Box VI-1

Unemployment and financial crisis

Research shows that there tend to be significant differences between recessions associated with financial crises and those associated with other shocks.[1] Recessions associated with financial crises are more severe and more prolonged than recessions associated with other types of shock, and recoveries from financial crises tend to be more sluggish. In the aftermath of a financial crisis, private consumption growth tends to be weaker than during other recoveries, and private investment continues to decline after the recession trough as private sector balance sheets are rebuilt and access to credit normalises. The unemployment rate therefore rises higher than usual and may do so much earlier in the downturn than in typical business cycles.

There also tend to be important differences between recessions that are highly synchronised across countries and those that are not. Highly synchronised recessions are deeper and more prolonged than those confined to individual regions or countries. Recoveries from synchronised recessions have therefore been weak, particularly because export growth can only play a limited role in the recovery. Recessions that are associated with both financial crises and a global downturn are very rare, but they tend to be unusually severe and protracted.

Unemployment outlook in comparison with other financial crises

The current downturn in Iceland is associated with a deep financial crisis and a synchronised worldwide recession. It is therefore likely to be unusually severe, and the recovery is expected to be sluggish. The real economy has responded sharply, as can be seen in rapidly escalating unemployment and other indicators. Unemployment has already risen by nearly 8 percentage points since September 2008.

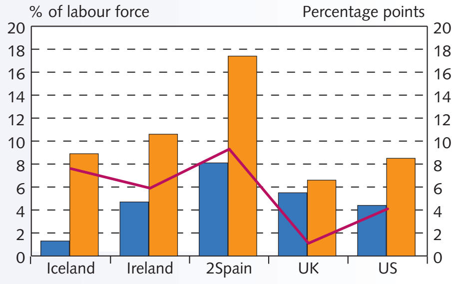
Although the real economy has already begun to adjust, unemployment rates are set to increase still further as output contracts, delaying the reallocation of workers across industries. According to the baseline forecast published in this *Monetary Bulletin*, unemployment will rise in the latter part of the year, peaking at over 11% in Q1/2010. Unemployment is expected to exceed 10% for about 1½ years, from Q4/2009 to Q1/2011, and remain very high well into 2013-2014. This is in line with the latest OECD forecast, which assumes that unemployment in OECD countries will peak in 2010 or early 2011, when it is expected to reach double-digit levels in many countries for the first time since the early 1990s.[2]

It is interesting to compare this scenario to the experiences of other countries that have suffered serious financial crises. According to a recent study of the aftermath of banking crises in the United States in 1929 and in wealthy countries and emerging markets in the post-World War II era, the unemployment rate has risen by an average of 7 percentage points from trough to peak.[3] As usual, the average conceals sizeable differences between countries. The greatest increase by far occurred in the US during the Great Depression, when unemployment rose by over 20 percentage points. The post-war crisis that came closest to this occurred in Finland in the early 1990s, when unemployment rose by 14 percentage points. This is followed closely by Colombia in 1998 and Spain in 1977, when unemployment increased by around 12-13 percentage points. In addition, during the 1990s Sweden experienced a larger-than-average rise in unemployment of about 8 percentage points. By comparison, the current baseline forecast assumes that unemployment in Iceland

1. International Monetary Fund, (2009). "From Recession to Recovery: How Soon and How Strong?", Chapter 3 in *World Economic Outlook*, April 2009, pp. 103-138.
2. OECD (2009). *Economic Outlook Interim Report* (March 2009).
3. Reinhart, C. M. and K. S. Rogoff (2009). "The aftermath of financial crises". *NBER Working Paper* 14656.

Chart 1

Unemployment[1]

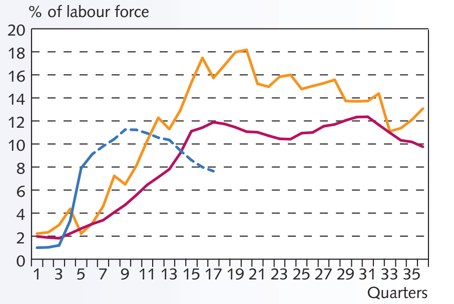


1. Latest month shows data for March for all countries excluding UK. Latest month for UK is January.
Sources: Directorate of Labour, Reuters Ecowin.

Chart 2

Unemployment after banking crises[1]

First quarter is taken to be peak output gap prior to the downturn



1. Central Bank of Iceland baseline forecast Q1/2009 - Q1/2012.
Sources: Directorate of Labour, Reuters Ecowin, Central Bank of Iceland.

will rise by 10 percentage points from Q3/2008 (the last quarter before the crisis hit) to Q1/2010, when it is expected to peak.

Comparing the current unemployment profile with the developments in Finland and Sweden in the late 1980s and the 1990s (Chart 2) shows that, during the present crisis, unemployment in Iceland is forecast to peak at levels below those in Finland and Sweden. It is also expected to decline more rapidly than it did in those countries. In both Finland and Sweden, potential growth declined for five years following the onset of the downturn because of a rise in the structural unemployment rate and a reduction in potential employment growth.[4] In the 1990s, Sweden and, more particularly, Finland were helped out of deep recessions by the strong global upswing in the latter part of the 1990s.

4. Haugh, D. , P. Ollivaud and D. Turner (2009), "The Macroeconomic Consequences of Banking Crisis in OECD Countries". OECD, Economics Department *Working Paper*, No. 683.