

BACKGROUND PAPER TO THE 2014 WORLD DEVELOPMENT REPORT

# The Social Impact of Financial Crises

Evidence from the Global Financial Crisis

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## Abstract

Financial systems can contribute to economic development by providing people with useful tools for risk management, but when they fail to manage the risks they retain, they can create severe financial crises with devastating social and economic effects. The financial crisis that hit the world economy in 2008–2009 has transformed the lives of many individuals and families, even in advanced countries, where millions of people fell, or are at risk of falling, into poverty and exclusion. For most regions and income groups in developing countries, progress to meet the Millennium Development Goals by 2015 has slowed and income distribution has worsened for a number of countries. Countries hardest hit by the crisis lost more than a decade of economic time. As the efforts to strengthen the financial systems and improve the resilience of the global financial system continue around the world, the challenge for policy makers is to

incorporate the lessons from the failures to take into consideration the complex linkages between financial, fiscal, real, and social risks and ensure effective risk management at all levels of society. The recent experience underscores the importance of: systematic, proactive, and integrated risk management by individuals, societies, and governments to prepare for adverse consequences of financial shocks; mainstreaming proactive risk management into development agendas; establishing contingency planning mechanisms to avoid unintended economic and social consequences of crisis management policies and building a better capacity to analyze complex linkages and feedback loops between financial, sovereign, real and social risks; maintaining fiscal room; and creating well-designed social protection policies that target the vulnerable, while ensuring fiscal sustainability.

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# THE SOCIAL IMPACT OF FINANCIAL CRISES: EVIDENCE FROM THE GLOBAL FINANCIAL CRISIS<sup>1</sup>

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# THE SOCIAL IMPACT OF FINANCIAL CRISES: EVIDENCE FROM THE GLOBAL FINANCIAL CRISIS

Inci Ötker-Robe and Anca Maria Podpiera<sup>2</sup>

*“The woman was from Patmos. Her husband had lost his job and come back to the island to be with their two children and find work. After he failed and she fell ill with cancer, they ran out of money. The bank seized their house; they could not pay the electricity bill. She was ashamed, she told Lazaros Papageorgiou, of Artos Drassi, a charity in Athens that feeds the poor. Six months ago she would never have dreamt she would come to depend on charity, but today she needed help.”*

*The Economist. “The Postcard from the Edge” August 11, 2012*

## 1 Introduction

Financial systems can contribute to economic development by providing people with useful tools for risk management, such as credit for productive investments, instruments for saving and insurance, and payments services. At the same time, when financial institutions fail to manage the risks they retain, they can create severe financial crises with devastating social and economic effects, especially for the world’s most vulnerable people. Crises can hit hard the weakest members of the society, particularly the poor, elderly, young, and women, who are not well-equipped to cope with the consequences of rising prices, eroding savings and asset values, loss of jobs, and reduction in core public services, such as social welfare, health care, and education. The various coping mechanisms households, communities, and the private and public sectors adopt in response to the crisis can have long-term development implications.

The global financial crisis that has shaken the world economy since late 2007 has transformed the lives of many individuals and families beyond imagination, even in advanced countries such as those in the Euro Zone and the United States. The bankruptcy of a US investment bank, Lehman Brothers, in 2008 turned a severe credit crunch into the worst financial crisis since the Great Depression, resulting in an unprecedented dislocation in financial markets and damaging stability and confidence in many advanced financial systems. The unprecedented pouring of financial support from national governments and monetary authorities may have limited the magnitude of a deeper collapse in economic growth, but also caused a rapid deterioration in many countries’ fiscal balances, reducing the fiscal room and governments’ ability to further support weak economic activity.<sup>3</sup> As economic activity further weakened and a massive number of jobs were lost around the world, unemployment rates climbed to unprecedented levels. Countries with weak institutional capacity and limited fiscal room have been particularly hurt.

This paper presents evidence on the extent to which the global financial crisis since 2007 has been associated with deteriorating economic and social well-being indicators. It discusses the key channels of transmission from financial to social crises, provides some stylized facts on the evolution of key social and economic indicators during the current financial crisis, and assesses how further back in time the crisis may have taken the most crisis-hit countries with respect to various indicators of social and economic well-being.

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<sup>3</sup> Kyrili and Martin 2010; World Bank and IMF 2010; UN 2011.

## 2 Channels of Transmission: From Financial Crisis to Social Crisis

Financial crises are costly for development, and can have serious implications both for economic and social well-being of the people and countries. While everyone is vulnerable to their adverse consequences, financial crises hurt disproportionately the poor, as with natural disasters, contagious diseases, or climate change, given that the poor have limited capacity and instruments to insulate themselves from the shock and recover from the impact of the crisis. Failure to manage financial risks effectively, before and after the risk materializes, can undermine the resilience of the poor to withstand adverse consequences of future shocks, as well as their ability to take advantage of development opportunities. In any given country, crises hit particularly the most vulnerable—the young, the old, women, and the ill. A severe financial crisis can morph into a social crisis if it is poorly handled, working its way through a number of channels (diagram 1).<sup>4</sup>

**Product and labor market channel:** Financial crises weaken economic activity, dampen consumption and investment demand, and result in sustained declines in economic growth, loss of jobs, reduced wages and benefits, and higher unemployment (or vulnerable employment that typically involves fewer hours and lower benefits). Relative price adjustments and currency depreciation can exacerbate these effects, especially where the public and private sectors hold high levels of foreign currency-denominated debt. Past experiences with financial crises indicate that on average, unemployment increases by 1.4 percent during crises and it takes 4-5 years for employment to return to its pre-crisis levels after economic recovery starts.<sup>5</sup> For example, in Mexico and Argentina, unemployment and wages took a serious hit in the aftermath of the financial crises in 1994-95 and 2001-02, respectively.<sup>6</sup> In Cote d'Ivoire, formal employment fell by almost 40 percent during the crisis of the early 1980s.

**Financial market channel:** Financial crises are typically followed by reduced financial flows across countries (in the form of foreign capital and remittances), erosion of savings, and reduced availability and/or higher cost of credit. As ailing financial institutions retrench from foreign markets and earnings of migrant workers decline, reduced financial flows affect countries that rely heavily on foreign capital to support credit and economic activity. Savings are eroded by low interest rates reduced by policy makers to stimulate demand and protect bank balance sheets, by falling asset prices, or by crisis response measures such as freezing bank deposits or forcing conversion at unfavorable rates (Argentina in 2001 and Ecuador in 1998). Bank deleveraging to repair balance sheets and to adjust to scarce funding and increased economic uncertainty can create credit crunch, contributing to weak economic activity and unemployment. Households and small firms can be deprived of credit as banks tighten credit standards and lend only to large customers perceived as creditworthy. During the Asian crisis and the current global crisis, credit crunch was felt more among small and medium enterprises (SMEs).<sup>7</sup> In Chile, large firms with reduced access to external financing crowded out SMEs, which, faced with inflexible wages and high firing costs, filed for bankruptcy or switched to retained earnings for funds. The unemployment rate almost doubled and took some time to return to pre-crisis levels.<sup>8</sup>

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<sup>4</sup> See the companion background paper Calvo 2013 for a more detailed discussion.

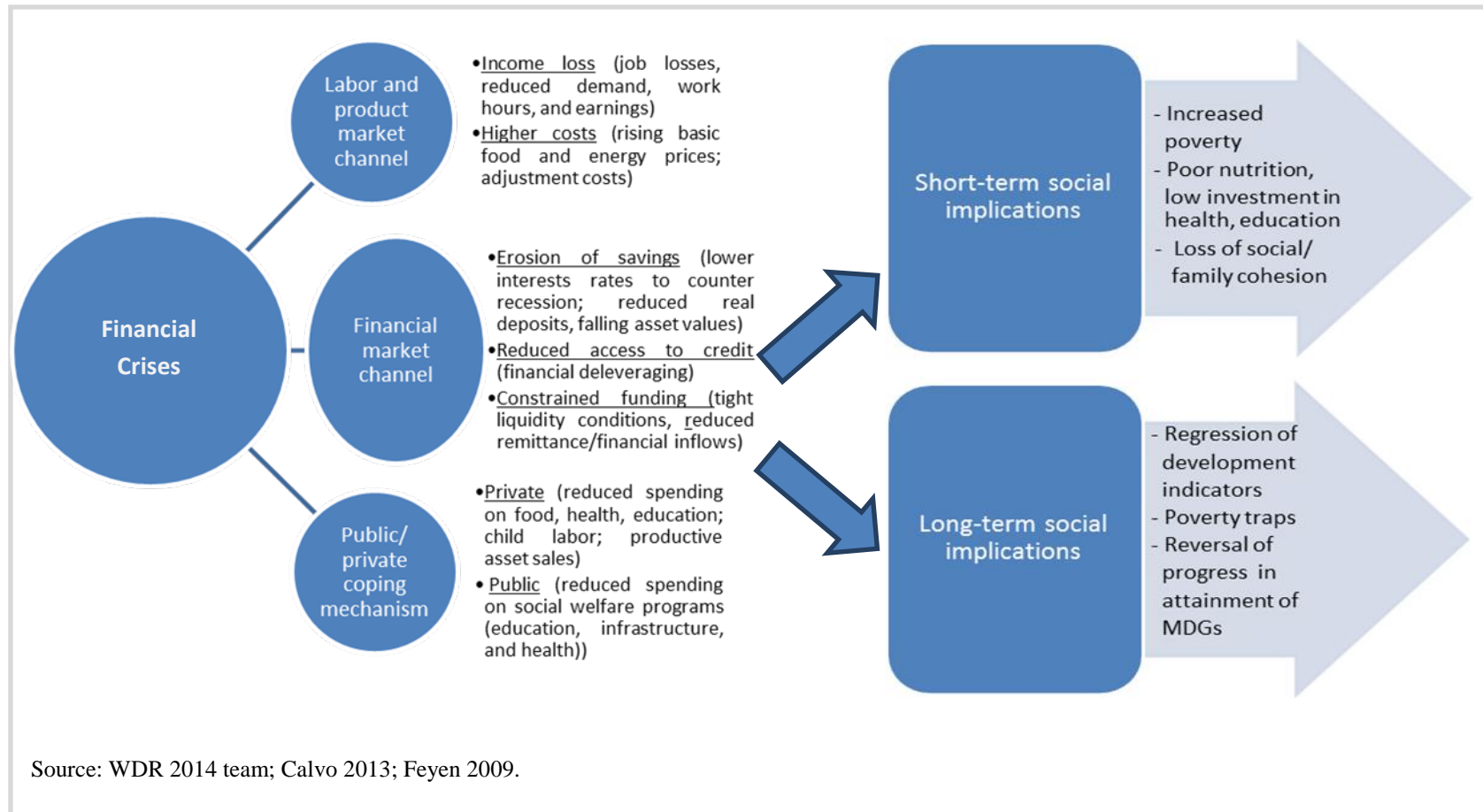
<sup>5</sup> Feyen 2009.

<sup>6</sup> Pastor and Wise 2003.

<sup>7</sup> Ding, Domec, and Ferri 1998 and Feyen, Kibuuka, and Ötoker-Robe 2012.

<sup>8</sup> Calvo 2013; World Bank 2005.

**Diagram 1. Transmission Channels from Financial to Social Crises**



**Public coping strategies:** Financial crises also affect the state's ability to expand spending to counter the adverse impacts of crises on people and interrupt the provision of essential public goods and services that further reduce long-run growth. Tax revenues decline as economic activity weakens and, combined with realization of contingent liabilities from bank recapitalization and restructuring or deposit guarantees, result in a weaker fiscal position. Hampered access to international financial markets, accompanied with the need to implement austerity measures and restore market confidence, could further reduce governments' ability to continue spending on infrastructure and supporting social protection programs at a time when populations need such support the most. Previous work notes the pro-cyclicality of social expenditures.<sup>9</sup> For example, health expenditures fell in Indonesia, Malaysia, and Thailand during the East-Asian crisis. The government cut spending on education by 15 percent during the 1994 Mexican peso crisis,<sup>10</sup> and public investment in education fell by 50 percent during 1987-1990 in Peru. Significant cuts in infrastructure investment were observed in Latin American countries in the 1980s and 1990s.<sup>11</sup> In developing countries, one common practice has been to reduce the investment portion of government social sector budgets.<sup>12</sup>

**Private coping strategies:** Individuals' responses to crisis situations enhance the deterioration of social well-being during and after financial crises. Faced with a loss of employment and income and reduced social support from the government, individuals may adopt costly coping strategies, including selling productive assets such as land and livestock; drawing on other assets—social, physical, natural, or financial; reducing the quality of food intake; economizing on health care; taking children out of school; reducing own consumption to protect young children; or borrowing.<sup>13</sup> In Indonesia, the use of health facilities dropped sharply during the 1997 crisis,<sup>14</sup> and Family Life Survey recorded a fall in school enrollment and a rise in dropouts during the crisis.<sup>15</sup> During the Argentina (1995) and Venezuela (1994) crises, daily protein intake dropped by 4 percent and 3 percent, respectively. In some cases, employees worked extra hours or in additional jobs to compensate for loss of income, but with smaller benefits and remuneration—as in Cambodia's tourism sector.<sup>16</sup> These coping strategies can have long-term consequences for individuals and make it difficult to escape poverty traps. Education and nutrition during early childhood provide a window of opportunity to shape a generation's future health, human capital, productivity, and earning potential, and enhance the ability to cope in crisis times.<sup>17</sup>

Past financial crises provide ample evidence of marked short- and long-term deterioration in social well-being indicators as they work through these transmission channels. Poverty (those who live under \$1.25 a day) rose in virtually all financial crises as a result of a combination of

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<sup>9</sup> Ravallion (2008).

<sup>10</sup> Feyen (2009).

<sup>11</sup> Easterly and Servén 2003.

<sup>12</sup> Calvo 2013 and World Bank 2009.

<sup>13</sup> Dercon 2011, Glewwe and Hall 1998, Fiszbein and others 2003, Goh and others 2005, Lokhsin and Yemstov 2001, and So and others 2010.

<sup>14</sup> Waters and others 2003.

<sup>15</sup> In other cases, however, mixed strategies were observed, including higher school enrollment in Peru in the 1990s and in Argentina in 2001.

<sup>16</sup> Overseas Development Institute 2009.

<sup>17</sup> Dercon 2011; Brinkman, de Pee, Sanogo, Subran, and Bloem 2010; Alderman, Hoddinott, and Kinsey 2006, Overseas Development Institute 2009.

loss of income, jobs, and access to goods and services by individual households and communities, rising prices and falling asset values, and the associated costly coping strategies that tend to affect economic and social well-being in the long run. Past trends indicate that 20 million people sink into poverty for each percentage point decline in GDP growth rate.<sup>18</sup> During the Asian crisis, overall poverty rose from 11 percent to 18 percent in Indonesia, and urban poverty doubled to 18 percent in Korea.<sup>19</sup> Previous studies also point to increased inequality associated with financial crises in a panel of advanced and emerging market countries during 1988-2010, with the impact rising along with severity of recessions.<sup>20</sup> Research also shows that average rise in income inequality during recessions tends to be larger than the fall during booms,<sup>21</sup> suggesting that the poor tend to get a bigger share of the pain than the prosperity.

Empirical literature also suggests pro-cyclicality of health and schooling outcomes in poorer countries—particularly so in Africa and low-income Asia. In middle-income countries in Latin America, while education outcomes are countercyclical (due to reduced opportunity cost of studying), health outcomes are more pro-cyclical (due to dominant income effects).<sup>22</sup> For example, in Mexico, infant and preschool mortality rose in the 1980s after the crisis, reversing the trend of the 1970s. Infant mortality also increased in the subsequent crises in Mexico (1994-95), Peru (1988-92), and Indonesia (1997-98). Higher malnutrition and lower birth weight were observed in Cameroon (the 1990s), Malaysia, Indonesia and Thailand (1997-98), and Argentina (2001-02). Life expectancy declined sharply in Russia and the former Soviet Union countries after the 1992 break up and in the 1998 crisis.<sup>23</sup>

Economic crises also coincide with deterioration in social cohesion. During the Great Depression in 1929-32, for example, there was a 40 percent increase in suicide rates and a 10 percent increase in deaths from all causes in the United States. Similarly, there was a 39 percent increase in suicide rates among males in Japan during the Asian crisis, a 44 percent increase in Hong Kong SAR, China, and a 45 percent rise in Korea and Thailand.<sup>24</sup>

### 3 Stylized Facts from the Ongoing Global Financial Crisis

These channels of transmission have also been at work during the global financial crisis that has shaken the global economy since late 2007, and have generated a similar deterioration in economic and social indicators around the world.

#### 3.1 Product and labor market channel

Available evidence indicates a substantial deterioration in output and employment conditions since 2007, although the extent of deterioration varies across regions. Economic growth plunged over the course of the crisis from 2007 to 2009 globally, and after a brief period of recovery in 2010, it tapered off before a subsequent dip in 2012 as the crisis resumed in the form of a

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<sup>18</sup> Feyen 2009.

<sup>19</sup> Baldacci and others 2002; Calvo 2013.

<sup>20</sup> Bordo and Meisner 2011.

<sup>21</sup> Calderón and Levy-Yeyati 2009.

<sup>22</sup> Ferreira and Schady 2009.

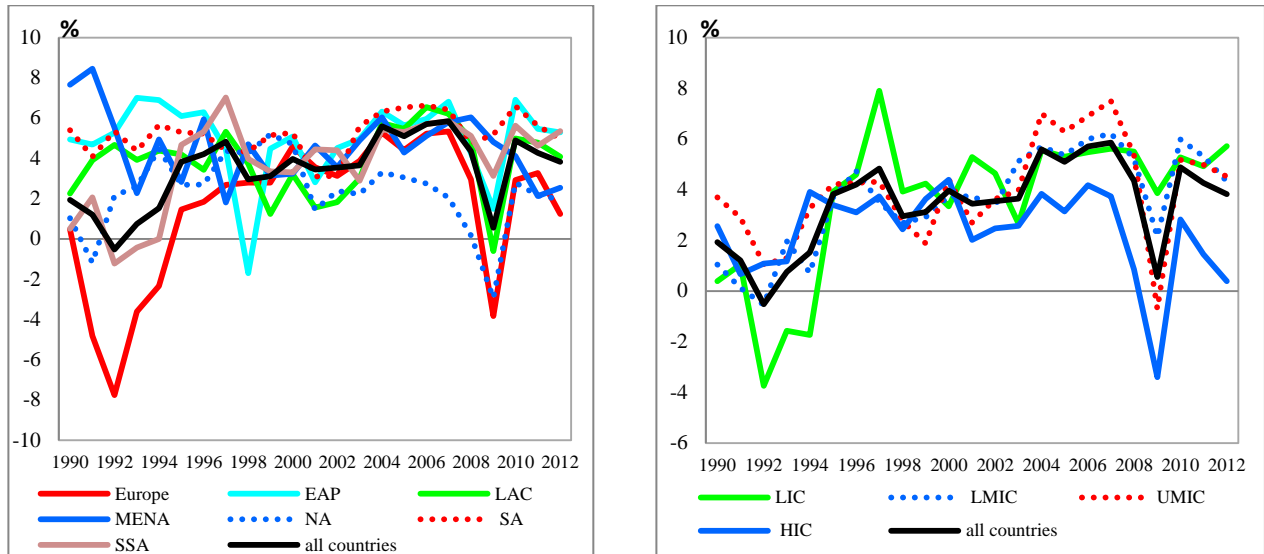
<sup>23</sup> UN 2011; Ruhm 2000.

<sup>24</sup> UN 2011.



sovereign debt crisis in Europe in fall 2011 (figure 1). While the crisis hit hardest the developed countries and members of the European Union (EU) that were at the epicenter of the global financial turmoil and sovereign debt crisis, the weakening of aggregate demand spilled over to developing and emerging countries through economic, trade, and financial linkages, resulting in a sharp turn in economic growth since 2010. It has affected particularly the countries in emerging Europe and Central Asia, Latin America and the Caribbean, and Middle East and North Africa.

**Figure 1. Average GDP growth by regions and income level**



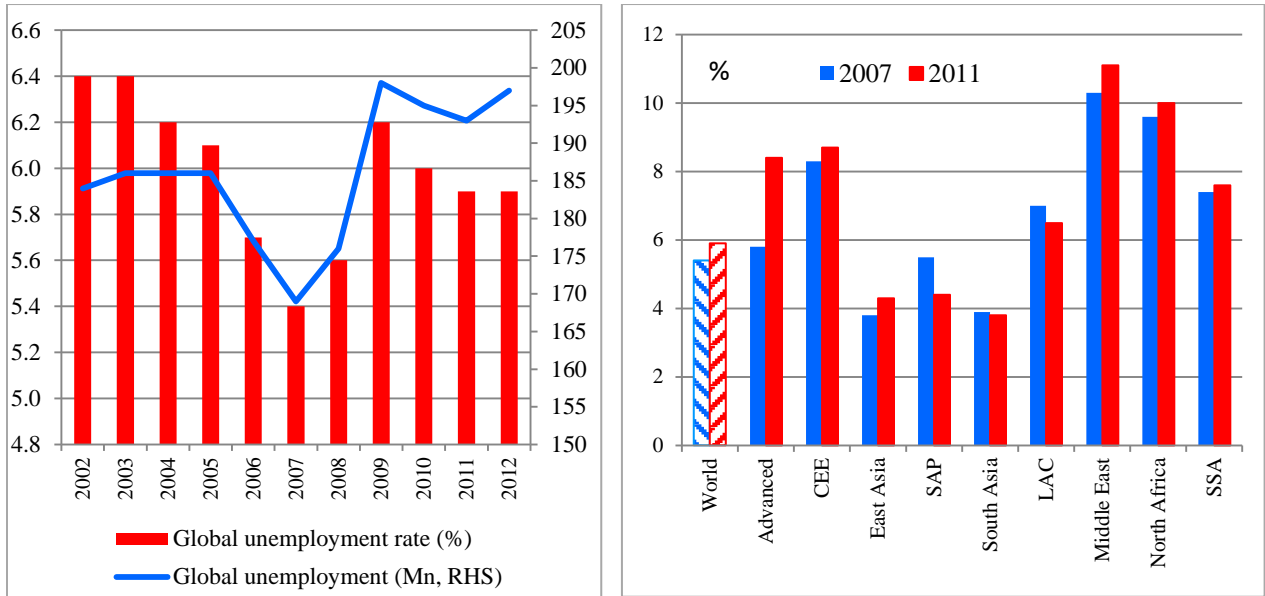
Source: Authors' computations based on World Bank's World Development Indicators database.

Depressed aggregate demand and weak economic activity have severely weakened labor market conditions around the world. About 28 million people have lost jobs since 2007, bringing the pool of globally unemployed to an estimated 197 million in 2012 (figure 2), as deteriorating macroeconomic and financial conditions have dampened economic prospects and opportunities for job creation worldwide. The rise in unemployment rates has been most severe in high- and upper-middle income countries that are either at the epicenter of the crisis (North America and western Europe) or are linked to them (Central and South-Eastern Europe, Latin America and the Caribbean, and advanced countries in Asia) (figure 3). The rate in developed countries rose on average from 5.8 percent from 2007 to an estimated 8.6 percent in 2012, reaching 12.1 percent on average for the Euro Area countries in mid-2013. A wide variation remains within the region, however, ranging from 5 percent in Austria, Germany, and Luxembourg to over 26 percent in Greece and Spain. Employment conditions deteriorated sharply in emerging Europe during the crisis but improved somewhat after 2009, while deteriorating in the Middle East and North Africa.

The youth have been particularly hit hard by the crisis, with an estimated 74 million of young people out of jobs in 2012 around the world. The jump in the youth unemployment rate has been most pronounced again in advanced economies (figure 4), rising from 12.5 percent in 2007 to an estimated average of 17.9 percent in 2012. The rate has reached alarming levels in the peripheral Euro Area countries, to 59 percent in Greece and 56 percent in Spain, compared with the average rate for the Euro Area at 24 percent in mid-2013 and 7.5 percent in Germany. The increase in the youth unemployment rate has also been high in the Middle East and North Africa, rising by

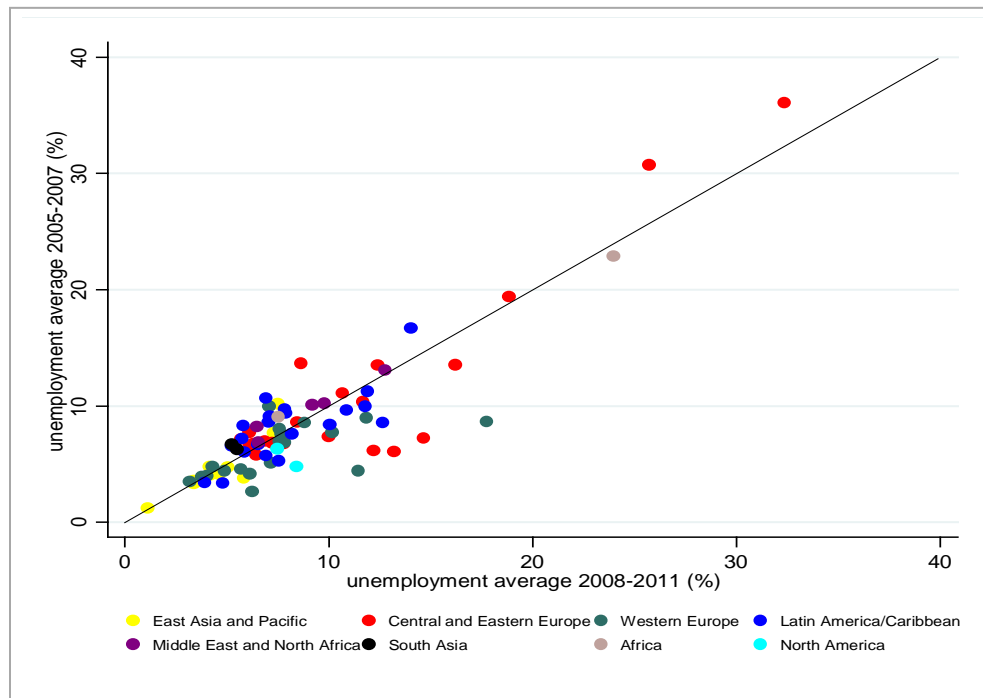
about 3 percentage points between 2007 and 2012 to 28.1 percent and 23.8 percent, respectively. Increased youth unemployment has longer term implications for the young, as many experience long-term unemployment from the start of labor market entry, according to the International Labor Organization—a situation that has not been observed during earlier cyclical downturns.

**Figure 2. Rising unemployment worldwide, with differences across regions and income levels**



Source: International Labor Organization 2013.

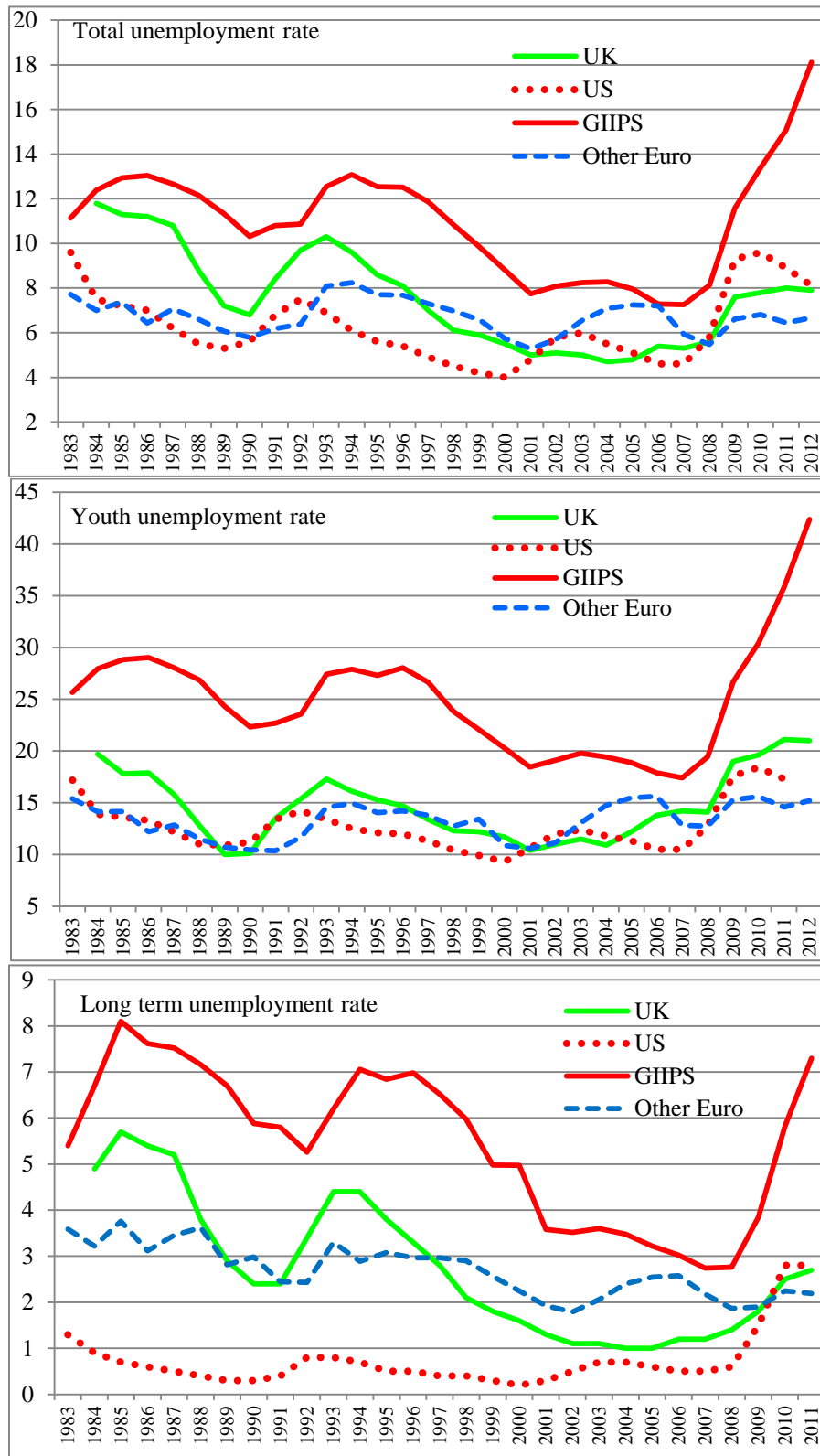
**Figure 3. The unemployment rate before and after the crisis**



Source: Authors' computations, based on World Bank World Development Indicators Database

Note: Countries below the 45 degree line had a higher average unemployment rate in the post crisis period.

**Figure 4. Evolution of unemployment rates in the global crisis-affected countries, %**



*Source:* Authors' computations, based on World Bank World Development Indicators; Eurostat Unemployment Statistics. GIIPS stand for Greece, Ireland, Italy, Portugal and Spain.

Long-term unemployment has indeed risen significantly, which is concerning as long spells of unemployment contribute to skills erosion and prevent building experience on the job. Apart from its financial and social effects on the unemployed, long-term unemployment affects social cohesion, with consequences for economic and social stability. Some 35 percent of all young unemployed have been out of a job for at least six months in advanced economies, compared with 28.5 percent in 2007,<sup>25</sup> and the rate has been rising markedly since 2008—particularly in the peripheral European countries, the United Kingdom, and the United States (figure 4).

There has also been a significant rise in vulnerable employment across regions since the start of the crisis (an additional 21 million people), according to the International Labor Organization. The rise was particularly marked during 2010-11, as some of the unemployed moved to poorly paid jobs in the informal sector that offers little or no unemployment insurance or compensation. About 49 percent of world workers were in vulnerable employment in 2012 (77 percent in South Asia and Sub-Saharan Africa). The number of working poor earning less than US\$2 a day increased by 15 million in the Middle East North Africa and Sub-Saharan Africa.

### 3.2 Financial market channel

The financial market channel has also been at work in transmitting the financial shocks to economic and social indicators (figure 5). There has been a marked decline in cross-border financial flows since the onset of the crisis. After rising spectacularly during the mid-2000s, foreign claims of cross-border banks (particularly of Europe) dropped sharply following the financial crisis and have remained subdued since early 2011. The flow of migrant remittances, which in normal times help reduce vulnerability to domestic shocks and provide a vital protection against poverty (e.g., as in Bangladesh) followed a similar pattern: the rate of growth of remittances dropped sharply in Europe, Latin America and the Caribbean, reflecting the deterioration of economic conditions in Europe and the United States, while remaining strong since 2010 in some regions (South Asia, Middle East and North Africa). Reduced flow of remittances can hurt economies highly dependent on such flows (such as Tajikistan and Kyrgyz Republic, where over 30-40 percent of GDP comes from citizens abroad).<sup>26</sup> Moreover, the ongoing crisis has led several governments to tighten their aid budgets, resulting in a decline in development aid by 2 percent in 2011 and 4 percent in 2012. There has also been a shift in aid allocations away from the poorest countries toward middle-income countries.<sup>27</sup>

The reduced availability of financial and aid flows, combined with financial institutions' continued process of deleveraging, had a dampening effect on the amount of credit extended to the private sector. To adjust to tighter funding conditions and to strengthen their balance sheets, financial institutions, particularly in Europe, reduced lending to the private sector, as well as retrenching from foreign markets.<sup>28</sup> Data also point to an erosion of savings as national authorities have maintained easy monetary conditions since the start of the global financial crisis, with the rate on deposits—a key savings vehicle in developing countries—falling more than the lending rates. The sharp falls in equity prices from early 2008 also had a negative impact on household wealth.

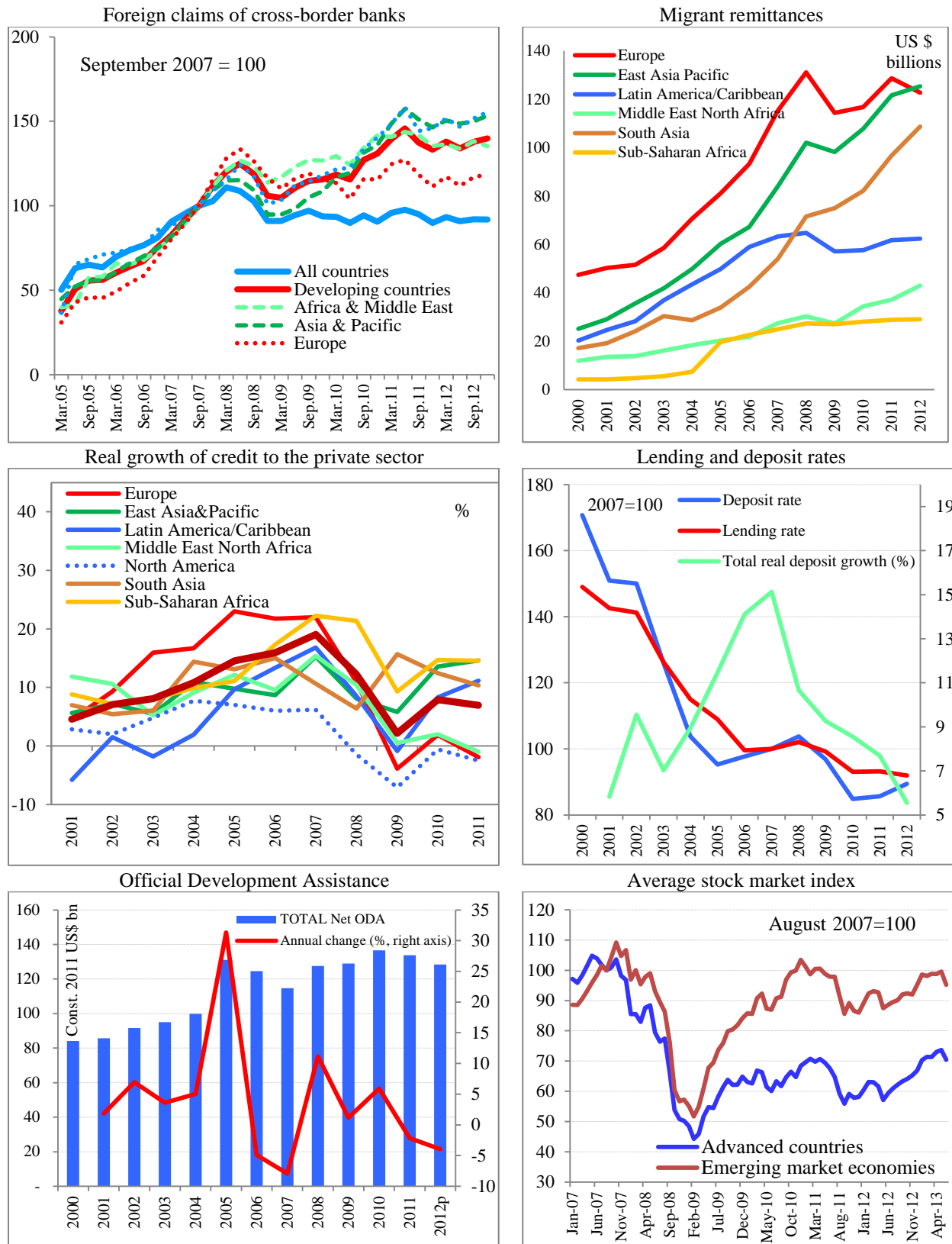
<sup>25</sup> International Labor Organization 2013.

<sup>26</sup> World Bank 2013.

<sup>27</sup> OECD 2013.

<sup>28</sup> Feyen, Ötker-Robe, and Kibuuka 2012 and Feyen and Gonzalez del Mezo 2013.

**Figure 5. Financial sector channels**



Sources: Authors' computations based on BIS, Bloomberg, IFS, OECD Aid Statistics 2013, World Bank WDI.

### 3.3 Private and public coping channels

Interruption or deterioration of the provision of essential public goods and services seems to have had an impact on growth and contributed to worsening social and economic outcomes. In the initial stages of the crisis, social expenditures increased substantially in most developed countries to address the greater need for social support as GDP growth slowed,<sup>29</sup> although some countries (Greece, Hungary) experienced drops in real social spending in 2010/11 compared to their levels in 2007/08. Public spending fell in other countries after they reached peak levels during the 2009-2011 period,<sup>30</sup> as governments were forced to undertake drastic cuts in spending. Social spending overall suffered in Eastern Europe and Central Asia. Government education spending declined since 2008 in countries with IMF programs, and low income countries had lower government spending on health in 2008-10, lower spending on infrastructure in 2010, and across-the-board declines in government spending on social protection.<sup>31</sup> Education budgets fell sharply in the majority of Eastern European countries, by as much as 25 percent in Serbia and 10 percent in Hungary.<sup>32</sup>

In many advanced countries hit hard by the financial crisis, the labor market has been further hit by fiscal austerity programs that often involved direct cutbacks or freeze in employment and wages.<sup>33</sup> Unlike the countercyclical responses to the initial crisis in 2009 and 2010, the policy reaction has been pro-cyclical in many cases in 2011 and 2012, contributing to the further drop in economic growth, rising unemployment, and deteriorating earnings—hence, to a further deepening of the crisis through the negative feedback loops between aggregate demand, weak labor markets, lower repayment capacity, and renewed financial stress. Available data show a marked decline in the global growth in real average wages, which was reduced by half in 2008 and 2009, compared to earlier years, highlighting that the crisis hurt not only those who lost their jobs, but also wage earners who managed to stay in work.<sup>34</sup> The decline in earnings was particularly pronounced in emerging Europe and Central Asia, with reduced number of hours worked and shifts in employment from the better-paid industrial sector.

Some countries were better able to implement countercyclical policies during the global crisis. Ferreira and Schady 2009 note, for example, that Latin American and Caribbean countries were less affected by the global crisis than the previous ones, in part owing to implementation of less

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<sup>29</sup> Social expenditures are defined by the OECD to include old-age pensions, health care, unemployment insurance, job-training programs, disability and survivors' benefits, housing assistance, family-support payments, cash payments and in-kind benefits (OECD 2012).

<sup>30</sup> For instance in Iceland, Ireland, Portugal, Spain, the United Kingdom, the Czech Republic, and Slovenia.

<sup>31</sup> An Oxfam study found that in 56 low-income countries, budget revenues fell by \$53 billion in 2009 and by \$12 billion in 2010, affecting the ability of governments to use countercyclical fiscal policy to cope with the crisis (Kyrili and Martin 2010). Using evidence from 10 low and middle income country studies (for Bangladesh, Benin, Botswana, Bolivia, Cambodia, Ghana, Kenya, Nigeria, Uganda, and Zambia), Overseas Development Institute 2009 found that social protection coverage was low, distribution of social programs inequitable, helping only a small percentage of the poor, offering disproportionate support to those in formal employment, and little evidence of any major increases in coverage in response to the crisis—with a few exceptions. Some countries were found to be struggling to meet pre-existing social protection commitments (Kenya and Uganda), others try to extend coverage (Ghana, Cambodia), or focus on stabilizing macroeconomic situation (Indonesia) or promoting stimulation packages by reducing social sector expenditure (Nigeria).

<sup>32</sup> Education International 2009.

<sup>33</sup> International Labor Organization 2013a.

<sup>34</sup> International Labor Organization 2010 and Khanna and others (2010) (for 41 middle-income countries).

pro-cyclical policies, made possible by the greater monetary and fiscal room to maneuver. More countries had countercyclical spending—some redirected fiscal resources to retain social services, some (temporarily) expanded safety nets, or used the crisis as an opportunity to achieve major reforms that improve efficiency and quality (e.g., Argentina channeled health funding to vulnerable people). Similarly, many countries in East Asia and the Pacific (including China, Indonesia, Malaysia, Philippines, Thailand, and Vietnam) had varying forms of fiscal stimulus to boost flagging economic growth and counter social impacts.<sup>35</sup> Having strengthened their macroeconomic fundamentals after the 1997 crisis, many countries in the region had accumulated significant foreign reserves and had fiscal space to implement spending measures aimed at supporting their economies.

Faced with a loss of employment and earnings and reduced social support, individuals have adopted a range of coping strategies to survive the global financial crises. While continuation of the crisis makes it difficult to have a full assessment of the coping strategies used to date, a number of recent studies explored the nature of coping strategies in a selection of countries and regions around the world. Based on a survey of qualitative research on the coping responses used by poor and vulnerable people in 13 countries,<sup>36</sup> Helberg, Hossain, Reva, and Turk 2012 found some evidence of costly coping measures by households in response to the recent financial, food and fuel crisis. Reducing the quality of food, the number of meals, and nonfood consumption were the most common behavior-based coping responses. Working longer hours, engaging in crime, and diversifying sources of income were common nearly everywhere. Migration, selling assets, borrowing from relatives, friends, and neighbors and pulling children out of school were also observed in about half of the countries surveyed. In Cambodia, household surveys compiled from nine villages in 2008 and 2011 showed that 46 percent of the households that experienced shocks in 2008 drew on savings, 22 percent borrowed, 3.3 percent reduced consumption, close to 10 percent received assistance from relatives, and 4 percent sold cattle or migrated.<sup>37</sup>

An analysis using cross-sectional household-level data from the 2010 *Life in Transition Survey* for countries in Europe and Central Asia also documents costly coping strategies deployed by households in response to the income shocks associated with the global financial crisis. It finds that households reallocated spending from non-essential goods to staple foods to cushion income shocks from the labor markets (in the form of wage reductions) and cut back on health care, while education was largely insulated from income shocks. Reductions in staple-food consumption were strongest among low-income households. Diversified income sources, as well as access to informal and formal credit, helped households to cushion income shocks, especially in middle-income countries.<sup>38</sup> Another study exploiting Crisis Response Surveys, conducted in Armenia, Bulgaria, Montenegro, Romania and Turkey during 2009 and 2010, also found that households are likely to adopt health-related coping mechanisms (reduce visits to doctors and spending on medicines). While households affected by income shocks reduced their education investments, they did not adopt harmful education-related coping strategies, such as withdrawing children from school or moving children from costly private schools to cheaper public schools.<sup>39</sup>

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<sup>35</sup> UNICEF 2009.

<sup>36</sup> Bangladesh, Cambodia, the Central African Republic, Ghana, Kazakhstan, Kenya, Mongolia, the Philippines, Serbia, Thailand, Ukraine, Vietnam, and Zambia.

<sup>37</sup> Seing 2013.

<sup>38</sup> Brown 2013.

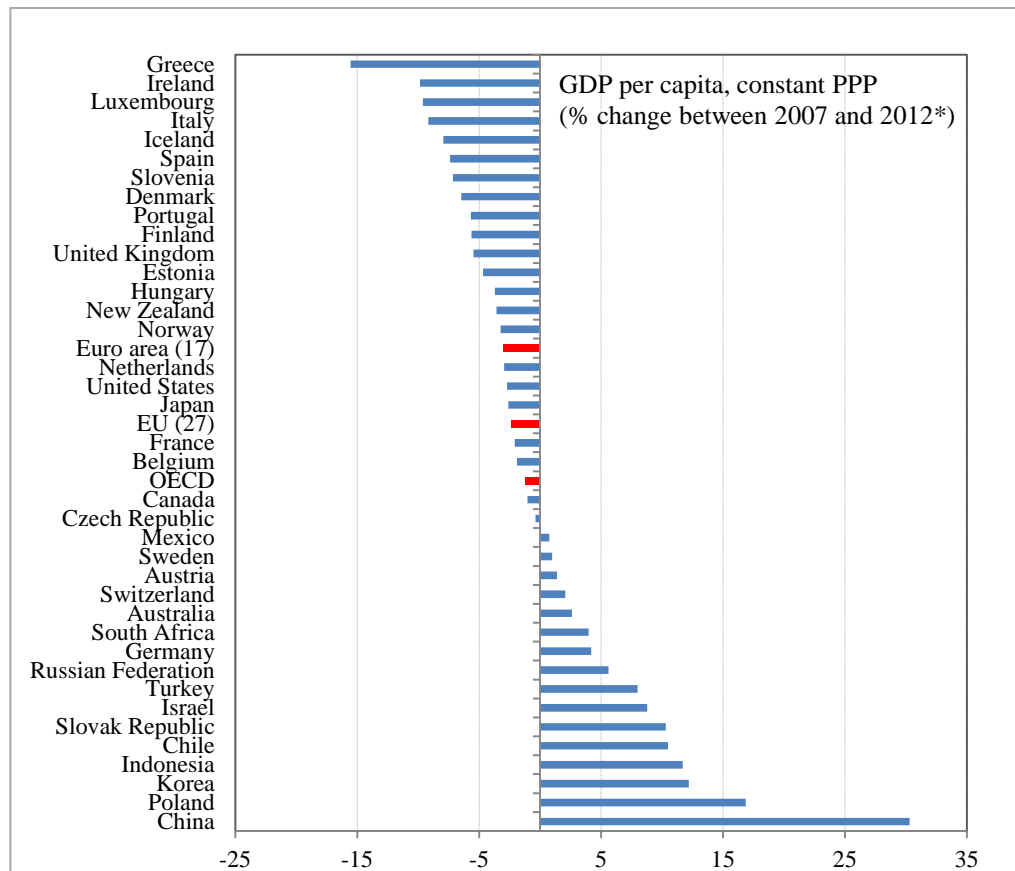
<sup>39</sup> Dasgupta and Ajwad 2011.

## 4 Evolution of Social Indicators during the Global Crisis

### 4.1 Income growth

Evidence points to a sharp deterioration in economic and social well-being indicators since the onset of the crisis in 2007. Economic performance has suffered, but not uniformly across the world. While some emerging market countries had marked improvements in their GDP per capita compared to the precrisis period, many others experienced deterioration (figure 6). Overall, 95 countries around the world are estimated to have their per capita incomes reduced in 2009 at the peak of the crisis. Per capita GDP fell on average by 3 percent in the Euro Area countries, with the largest declines found in countries hardest hit by the economic and financial crisis in Europe (e.g., Greece, Ireland, Iceland, Italy and Spain). Previous analysis focusing on a set of developed and developing countries over four decades suggests, indeed, that an increase in GDP volatility from normal to crisis related levels can reduce long-run per capita GDP growth by around 2 percentage points a year.<sup>40</sup>

**Figure 6. Impact of the crisis on GDP per capita**



Source: Authors' computations based on OECD data.

\* 2011 for Australia, Chile, Canada, Greece, Japan, Mexico, New Zealand, Turkey, United States, Russian Federation, and South Africa, and 2010 for China and Indonesia.

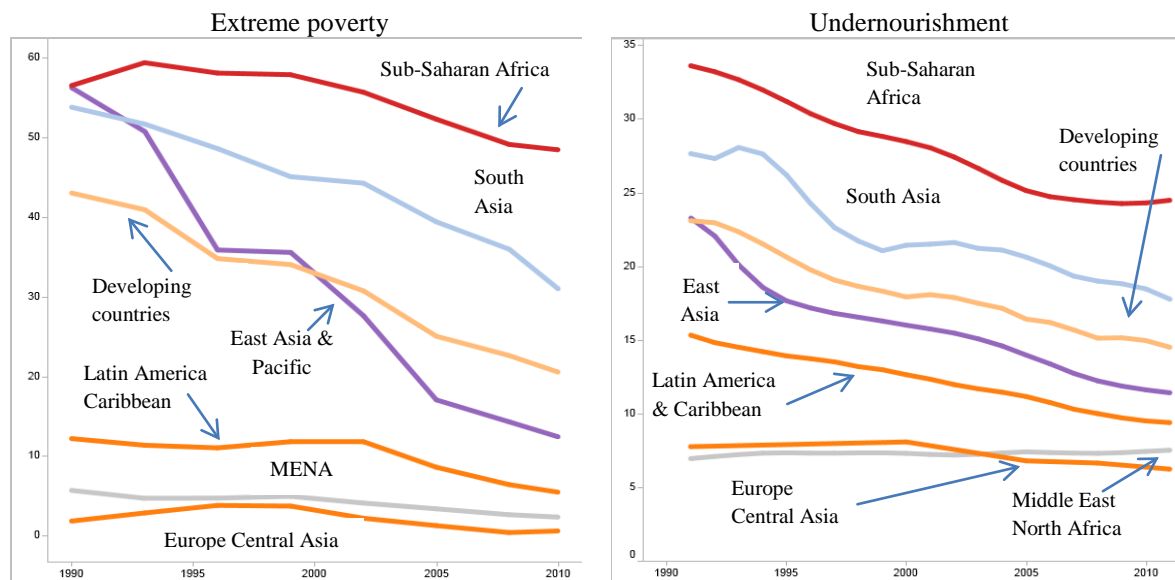
<sup>40</sup> Hnatkowska and Loayza 2005.



## 4.2 Poverty and development

Having completed its fifth year, the global crisis appears to threaten a reversal of the hard-won development gains around the world. Globally, 47-84 million people are estimated to have fallen into, or are trapped in, extreme poverty in 2009 because of the crisis. An additional 64 million became poor by 2010.<sup>41</sup> Granted, the developing countries as a whole have continued to make progress on poverty reduction, as the number of people living on less than \$1.25 a day fell to 1.22 billion (or 20.6 percent of the developing world population) in 2010, from 1.94 billion (or 52.2 percent) in 1981. But the progress has been uneven, with East Asia and Pacific making up a large part of the reduction in extreme poverty, thanks to strong growth in China. The pace of reduction in extreme poverty has also slowed—particularly in upper middle income countries in Europe Central Asia and Latin America (figure 7, panel 1). The prevalence of extreme poverty increased in some countries (figure 8).<sup>42</sup> Increased poverty rates in Europe and Central Asia reversed the marked progress made following the 1998 Russian crisis when some 50 billion people crossed over the poverty line thanks to rising real wages among the working poor. The global crisis is believed to have put at risk the 120 million people living just above the poverty line to easily fall back into poverty.<sup>43</sup> As well, some 1.5 billion of the world's poorest people continue to live in countries where fragility and conflict have created vicious cycles of poverty and violence, with very limited progress made in halving extreme poverty.<sup>44</sup>

**Figure 7. Progress toward Millennium Development Goals (percent of population)**



Source: Global Monitoring Report 2013, Global Progress Toward Achieving MDGs.

The setback in the progress in reducing poverty has not been limited to developing countries. In the United States, where the financial crisis set off, poverty rates increased during the three

<sup>41</sup> World Bank and the IMF 2012; Chen and Ravallion 2009.

<sup>42</sup> Including in Madagascar, Bolivia, Chile, Costa Rica, Honduras, El Salvador, Mexico, Georgia, Kyrgyz Republic, and Turkey.

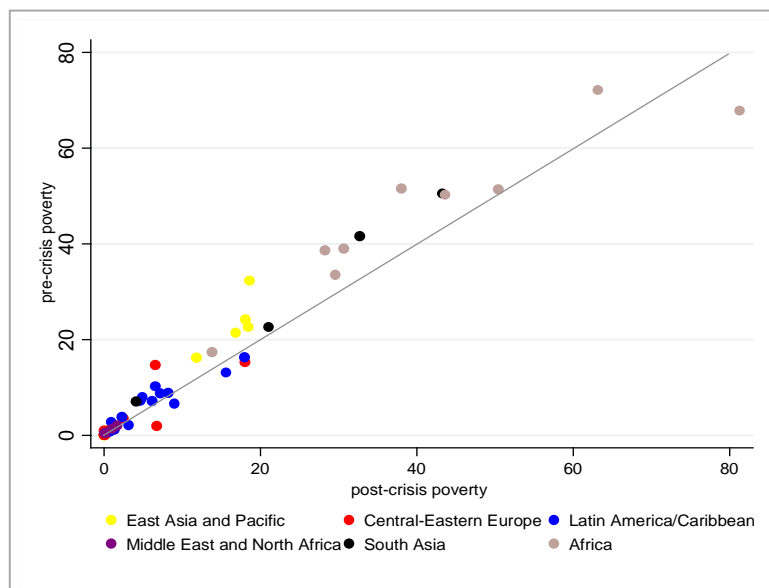
<sup>43</sup> Sugawara, Sulla, Taylor and Tiongson 2010.

<sup>44</sup> OECD 2013; Ötker-Robe 2013; World Bank 2013.

consecutive years 2008-11 to 15 percent of the population (46.2 million people). In Europe, a growing number of people are believed to have fallen below the poverty threshold, where poverty is measured in relation to the median living standards in each country. An estimated 16.4 percent of the population (or 80 million people) were living below the poverty threshold in 2010, with the highest rates observed in Bulgaria, Romania, Greece, and Spain (around 20 percent). Across the EU, the poverty rates are higher among women (17.1 percent on average against 15.7 percent for men), children (20.2 percent), and the young (21.6 percent) who are either unemployed or hold precarious jobs (part time or fixed term). In terms of households, the poverty rate has been the highest among single-parent families (36.9 percent) with no possibility of risk sharing within the family.<sup>45</sup> While social welfare programs shielded some of the poorest Europeans (especially children and youth) from the most severe effects of the financial crisis through 2010,<sup>46</sup> the cuts in these programs as part of the austerity measures adopted by governments are expected to further worsen the situation going forward.

Opinion survey results support these warnings. According to the Flash Barometer survey 289 that monitors public views about the social impact of the global crisis in EU member states, many EU citizens considered that poverty was rather widespread in their country (at least 20 percent of their country's citizens), more so for respondents in East and Southeast Europe than Northern and Central European member states.<sup>47</sup> Respondents, notably in Greece, Romania, Portugal and Spain, thought that poverty had increased strongly in their countries. Respondents also noted difficulties in paying ordinary bills, keeping up with credit commitments, bearing the cost of general health care, childcare and social care services for themselves and their relatives, and expressed pessimism about their financial prospects and the ability to maintain their current jobs in the future.

**Figure 8. Poverty headcount ratio at \$1.25 a day (PPP) (% of population)**



*Source:* Authors' computations based on 57 countries that have data for both precrisis and postcrisis periods.

*Note:* Countries below the 45 degree line had higher average poverty rate in the post crisis period than precrisis.

<sup>45</sup> US Census Bureau 2011.

<sup>46</sup> OECD 2012.

<sup>47</sup> European Commission 2010.

A recent European Commission report concluded that almost one in four people in the EU (119.6 million people) was at risk of poverty and social deprivation in 2011—those either with household income below the poverty threshold, or severely materially deprived, or living in a household with low work intensity.<sup>48</sup> The highest shares of people at the risk of poverty and social exclusion were recorded in Bulgaria (49 percent), Romania and Latvia (40 percent), Lithuania (33 percent), and Greece and Hungary (31 percent), while the lowest rates were found in the Czech Republic, the Netherlands, Sweden, Luxembourg, and Austria (around 16 percent). A 2011 independent expert assessment concluded that during 2011, the financial and economic crisis and the associated austerity measures led to a rise in poverty and social exclusion in more than half of the member states.<sup>49</sup> Contributing to the deterioration were old age, low wages, rising unemployment, persistence of already high levels of unemployment, or jobs with temporary contracts and limited benefits. Children, immigrants and people from a migrant background, ethnic minorities, and disabled were identified as groups most at risk, as well as homeless, the old, and women in some countries.

Beyond extreme poverty, the ongoing crisis also poses significant challenges to attaining the other development goals, including reducing malnutrition and maternal and under-5 mortality rates, and improving gender equality in education and access to clean water and sanitation. While most developing countries have made progress in reducing the incidence of undernourishment and mortality rates and in improving the share of populations with access to primary education and improved water and sanitation, there has been a visible reduction in the pace of progress toward achieving these goals by 2015, particularly reducing malnutrition, in most regions and income groups (figure 7, second panel, and figure 9).

The slowdown (or reversal) in progress has been more evident within the middle income country group (figure 9). Some countries in Latin America and the Caribbean, the Middle East and North Africa, and Sub-Saharan Africa observed deterioration in the progress toward reducing undernourishment, compared to the pre-crisis period (figure 10), reflecting the combined effect of the food crisis in 2008 and weak growth following the global crisis.<sup>50</sup> Brinkman and others (2010) suggest that based on survey evidence in Europe and Central Asia, Africa, and Latin America, coming up on top of the food and fuel crises, the global economic and financial crisis has been associated with a rising cost of the food, forcing large numbers of vulnerable households to reduce the quantity and quality of food consumed at the risk of increased malnutrition. Deterioration in the progress toward improving maternal mortality rates and gender parity in education was also more evident in Europe and Central Asia and Latin America. In many developing countries, especially fragile and conflict-affected-states, achieving the MDGs by 2015 remains a distant hope (figure 11).

The ongoing crisis has jeopardized the well-being of people even in the developed world. Recent reports by UNICEF, for example, point to a significant deterioration in child well-being in a number of advanced countries, based on measures of material well-being, health and safety, education, behaviors and risks, and housing and environment. The deterioration is most evident in Spain, where more than 2.2 million children are estimated to live below the poverty line in

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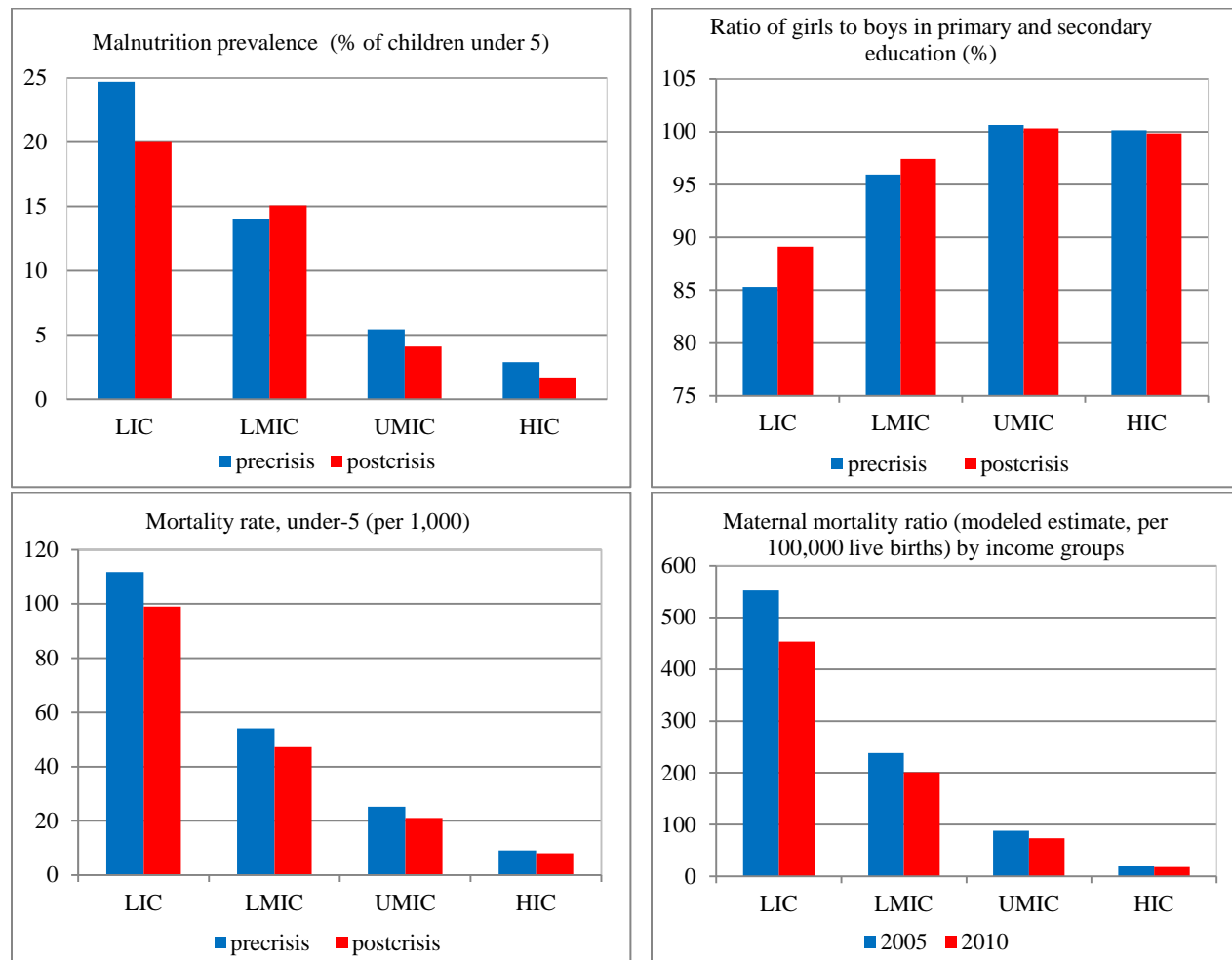
<sup>48</sup> Eurostat 2012 based on EU-SILC survey; <http://ec.europa.eu/eurostat>.

<sup>49</sup> Frazer and Marlier 2012. The Report is the summary findings of national reports prepared by members of the EU Network of Independent Experts on Social Inclusion assessing policy developments in their countries during 2011.

<sup>50</sup> Tiwari and Zaman (2010).

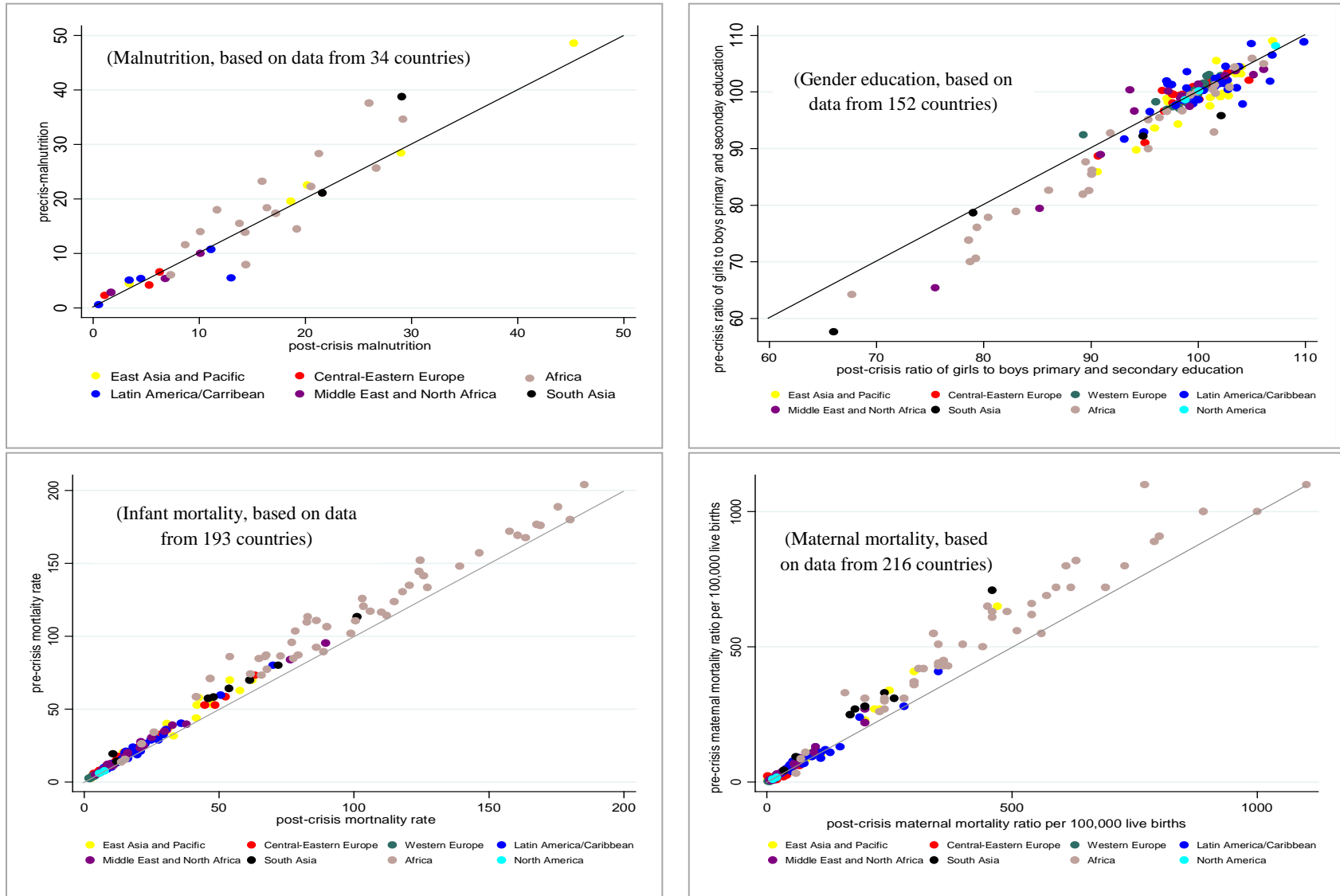
2011—80,000 more than in 2010, with many families cutting down basic necessities such as food and reducing the quality and the amount of food intake. The well-being of children in the Czech Republic, Poland, Greece, and the United States also seems to have deteriorated. Similarly, the UN composite Human Development Index, computed as a function of measures of life expectancy at birth, access to knowledge, and a decent standard of living, declined between 2007 and 2012 for a number of middle and high income countries in the Middle East and Europe (the United Arab Emirates, Bahrain, Greece, Luxembourg, Ireland, and Iceland) as well as for small island states. Advanced countries and regions closely linked to them registered the smallest improvement in the index (figure 12).

**Figure 9. Development indicators before and after the crisis by income group**



Source: Authors' computations, based on World Bank's World Development Indicators database.

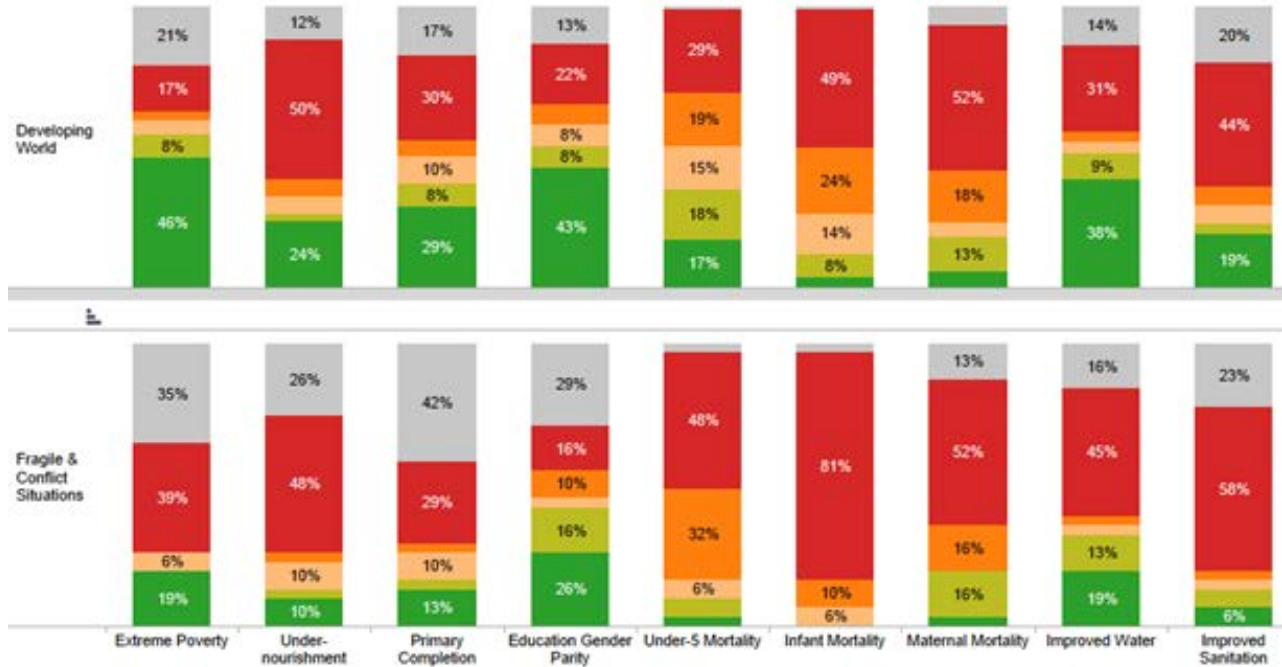
**Figure 10. The evolution of development indicators since the global crisis**



Source: Authors' computations, based on World Bank WDI Database.

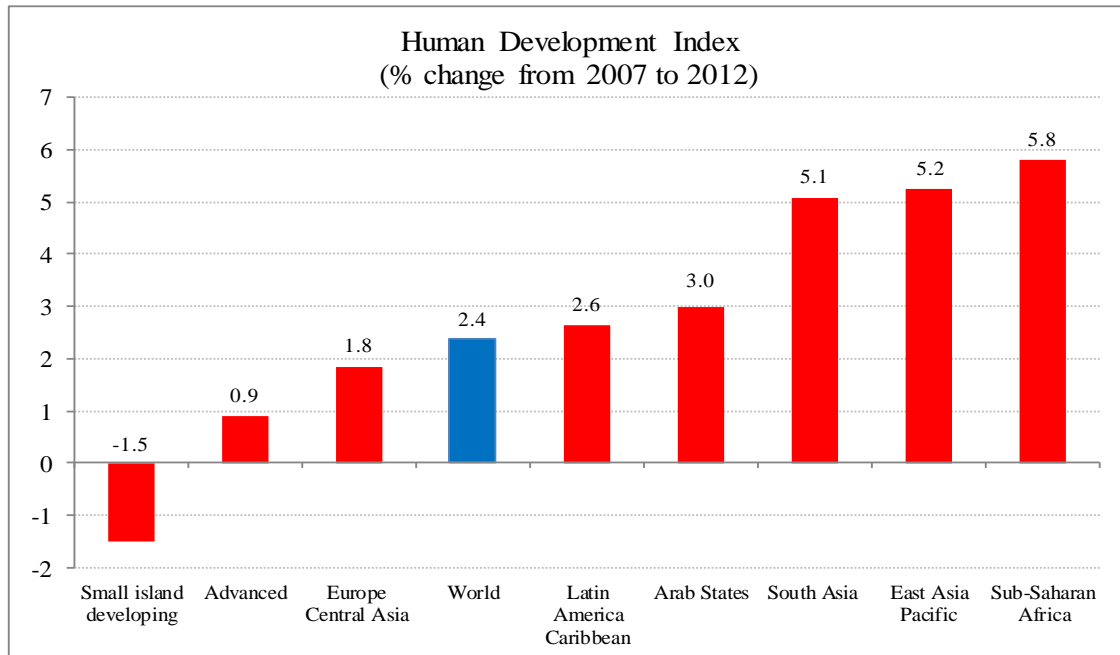
Note: Countries below the 45 degree line had higher prevalence of malnutrition, better gender education parity, and higher postcrisis under-5 and maternal mortality rates.

Figure 11. Progress toward meeting the Millennium Development Goals by 2015



Source: Global Monitoring Report 2013: Progress Status.

Figure 12. A measure of human development



Source: Authors' computations based on United Nations' Human Development Report 2013.

Note: Human Development Index is a composite index that measures the average achievements in a country in the basic dimensions of human development: a long and healthy life (measured by life expectancy at birth), access to knowledge (measured by adult literacy and combined enrollment in secondary and tertiary level education), and a decent standard of living (measured by GDP per capita).

### 4.3 Income inequality

Macroeconomic volatility accompanying financial and economic crises also worsens income equality, since lower income segments of the population are less protected from economic downturns. As observed in previous crises, the substantial deterioration in development indicators has been accompanied by a worsening income distribution in some countries during the current crisis (figure 13), although with no clear indication that income inequality worsened more in the countries hardest hit by the global crisis. A commonly used measure of income equality, the Gini index,<sup>51</sup> increased post-crisis in a number of advanced countries such as Iceland, Sweden, Switzerland, Croatia, and Luxembourg, suggesting increased income inequality and a growing gap between rich and poor. Even in Germany, where the poverty rate is lower than most European countries, inequality seems to have increased, with the richest 10 percent of the population now controlling 60 percent of all wealth. The Gini index sharply deteriorated after the crisis in several developing countries in Europe and Central Asia and Sub-Saharan Africa, adding to the worsening socio-economic conditions. There seems to be a positive association between the rise in income inequality and a slowdown in economic growth (figure 14).

At the same time, the Gini index fell markedly in other advanced countries, suggesting reduced income inequality, including in a number of heavily-hit countries by the crisis, such as Portugal, Ireland, Greece, Spain, and Italy, as well as Romania, Hungary, Estonia and Norway (figure 15). The severe recessions and sharp drops in incomes due to prolonged periods of unemployment may have brought the distribution of income somewhat more aligned within these countries. This finding seems consistent with several earlier studies that point to drops in income inequality as a consequence of financial crisis.<sup>52</sup>

### 4.4 Social and political cohesion

Evidence also points to a sharp deterioration in social and family cohesion during the global crisis. In a number of countries, rates of mental illness, substance abuse, and suicides increased since the onset of the crisis according to the United Nations.<sup>53</sup> Labor migration in response to the crisis and reported increase in the incidence of child abandonment, abuse and trafficking show signs of deterioration in social and family cohesion. Surveys indicate growing prevalence of depression in India, Indonesia, Pakistan, South Africa, and Thailand, and reported rises in suicide rates in Egypt, Japan, Latvia, South Africa, and the United States, similar to the evidence from the previous crises (a doubling of suicides in Korea after the onset of the 1997 crisis).

Evidence also suggests deterioration in socio-political indicators. In particular, there was an increase in outbreaks of conflicts, protests, violent demonstrations and perceptions of crime in 2009 compared to previous years, based on an index of global peace calculated by the Institute for Economics and Peace. The Global Peace Index that examines 23 indicators for 158 countries continued to deteriorate until 2012, as reflected in higher levels of organized crime and violent conflict, perceptions of criminality in society, greater likelihood of violent demonstrations, and increased number of homicides, jailed population, and deaths from organized conflict, as many

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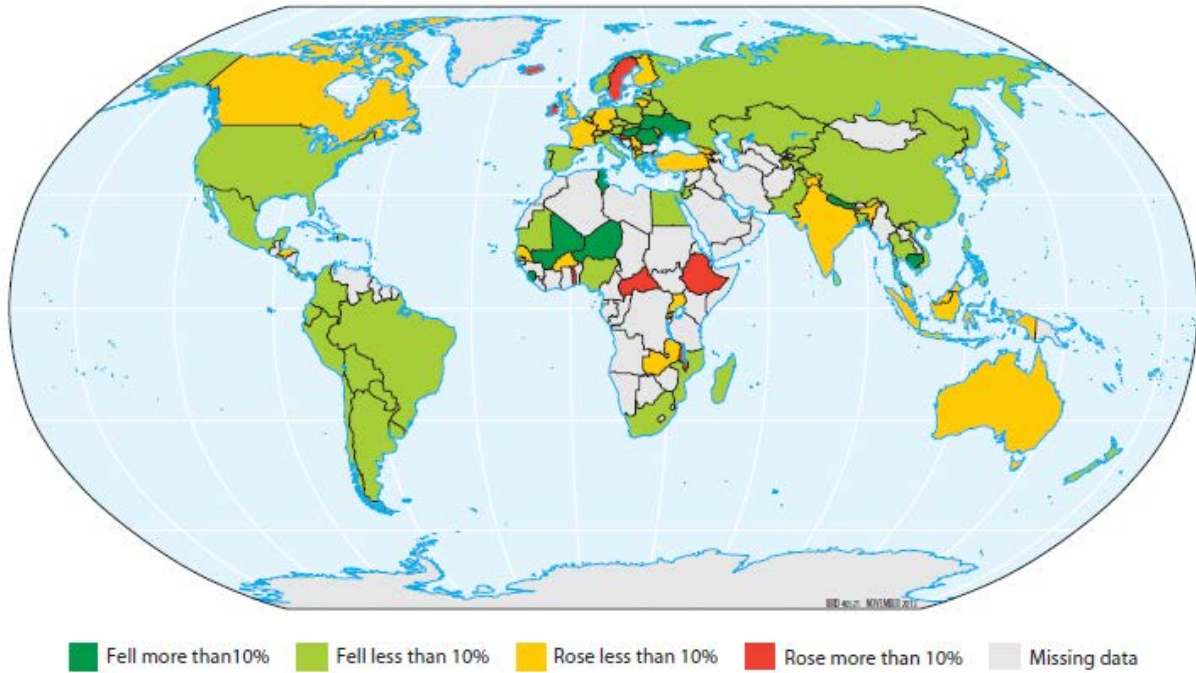
<sup>51</sup> The Gini index measures the extent to which the distribution of income among individuals and households within an economy deviates from a perfectly equal distribution

<sup>52</sup> See Calvo 2013 and references cited there in.

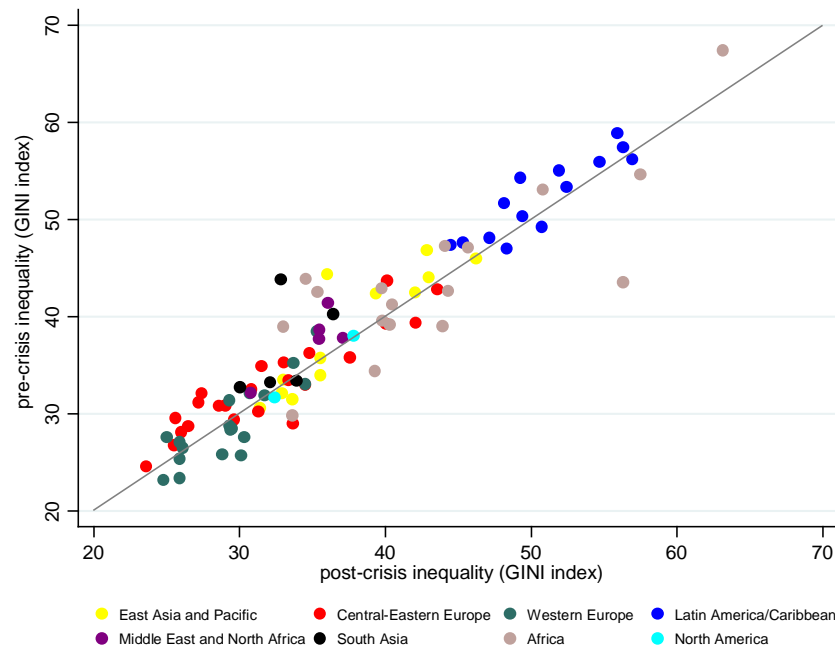
<sup>53</sup> UN 2011.

**Figure 13. Evolution of income distribution before and after the crisis**

**a. Income inequality increased in some parts of the world following the crisis**



**b. Widening gap in between rich and poor in many countries**

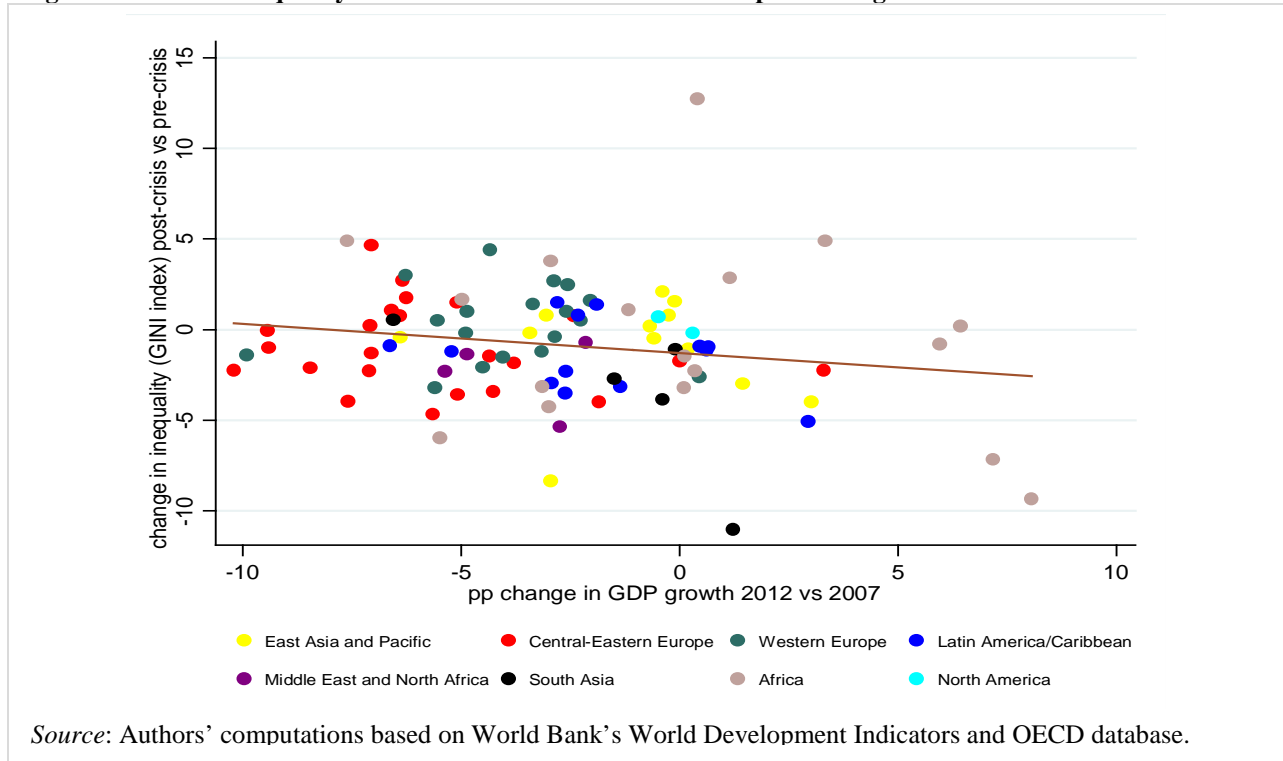


*Source:* Authors' computations, based on World Bank World Development Indicators Database.

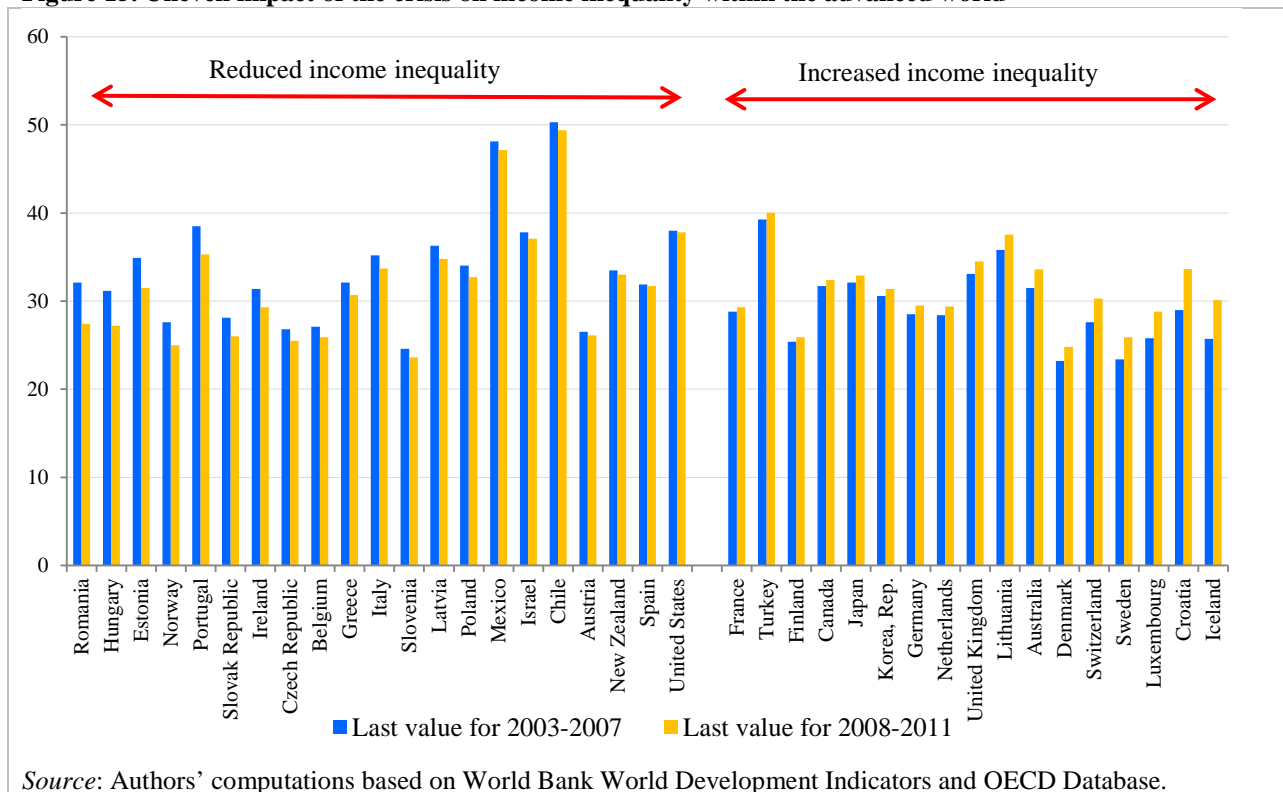
*Note:* Countries below the 45 degree line had higher Gini Index (less equal income distribution) in the post crisis period than before the crisis.



**Figure 14. Income inequality worsened more in countries that experienced greater economic slowdown**

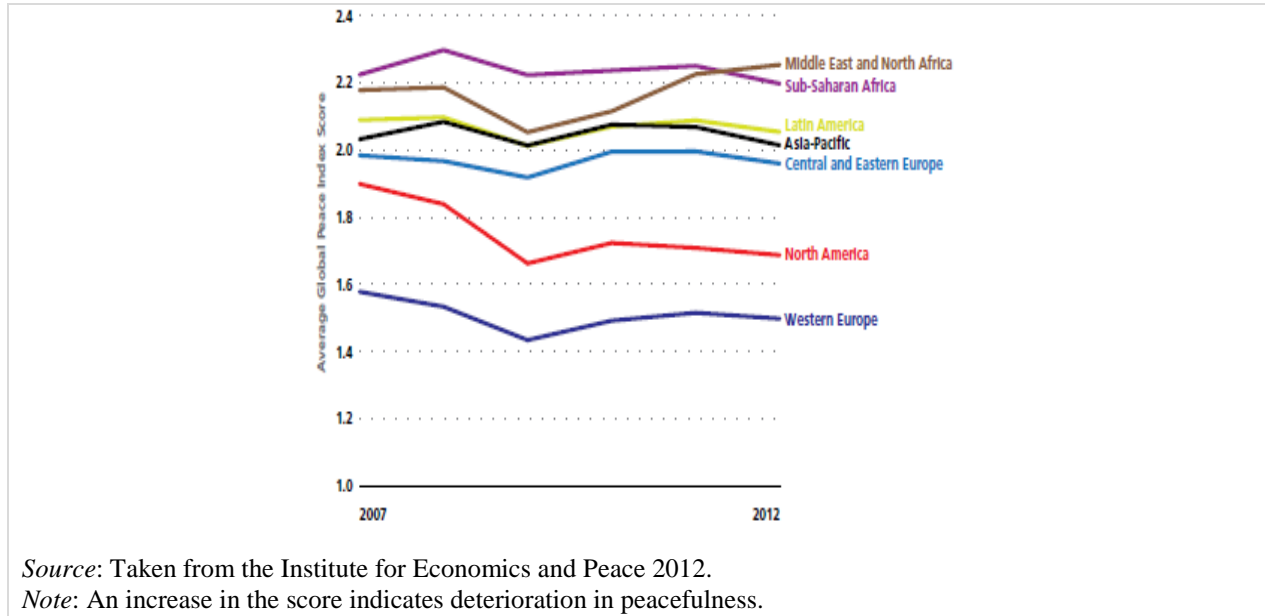


**Figure 15. Uneven impact of the crisis on income inequality within the advanced world**



countries experienced growing instability and heightened disharmony linked to rapid rises in food, fuel, and commodity prices and the global economic downturn.<sup>54</sup> In 2012, the overall index of peacefulness improved across all regions, except in the Middle East and North Africa, where many countries continue to experience waves of uprisings, protests and revolutions, sparked by the Arab Spring (figure 16).

**Figure 16. Evolution of peacefulness over the global crisis, 2007-12**



## 5 The Global Crisis and Loss of Economic Time

The available evidence presented in the previous section suggests that the financial crisis has reversed the significant economic advances made in the past decades for many countries around the world. To assess how much economic progress the crisis has undone, this section follows a similar analysis undertaken by *The Economist* magazine, and constructs a measure of “lost time” for a range of advanced and developing countries (the Proust Index).<sup>55</sup> For twelve advanced countries hard-hit by the ongoing crisis, *The Economist* computed a measure of “lost time”—that is, the number of years the economic clock turned back for each country. The index was computed as a simple average of how much time has been lost in each of the three categories of seven indicators of economic health: household wealth indicators (such as property and stock market prices); economic performance indicators (nominal GDP, real per capita GDP, and private consumption); and income indicators (real wages and unemployment rate). It showed that advanced economies have lost more than a decade of wealth, income and employment: Greece’s economic clock has been turned back by more than 12 years, Ireland, Italy, Portugal and Spain lost 7-9 years, the United Kingdom went back 8 years, and the United States a decade.

A similar approach has been taken here to calculate the number of years that a country relapsed, for as many countries as possible, from all regions and all income levels. Our overall index is an

<sup>54</sup> Institute for Economics and Peace 2012.

<sup>55</sup> “Lost Economic time: The Proust index.” *The Economist*. February 25 2012.

average number of years that have been lost in terms of GDP per capita, household consumption per capita, equity prices, and unemployment. The lost time for each indicator is computed as the number of years between the year in which a country recorded the worst crisis value and the year when a worse value was last observed.<sup>56</sup> The overall measure of lost time shows that the peripheral European countries that have been hardest hit by the global financial crisis lost more than a decade of economic development—Greece lost 14 years, Iceland 12 years, Portugal and Ireland about 10 years, and Spain about 9 years (figure 17, panel a). In the United States and the United Kingdom, the epicenters of the global financial crisis, the economic clock turned back by more than 8 years. Regionally, Western European and North American countries lost more than six years of economic time on average. Central and Eastern Europe and South Asia lost on average more than four years (figure 17, panel b).

From the perspective of individual indicators, the biggest loss of economic time has been in terms of unemployment, with almost a third of all countries turning back in time by more than 10 years (figure 18), and high income OECD countries reversing employment, on average, by ten years). High income countries lost the most time in terms of GDP per capita, unemployment, and equity wealth, while low income countries relapsed the most in terms on household consumption per capita. Regionally, Western Europe lost the most time in terms of GDP per capita, asset prices, and household consumption per capita, where Africa and South Asia followed very closely. North America saw the largest reversal in unemployment (figure 19).

## 6 Summary and Policy Implications

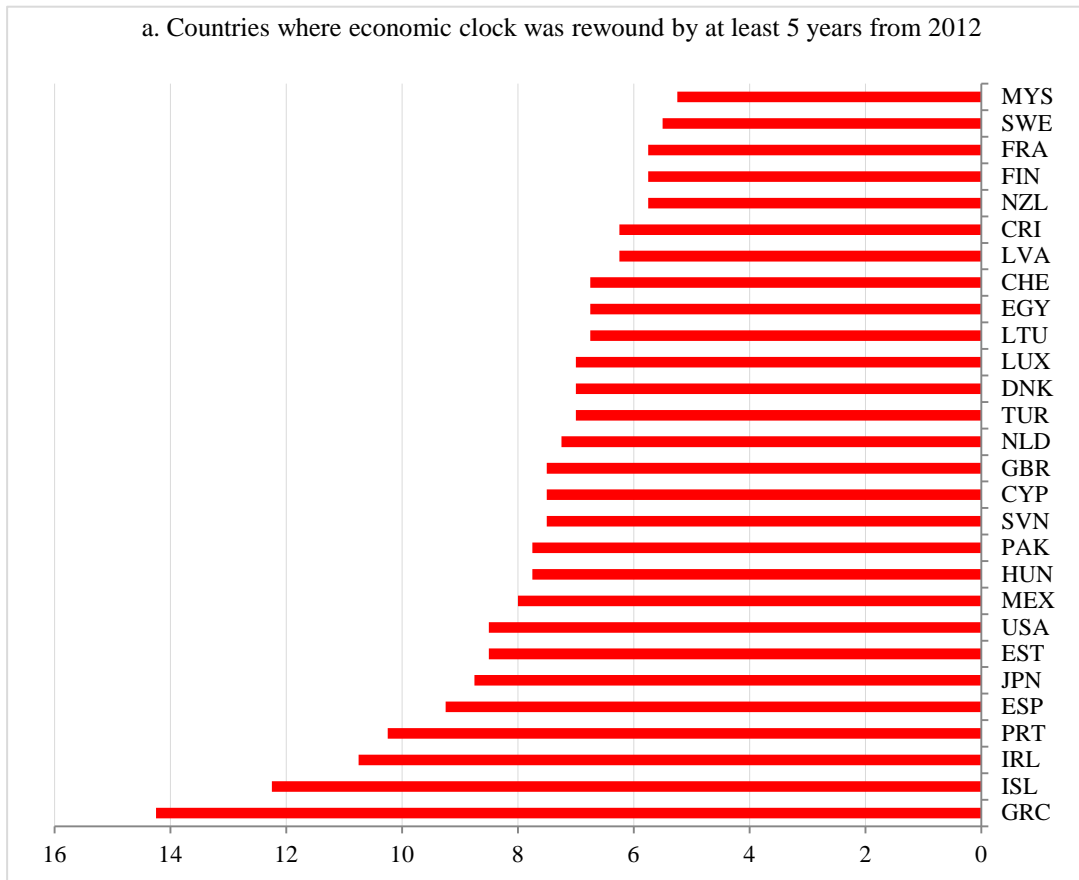
Available evidence from the global financial crisis suggests that financial crises can have significant short-term and long-term social costs. Through product and labor markets, financial crises weaken economic activity, dampen consumption and investment demand, and result in sustained falls in economic growth, loss of jobs, reduced wages and benefits, and higher unemployment. Reduced asset values lower wealth through the financial market channel, and deceleration of capital inflows, foreign aid, or remittances increases the scarcity and cost of credit that dampens economic activity and employment. Coping strategies by the public sector can affect its ability to lessen the pain inflicted by the crisis through continued provision of social protection and essential public goods and services. Costly coping strategies by individuals can limit the quantity and quality of food intake, increase working hours at jobs with limited benefits, result in engagement in crime or violence, sale of productive assets, or pulling children out of school—all with long-term development consequences. Migration, informal credit from relatives, friends, and neighbors, and diversifying assets can help cushion the blow. Available evidence suggests that these channels have been at work during the global financial crisis.

As a result, economic and social indicators have deteriorated significantly since 2007. The loss of 28 million jobs since 2007 brought the pool of globally unemployed people to an estimated 197 million in 2012. The unemployment rate increased sharply, especially in high- and upper-middle income countries that have been at the epicenter of the crisis or had close economic and

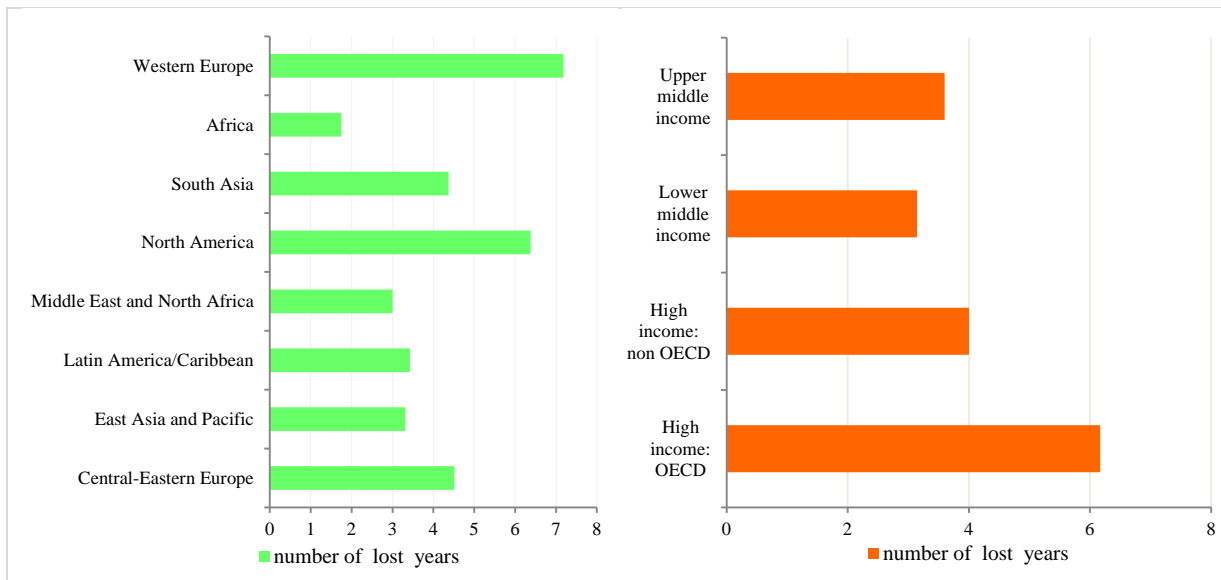
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<sup>56</sup> The analysis does not account for each country's business cycle development. To include all countries for which full time series are available since 1990, a varying sample of countries is taken for each indicator: for GDP per capita the sample includes 180 countries, for household consumption per capita 134 countries, for unemployment 79 countries, and for equity indices 73 countries.

**Figure 17. A Measure of “lost time” in economic development: the Proust index**



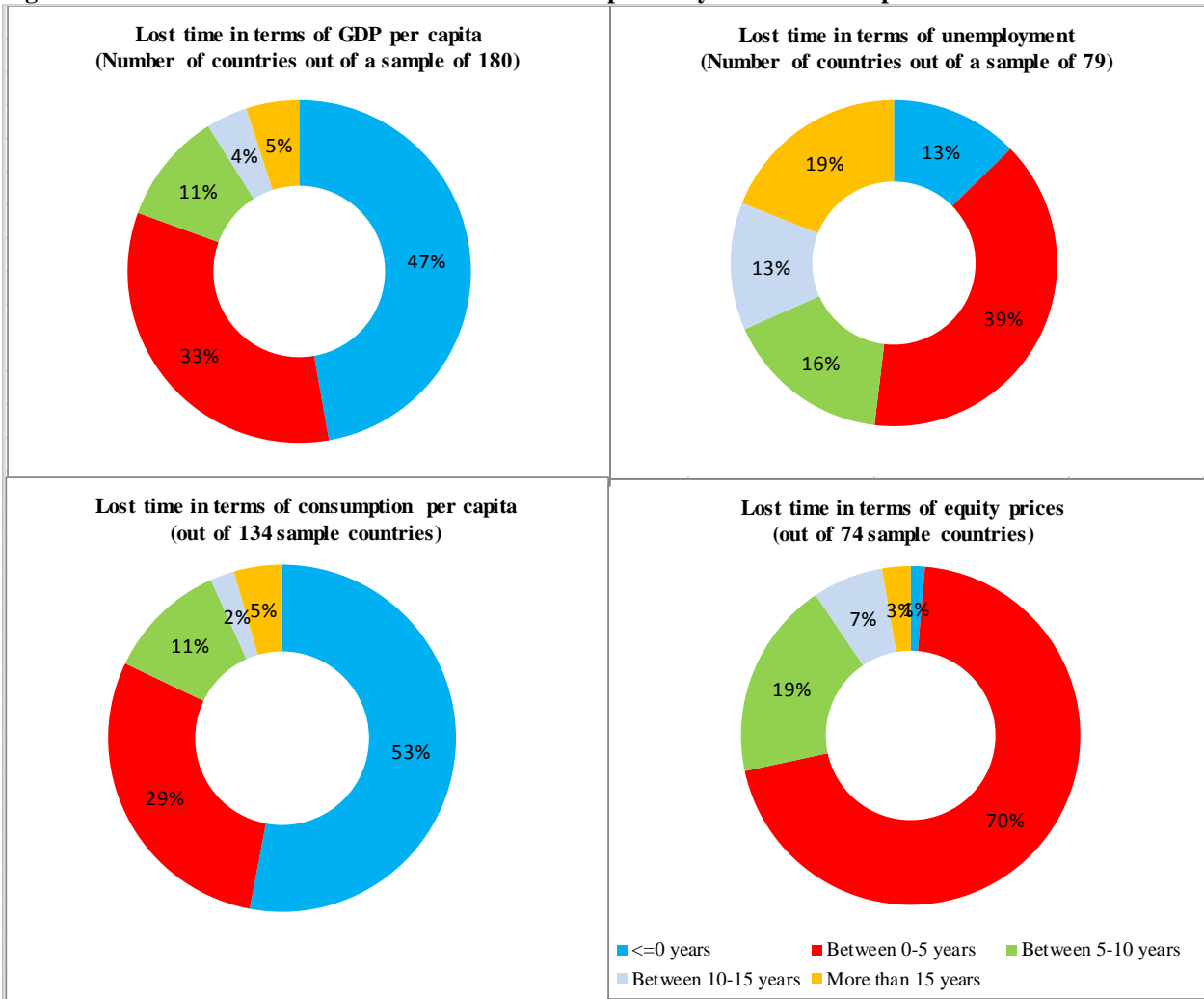
b. The Proust index by region and income level



*Source:* Authors’ computations based on data from Bloomberg (equity prices); World Bank WDI for GDP and consumption per capita; and WDI and ILO for the unemployment rate.

*Note:* Lost time is computed as a simple average of lost time in terms of GDP per capita, household consumption per capita, equity prices, and unemployment for 52 countries for which data for all four indicators are available.

**Figure 18. A Measure of “lost time” in economic development by individual components of the Proust index**



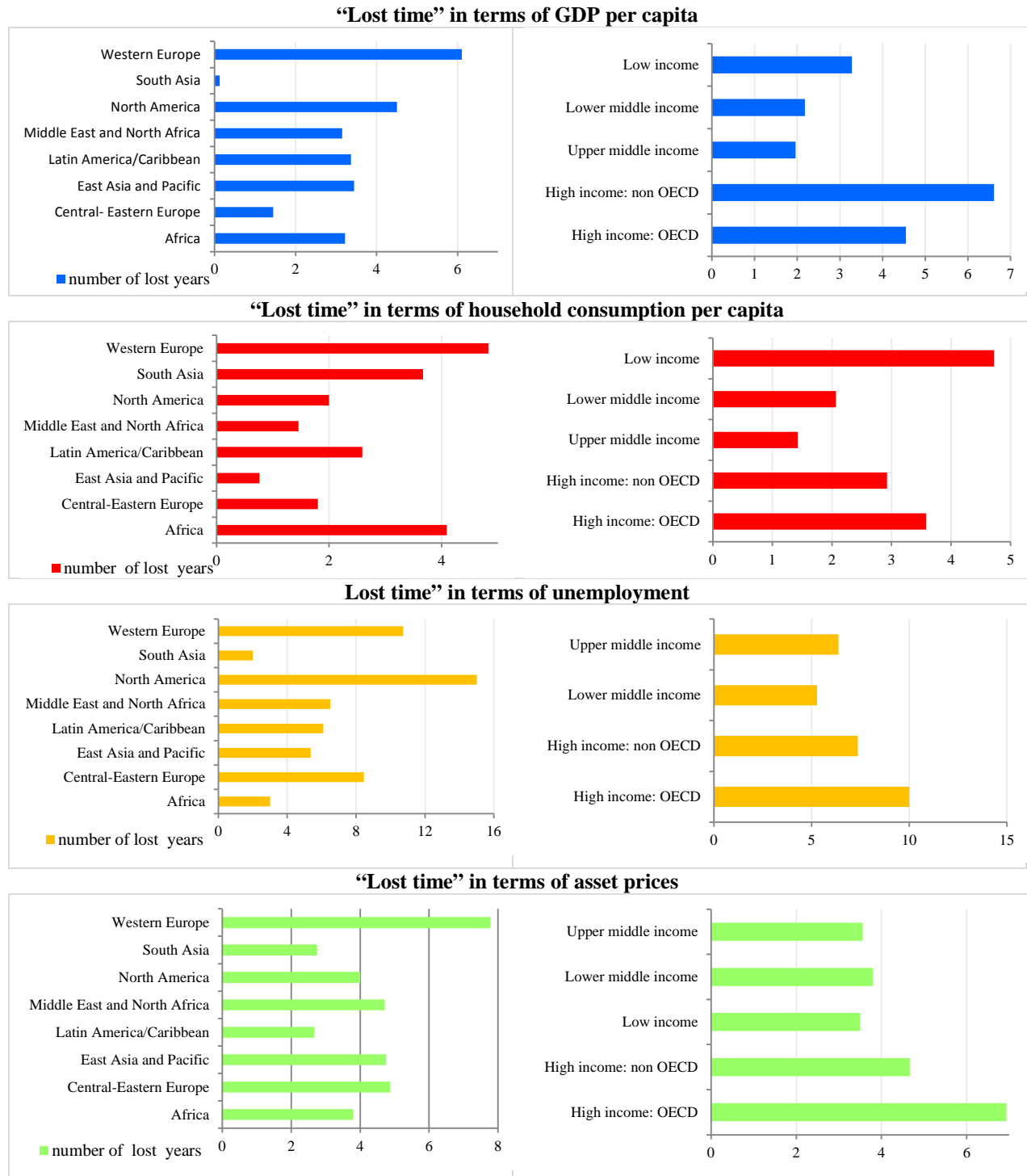
*Source:* Authors' computations based on data from Bloomberg (equity prices); World Bank WDI for GDP and consumption per capita; and WDI and ILO for the unemployment rate.

financial links with them. The youth has been hit particularly hard, with an estimated 74 million young people out of jobs in 2012 globally. The jump in the youth unemployment rate has been most pronounced in advanced economies, reaching alarming levels in the peripheral Europe with more than half of the youth labor force unemployed in Greece and Spain. Among those employed worldwide, 49 percent on average are in vulnerable employment, taking poorly-paid jobs in the informal sector that offer limited insurance or compensation.

What is more, the ongoing financial crisis has disproportionately hurt the poor. While developing countries have continued to make progress on poverty reduction, over a billion people still live in extreme poverty. The progress in poverty reduction has been uneven across regions, and the pace has slowed since 2007 across the board. The crisis has also posed challenges to attaining other development goals, including reducing the prevalence of malnutrition and mortality rates, and improving gender equality in education and access to clean water and sanitation. Progress toward meeting the millennium development targets for undernourishment, primary education, maternal

mortality, and improved sanitation particularly slowed in the most crisis-hit countries. A worsening income distribution has accompanied the deterioration in development indicators in several countries in Europe and Central Asia and Sub-Saharan Africa.

**Figure 19. Proust index by individual indicators**



Source: Authors’ computations based on data from Bloomberg (equity prices); World Bank WDI for GDP and consumption per capita; and WDI and OECD for the unemployment rate.

Setbacks in the progress to reduce poverty go beyond developing countries. In the United States and Europe, a growing number of people are believed to have fallen below domestic poverty thresholds. Across the EU, the poverty rates have been higher among women, children, and the young, as well as among single-parent families, and poverty and social exclusion are believed to have increased in more than half of the EU member states. Children, the elderly, women, immigrants, ethnic minorities, the homeless and the disabled are found most at risk. Evidence also points to a deterioration in family and social cohesion globally, as reflected in the increasing rates of mental illness, substance abuse, suicides, outbreaks of conflicts and demonstrations, and perceptions of crime.

The evolution of these indicators of economic and social well-being suggests a significant loss of economic time or a reversal of progress in development. Countries that have been hardest hit by the global financial crisis appear to have lost more than a decade of economic development. Regionally, advanced European and North American countries lost on average more than six years of economic time, while Central Eastern Europe and South Asia lost at least four.

The deterioration in the provision of essential public goods and services had important implications for growth and contributed to worsening social and economic outcomes, as governments were forced to undertake cuts in social spending to restore financial health. In many advanced countries hit badly by the financial crisis, the labor market has been further hit by fiscal austerity programs that often involved direct cutbacks or freezes in employment and wages. Some countries were less affected by this global crisis than in the previous ones, owing, in part, to the ability to implement less pro-cyclical macroeconomic policies made possible by adequate fiscal room.

A number of policy implications follow:

- The substantial deterioration in economic and social well-being inflicted by the ongoing financial crisis underscores the need for systematic, proactive, and integrated risk management by individuals, societies, and governments to prepare for adverse potential consequences of financial shocks. The observed slowdown in, or reversal of, progress toward achieving the MDGs highlights the need to mainstream proactive risk management strategies into the global development agenda, to better prepare for risks and protect the strategic goals of eliminating poverty and boosting shared prosperity for the international community.
- The adverse consequences of costly coping responses by the public sector also stress the importance of establishing proactive contingency planning mechanisms to minimize the adverse implications of crises on people. Such strategies are essential to limit the risk of introducing policies with unintended economic and social consequences (such as austerity programs without adequate social safety nets for the vulnerable). The failure to anticipate the complex linkages and feedback loops between financial, sovereign, real and social risks during the crisis highlights the importance of integrated risk management that considers multiple risks with a long-term view and the need to establish capacity to conduct policy analyses that can be used to formulate policy responses.

- The relatively limited impact of the crisis on those countries that implemented less procyclical policies during the global crisis stresses the need to create sufficient fiscal space. Accumulating adequate resources in good times can help governments to continue their social protection and welfare programs when shocks hit. Governments, with the help of the international community and drawing on the positive experiences of other countries, could build capacity to implement countercyclical policies.
- The disproportionate effects of the crisis on specific segments of the population (the poor, young, elderly, and women) call for well-designed social protection policies targeted at the most vulnerable. Social protection policies that encourage self-preparation can reduce the risk of moral hazard, while protecting the vulnerable and limiting a deterioration of income inequality and social gaps over a longer term.



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