CENTRE FOR MACROECONOMICS

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

Medium and long run prospects for UK growth in the aftermath of the financial crisis

CFM-DP2013-07

Nicholas Oulton[1,2]

[1]Centre for Economic Performance; and [2]Centre for Macroeconomics

The performance of the UK economy in the period 1990-2007 was excellent. Labour productivity grew strongly, and since 2000 inflation was broadly on target and unemployment was low. But the financial crisis and the Great Recession which began in Spring 2008 have dealt this optimistic picture a devastating blow. Both GDP and GDP per hour have fallen and are still below the levels reached at the peak of the boom.

The big issue is whether the economy will eventually return to the track which it was following up to the beginning of the recession. Or will the financial crisis leave a permanent mark on productivity and GDP? In this paper I argue that the *growth rate* of productivity will eventually return to the rate which would have been predicted prior to the crisis. But the *level* of labour productivity will be permanently affected by the crisis: though growing, it will always be lower than it would have been if the crisis had been avoided.

Based entirely on pre-crisis data, and using a two-sector growth model, I project the future growth rate of GDP per hour in the UK market sector to be 2.61% per annum. This includes an important contribution from ICT which is estimated to add an additional 0.52% p.a. The source of this contribution is the rapid decline in the prices of ICT products (computers, software and communications equipment) which is projected to continue albeit at a somewhat slower rate than up to around 2005.

The crisis might seem to call any such projection into question. Not only has growth stopped but the level of labour productivity has actually fallen and is still below the level achieved during the boom. I have examined nine hypotheses put forward to explain the productivity puzzle. These are:

1. Reallocation of labour to sectors with lower productivity
2. Excessive influence of hard-to-measure sectors

3. Mis-measurement of GDP due to mis-measurement of banking output
4. Overheating in the boom
5. Lower physical capital input
6. Lower human capital input
7. Labour/capital hoarding
8. Crippled banks and zombie firms
9. Austerity

I find that most of these hypotheses (including austerity) don't hold water. Only misallocation of resources due to crippled banks keeping zombie firms alive and capital hoarding show promise, but in both cases we lack the evidence to assess them.

Arguably, all these hypotheses relate to short-term effects. Theory suggests that banking crises can have long-lasting effects. One plausible mechanism is through a temporary interruption in TFP growth (or more broadly, innovation) which cannot be made up later. Employing cross-country panel date for 61 countries over 1950-2010, I estimate a model which allows one to distinguish between a short run effect of financial crises on growth rates and a long run effect on levels. I find that banking crises (as defined by Reinhart and Rogoff) have a significant long run impact on the *level* of productivity. The permanent reduction in the level of GDP per worker resulting from the crisis could be substantial, about 5½% if the financial crisis lasts five years. The cross-country evidence also suggests that there are permanent effects on employment, implying a possibly even larger hit to the level of GDP per capita of about 9%. Based on these results, the UK will eventually return to the long run growth rate predicted prior to the crisis.

The paper concludes with two case studies, the US after the Great Depression of the 1930s and Japan after the bubble burst in 1990. The US case supports the argument that the long run effect is on levels not growth rates while the Japanese case tends to the opposite conclusion. I conclude tentatively that what is different about Japan after 1990 is the huge rise in the government debt-GDP ratio. My projection for the UK is therefore conditional on the UK continuing to follow reasonably good policies, in particular not allowing the government debt-GDP ratio to rise excessively.