Regional recovery in a diverse union[1]

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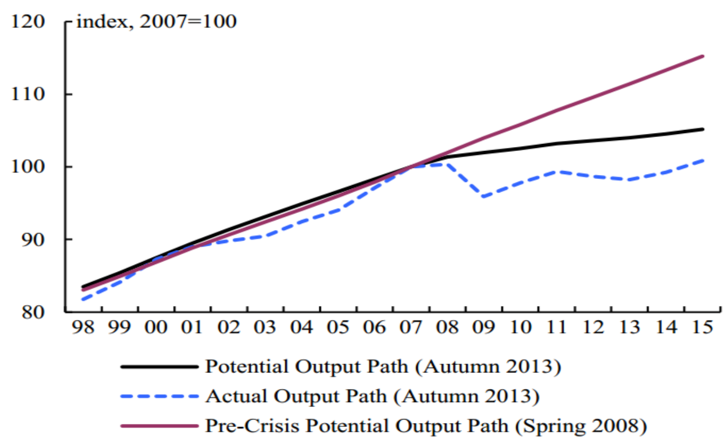
Abstract

This article reviews the diverse state of economic recovery across the Euro area and across the UK. Distinctions are drawn between the experiences within the Euro area, particularly among the high debt countries, and the UK. The focus then turns to whether the ongoing reforms set out in the Four Presidents' Report "Towards a Genuine Economic and Monetary Union" address the right issues. Turning to the most recent evidence on regional disparities within countries, it is clear that challenges remain, both for the Euro area and the UK. In the case of the UK, recent evidence on regional disparities in house prices present a challenge for the Bank of England and its Financial Policy Committee and are likely to provide a challenge to the use of its macro-prudential policy toolbox in the near future.

1 Introduction

The Euro area is showing a muted pickup in GDP (having returned to positive growth in Q3 of 2013). In the words of the IMF's most recent World Economic Outlook, this looks to be a 'fledgling recovery', still fragile and with a number of downside risks. Notably unemployment, especially youth unemployment, and other measures of 'slack' remain very high and inflation has stayed below the European Central Bank's medium term objective, renewing fears of further disinflation and possible deflation.

Figure 1: "Early stages of a gradual recovery" Euro area paths of actual and potential output

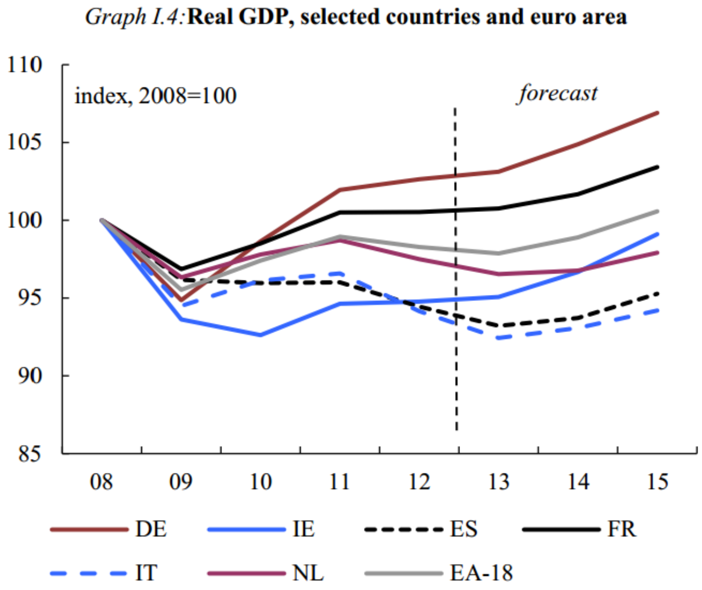


Source: Reproduced from European Commission (2013), Chart 1.3, p 11.

Looking across countries within the Euro area, this is clearly a multi-speed recovery with diverse experiences.

[1] *This article is based on the opening talk of a panel discussion on 'Insurance and adjustment in a diverse monetary union – what can the Eurozone learn from the UK?' delivered at the London School of Economics' European Institute public seminar series 'Towards a Genuine Economic and Monetary Union' on 29 January 2014.*

Figure 2: Multi-speed recovery



Source: Reproduced from European Commission (2013)

In Figure 2, the data are indexed at 100 in 2008, that is pre- recession. The horizontal line drawn at 100 is there for reference and shows that Germany and France's real GDP recovered to 2008 levels during 2011, while other EU countries will fail to do so throughout the forecast period (to 2015).

So, while the forecasts signal positive growth for the Euro area (EA-18) by 2013-14, it will be some time before some countries such as Italy, Spain etc. will see an end to depressions. (Here I'm using the National Institute of Economic and Social Research's definition of the end of a depression, ie. when real GDP surpasses the pre-crisis peak). [2] Hence, a return to long term trends experienced before the recession remains a more distant possibility.

Looking at a wider range of countries in Table 1, the diversity of experience across Europe and worldwide is even more evident.

For each country , Table 1 shows i) the size of the drop from the pre-crisis peak to the trough of the recession; ii) the duration of the decline; iii) when the pre-crisis peak has been surpassed (if at all); and a snapshot of how each countries' position in 2013 compares to its pre-crisis peak.

The latest figures for year on year growth in GDP, while positive, should be interpreted in this context. Even on the latest release of UK data, the UK economy is only expected to return to its 2008 level of GDP during 2014, and a significant gap remains in other indicators such as measures of median household disposable income. Indeed, the Institute of Fiscal Studies has suggested this is not expected to surpass the pre-crisis peak until 2016 (see Phillips, 2013).

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[2] *As noted in NIESR Monthly Estimates of GDP at http://niesr.ac.uk/sites/default/files/gdp0214.pdf*

Table 1: Depth and duration of decline; and progress of recovery.

	% decline in real GDP from pre-crisis peak to trough	# years of declining real GDP between 2007 and 2013	Year in which surpassed pre-crisis peak	2013 volume of GDP relative to pre-crisis peak
Greece	-22.7	6	-	-22.7
Italy	-8.9	4	-	-8.7
Portugal	-8.6	5	-	-8.5
Spain	-6.8	4	-	-6.8
Ireland	-7.4	3	-	-5.1
Iceland	-10.4	2	-	-5.0
Finland	-8.5	3	-	-4.7
Netherlands	-3.7	3	-	-3.6
Denmark	-5.7	3	-	-3.4
Euro area	-4.4	3	-	-2.0
United Kingdom	-5.2	2	2014	-1.0
Luxembourg	-5.9	3	2013	+0.5
Austria	-5.0	1	2012	+0.7
France	-3.1	2	2011	+0.7
Belgium	-2.8	2	2011	+1.3
Germany	-5.1	1	2011	+3.4
Total OECD	-3.5	1	2011	+4.1
United States	-2.8	2	2011	+6.1
Sweden	-5.0	2	2011	+6.1

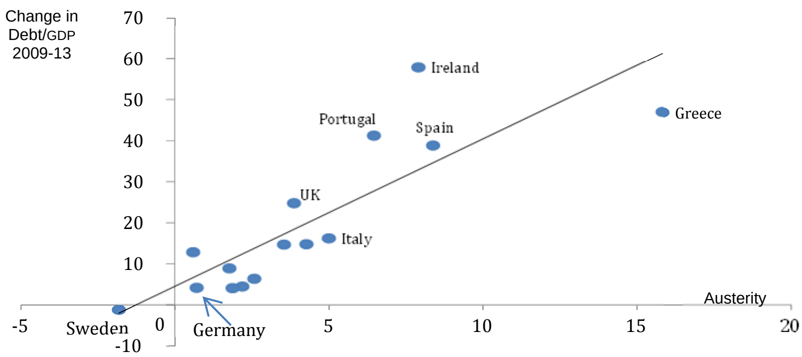
Returning to Table 1, in 2013, Greece, Italy, Portugal and Spain have yet to return to positive growth and significant long term damage to their potential output now seems unavoidable. These are of course countries that had the highest debt to GDP ratios as the crisis deepened. But they are also the countries that have instituted the largest austerity efforts over the period 2009-2013 as is shown in Figure 3. [3]

Austerity effort, on the horizontal axis, is calculated as the increase in primary balances over the period, adjusted for the cycle (i.e. "structurally adjusted primary balances"). Despite this austerity effort, debt stocks have yet to stabilise as a percentage of GDP, and the largest increase in debt to GDP ratios over the period occurred in those countries making the greatest austerity effort. Of course, this in part reflects the front loaded nature of the adjustments and their negative impact on GDP, the denominator of the debt ratios.

Given the continued sizeable divergences in debt to GDP ratios, as shown in Figure 4, plus the current priorities within EMU, these austerity efforts are set to continue for some time to come.

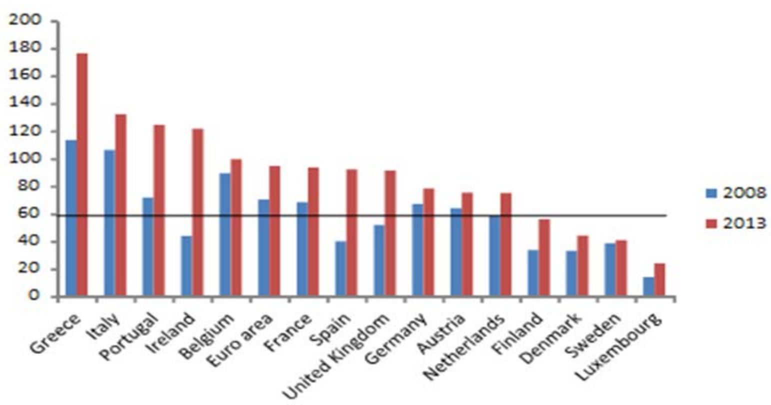
[3] *This chart is an updated version of that originally shown in DeGrauwe and Ji (2013)*

Figure 3: Change in Government debt to GDP ratio and austerity, 2009-13



Austerity is defined here as the % change in the structurally adjusted primary government budget from 2009-13.

Figure 4: Gross Government debt as % of GDP



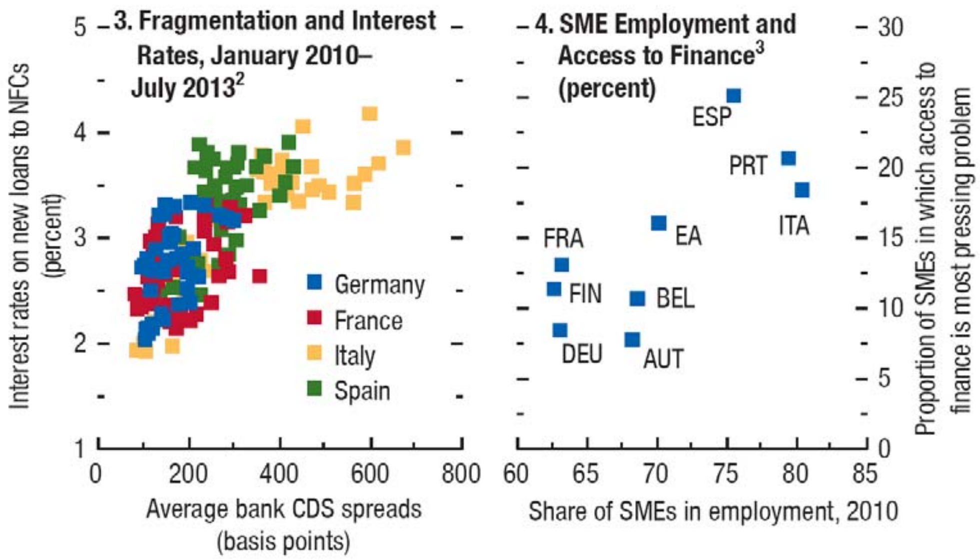
Source: OCED Economic Outlook, November 2013

2 Is the Euro area in a different position to the UK?

In a number of important ways the UK is in a different position to the high debt countries within the euro area. First, austerity in the Euro area has been much more severe than in the UK; especially for those countries forced into austerity by their inability to sell government bonds at reasonable interest rates.

Second, while the scope for stimulus from conventional monetary policy has been limited everywhere, in that all Central Bank interest rates are close to the zero lower bound, in the Euro area this is compounded by below target inflation, falling consumer prices in the worst hit countries and financial fragmentation showing up in continuing interest differentials and differential access to finance across countries (see Figure 5).

Figure 5: Financial factors holding back growth



Source: IMF World Economic Outlook (2013)

In the UK, quantitative easing has helped to keep bond yields low, both for government and corporate bond issuers. Most recently, communication around the Bank of England's 'forward guidance' has strengthened the message that they will maintain a low interest rate for some time to come and do not expect to unwind quantitative easing until after the interest rate has begun to return to more normal levels. In contrast, in the Euro area unconventional measures seem to have been less coherent and there have been episodes of considerable policy uncertainty.

Until the announcement in September 2012 that the ECB would 'do whatever it takes' via Outright Monetary Transactions, sovereign bond spreads played the role of a 'crisis barometer', reacting strongly to debt sustainability fears and in a self-fulfilling manner having dramatic consequences for the Euro area's weaker economies.

3 Do the ongoing reforms outlined in the "Four Presidents' Report"[4] address the right issues?

The Four Presidents' Report outlined three stages of proposed reforms. The first, now largely complete, aimed to address a number of weaknesses in the design, surveillance and enforcement of the EMU's fiscal rules, as expressed in the Stability and Growth Pact and before it, the Maastricht Treaty), and set out more predictable ways of dealing with countries in severe fiscal difficulties.

Even prior to the current crisis, fiscal monitoring across the Euro area was not an unqualified success. It was focused predominantly on assessing whether plans met the deficit rule, and paid too little attention

[4] *See Van Rompuy (2012): the "Four Presidents Report" was written by Herman Van Rompuy, President of the European Council in close collaboration with José Manuel Barroso, President of the European Commission, Jean-Claude Juncker, President of the Eurogroup and Mario Draghi, President of the European Central Bank.*

to debt to GDP ratios, possibly due to a misguided belief in the disciplining effect of financial markets in 'normal' times.

One factor that contributed to inadequate budgetary control was a widespread optimism bias in forecasts, particularly at the two and three year planning horizons.

By regularly promising more than was ultimately achieved in both projected budgetary adjustments and growth forecasts, countries in the Euro area effectively escaped the strictures of the deficit rule and evolving government debt took up the slack.

Amongst others, Frankel and Schreger (2013) have argued that there is clear potential for independent fiscal authorities to curb this tendency toward biased projections, improve ex post surveillance and facilitate more efficient early warnings. The Office of Budget Responsibility has been useful to the UK in this regard.

Once the more immediate problems in the Euro area are contained, these insights should improve fiscal governance going forward, and elements of the EMU reforms should help.

However, the restatement by the European Commission of the 60% reference value for the gross debt to GDP ratio[5] is in my view disappointing. Restoring debt sustainability is important and there is undeniably a need for 'fiscal space' to deal with the next set of challenges including the fiscal consequences of aging populations. However, from where we are now, stabilising debt to GDP ratios would seem to be a more sensible primary objective. If applied to all Euro area countries, this could allow for some limited stimulus in countries that have already achieved a stable debt to GDP ratio (eg Germany) with the possibility of positive spillover effects aiding a more widespread Euro area recovery.

However, lack of debt control prior to the crisis was only part of the problem. The crisis exposed other flaws in EMU. A wider list of shortcomings would include the following:

- The lack of a financial dimension to macroeconomic stability (a flaw shared with the UK, US and others);
- The lack of clear crisis resolution mechanisms;
- Slow progress with structural reforms; and
- The fact that EMU does not look to be an Optimal Currency Area and may not develop into one[6].

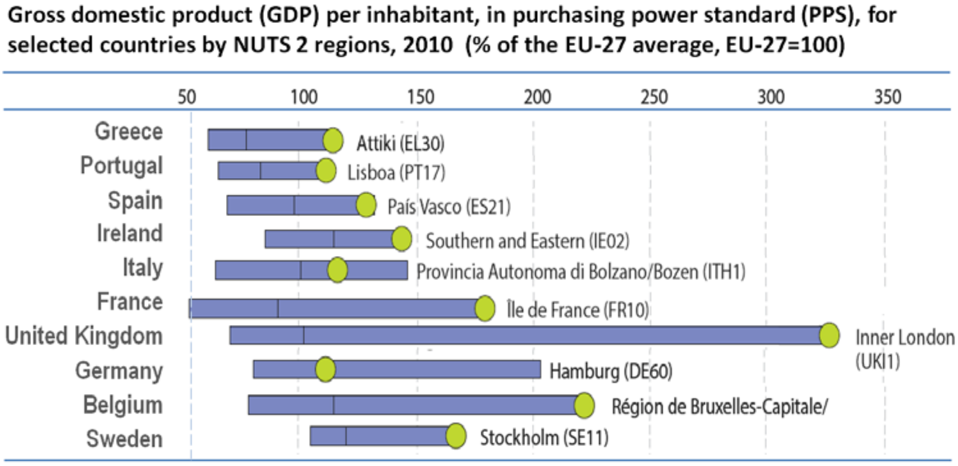
In particular, it seems clear that the less resilient countries have insufficient flexibility to handle large negative shocks and/or growing divergence.

Some of the reforms planned reforms discussed in the "Four Presidents' Report" will help. Steps toward a Banking Union aim to break the vicious circle between banks and sovereigns, allowing banks to improve the functioning of financial markets. But this requires agreements on Euro area wide regulation, supervision, and clarification on resolution mechanisms.

[5] The restatement of the 60% reference value for the gross debt to GDP ratio is part of the 'six pack' of fiscal reforms that entered into force at the end of 2011, and referred to in the Four President's Report. A brief gujde is provided in European Commission (2012).
[6] For a recent discussion on this point see De Grauwe (2013).

Reaching agreement on the third stage of the proposed reforms is likely to be even harder to achieve. This stage is intended to involve "establishing a well-defined and limited fiscal capacity to improve the absorption of country-specific economic shocks, through an insurance system set up at central level" Van Rompuy (2012 p5). The feasibility of a system that would involve transfers from countries that temporarily experience 'good' economic times to countries that are simultaneously experiencing 'bad' times, where transfers do not always go in the same directions is threatened by the current and growing divergence, and restatement of the Euro area wide 60% debt to GDP ratio objective does not help. Hence, it is possible that some element of debt forgiveness may still be necessary.

Figure 6: Regional disparities within selected EU countries



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The figure shows the range of the highest to lowest region for each country; the black vertical line is the average (mean); the green circular marker is the capital city . The name of the region with the highest value is also included. Source: Eurostat Yearbook 2013

4 Regional disparities within countries

The aggregate European country data hides disparities across regions *within* countries, and in this regard the UK is certainly not immune. Figure 6 compares GDP per inhabitant within and across selected EU countries. The bars show (i) the range of the highest to the lowest region for each country; (ii) the green dot represents the GDP per inhabitant in the capital region; and (iii) the vertical line shows mean GDP income. In fact, the largest disparity between regions within each country in the EU is in the UK, where the dominant position of Inner London is clear.

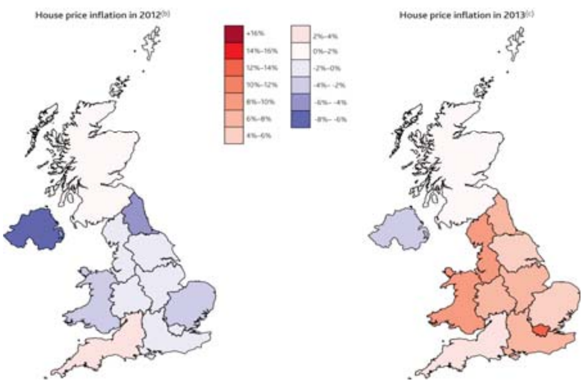
Looking at the reported growth in GVA for each UK NUTS1 region over the period 2007-2012 using the ONS's December 2013 release of regional indicators shows that London's nominal GVA grew by 15% in the five year period 2007-2012, while for the UK as a whole, nominal GVA grew by 8.5%. Only London and the South-East of England achieved growth in nominal GVA that was above the UK average over this period, albeit still at a far lower annualised growth rate than had been achieved in the decade prior to 2007. London had increased its share of UK GVA to 22.8% by 2012.[7] As the UK's recovery is progressing, disparities between the best and worst performing regions look to have increased.

Table 2: Regional GVA growth and shares in UK GVA

%	Growth in nominal GVA 2007-12	Average annual growth rate in nominal GVA 2007-2012	Average annual growth rate in nominal GVA 1997-2007	Region's share of UK GVA in 2007	Region's share of UK GVA in 2012
London	15.4	2.9	6.2	21.0	22.4
South East	11.3	2.2	5.2	14.3	13.5
East of England	6.7	1.6	5.1	3.1	2.9
East Midlands	7.0	1.6	5.3	8.5	8.0
South West	6.8	1.3	4.8	5.9	5.4
North West	6.8	1.3	5.4	7.5	7.0
North East	6.7	1.3	5.2	9.6	9.0
Scotland	6.7	1.3	5.1	3.1	2.9
Wales	6.6	1.3	5.0	7.8	7.5
West Midlands	6.2	1.2	5.1	3.5	3.2
Yorkshire/Humber	5.4	1.1	4.4	7.3	6.8
Northern Ireland	-1.0	-0.2	5.0	2.3	2.1
United Kingdom	8.5	1.6	5.4	100	100

Note: Figures are for NUTS 1 regions. Nominal growth rates were calculated from the published series for Workplace based GVA at current basic prices. Source: ONS Regional Economic Indicators December 2013 Release http://www.ons.gov.uk/ons/rel/regional-accounts/regional-gross-value-added--income-approach-/december-2013/rft-nuts1.xls

Figure 7: Annual house price inflation in 2012 and 2013 across the United Kingdom[a]



Sources: Halifax, Nationwide and Bank calculations. (a) The stylised maps show the average of the Nationwide and Halifax regional house price series (b) The 2012 map shows house price inflation between 2011 Q4 and 2012 Q4.(c) The 2013 map shows house price inflation between 2012 Q4 and 2013 Q3, scaled to an annual rate.Source: Bank of England: Financial Stability Report, November 2013 (Chart 2.17)

[7] *The quoted figures are constructed from the published workplace-based UK regional GVA series. Commuting means that London's share in UK GVA is increased, and the south-east figure reduced relative to residence based figures. Nonetheless, London has both the highest residence-based and workplace-based GVA across the UK's NUTS1 regions.*

Recent data also shows marked regional disparities in the increase in house price inflation over 2012 and 2013 indicating a UK growth trajectory that is regionally unbalanced.

5 How can macroeconomic policy address these regional imbalances?

The new governor of the Bank of England has been clear that the Bank is mindful of the risks posed by sustained loose monetary policy. The Bank's Inflation reports, Financial Stability reports, minutes and briefings make clear that developments are being monitored and a macro-prudential policy toolbox[8] is now available to the Financial Policy Committee, to enable it to manage these risks. The aim is that this will allow the Monetary Policy Committee to focus its efforts on establishing the conditions for a sustained recovery, while maintaining price stability.

A key question is will this aim be achieved, and in a more balanced way across regions? Well, it looks like we may soon find out!

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[8] The contents of the macro-prudential policy toolbox include imposition of capital requirements which are intended to enhance the resilience of lenders' balance sheets; a possible counter-cyclical capital buffer; the potential to set limits on loan to value or loan to income ratios of mortgages; the possible introduction of compulsory stress tests of mortgage applicant's repayment abilities; and recommendations that the Financial Stability Committee may make to HM Treasury in relation to the Help to Buy scheme. For further details see Bank of England Financial Stability Report, November 2013, especially Table 5.A, page 64.