

# Back to the future

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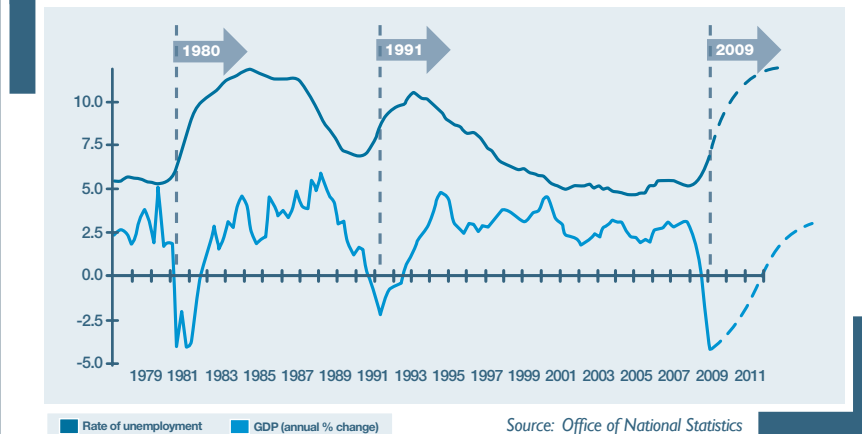
“In the last two recessions, tens of thousands of young people were written off to become a generation lost to work - a mistake this government will not repeat...”

Rt Hon Gordon Brown MP, UK Prime Minister, June 2009

Despite the UK media's pathological obsession with bad news, behind the headlines there are signs that the recession has bottomed out and the economy is now moving back towards positive growth. Unfortunately this will not be sufficient to prevent unemployment rising well above three million by the middle of 2010. The recent rise in unemployment ranks amongst the worst seen in the post-war period. Vacancies are vanishing at an alarming rate. It is only now that the scale of the recession is beginning to hit home, particularly for young people. It is predicted that half of the 600,000 people leaving education will fail to find work over the next year.

The UK workforce is now much more flexible in terms of pay and working conditions than when the recession hit in the 1980s. However, the speed and depth of the recession has taken everyone by surprise. As it currently stands, the economy is incapable of generating sufficient jobs to absorb the increasing numbers of unemployed. In the short-run, there is little that can be done. It is not only economically illiterate but also inhuman to believe that at this stage in a recession the tide of rising unemployment can be turned by people taking large pay cuts.

Figure 1: Economic growth and employment



## Youth unemployment

Recessions and associated rises in unemployment are features of market based economies. However, as a nation we should be particularly concerned about youth unemployment. Academic studies show that experiencing unemployment while young creates permanent scars rather than temporary blemishes. It damages an individual psychologically, emotionally and economically - not just for a year or two, but for life. Such studies only confirm what we instinctively know. A society that cannot offer sufficient reasonably paid jobs to its population is not only failing to defend living standards but it also undermines the very concept of an inclusive society.

As can be seen from Figure 1 (above), the rate of unemployment starts to rise as the growth of Gross Domestic Product (GDP) slows and turns negative. Based on the experience of the 1990s, it will take nearly five years before unemployment returns to its pre-recession level.

This reflects the fact that during recessions firms accumulate spare capacity and overtime is no longer an option. In many cases firms reduce employees' working hours. It is only after a period of rising demand that surplus capacity is exhausted and firms find it necessary to expand their workforces. Figure 1 suggests that matters might have been much worse had it not been for the realistic attitude of the unemployed.

Following the recession in 1980 there was a great reluctance by many of the unemployed to take jobs that offered a reduction in their previous earnings and the effect is clear to see. The more responsive labour markets of the 1990s appear to have resulted in a more rapid decline in the rate of unemployment following the 1991 recession, although the 1980 recession was much deeper.

It is therefore sensible to conclude, particularly given the speed and depth of this recession, that after unemployment reaches its peak in 2010 (which Figure 1 suggests is likely to be at least as high as the 1982 peak); the best we can hope for is that unemployment figures will decline steadily reaching their 2008 level in 2013. This is particularly bad news for the under 25s who appear to be bearing the brunt of the rise in unemployment. This concern is apparently shared at the highest levels. In a statement to the House of Commons in June 2009, the Prime Minister unveiled a draft legislative programme to boost employment amongst young people. He said: "In the last two recessions, tens of thousands of young people were written off to become a generation lost to work - a mistake this government will not repeat... from January 2010, every young person under 25 who has been unemployed for a year will receive a guaranteed job, work experience or training place." However, it is far from clear how Gordon Brown, or perhaps more realistically, the next occupant of Number 10, will be able to deliver this.

Let us hope that the signs of recovery prove correct and the economy is in the early stages of returning to positive growth. Even if this is the case, whoever is in power this time next year will face a huge public sector deficit.

According to some estimates the deficit could rise to 16% of GDP, which is approximately double the size of the debt following the 1991 recession. The reasons for such a large deficit are well known: the enormous cost of bailing out certain banks as a result of the reckless behaviour of their leaders; and the loss of tax revenues as the recession bites.

The proven post-war policy to reduce unemployment in the short-run is for governments to spend more; allowing the public sector to go into further debt. But this will not be an option next year; quite the contrary. The historically high level of the public sector's deficit will force widespread cuts in public expenditure, probably in excess of the 10% currently mooted.

This bleak economic landscape is menaced by dark clouds emanating from the knowledge that over the past ten years three sectors have been largely responsible for the growth of employment: financial services; retail and the public sector. Sadly none of these are expected to take a leading role in the creation of post-recession jobs. The UK will emerge from the recession with a smaller financial services sector as banks are forced to behave more responsibly. The rise in household savings indicates that the debt fuelled binge spending which characterised the retail sector in the last ten years is unlikely to be a prominent feature of the post-recession economy. However, most worrying of all is the effect of public sector cutbacks.

Since the Labour government came to power in 1997 some 2.8 million jobs have been created in the UK. Of these, more than half (54%) have been provided by the public sector.

Given the scale of the likely cutbacks in public sector expenditure it would be obvious, even to those gifted with an extremely optimistic disposition, that the expansion of public sector employment is likely to remain, for the foreseeable future, a feature of the past.

According to the Chartered Institute of Personnel and Development (CIPD), the public sector is likely to shed 350,000 jobs in the next five years once the government gets to grips with its massive budget deficit. In short, if the economy is to repeat the experience of the 1990s, after 2010 there will be a slow, but steady decline in the numbers of unemployed, leaving the private sector to create more jobs than it has done in recent years.

This unquestionable logic does not answer the really big question, namely, where will these much needed jobs come from? Another way of viewing this question is to ask what kind of economy is going to emerge from the recession? The answer is rather surprising. I suspect that manufacturing is going to reverse its long term decline and together with associated business services, it will become a bigger contributor to both GDP and employment than it has been in the recent past.

Since 1997, the manufacturing sector has shed some 1.5 million jobs and now accounts for just over 9% of all employment compared to almost 16% in 1997. However, there are good reasons to believe this trend is about to be reversed. This prediction might seem at odds with the knowledge that manufacturing, together with the construction industry, has borne the brunt of the job losses so far.

Although the recession was triggered in the finance sector, as in most previous recessions it is the real economy, and manufacturing in particular, that suffers most. However, at an aggregate level the manufacturing sector will gain from the recent depreciation in the value of the pound.

Over the past two years the pound has lost more than 20% of its value and this has imparted a significant competitive boost to the UK's manufacturing sector. Figure 2 (below) shows how manufacturing's output responded to the fall in sterling's value in 1992 and as can be seen, sterling's recent depreciation is far more marked. The boost to manufacturing will come not only from overseas buyers in response to the improved competitiveness of UK exports; but also domestic customers who will find UK produced goods relatively cheaper than imports.

In both cases the UK will be able to play to its strengths in areas such as aircraft, high-tech IT equipment, electrical components and pharmaceuticals. Masked by the overall decline in manufacturing's share of GDP, high-tech manufacturing has been expanding: up by more than a third since 1995. This growth has also benefited business services as a result of outsourcing functions such as marketing and logistics. Most importantly, it offers prospects to younger people who possess the appropriate skills.

Evidence that prospects for manufacturing are a lot brighter than current statistics would suggest is confirmed by UK manufacturers that are doing all in their power to seek alternatives to redundancy such as pay freezes, pay cuts and reduced working hours. For example, Honda may have closed its plant at Swindon for four months while car showrooms de-stocked but it sought to retain its entire workforce. This suggests that Honda expects demand to return as domestic and overseas distributors order replacement stocks. The recent depreciation of sterling must have reinforced this belief. Without similar action across the sector, the impact of the recession on UK manufacturing employment would have been even worse.

The manufacturing sector is also likely to benefit from the growing demand for low carbon products and 'green' technology. However, where matters 'green' are concerned there is always a tendency for advocates to exaggerate the potential and this applies particularly to the scope for job creation. In a recent article, Lord Mandelson, First Secretary of State for Business, Innovation and Skills, argued that the global market for low carbon and environmental goods and services is currently worth about £3 trillion. Interestingly, this market is projected to grow strongly over the next decade as both the developed and the emerging world shift towards lower carbon economies.

Currently around 400,000 people work in the 'green' economy in Britain compared to some 1.5 million in Germany. The government has suggested that the numbers working in the green economy could be doubled by a shift to a low-carbon economy with jobs ranging from lagging lofts to building and operating nuclear power stations. All of this sounds like good news for the manufacturing sector and supporting business services but we must avoid the temptation to get carried away.

Most of the jobs that have been created in the fledgling 'green' manufacturing and service sectors involve, to some degree, government support. Friends of the Earth suggests that the government needs to invest some £20 billion annually over the next ten years to get the low-carbon economy moving. Whatever the longer term merits, such levels of funding are completely out of the question for many years. We need to keep our feet on the ground and recognise that even if it were possible to fund a rapid expansion of the low-carbon economy, the number of new jobs created would be offset to some degree by the loss of jobs that are dependent on fossil fuel or are heavily carbon-emitting.

The UK manufacturing sector now has its best chance in a quarter of a century to reverse its long term decline. In the UK, high-tech manufacturing is extremely well placed to benefit from two of the key drivers of economic activity: globalisation and technological change. History will look back on the last ten years as a time of madness. For a decade, we have believed that trading in ever more complex financial instruments was the route to wealth creation. We now know it was quite the reverse and was actually the destroyer of wealth, far beyond the financial sector. Manufacturing is a traditional wealth creating activity and offers Britain the opportunity to follow a path which, if successful, will lead to GDP growth and job creation. [MF]

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**Figure 2: Manufacturing output and the rate of exchange**

