



# Back to the drawing board

Nobel prize winner **Christopher Pissarides** is chair of a new £5m Centre for Macroeconomics at LSE that will bring together world-class experts to carry out pioneering research on the global economic crisis and help design policies to alleviate it. Here he sets out one of the key areas – the tension between unemployment and fiscal austerity.

**T**he Great Recession of 2008 is still having a major impact both on our economies and on the subject matter of economics. Mainstream macroeconomics, which played such a prominent role in defeating inflation and (we thought) large fluctuations in economic activity, has come under criticism, and rightly so. To put it bluntly, we did not know what hit us.

Do we let banks collapse and start again from the beginning? The collapse of Lehman Brothers gave the answer to that question the hard way. Do we

ignore sovereign debt and expand the economy to avoid a Keynesian depression? The rating agencies and international lenders took care of that. Do we impose austerity in the middle of recession to save enough money to give to the banks? Ask the Irish and the Spanish. And what do we do about the diverse needs of countries that share a common currency and a common market? Talk to Greek youths.

There was a clear message that macroeconomists needed to get back to the drawing board. Back in the 1970s we faced a similar problem. Rising oil prices were

bringing industrial strife, unions were fighting hard to preserve the living standards of their members and unemployment was rising. The West's industrial base was being eroded and we could do nothing about it. At LSE we responded by setting up the Centre for Labour Economics, a research centre that brought together all of us interested in unemployment, to exchange ideas and interact with other economists from Britain and abroad. In the next ten years we produced several articles and books on unemployment, which today are the mainstream models used to understand it and manage it with effective policy tools.

My own work on unemployment was developed within that research group. So was the influential work of Stephen Nickell and Richard Layard. Now we need to start again, not only with unemployment, which we understand much better than in 1980, but with a new set of problems that brings together the financial sector, the labour market, monetary unions and fiscal debt and deficits.

As back then, we have obtained funding from the ESRC for a new £5m Centre for Macroeconomics. The members of the Centre come from LSE, University College London (UCL), Cambridge University, the Bank of England, the National Institute of Economic and Social Research (NIESR) and other leading global institutions.

Five major research programmes will address the key issues of unemployment, fiscal austerity, financial markets, shifts in the world economy and the development of new methodologies to address the new world problems. Our objective is to provide both pioneering research into the macroeconomics of these issues and also research leadership for macroeconomists and policymakers. The Centre will encourage interaction with policymakers at the highest level, giving them access to our research and inviting them to give us feedback and new ideas about what we are doing.

Having said that we understood unemployment, one might wonder why we let it reach the heights that we are seeing today. When recession first hit, unemployment went up virtually everywhere in the developed world but at modest levels. The average increase in unemployment in the OECD between 2007 and 2009 was 2.7 points and in the Eurozone a mere 2 points. But then, starting in 2009, experiences diverged. Germany and the United States both experienced reductions in unemployment, as did the OECD as a whole. But the Eurozone suffered a further rise, concentrated mainly in the southern countries that were most strongly affected by the sovereign debt crisis. People talk of unsustainable debt levels and ask what we should do about them. I think what is less sustainable is the high unemployment rate in some of those countries. Spain and Greece have youth unemployment rates over 50 per cent. Sooner or later the fabric of society will be destroyed and what used to be civilised pleasant countries to visit will be unhappy countries with rioters and beggars in the streets.

Why don't we do something about it? A problem is that we know what needs to be done but it is expensive. For as long as the priority is on debt reduction, unemployment will keep going up, or if we are lucky it will stay where it is today. The current research priority is on ways to manage the debt crisis and to understand how to manage a sound and efficient banking system, not to understand supply and demand in the labour market, which was our priority in the 1980s. So far governments have reacted to the debt crisis with austerity, either voluntarily or, more often, because they had to if they were to get loans from international institutions. But Keynes could have told them the outcome of what they are doing. Indeed, one of the lessons of this recession is that Keynes and his theories are not dead. Forget his lessons and he will come back to haunt you.

There are some things that we can do to help the unemployed and it is encouraging to see the

IMF coming up with research supporting what I am about to say. As an aside, it is interesting that the IMF research is under the guidance of its chief economist, Olivier Blanchard, who was a frequent visitor to our research centre on unemployment in the 1980s and was both a consumer and a contributor of ideas. We are hoping that the new Centre will do more of this kind of research. The point that I want to make about unemployment is not the fairly obvious one that programmes help reduce the burden of job loss. The Scandinavian countries have been leaders in that endeavour and the results are showing up in lower unemployment rates, especially long-term ones. My main point is that, although the combination of fiscal austerity and structural reforms will eventually bring benefits to our economies and to Europe as a whole, the timing is not good for the unemployed.

On the one hand, fiscal austerity has an immediate impact on the economy. Demand drops, jobs close down and firms do not create new jobs to absorb those who get displaced. On the other hand, structural reforms create the environment for more profitable investment and for productivity improvements. But these reforms take time to have an effect. Employers need to see that the reforms are being implemented, they need to evaluate their potential impact on their business and they need to make sure that unions will cooperate and government will not turn a blind eye to non-compliance. In Britain, when deep structural reforms were implemented in the 1980s productivity growth did not respond for two to three years and unemployment kept going up for five to six years. In Germany, when reforms were introduced in 2003-05, there was no response from the labour market until well into 2007. The positive impact of those reforms provided a cushion in that country for the global recession that followed. In George Osborne's Britain, fiscal austerity had an immediate impact in keeping unemployment high but three years later the private sector has not yet responded with enough new jobs to absorb those who have lost their jobs in the public sector.

Our research at the Centre for Macroeconomics will go deep into the mechanisms that link fiscal austerity, structural reforms and unemployment, to avoid future repetition of the problems that are being faced today by countries that implement such programmes. The need for new research is urgent – and, given the state of those countries and the failure to bring unemployment down in the world economy, we believe that there is still time for the research of the Centre to have an impact in this recession. ■



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is School Professor of Economics and Political Science and chair of the new Centre for Macroeconomics at LSE.

## Systemic Risk Centre

LSE has also set up a new centre to study the risks that could trigger the next financial crisis. The £5m Systemic Risk Centre will undertake an economic analysis of the fundamental risks to the financial system, based on an interdisciplinary approach. It will bring together experts from finance, economics, computer science, political science, law and the natural and mathematical sciences.

Dr Jean-Pierre Zigrand, co-director of the Centre, said: "When a big crisis happens it's often not because there is a big external shock to the system but because of how small shocks are amplified through feedback loops within and between systems. We will be trying to understand those loops and networks – who is connected to whom, what that means and why."

The Centre will also analyse how computer-based trading, and high frequency trading in particular, contributes to systemic risk. A partnership with the Department of Computer Science at University College London will allow the Centre to run algorithms in a simulated environment. It is hoped that this will provide new insights into the risk of algorithms coordinating and feeding back on one another, as well as help to develop smart tools that can detect problems in real time, such as intelligent circuit breakers.

Dr Jon Danielsson, co-director of the Centre said: "We believe that the same fundamental underlying mechanisms are at work in every crisis, even though the trigger for each is different. There will be another crisis and we won't be able to predict it because the world is too complex. And it may even be exacerbated by poorly thought-out financial regulations which are meant to guard against extreme risk-taking but which may perversely increase its likelihood and severity. However, we hope through our work that we will be able to understand how to build a more resilient financial system and prevent the worst impacts of any eventual crisis."

Markit, the financial information services company, is the lead data partner to the Centre. Their data will help provide information about new vulnerabilities emerging in the financial system.



Systemic Risk Centre