Institute for Fiscal Studies

Different this time – microeconomic consequences of the recession

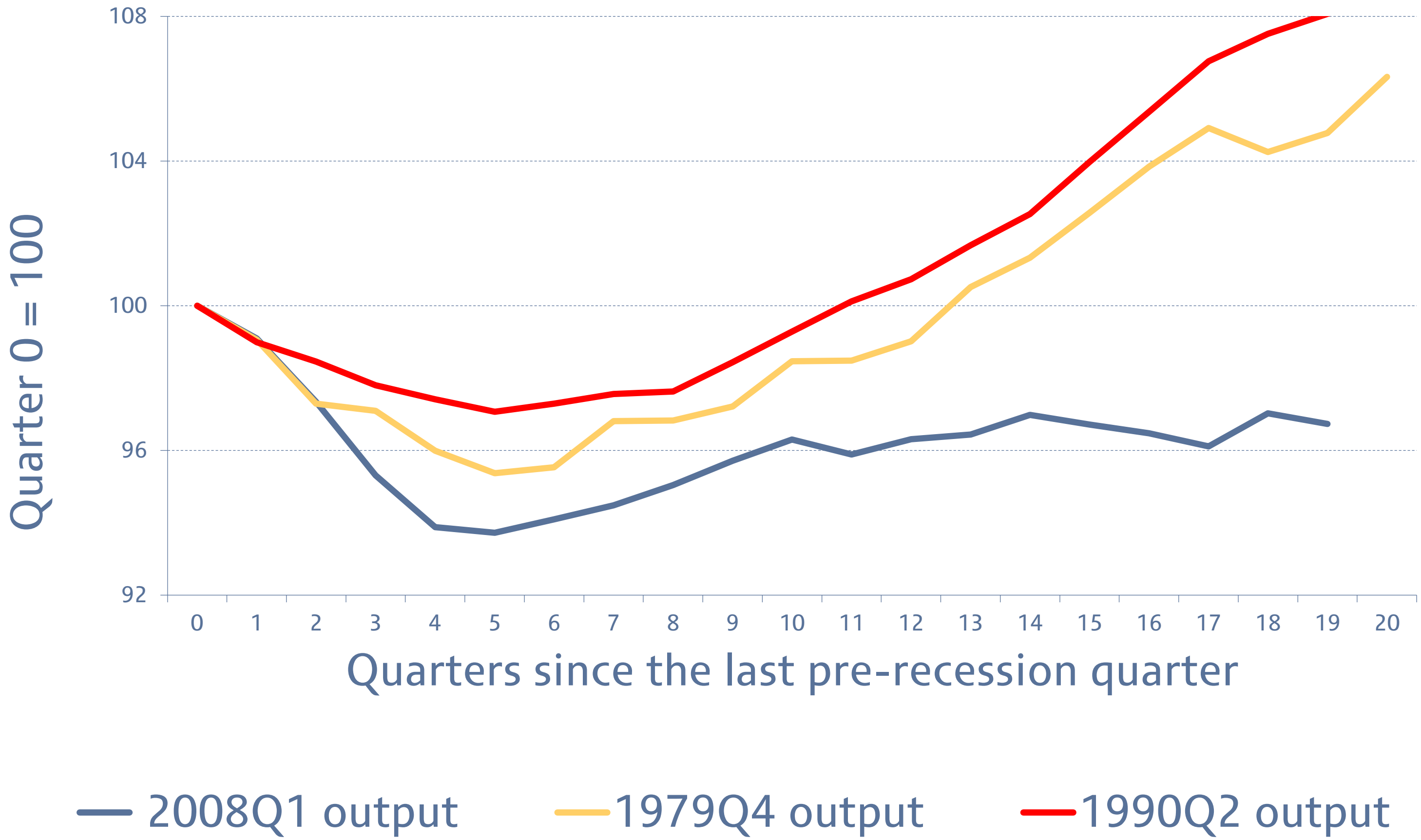
Paul Johnson (IFS)

Based on papers in June 2013 special edition of *Fiscal Studies*

Different this time

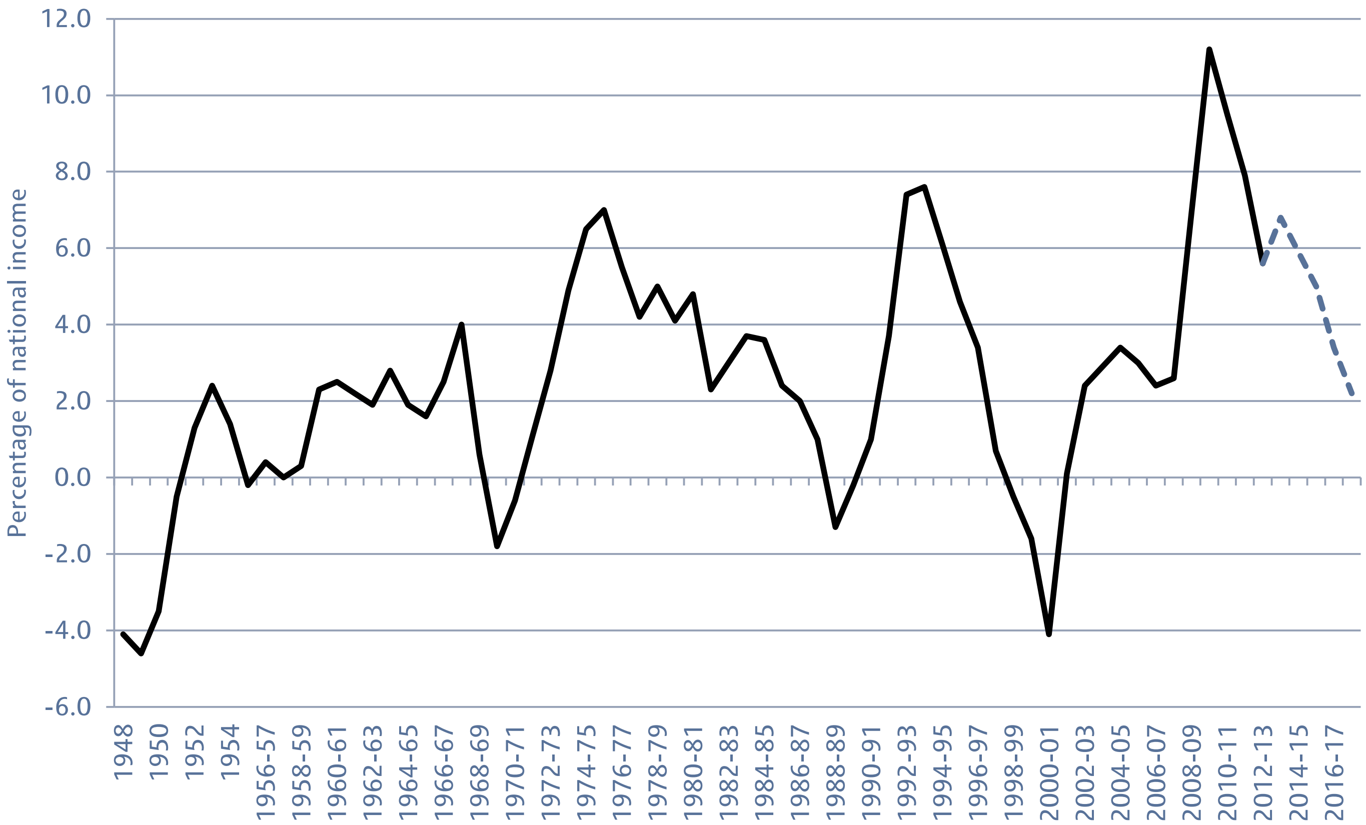
- Output has fallen further and stayed low longer
  - With well known consequences for public finances

Output has not recovered in this recession



Institute for Fiscal Studies

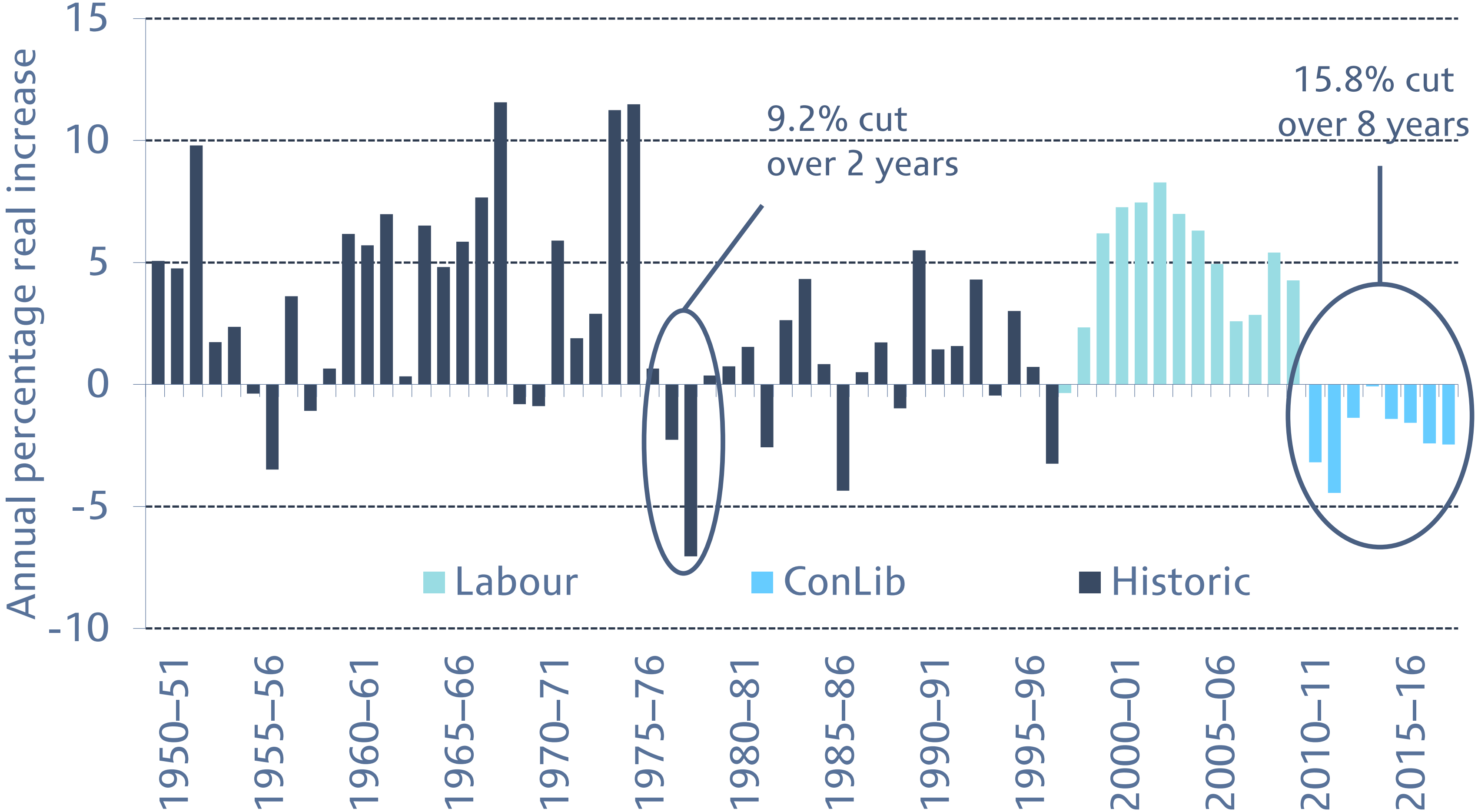
Leaving borrowing at historically high levels



Institute for Fiscal Studies

~~7-year~~ 8-year

~~6–year~~ squeeze on public service spending



Note: Figure shows total public spending less spending on net social benefits and public sector net debt interest. Data exclude 3G and 4G spectrum sales and Royal Mail pension transfer.

Institute for Fiscal Studies

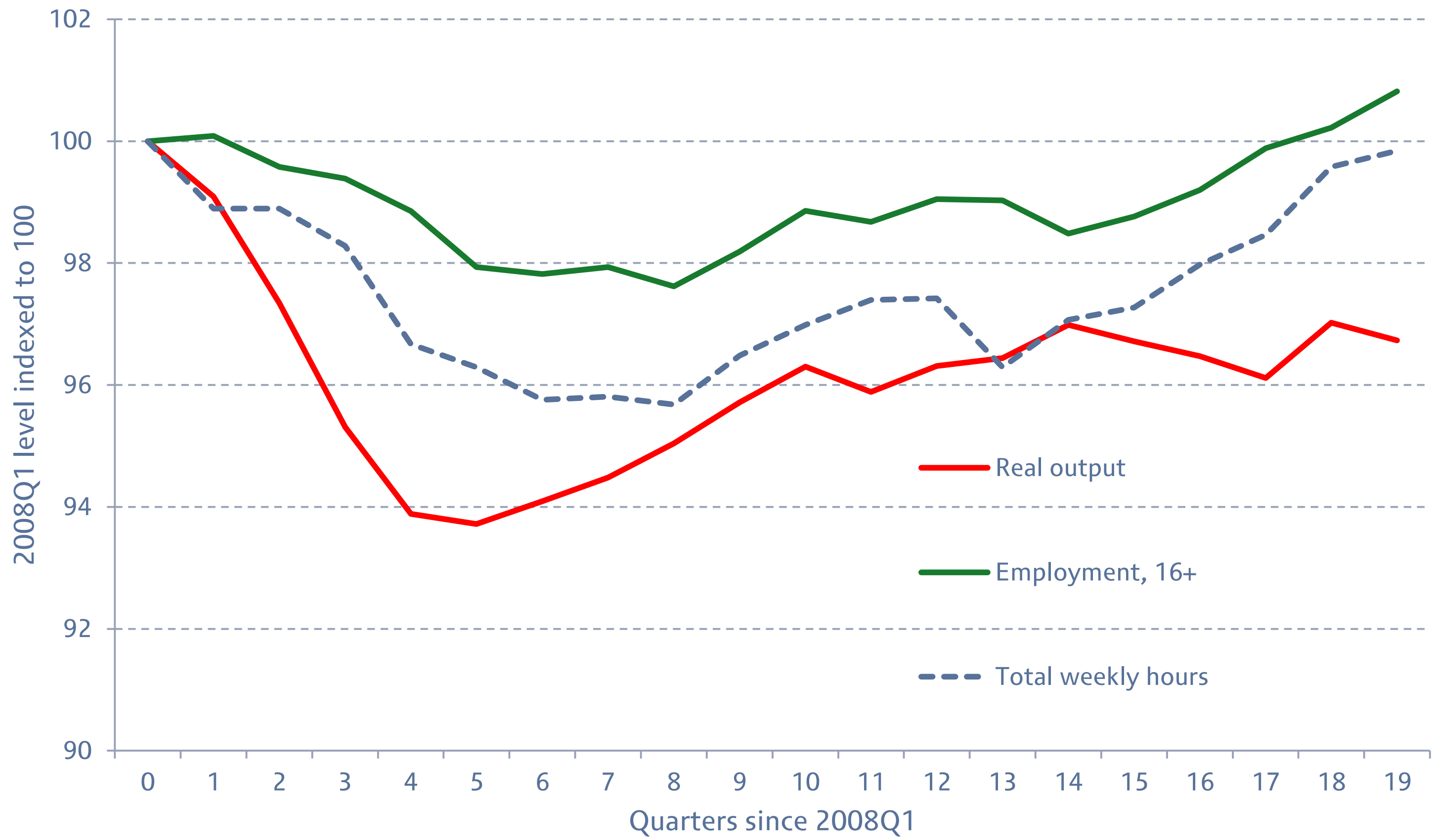
But these aren't the only things different this time

- Employment levels have held up well
- Productivity has fallen dramatically
- Incomes have become more equal
  - Though that will likely unwind
- Consumption patterns have changed
  - With the young suffering much worse than older groups
- Though some in older groups have been exposed to wealth losses
- And policy of course is different

Employment, productivity and wages

- Employment is back at pre-recession levels
  - Output is not

Changes to output, employment and hours since 2008

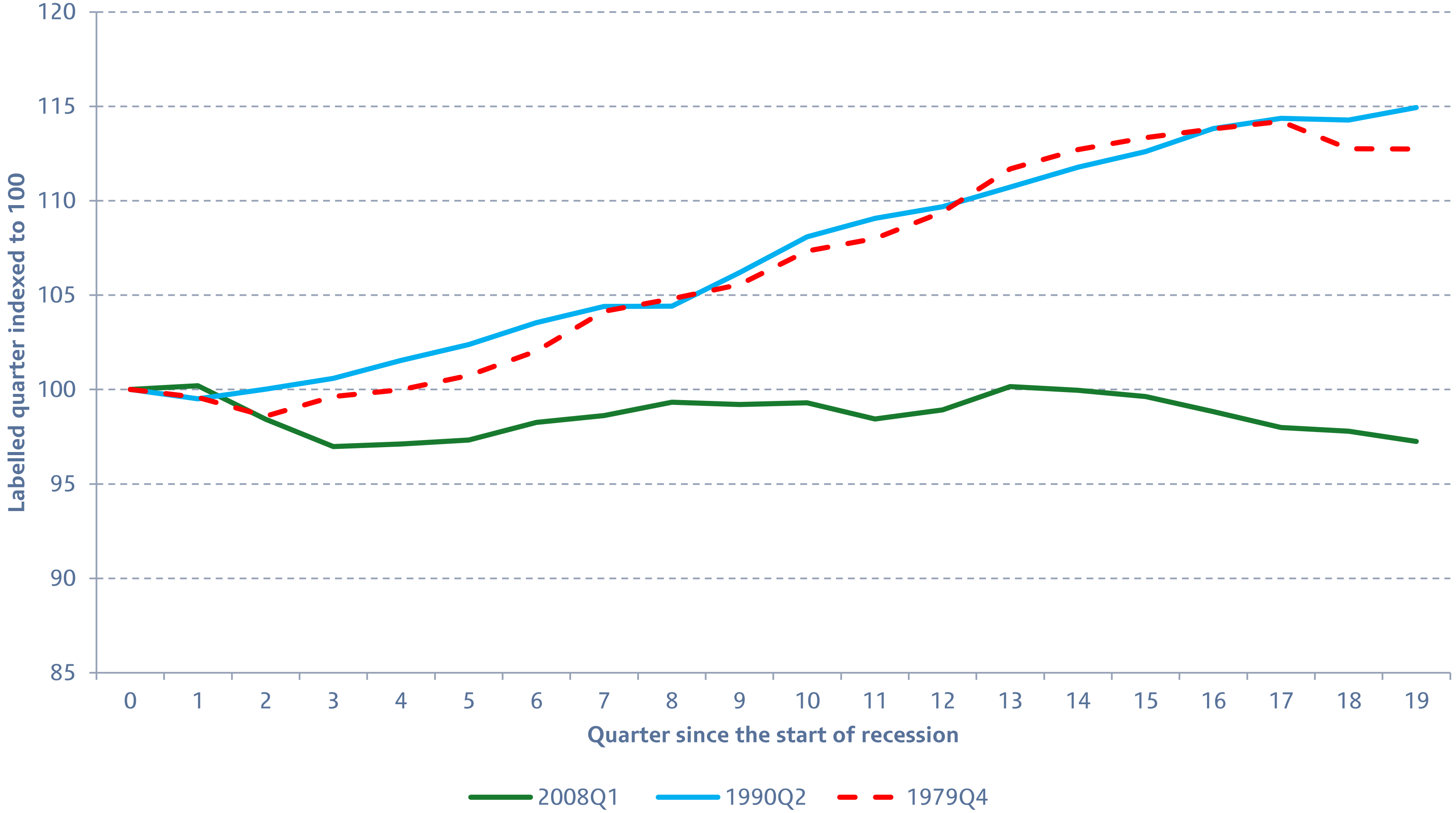


Institute for Fiscal Studies

Employment, productivity and wages

- Employment is back at pre-recession levels
  - Output is not
- So output per hour has fallen
  - In a way not seen in previous recessions

Changes to real output per hour by recession



Institute for Fiscal Studies

Employment, productivity and wages

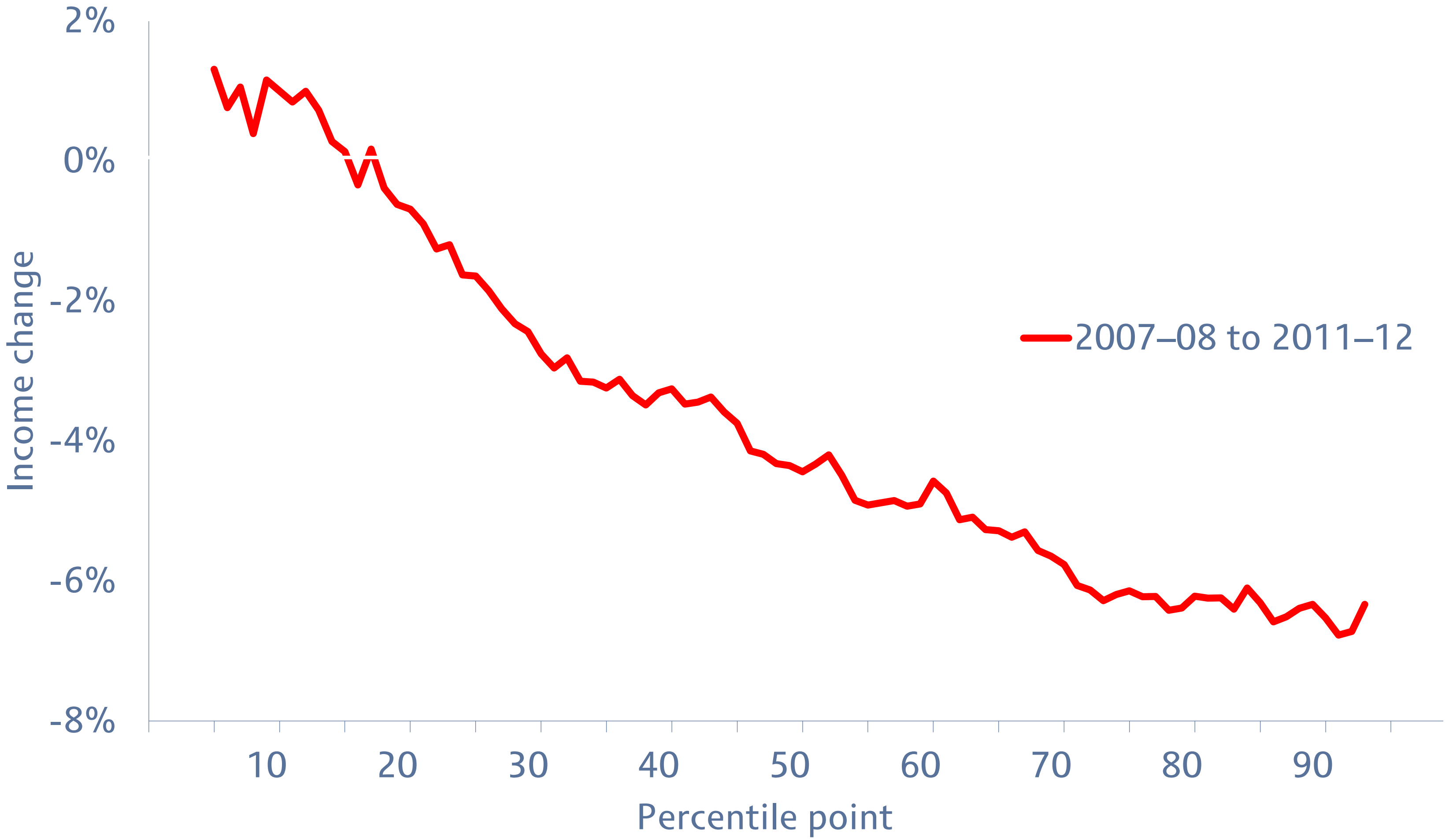
- Employment is back at pre-recession levels
  - Output is not
- So output per hour has fallen
  - In a way not seen in previous recessions
- Wages have also fallen
  - They were 6% lower in real (CPI adjusted terms) at end 2012 compared with start 2008
  - Again we did not see this in previous recessions

Changes in real wages by recession

Of course this will hit incomes

- The surprise is that incomes continued growing up to 2009-10
  - Supported by fiscal expansion
- They then fell sharply
  - By more at the top than at the bottom resulting in a big fall in inequality

Inequality simulations: 2007-08 to 2011-12



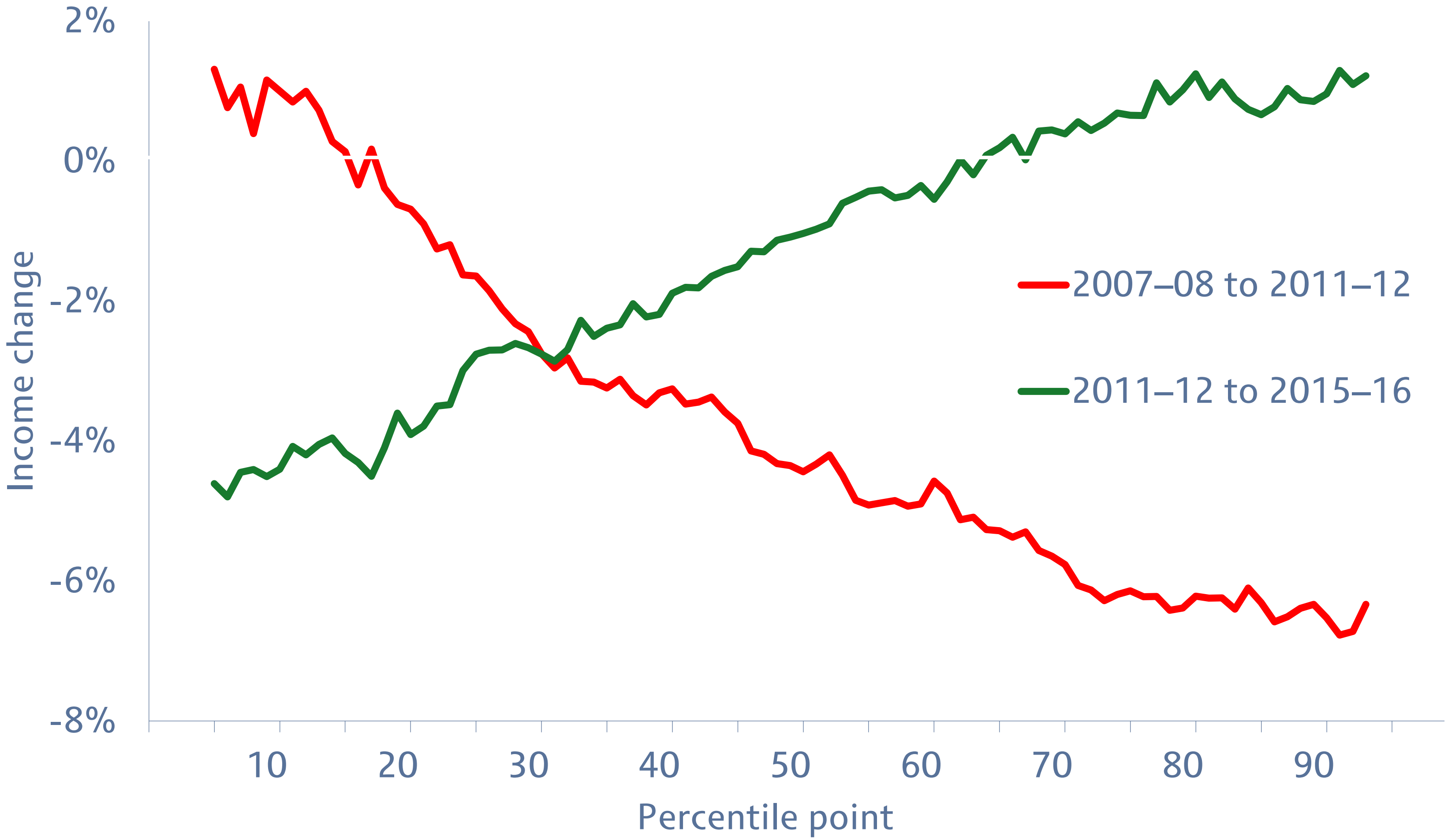
Source: Figure 3.3 of ***Living Standards, Poverty and Inequality: 2013***

Institute for Fiscal Studies

Of course this will hit incomes

- The surprise is that incomes continued growing up to 2009-10
  - Supported by fiscal expansion
- They then fell sharply
  - By more at the top than at the bottom
- The next couple of years will see poorer households do worse as benefit cuts bite
- Simulations suggest that by 2015-16 incomes will have fallen by around 5 per cent across the distribution

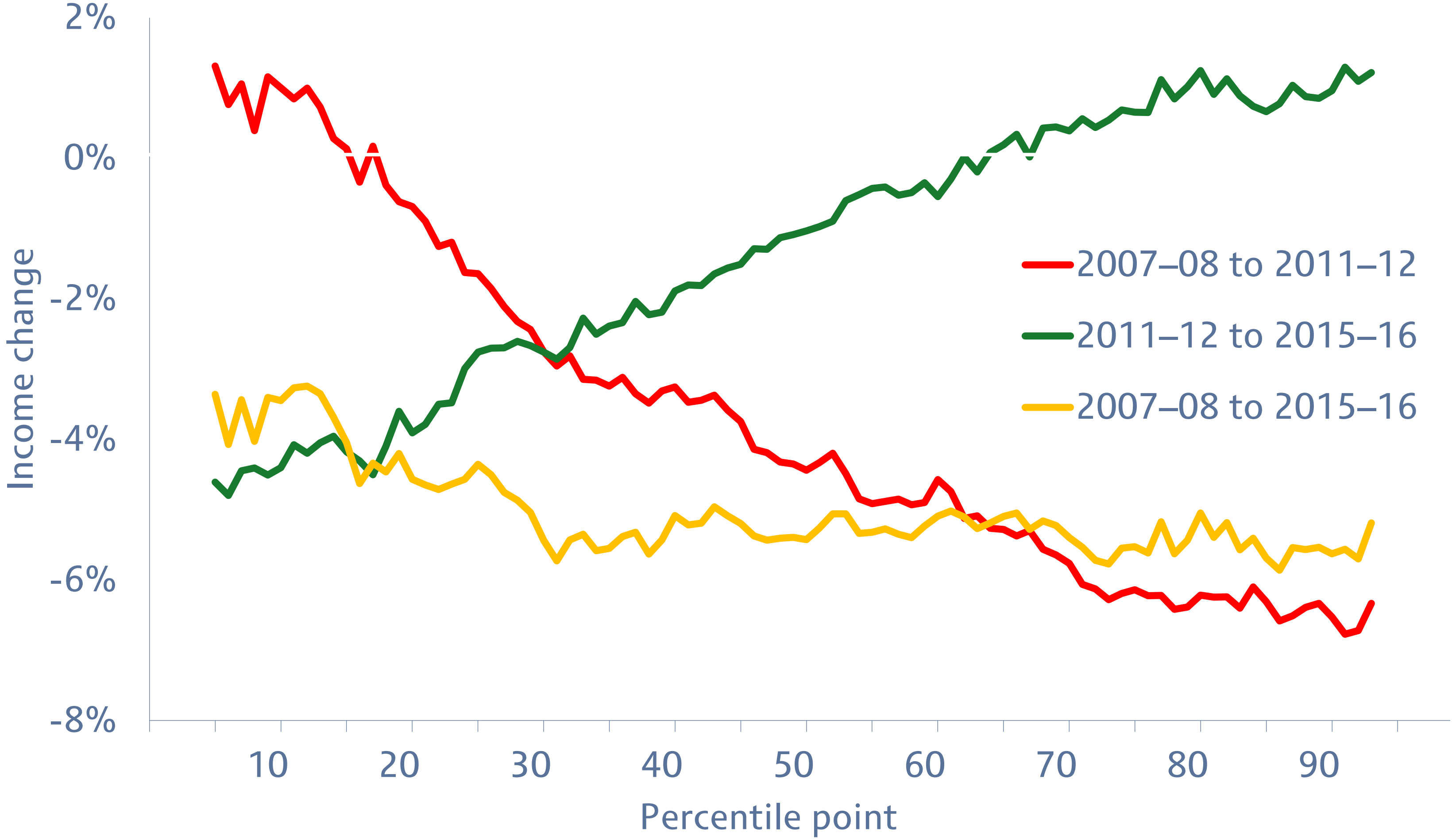
Inequality simulations: 2007-08 to 2011-12 and 2011-12 to 2015-16



Source: Figure 3.3 of ***Living Standards, Poverty and Inequality: 2013***

Institute for Fiscal Studies

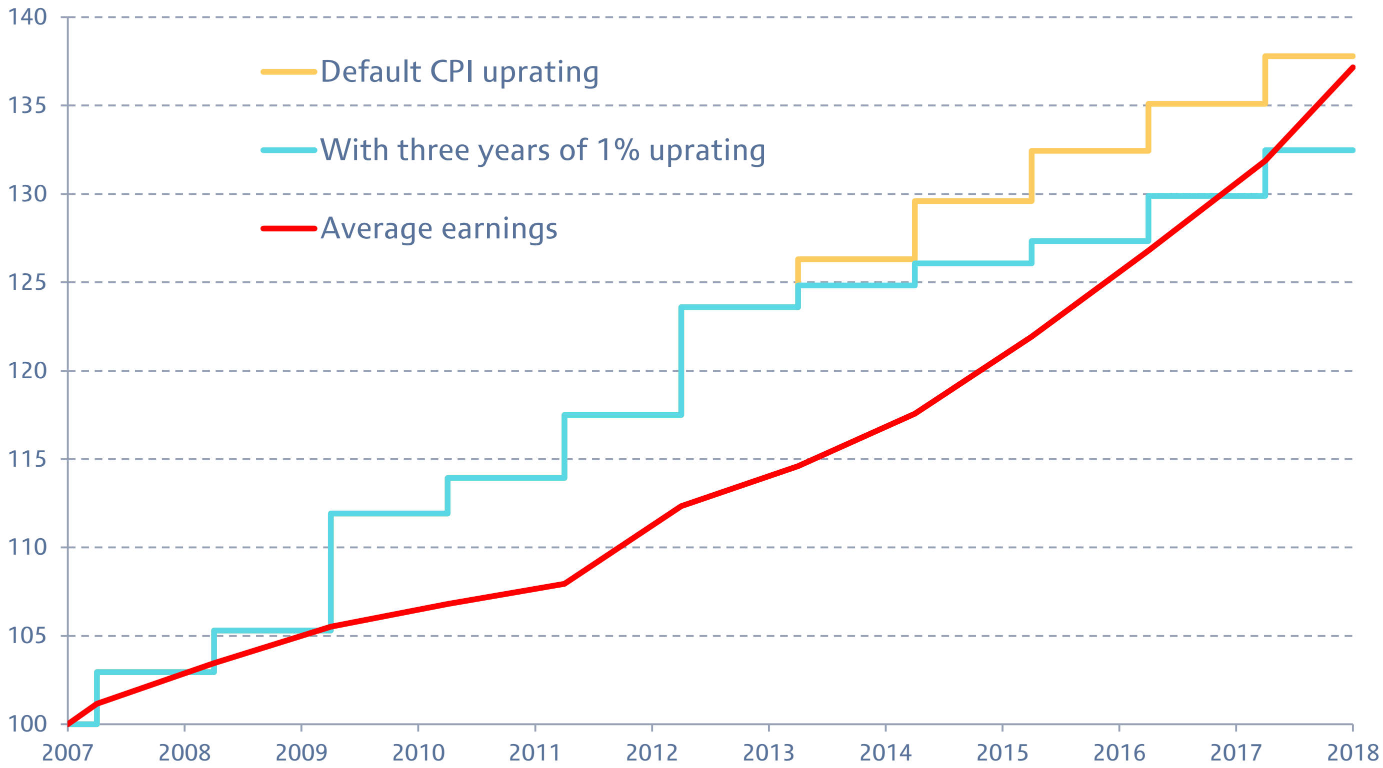
Inequality simulations: 2007-08 to 2015-16



Source: Figure 3.3 of ***Living Standards, Poverty and Inequality: 2013***

Institute for Fiscal Studies

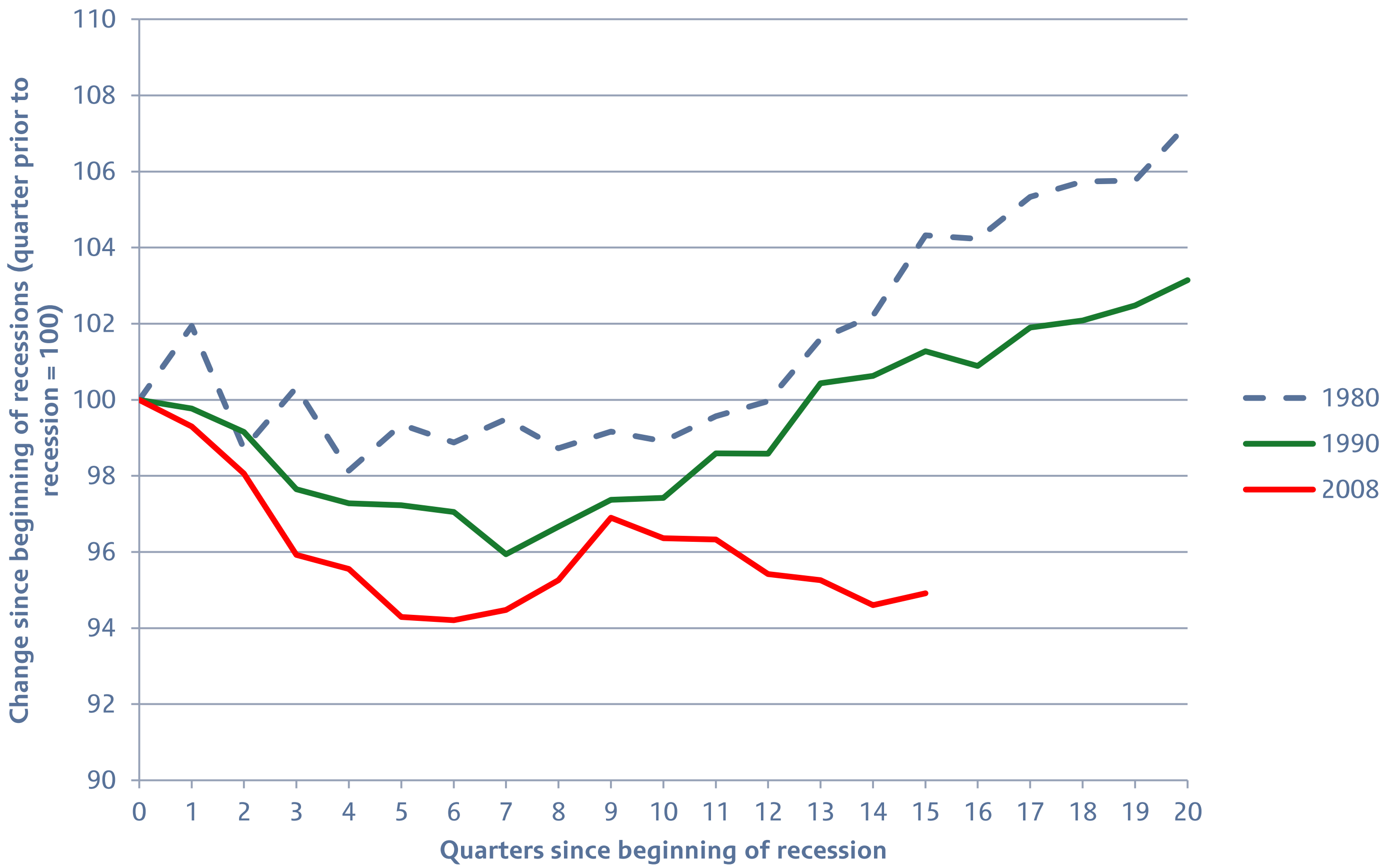
Relationship between benefit levels and average earnings is a key driver



Consumption

- Has of course fallen – but again the patterns are unusual
- Consumption of non-durables (like food) fell further and for longer than in previous recessions

Consumption of non durables fell much more than in previous recessions



Institute for Fiscal Studies

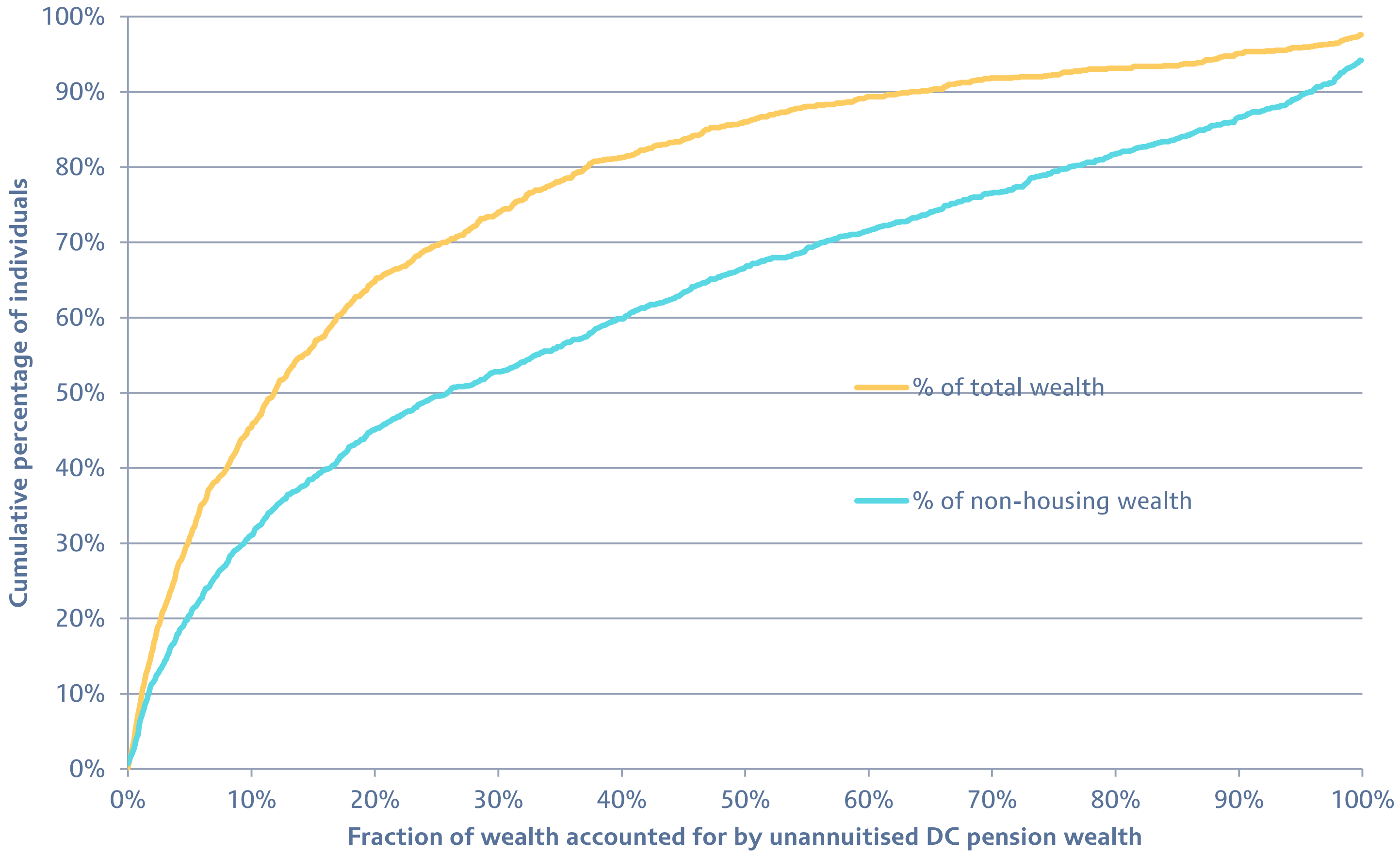
Consumption

- Has of course fallen – but again the patterns are unusual
- Consumption of non-durables (like food) fell further and for longer than in previous recessions
- And the pattern by age is different
  - Spending by those under 35 fell the most
  - Spending by those over 65 and over did not fall at all
  - Pattern much more pronounced than in previous recessions

Wealth holdings

- The recession was of course accompanied by falls in house prices and in the stock market
  - But to what extent were people exposed to these?
- Simulations suggest a fall in total wealth averaging £60,000 (about 10%) for the over 60s
  - A bit more than half that from falling property prices
- Crucially the impact of falls in asset prices (and annuity rates) is likely to grow over time as more depend on DC pension
  - About 40% of 50-60 year olds currently have an unannuitised DC pension
  - For many it is a key source of financial wealth

For those 50-64 year olds with a DC pension it is a big share of wealth



Source: Crawford and Tetlow (2012)

Policy responses

- Paper by Nick Crafts points out that austerity itself need not lead to slow growth
  - But additional policy activity is needed
- 1930s saw higher inflation reducing real interest rates
  - Loose monetary policy transmitted to real economy through housing
  - loose planning rules and cheap money leading to huge house building
- 1980s saw financial liberalisation and supply side reform
  - Tax system reform, deregulation of labour and product markets, focus on competition
- Post 2008 strategy is less clear
  - Real interest rates constrained by low inflation
  - No clear supply side strategy on tax, planning, infrastructure etc

To conclude

- Productivity has fallen as employment has stayed high
- In part this has contributed to a remarkable fall in income inequality
  - Though benefit cuts will see inequality return to pre-recession levels
- Consumption has also stayed lower longer than after previous recessions
  - With the young suffering particularly badly
- Wealth shocks are likely to become an increasingly important aspect of downturns
- The policy outlook remains rather unclear