewhere a difficult proposition politically.

Chart 9a: Unemployment by duration in 2008



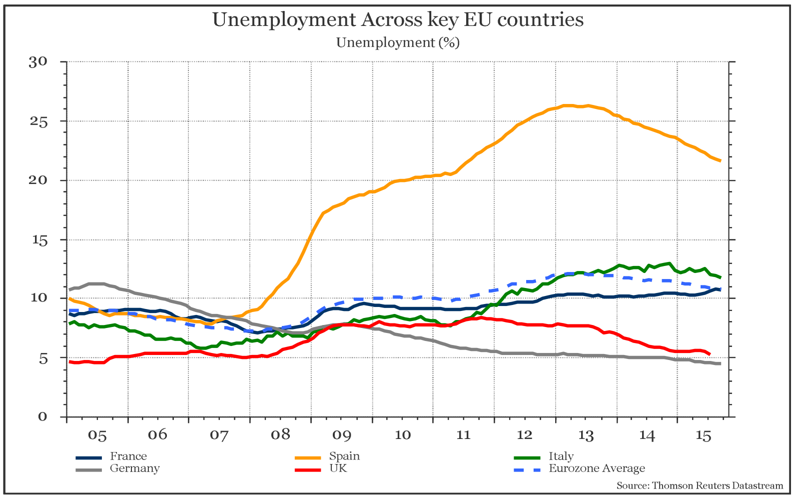
Source: Eurostat

Chart 9b: Unemployment by duration in 2014



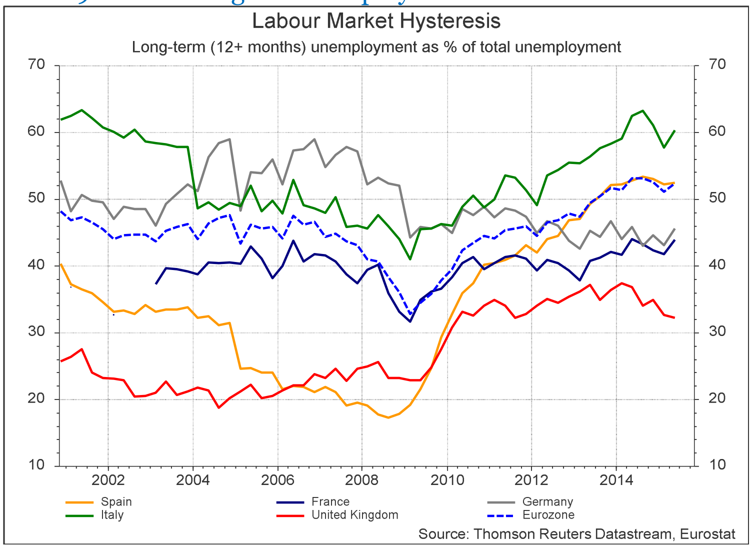
Source: Eurostat

Chart 9.c: Unemployment in selected countries, 2008-2014



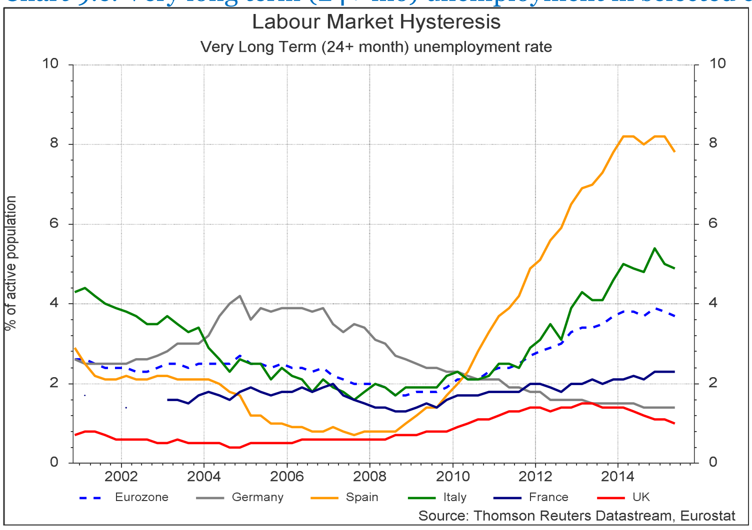
Source: Eurostat

Chart 9.d: Percentage of unemployment >12mo



Source: Thomson Reuters Datastream, Eurostat

Chart 9.e: Very long term (24+ mo) unemployment in selected countries

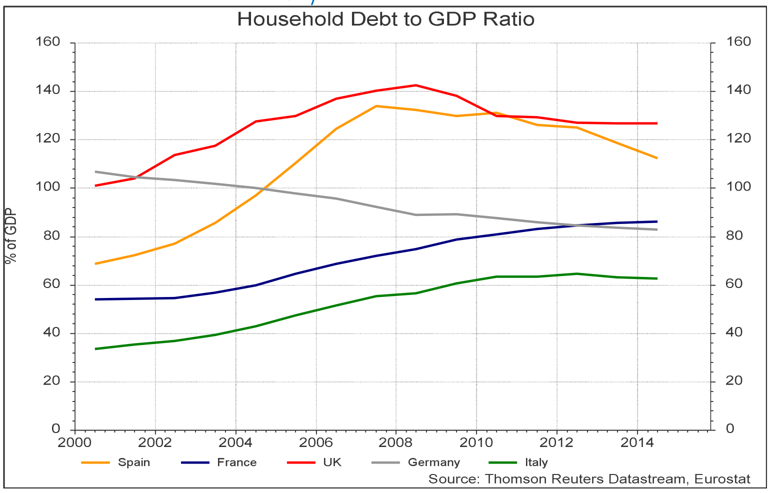


Source: Thomson Reuters Datastream, Eurostat

2.5 Deleveraging

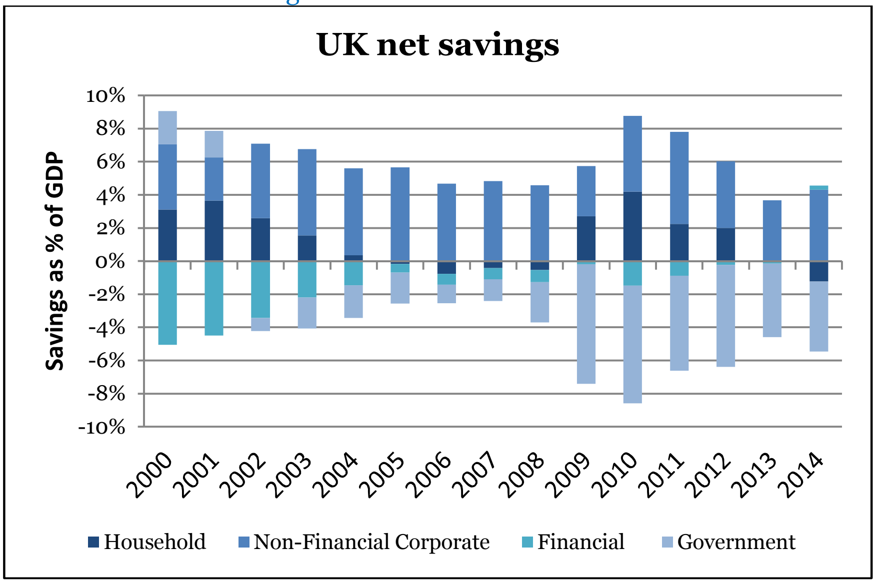
The rates of consumption in the United Kingdom pre-crisis were financed in large part through access to significant credit, which also depressed the growth of investment. Households in particular were carrying a significant amount of household debt, peaking at above 140% of GDP. Most large European countries were significantly below 100% of GDP, the exception being Spain, which was experiencing an investment bubble in the mid-2000s (Chart 10). The higher level of consumption and debt is also reflected in the UK's pattern of saving. Alone among the large EU economies, the UK had negative household savings rates before 2008; net household savings was negative from 2005 to 2008. Only non-financial corporates were the only sector within the economy to have positive savings, government saving and financial saving was also negative at this time (Chart 11.a and 11.b).

Chart 10: Household Debt/GDP Ratio



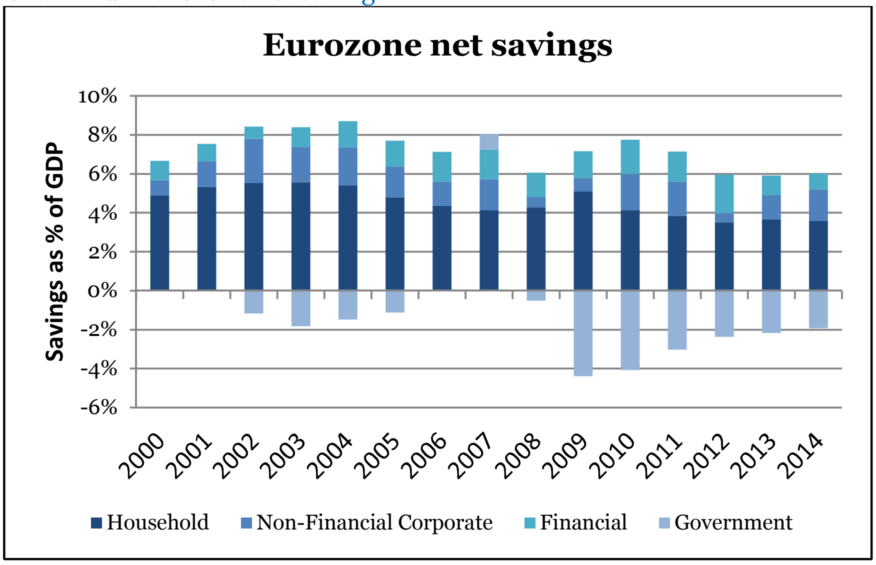
Source: Thomson Reuters Datastream. Eurostat

Chart 11.a: UK net savings



Source: Eurostat

Chart 11.b: Eurozone net savings



Source: Eurostat

After the crisis, the UK economy began a process of deleveraging. The limited access to credit and uncertainty caused by high unemployment and low confidence caused household saving rates to increase to a height of 4.2% of GDP in 2010. This was accompanied by an increase in government dissaving in 2009 and 2010 as government revenues declined from 41.5% of GDP in 2009 to 38.8% in 2009 and countercyclical spending on automatic stabilisers rose, causing total expenditures to rise from 46.6% in 2008 to 49.6% in 2009[4]. This has led to an increase in the public debt-to-GDP ratio in the UK which now has a public debt of 89.4% of GDP, up from 43.6% in 2007. However, this combination was able to underpin sufficient confidence and growth that the recovery eventually became self-sustaining.

The deleveraging that did occur had a mix of causes both private and public. Low consumer confidence caused households to be more cautious with their earnings, raising savings while depressing consumption. Meanwhile, the financial crisis caused banks to be more cautious with their lending, while the Bank of England began to pursue macroprudential supervision – directly regulating the growth of financial imbalances in targeted sectors through tools including leverage ratio requirements and increased capital standards on financial institutions.

However, as the crisis abated and growth returned, the deleveraging process slowed, between 2008 and 2011; household debt fell from 142% to 129% of GDP, but has only fallen to 126% since then, and remains the highest of the large EU economies as Spain has continued deleveraging. Meanwhile, UK households have begun to return to their previous pattern of low savings, including negative savings of roughly 1% of GDP in 2014. While macroprudential standards remain in place to prevent too significant leveraging in the system, consumer behaviour seems to have returned to its pre-crisis model of high consumption.

The household savings rate in most Eurozone countries are higher than in the UK, and the savings patterns of households, corporates and governments have been more consistent (Chart 11.b). The Eurozone average household savings has fallen modestly as households are forced to draw on their savings in areas of high unemployment; in the years from 2000 to 2007, household savings averaged 5.0% and has only averaged 3.6% since 2011. However, other than during the deleveraging in 2009-10, Eurozone household savings have consistently remained higher than the UK.

[4] Source: Eurostat

Part 3: Disparities within the Eurozone

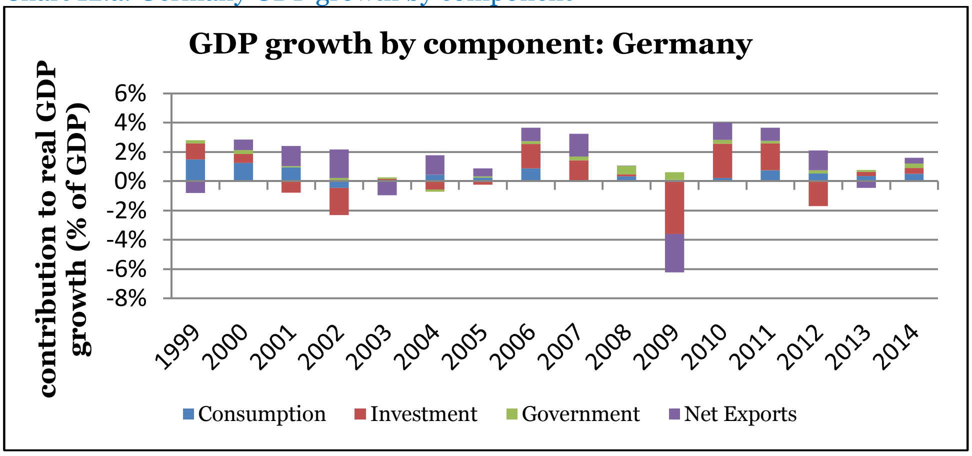
3.1 Overview of the Eurozone

When comparing the UK to the Eurozone, it is important to acknowledge that the Eurozone, of course, is not one economy. Most of the disparities between the UK and the Eurozone discussed above – higher savings, lower consumption growth, higher investment, and lower labour force participation – concern features which are generally shared in common among other large EU economies: Germany, France, Italy, and Spain, for which the UK is an outlier. However, in many instances the disparities within the Eurozone are particularly wide. In particular, the depth of GDP decline in both 2009 and in 2012, the dependence, or lack thereof, on investment, government or exports to sustain growth, the degree of overleveraging in household credit, the savings rate of households, corporates and the government, and the degree of labour market flexibility all differ substantially across the Eurozone, although the UK is an outlier in almost all these dimensions. It is therefore worth analysing the economies of each of the large economies in more depth individually and how they vary from the Eurozone average.

Part 3.2 Germany – low consumption, high employment, export-driven growth

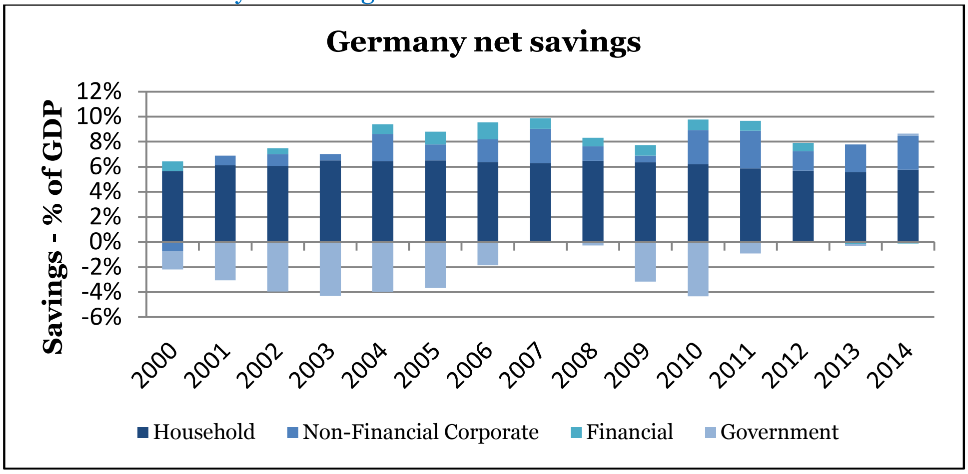
The growth of the consumption portion of German GDP has been has been consistently modest – consumption has not contributed more than 1% to real GDP growth since 2000. Additionally, Germany's labour market was only modestly affected by the financial crisis, its total unemployment rose less than one percentage point and returning to pre-crisis levels by 2011, (see Chart 12c), while due to the ongoing effects of its labour market reforms in early 2000s actually saw its very-long-term unemployment rate fall throughout 2008 and 2009, from 3.1% in Q1 2008 to 2.3% in Q4 2009 (Chart 9.d, earlier). However, due to Germany's low consumption growth in the years after the crisis, GDP growth has been driven by fixed capital formation, which varies significantly from year to year, and net exports consistently higher than any European country, which have grown at an average of 0.55% per year since 2000 (Chart 12a). This also means the consumption portion of their GDP has grown every year since 2010. Their trade surplus and low consumption allows German household savings alone to remain above 5% a year consistently since the crisis, and allows for a modest but relatively stable level of corporate savings.

Chart 12.a: Germany GDP growth by component



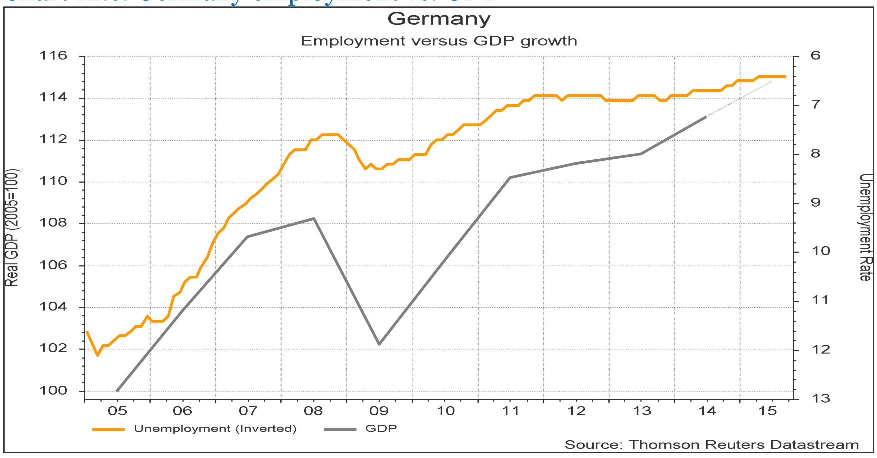
Source: OECD

Chart 12.b: Germany net savings



Source: Eurostat

Chart 12.c: Germany employment vs. GDP

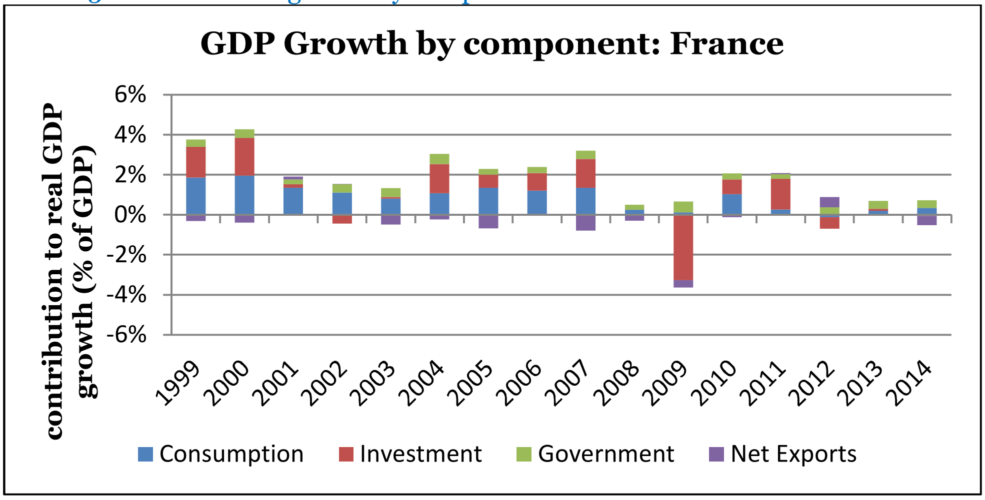


Source: Thomson Reuters Datastream

Part 3.3 France – underperformance in employment and growth

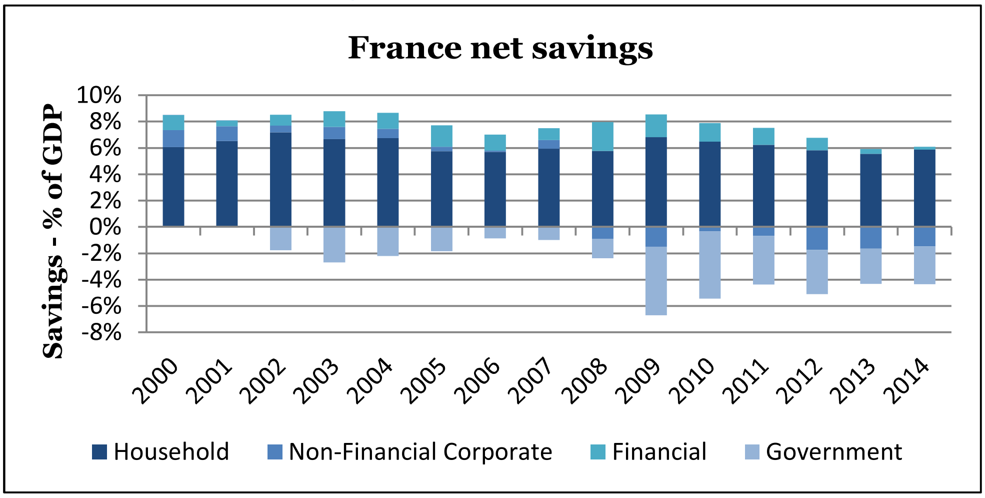
France was hit relatively lightly by the 2008 financial crisis and its GDP recovered from the financial crisis by 2011, based in large part on the rebound of investment and increased government consumption. It was also not hit particularly hard by the Eurozone crisis. GDP growth in 2012 was still positive at 0.18% of GDP, down from 2.08% in 2011, but avoided a double dip recession. Despite this, the French unemployment has been slowly rising ever since (Chart 13.c). Labour market hysteresis is a likely explanation; France's very long term unemployment has grown from 1.3% to 2.3% the labour force between 2008 and 2015. Both consumption and investment have grown on average 0.14% and -0.18% a year since 2012 respectively. Only government consumption is at a similar level to where it was pre-crisis averaging 0.38% a year since 2012. (Chart 13.a). The lack of growth can be seen in the employment figures. Unlike other core countries, employment has continued to decline since 2011 and is unemployment is now at 10%, higher than at any point since the crisis (see chart 13.c). Despite the high unemployment, net household savings remain high, above 5% of GDP but the government dissaving rate has become consistently high to support what growth remains.

Chart 13.a: France GDP growth by component



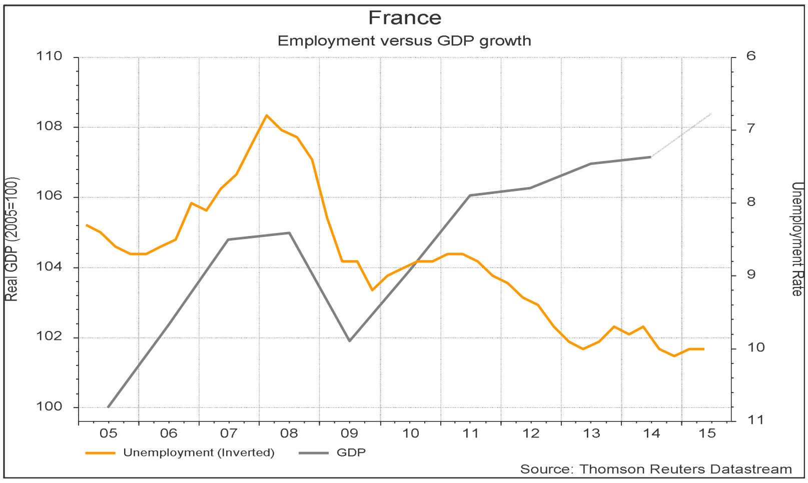
Source: OECD

Chart 13.b: France net savings



Source: Eurostat

Chart 13.c: France Employment vs GDP

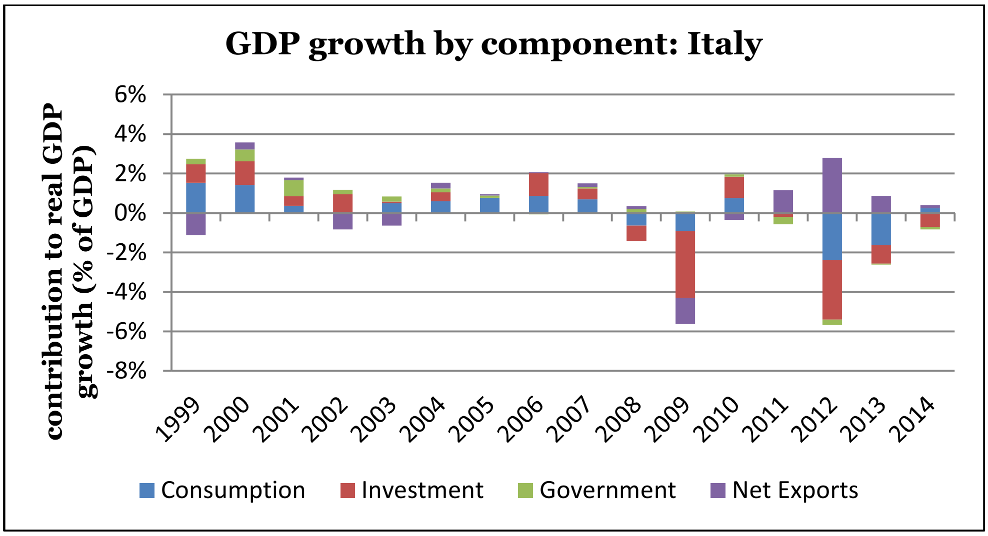


Source: Thomson Reuters Datastream

Part 3.4: Italy – high structural barriers

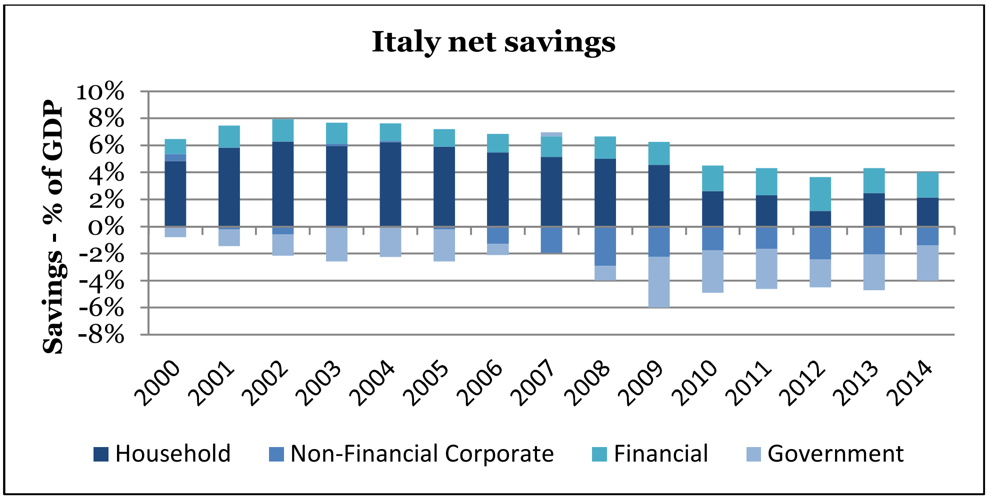
Italy was affected by slow growth across all components even before the crisis. It already had a high level of very long term unemployment before the crisis (Chart 9.d and 9.e), and, unlike France was hit hard by both the financial crisis and the Eurozone crisis, with the economy shrinking by 5.5% in 2009 and 2.8% in 2012. As a consequence, unemployment has risen to over 12% (Chart 14.c), 60% of whom are long-term unemployed, while very-long-term unemployed make up 4.9% of the active population. Troublingly, those who remain employed have also not seen an increase in their productivity, limiting the country's ability to be competitive in the longer term. 2015 is expected to be the first year since the Eurozone crisis in which growth is positive. As a result of the low labour market participation. The increase in consumption has remained consistently below 1% of GDP since 2002, and during that same time, capital formation growth only exceeded 1% in two years (1.15% in 2006 and 1.08% in 2010) (Chart 14.a). Neither GDP nor employment has recovered, suggesting demand or consumption will not rise in the future. Italy's household savings rate has declined, while corporate savings rate has remained negative (Chart 14.b).

Chart 14.a: Italy real GDP growth by component



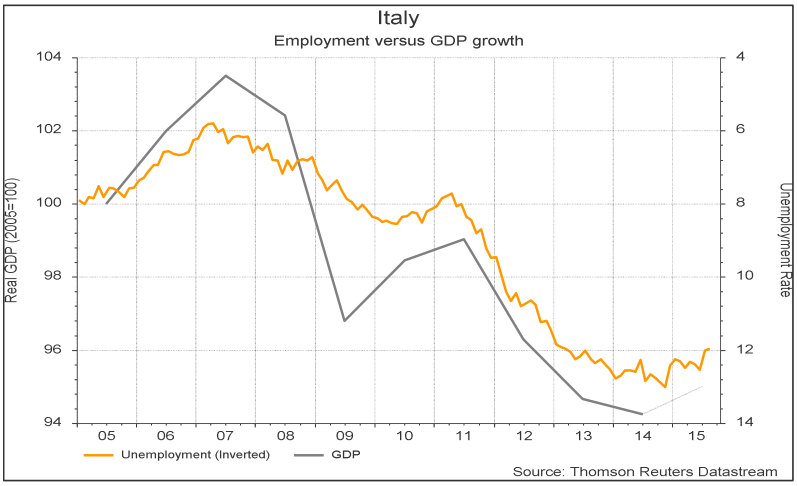
Source: OECD

Chart 14.b: Italy net savings



Source: Eurostat

Chart 14.c: Italy Employment vs GDP



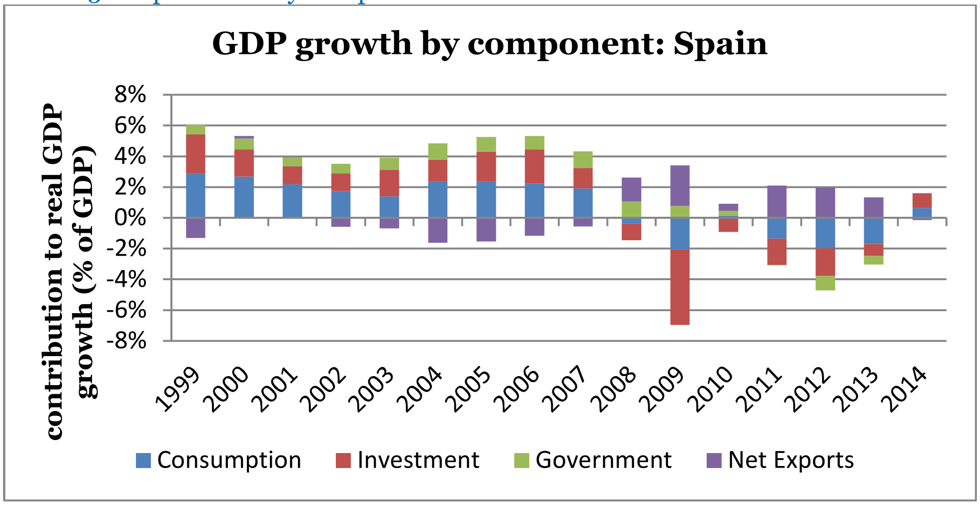
Source: Thomson Reuters Datastream

Part 3.5: Spain – bouncing back, but permanently scarred?

As mentioned previously, Spain had a household debt-to-GDP ratio of 134% of GDP before the financial crisis. This allowed Spain to experience high levels of growth in consumption, investment and government spending in absolute terms before the crisis while still maintaining high savings rates in all sectors (Charts 15.a and b). Since 2008 Spain has seen a stunning reversal with net household savings declining from 5% in 2007 to below -6% from 2009 onwards, as persistently high unemployment forces workers to draw down savings. Spain's corporate and government sectors remain positive savers. Notably, unlike France and Italy, Spain pursued a robust austerity programme, to allow its government savings to remain positive and consequently government consumption shrunk as a portion of GDP. Meanwhile, since worker productivity growth since 2008 is by far the highest in any large European country, the macroeconomic damage of the incredibly high unemployment rate is mitigated somewhat.

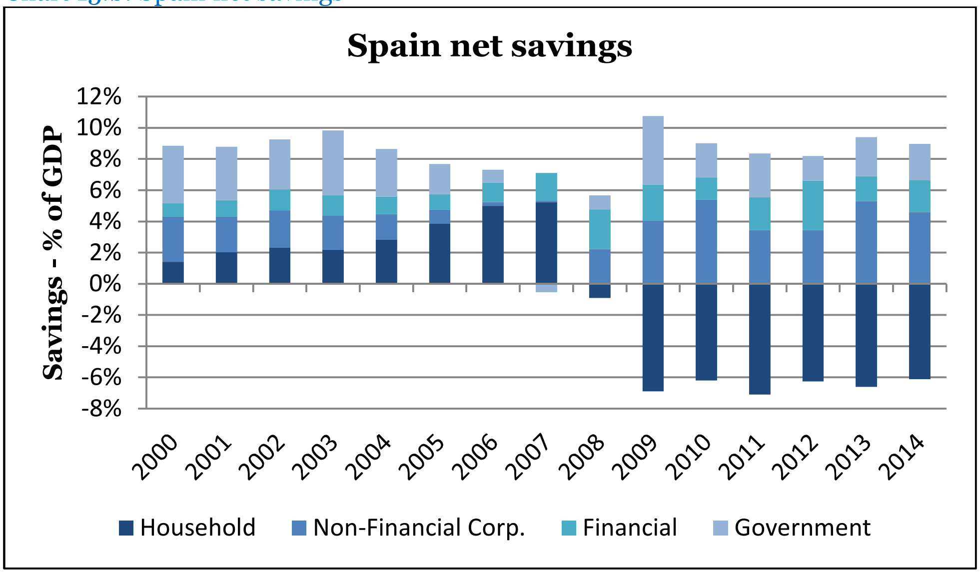
However, the future of Spain's labour market is uncertain. The labour market hit its nadir in 2013 and unemployment has since begun to decline (Chart 15.c) , As a consequence, the contribution from consumption to GDP growth is now positive again although still well below its pre-crisis levels. Even since 2012, Spain's deleveraging has continued apace, declining to from 125% in 2012 to 112%. Unemployment has declined from 26.2% at its peak to 22.2%, although it is unclear to what extent hysteresis means the still large very-long-term unemployed population who represent 7.8% of the total population will remain permanent.

Chart 15.a: Spain GDP by component



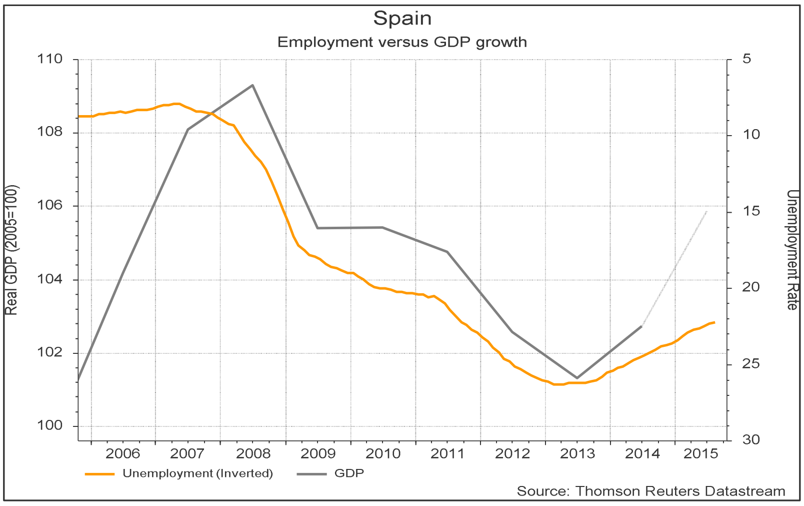
Source: OECD

Chart 15.b: Spain net savings



Source: Eurostat

Chart 15.c: Spain Employment vs GDP



Source: Thomson Reuters Datastream

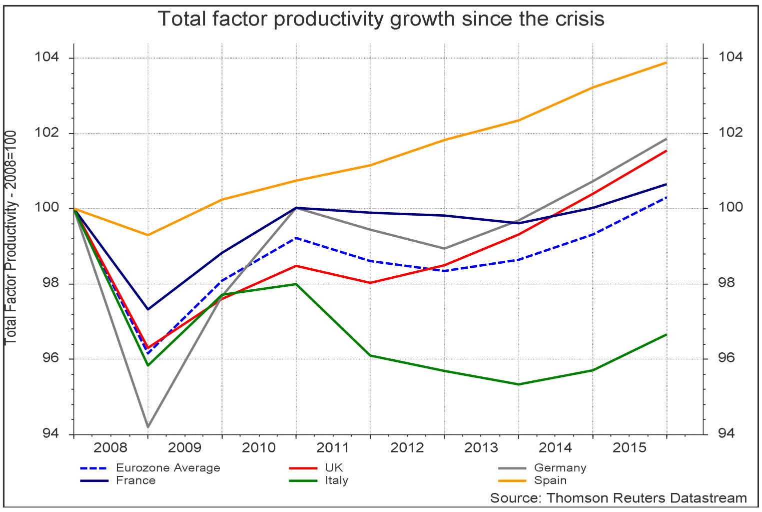
3.6 Cleavages within the EU

The countries in the Eurozone, especially France and Italy which are currently growing the slowest, face a three-fold problem. First, so long as unemployment in France and Italy is stagnant or increasing, confidence will lower and consumer demand will continue to decline. Second, consumption levels were not especially high pre-crisis, so any decrease in consumption or employment reinforces already substantial negative trends, including low labour force participation rigid labour markets and modest consumption increases (see Table 4). Finally, capital formation levels remain persistently low across the Eurozone, and are much further from returning to their 2008 levels than consumption (Table 6.b). This is especially problematic for the Eurozone, as those economies have historically been more dependent on capital formation for GDP growth than the UK's more consumption-driven economy. Lower savings rates among households will also reduce any growth in capital formation. If consumption and investment are both likely to remain supressed, other potential drivers of GDP growth include increased exports – the approach somewhat successfully undertaken by Germany, or increased government spending – the approach taken, with somewhat less success, by France.

The slower pre-crisis growth in consumption in the Eurozone can be attributed to the lag in unemployment rate recovery. If a large percentage of the population is out of work, they are less likely to make signficant spending decisions. Indeed, countries such as Germany and the UK that have come close to their pre-crisis levels of consumption have seen consumption rebound faster than countries such as France and Italy which have not. The prevalence of long-term and very-long-term unemployed , especially in Spain and Italy, will exacerbate the problem if labour markets are not flexible enough to reintegrate the long-term unemployed.

In measuring the ability of Eurozone economies to recover, total factor productivity tells a similar story (Chart 16). Spain, which has reformed its labour markets and is experiencing significant gains, along with Germany which had reformed its labour markets before the crisis, and did not have the handicap of high unemployment from the Euro ciris. Meanwhile France, and especially Italy, lag behind. This dichotomy between countries within the Eurozone between more dynamic labour markets and less dynamic, may become a greater cleavage than the traditional 'core/periphery' dynamic.

Chart 16: Total Factor Productivity

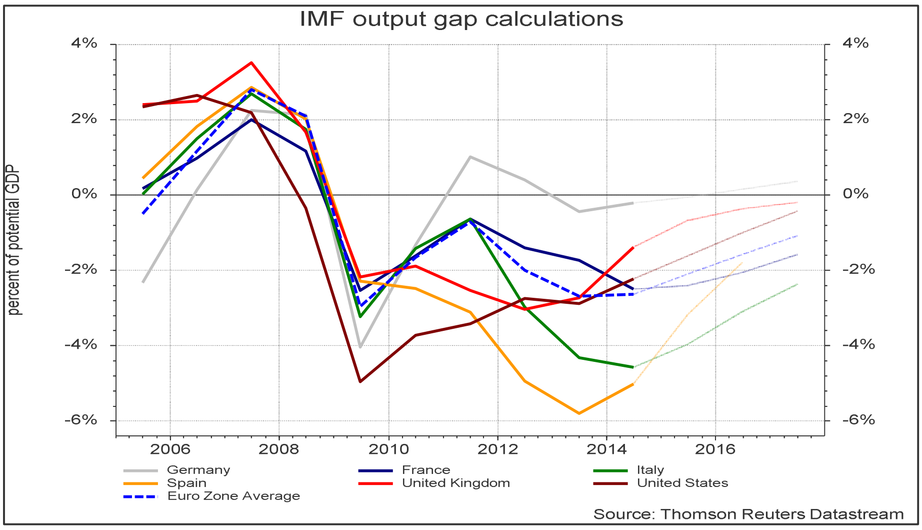


Source: Thomson Reuters Datastream

Part 4 – Will the Eurozone reach its potential? Has the UK reached its?

Many of the Eurozone countries are operating at a significant output gap. Of the five Eurozone economies, the IMF has estimated that only the UK and Germany have an output gap below 1%. The UK has an output gap of only 1%, while Germany's is near zero (Chart 17). To pursue further growth, the UK will need to continue deleveraging, maintain its high level of investment growth, and increase its worker productivity.

Chart 17: IMF output gap calculations



Source: Thomson Reuters Datastream

Of the countries operating significantly below their potential GDP, the case of Spain is in many ways the most optimistic. Labour productivity growth has been the fastest in Europe, labour markets have been reformed, and GDP growth is high. Their greatest pitfall is if their labour market reforms are insuffcent, and their high rates of long-term unemployment become permanent due to hysteresis. if GDP growth is sustained, it will create a virtuous circle as increased employment stimulates demand. Spain also had a more-consumption driven economy before the crisis, suggesting it has a higher potential to grow if demand returns. Indeed, the IMF has estimated it has the largest output gap of any of the large european economies, at roughly 5% of total output.

France and Italy are both operating significantly below their potential and do not look set to rebound. France managed to escape serious shocks from both the global financial crisis and the Eurozone crisis, and has maintained GDP growth, albeit slow. Nevertheless, its output gap has increased every year since 2011. Meanwhile Italy has numerous structural factors which remain unaddressed, an already low labour force participation rate and high long-term unemployment which have been severely exacerbated by the crisis, negligible worker productivity growth since the crisis and negative total factor productivity growth. This combination had led Italy to be the only large European economy to not yet return to growth, and will consistently produce below its capacity until these structural issues are resolved.

The UK seems to be doing well. However, its lack of worker productivity growth and still-high household debt burden, now compounded by higher public debt burden, will limit its ability to maintain consumption-led growth indefinitely. At the moment, it is experiencing a significant degree of investment-led growth that is unusual in its recent history. Whether this can be sustained, or will return to its previous levels will affect the UK's ability to grow further.

Conclusions

Throughout this paper, we have tried to examine the details of why the UK has taken such a different trajectory from the rest of the Eurozone. While there are some external shocks that have worked in the UK's favour – it was not as badly affected as some peripheral economies by the Eurozone crisis – both the magnitude of its growth, and the consistency of slow growth across the Eurozone suggest that the UK's success has deeper causes.

We argue that the primary cause is that the UK's more consumption-heavy model of growth has been easier to rebound after a shock, once a basic level of consumer and industrial confidence was restored. This is due to its flexible labour market, which has allowed the economy to both shed jobs quickly and restore them quickly once confidence has returned. This is in contrast to European economies which have had less flexible labour markets and more reliance on capital formation. In these economies, households, businesses and governments will draw down on their savings in times of low economic growth, leading to less investment-led growth. Their less flexible labour markets also mean that workers who lose jobs are more likely to remain outside the labour pool for longer, saving and consuming less.

This is not to say that the model is not without its flaws. The UK is still significantly leveraged, despite deleveraging throughout the crisis and its public sector has taken on a large portion of debt through the crisis. However, its problems have proven more able for policymakers to mitigate than the labour market distortions and investment shortages than still hurt the competitiveness of most Eurozone economies.

Finally, the economies in the Eurozone who are succeeding now are generally those which have grappled with their unreformed labour market the most effectively, and we can see this dichotomy slowly become a new cleavage within the Eurozone that may surpass the current core/periphery cleavage.