Recession to leave permanent scars

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Published: November 24 2009 02:00 | Last updated: November 24 2009 02:00

On a blustery November morning at an airfield outside London, an enormous second-hand car auction is buzzing. Demand is so great that average prices have risen 27 per cent over the past year. "The turnround started in January and we haven't looked back since," says Tim Naylor of British Car Auctions.

The global recovery is now evident across the world. The risk of a double-dip recession remains. In recent weeks, though, the US, eurozone and Japan have all reported that their economies grew again in the third quarter. Some trade-dependent economies are setting new records as they bounce back. Singapore has enjoyed the fastest rise in national income over the past six months since quarterly records began in 1975.

But though the recovery is real, so are the scars from the global recession. Some will be permanent and many will heal only very slowly. From global output on a persistently lower path than expected before the crisis, to severely weakened public finances, to the evils of long-term unemployment, to rising inequality and to a permanently altered balance of global economic power, the effects of the 2008-09 financial crisis and recession are akin to those of a war.

Professor Carmen Reinhart of the University of Maryland, who has jointly compiled the definitive history of financial exuberance followed by crisis with Professor Kenneth Rogoff of Harvard University, says: "More money has been lost because of the four words 'This time is different' than at the point of a gun."

Spanish unemployment at almost 20 per cent of the workforce with a budget deficit expected to reach 10 per cent of national income is just one legacy of the culture of easy credit-fuelled growth followed by last year's collapse.

In California, whole neighbourhoods in cities such as Palmdale and Lancaster have been left empty because of mortgage foreclosures that have continued unabated. Unemployment across the state - the most populous in the US - is running at more than 12 per cent, and the state's budget is in crisis.

The economics profession, so adept at chronicling the "Great Moderation" of economic shocks since the mid-1980s, has been forced to shelve this work. Delving deeper into history and scanning a wide horizon, it is producing evidence and clues about how lasting the scars are likely to be.

The emerging consensus - for the advanced world at least - is that they will be deep and long-lived. In its recent World Economic Outlook, the International Monetary Fund examined 88 historical banking crises between 1970 and 2002 and found, on average, that countries do not earn back all the lost ground after the recession slips into people's memories. In its database, it found that seven years after a crisis, output had fallen by 10 per cent compared with the pre-crisis path. Economic growth generally returned to the pre-crisis rate, but the loss of output seems permanent.

This average result is far from uniform, but the persistent output loss was statistically significant and, in 90 per cent of the banking crises it studied, ranged between 7 per cent and 13 per cent. After seven years, the IMF found that three separate and equally-sized forces tended to prevent economies rebounding to their pre-crisis trends.

First, the employment rate is persistently lower, as the pre-crisis boom sucked labour into parts of the economy - such as residential construction in the US - which is no longer required in large numbers. Reallocation of labour across sectors takes time and if the initial surge in unemployment persists, former employees lose skills, contacts and attachment to working. These losses are permanent.

Second, the capital stock takes a permanent knock as some plant and equipment is scrapped prematurely, while other companies struggle to invest in viable projects because banks restrict credit to shore up their finances.

Third is that labour and capital tend to combine to produce less than before, perhaps because innovative companies cannot raise capital or, as the IMF says, "productivity may also suffer due to less innovation, as research and development spending tends to be scaled back in bad times".

These effects were particularly important for countries with high investment rates before the crisis.

From his joint analysis of financial crises over 800 years, Prof Rogoff told US radio : "These are very traumatic events. They have political consequences that you can see for decades. They have profound consequences on how the economy is structured. This is going to influence a whole generation that's been through this."

The sober tone of studies of past banking crisesis evident in a study published last week in the Organisation for

Economic Co-operation and Development's Economic Outlook.

Although it calculates the initial impact of the crisis on potential output is only 3.5 per cent, this comes at a time when rich country economic speed limits are "still expected to slow from the 2 to 2¼ per cent per annum achieved over the seven years prior to the crisis to around 1¾ per cent in the medium-term, primarily reflecting the impact of ageing populations on potential employment growth".

Not all economists are so certain the scars are inevitable. Drawing on Rogoff and Reinhart's book title *This time is different,* Stephen Cecchetti, Marion Kohler and Christian Upper argue on VoxEU.org that this crisis has little in common with those studied by others.

"The current crisis is less similar to all of the crises in our database than, say, the Japanese financial crisis of the 1990s is to either the crisis experienced by Ecuador in 1998 or the one that took place in Bulgaria during the transition," they write, predicting that the particular circumstances of this recession suggests output should reach its pre-crisis level by the second half of 2010.

That would represent a much faster recovery in advanced economies than expected. But even so, they do not think the scars will heal quickly. "Regardless of whether crisis-country output returns to its pre-crisis level slowly or quickly, it is still likely to have lasting costs," they say.

Additional reporting by Kevin Brown in Singapore, Matthew Garrahan in Los Angeles and Victor Mallet in Madrid

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