



The return of depression economics?

We may see governments intervening much more in markets

Romesh Vaitilingam, economics journalist

TEN YEARS AGO, Professor Paul Krugman, the most recent winner of the Nobel Prize for economics, published a book called *The Return of Depression Economics*. His focus was on the two economic disasters of the 1990s: the lost decade of economic growth in Japan; and the wave of currency crises and severe recessions, from Britain and Sweden in the early part of the decade to East Asia, Russia and Brazil in the closing years of the 20th century.

But with the credit crunch that began in August 2007 and the global financial crisis in the autumn of 2008, many now fear an economic downturn so deep and widespread as to be comparable to the Great Depression of the 1930s. Professor Krugman himself says: "All signs point to an economic slump that will be nasty, brutish – and long."

Professor Nick Bloom of Stanford University and the Centre for Economic Performance thinks about the potential recessionary impact of the financial crisis in terms of what it does to levels of uncertainty. He notes that one of the most striking

Many now fear an economic slump comparable to the Great Depression.

effects of the credit crunch is the huge surge in stock market volatility. Fears about the extent of financial damage, the identities of the next banking casualties and the unpredictability of the policy response have all led to tremendous instability.

As a result, an indicator commonly known as the index of 'financial fear' (the 'implied volatility' of the S&P 100, a US stock market index) has increased by a factor of nearly six since August 2007. Indeed, since the credit crunch began, the index has jumped to levels even greater than those witnessed after the 9/11 terrorist attacks, the Gulf wars, the Asian crisis of 1997 and the Russian default of 1998.

So why are the banking collapse and the ensuing rise in uncertainty likely to be so damaging to what everyone now calls the 'real economy'? Professor Bloom points to three channels. First, the lack of credit is strangling firms' abilities to make investments, hire workers and start innovative new projects. Second, for the lucky few firms with access to credit, the heightened uncertainty is leading them to postpone making investment and hiring ➤

ECONOMY THE RETURN OF DEPRESSION ECONOMICS?

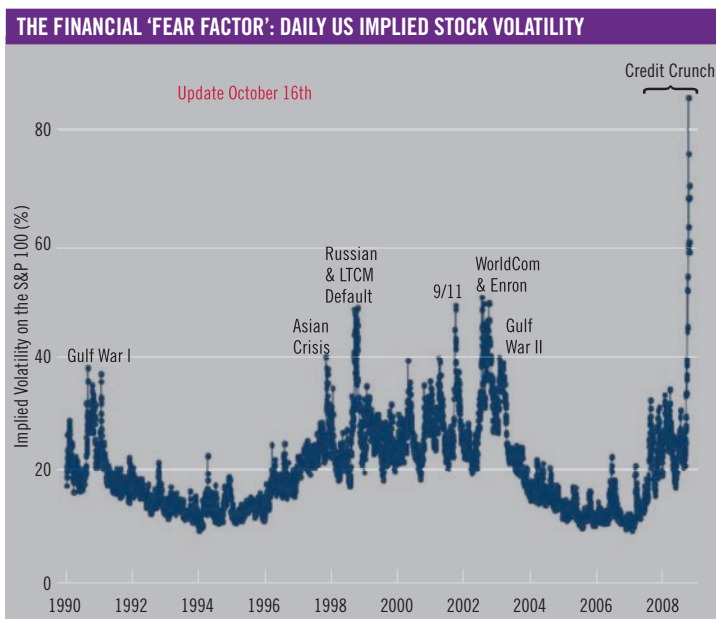
► decisions. Finally, he fears, there is the spectre of a damaging political response, most dangerously in a potential bout of protectionism. One of the major factors compounding the Great Depression was the Smoot-Hawley Tariff Act of 1930, which was introduced by desperate US policymakers as a way of blocking imports to protect domestic jobs, but which helped worsen the recession by freezing world trade.

Professor Krugman's book of a decade ago said: "Most modern economists regard the Great Depression as a gratuitous, unnecessary tragedy. They believe that what might have been an ordinary, forgettable recession became a nightmarish slump thanks to the stupidity (or at least the ignorance) of policymakers." So if he's expecting a slump now, where might be the big policy mistakes?

One problem may be not so much error as ineffectiveness. In a depression, monetary policy – the key tool of macroeconomic management for at least the last two decades – may not work. This was one of the revolutionary insights of John Maynard Keynes' book *The General Theory of Employment, Interest and Money*, published in 1936: sometimes cutting interest rates won't persuade the private sector to spend more, and the government must step into the breach with higher public spending or lower taxes.

In the introduction to a new edition of *The General Theory*, published in 2007, Professor Krugman notes that this applied to Japan in the 1990s as well as during the Great Depression: "From the early 1990s at least through 2004, Japan was in much the same monetary state that the US and UK economies were in during the 1930s. Short-term interest rates were close to zero, long-term rates were at historical lows, yet private investment spending remained insufficient to bring the economy out of deflation. In that environment, monetary policy was just as ineffective as Keynes had described."

Professor Krugman continues: "Attempts by the Bank of Japan to increase the money supply simply added to already ample bank reserves and public holdings of cash while doing nothing to stimulate the economy. And when the Bank of Japan found



itself impotent, the government of Japan turned to large public works projects to prop up demand."

Robert Chote, director of the Institute for Fiscal Studies, suspects that economic policymakers in Britain will opt for a Keynesian stimulus in response to the current recession: "The government may feel it has to give away more money in the short term, to help the Bank of England sustain economic growth – and to show the voters that it feels their pain."

But he worries about the longer-term fiscal implications: "Experience from the last recession suggests that we may well be left with an unsustainably large structural budget deficit. This would reflect a combination of factors – the large structural deficit we already had, a lower estimate of present economic capacity, a possible fall in the future trend growth rate of the economy, the policy loosening we have seen since the Budget, the big declines in the housing market and the equity market, and a diminished medium-term role for the financial sector."

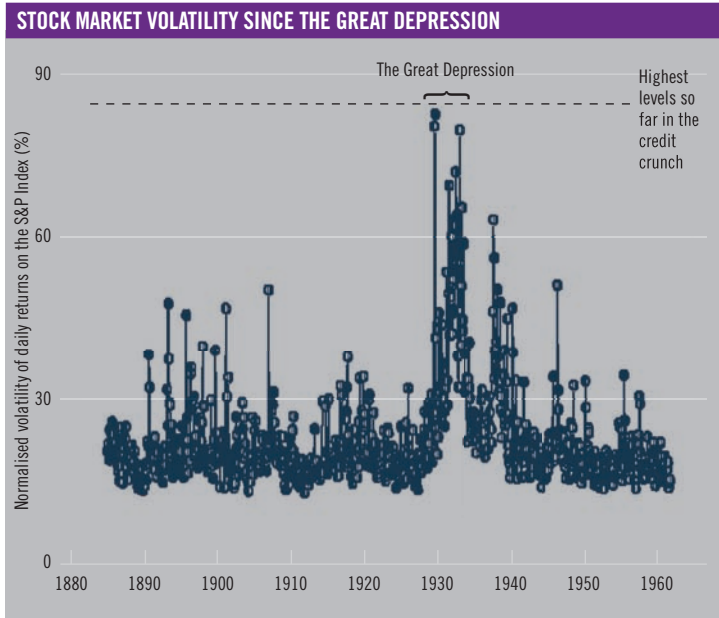
What's more, Chote adds: "There is the much more uncertain magnitude of any long-term losses on the government's investments in the banks, plus any costs accrued if its guarantees to the interbank market are called upon."

What about the future for the banks themselves? Former chair of the ESRC Lord Turner, who became chair of the Financial Services Authority in the summer of 2008, is looking to put his stamp on a new era of financial market regulation: "We'll have more people looking at the high-impact, systemically important firms with major knock-on effects than we did before," he says. "We will pay more than necessary to attract the correct quality of people from outside. Poachers turned gamekeepers are very attractive to hire."

Lord Turner plans work in three areas. First, the capital adequacy regime for banks: current rules may have encouraged institutions to lend too liberally in the boom years and too little when times got tough.

Lord Turner on recruiting new regulators: "We will pay more than necessary to attract the correct quality of people from outside. Poachers turned gamekeepers are very attractive to hire."





Second, liquidity, focusing on whether financial institutions' business models are solid enough in bad times as well as good. Finally, pay, on which Lord Turner comments: "Our role is to look at the structure of remuneration going forward – whether there is the danger of somebody being paid a large amount of money for something that looks clever at the time but two years later turns out to be toxic."

Professor Andrew Oswald of the University of Warwick thinks more needs to be done to understand the roots of financial crises in 'herd behaviour'. "Why do herds form?" he asks. "They happen when relative position matters. People paid extraordinarily high prices for houses, even though not justified by fundamentals, because they felt they were trailing behind the Joneses. Brokers sold unsound mortgages because they had to keep up with rival brokers. Money managers – remunerated on their relative performance against other managers – traded shares with the same motive."

Professor Oswald is critical of the economics profession: "The word 'herd' does not appear in

Current rules may have encouraged banks to lend too liberally in boom times.

dioxide emissions. Pollution is tightly linked to the level of economic activity, so that a few years of negative growth would lead to reductions in pollution levels not seen since the 1970s."

There might also be a change in people's attitudes to inequality. When the economy is growing and almost everyone's standard of living is improving, there tends to be less public concern with the distribution of income. Indeed, as research by Professor Alan Manning of the Centre for Economic Performance finds, while inequality in Britain now is much higher than it was in the 1970s, the popular demand for redistribution of wealth is much lower.

Professor Manning explains that many fewer people seem to believe in the 'class war' – that there is one law for the poor and one for the rich, or that big business benefits owners at the expense of workers – and those in the middle are no longer envious of the rich, instead aspiring to be the rich. But these views could shift, he says: "As we enter a recession in which the average Briton is quite likely to feel the pinch, it may once again become an attractive political policy to seek to increase the share of taxes paid by the rich."

Robert Chote too sees the possibility of changed attitudes: "An interesting political question is whether the growing popular perception that it was overpaid, under-taxed bankers and City financiers who got us into this mess will affect how the government chooses to raise the money," he says. "For example, will it affect how much the government tries to collect from high-income households versus middle-income households and from taxes levied formally on the personal sector versus the corporate sector?"

If the Great Crash of 2008 is indeed followed by the return of depression economics, we could see many changes of this kind as newly interventionist governments respond to public demand for action to limit the power of markets. ■

<http://www.ifs.org.uk>

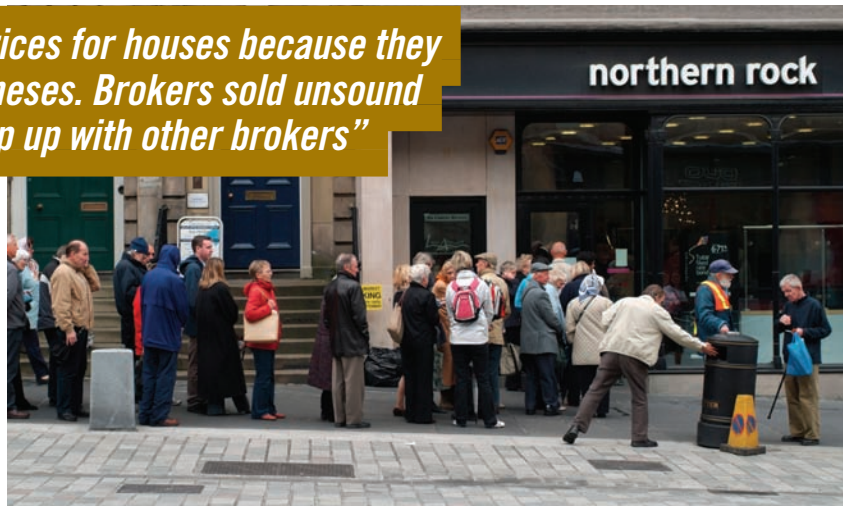
<http://cep.lse.ac.uk>

<http://www.andrewoswald.com>

"People paid extraordinarily high prices for houses because they felt they were trailing behind the Joneses. Brokers sold unsound mortgages because they had to keep up with other brokers"

leading textbooks. In consequence, those texts do not offer an intellectual framework that could have predicted, or that can help policymakers in, our current dilemma. Just as before the Great Depression, economists and central bankers have been using the wrong model of human behaviour. It will be necessary to rewrite standard economics."

What other changes might we see? Professor Bloom points to climate change: "The only upside of all this is that the massive slowdown in economic growth will rapidly cut the growth rates of carbon



Location, location, location

THE SPATIAL DISTRIBUTION OF PROSPERITY

DR HENRY OVERMAN,
Director, Spatial
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LAST SUMMER, the thinktank Policy Exchange caused controversy with a report on urban regeneration. In essence, this suggested that some places in Britain (mostly in the North) have lost their *raison d'être*, that regeneration efforts aren't making a difference and that we should build houses (in the South) so that people can move to places with better opportunities. Conservative leader David Cameron, who was touring marginal northern constituencies at the time, dismissed the report as insane. Government ministers agreed. The authors faced a barrage of criticism from offended individuals and local authorities.

The basic counter-argument goes like this: 'I am from [insert name of place]. It's a lovely place to live because [insert something nice about the place or mention the low cost of living]. If you want to see where [insert name of place] is heading, just look at the development of [insert name of nice new buildings].'

These reactions remind us that people and places are different and that amenities and cost of living matter as much as economic opportunities. But they miss a much more serious question: why do some regions, cities and communities prosper while others don't, and what, if anything, should government policy try to do about it?

There is no doubt that economic activity in Britain is very unevenly distributed. In 2004, gross value added (GVA) per person (adjusted for commuting) in inner London, and in Berkshire, Buckinghamshire and Oxfordshire was £24,500 and £23,700 respectively – about 40 per cent above the national average of £17,100.

The trade-off between these costs and benefits determines which areas are rich and which are poor

In the same year, Cornwall and the Isles of Scilly, west Wales and the Valleys, and the Tees Valley and Durham had GVA per head of £11-13,000 – 24 per cent or more below the national average. The differences would be even more striking if we considered particular cities or neighbourhoods within cities.

This unevenness can not be explained purely by inherent differences in physical geography, such as natural resources. Instead, over time, the economic system amplifies initial differences to generate persistent disparities. This happens because there are self-reinforcing benefits from the concentration of activity.

These benefits arise in many different ways. As long ago as 1890, Alfred Marshall suggested that spatial proximity benefits firms and people because it helps the transfer of knowledge, allows people and firms to specialise and makes it easier to trade goods and services that are costly to transport. Economic geographers continue to research to quantify these benefits.

A range of costs offset the benefits: as activity

concentrates, the prices of scarce resources, such as land, increase; firms face more competition, roads get congested and pollution worsens. The trade-off between these costs and benefits determines which areas are rich and which are poor; which grow fast and which grow slowly. Factors like technological change and globalisation affect the trade-off, with fundamental implications for Britain's spatial economy. Responses to these changes are not instantaneous, but play out over time as people and organisations slowly adjust. And, of course, government policies shape all these relationships.

Understanding spatial disparities, and identifying the appropriate policy responses, requires a much deeper understanding of the costs and benefits. What causes them? Are they changing? What are the implications? What policy interventions are effective? Are there trade-offs between spatial disparities and economic efficiency?

These questions are difficult to answer. There are many sources of costs and benefits and their importance differs across individuals, firms and locations, raising the possibility of 'sorting': different kinds of individuals and firms choosing to locate in different places.

Sorting is a key factor that makes spatial policy so difficult to get right. Many disparities reflect inequalities in society that may not be directly affected by spatial policy. Differences between the North and South, between Manchester and Leeds, between Hackney and Westminster, partly reflect decisions by people and businesses about where is best for them to live, work or produce. The greater the difference between the fortunes of financial services and traditional manufacturing, or between low- and high-skilled workers, the greater will be the likely spatial differences that result.

Personal inequality in Britain is high relative to many other European countries, as is the contrast between the performance of some of our manufacturing and financial services. So it's no surprise that spatial inequalities – such as 'postcode lotteries' in health or 'north-south divides' – partly reflect that. Spatial policy may play a role in addressing these equity concerns. But other policies that directly affect the underlying personal inequalities are likely to be far more effective.

At the same time, because some economic outcomes depend on location, even for similar people or firms, there can also be a role for spatial policy in making the economy function more efficiently. The difficulty is determining when this is happening and what policy might do, particularly since sorting based on personal differences means the existence of spatial inequalities per se tells us nothing about whether or not such effects are important.

In the current economic climate, getting the answer to these questions right and formulating the appropriate policy response matters much more than whether I think my town is better than yours. ■

<http://www.spataleconomics.ac.uk>



WHO PLANS FOR RAINY DAYS?

Government assumptions that we will behave rationally with money may be optimistic at best

THE GOVERNMENT IS increasingly encouraging us all to plan ahead financially. Give us all adequate information, it seems to assume, and we'll make good choices. But what is the reality of people's decision-making about money?

We know that how much you have – and to some extent, your gender – plays an important part in how people think about future risky life events. Research by David Abbott, Deborah Quilgars and Anwen Jones, has explored other aspects of people's lives in relation to financial planning.

Their study, as part of the Network, Social Contexts and Responses to Risk, has examined how being a practising Christian or Muslim, being gay, lesbian or bisexual, being disabled or being black or Asian influences individuals' approaches to money. Might people make decisions that make sense to them and their situation, but which won't always make sense to the rational policymaker?

The study finds that Christians and Muslims refer to their beliefs in the way that they approach money. Muslim people have a strong preference for minimising borrowing, avoiding interest on savings and taking only essential insurance policies. Giving money away is important to both Christians and Muslims: "If you give to the poor, God gives you more – and that's my theory, really," said one Muslim woman.

Some Christians see risky events more as being part of 'God's plan' than as things that could be avoided. Muslim people say that being careful with money is an important aspect of their cultural background: "It's heavily indoctrinated... to save and not be too frivolous."

Very few people interviewed thought that they faced significant risks in relation to money, job security or ill health. Most said they were more concerned with having enough money to be comfortable in old age. This was especially true for

Christians may see risky events as being 'part of God's plan'.

gay people, where the emphasis was on being able to maintain a 'good lifestyle' into old age, perhaps in the absence of more traditional family networks to support them.

One group stands out: disabled people. They said that their place in the labour market felt precarious and they didn't feel that there were other jobs they could readily take up if the need arose. The extra costs of disability make it difficult to save and they reported facing exclusion and discrimination when it came to financial services such as insurance.

So what's the conclusion? Faith appears to have a net positive impact: risks are feared less, but planning is helped by a dislike of debt and a desire to live within one's means.

Roughly half of the gay people in the study said that they thought that their sexuality did have an influence on their choices. Black people said they thought their ethnicity made very little difference and felt they were making the same choices and having similar chances as their white peers. Asian people – particularly Asian men – prioritised working hard, saving hard and minimising debt, and said this was part of their upbringing. Disabled people faced risky and uncertain futures and were, in some ways, least well placed to protect themselves from risk.

Of course, the research is showing us just how complex decision-making is. Faith, sexuality, ethnicity and disability sit alongside other important factors, such as upbringing, friends, opinions and having children.

All these things get taken into account when we plan – or don't plan – for future rainy days. But recognising the complexity is a message to policymakers: assuming that we'll all 'do the right thing' when it comes to money may well be wide of the mark. ■

<http://www.kent.ac.uk/scarr>

AT A GLANCE

Religion, sexuality, race and physical disability all influence how we approach the planning – or lack of planning – of our personal finances.



ANNUITIES: MANAGING THE RISKS OF UNCERTAIN MORTALITY

THE ANNUITY MARKET has traditionally offered people a means of protecting themselves from the risk of living for a long time. Essentially it works by pooling the resources of a group of people of the same age, with the resources of those who die early being transferred to those who live longer.

The amount that any annuity can pay out is based on forecasts of the number of each insured cohort that is expected to survive to any given age. So an insurance company that sells annuities faces a risk: if its customers live longer on average than it has forecast, then it is out of pocket on the deal.

If annuity buyers die early, the company gains. But the two outcomes probably do not offset each other because companies have to worry about going bust as a result of over-generous promises. The fact that they may be equally likely to make a profit does not really compensate for this.

Data on pension buyouts suggest that relatively large charges are imposed to protect insurance companies from this risk, with the result that annuitants may feel they get a poor deal. Research by Martin Weale at the National Institute of Economic and Social Research (NIESR) has examined whether annuities might function better if annuitants carry the risks associated with uncertain mortality rates – a situation they are likely to prefer to facing a substantial charge for protection from the risk.

The NIESR analysis as part of the World Economy and Finance programme suggests that even for a population that is not very tolerant of risk, a mortality-adjusted annuity would, in its early stages, pay out about 0.2 percentage points less than in the absence of risk and uncertainty. This would provide a reserve to be used if mortality rates were lower than forecast.

If forecasts were met, there would be an upward drift in payments. If they were awry, payments would be cut. But there is a chance of less than one in two hundred that payments would fall by as much as a fifth as a result of unexpected longevity. These findings show that annuities of this type offer a better means than high charges as a way of handling uncertainty about future mortality rates. ■

<http://www.worldeconomyandfinance.org>
<http://www.niesr.ac.uk>

THE FUTURE OF BRITAIN'S FOOD SUPPLY

What will be the impact of rising prices?

FOOD PRICES IN Britain rose by nearly ten per cent in 2008, and there were similarly sharp price rises across global food markets as demand for food rose and supply was constrained. To assess the likely future impact of these forces on Britain, a team of researchers recently gathered under the Chatham House banner to convene stakeholders in the food supply lines for dairy and wheat. The team included Professors Robert Lee and Terry Marsden from the Centre for Business Relationships, Accountability and Society at Cardiff University.

The focus of the discussions was the series of future scenarios outlined in the chart opposite. These asked, across slightly different time frames, whether recent rises in prices were 'just a blip' or Britain faced more persistent food inflation; whether there would be a 'food crisis'; and if so, whether new modes of agricultural production would develop.

A rising global population means not just more mouths to feed but more sophisticated tastes to satisfy as developing countries grow wealthier. The 'nutrition transition' in countries like India and China involves a shift away from traditional vegetable staples towards consumption of more meat and dairy products, more refined and processed food, and more sugars, oils and fats. These foods require far more inputs at a time when global supply capacity is struggling to keep up.

That food prices should rise at the same time as oil prices is not accidental. The World Bank warned in 2008 that high costs of petrochemical-based fertiliser could reduce agricultural production, especially in poorer countries, causing shortages and inflating food prices. Transportation is another factor, as freight costs are also pushing up the price of food. At the same time, the recent sudden switch into crops for biofuels could be responsible for as much as three quarters of food price rises.

Resource constraints in other areas are beginning to affect food production. Agriculture consumes 70 per cent of potable water and trade in food is shifting significant quantities of embedded water around the globe. But water resources are under pressure in many parts of the world.

In addition, although there may be room to expand the amount of land under cultivation to address demand for produce, factors such as rising population, soil erosion and competing pressures on land under climate change may mean that crop land may expand only slowly, if at all.

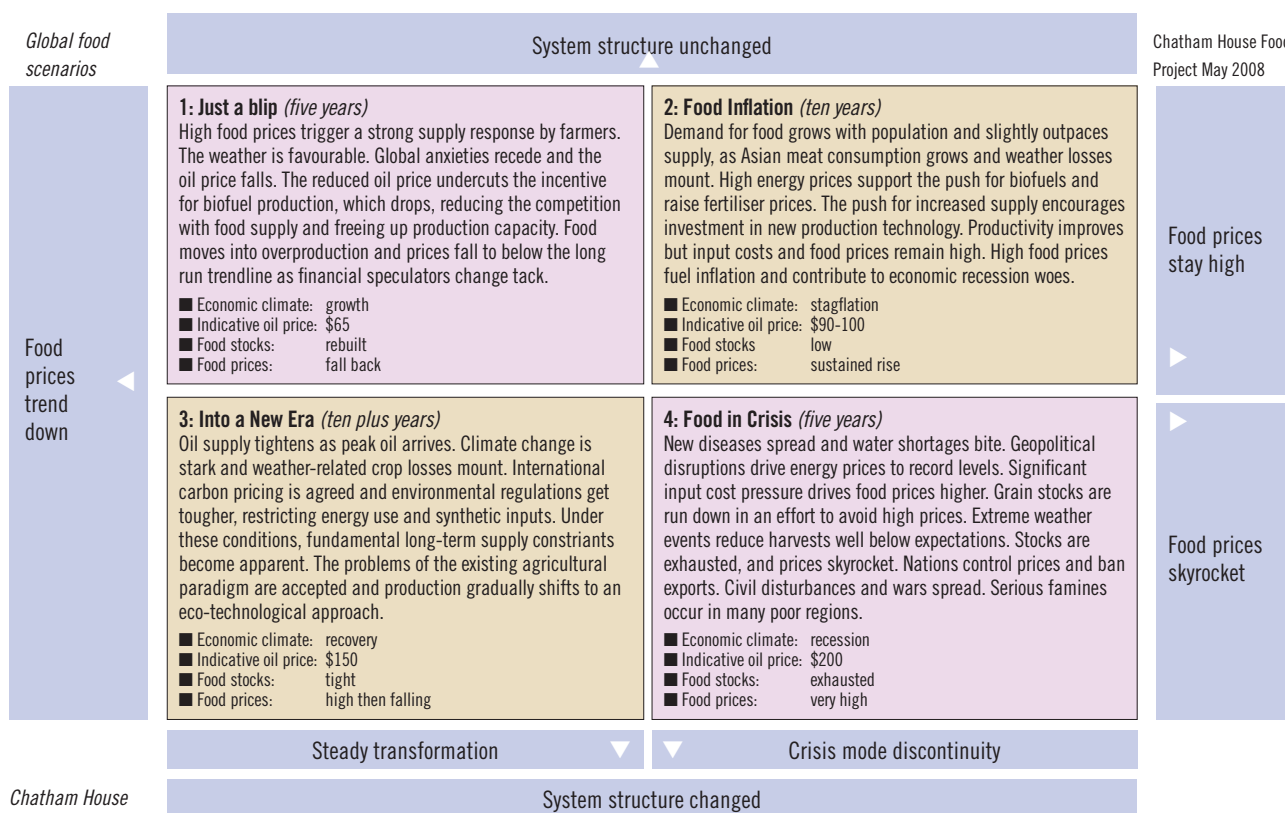
As for climate change, agricultural production – particularly of meat and dairy – is itself a source of greenhouse gas emissions. This constitutes

AT A GLANCE

Annuities can offer an effective and relatively risk-free means of handling uncertainties about future mortality rates, but they may be more effective if the annuitants themselves carry this risk.

Global food scenarios

Chatham House Food Project May 2008



an unwanted additional stress at a time when the sector is trying to curtail costs. Climatic disruption generates uncertainty of supply and may demand continual processes of adaptation if yields are to be maintained. Until recently, for a 20-year period, food prices fell steadily in real terms. This may have produced complacency. Levels of grain stocks are now lower than at any time during that period, with some countries imposing export bans on food.

According to the Food and Agriculture Organisation of the United Nations, in the last 12 months alone, 100 million people have joined the world's hungry and 22 countries remain particularly

None of the scenarios in the chart may represent the way things play out, but they are a useful tool for identifying different pathways

vulnerable to chronic hunger. But in developed countries too, the availability and cost of food will begin to carry a political, economic and social significance not seen for generations.

So what of that future? None of the scenarios in the chart may represent the way things eventually play out. But they are a useful tool for identifying different pathways through the future and gauging the reactions of stakeholders across the European food supply system.

At the Chatham House meeting, few participants thought that the 'just a blip' scenario was likely. They envisaged price volatility at the very least, and both the grain and dairy sectors foresaw a reversal of the trend of decreasing spending on food. Though there was some acceptance that present systems were

hitting limits, doubts were raised about the ability of alternative systems to deliver.

They did not rule out the possibility of a food crisis, perhaps caused by a bio-security hazard such as the animal disease blue tongue. But for Britain, a crisis was taken to mean not starvation but possible shortages, reductions in product ranges and a return to more staple foods. There was some consensus among stakeholders that 'business as usual' models would at worst fail, and at best be poor preparation for the coming period. As the ability to secure raw materials and effectively use resources becomes crucial, consideration may need to be given to the current division of responsibilities between Britain and the EU in a number of areas affecting food supply. There may be a greater role for government than in an era when the private sector could be relied on to deliver cheap and plentiful food. At the same time, opportunities could be created within the food industry to develop new competitive strengths.

The initiatives that will deliver this are likely to be built around a framework that encourages innovation, waste reduction, partnership-led approaches and the acceptance of possible changes in consumption patterns. Increased investment in scientific and technological research and development, and the question of how such efforts should be funded and focused, will be a critical part of the necessary response.

Long-term planning needs to start now. Exploring alternative futures facilitates the better planning of food systems and helps to avoid short-term responses that threaten to exacerbate rather than resolve current pressures in the system. ■

<http://www.brass.cf.ac.uk>

AT A GLANCE

The availability and cost of food will begin to carry a political, economic and social significance not seen for generations.

OFFSHORING INNOVATION

Much UK research and development now takes places overseas, but is this really a bad thing?

BRITISH FIRMS NOW carry out around half their research and development (R&D) activity overseas. Politicians and the media often see this as a cause for concern, with high-skilled jobs abroad supposedly displacing those at home. But is the offshoring of innovation really such a bad thing?

Offshoring is certainly not unique to Britain. Firms in other countries are also choosing to locate more of their innovation overseas, some of it in Britain. For European multinationals, especially British ones, the United States remains the most important location for foreign investment in innovation. More recently, a growing number of firms have established R&D centres in emerging economies such as China and India.

The offshoring of innovation is just one facet of globalisation, in which goods and services move more easily across national borders than they did in the past. This ease of movement in turn reflects rapidly falling communication and travel costs, along with other changes to the world economy, such as the economic integration of the European Union and the growth of the emerging economies.

So how do we judge whether offshoring harms innovation at home? Laura Abramovsky, Rachel Griffith and Helen Miller of the Institute for Fiscal Studies (IFS) have compared the growth of innovative activity at home and abroad for a large number of multinational companies across 15 European countries.

The IFS research finds that the firms that have increased their innovative activity most rapidly

abroad have also tended to increase it most rapidly at home. This comparison takes account of many other factors that might influence the amount and location of innovative activity, including the characteristics of the multinational firm, the industries in which the firm operates and macroeconomic conditions.

These findings suggest that when British firms locate innovative activity offshore, it does not displace activity based in Britain. This is not as surprising as it may appear. The idea that activity offshore displaces activity at home implicitly assumes that firms have a fixed amount of innovative activity that they wish to carry out and then simply choose where to do it.

But the level of activity undertaken will respond to the opportunities provided by the characteristics of various locations, such as costs and the pool of skills. As a result, it is not necessarily the case that had activity not been located abroad, it would have been conducted in Britain. In addition, there is increasing evidence of significant benefits from combining R&D activities undertaken in different locations. Stories abound of firms sourcing technology from foreign centres of excellence and reaping the benefits of this in the home market.

So should policymakers care where firms conduct their innovative activity? The traditional view sees substantial benefits from having researchers located in your own country, such as the opportunity for interaction between researchers and knowledge exchange through informal networks.

But more recent research lends support to the 'death of distance' in innovation. Falling

AT A GLANCE

The offshoring of innovation is not unique to Britain – and other countries sometimes choose to do their R&D here. It is a product of globalisation, but what is the effect on Britain's innovation?

Hot and cold seasons in the housing market

THE DIFFERENCE IN the price you pay for the same house in the summer or in the winter is huge, according to research by Drs Rachel Ngai and Silvana Tenreyro of the Centre for Economic Performance. While we are all well aware that house prices and trading activity in Britain have fallen dramatically in recent months after a long upswing, this study finds that booms and busts don't just happen over decades. Indeed, they are as frequent and predictable as the seasons.

Every year in all regions of Britain, as well as in other European countries, a housing boom of considerable magnitude takes place from April to

September – the 'hot season' – followed by a bust from October to March – the 'cold season'. In contrast, there are no seasonal booms and busts of this kind in the United States: while far more houses are sold in the hot season, they do not cost more.

The fact that house prices in many countries tend to surge in the summer and stagnate in the winter is why house price indices are typically presented in seasonally adjusted form by statistical agencies. For anyone interested in trends in housing prices, this is a clean way to look at the data.

But for actual buyers and sellers, seasonal fluctuations cannot be glossed





communication and travel costs not only allow goods and services to flow more easily across borders, they allow knowledge to flow more easily too. If knowledge can be disseminated more widely and more easily, access to new ideas relies less on location. If all this is true, the challenge for policy is not to persuade British firms to innovate here, but to help them develop the best technologies the world has to offer. ■

<http://www.ifs.org.uk>

Just because a firm locates innovative activity abroad does not mean they do not carry out similar activity in Britain.

How much money will you need in your pension fund?

$$37 - \frac{\text{Your age}}{3} - \frac{\text{Expected retirement age}}{7} \times \text{Current Salary} = \text{Enough money in your retirement fund}$$

CALCULATING THE COST OF A PENSION

HOW MUCH WILL you need in your pension fund for an adequate income in retirement? Dr Edmund Cannon of the University of Bristol, for the Centre for Market and Public Organisation, has worked out a formula: start with 37, subtract one third of your age, subtract one seventh of your expected retirement age and then multiply the result by your current salary.

Planning for a pension is one of the biggest financial decisions we have to make. Yet there is widespread misunderstanding about the decisions are required, let alone how to make the 'best' one. In the era of final salary pension schemes, this did not matter because employers made the decisions, providing a pension as part of their employees' package. In some cases, the value of the pension was large relative to wages. But, for various reasons, final salary schemes are disappearing and, increasingly, people have to plan for their own pension provision.

How much will a pension cost? In this context, a 'pension' means a guaranteed income until death. Consider a single man earning £30,000 just before retirement. A pension of £21,000 would be a target since the cost of living is lower in retirement. To buy an annuity would cost £300,000, since the annuity rate for men aged 65 is just over seven per cent.

An annuity rate of seven per cent can be compared with the rate of return on government bonds of about 4.5 per cent. The reason that an annuity pays a higher rate than a government bond is that it pays an income only until the man dies. By buying an annuity, the man avoids the possibility of running out of money if he lives a very long time, since that risk is borne by the insurance company.

For someone about to retire, the cost of a pension is easy to calculate; it is the desired pension divided by the annuity rate. The Financial Services Authority sends information on annuity rates to people who are reaching this point in their lives.

But what about someone who is going to retire in the future and needs to know how much they should try to save in their pension fund? Making such a calculation requires assumptions about wage growth: 25-year-olds earning £20,000 now are likely to be promoted and earn much more by the time they retire. The need to make difficult numerical calculations involving compound interest does not make things easier. Dr Cannon's formula provides a simpler way of calculating the likely costs of buying a pension. ■

<http://www.bristol.ac.uk/cmppo>

over. If you spend £500,000 on a house in a typical February, you might expect to pay £515,000 if you waited until June (in addition to the rent paid for the property in which you live while waiting, if you are letting, or the rent forgone, if you could have let it). Those many thousands of pounds could have been saved for better purposes.

This finding raises a natural question: if houses prices are typically higher in the summer, why do most people buy in the summer? It may be that it is simply more convenient to move in the summer: most people get married in this season and young families may find it easier to search before sending their children to new schools. But it is not clear that this will be worth so much money.

Drs Rachel Ngai and Silvana Teneyro offer an explanation to the puzzle. Start with the observation that

both houses and family needs can vary quite a bit. Finding the ideal house takes time as well as money.

In thick markets (where there are many houses for sale), it might be easier to find the ideal house, which may not be available in a very thin market. As a result, buyers prefer to purchase houses in the summer, so house prices are slightly higher in the summer, so sellers prefer to put their houses on the market in the summer – and with more houses on the market, the market is thicker.

That means that buyers are more likely to find the exact house they want and so are willing to pay more. With prices higher, more sellers are attracted into the summer market and so on. This self-reinforcing dynamic can thus lead to higher prices in the summer and more market transactions. ■

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The global financial crisis

FOUR KEY ISSUES ON THE RESEARCH AGENDA

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THE PROXIMATE CAUSE of the global financial crisis was the collapse of the US house price bubble. But its origins lie in the global regulatory and financial structure that has evolved since the 1980s and the financial environment that has evolved over the past decade or so. A central feature of this evolution was that many of the mortgages taken out to fuel the housing bubble had been 'securitised'. This means that they were bundled up and sold on, with the originator of the mortgages taking a fixed fee and passing on the risk to the next holder of the bundle.

The purchasers of the mortgage-backed securities were happy to buy them because the assets offered high returns. But when the housing bubble burst in 2007, many of the highly leveraged borrowers defaulted on their loans and the mortgage-backed securities plummeted in value.

This was a problem for the whole financial system because many institutions – particularly banks – had large amounts of the mortgage-backed securities sitting on their balance sheets. As investors rushed to sell these securities, their market value spiralled down and the banks were left nursing huge losses – as high as \$1.4 trillion according to an estimate by the International Monetary Fund (IMF) in October 2008.

Because the value of the banks' mortgage-backed securities were 'marked to market' (valued at the current market rate) in accordance with international regulatory requirements, there was a big impact on the banks' solvency. And since banks need to maintain a ratio of assets to liabilities, the whole financial system

It is perhaps time for a unified social science approach to the problems of the international financial system

then became unstable as liquidity – basically the ease of borrowing – dried up.

There are at least four key issues emerging that will drive the research agenda in the coming years.

First, there are questions about the design of monetary policy. At least one factor that fuelled the housing bubble – in Britain, the United States and elsewhere – was the very low level of interest rates, as the explicit and implicit adoption of inflation targeting in many developed countries had apparently delivered low inflation and provided a platform for stable growth.

There seemed to be a consensus among economists on both sides of the Atlantic that asset markets, including the housing market, could be left to their own devices and that interest rate policy should be directed solely at controlling price inflation, not asset price inflation. As graduates of the Crash of 2008, economists now need to reconsider whether inflation targeting needs to be supplemented by some form of 'leaning against the wind' so as to dampen asset markets that appear to be overvalued.

Second, there are questions about the appropriate regulation of financial markets. Since the early 1980s there has been an international trend towards deregulation. Moreover, some of the regulations introduced – such as 'mark to market' accounting – actually exacerbated rather than ameliorated the crisis. Designing appropriate regulation is no easy task. Regulation of any kind tends to have distorting effects on incentives. Financial markets are also remarkably adept at circumventing regulation. But where the 'first-best' solution – freely functioning markets – fails, the 'second-best' alternative of appropriate regulation becomes inevitable.

Third, a remarkable feature of the crisis in 'subprime' mortgages that triggered the global financial crisis in the summer of 2007 was that it appeared to take the world by surprise, including financial market participants, policymakers and academics. This is not to say that certain symptoms of the impending crash went unnoticed. Judging by such publications as the IMF's *Global Financial Stability Report* or the Bank of England's *Financial Stability Report* in early 2007, it is clear that the subprime market had featured on their radar screens as a risk to stability. But their assessments were that the financial system was not under immediate threat. No alarm bells were sounded.

This is itself somewhat alarming since, following similar surprise at the Asian financial crisis of a decade ago, there has been a substantial amount of research on 'surveillance' and 'early warning indicators' of financial crises, both at policy institutions such as the IMF and in academia. For example, searching Google Scholar for the keywords 'financial surveillance' generates 234,000 hits. Yet we still were not able to see the looming crisis.

Perhaps this is because of an inherent nonlinearity in the world, such that the interaction of economic forces produces outcomes that are highly context-specific and therefore unpredictable. If the world is unpredictable in this sense, we need to know that and at least learn to expect the unexpected. If it is not, then we need to develop more refined early warning systems.

Fourth, and finally, perhaps it is time to widen the scope of investigation to encompass a range of academic disciplines. As I write, for example, there is a clear disconnect between the 'economic fundamentals' and financial market behaviour, as market participants are gripped by jitters, herding behaviour and a loss of confidence that appears to be related more to psychology than economics.

Similarly, the international financial structure is built within a political, sociological and geographical framework that governs its behaviour in important ways – the financial deregulation of the past two decades, for example, had its roots in political ideology. It is perhaps time for a unified social science approach to the problems of the international financial system. ■

<http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/taylor>



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Getting to know us

Know society. Society Now

Are the poor always with us?

INEQUALITY PERSISTS IN THE FACE OF PROSPERITY

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B RITAIN'S OFFICIAL STATISTICIANS won their formal independence of government in 2008. They celebrated by issuing a powerful, if measured, reminder that we are still two nations: "Better off, on average," they said, "but inequality persists." The contrasting facts are clear enough. Real household disposable income per head has increased by more than half over the past 20 years. Yet one sixth of the population still lives below the official poverty line.

Overall inequality has been steady, but there have been important changes in detail over the years. The number of children in poverty increased rapidly under Margaret Thatcher, steadied under John Major and fell under Tony Blair. Even so, the proportion of Pakistani and Bangladeshi children in poverty remains stubbornly over 50 per cent.

Well-educated women, especially mothers, are much less disadvantaged in the labour market than they were in the 1970s. But the employment prospects of less well-qualified disabled men have slumped. The overall proportion of adults in work has hardly changed. But the rise in the number of work-rich, two-earner families has been offset by an increase in the number of work-poor, no-earner families.

In some ways, increasing prosperity for the many has led directly to increasing disadvantage for the few. In the early 1980s, more than a third of all households lived in council housing. The rapid rise in home ownership has

If we define poverty relative to the national average, the poor inevitably have to struggle to keep up with an increase in that average

been a boon for the new owners. But the resulting squeeze on social housing has left the remaining tenants much deeper in disadvantage.

What change in inequality would be expected to result from rising overall prosperity? There is no logical sequence. If we define poverty relative to the national average, the poor inevitably have to struggle to keep up with an increase in that average.

Many argue that high inequality has to be maintained to provide the incentives essential for economic growth. Encourage the rich to get rich, they say, and the fruits of growth will 'trickle down' to the poor. Not surprisingly, this theory is most often advanced by the rich people who are the first-round beneficiaries of the approach.

An alternative viewpoint is that the growth dividend should be targeted on middle and low-income families, in the form of either tax and benefit provisions or spending on public services.

Comparing countries often shows that those with a higher national income have a narrower range of inequality. The top ten per cent of incomes in Denmark

are not much higher than the top ten per cent in Portugal. It is among the bottom ten per cent that the Danes are so much better off than the Portuguese. But that logic – higher national wealth being targeted on the poor – does not seem to work when comparing the same country from year to year.

It can be argued, though, that long-run improvements in social and economic conditions benefit low-income families, as well as those on high incomes, even though inequality remains entrenched. The mortality rate among the infant children of unskilled workers may still be nearly double the rate among the children of managers and professionals. But the fact that mortality rates among both groups have plummeted over the decades means that thousands of children are alive today who would not have survived their disadvantage under previous conditions.

A key issue is the construction of social norms – and therefore of poverty standards – over time. No one is suggesting that the standards of living common when the welfare state was launched provide an appropriate benchmark for measuring poverty now. But it would be absurd to suggest that the doubling (or halving) of every household's income over a ten-year period would have no effect on the prevalence of poverty.

Social norms are formed over time, and adapt only gradually to changes in prosperity. People are content if they think their current position is satisfactory in relation to their childhood experience and to the social ladder that existed at some time in the past.

This leads to the suggestion that poverty should be benchmarked, not against the current median income, nor against the median at some fixed point in the past, but against the median observed ten or 20 years ago – a 'lagged' poverty line.

Such a measure would reduce the amount of poverty observed during periods of rising incomes, make no difference to the poverty count when trends are flat, but increase the prevalence of poverty during times of economic decline. Surely this makes more sense than assuming an instantaneous adjustment of norms to changing circumstances.

"Better off, on average, but inequality persists." What is the assumption behind that 'but' in the statisticians' summary? There is no natural economic process by which rising incomes should lead directly to narrowing inequality. Many would argue for a political process in which increased national resources are channelled towards the disadvantaged with no immediate cost to the privileged – and it is a matter of political judgement how successful that approach has been in recent decades.

An overall rise in prosperity serves at least to modify the experience of disadvantage. The worst scenario would be if inequality persisted during a period when we were not getting better off on average. ■

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