

RECESSION BRITAIN

Findings from economic and social research

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BRITAIN

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Foreword

The financial market collapse and the ensuing global recession have created an urgent need for research and knowledge – about financial markets, public intervention, unemployment, poverty and much more. Social scientists will be expected to examine the causes of the crisis, the resulting economic and social distress, and potential solutions.

This is a challenging research agenda, but we are certainly not starting from scratch. Researchers in the social sciences have thought a great deal about past recessions and it is very valuable to look back – to see what happened, what policy lessons can be learned, and how we might avoid some of the worst outcomes of the past, for example generations of young people becoming permanently detached from the labour market.

We can also think about issues like happiness and wellbeing (which were not really on the research radar in the last recession but have attracted considerable attention in recent years) as well as big global questions, such as the 'environmental crisis' and the impact of recession on the world's poorest countries.

This report provides a broad overview of findings from economic and social research on recession Britain, its causes, consequences and policy responses. It aims to be a short statement of 'what we know' as well as an indication of 'what we need to know'. For that future research agenda is of the utmost importance: as we emerge from the downturn, top-quality social science must remain a priority to help ensure the future prosperity of the nation.

**Professor Ian Diamond FBA AcSS, Chief Executive,
Economic and Social Research Council**

Introduction and summary

Britain has now been in recession for over a year. Why has it happened now after more than a decade and a half of steady growth? When is the economy likely to turn around and recovery begin? How can policymakers respond most effectively, on a global scale as well as nationally? And what are the effects – both now and in the future – on jobs, on businesses and on people's lives?

This report explores what can be learned from evidence on previous recessions: the three that Britain has experienced most recently – in the mid-1970s, the early 1980s and the early 1990s – as well as recessions elsewhere in the world, and the global recessionary period to which current times have often been compared, the 1930s.

The report draws on analysis of a broad range of data sources and the work of numerous researchers and research institutions, many of them centres, programmes and individual scholars funded by the Economic and Social Research Council (ESRC). It also refers to some of the findings presented at a series of policy seminars and public discussion meetings on the recession, which the ESRC has hosted around the country during the first half of 2009.

It is tempting to use the experiences of previous recessions as a guide to the likely impact of the current recession. But given the severity of this recession – and its origins and continued problems in financial markets – the past may not necessarily be the best guide to the future. While research can reveal the 'average' impact of previous recessions on people's jobs, businesses and daily lives, it is as valuable to explore differences between those experiences as to examine the similarities.

FORTY FINDINGS

from economic and social research



BRITAIN IN RECESSION

■ The extent of the downturn

In June 2009, the British economy was around 5.5 per cent below its peak in the first quarter of 2008, when the recession began. National income per head is predicted to take until March 2014 to return to its level in March 2008.

■ Uncertainty and investment

The financial crisis has increased uncertainty in the 'real economy', and higher uncertainty has led firms to postpone making investment and hiring decisions. The longer firms wait, the more economic activity will slow down.

■ House prices

Prices may fall for three more years. With fewer houses on the market, potential buyers know that it will be harder to find a house that matches their tastes or needs – so more buyers drop out of the market, leading to further declines in prices.

■ The impact on spending

By reducing household wealth and thereby reducing consumer spending, falling house prices can sustain an economic downturn. Reduced household wealth also makes it harder for entrepreneurs to finance new businesses.

■ Public spending cuts

The financial crisis and the recession have made real cuts in some areas of spending on public services inevitable. Britain's 1920s experience of the 'Geddes Axe' offers a model of how to put public spending growth into reverse.

THE IMPACT ON JOBS

■ Unemployment

The full impact of a recession may not feed through to job losses until several quarters after the recession officially begins. In the 1980s and 1990s, it was five years after the recession began before unemployment fell to its pre-recession levels.

■ Regional disparities

The south was unusually hard hit in the early 1990s recession, which suggests that it is very capable of bouncing back even if it is worst hit this time. There is unlikely to be a fundamental long-run shift in Britain's economic geography.

■ Labour market losers

Lay-offs in financial services notwithstanding, it is low-educated, low-skilled workers whose employment prospects have suffered most as the recession gets worse. This has not been the 'middle-class recession' that many people predicted.

■ Longer-term damage

After the early 1990s recession, there were severe longer-term consequences for many workers who lost their jobs. The experience of unemployment can damage people's chances of keeping a job once they find one.

■ Older workers

Past recessions suggest that employment among older workers may be particularly sensitive to the economic cycle. But the situation now is very different: access to early retirement benefits or disability benefits is much more restricted.

■ Youth unemployment

Just as in previous recessions, younger workers are being particularly hard hit by this recession. Unemployment is most volatile for 18-24 year old workers, whose unemployment level has grown at a rapidly accelerating rate.

■ The threat of ‘scarring’

The early 1980s recession had a lasting adverse effect on the employment prospects of low-skilled young people aged 16-18 in 1981. Higher-skilled individuals of this generation stayed out of the labour market to develop skills.

■ Job guarantee

Policy interventions – like the Job Guarantee – designed to reduce the exposure of young adults to substantive periods of unemployment could, if successful, have substantial returns in terms of the individual's lifetime earnings.

■ School-leavers

In previous recessions, many young people who left school with few or no qualifications ended up shuttling between labour market programmes, inactivity and unemployment, accumulating long spells of stigmatising joblessness.

■ Staying in school

Rising unemployment may help the government to meet targets in terms of increasing the number of young people staying on in education. The extension of the legal minimum school leaving age to 17 will enhance these efforts.

■ Graduate unemployment

There is a risk of lifetime earning losses for the generation of graduates joining the labour market in the recession. The situation may be worsened by the increased supply of graduates and lower returns to a degree for some graduates.

THE IMPACT ON PEOPLE'S LIVES

■ Incomes

Average household incomes fell in real terms during each of the past three recessions, with falls continuing after the recessions ended as unemployment continued to rise. The incomes of the less educated fell the most.

■ Living standards

Families dependent on wages and salaries – working-age adults without children and couples with children – are more affected by recessions than people dependent on fixed incomes or benefits – pensioners and lone parents.

■ Reduced benefits

Compared with previous recessions, a sharp rise in unemployment may have a bigger impact on the relative living standards of those losing their jobs. Unemployment benefits have fallen relative to average incomes for the past 20 years.

■ Unemployment and divorce

People who lose their job in Britain increase the chances that they will lose their partner. A woman losing her job is increasingly likely to lead to partnership dissolution the longer the partnership has lasted.

■ Falling house prices and family life

Unexpected downturns in the housing market can damage family stability. Price falls are particularly destabilising for the relationships of young couples with low family income, high mortgage debt and dependent children.

■ Unemployment and health

Unemployment increases the risk of psychological disorders such as depression. Secure employment among healthy adult men and women of all ages greatly reduces the risk of developing a work-limiting illness.

■ Longer-term effects

Young men from advantaged backgrounds, who did well at school but who were unemployed for a year or more in the 1980s recession, were much less likely to be high earners, in a professional job or own their homes by 1991.

■ Job loss and happiness

One fifth of the steep decline in happiness that people experience when they lose their job is because of the fall in income. But the rest comes from something different – perhaps loss of status, self-esteem or social networks.

■ Housing and health

Housing repossession (but not evictions) and unsustainable housing commitments, which are likely to be greater in a recession, significantly increase the risk of common mental illness and reduced wellbeing.

■ Social attitudes on housing

As of the summer of 2008, people's certainty in the advantages of home ownership had been shaken, but it had not dented their faith in home ownership being the ideal arrangement. Perceptions may be more negative now.

■ Social attitudes on public finances

In 2007, for the first time since the mid-1980s, the level of support for more taxation and spending dropped below the level of support for keeping taxation and spending the same. It remained at a similar level in 2008.

THE IMPACT ON BUSINESS

Productivity

Productivity tends to fall in the early stages of a recession but rebounds as weaker firms close. In the early 1990s, the dispersion of productivity across all firms fell because the lower tail of poorly performing firms was reduced in size.

Shedding workers

Employment is falling much faster than output in the US recession. This may be because information technology and aggressive management practices are allowing firms to cut workers and introduce new practices that keep output high.

Profitability

Performance differences between firms tend to increase significantly in recessions. While the average profitability across firms follows the path of the business cycle, the variation in profitability across firms rises sharply in a downturn.

Returning to growth

Firms cannot cut their way out of the recession but must grow their way out. Since growth will not come by competing on cost, it is essential to move up the 'value chain', offering ever more valuable products and services.

Innovation

Firms that have innovated at some point in the past are better able to flourish in a recession, perhaps because of better management practices. Bad 'shocks' can actually stimulate firms to innovate, especially making organisational innovations.

Small businesses

Despite the severity of the current recession, a higher proportion of firms expect to expand in the coming years than in 1991. Fast-growth and innovative firms are especially resilient: over two thirds expect to expand in the next three years.

Competition policy

Recessions have provided opportunities for anti-competitive mergers to concentrate markets unnecessarily. Suspension of competition policy in the United States in the 1930s may have extended the Great Depression for seven years.

Charitable giving

The proportion of individual income given to charity is likely to remain generally constant, as it did during the Great Depression. In Britain's 1980s recession, there was no obvious effect on the average amount of household donations.

WORLD IN RECESSION

Trade

There is a danger that countries will respond to the decline in trade with protectionist policy measures, for example, the 'Buy in America' provisions associated with the US fiscal stimulus. This could lead to a protectionist spiral as in the 1930s.

Migration

History and recent experience suggest that every 100 jobs lost in a high-immigration country result in ten fewer immigrants. History also reveals rising anti-immigrant sentiment in a global recession: this is evident in Britain today.

Aid

Developing countries may suffer from reduced aid budgets in developed countries as they face recession and retrenchment of public finances. Between 1975 and 2005, per capita aid in Africa was higher during good times and lower during bad times.

Climate change

An environmental tax reform could shift taxes from wages to pollution in a 'revenue-neutral' way, which would be good for jobs and bad for pollution – an ideal policy to boost employment without extra borrowing, 'saving the economy and the planet'.

Financial markets

Current regulatory systems assume that regulations that make individual banks safe also make the whole system safe. 'Micro-prudential' (bank-level) regulation and 'macro-prudential' (system-wide) regulation must be co-ordinated.

BRITAIN IN RECESSION



1

The recessionary impact of the financial crisis

The housing market

Why economies may be slow to come out of recession

Monetary and fiscal policy responses

Cutting public spending

The British economy was officially declared to be in a recession in January 2009, when the Office for National Statistics (ONS) announced that the preliminary estimate of gross domestic product (GDP) – a standard measure of the total value of a country's output of goods and services – showed a fall of 1.5 per cent in the last three months of 2008 after a 0.6 per cent drop in the previous quarter:

These figures indicated that the widely accepted definition of a recession – two consecutive quarters of 'negative economic growth' (contraction of the economy) – had been met. They represented the biggest quarter-on-quarter decline since 1980, and the first time the economy had been in recession since 1991.

ONS figures show that GDP fell by 2.4 per cent in the first quarter of 2009 compared with the last quarter of 2008, the sharpest contraction of output since the second quarter of 1958. GDP fell by a further 0.7 per cent in the second quarter of 2009, leaving the level of GDP 5.5 per cent lower than in the second quarter of 2008, the largest annual fall on record.

Previously the biggest drop in Britain's national output in a 12-month period was 4.1 per cent, recorded in the last quarter of 1980. In comparison, the worst fall in the 1990s recession was 2.2 per cent, recorded in the second quarter of 1991.

The National Institute of Economic and Social Research (NIESR), which uses monthly ONS data for industrial production, manufacturing output and retail sales to provide GDP estimates for any three-month period (Mitchell et al, 2005), calculates that GDP first stopped growing in March 2008.

NIESR's July estimates suggest that GDP fell by 0.4 per cent in the three months ending in June 2009, after a decline of 1.3 per cent in the three months ending in May. In their view, the economy is now stagnating rather than continuing to contract at a sharp pace.

According to NIESR's estimates, in the three months to June 2009, the British economy was around 5.5 per cent below its peak in March 2008 – see Figure 1 below, which compares this period of 'depression' with Britain's experiences of economic contraction in the early 1930s, the early 1980s and the early 1990s.

In its April 2009 budget, the government forecast that the economy would shrink by 3.5 per cent in 2009, which would be the biggest fall in national output since 1945. But growth is expected to return in 2010, with the economy predicted to expand by 1.25 per cent.

Other forecasters are less confident. The average of independent forecasts suggests a contraction in 2009 of 3.7 per cent. And in late June, the Organisation for Economic Co-operation and Development (OECD) described Britain as being in 'a sharp recession' with output set to contract by 4.3 per cent in 2009 (worse than its previous forecast of a 3.7 per cent fall) and with zero growth in 2010. In September, the OECD revised its forecast contraction for Britain in 2009 to 4.7 per cent.

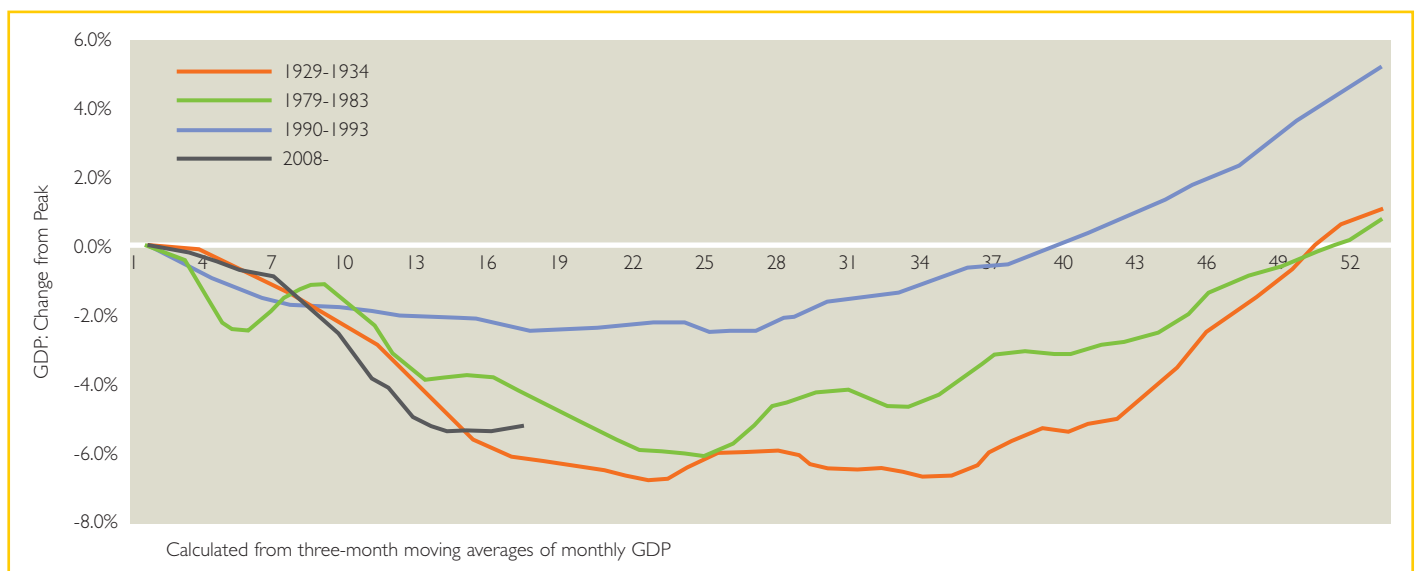
NIESR's quarterly forecast published in late July sees GDP falling 4.3 per cent in 2009 before growing one per cent in 2010 and 1.8 per cent in 2011. But GDP per head is predicted to take until March 2014 to return to its level in the first quarter of 2008, when the recession began.

The view that the recovery in output will be slow is widely shared among economists in both Britain and the United States. The expectation is of a 'tick-shaped' recovery: a short, rapid rebound, but then a much slower haul for most of the rest of the recovery. This is because of the need to work off the excesses in the financial markets and the housing markets out of which the crisis and the recession emerged.

THE RECESSIONARY IMPACT OF THE FINANCIAL CRISIS

The recession in Britain and across the world was a direct result of the credit crunch that began in August 2007 and which worsened dramatically into a global financial crisis in the autumn of 2008. As elsewhere in the world, notably in the United States, the central problem was Britain's banks, which had invested their reserves in assets that turned out to be unsafe, illiquid or even worthless.

Figure 1: The profile of the depression: months from the start of the depression



As this problem became apparent and was compounded by domestic and foreign holders of capital withdrawing their deposits, the banks had to cut back their loans. They continue to do so.

Nick Bloom of Stanford University and the ESRC Centre for Economic Performance (CEP), who in the spring of 2008 forecast that the credit crunch would lead to an economic slowdown much worse than was then anticipated, explains the recessionary impact of the financial crisis in terms of what it does to levels of uncertainty. Fears about the extent of financial damage, the identities of the next banking casualties and the unpredictability of the policy response all led to tremendous stock market instability.

As a result, a standard measure of uncertainty – the ‘implied volatility’ of the S&P100 of the US stock market, commonly known as the index of ‘financial fear’ – increased six-fold between the first emergence of the US ‘subprime’ crisis in August 2007 and October 2008, not long after the collapse of Lehman Brothers and at the height of the financial crisis. Indeed, the index reached levels far higher than after the 9/11 terrorist attacks, the Gulf wars, the Asian crisis of 1997 and the Russian default of 1998.

So why is this rise in uncertainty so damaging for the ‘real economy’? First, the lack of credit strangles firms’ abilities to make investments, hire workers and start new innovation projects. Second, for the lucky few firms with access to credit, the heightened uncertainty leads them to postpone making investment and hiring decisions. It is expensive to make a hiring or investment mistake – so if conditions are unpredictable, the best course of action is often to wait (Bloom, 2009).

If every firm in the economy waits, then economic activity slows down. This directly cuts back on investment and employment, two of the main drivers of growth. Uncertainty among firms in Britain is evident in ONS data published in August, which show business investment suffering its worst fall in 24 years. Capital spending dropped by 10 per cent in the second quarter of 2009, which left investment 18 per cent down from a year previously, the worst performance since records began in 1967.

Similarly damaging effects happen on the consumers’ side: when uncertainty is high, people avoid buying consumer durables like cars, fridges and TVs. The housing market is also hit hard since uncertainty makes people cautious about buying a bigger house.

THE VIEW THAT THE RECOVERY IN OUTPUT WILL BE SLOW IS WIDELY SHARED AMONG ECONOMISTS IN BOTH BRITAIN AND THE UNITED STATES

THE HOUSING MARKET

In a sense, the housing market is the epicentre of the crisis. Financial turmoil was initially triggered in the United States in mid-2007 by the rise in defaults by so-called ‘subprime’ mortgage borrowers – house buyers whose income and job prospects were relatively poor. Their mortgages – totalling over one trillion dollars – had been bundled together and sold as ‘mortgage-backed securities’, offering the promise of safe, high returns to British banks and many other institutions around the world.

When US housing markets turned down, there were lots of simultaneous defaults (over a million foreclosures within a year) and the market value of the mortgage-backed securities collapsed. This was followed by the implosion of the global market for the complex financial instruments that banks and other investors had devised to slice up and resell mortgage-backed securities and to hedge against risks.

In the latter half of 2007 and into 2008, more and more banks found that securities they thought were safe were ‘toxic assets’. At the same time, the rising number of foreclosures helped speed the fall in house prices, and the number of prime mortgages in default began to increase. While housing prices kept falling, banks’ balance sheets kept deteriorating, leading to further fears of bank insolvency, further reductions in available credit and so on.

As in the United States, house prices in Britain have fallen a long way from their peak. CEP research suggests one reason why prices may keep falling for a while longer. As prices decline, more potential sellers take their houses off the market. With fewer houses on the market, potential buyers know that it will be harder to find a house that matches their tastes or needs, so more buyers drop out of the market, leading to further declines in prices (Ngai and Tenreyro, 2009). NIESR’s July forecast suggests that house prices in Britain will keep falling for another three years.

By reducing household wealth and thereby reducing consumer spending, falling house prices can cause or sustain an economic downturn. Estimates of this ‘housing wealth effect’, published by



John Muellbauer of Nuffield College, Oxford, in the summer of 2008, indicated that a recession in Britain would be hard to avoid (Muellbauer, 2008). With the housing wealth decline compounded by falling share prices and inflation-eroded real incomes, he forecast the drop in consumption that has since emerged – a fall of 3.7 per cent in 2009 and 1.1 per cent in 2010, according to NIESR's forecast.

WHY ECONOMIES MAY BE SLOW TO COME OUT OF RECESSION

An alternative definition of a recession is a period when the economy is growing at below its long-term trend rate of growth – which for Britain over the past 25 years is between 2.5 per cent and three per cent a year – and where there is 'spare capacity'. In such a situation, people have unsatisfied wants and there are workers who would be willing to satisfy those wants – and yet these workers cannot find employment.

How can that be? A classical, but controversial, explanation is that wages and prices are 'sticky' or slow to respond to changes in economic circumstances. If only wages and prices could fall, then firms would be willing to hire the extra workers and consumers would be willing to consume the extra goods.

But some economists do not believe that prices and wages are sticky. For example some have argued that when sales are included in the analysis, prices are not sticky at all. Work by CEP researchers responds to this criticism by showing that even if sales make prices flexible at the level of individual sale points, the average price across sale points remains sticky (Guimaraes and Sheedy, 2008).

Others have argued that even though wages seem sticky over time, there are theoretical arguments to suggest that this rigidity is only apparent and cannot be a source of unemployment and recessions. One strand of CEP research demonstrates empirically that wage rigidity is important (Olivei and Tenreyro, 2007, 2008). But another strand of CEP work lends some support to the sceptics' argument, showing that wages of newly hired workers tend to be considerably more flexible than those of existing workers (Pissarides, 2007).

MONETARY AND FISCAL POLICY RESPONSES

Central banks around the world have responded to the financial crisis and the recession by cutting interest rates to unprecedentedly low levels. Between October 2008 and March 2009, the Bank of England reduced the base rate from five per cent to 0.5 per cent the lowest since the central bank was founded in 1694. It has also embarked on a programme of 'quantitative easing' – buying assets, mainly government bonds, and creating the money to do so – to boost the money supply and help companies to borrow.

But in a deep recession, movements of short-term interest rates – the key tool of macroeconomic management for at least the last two decades – may not work, particularly once they get close to the 'zero bound' of nought per cent. This was one of the revolutionary insights of John Maynard Keynes' book *The General Theory of Employment, Interest and Money*, published in 1936: sometimes cutting interest rates will not persuade the private sector to spend more, and the government must step into the breach with 'fiscal stimulus' – higher public spending or lower taxes. Part of this support for the economy comes without any active government intervention via the 'automatic stabilisers' – a recession naturally reduces tax revenues and increases the total amount spent on benefits, health and pensions. Part comes through 'discretionary' fiscal policy. For example, in the pre-budget report of November 2008, the government announced that it was temporarily reducing the rate of value added tax (VAT) from 17.5 per cent to 15 per cent with effect from 1 December 2008 to 31 December 2009.

CENTRAL BANKS AROUND THE WORLD HAVE RESPONDED TO THE FINANCIAL CRISIS AND THE RECESSION BY CUTTING INTEREST RATES TO UNPRECEDENTEDLY LOW LEVELS

Analysis by the Institute for Fiscal Studies (IFS) suggests that the cut will boost consumer spending by 1.25 per cent over what it would otherwise be (Crossley et al, 2009). The researchers see this as a significant impact: "The 1.25 per cent fall in prices due to the cut in VAT reduces the price of spending today by more than a one per cent point cut in the interest rate. It is surprising that some commentators have labelled the former as 'small', while the latter would typically be considered a large cut."

CUTTING PUBLIC SPENDING

A fiscal stimulus may encourage private spending and promote economic recovery. But increasing public spending or cutting taxes can do more harm than good if they jeopardise the sustainability of the public finances. As is clear from the current political debate about future public spending, governments need a credible plan to set aside enough resources once the recession is over to repay the additional public debt their stimulus has added.

The government's April 2009 budget forecast that the tax burden this year will reach its lowest level since 1960/61 – just 35.1 per cent of GDP – and next year's public spending as a share of GDP

will equal its 1982/83 peak of 48.1 per cent. As a result, borrowing is forecast to be 12.4 per cent of GDP (£175 billion) this year and 11.9 per cent of GDP (£173 billion) next year – both levels that have not been seen since 1945.

The OECD says Britain's budget deficit will be even higher next year at 14 per cent of GDP. July data from the ONS show that total outstanding government debt in Britain had hit a record £799 billion or 56.6 per cent of GDP, the highest since records began in 1974.

A report from the ESRC's Public Services Programme (PSP) explores lessons from two earlier periods of restraint or cutbacks in public spending: the 'Geddes Axe' of the 1920s and the 1975-85 era, which included the 1976 loan from the International Monetary Fund (IMF) and subsequent measures to restrain public spending under both Labour and Conservative governments (Hood et al, 2009).

According to this research, the experience of the 1970s and 1980s offers a model of how to 'brake' the growth of public spending while the 1920s experience offers a model of how to put public spending growth into reverse. But in neither of these cases was health spending cut back, and checking or reversing this category of spending (currently 17 per cent of the total and rising by five per cent a year in real terms over the last decade) is a major challenge for policymakers dealing with public spending reductions today.

In both periods, 'normal' treasury processes of negotiating spending with departments were augmented by other institutional measures: in the 1920s by a special high-powered committee that effectively doubled the cuts made by the 'normal' processes; and in the 1970s by the conditions attached to the IMF loan, which served to change policy from a stance of spending stability and deferred tax rises to a stance of immediate spending cuts and tax increases.

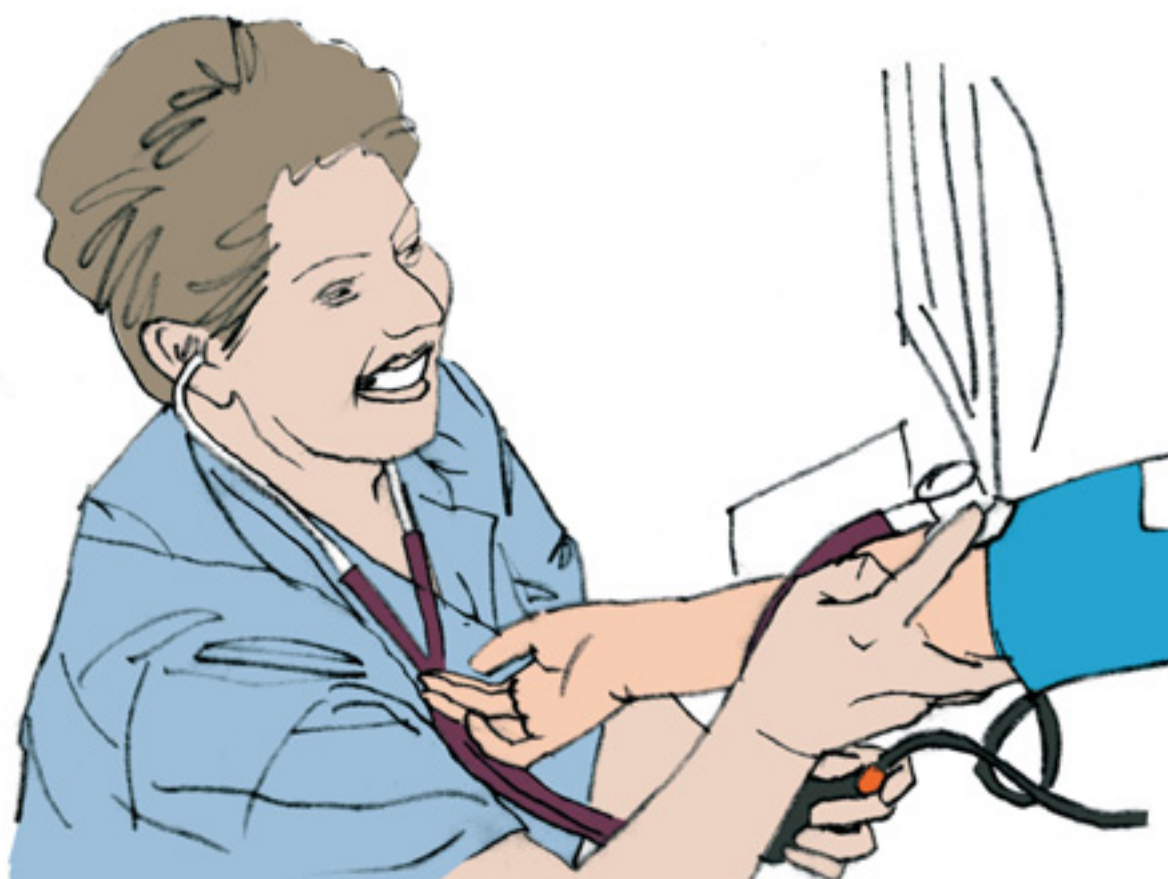
The government estimates that the financial crisis has permanently weakened the public finances by about 6.5 per cent of national income, or £90 billion a year. Its plan is to bring the public finances back on track over the eight years to 2017/18, starting after the probable date of the 2010 general election.

Half of the tightening is to come in the next parliament and comprises tax rises (covering about ten per cent of the total tightening), cuts in capital spending (about 15 per cent of the total) and so far unspecified cuts in departmental current spending, to amount to 25 per cent of the total. The remaining half is to come in the parliament after next and is to come from so far unspecified increases in tax or cuts in current spending.

Christopher Hood director of the PSP, co-author of the report and of an earlier study of spending cuts (Dunsire and Hood, 1989), concludes: "Even if that forecast proves any more robust than previous forecasts, and if it proves politically durable, it means the equivalent of one-quarter to one-half of the spending cuts imposed by the Geddes Axe 90 years ago, making real cuts in some areas of spending on public services inevitable."

A joint study by the IFS and the King's Fund points out that since both the government and the opposition have said they will protect public health budgets in coming years, this will mean cuts in other departments or tax rises. But even the most generous forecast for the National Health Service (NHS) is not enough to prevent it having to tighten its belt now (Appleby et al, 2009).

John Appleby of the King's Fund says: "The NHS is facing the most significant financial challenge in its history... The NHS has enjoyed unprecedented increases in funding since the turn of the century, but those days will soon be over. That's why it's crucial that the service does all it can over the next two years to prepare itself for the financial freeze that will take hold over the two coming spending review periods."



THE IMPACT ON JOBS



2

Regional disparities?

A 'middle-class' recession?

Older workers

Youth unemployment and the threat of 'scarring'

Strategies for tackling unemployment

Education and skills policy

Graduate employment prospects

REGIONAL DISPARITIES?

Job losses and a rising rate of unemployment are perhaps the most prominent features of an economy going into recession – see Figure 2 below, which shows that unemployment in Britain rose during each of the three previous recessions (in the mid-1970s, early 1980s and early 1990s) and was rising in 2008 as the current recession began. The largest rise in unemployment occurred during the early 1980s recession, with unemployment continuing to rise even after the recession had finished, not peaking until 1984.

It is worth noting that in all three previous cases, unemployment did not rise until the second year of the recession. And in both this recession and the 1991 recession (as well as in the early 2000s recession in the United States), output has fallen much less than employment. Employment is continuing to fall heavily now despite the fact that output is stabilising.

This is why unemployment is often described as a ‘lagging indicator’ of recession, and suggests that the full impact of a recession may not feed through to job losses until several quarters after the recession officially begins. The negative impact can last several years: Paul Gregg of the ESRC Centre for Market and Public Organisation (CMPO) notes that in both the 1980s and 1990s, it took five years after the recession began for unemployment to return to its pre-recession levels.

The August ONS figures show that the number of jobs fell by 271,000 in the three months to June 2009 (and by 573,000 over the year), the largest quarterly fall since modern records began in 1971. The employment rate for people of working age was 72.7 per cent for the three months to June 2009, down 0.9 from the previous quarter. Total employment now stands at just under 29 million people. Britain’s unemployment rate was 7.8 per cent for the three months to June 2009, up 0.7 percentage points over the previous quarter and from 5.4 per cent a year earlier. The number of unemployed people rose by 220,000 over the quarter (and by 750,000 over the year) to reach 2.43 million, the highest since 1995. And the number of people claiming unemployment benefits reached 1.58 million in July, the highest level since May 1997, just as the present government first took office.

The ONS data show that unemployment rates vary across regions. When unemployment was at its lowest, the rate ranged between a high of 6.6 per cent in London to a low of 3.7 per cent in the South West. By the end of 2008, the unemployment rate had risen in all regions, although there were significant differences in the amount it had increased. The North East had the largest increase of 2.6 percentage points to 8.4 per cent, while Scotland had the lowest increase of 0.3 percentage points to 5.1 per cent.

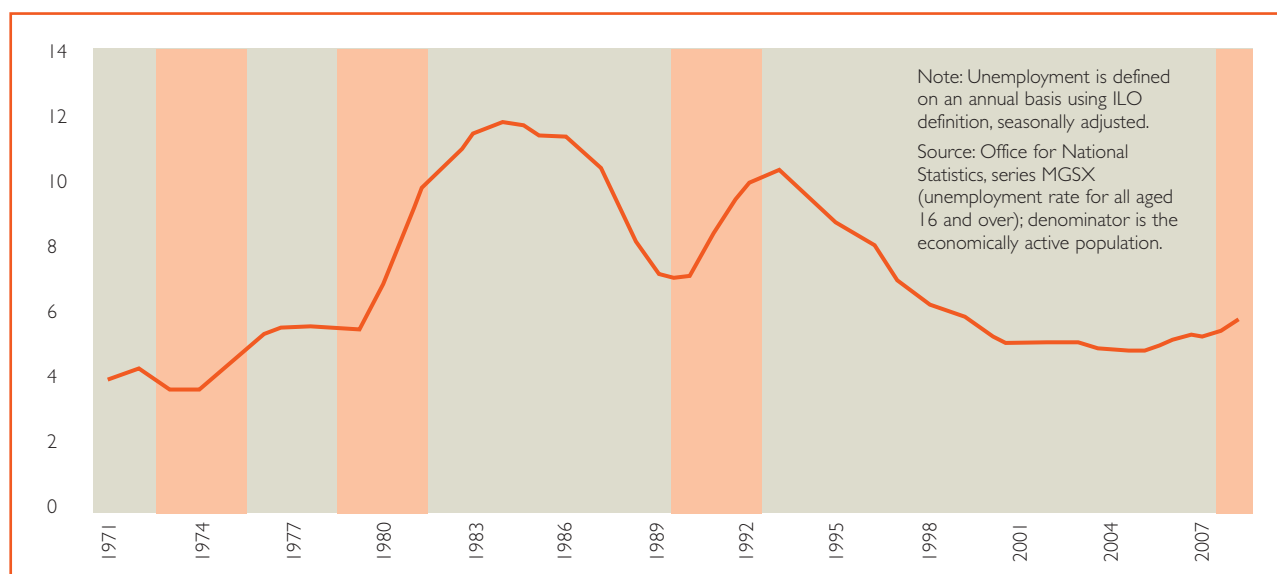
Differences in unemployment rates by local areas are even more marked. The lowest unemployment rate in Britain is in both the Orkney Islands and Aberdeenshire at 2.3 per cent. Within London, the highest unemployment rate is in Tower Hamlets at 11.3 per cent (also the highest rate in the country) and the lowest rate is in Richmond-upon-Thames at 3.7 per cent. The highest rate outside London is 10.4 per cent in Leicester.

Some commentators have argued that since recessions tend to spread the misery around, Britain’s ‘north-south divide’ may narrow in this recession, particularly with sectors over-represented in the south (such as financial services) especially hard hit. But is this likely to lead to a fundamental shift in the economic geography of the country?

Henry Overman director of the ESRC’s Spatial Economics Research Centre comments: “A higher proportion of those directly affected may indeed live in the south. But these kinds of changes still won’t be enough to eliminate the gap in income levels. You would then need the working of the economy to reinforce these initial changes. But theories of economic geography tell us that it can take very large shocks to alter existing geographical differences.”

There is some evidence that the south was unusually hard hit in the early 1990s recession, which suggests that the south is very capable of bouncing back from recession. So overall, a fundamental long-run shift in Britain’s economic geography is not impossible in response to the recession, but it is unlikely.

Figure 2: Rate of unemployment in the UK, % (recessions shaded in orange tint)



A 'MIDDLE-CLASS' RECESSION?

In the early stages of the recession, some commentators suggested that it might be a 'middle-class' or 'white-collar' recession, unlike anything seen in the past. Because the recession started in the financial sector (which also saw the first mass lay-offs), it was argued that university-educated workers would suffer more than their semi-skilled and manufacturing counterparts – in stark contrast to previous recessions, in which low-skilled, low-educated workers were hardest hit.

IFS research indicates that these predictions are not borne out by the data (Muriel and Sibieta, 2009). Low-skilled 'elementary' occupations (such as shelf-fillers and cleaners) and process, plant and machine operatives have suffered most since 2008 – with an increase in unemployment amounting to nearly five per cent of the workforce. Skilled trades (such as plumbers and motor mechanics) and sales occupations (such as shop assistants) have also suffered, with their unemployment rate rising by around four per cent.

In contrast, managers and senior officials have seen their unemployment increase by only one per cent, and 'white-collar' professional unemployment has increased by just 0.7 per cent. Bank lay-offs notwithstanding, the data suggest that it is the low-educated, low-skilled workers whose employment prospects have suffered most as the recession worsened.

A study of unemployment after the early 1990s recession (by the Institute for Social and Economic Research, ISER) suggests that there might be longer-term consequences for workers losing their jobs now. It finds that the experience of unemployment can damage people's chances of keeping a job once they find one.

Individuals who find work after being unemployed are four times more likely to be laid off and three times more likely to become unemployed than workers who enter a new job from another job.

The research finds that one in five workers re-enter unemployment within 12 months of starting a job, but fewer than half of the jobs that follow unemployment last for 12 months or more. There are two main causes of such short job tenure: those who have previously been unemployed are more likely to take up temporary jobs; and they are also more likely to be laid off (Boheim and Taylor, 2002).

More recent ISER research suggests that the substantial increase in the jobless during this recession will hit ethnic minority groups, young adults and those with poor educational qualifications hardest (Berthoud, 2009).

The study predicts that the proportion of Pakistanis and Bangladeshis out of work – already high at 47 per cent – will rise by nearly seven percentage points; the number of 20-24 year olds without jobs will soar by a quarter, compared with those aged 55-59 who will see a rate rise of just one in 25; and under-qualified people – already seriously disadvantaged – will see an increase of between four and five percentage points, compared with an increase of two percentage points for those with good qualifications.

ISER's Richard Berthoud comments: "These results are based on the assumption that the unemployment rate doubles in the current recession – which has already happened. Given that the rate peaked at more than 10 per cent in the recessions of 1983 and in 1993, a further substantial increase in joblessness may well take place before the tide turns. If so, all the outcomes will be worse than those predicted in this research."



OLDER WORKERS

The early 1980s and early 1990s recessions were associated with big falls in employment among older workers (Tanner, 1999). Firms found it cheaper to lay off older workers through early retirement onto occupational pension schemes, and disability benefits provided a route for those with no company pensions.

This trend has only recently been reversed; the good times before the current recession were particularly good for older workers. IFS research shows that employment among older workers has increased at a faster rate than among younger workers (Disney and Hawkes, 2003).

There is therefore evidence that employment among older workers may be particularly sensitive to the economic cycle. But the situation now is very different than in the early 1980s or early 1990s: firms do not have large surpluses in their pension funds to afford generous early retirement benefits, while eligibility for disability benefits is also being tightened. Older workers seeking to retire may also be hit by falling house prices and falling share prices.

YOUTH UNEMPLOYMENT AND THE THREAT OF 'SCARRING'

Many commentators have expressed a fear that younger workers will be particularly hard hit by this recession, just as they have been in previous recessions. This is because they are more likely to be

entering the labour force for the first time (having less experience than other workers and finding fewer vacancies) and more likely to be on temporary contracts (often the first to be cut by companies seeking to reduce costs).

The IFS research confirms that this fear is well founded: unemployment is most volatile for 18-24 year old workers, whose unemployment level grew at a rapidly accelerating rate over the course of 2008. In October 2008, their unemployment level was more than 2.5 percentage points higher than in October the previous year. For older workers (25-49 and 50-plus), unemployment was around one percentage point higher in October 2008 than a year earlier.

By July 2009, the unemployment rate among 18-24 year olds was 17.3 per cent compared with 11.9 per cent a year earlier. And the number of unemployed 16-24 year olds reached a 16-year high of 726,000, with those out of work for more than a year at 528,000, the highest level for 11 years. This raises concerns about the danger of these young people – sometimes described as NEETs ('not in education, employment or training') – being permanently 'scarred' by their bad first experiences of the labour market.

Scarring is a phenomenon that has been studied by Simon Burgess and colleagues at CMPO. One report looks at the impact of the early 1980s recession, when unemployment more than doubled from 5.8 per cent in 1979 to 13.1 per cent in 1984. For young people, the labour market was particularly bad, with unemployment of those under 18 years at 30.8 per cent in July 1981 (Burgess et al, 2003).

The research finds that high aggregate unemployment when a cohort is aged 16-18 has mixed effects on subsequent unemployment. For low-skilled individuals, there is a lasting adverse effect. In this sense, the 'class of '81' have continued to feel the impact of the deep recession that coincided with their entry into the labour market.



PEOPLE OUT OF WORK FOR LONG PERIODS BECOME STIGMATISED, DEPRESSED AND HARD TO PLACE

But for high- and mid-skilled individuals, there is a small fall in subsequent unemployment rates. The adverse economic climate may have encouraged these individuals to remain out of the labour market and take more, or more advanced, qualifications, thus making them more employable later. This might explain the boom in demand many sixth-form colleges and universities are now experiencing as young people seek to acquire more skills and delay entering the world of work.

A CMPO study by Paul Gregg and Emma Tominey examines the consequence of youth unemployment for wages up to 20 years later. They find that youth unemployment imposed a sizeable wage 'scar' (lower earnings) on both young men and women at age 23. This was followed by substantial recovery over the next ten years, but only if the individual avoided further spells of unemployment. A modest residual wage scar persisted up to 20 years later even for those who had no further experience of unemployment (Gregg and Tominey, 2004).

The evidence on scarring suggests that policy interventions to reduce the exposure of young adults to substantive periods of unemployment could, if successful, have substantial returns in terms of the individual's lifetime earnings and could represent a good investment. One such intervention is the Job Guarantee for the young unemployed, announced in the April 2009 budget, which will offer jobs or training of 25 hours a week and lasting six months.

CMPO's Paul Gregg and CEP's Richard Layard, who support the proposal, comment: "The greatest danger we face is the build-up of long-term unemployment. As we saw in the last two recessions, people out of work for long periods become stigmatised, depressed and hard to place. They become separated from the labour market. So, even when economic recovery comes, unemployment can remain unnecessarily high. The key is to prevent long-term unemployment in the first place."

An examination of the research evidence on the employment effects of active labour market policies suggests that they while provide a wage and alleviate hardship, some result in a 'lock-in' effect, in which temporary job creation actually leads to reduced job search and hence job finding. The Job Guarantee aims to avoid this outcome by building on the broadly successful New Deals for the unemployed, but with more focus on participants' continued job search and incentives for job providers (Gregg, 2009).



STRATEGIES FOR TACKLING UNEMPLOYMENT

In the aftermath of the Great Depression and the Second World War, the Keynesian consensus was that unemployment was essentially a problem of demand. Governments needed to get the level of aggregate demand right to maintain full employment through a mixture of monetary and, especially, fiscal policies. The appearance of 'stagflation' – growing inflation and unemployment – in the 1970s shattered this happy state of affairs.

Out of the crisis, the Conservative government that came to power in 1979 drew on Milton Friedman's work to emphasise the failure of demand management and the need to allow the market to let unemployment find its 'natural' level – the NAIRU or 'non-accelerating inflation rate of unemployment'. Printing money to boost demand led only to accelerating inflation.

A major strand of CEP research – eventually summarised in a textbook by Richard Layard, Stephen Nickell and Richard Jackman, first published in 1991 – agreed that there was a NAIRU. But rather than being something immutable, microeconomic 'supply-side' policies could be used to lower the NAIRU and thereby reduce unemployment. Simply cutting unemployment benefits was not the only way of achieving lower unemployment.

Until the financial crisis, the experience of nearly two decades had suggested that given sensible macroeconomic policies, it was possible to ensure that unemployment remains fairly close to the full employment level through active labour market policies.

Four strategies are particularly relevant, all likely to be tested in the current recession (Layard et al, 2005, 1991).

First, to prevent people drifting into long-term unemployment, there should be active policies to ensure that everyone gets offers of work or training within a year of becoming unemployed. The work should where possible be with regular employers, and secured if necessary by a recruitment subsidy. Hence the Job Guarantee.

Second, 'welfare-to-work' will not prevent long-term unemployment if individuals who receive offers from employers can instead choose to continue living on benefit. A system of complementary rights and responsibilities is needed where the citizen can expect high-quality help in finding work, but in return must take advantage of it or cease to draw benefits – 'conditionality' (Gregg, 2008).

Third, further policies are needed to deal with regional unemployment. And finally, policies that reduce labour supply, such as early retirement and uncontrolled access to invalidity pensions, should be phased out since 'welfare-to-work' policies make it possible to deal with redundancies without having to implement (high-cost) early retirement for older workers.

EDUCATION AND SKILLS POLICY

Education is always a central issue in public debate. It becomes even more important when the economy is in recession, unemployment is rising rapidly and disadvantaged members of society are in danger of becoming even worse off and perhaps permanently scarred by job loss or inability to join the labour market at all.

Raising the quantity and quality of skills is a key route to improving growth and increasing employment at the best of times. In a recession, it must become a central goal – not least for the benefit of young people in their final years of compulsory education who may be downhearted by the tough labour market. At the same time, they may be encouraged to stay on at school and perhaps go to university.

RAISING THE QUANTITY AND QUALITY OF SKILLS IS A KEY ROUTE TO IMPROVING GROWTH AND INCREASING EMPLOYMENT AT THE BEST OF TIMES

So what is the evidence on the potential role of education and skills policy in a recession? In relation to skills specifically, interventions to raise the skills of less able workers will continue to be an important component of any policy to combat unemployment. But not all interventions aimed at improving workers' skills are likely to be successful.

In previous recessions, many young people who left school with few or no qualifications ended up shuttling between labour market programmes, inactivity and unemployment, without finding regular employment and in the process accumulating long spells of stigmatising joblessness (Gregg and Wadsworth, 1998). Policy solutions to youth unemployment have generally focused on providing training programmes for the long-term unemployed.



GRADUATE EMPLOYMENT PROSPECTS

These have been relatively ineffective in the past, particularly in the United States (Friedlander et al, 1997). In Britain, the evidence on the effectiveness of youth training is mixed. The youth training schemes of the 1980s generated small positive employment effects but negative impacts on participants' pay and work-based training programmes seemed to crowd out or displace regular youth employment (Ryan, 2001).

The ineffectiveness of training interventions for the long-term unemployed and the high value of full-time education in the labour market suggest the importance of keeping young people in education rather than trying to 're-skill' them once they have become long-term unemployed. On this, there are grounds for optimism. Rising unemployment may help the government meet targets in terms of increasing the number of young people staying on in education.

Generally low unemployment rates draw young people into the labour market. Research that has modelled the relationship between economic conditions and education participation may prove useful to policymakers in terms of predicting education participation. The extension of the legal minimum school leaving age to 17 will enhance efforts to increase participation in full-time education (Clark, 2002).

The latest research on the impact of the youth labour market on enrolment in post-compulsory education analyses data for a panel of English regions, using variation in youth unemployment rates across regions and over time. The estimates suggest that the youth labour market has effects at least twice as large as previous estimates, which helps to explain why the growth of enrolment slowed down from the mid-1990s. It also suggests that the weakening youth labour market will cause enrolment to increase significantly again (Clark, 2009).

'Upskilling' will not always insulate people from a downturn, especially those entering the labour market for the first time. For example, in previous recessions, graduate unemployment has been a problem. There is certainly a risk that there will be lifetime earning losses for the generation of graduates who come on to the market in the middle of a downturn. The situation in this recession may be worsened by the fact that in recent years, the supply of graduates has increased dramatically and the returns to a degree appear to be falling for some new graduates (O'Leary and Sloane, 2005).

As demand for new graduates falls, particularly in financial services and related industries, graduate unemployment will rise and starting salaries for graduates will fall further. This may not, however, lead to falling participation in higher education if labour market prospects for new entrants to the labour market are dire and young people shelter from the downturn by remaining in higher education.

Not all graduates will be similarly affected by the recession. It is clear that the value of degrees varies hugely by subject, with quantitative degrees having greater value (Walker and Zhu, 2003; O'Leary and Sloane, 2004). Since the demand for these skills is relatively stronger going into the recession, it is likely that these graduates will be more protected from the downturn.



THE IMPACT ON PEOPLE'S LIVES



3

Living standards, inequality and poverty

Family life

Health

Happiness and mental health

Social attitudes towards the housing market

Social attitudes towards public spending and inequality

The current recession is the first that Britain has experienced since the early 1990s. Much has changed since then, and society's collective memory of who fared worst during previous recessions seems likely to have faded. So what is the evidence on the effects of lost jobs, lower incomes and falling house prices on people's everyday lives – their standards of living, family life, health, happiness and social attitudes?

LIVING STANDARDS, INEQUALITY AND POVERTY

An IFS study examines how the three previous recessions – in the mid-1970s, early 1980s and early 1990s – have affected living standards, poverty and inequality as well as their impact on different groups in society (Muriel and Sibieta, 2009). It shows that average household incomes fell in real terms during each of these recessions, with falls continuing after the recessions ended as unemployment continued to rise. The incomes of the less educated fell the most.

The living standards of families more dependent on wages and salaries – such as working-age adults without children and couples with children – were more affected by recessions than people more dependent on fixed incomes or state benefits – such as pensioners and lone parents.

Inequality fell during the recession of the mid-1970s, rose during that of the early 1980s and was more or less unchanged during the early 1990s recession. But in all these recessions, incomes in the middle of the income distribution fell by more than those at the bottom.

In principle, a recession can push relative poverty either higher or lower. Rises in unemployment will increase the number of low-income households. But falls in average incomes will lower poverty thresholds defined relative to average income, such as the 60 per cent of median income definition used for the government's child poverty targets.

In practice, relative poverty across the whole population has fallen in recessions, driven by big falls in pensioner poverty. Pensioners are less likely to be affected by rising levels of unemployment or lower earnings growth than people of working age. But absolute poverty (defined against a poverty threshold that does not decline with average incomes but is just updated with inflation) has risen, particularly for families with children.

The IFS study uses data for the current recession to highlight particular areas for concern over the coming months. A sharp rise in unemployment may have a bigger impact on the relative living standards of those losing their jobs this time compared with previous recessions, because out-of-work benefit entitlements have been falling relative to average incomes for the past 20 years.

This is particularly true for working-age individuals without children. For example, out-of-work benefits for single adults under 25 are now worth only 40 per cent of the poverty line (after housing

costs have been deducted), compared with 55 per cent just before the start of the early 1990s recession. Although they are entitled to more, there have been equally large declines for single adults over 25 and couples.

Meanwhile, even though the job prospects of high earners are not being hit disproportionately, their incomes are likely to fall or stagnate. People at the top of the income distribution are particularly sensitive to the performance of financial markets: they receive more of their income from savings and investments than those lower down; and a significant fraction work in the financial sector.

Joint IFS research with ISER looks at the prospects for reaching the government's child poverty target for 2010/11 and finds that without an extra £4.2 billion spent on tax credits for low-income families, child poverty numbers will be 600,000 above target (Brewer et al, 2009). The increase in the cost of achieving the target coincides with the dramatic deterioration in the outlook for the public finances that is already pushing up social security costs.

FAMILY LIFE

What impact might the recession have on divorce and separation? One way it might affect family life is through the rise in unemployment. Becoming unemployed is a stressful experience, so it is likely that there might be a causal connection between unemployment and another deeply stressful experience: divorce for married couples or separation for cohabiting couples.

Research by Morten Blekesaune of ISER reviews the evidence on the links between unemployment and partnership dissolution. He finds that people who lose their job in Britain – whether they are a man or woman – increase the chances that they will lose their partner. This contrasts with evidence for Scandinavia, where male unemployment is associated with a greater chance of partnership dissolution than female unemployment.

Although on average the effect of male and female unemployment is the same in Britain, a woman losing her job is increasingly likely to lead to partnership dissolution the longer the partnership has lasted. The effect of a man being made unemployed is the same regardless of how long a couple has been together (Blekesaune, 2008).

Another ISER study (Rainer and Smith, 2008) examines the impact of falling house prices on families and concludes that unexpected downturns in the housing market can damage family stability. Price falls are particularly destabilising for the relationships of young couples with low family income, high mortgage debt and dependent children.

The researchers comment: "For a majority of married couples, the most important asset of the marriage is the family home. So it follows that what happens to the value of this asset should be one of the main concerns of couples considering whether to remain married or divorce. The fact that it is young families in relatively poor and indebted households who are the most sensitive to falling prices has consequences both for the social security system and for the wellbeing of disadvantaged families."

YOUNG FAMILIES IN RELATIVELY POOR AND INDEBTED HOUSEHOLDS ARE THE MOST SENSITIVE TO FALLING HOUSE PRICES

One other way the recession might affect family life is through its impact on fertility. Britain's birth rate has increased steadily since 2001 and now averages 1.9 births per woman, the highest level since 1974. Recession could push it either way: on the one hand, reduced incomes are likely to discourage people from having children; on the other hand, a spell of unemployment, particularly for women, may encourage them to have children now rather than later when they return to work. Research evidence suggests that fertility is typically 'pro-cyclical', falling in recessions and rising in recoveries (Ahn and Mira, 2002).

HEALTH

Mel Bartley director of the ESRC's International Centre for Lifecourse Studies in Society and Health has surveyed the research evidence on the adverse effect of recession and unemployment on overall health. She notes that during the 1980s, many studies of unemployment and health indicated that unemployment increases the risk of psychological disorders such as depression.

But any relationship between unemployment and physical health was more difficult to assess. There seemed to be a tendency for unemployment to hit hardest those who already had some health problems. In fact, for some people in heavy and arduous jobs, a spell of unemployment made them feel that their health had actually improved.

There was a higher mortality risk for men who were unemployed at the time of the 1971 and 1981 censuses. But it was difficult to know whether this was due to their previous jobs, some of which (such as mining and shipbuilding) involved many health hazards.

Researchers have now collected more information on the longer-term outcomes for those who experienced unemployment in the recessions of the mid-1970s, early 1980s and early 1990s. For example, men who were unemployed as far back as 1971 still had a higher risk of a work-limiting long-term illness in 1991, 20 years later:

Conversely, secure employment among healthy adult men and women of all ages in the 1990s greatly reduced the risk that they would develop a work-limiting illness and increased the likelihood of recovery. Employment security between the ages of 26 and 30 in the late 1990s was even more important for the mental health of people who had experienced some psychological problems than in those who had not.

Looking at unemployment in this 'lifecourse' perspective makes it possible to see whether it damages people's prospects for social and economic achievements (Blane et al, 2007). For example, a group of intelligent young men who came from advantaged backgrounds, who did well at school but who were unemployed for a year or more during the 1980s recession were considerably less likely to be high earners, in a professional job or own their homes by 1991 than those who were more steadily employed (Cable et al, 2008).

Health behaviours such as smoking, drinking and exercise were also worse in those who had been unemployed, even though at the time of measurement they were back in work again. These findings show that the health and wellbeing effects of long-term unemployment can be felt for several years – and potentially a long time after the recession itself has ended (Bartley, 2003).



HAPPINESS AND MENTAL HEALTH

Research by Andrew Oswald of the University of Warwick has explored the damaging impact of unemployment on happiness and mental health – see Figure 3 below, which charts the average life satisfaction of employed and unemployed Europeans between the mid-1970s and the early 1990s.

Oswald's work shows that about one fifth of the decline in happiness that people experience when they lose their job is because of the fall in income. But the remaining 80 per cent of the unpleasantness and bad mental health effects of joblessness come from something different – perhaps loss of self-esteem, loss of social networks or decline in status in the individual's own eyes as well as other people's (Di Tella et al, 2001, 2003).

Oswald's research on wellbeing also finds that experiencing unemployment reduces people's life satisfaction even when they are back in a job (Clark and Oswald, 1996). In addition, his work indicates that there is a more generalised impact of recession on the population: "Recession fear hurts even you and me. I'm very unlikely, I think, to lose my job, I'm glad to say. But for reasons we don't completely comprehend, mental health and happiness suffers even among those in work. It may be that we're upset by our family members losing their jobs."

Research by David Pevalin of ISER looks at the impact of housing repossessions and evictions (events that are far more common in a recession) on the likelihood of people suffering from common mental illness. He finds that housing repossession (but not evictions) significantly increases the risk of common mental illness (Pevalin, 2009).

Related ISER work finds similar psychological costs from unsustainable housing commitments (Taylor et al, 2007), which are likely to be greater in a recession. A subsequent study for the Financial Services Authority examines the interconnections between people's wellbeing and their ability to take control of and manage their finances (Taylor et al, 2009).

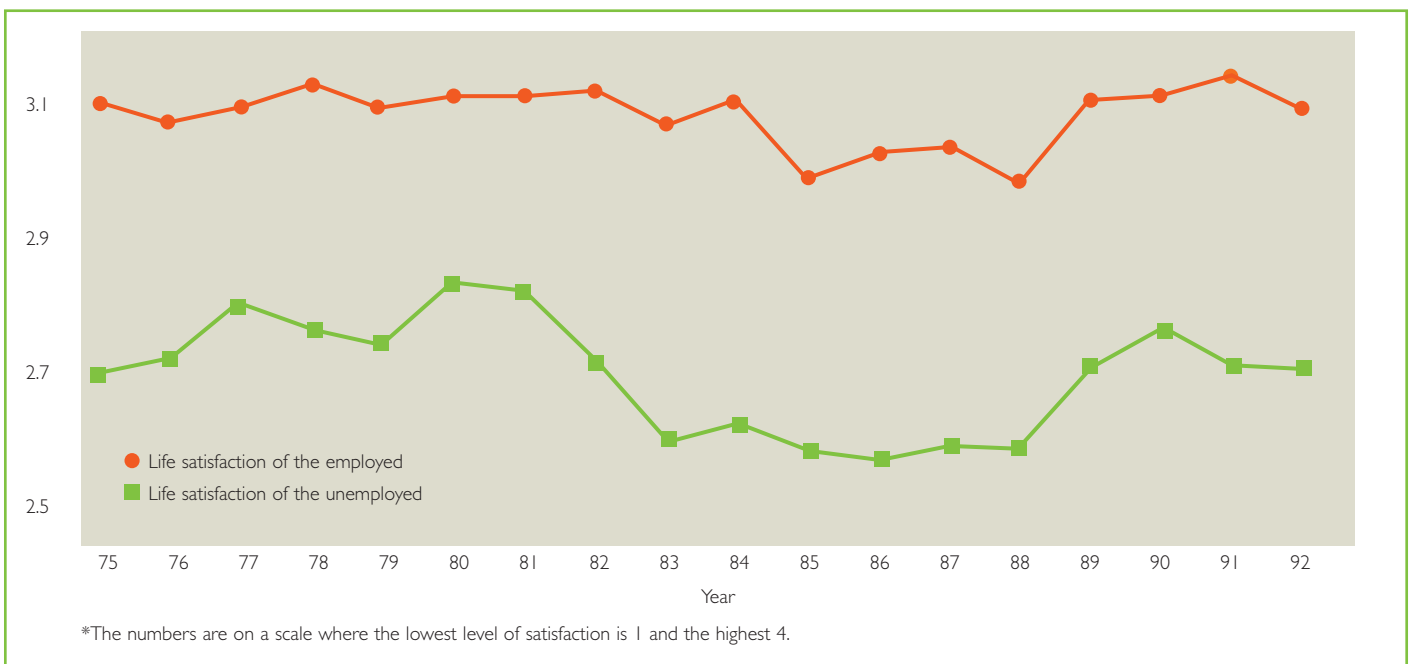
SOCIAL ATTITUDES TOWARDS THE HOUSING MARKET

Are the social attitudes of people in Britain affected by recession? The British Social Attitudes (BSA) survey conducted by the National Centre for Social Research (NatCen) has regularly collected views on housing, asking whether people would advise an imaginary young couple to buy or rent a home. The buy options are split in two: 'buy a home as soon as possible' or 'wait a bit, then try to buy'.

The most popular response by far has always been the 'buy now' option. In 1986, 74 per cent of people opted for this; in 1991, this fell to 60 per cent, and to 54 per cent by 1996 (reflecting the housing market problems of the early 1990s). By 2004, it had bounced back to 71 per cent but the latest data (collected in the summer of 2008, after the credit crunch had gained momentum but before the recession was widely recognised) put it at 45 per cent, the lowest level ever.

This does not mean that people reject home ownership: they would now just advise the young couple to 'wait a bit' (40 per cent chose this option in 2008 compared with 20 per cent in 1986) and only two per cent would advise the couple not to buy at all.

Figure 3: Average life satisfaction of employed and unemployed Europeans* (based on a random sample of 271,224 individuals)



The BSA also asks how much people think that owning your own home can be 'a risky investment': in 1986, 25 per cent agreed, rising to 43 per cent in 1991 and 50 per cent in 1996. By 1999, it was back down to 40 per cent, and in 2008, it still stood at 40 per cent (though negative equity had not yet become an issue).

Asked whether buying a home works out as less expensive than paying rent, 44 per cent of people agreed strongly with this view in 1986, falling to 30 per cent in 1991. In 1999, 47 per cent agreed strongly – and in 2008, 39 per cent. This suggests that, as of the summer of 2008, people's certainty in the advantages of home ownership had been shaken, but it had not dented their faith in home ownership being the ideal arrangement.

Perceptions of home ownership may have become more negative since then. This may not be an undesirable outcome in a country seemingly obsessed with home ownership. There is evidence that job satisfaction is higher among renters and commuting times are longer for homeowners. Homeowners also express less willingness to move when asked what they would do if they lost their jobs. High levels of homeownership have also been linked with higher rates of unemployment (Oswald, 1996).

SOCIAL ATTITUDES TOWARDS PUBLIC SPENDING AND INEQUALITY

NatCen researchers have also used the BSA to explore whether social attitudes to the level and composition of public spending are affected by a recession. In general, they find that social attitudes seem to be explained relatively little by economic circumstances.

For example, people's spending priorities have changed considerably since 1983, although health and education continue to dominate. One of the biggest changes in popularity relates to help for industry: in 1983, 29 per cent said it would be their first or second priority for more spending. This then fell steadily throughout the 1980s and by 2008 stood at five per cent. So there was no sign of an increase in support for more spending on industry during the early 1990s recession.

On views about levels of taxation and public spending, the BSA finds a surge in support for more taxation and more spending between 1990 and 1991 (from 54 per cent to 65 per cent), which might reflect the bad economic circumstances of the time. But support then continued to remain at this level throughout the 1990s, with no decline once the recession ended. In 2007, for the first time since the mid-1980s, the level of support for more taxation and spending dropped below the level of support for keeping taxation and spending the same. It remained at a similar level in 2008.

The BSA has also gathered data on people's views about benefit recipients. Although these seem to become more sympathetic during times of unemployment, they also appear to have hardened over the last few decades.

For example, the survey asks people to choose between two views about unemployment benefits: that they are 'too low and cause hardship' or that they are 'too high and discourage them from finding jobs'. In 1983, 35 per cent of people agreed with the latter view, and there did seem to be a softening of attitude during the recession in the early 1990s: by 1994, only 24 per cent agreed.

But in the late 1990s, this proportion began to rise (particularly among Labour supporters in 1997/98, suggesting that a change in Labour's position on welfare was a key factor). In 2007, 54 per cent of people thought unemployment benefits were too high; the figure for 2008 is even higher at 61 per cent. So far then, there are no signs that worries about the economy are starting to affect people's views about welfare. But this might have changed over the past 12 months since the survey was last conducted.

There might also be a change in people's attitudes to inequality. Research by Alan Manning of CEP, which predates the recession, finds that while inequality in Britain now is much higher than in the 1970s, the demand for redistribution is much lower (Georgiadis and Manning, 2007).

Manning explains that many fewer people seem to believe in the 'class war' – that there is one law for the poor and one for the rich, or that big business benefits owners at the expense of workers – and those in the middle are no longer envious of the rich, instead aspiring to be the rich. But these views could shift, he says: "as we enter a recession in which the average Briton is quite likely to feel the pinch, it may once again become an attractive political policy to seek to increase the share of taxes paid by the rich".

MANY STUDIES OF UNEMPLOYMENT AND HEALTH INDICATE THAT UNEMPLOYMENT INCREASES THE RISK OF PSYCHOLOGICAL DISORDERS SUCH AS DEPRESSION

Robert Chote director of IFS also sees the possibility of changed attitudes: "An interesting political question is whether the growing popular perception that it was overpaid, under-taxed bankers and City financiers who got us into this mess will affect how the government chooses to raise the money."

THE IMPACT ON BUSINESS



4

Productivity

How firms cope with recession

Innovation

Small and medium-sized enterprises

Government policy for business

Charitable giving and the third sector

PRODUCTIVITY

What will the current recession mean for the private sector in Britain? As in previous recessions, construction has been badly hit in the early stages. The ONS figures show that construction output fell by five per cent in the last quarter of 2008, 6.9 per cent in the first quarter of 2009 and 2.2 per cent in the second quarter of 2009. And it was new data for the construction sector that accounted for half of the large downwards revision of the first quarter contraction of GDP from an earlier estimate of 1.9 per cent to 2.4 per cent, the biggest fall in over 50 years.

In terms of job losses, the manufacturing sector suffered the most in the first quarter of 2009, with employment falling by 78,000 to 2.94 million, the lowest level since records began in 1978. In terms of output, the GDP figures for the first quarter show production industries falling by 5.1 per cent, service industries falling by 1.6 per cent and contractions in all sub-industries except government and other services, which grew by 0.2 per cent.

Writing in January 2009, Andrew Oswald suggested that the businesses likely to be particularly badly affected by the recession are those linked to the four key drivers of the recession: the fall in the housing market; the spike in the oil price in 2008; the loss of confidence in financial institutions; and the contraction in bank lending.

The first factor indicates problems for estate agents and producers and retailers of furniture, paint and wallpaper, carpets, etc. The second is bad news for activities linked to the price of oil: the car business, air travel, chemical and fertiliser industries, and many pharmaceutical industries that rely on oil products. The third cause has already hit and may continue to damage most sectors connected to financial services (though as some firms in an industry disappear, others will benefit).

The final recessionary influence is, Oswald says, the one with the furthest reaching consequences: "Entrepreneurs, including lots of small businesses, will take the early salvo. There is much research to show that small businesses depend especially delicately on the supply of even quite small amounts of capital. For this reason, self-employment rates will be hit. And big-ticket items – cars and expensive electrical goods are natural examples – are particularly harshly affected by restrictions on credit."

AS ECONOMIC ACTIVITY SLOWS DOWN, INVESTMENT AND EMPLOYMENT ARE CUT BACK WITH KNOCK-ON EFFECTS IN DEPRESSING PRODUCTIVITY GROWTH

The key driver of economic prosperity over the long run is productivity growth. But there is a notorious and longstanding productivity gap between the British economy and the other big western economies: despite recent improvements, in 2008, output per hour was still 15 per cent behind the United States and France and ten per cent behind Germany (Advanced Institute of Management Research, AIM, 2009). So is the recession likely to be beneficial or damaging to Britain's productivity growth?

The July ONS data show that productivity across the whole economy, as measured by output per worker, fell by 4.2 per cent in the first quarter of 2009 compared with the same quarter in 2008. The alternative measure of productivity – output per hour worked – shows that hourly productivity across the whole economy fell by 2.4 per cent in that period. Productivity in manufacturing on an output per job basis was down considerably more: 8.3 per cent lower than in the same quarter of 2008.

This is in line with a great deal of research evidence on the early path of productivity growth in a recession. As economic activity slows down, investment and employment are cut back with knock-on effects in depressing productivity growth.

Most productivity growth comes from 'creative destruction' – productive firms expanding and unproductive firms shrinking (Disney et al, 2003). But if the first reaction of firms is to stop hiring and investing, then creative destruction temporarily freezes – productive firms do not grow and unproductive firms do not contract. Given the particularly high level of uncertainty in this recession, firms may be opting for a significant slowdown in reallocation, which is a major contributor to productivity (Bloom, 2007).

In countries like Britain and the United States, where labour market flexibility is relatively high, the fall in productivity growth is likely to be greater but the recovery swifter. This is because eventually the downturn leads the weakest firms to close.

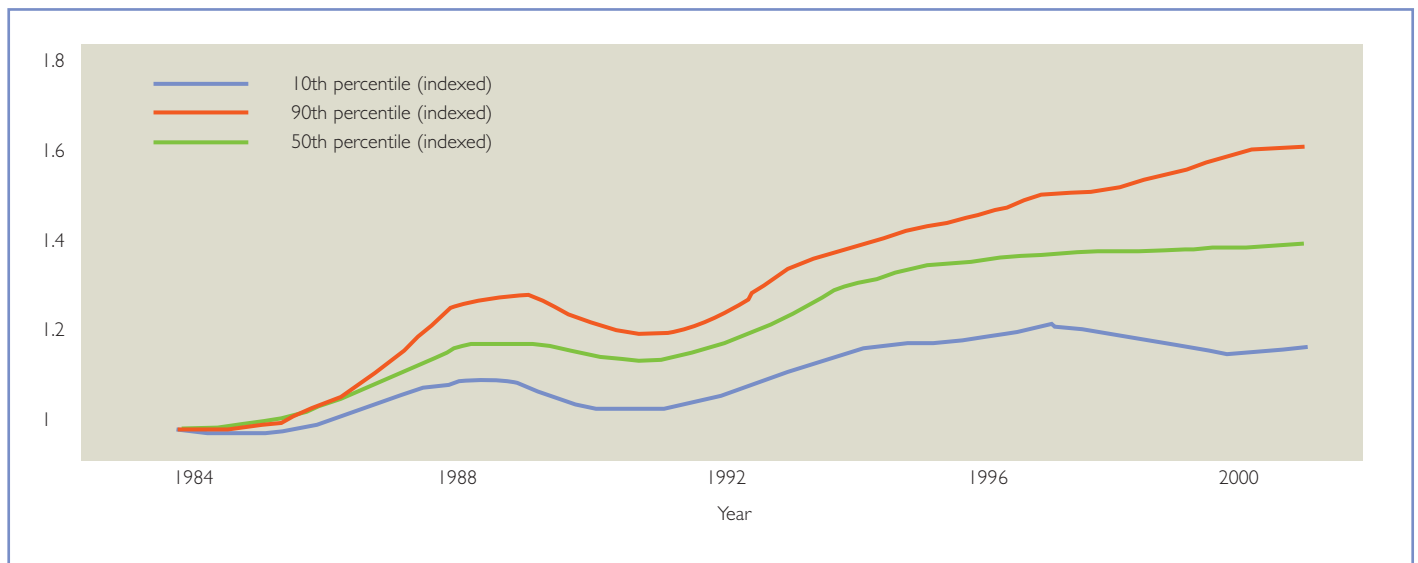
This is creative destruction in action, sometimes called 'the cleansing effect of recessions' – see Figure 4 opposite, which shows evidence from CEP research that in the early 1990s recession, the dispersion of productivity across all firms in the economy fell because the lower tail of poorly performing firms was reduced in size (Faggio et al, 2007).

If the dispersion of productivity is falling because the lower tail is shrinking, this increases average firm productivity.

In the United States, the heavy fall in employment relative to output in this recession (and in the US recessions of the early 1990s and early 2000s) is leading to a huge increase in productivity as the economy reaches the bottom. This may be because information technology (IT) and aggressive US management practices are allowing firms to cut workers and introduce new practices that keep output high.

So why did firms not simply introduce these productivity-improving practices before? One view is that the recession has provided firms with an excuse: it is easy to blame the recession for lay-offs when they are really a way to make long-needed productivity-changing improvements.

Figure 4: Productivity dispersion in the whole economy FAME data 1984-2001



Given the evidence that US firms make more effective use of IT (Bloom, Sadun and Van Reenen, 2007), this suggests that Britain will not have such a benign recession as the United States. Management practices in Britain are not up to the levels of those in the United States (Bloom and Van Reenen, 2007), so it is possible that firms are less effective at using the recession as an excuse to re-organise.

HOW FIRMS COPE WITH RECESSION

Research on the early 1990s recession by the late Paul Geroski and CMPO's Paul Gregg indicates that performance differences between firms increase significantly in recessions. While the average profitability across firms follows the path of the business cycle, the variation in profitability across firms rises sharply in a downturn.

Over the course of the early 1990s recession, 10 per cent of firms accounted for 83 per cent of the gross fall in profits and 20 per cent accounted for 92 per cent of the gross fall. The worst hit ten per cent of firms also accounted for 85 per cent of the gross fall in employment. At the same time, 40 per cent of firms saw their profits rise and half raised employment (Geroski and Gregg, 1997). This diversity is an important aspect of industrial change in periods of both growth and recession: even within very specific sectors, firms vary hugely in performance and potential at any time. Increased variability in firm performance eventually sets the stage for some firms to grow and some to contract or exit, and for new firms to enter.

The study by Geroski and Gregg analysed the recessionary experiences of 600 medium-sized firms in Britain. All firms reassessed corporate strategy and focus, whether or not they felt seriously affected by the recession. Almost all firms modified management methods, marketing and organisational procedures, rethought their product lines and explored the potential for mergers and acquisitions.



Not surprisingly, the first and primary response of firms that considered themselves seriously threatened by the recession was cost control, mainly through labour reorganisation: employment cuts, wage growth cuts and business unit closures. Financial responses – disposing of assets, reducing dividends and rescheduling debt – took the backseat to cost control. The workforce took the brunt of the adjustment.

But what is particularly significant is the high degree of variation in firms' investment behaviour. Many firms postponed major investments but others brought them forward, transforming activities rather than cutting them back. Investments that involved reorganisation and redeployment of existing assets, with potential for only longer-term payoffs, were more likely to be brought forward in the face of recession. This included research and development (R&D) and product and process innovations.

More recent AIM research finds wide acceptance that firms cannot cut their way out of the recession but must grow their way out. Since growth will not come by competing on cost, it is essential to move up the 'value chain', offering ever more valuable products and services (Martinez et al, 2008). That demands innovation and not simply in terms of products and processes but also in terms of practices and organisation (Birkinshaw and Mol, 2009).

AIM research indicates that Britain is a strong base for innovation in terms of capacity and infrastructure but that needs to be capitalised on by continuing to invest and develop the business base (AIM, 2008). It is also important to recognise and develop opportunities in changes within what management researchers call 'complex value networks' (Jacobides et al, 2007). There are some good examples of firms doing this – for example, in the software and gaming industries (Sapsed et al, 2008) – but they appear to be exceptions rather than the rule (Delbridge et al, 2006).

INNOVATION

So how much danger is there that firms will be investing less in developing and adopting new products and processes in the current recession, and that long-term growth may suffer? The answer to this question is not obvious.

During a recession, the cost of investing in innovative activities is lower than in times of expansion. Labour and other inputs will be less in demand, and thus are likely to be cheaper. In addition, when a firm is experiencing slack demand for its product, the firm's internal resources are likely to be underused, and thus undertaking innovative activities will be less costly.

Helen Miller of the IFS cites the example of a retail firm that could implement a new computer system to monitor stock flow on the shop floor. A recession may be the best time to implement this new technology. If the firm needs to shut the store down to install the new equipment, and to divert staff away from normal sales activities to undertake training, this will be less costly when the firm is selling less.

Managers will have more time to reorganise current practices, and workers are likely to be more willing to accept change when their job security is less certain. It may also be a good time to lay off some workers and to hire new workers with more appropriate skills.

As well as adopting new technologies or processes, firms may use this time to invest in R&D with the aim of inventing new products. This process of investment may be reinforced by businesses that feel the threat of bankruptcy.

There is evidence that in recessions, firms that have innovated at some point in the past are better able to survive and flourish (Geroski et al, 1993) though this may be because of other reasons that help a firm to survive, such as better management.

WHETHER THE RECESSION TURNS OUT TO BE GOOD OR BAD FOR INNOVATION REMAINS AN OPEN QUESTION

There is also evidence that bad 'shocks' like a recession can actually stimulate firms to innovate, especially making organisational innovations (Nickell et al, 2001).

The notion that downturns are not necessarily bad for innovation fits into the 'pit stop' view of recessions as being periods when firms can reorganise their activities and invest in new ideas, which cost time but save money. Tougher times may also make managers work harder; just as tougher competition spurs better management practices and better economic performance (Bloom and Van Reenen, 2007). Recessions may therefore spur activities that enhance long-run growth.

But many firms may want to be investing in innovative activities, but find that they do not have the finances to do so. When firms face a drop in demand for their products, they also tend to experience tighter credit constraints. Some changes, such as reorganising management practices or retraining workers may be relatively cheap and do not need to rely on external finance. But others may have large upfront costs.

Miller notes of her example: "A firm that wishes to introduce a new technology may need access to credit to purchase and install the new equipment. Credit could also be a limiting factor if the firm wishes to engage in inventing a new product. Liquidity constraints are likely to be particularly pertinent in the current recession. Firms are finding it hard to access credit and may therefore be unable to invest in innovation."

Whether the recession turns out to be good or bad for innovation remains an open question. Given the severity of this recession – and its origins and continued problems in financial markets – the past may not necessarily be the best guide.

SMALL AND MEDIUM- SIZED ENTERPRISES

Between November and December 2008, Alan Hughes and colleagues at the UK Innovation Research Centre surveyed over 800 independent businesses employing less than 500 people in Britain's manufacturing and business services sectors. The results – which they compare with a survey of similar firms in the early 1990s recession – give an indication of how small and medium-sized enterprises (SMEs) are faring (Cosh et al, 2009).

Less than a fifth of firms report finance as a significant or crucial constraint on their businesses. For example, 82 per cent of firms say that leasing and hire purchase finance is not more difficult to obtain than before, and over 60 per cent say the same about overdrafts and grants.

But a majority of firms report that it is harder or substantially harder to obtain commercial loans or mortgages. And the proportion of finance obtained has declined from 78 per cent to 55 per cent and the costs of obtaining finance have risen substantially in terms of arrangement fees and the security of collateral required.

There has also been substantial tightening in the market for trade credit and a rise in the time spent on assessing creditworthiness. But comparing now with the early 1990s recession suggests that the pressures on trade credit arrangements are not as bad as in 1991, even though the recession then proceeded less rapidly.

Much more significant is the increase in the extent to which firms see demand constraints as a very significant or crucial restraint on meeting their business objectives. In part this is because exceptionally high interest rates in 1991 made the cost of finance much more significant then. But it is also because the rapid decline in demand in the current recession has made that of central importance in how businesses perceive their ability to meet their objectives.

Yet despite the severity of the current recession and the depth of the financial crisis, the survey finds a higher proportion of firms expecting to expand in the coming years. In this sense, the business response suggests a more resilient frame of mind than in 1991.

Fast-growth and innovative firms are especially resilient: over two thirds expect to expand in the next three years.

At the same time, there may be constraints on new small businesses. A substantial body of research evidence suggests that access to start-up capital is what matters most for aspiring entrepreneurs (Oswald and Blanchflower, 1998). Getting that access is likely to be difficult with the tightening of bank lending and falling house prices making housing wealth a weaker source of business finance.

GOVERNMENT POLICY FOR BUSINESS

When, as in this recession, uncertainty is high, firms become cautious, so they react much less readily to monetary and fiscal policy designed to promote recovery. CEP research finds that uncertainty shocks typically reduce the responsiveness of firms by more than half, leaving monetary and fiscal policymakers relatively powerless (Bloom, Bond and Van Reenen, 2007). Nick Bloom notes that this problem is well known to Federal Reserve chairman Ben Bernanke, whose doctoral thesis explored the negative effects of uncertainty shocks (Bernanke, 1983).

In a document published in April 2009, the government proposed a more 'activist' approach to Britain's private sector. But it also promised that the new approach would not involve 'the picking of national winners, the revision of European state aid rules or the erection of trade barriers... It recognises that while a role for Government in working with the private sector to build our competitive future is necessary, that role also has important limits' (HM Government, 2009).

THE 1980s RECOVERY WAS DRIVEN BY DEREGULATION IN MOBILE PHONES, AIRLINES, UTILITIES, THE MEDIA AND THE HOUSING MARKET

At the same time, there is the possibility of a political shift towards more regulation of business. Many economists fear that this is an overreaction and that the remedy will be worse than the illness. One CEP study suggests that excessive labour market regulation led to the severe recession of 1920-21 and the Great Depression (Ebell and Ritschl, 2008).



Bruce Lyons deputy director of the ESRC's Centre for Competition Policy fears that the recession may lead to a weakening of competition policy: "It is still fragile and vulnerable to crude, populist, deeply flawed claims that it is an unnecessary luxury in times of recession or even that the crisis itself is due to 'too much competition'."

He notes that recessions have provided opportunities for anti-competitive mergers to concentrate markets unnecessarily: Lloyds-TSB and HBOS may be one such (Lyons, 2009). A study of President Roosevelt's suspension of competition policy in the 1930s suggests that this was responsible for raising unemployment by 24 per cent and extending the Great Depression for seven years (Cole and Ohanian, 2004).

More positively, another CEP study indicates that product market deregulation led to the boom of the 1980s and 1990s (Ebell and Haefke, 2008). And Nick Bosanquet of Imperial College argues that: "If there is one clear lesson from the past, it is that recovery comes from competition and innovation. The 1980s recovery was driven by deregulation in mobile phones, airlines, utilities, the media and the housing market."

With competition policy Lyons suggests that the recession should be taken as an opportunity: "Rather than fall into the fallacy of sacrificing competition policy supposedly to avoid the short-term consequences of recession, we need to enforce competition policy robustly to avoid the long-term consequences." He calls for greater vigilance on agreements between firms ('crisis cartels'), abuse of dominance, mergers, state aid and protectionism.

CHARITABLE GIVING AND THE THIRD SECTOR

The potential impact of the recession on voluntary action and the third sector more generally is considerable. Some of the basic characteristics of the sector may make it particularly vulnerable, notably its dependence on voluntary and philanthropic support from individuals and on statutory sources of income. Recent surveys predict a tough future for the sector, with a steep decline in donations, legacies and government funding, just as demand for its services increases with growing social need.

John Mohan director of the ESRC's Third Sector Research Centre and Karl Wilding of the National Council for Voluntary Organisations use the accounts of British voluntary hospitals during the interwar period and trends in charitable-giving in North America during the Great Depression of 1929-31 to assess the



likely impact of the current recession on charities. Their historical evidence suggests that voluntary organisations may weather the current recession better than expected (Mohan and Wilding, 2009). History suggests that charities have been creative in developing new sources of income and the impact of this recession will depend as much on the internal management, decision-making and resources of individual charities as on the external environment – as was the case with British hospitals in the interwar years, ‘survival of the fittest’ will prevail.

CHARITIES CAN HELP THEMSELVES BY DEMONSTRATING THAT CONTRIBUTIONS ARE BOTH NEEDED AND HAVING A MEASURABLE IMPACT

The proportion of individual income given to charity will remain generally constant – as in the Great Depression – but as unemployment rises, fewer people will be in a position to give anything. Some sources of income, such as major gifts, tend to march in step with the stock market and may recover quickly, so the sector needs to retain the capacity to respond to an upturn in income.

The biggest charities will not necessarily be best placed to maintain donations; giving may be redirected towards local, community-based organisations, as was the case with local appeals during the 1930s and the self-help initiatives founded during the miners’ strikes of 1984-5. And long-term data from the Charity Commission suggests there have been steady increases in the rate of formation of new charitable organisations, even during recessionary periods.

Mohan comments: “Charities should beware of crying wolf. There will be casualties of this recession, but predictions of widespread gloom are likely to prove exaggerated. History suggests long-term stability in the resources available to voluntary organisations, but inevitably some causes or types of organisations will suffer more than others. It is important that policy responses are flexible and aimed at protecting organisations and sectors that appear likely to be strategically significant.”

Cathy Pharoah co-director of the ESRC’s Centre for Charitable Giving and Philanthropy is also positive about the prospects for charities: “Reports of dramatic falls in charitable giving are overblown and potentially self-fulfilling. People are able to make careful decisions about where their money is best spent, and fatalistic claims may only serve to undermine confidence and deepen any recessionary impact on giving – just at a time when charities’ services are particularly needed.”

She adds: “Donors may have less money to spend, but all spending decisions are questions of priorities and they may not automatically tighten their altruistic belts first. Charities can help themselves by demonstrating that contributions are both needed and having a measurable impact.”

Peter Backus (of the Third Sector Research Centre), Cathy Pharoah and colleagues have looked at British charitable giving for overseas development over the past 30 years. Since 1978, donations have grown in real terms at a rate of 7.5 per cent a year but growth has been far from steady over time, surging in the mid-1980s (which is associated with African famines) and again between 1997 and 2004. Encouragingly, in view of the current recession, the previous fall in household income in the early 1990s was not associated with a sharp decline in donations (Atkinson et al, 2008).

IFS research also finds no obvious effect of the early 1980s recession on household donations to charity, either in terms of the proportion of people who donated or the average amount (Banks and Tanner, 1997).

WORLD IN RECESSION



5

Trade

Migration

Poverty and development

Climate change

Financial markets

The financial crisis and economic recession that began in the United States and Britain have spread devastatingly to the rest of the world economy. Before this recession, the three previously recorded falls in world output per person were in 1975, 1982 and 1991, according to the IMF. But this one is much deeper than previous troughs: global output per head is likely to have fallen by 2.5 per cent in 2009, compared with an average of 0.4 per cent in the previous global recessions (IMF, 2009).

IMF research has examined 122 recessions in developed economies since 1960 and notes two characteristics of this one that suggest a deep recession and a weak recovery. First, it was precipitated by a financial crisis: in such recessions, investment tends to fall even after the trough, while consumption grows more slowly than in other recoveries. Second, this is a globally synchronised recession and, in these cases, recovery typically takes 50 per cent longer than other recoveries (Kose et al, 2008).

Writing in June on the Vox website run by the Centre for Economic Policy Research (CEPR), Barry Eichengreen of the University of California, Berkeley, and Kevin O'Rourke of Trinity College Dublin compare today's crisis to the Great Depression – see Figure 5, which charts their finding that world industrial production, trade and stock markets are diving faster now than during 1929-30 (Eichengreen and O'Rourke, 2009).

Fortunately, these researchers believe, the policy response to date is much better – though the question remains whether the policy response will work. Most economists agree with the IMF's warnings that 'a slide toward trade and financial protectionism would be hugely damaging to all, a clear warning from the experience of 1930s beggar-thy-neighbour policies', and that what is needed is 'stepping up efforts to heal the financial sector, while continuing to support demand with monetary and fiscal easing.'

TRADE

The decline in GDP in Britain and abroad has led to sharp falls in industrial production and trade flows: after a long period of steady growth, the overall volumes of trade in goods have fallen dramatically and much more rapidly than GDP. In previous global recessions, trade merely stagnated; in this one, global trade may shrink by almost 12 per cent.

Credit constraints have arguably disproportionately affected trade with much anecdotal discussion of the lack of availability of trade credit. Another potential explanation for the disproportionate drop in trade is 'vertical specialisation', where stages of production are spread across national borders. Because trade is measured in terms of gross output rather than 'value added', value added is counted twice as goods cross national borders multiple times. A fall in output therefore has a disproportionate effect on trade (Bernard et al, 2007).

How much will Britain be affected? On the one hand, the decline in industrial production and trade in goods may have a less adverse effect than in, say, Germany because of the smaller size of the manufacturing sector in Britain. In addition, the depreciation of sterling relative to the dollar and the euro may help to offset the decline in GDP abroad and bolster export opportunities for British firms.

On the other hand, the financial sector plays a much greater role in Britain than in Germany and this sector has obviously been sharply affected by the crisis. The resulting decline in trade in services could therefore disproportionately affect Britain.

The macroeconomic implications of the crisis for Britain's current account depend on the impact on savings relative to investment. The sharp increase in savings due to the credit crunch and declines in people's net worth associated with falling stock prices could lead to an improvement in the current account as observed in the United States.

The real fear is that countries will respond to the decline in trade with protectionist policy measures, for example, the 'Buy in America' provisions associated with the US fiscal stimulus. This could lead to a protectionist spiral as in the 1930s. One of the major factors compounding the Great Depression was the Smoot-Hawley Tariff Act of 1930, introduced by desperate US policymakers as a way of blocking imports to protect domestic jobs but which helped worsen the recession by freezing world trade.

In June, CEPR launched an independent website to collect evidence of countries adopting protectionist policies to counter the global recession. Global Trade Alert, which is supported by the Department for International Development (DFID) and the Department for Business, Innovation and Skills, draws on expertise from independent research institutes in seven regions of the world, and monitors not just tariff barriers but also non-tariff barriers and national crisis measures (CEPR, 2009).



Figure 5a: World industrial output

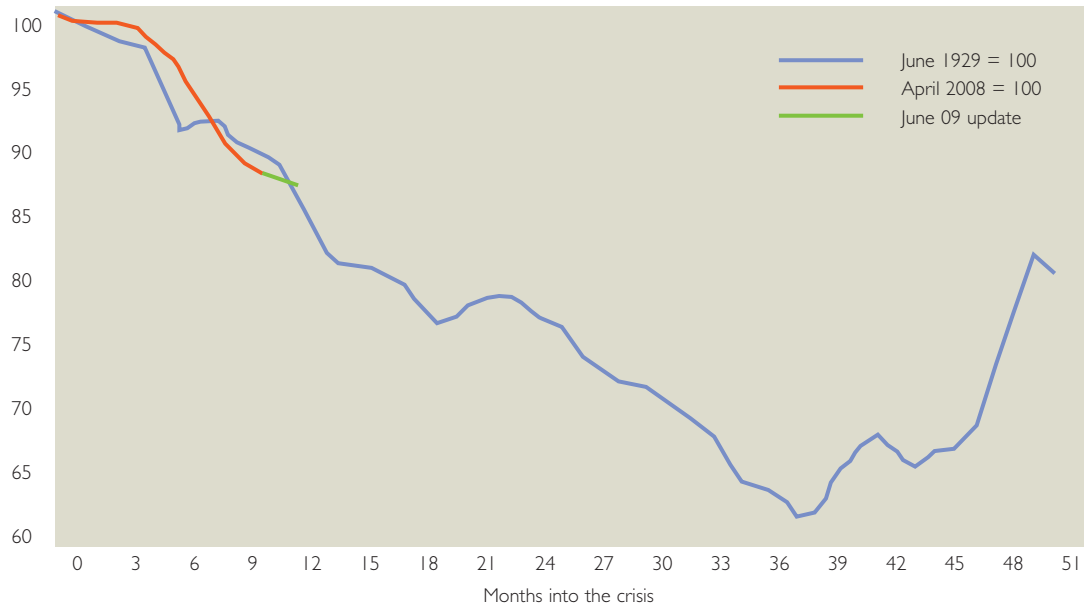


Figure 5b: Volume of world trade

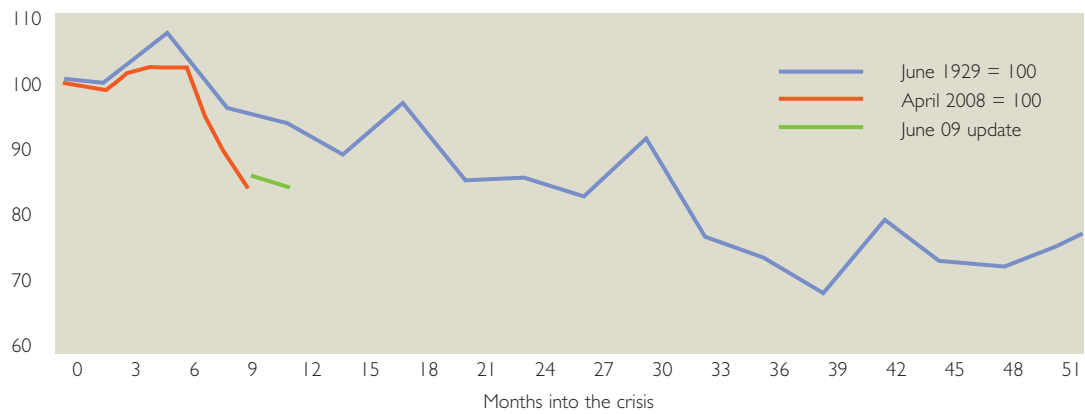
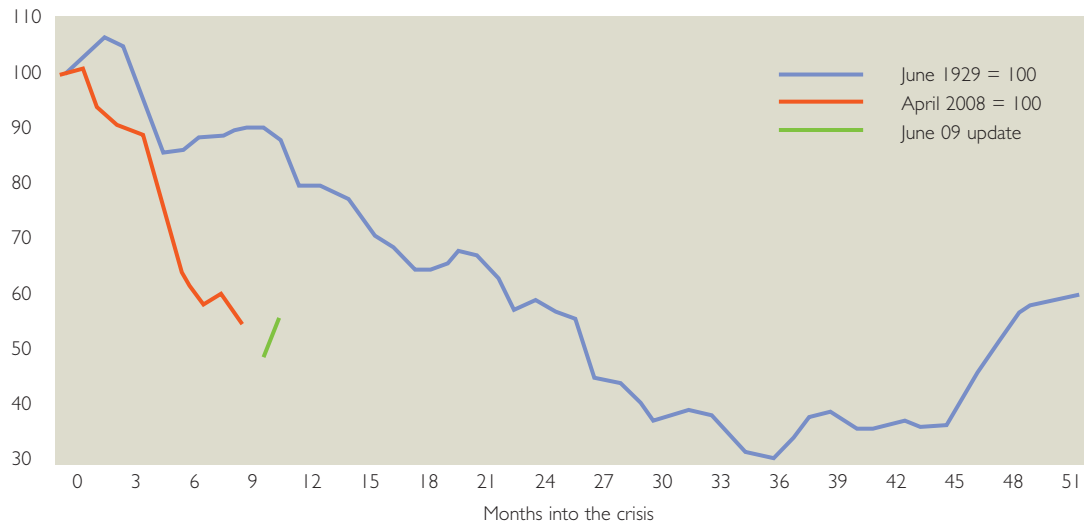


Figure 5c: World stock markets



MIGRATION

What happens to international migration in a recession? Research by Tim Hatton of the Australian National University shows that migration has always responded to the ebb and flow of the business cycle. Emigration is negatively related to unemployment in the destination country and positively related to unemployment in the source country. But what happens when economic conditions deteriorate at both source and destination?

History provides an unambiguous answer: conditions in the host country dominate. For example, in the period 1870-1913, the rise in unemployment abroad had nearly three times the effect on emigration from Britain as a rise in unemployment at home. During the Great Depression, net immigration to the United States turned negative as new immigration virtually ceased and previous immigrants headed home. For countries of emigration, the result was just the opposite: as the global depression deepened, their labour markets became even more glutted as fewer left and more returned.

So the response of migration to global recessions tends to soften labour market slumps in destination countries and intensify them in source countries. But how big are these effects? History and recent experience suggest that every 100 jobs lost in a high-immigration country result in 10 fewer immigrants (Hatton and Williamson, 2005).

History also reveals rising anti-immigrant sentiment in a global recession. Data from the European Social Survey indicate that this time is no different: there has been a notable deterioration in public perceptions of migrants driven by concerns that as recipients of the generous social transfers, they are a 'fiscal burden'. The proportion of people in the European Union (EU) demanding that migrants be repatriated if they are long-term unemployed has increased threefold in Spain, twofold in France and Italy, and between one third and one quarter in Britain and Germany (Boeri, 2009).

Focusing specifically on Britain, a report on the vulnerability of migrant workers in the recession by the ESRC Centre on Migration, Policy and Society finds a marked rise in hostility to immigrants. This coincided with widespread publicity given to the 'British jobs for British workers' protests. It includes high levels (by comparison with other European countries) of opposition to the rights of non-British EU citizens to work in the country (Rogers et al, 2009).

Research by Christian Dustmann and colleagues at the Centre for Research and Analysis of Migration examines the fiscal consequences of migration to Britain from the eight Central and Eastern European countries that joined the EU in May 2004. These immigrants are less likely to be claiming welfare benefits and less likely to be living in social housing than people born in Britain. The immigrants are also paying more in taxes than they receive in direct or indirect public transfers (Dustmann et al, 2009).

POVERTY AND DEVELOPMENT

The global recession is having a deeply damaging effect on the developing world. Demand for its exports of commodities and manufactures have been dramatically reduced, and capital flows are far lower, including direct and portfolio investment and remittances.

The Overseas Development Institute (ODI) estimates that by the end of 2009, developing countries will experience an income reduction of at least \$750 billion – \$50 billion in sub-Saharan Africa alone. This will mean a rise in unemployment, poverty and hunger. In June, the Food and Agriculture Organisation said that the total number of people suffering from hunger had risen by 100 million in the previous year – the steepest increase ever – to a total of just over one billion.

ODI is calling for a 'global poverty alert system' to monitor the economic impact of declines in trade, financial flows, remittances and aid. This system would also track the impact the recession is having on people's lives, including loss of jobs, lower incomes and falling investment in health and education (ODI, 2009).



Studies of developed countries show that mortality risks for adults and children are actually lower in recessions (Ruhm, 2000). But the reverse seems to be true in developing countries. For example, Sonia Bhalotra of CMPO finds that when the economy turns down in rural India, the risk of children dying in infancy increases significantly, with girls much more likely to die than their brothers. The effects of recessions on lifetime health are even greater since, where children survive income falls in childhood, early exposure to poor living conditions has lasting adverse effects on their health (Bhalotra, 2007).

THE GLOBAL RECESSION IS HAVING A DEEPLY DAMAGING EFFECT ON THE DEVELOPING WORLD

Allister McGregor of the Institute of Development Studies, who led the ESRC's research group on Wellbeing in Developing Countries, is particularly concerned about the threat to social protection schemes of vulnerable people in developing countries as government budgets are squeezed by the recession. He says: "I believe that it's absolutely essential for the global community to act to alleviate fiscal pressure and to provide funding for the safety nets, to mitigate the crisis in countries that have had little responsibility in generating this kind of current crisis."

So will developing countries suffer from reduced aid budgets in developed countries as they face recession and retrenchment of public finances? According to John Page of the International Growth Centre, history suggests that they will: between 1975 and 2005, per capita aid in Africa was higher during good times and lower during bad times.

Page says: "In the past, aid has been pro-cyclical. There is a high risk that it will prove to be so again. The agreement of the G20 heads of state to increase support for the low-income countries in response to the current crisis is an important first step towards making aid to Africa counter-cyclical. But realising that promise will need sustained effort in the face of today's fiscal realities" (Page, 2009).

But Peter Boone of CEP, whose research in the early 1990s revealed the failure of large aid flows either to increase growth or reduce poverty (Boone, 1996), believes that during this recession, more can be achieved than in the past despite substantially less funds. He argues that to have a real impact on extreme poverty, aid needs to be much more carefully targeted, allocated on the basis of good scientific evidence of its effectiveness and delivered through well-designed institutions.

Boone, who runs Effective Intervention, an organisation that aims to design, implement and evaluate aid projects to demonstrate effective, inexpensive means to reduce child mortality in the developing world, calls for systemic changes. He says: "An authority needs to be charged with monitoring and acting on false or misleading claims. And we need to introduce a rigorous concept of "substantial evidence of efficacy" into our decision-making over all aid spending with taxpayers' funds."



CLIMATE CHANGE

Deeply entwined with the issue of the development and the economic crisis is the 'other crisis' of global warming. Nick Bloom notes that: "The massive slowdown in economic growth will rapidly cut growth rates of carbon dioxide emissions. Pollution is tightly linked to the level of economic activity, so that a few years of negative growth would lead to reductions in pollution levels not seen since the 1970s."

But this would be no consolation for the poorest countries. Nicholas Stern, who led the work of the Commission for Africa report and the highly influential *Stern Review on the Economics of Climate Change* (and chairs the ESRC's Centre for Climate Change Economics and Policy), said at a DFID summit in March 2009: "The two great challenges of the 21st century are the battle against poverty and the management of climate change... If we fail on either one of them, we will fail on the other."

THE MASSIVE SLOWDOWN IN ECONOMIC GROWTH WILL RAPIDLY CUT GROWTH RATES OF CARBON DIOXIDE EMISSIONS

He continued: "Unmanaged climate change will irretrievably damage prospects for development in many parts of the world, and action on climate change which hinders development can never build the global coalition on which such actions depend." This is the central issue for the Copenhagen climate change summit in December 2009.

Many are concerned that the current crisis might increase the chances of environmental disaster because governments and companies are now less inclined to implement the necessary regulatory framework and make the required investments.

At the same time, this might be a good opportunity to address environmental problems. The credit crunch clearly shows how failures that build up slowly over a long time are extremely costly when addressed too late, but relatively cheap when dealt with early, and that this sometimes requires drastic policy measures on the

basis of uncertain forecasts. The current willingness to implement drastic 'all-it-takes' policy measures could be used to put the world on the right track for addressing climate change.

For example, fiscal stimulus could come be delivered in the form of investments in a carbon-free economy. One idea for Europe would be an integrated superconducting electricity grid, distributing solar energy from northern Africa and offshore wind energy from northern Scotland and elsewhere. Another suggestion is subsidies for improving the energy efficiency of the housing stock, which would directly help homeowners struggling with mortgage payments as well as the hard-hit building industry.

The key concern is how to pay for such spending packages. Ralf Martin of CEP proposes an environmental tax reform, which would avoid this problem by shifting taxes from wages to pollution in a 'revenue-neutral' way. This would be good for jobs and bad for pollution – the ideal policy to boost employment without extra borrowing.

The standard argument against pollution taxes is that poorer people spend a larger fraction of their income on energy and thereby pollution. But they also receive an even larger fraction of their income in wages, which would increase with reduced wage taxes and lead to more disposable income. This extra spending power would provide an additional boost for the economy (Martin, 2009).



FINANCIAL MARKETS

Finally, what about the reform of the financial markets, the main channel through which the recession began? The IMF report describes what most agree is vital in the short term: 'one, ensuring that financial institutions have access to liquidity; two, identifying and dealing with distressed assets; and three, recapitalising weak but viable institutions' (IMF, 2009). But there is much debate about the appropriate design of global financial regulation for the longer term.

Catherine Schenk of the University of Glasgow (and a researcher in the ESRC's World Economy and Finance research programme) asks why international financial regulation has not worked in the past. Among the causes, she lists a lack of commitment by national authorities to relinquish sovereignty, reinforcement of the national approach by the variety of institutional structures (political and legal as well as financial) and the fact that although co-operative planning is prompted by a crisis, the incentives for implementation recede as the urgency for action eases (Schenk, 2009).

How does this help us with the current crisis?, Schenk asks. "We need to be sure to avoid the mistakes of the past", she says. "The strategy of developing ambitious global standards imposed by an external institution has failed repeatedly. We need a new more market-based approach that creates lasting incentives to promote less risky behaviour among borrowers and lenders and to increase transparency. The current strategy of encouraging the merger and acquisition of weakened financial institutions will make effective supervision and enforcement much more difficult."

FINANCIAL MARKETS ARE LIKELY TO FACE MUCH TOUGHER REGULATIONS, AND THERE MAY BE AN OVERREACTION

Charles Goodhart (of the Financial Markets Group) and colleagues argue that today's financial regulatory systems assume that regulations that make individual banks safe also make the financial system safe. Their latest report, published by CEPR, shows that this thinking is flawed. Actions that banks take to make themselves safer can – in times of crisis – undermine the system's stability (Brunnermeier et al, 2009).

The report calls for a different approach, in which there is 'micro-prudential' (bank-level) regulation, 'macro-prudential' (system-wide) regulation and careful co-ordination of the two. Macro-prudential regulation needs reform to ensure it countervails the natural decline in measured risk during booms and its rise in subsequent collapses.

'Counter-cyclical capital charges' are the way forward; regulators should adjust capital adequacy requirements over the cycle by two multiples: the first related to above average growth of credit expansion and leverage, the second related to the mismatch in the maturity of assets and liabilities. 'Mark-to-market' procedures must also change.

Macro- and micro-prudential regulation should be carried out by separate institutions since they differ in focus and expertise required. Central banks should be tasked with macro-prudential regulation, financial services authorities with micro-prudential regulation. Improved international coordination is also important. Since financial cycles differ from country to country, counter-cyclical regulatory policy needs to be implemented mainly by the 'host' rather than the 'home' country.

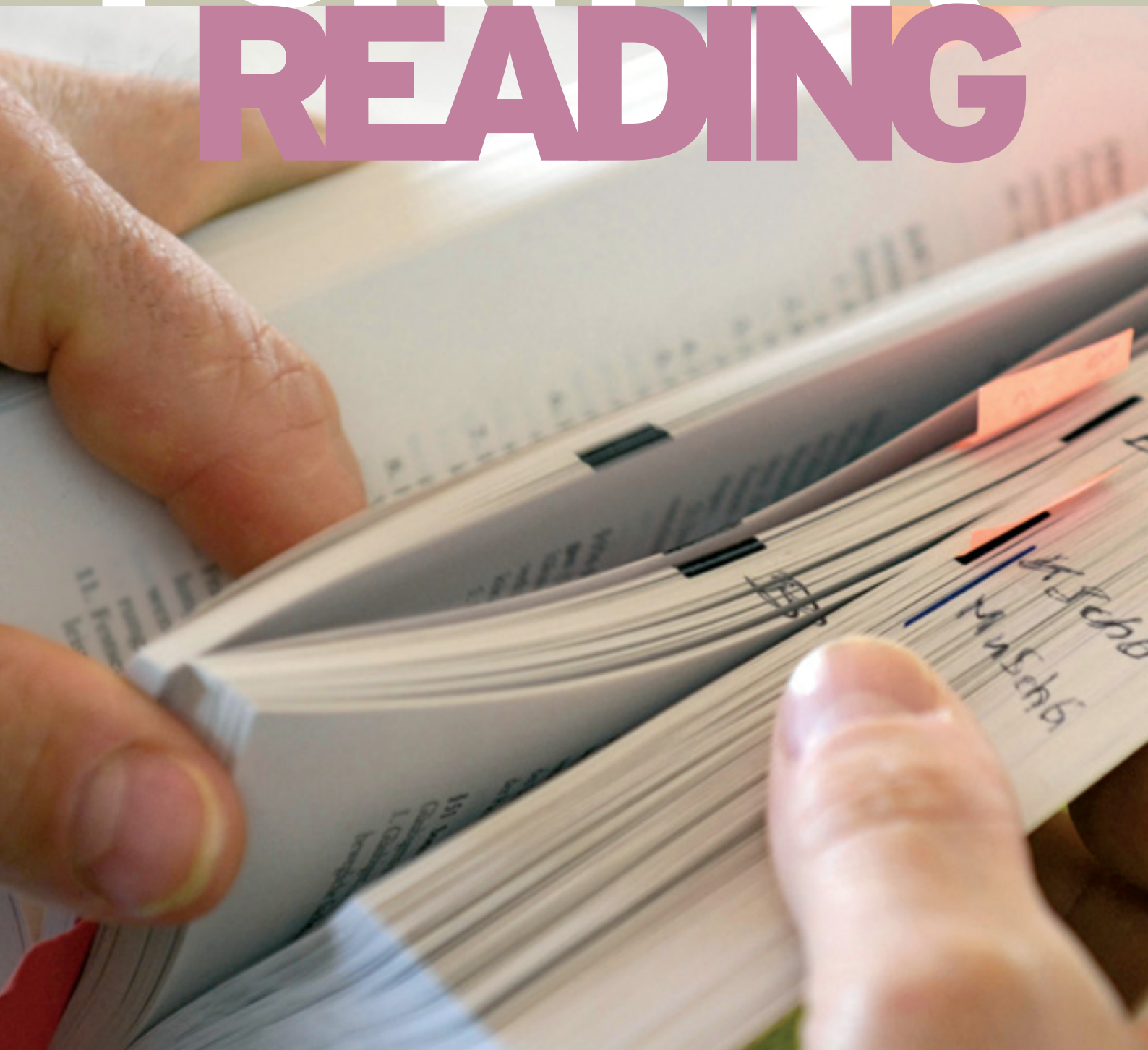
In July, the Treasury set out proposals for the reform of the financial system in a white paper. These include plans for higher capital requirements on firms that present greater risks to the system, steps to help consumers make better informed choices, and a new Council for Financial Stability – which will bring together the Bank of England, the FSA and the Treasury to monitor system-wide financial stability and respond to long-term risks as they emerge (HM Treasury, 2009).

Willem Buiter of the London School of Economics is sceptical: "Just how weak is the UK government's recent white paper? Imagine one small spoonful of tea leaves in a teapot the size of an adult beer barrel. That's how weak... four areas of weakness: (1) the continued subsidisation of the banking sector's cost of capital, (2) the failure to address the too big to fail problem, (3) the unholy mess that is the UK's Tripartite Arrangement, and (4) the foot dragging as regards the creation of new macro-prudential instruments."

On the wider international question, John Drifill, director of the World Economy and Finance programme, comments: "Financial markets are likely to face much tougher regulations, and there may be an overreaction. Their role in the global economy will be scaled back. But the financial international institutions are likely to enjoy more business in the next few years. More countries will need IMF support. The Bank for International Settlements will be busy with the redesign of global financial regulation and supervision. There will be more demand for World Bank development loans and assistance."

Drifill concludes: "Although it may take many years of high saving for households, firms, banks and governments in the West to repair their balance sheets, growth will pick up again in the longer term. The Asian tigers bounced back pretty well from 1997's financial crisis and Argentina from that of 2001. Fifteen years from now we may be arguing about whether the present crisis had any lasting effects at all."

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FURTHER READING

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ESRC RESEARCH AND ACTIVITIES

ESRC RESEARCH INVESTMENTS

The ESRC funds world class social scientists to deliver the highest quality research on the most pressing economic and social issues that we face. Some of our researchers are tackling problems close to home such as poverty, health, education and crime. Others are addressing key conundrums on the global stage – intractable issues such as the economy, environment, terrorism, sustainability and the world's poor.

Here we give an overview of the major ESRC investments in economics and financial research. To see a full listing of all ESRC research projects and investments please see: <http://www.esrcsocietytoday.ac.uk/ESRCInfoCentre/research/>

INVESTMENT	TYPE	DATE	CONTACT
An Examination of the Impact of Family Socio-economic Status on Outcomes in Late Childhood and Adolescence	Large Grant	April 2007 – March 2012	Professor Paul Gregg Tel: 0117 331 0825 p.gregg@bristol.ac.uk http://www.bristol.ac.uk/ifssoca/
Business Taxation and Welfare	Large Grant	October 2008 – September 2012	Professor Michael Devereux Tel: 01865 288507 michael.devereux@sbs.ox.ac.uk http://www.sbs.ox.ac.uk/tax/
Centre for Charitable Giving	Venture	2008/09 – 2012/13	Professor Jenny Harrow Tel: 020 7040 5210 j.harrow@city.ac.uk http://www.cass.city.ac.uk/philanthropy
Centre for Competitive Advantage in the Global Economy (CAGE)	Venture	October 2009 – September 2014	Professor Nicholas Crafts Tel: 02476 523468 n.crafts@warwick.ac.uk
Capacity in Economics of Health	Venture	2008/09 – 2011/12	ESRC office comms@esrc.ac.uk
Centre for Competition Policy (CCP)	Centre	September 2004 – August 2013	Professor Catherine Waddams Tel: 0160 359 3715 c.waddams@uea.ac.uk http://www.ccp.uea.ac.uk
Centre for Economic Learning and Social Evolution (ELSE)	Centre	October 1995 – September 2010	Professor Mark Armstrong Tel: 020 7679 4565 mark.armstrong@ucl.ac.uk http://else.econ.ucl.ac.uk
Centre for Economic Performance (CEP)	Centre	April 1990 – September 2015	Professor John Van Reenen Tel: 020 7955 7049 j.vanreenen@lse.ac.uk http://cep.lse.ac.uk

INVESTMENT	TYPE	DATE	CONTACT
Centre for Market and Public Organisation (CMPO)	Centre	October 2004 – September 2014	Professor Simon Burgess Tel: 0117 928 8436 simon.burgess@bristol.ac.uk http://www.bris.ac.uk/cmipo
Centre for the Microeconomic Analysis of Public Policy (CPP)	Centre	April 1991 – September 2011	Professor Richard Blundell Tel: 020 7291 4820 r.blundell@ifs.org.uk http://www.ifs.org.uk/esrc
Corporate Governance, Capital Markets and Performance	Large Grant	November 2006 – April 2010	Professor Julian Franks jfranks@london.edu http://www.london.edu
Spatial Economics Research Centre	Venture	2008/09 – 2010/11	Dr Henry Overman Tel: 020 7955 6581 h.goverman@lse.ac.uk http://www.spatial-economics.ac.uk
Health, Economics and Data Group	Large Grant	October 2008 – September 2012	Professor Nigel Rice Tel: 01904 321438 nr5@york.ac.uk
Economic Development and Population	Venture	2007/08 – 2010/11	ESRC Office comms@esrc.ac.uk
World Economy and Finance Programme (WEF)	Programme	March 2004 – February 2009	Professor John Driffill Tel: 020 7631 6417 j.driffill@ems.bbk.ac.uk http://www.world-economy-and-finance.org

ESRC GLOBAL FINANCIAL CRISIS LECTURE SERIES

In early 2009 the ESRC held a series of lectures designed to provide a platform for expert researchers to explore the policy issues surrounding the global economic crisis. The events provided an opportunity to participate in the discussion regarding the social issues that will arise as a consequence of the crisis.

RECESSION, HEALTH AND HAPPINESS

In the past 50 years individual levels of wealth have increased but so have crime, deprivation, depression and addictions to alcohol and drugs. Most of us believe that more money will make us happier; however, as societies become richer, research findings suggest that wealth does not positively impact on an individuals' happiness.

The lecture, chaired by economist and journalist, Evan Davis featured speakers Lord Professor Richard Layard, London School of Economics; Professor Mel Bartley, University College London; and Professor Andrew Oswald, University of Warwick, who all gave insights on the subject of how our mental health and happiness is affected by an economic downturn.

GLOBAL POVERTY AND THE RECESSION

Of the six billion people sharing our planet, almost half live under the poverty line of \$US2 per day. Though growth predictions vary, it is likely that, by 2020, the population will increase by approximately another 1.2 billion, of which some 95 per cent will live in developing countries. Such figures highlight the need to address the issues surrounding global poverty as a priority.

Chaired by Evan Davis, speakers included Dr Peter Boone, Centre for Economic Performance; Professor Tony Venables, University of Oxford; and Dr J Allister McGregor, University of Sussex.

RECESSION AND THE GREEN ECONOMY

The third and final ESRC Global Financial Crisis lecture series focused on the opportunities offered by the green economy in the current economic downturn. Despite the current financial climate the Government's latest Budget contained new measures to combat climate change – but are they signs of more to come or a missed opportunity?

Chaired by journalist and writer Polly Toynbee, speakers at the lecture included Dr Ralf Martin, Centre for Economic Performance; Dr Alex Bowen, Grantham Research Centre; and Professor Paul Ekins, Kings College London.

ESRC PUBLIC POLICY SEMINARS

The ESRC Public Policy Seminars are an established platform for expert researchers and practitioners to explore the important economic and policy issues facing the UK and the wider global society. The seminars aim to bring the best social science concepts and evidence into the policy arena and stimulate a discussion of how, in the light of these insights, policy can be developed. The goal is to encourage evidence-based policy through an exchange between researchers and policymakers. In 2009 the ESRC hosted an additional five seminars exploring the economic downturn and the recession.

RECESSION AND THE THIRD SECTOR

The ESRC in collaboration with the Scottish Council for Voluntary Organisations and with support from the Scottish Government organised this seminar to gain a greater understanding of the wider ramifications on the third sector during an economic downturn whilst providing awareness among third sector organisations of the ways they might address these.

Questions raised were, is the Third Sector likely to see the voluntary sources of its income such as general public donations contract? Should the sector expect to see the costs of maintaining assets such as community centres and village halls soar? And will there be an increasing reliance on income from and therefore dependence on public sector funding?

RECESSION AND THE WORLD ECONOMY: HERD BEHAVIOUR, CONTAGION AND REGULATION

What causes herd behaviour in financial markets? What is the likely impact of herd behaviour? And does the existence of contagion in the world economy mean that we should look more closely at the regulation of international financial markets?

These were just some of the questions raised in this seminar looking at the role of contagion in world financial markets and what lessons can be learnt for the future. Organised in collaboration with the British Academy, it brought together researchers, practitioners and policymakers to explore these issues.

SOCIAL ENTERPRISE AND THE RECESSION: OPPORTUNITIES AND THREATS

The recession will not only be a challenge for businesses and policymakers of all kinds but it will also provide a chance for change. And, with this in mind, it is important to understand how social enterprises will differ in their experiences and responses compared to conventional businesses. As a different kind of economic agent, we need to understand the contribution social enterprises can make to a society with increasing need and reduced economic demand. As a means for delivering social, environmental and economic benefit sustainably, the crisis could be an opportunity for the movement to grow and change mind sets.

Organised in collaboration with the Social Enterprise Coalition the seminar allowed entrepreneurs and policymakers to discuss issues and decide on how they will face tests of priorities and judgement.

ESRC PUBLIC POLICY SEMINARS

RECESSION, CHANGING ECONOMIC CIRCUMSTANCES AND HEALTH: THE ROLE OF RESEARCH IN BETTER POLICY-MAKING

This seminar, organised in collaboration with the Office of the First Minister and Deputy First Minister, highlights research that indicates social, economic and environmental conditions play a major role in determining health. This timely discussion looked at the implications of changing economic circumstances for not only health policy but also other policy areas, examining the relationship between research and policy-making in the field of health and changing economic circumstances.

The debate built upon existing work undertaken within Northern Ireland by the Institute of Public Health whose work has focussed on increasing knowledge and understanding to highlight the influence of social and economic factors on health.

VOLUNTARY ACTION AND THE ECONOMIC DOWNTURN: THREATS AND OPPORTUNITIES

Through a collaboration with the Volunteering England and National Council for Voluntary Organisations, this ESRC seminar looked at the impact of the current economic crisis on voluntary action and the third sector.

It has been suggested that some of the fundamental characteristics of the sector may make it particularly vulnerable, for example; its dependence on voluntary and philanthropic support from individuals; on statutory sources of income, and on philanthropic support from other institutions. Demand for its services may also increase in the light of growing social need. The debate raised the question of what exactly these effects will be on the sectors and what likely impact they will have.

**ALL LECTURES AND SEMINARS CAN BE FOUND IN MORE DETAIL AT
<http://www.esrcsocietytoday.ac.uk/recessionbritain/>**



The Economic and Social Research Council is the UK's leading research and training agency addressing economic and social concerns. It aims to provide high-quality research on issues of importance to business, the public sector and Government. The issues considered include economic competitiveness, the effectiveness of public services and policy, and our quality of life.

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