We Are Going Back to Work, But. *Published in* *The Times* *Jan 5, 2009*

Andrew Oswald
Professor of Economics
University of Warwick

Unemployment in the UK will rise strongly this year. From its current level of 6%, it is likely to reach a figure of 9% by early 2010. As is now widely appreciated, this will be a more painful economic downturn than young people, including young economists, have seen. But an economy is a patchwork of countless sectors and firms. Although employment almost everywhere will suffer, where is the downturn likely to have its most severe consequences?

Each recession has a distinctive character that is moulded by the special early forces that gave it life. To foresee where in the economy the most severe rises in unemployment will come, we need to think about those underlying forces.

Four things drove this recession. They were the housing market, the price of oil, a loss of confidence in financial institutions, and a contraction in bank lending. These, in turn, tell us which sectors of the economy can be expected in 2009 to experience the most hardship.

The primary source of the economic downturn can be traced back to the housing market. In a sense, the world's unemployment rate is now soaring because western society came to believe that house prices only go up. Nobody wanted to fall behind their neighbour, whether literally or figuratively, and the idea of a world with ever-increasing house prices was therefore promoted by mortgage lenders keen to outdo their commercial rivals, borrowers keen not to be left behind on the owner-occupier ladder, and consumers keen to borrow for a bigger car than Ms Jones living next door. As the price of housing relative to incomes and other prices went further and further above ratios ever seen, almost no-one, particularly UK politicians, wanted to point that fact out, and, just as in the earlier dotcom bubble, some analysts constructed complicated stories in their minds to rationalize the fundamentally implausible. The return now of more sensible house-price levels is making almost everyone feel worse off, although we should spare a thought for the next generation, in their school classrooms at the moment, who will benefit tremendously -- and rightly.

Because of this, the current downturn will particularly hurt -- and has already -- any sector of the economy directly or indirectly connected to the UK's owner-occupied housing market. Estate agents have already suffered. Through 2009, the effects will spread through the retailers that sell, and ultimately the firms that produce, furniture, paint, wallpaper, carpets, and everything to do with the furnishing of a home.

The second trigger for this recession was the price of oil. A useful fact to know is that eleven of twelve post-war economic downturns have been preceded by a spike in the price of oil. Some commentators have forgotten that there was evidence of a slowing UK economy even at the start of 2008. One reason was the delayed consequences of exceptional oil prices. Fossil energy is the deepest ingredient of modern life. Expensive energy causes slow-acting but corrosive increase in businesses' costs. We know from research that it erodes profit margins and leads to unemployment up to two years later.

For this reason, the second segment of the economy that will be badly affected in this recession is all activities linked to, or that depend upon, the cost of petroleum. This means the car business in all forms, air travel, chemical and fertilizer industries, and many pharmaceutical industries that rely on oil products.

The third cause of the recession, and by now the most-discussed, was the evaporation of trust in the world's banking institutions. Here, few analysts, including me, were able to forecast what happened.

In 2009, all sectors connected to modern finance will be especially hit. Those comparatively dull but important sub-sectors, like insurance, may survive without major retrenchment. But the volatile and glamorous segments of the financial services sector will not.

The fourth and final recessionary influence was a domino-like decline in bank lending. Bankers collectively now see loans as risky. That group belief creates a spiral. As one lender demands greater collateral, that leads to a multiplier effect whereby others do. Credit begets credit. Lack of credit works in the same way in reverse.

Unfortunately for our economy, and for jobs, this foundation of the current recession is the one with the furthest-reaching consequences. Entrepreneurs, including lots of small businesses, will take the early salvo. There is much research to show that small businesses depend especially delicately upon the supply of even quite small amounts of capital. For this reason, self-employment rates will be hit in the coming year. Another susceptible part of the economy is the one that sells big-ticket items. These of all sorts -- but cars and expensive electrical goods are natural examples -- are particularly harshly affected by restrictions on people's credit.

An economy can be thought of as part-engine and part-organism. When the engine begins to stall, there are automatic mechanisms that are produced from within to attempt to repair it. That is why it is a mistake to view the economy, as Soviet planning once did, as merely a machine. Machines are not self-repairing. However, the idea of the economy as a <u>fully</u> self-correcting organism came to prevail in the last 20 years, just as it did in the run-up to the Great Depression of the 30s. This is natural but mistaken. When you sail on a flat sea for long enough, you come to believe that you have learned to make the sea flat.

Unfortunately, as John Maynard Keynes reminded us, an economy is not wholly organism; it cannot always be relied upon to fix itself. That is why action is now needed. Counter-intuitively, it is a good time to use debt to spend our way out of debt. What is irrational (indeed foolish) for a person can be rational (in fact crucial) for an economy.