Capital Shocks and UK Regional Divergence

This paper uses uniquely-detailed large-scale commercial real estate investment data to examine how financial markets perceived the attractiveness of investing in UK regions during the last two decades. **It helps to provide a new explanation as to why UK regional productivity gaps have accelerated in recent years.**

The sudden and dramatic regime change in capital markets associated with the 2008 global financial crisis profoundly altered investors' sentiments from viewing all UK regions pre-crisis as being little different from each other in terms of their investment attractiveness, to a post-crisis reality where London was perceived of as providing a fundamentally different financial and investment offering to the rest of the UK.

How investors favoured London

Our analysis demonstrates that prior to 2008, all regions of the UK were perceived in a similar manner in terms of risks and expected growth rates.

However, the financial crisis engendered a flight to safety of capital into London, largely at the expense of other UK regions. The London economy enjoyed a surge of capital inflows at very low prices, also enhancing the collateral and leveraging positions of local real estate owners.

This contributes to a thinking by investors that whatever the circumstances, the performance of the London's economy will be prioritised and protected by the UK state.

How the rest of the UK fell behind

Considering what Ben Bernanke in his 2022 Nobel Prize lecture calls the 'External Finance Premium', namely the difference between official central bank discount rates and the risk-pricing that capital markets afford investments, in the wake of the 2008 global financial crisis the UK partitioned geographically into two very different capital pricing regimes.

The post-2008 crisis recovery of investors' confidence in London's recovery was rapid. London risk-pricing closely followed the downward risk-trajectory of quantitative easing.

In marked contrast, other UK regions shifted rapidly into junk bond territory, and have remained there ever since. Quantitative easing appears to have had no effect on the risk-pricing perceptions of capital markets on other UK regions.

These asymmetric capital shocks led to profound and adverse impacts on the subsequent productivity growth and population growth of the other UK regional economies.

As far as we are aware, these asymmetric regional capital market shocks have never before been documented. They provide a powerful new demand-side explanation as to why UK regional productivity disparities have increased in recent years.

How the analysis was undertaken

The researchers used detailed real estate investment data to examine the investment attractiveness of regions, from the perspective of investors, who continuously evaluate local growth opportunities in the context of broader financial markets. Large scale commercial real estate investments are typically long term and funded by multiple money market channels. The dataset used consisted of 7,465 transactions of commercial properties, including offices, retail and industrial property, across the UK from January 2003 to July 2015. The researchers then built an analytical and empirical framework and models around the CAPM Capital Asset Pricing Model to examine in detail the risk-related features of the UK urban system and how the risk-related features played out with respect to the different UK regions and cities both before and after the 2008 global financial crisis.

To read more about the research synthesised in this Executive Summary, please read The Productivity Institute Working Paper 035 *Capital Shocks and UK Regional Divergence* by Michiel Daams, Philip McCann, Paolo Veneri and Richard Barkham.