FINANCIAL CRISIS AND ECONOMIC PERFORMANCE: INTRODUCTION

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The performance of the UK economy has been poor since the financial crisis that began in 2007. At the end of 2013, UK GDP was still almost 2 per cent lower than it had been at its most recent peak in the beginning of 2008 and GDP per capita was over 6 per cent lower than it had been six years earlier. These outturns were much weaker than could reasonably have been expected taking account of the normal pace of economic growth. At the time of the 2007 *Pre-Budget Report*, the UK government based its projections for the public finances on the 'cautious' assumption of average annual growth of 2½ per cent. The expected level of GDP at the end of 2013 was around 18 per cent higher than was actually achieved. Moreover, employment has actually increased by over 600,000 since the end of 2007, so that it has taken more workers to produce less output.

The papers in this special issue of the *Review* assess some of the causes and consequences of poor economic performance since the financial crisis.

The first paper, by Paul Gregg, Stephen Machin and Mariña Fernández-Salgado, focuses on the impact on living standards. They estimate that median real weekly wages have fallen by around 8 per cent since early 2008. They identify three factors that have driven lower median real wages. First, unemployment has exerted more downward pressure on real wages than in previous recessions. Second, lower real wages have gone hand in hand with lower productivity in a mutually reinforcing relationship. Not only have lower real wages been a consequence of lower productivity, they have also contributed to it by creating incentives for firms to meet demand by hiring more workers rather than through capital investment. Third, real wages of typical workers have declined relative to productivity. This is partly because a larger share of worker compensation has gone towards supporting pensions, including those of already retired workers. It is also because a higher share of overall worker compensation has gone to the highest paid and a lower share to ordinary workers.

The second paper, by Rebecca Riley, Chiara Rosazza-Bondibene and Garry Young, investigates whether the poor performance of productivity was likely to have been caused by changes in the lending practices of UK banks since the financial crisis. In particular, it could be that restricted credit availability stunted the development of highly productive but bank-dependent businesses while at the same time allowing struggling businesses to survive. In favour of this hypothesis, they document a range of evidence suggesting that credit conditions for companies became more stringent, especially in the immediate aftermath of the financial crisis. But they do not find much evidence that the weakness in productivity was confined to the more bank-dependent industrial sectors, as would have been expected if banking sector impairment had been the key factor holding back productivity growth. Nor do they find strong evidence that a lack of reallocation of resources across businesses has been a substantial drag on productivity growth. The widespread weakness of productivity across sectors and businesses, even those not reliant on bank credit, casts doubt on the tightness of credit having been the major cause of the weakness of productivity. Instead it suggests a possible role for

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weak confidence, driven by elevated uncertainty, as a factor that might have held back investment in growth enhancing activities and so productivity.

The third paper, by Alina Barnett, Ben Broadbent, Adrian Chiu, Jeremy Franklin and Helen Miller, explores whether impairment to capital reallocation has contributed to the weakness of productivity. They argue that there were incentives for capital and labour to be reallocated across sectors and businesses in the aftermath of the financial crisis. Consistent with this, they find evidence of a significant increase in price dispersion and greater variability in firm rates of return in the United Kingdom since the crisis. But they also find a change following the crisis in the extent to which capital has moved in response to such incentives. It could be that more productive businesses have been unable to respond to these incentives because of financial frictions, but it could also be that they have been unwilling to do so because of weak and uncertain demand conditions. These may have encouraged them to delay the investment needed to realise the gains from reallocation. But, as the authors suggest, the resulting effects on productivity of this misallocation are likely to be only part of the explanation for weak productivity growth, in line with the findings of Riley *et al.*

The fourth paper, by Holger Görg and Marina-Eliza Spaliara, examines the impact of the financial crisis on the performance of UK manufacturing firms in export markets. One of the key puzzles following the crisis was why there was not a more significant response of UK exports to the large depreciation of sterling in 2007–8. In their examination of firm-level data, they find that companies that start becoming exporters in any given year tend to have higher levels of debt and lower liquidity than continuing exporters, suggesting that entering export markets for the first time puts companies in a more precarious financial position. They find that the impact of financial factors on the decision to become an exporter changed during 2008 and 2009, the financial crisis years in their sample. In particular they find that the level of a firm's debt was a much stronger deterrent to becoming an exporter in the financial crisis. This could potentially account for some of the disappointing export performance of UK firms in the immediate aftermath of the financial crisis.

The fifth paper, by Mary Daly, John Fernald, Òscar Jordà and Fernanda Nechio, assesses cross-country evidence on labour market performance following the financial crisis through the lens of Okun's Law, the relationship between changes in the unemployment rate and output growth. They show that typically a 1 percentage point rise in the unemployment rate is associated with a 1–1.5 percentage point fall in the growth rate of output – an Okun coefficient of 1 to 1.5. But in the crisis they find that the Okun coefficient was larger, especially in Germany and the United Kingdom. Further investigation suggests that in these countries unemployment rose relatively little following the financial crisis, but this was at the expense of weaker productivity. In other countries, the pattern was different, especially in the United States where unemployment adjusted by more and productivity was not so weak. They suggest that the response of unemployment and productivity to what was arguably a common global financial shock in the financial crisis was largely a reflection of the labour market institutions in place. In line with Gregg *et al.*, their findings point to greater wage flexibility in the United Kingdom as being one of the key factors in explaining the weakness of productivity since the financial crisis.

The papers in this special issue point to a number of factors that can explain some of the weakness in productivity and living standards in the United Kingdom in the aftermath of the financial crisis. To some extent it appears to have reflected the interaction of greater uncertainty, that encouraged businesses to delay investment and not take advantage of profitable opportunities for capital growth, with more wage flexibility, that encouraged businesses to take on labour instead of capital. To the extent that uncertainty now appears to be dissipating and confidence returning, there is the optimistic possibility of burgeoning investment and improving productivity in the years ahead as profitable investment finally takes place.