Long-term effects of recessions: Lessons from the Swedish economic crisis in the 1990s

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The ongoing Covid-19 crisis has renewed the scholarly interest in questions related to the labor market consequences of recessions. How long can the effects of recessions last? Are different groups of workers affected differently? This report sheds new light on these questions by analyzing the long-run labor market effects of the Swedish economic crisis in the 1990s.

The Swedish economic crisis was unusually severe and long-lived – international experts deem it as one of the worst recessions in modern times. It was the result of numerous concurrent factors. Extensive capital market deregulation in the 1980s gave rise to rapid increases in lending, asset prices, and consumption. However, factors such as a rise in interest rates due to the German reunification and the large Swedish tax reform in the early 1990s ended up puncturing the overheated Swedish economy. The recession transformed into a deep financial crisis, which, in turn, brought about large cuts in public spending.

Our empirical approach adopts a local labor market perspective. We use high-quality administrative data covering the entire Swedish population and restrict our sample to individuals aged 30–49 living in Sweden the year prior to the start of the crisis. We compare changes in employment and earnings for workers who prior to the crisis were living in areas that were strongly affected by the crisis to observationally similar workers from areas that were more mildly affected. In doing so, we are able to isolate the effects of the local economic shocks from secular, national trends (e.g., related to demographic and technological change and globalization). Throughout the analysis, we control flexibly for age as well as income and industry prior to the crisis, which ensures that we compare outcomes across workers who are similar in terms of key characteristics. A unique feature of our study is that we are able to follow the same workers over a very long time frame and analyze effects up to almost 30 years after the beginning of the crisis.

Our main findings show that the local shocks arising due to the crisis in the 1990s caused lower earnings and employment for affected individuals in both the short and long run. For example, our estimates imply that an individual living in a severely affected area (around the 90th percentile in terms of the shock measure) prior to the crisis had an earnings growth that was 8–9 percentage points lower up until 2010 compared to an individual from a mildly affected area (around the 10th percentile). In terms of employment, we see some indications of a recovery over time – in other words, the negative effect diminishes somewhat in size over time – while the effect on earnings is more permanent.

These results imply that the crisis gave rise to persistent differences in employment and earnings between individuals from different local labor markets and that many of these differences remained several decades after the beginning of the crisis. A possible interpretation of the observed pattern is that the crisis in the 1990s in part caused the persistently lower employment rate at the national level following the crisis and that this drop in employment would not have occurred in the absence of the crisis.

We also explore whether the long-run effects of the crisis differed for various groups of workers. Our results suggest that women suffered more from the crisis compared to men. Similarly, we find suggestive evidence that individuals with less education and individuals born outside the Nordic countries suffered from larger negative effects compared to highly educated workers and individuals born in the Nordic countries. However, these latter results are statistically uncertain.

The qualitative patterns we find are consistent with similar evidence from the recent financial crisis in the US. However, our study shows that the negative effects of recessions can last for more than 20 years, whereas the US evidence is only able to document negative effects up to about 5 years after the crisis. Our results are also in line with evidence from related but different studies that analyze the long-run effects of own unemployment or layoffs and the effects of entering the labor market during recessions. A reoccurring theme is that unemployment and recessions cause long-run negative effects for the affected workers. Effect sizes, however, are difficult to compare, primarily since different studies address different questions using different types of data.

The economic impact of the Covid-19 crisis differs in several respects from the crisis in the 1990s. In the 1990s, the manufacturing and construction sectors were initially hit hard, whereas the current crisis has primarily affected the service and hospitality sectors. The current crisis also appears to be less severe (economically), although it is still uncertain how the pandemic and its economic impacts will evolve. For example, during the first years of the crisis in the 1990s, unemployment rose by almost 8 percentage points and remained high for several years. During

the first year of the pandemic, unemployment rose by about 2 percentage points in Sweden, albeit starting from a higher level. However, the two crises are similar in other ways. At least in the short run, for example, they both appear to largely affect the same groups of workers the most (e.g., youths, immigrants, and individuals with a weaker attachment to the labor market). While the main objective of our research is to offer general insights into the long-run effects of recessions, we also believe that our findings can be useful for understanding the consequences of the current crisis.

A key difference between the Swedish crisis in the 1990s and the Covid-19 crisis is that the feasible economic policy options in the 1990s were more restricted by the severity of the crisis and the rapidly rising public debt. The policy setting is quite different today as we face the Covid-19 crisis. While a large body of international research leads us to believe that the current recession will also have substantial long-run impacts – for instance, for youths about to enter the labor market and workers from severely affected local labor markets – the ability to adopt a more active fiscal and monetary policy response today might mitigate some of these long-run adverse effects.