The Great Financial Crisis: How Effective is Macroeconomic Policy Response in the United Kingdom?

Clements A. Akinsoyinu

Faculty of Finance, Cracow University of Economics

Tel.: +44 788 2507830

Abstract

The Great Financial Crisis has been touted to be the worst crisis since the Great Depression of 1930; its effect has profound ramifications on the global economy. The nature and the severity of the crisis provoked an unprecedented policy response from policy makers at both global and domestic levels. To address the rampaging crisis, the Bank of England implemented a number of conventional and unconventional policy measures to curtail the economic rot and to stimulate economic growth. There is a broad consensus in the empirical literature and other evidence found in this paper that a number of the policies implemented in the United Kingdom played a significant role in re-directing and stimulating the economy. This paper reviews the various policy measures adopted by the Bank of England from the inception of the financial crisis in 2008 and assesses their effectiveness in bringing back the economy from the brink of collapse. Our review shows that quantitative easing (QE) policy and the expansionary fiscal policy adopted by the Bank of England were effective policy tools used in stimulating economic growth, stemming the effect and shortening the duration of the crisis in the United Kingdom

Key words: Policy rates, expansionary fiscal policy, recession, financial crisis, quantitative easing (QE), macroeconomics, public debt, monetary policy

JEL Classification: E580, E590, E620

Introduction

The Great Financial Crisis was considered to be the most severe financial and economic crisis since the Great Depression of 1930, the impact of the crisis which is rooted in the credit boom induced subprime burble in the United States shook the global economy to its foundation. Seven years since the end of the crisis, many economies - developed and developing alike are yet to break free from its shackles. The severity of its impact on the financial system and the economy at large provoked policy makers around the world to implement unprecedented policy measures to stimulate and stabilize the financial system and also to curtail the global economy's downward spiral into the abyss.

The rapidity at which the global economy deteriorated brought about a palpable apprehension that can be felt across the globe and in every sector of the economy; near collapse of the global financial system, drastic fall in GDP, high unemployment rate, fall in industrial outputs, fall in real household disposable income and the economic hardships it created took a heavy toll on ordinary people. Apart from the United States, the United Kingdom was one of the worst hit by the crisis among the Group of Seven (G7) countries. At the height of the crisis, the British economy Quarter on Quarter growth plummeted from the pre-crisis Gross domestic Product¹ (GDP) level of 1.1% in 2005 Q4 to -2.1% in De 2008 Q4, unemployment rate rose from 5.4% in December 2006 to a 7.6%, government deficit grew

¹ Sources: Office For National Statistics

substantially from £36.9b in 2006 to £153.5b in 2009 representing 3.1% and 10.2% as a percentage of GDP² (Office for National Statistics & Office for Budget responsibility) while Northern Rock Bank and Bradford and Bingley were unable to honour claims against them by their customers and also incapable of funding their operations to maintain their going concerns in the Q4 of 2007 and 2008 respectively. According to the National Audit Office, the UK government has spent a whopping £850 billion on the financial crisis as at 2009. Table I below show the breakdown of this amount. Government provision of support to UK banks during the crisis was of two types: The first is the provision of guarantees and other non-cash support; this includes the Asset Protection Scheme, Special liquidity scheme, Credit Guarantee Scheme and other forms of guarantees and indemnities. The second category of support involves making cash available in form of loan to bankrupt banks to support their deposits and purchase of bank share capital (see Table 1)

Table 1: Breakdown of UK Commitment to Financial Sector as of December 2009

Program	Amount	Description
Purchase of Bank Share Capital	£76 billion	Shares in RBS and Lloyds
Liquidity Support	£200 billion	Quantitative Easing
Credit Guarantees	£250 billion	Guarantees on bank's borrowing
Loan	£40 billion	Loan to Bradford & Bingley and others
Other guarantees	£280 billion	To provide insurance cover for banks

Source: National Audit Office

Financial crises are not a recent phenomenon, it is a regular occurrence with similar causes (Reinhart and Rogoff (2009); and the United Kingdom is not a stranger to economic crises, its economy has survived many of the worst economic crises in history started with the Panic of 1857. In her long economic history, the UK policymakers have adopted various macroeconomics policies from Keynesian to Monetarist to resolve the various crises. However, the policy responses adopted by the policy makers to manage the

Great Financial Crisis produce a paradigm shift in the management of economic and financial crises in the country. Policymakers had to dig deeper beyond the conventional Keynesian and Monetarist economics to manage and curtail the effects of the crisis. A number of unconventional measures were adopted in conjunction with regular economic policies.

Plausible explanations for this unprecedented move could include those stated in the preceding paragraph and also due to the severity of the recession on the British economy being the sharpest contraction in the nation's history³, the acute liquidity squeeze among the nation's financial institutions and eventual collapse of the banking sector and the effect of the crisis on investors and public confidence. The overarching objectives of the UK government that called for such unparalleled policy response to the crisis include: securing financial stability of the UK economy by maintaining liquidity and capital for UK banks, protecting the taxpayer and shareholders' interests⁴.

The objective of this paper is to assess the efficiency of the key economic policies or measures adopted in the United Kingdom to manage the Great Financial Crisis. The next section briefly discusses causes of the financial crisis. The following section provides a summary of the impact of the crisis on the UK economy; Section 4 reviews the main economic policies implemented in Britain. The paper then assess the effectiveness of each of the policy responses adopted by UK policymakers. The final section concludes.

Great Financial Crises and Its Causes

In this section, we provide a brief discussion of the immediate and remote causes of the worst financial crisis since the Great Depression. The crisis that started in 2007 and heightened by the collapse of Lehman Brothers in September 2008 almost brought the global economy to a standstill, despite concerted effort by both domestic and international policymakers to restore stability to the global financial system. The causes of the crisis are multiple and there had been finger-pointing; the financial markets, policymakers and

³ Gross domestic Product (GDP) in the United Kingdom in 2008 and 2009 were -0.8% and -5.2 % respectively

⁴ "Banking Crisis: dealing with the failure of the UK banks", House of Commons Treasury Committee, Seventh Report of Session 2008-2009. April 2009.
www.publications.parliament.uk/pa/cm200809/cmselect/.../416/416.pdf

² Borrowing amount figures exclude public sector banks.

regulators among others have all been singled out for blame and eight years later, the blame game continues.

Two major factors have been identified as the root cause of the Great Financial Crisis, macroeconomic policies adopted in the years preceding the crisis particularly in most of the developed economies have been identified as a major culprit. A considerable amount of literature explained that the root causes of the crisis can be traced to both economic policies and inadequate regulatory framework. Adrian Blundel-Wignal and Paul Atkinson

Kingdom Government Bond 10Y from 1985 to 2014, it decreased to 1.90 percent in December of 2012 from 11.7 percent in December of 1990. Low interest-rate It is impossible not to mention the contribution of global imbalance to the in the periods leading to the crisis (see Bernanke 2009, Morris 2008), where countries such as the UK and the US run large current account deficit

(2008) submitted that global macro policies lead to the creation of excess liquidity in the system while the regulatory framework was not adequate enough to provide the required control of the financial system. Obstfeld M. and Rogoff K. (2009) on the other hand state that the major cause of the crisis was the economic policies. They explained that these policies created a negative platform on which other factors developed (see also Taylor 2008, Calomiris 2008). They argued that the loose monetary policies give rise to low inflation and low interest rates. Figure 1 below shows the United

created a conducive environment for the purchase of residential mortgages and incentive to markets participants to pursue riskier assets for higher returns.

compare to large surpluses run by other countries particularly the emerging economies such as China (see Table 2).

Data Source: Bank of England

Figure 1: Falling Interest Rates – 10Y UK Government Bond

Table 2: Top Ten Surplus and Deficit Economies⁵ (Absolute value)

Surplus Economies			Deficit Economies		
1996	2007		1996	2007	
9	1	China	1	1	United States
102	2	Germany	26	2	Spain
1	3	Japan	7	3	United Kingdom
3	4	Netherlands	4	4	Australia
5	5	Switzerland	118	5	Italy
10	6	Sweden	15	6	Greece
6	7	Singapore	25	7	Turkey
8	8	Chinese Taipei	116	8	France
12	9	Canada	23	9	Romania
92	10	Malaysia	12	10	Portugal

Data Source: OECD, IMF

⁵ Kowalski, P. and M. Leshner (2011)

According to the Office for National Statistics data, the United Kingdom has consistently recorded yearly Current Account deficit since 1984 with a steady increase up to 1989. Figure 2 below shows the UK Current account from 1993 to 2013. The current account deficit narrowed between 1993 and 1997. Between 1998 and 2008 it widens to £56.4 billion in 2008 then narrowed to £27.0 billion in 2011. From 2012 the deficit account has continued to widen, it reached a record high of £72.4 billion in 2013. It has been argued that the growing imbalance has become unsustainable which resulted in huge financial flows and help to push down the interest rates in the UK and other countries with large current account deficit. Martin, C. and Milas, C (2009) find that sharp rise in liquidity between 2001 – 2007 was as a result of large current account deficit and loose monetary policy.

Impact of the Financial Crisis on the UK Economy

After many years of successive Gross Domestic Growth (GDP) growth, the UK GDP contracted sharply during 2008 second and third quarters and entered into a recession. The contraction in the GDP lasted for six consecutive quarters to the third quarter of 2009 (See Figure 3). The GDP fell by 2.6% in the first quarter of 2009 and the actual economy contracted by -5% at the end of the year making the recession the “deepest” in the UK since the second World War. The recession has a significant impact on the UK economy, with severe impacts on the economy, unemployment, wages, budget deficit, taxation, government spending and the different sectors of the economy.

Unemployment & Labour Productivity: As the great recession lingers on, many firms continues to lay off their employees, while majority cut back the employment of new ones in an effort to reduce costs; more than 2.6 million people were unemployed in the United Kingdom. During the recession, labour productivity in the United Kingdom was very weak due to both cyclical reasons and causes related to the effects of the financial crisis.

Government Spending: The recession caused a rise in government spending; rising government spending on welfare payment in the form of benefit and income support for a large unemployed population and migrants from the European Union.

Budget Deficit: spending during the crisis deepened the UK budget deficit, the stimulus programme implemented during the crisis, the collapse in tax

revenues and the rise in welfare spending (automatic fiscal stabilisers) all contributed to the increase in the budget deficit.

Policy Response to the Financial Crisis in the UK

The collapse of Northern Rock Bank⁶ in 2007 marked the beginning of the British government intervention in stemming the negative impacts of the crisis on both the economy and the financial system. Following an announcement by the bank of funding problems, the government announced it would provide an implicit guarantee for deposits in Northern Rock Bank. Shortly after the nationalisation of Northern Rock Bank, the government waded into rescuing other vulnerable financial institutions and the large economy by enacting a wide range of financial and economic policies. In this paper we would limit our discussion to the macroeconomic policies implemented by the UK government:

Macroeconomic Measures

This section summarises the macroeconomic policies adopted in the United Kingdom in response to the financial crisis. *Interest Rates* The Bank of England Monetary Policy Committee (MPC) cut interest rates from 5.0% in September 2008 to 0.5% in March 2009. This rate represents the lowest in more than three centuries. Six years after the recession, the policy rates remain unchanged (see Figure 4). The Bank of England introduced Quantitative Easing (QE)⁷ policy measure in response to the recession in March 2009. Quantitative Easing (Asset Purchase Facility) policy is primarily implemented to stimulate the level of economic activity or demand during the recession. Under this policy, the Bank of England creates new money and injects it into the economy by buying financial assets, like government bonds to stimulate spending by companies particularly financial institutions. With more cash at the disposal of these financial firms, it is hoped that banks will be encouraged to lend more money to their customers; this will make more money available to consumers to spend.

⁶ Northern Rock Bank was the fifth-largest mortgage lender in the United Kingdom. The bank was nationalised by the UK government in February 2008 and injected £3bn to help the bank's funding problems.

⁷ Bank of England News Release, Bank of England Reduces Bank Rates by 0.5 Percentage Points to 0.5% and to Undertake a Programme of Asset Purchases of £75 Billion, 5 March 2009.

Data Source: Office for National Statistics

Figure 2: United Kingdom Current Account (GBP billion)

Data Source: Office for National Statistics (ONS)

Figure 3: Gross Domestic Product - United Kingdom, (quarterly growth): Percentage change

Data Source: Bank of England

Figure 4: U.K Monetary Policy Rates, Monthly, 2007 – 2011 (per cent)

Quantitative Easing (QE)

The BOE sets the initial level of QE at £75 billion; this amount has been reviewed upward at various MPC meeting. From March 2009 to January 2010, a total of £200 billion worth of assets were purchased by the

Bank of England representing about 14% of annual GDP. Further asset purchases between 2011 and 2012 pushed the total commitment to QE to £375 billion.

Fiscal Policies

This policy involves the government varying the level of tax and public spending to meet economic policy objectives and influence the Aggregate Demand (AD)⁸ in the economy. During the recession, the main objectives of the government fiscal policy include stimulating economic growth and keeping inflation within the target of 2%. The government made use of both automatic stabilisers and discretionary measures to prevent the recession from deepening. In the 2008 pre-Budget Report (PBR) the Labour government embarked on discretionary fiscal measures to prop the economy as monetary policy – interest rates are not enough to stimulate the economy. This involves mainly the temporary cut in the standard rate of Value Added Tax (VAT) from 17.5% to 15% from 1 December 2008 to 31 December 2009, at a cost of £12.4 billion.⁹ The government also announced a number of other measures to raise revenue, including an increase in the rates of National Insurance Contributions for employees, employer and the self-employed by a 0.5% point from April 2011. In Budget 2010¹⁰, the labour government announced further fiscal measures including: a top rate of income tax of 50% on incomes over £150,000 from April 2010, an increase in national insurance by 1% point from April 2011 and reduction in public spending growing by 0.8% per year between 2011/12 and 2014/15 and public sector net investment will fall to 1.25% of GDP by 2013-14.

Change in government saw a reverse of the some of the above fiscal policies, as the Coalition government put more emphasis on deficit reduction. In the 2011 budget, the government announced a package of fiscal tightening of about £40 billion by 2014 and 2015. VAT rates increase from 17.5% to 20% from January 2011.¹¹

Effectiveness of Policy Responses to the Financial Crisis in the United Kingdom

Monetary Policy

Conventional monetary policy does not prove to be a very effective instrument for managing the crisis. The Bank of England dropped the policy rates from 5% to its effective lower bound of 0.5%. Once the effective lower bound is reached, monetary policy becomes significantly limited in scope to incentivise a depressed

economy. With this limitation in mind, the BOE embarked on an unconventional monetary policy of asset purchases or quantitative easing (QE) to stem the economy rot. Evidences from literatures and other sources indicate that the implementation of quantitative easing by the Bank of England had a substantial impact on both gilt yield and corporate bonds, and also help to stimulate the economy during the recession (See, Meier (2009), Baumeister and Benati 2010, Joyce et al. 2011, Agarwal et al. 2010, D'Amico and King 2010). Hamilton (2010) does not find the effect of QE to be significant.

Baumeister and Benati 2010, find that without QE, real growth in the UK would have been 4 percentage point lower in 2009Q1. Weale and Wieladek (2014) in a recent study concluded that quantitative easing equivalent to one-percent of GDP, is proportional to 0.18 and 0.3 percentage-point increase in UK real GDP and CPI respectively after five to eight quarters of quantitative easing.

Fiscal Policy Contrasting to the monetary economics, the British government follow the Keynesian economic blueprint of expansionary fiscal policies via an increase in public spending and cuts in tax rates to stimulate the depressed economy. There are evidences that the fiscal policies adopted by the government produced the desired result of stabilising the economy, curtailing the severity and shortening the duration of the crisis (See Alesina, 2012 and Shoag, 2012). Dolls et al (2010) analyzed the effectiveness of the transfer systems in the European Union and the US to act as an automatic stabilizer during the financial crisis. They find that automatic stabilizers absorb 38 per cent of a proportional income shock in the EU, against 32 percent in the US. For unemployment shock 48 percent of the shock are absorbed in the EU, compared to 34 per cent in the US, and concluded that the cushioning of disposable income leads to a demand stabilization of 23 to 32 percent in the EU and 19 per cent in the US. With respect to the duration of the crisis, Baldacci et al (2009) concluded that timely implementation of countercyclical fiscal measures contributes to shortening the length of crisis by stimulating aggregate demand in the economy. In a study conducted by the International Monetary Fund, the Fund concludes that fiscal policy is an appropriate countercyclical policy tool, particularly when monetary policy has reached the zero lower bound (See IMF, 2013).

⁸ AD is the total level of planned expenditure in an economy ($AD = C + I + G + X - M$)

⁹ HC Deb 24 November 2008 c492, c 495

¹⁰ Economic and Fiscal Strategy Report and Financial Statement and Budget Report, March 2010

¹¹ HM Treasury: Budget 2011, HC 836. March 2011

UK Financial Crisis Macroeconomic Policy Scorecard

Steady Economy Growth - (GDP)

The fact that the economic policies adopted by the British government to manage the Great Recession are effective can be inferred from the pattern of the UK economic performance since the outbreak of the crisis. According to the Office for National Statistics, The Quarterly National Accounts confirmed that the UK economy grew at an unrevised rate of 0.7% in Q3 2014, contributing to an annual growth of 2.6%. This represents the seventh consecutive quarter of GDP growth since the beginning of the economic crisis in 2008. Figure 5 shows the pattern of economic growth right after the end of the crisis, presenting GDP and GDP per capita. The level of GDP growth was about 2.2% higher in Q3 2014 than in Q4 2013.

Fall in Unemployment Rate

Data from the Office for National Statistic (ONS) confirmed that the unemployment rate¹² in the UK decreased to 5.7 percent in December 2014 compared to 5.8 percent in the previous period, the fall is the lowest levels since the height of the financial crisis (See Figure 6). The unemployment rate was as high as 8.0 percent during 2008 – 2009 during the financial crisis rising to about 8.5 percent in 2012. Figure 6 shows a steady decrease in unemployment from this level to December 2014.

Increase in Public Debt

The Great Financial Crisis have provoked a massive increase in UK's public debt, Since the inception of the financial crisis in 2008, net public debtor rose significantly from 45% to 74% of GDP at the end of the first quarter in 2009 and 2013 respectively¹³. Figure 7 shows the sharp increase in Public Debt from 2000/2001 to 2012/2013, the rise was very pronounced from 2007//2008. It is important, however to note that not all the total public debt in the UK is due to the effect of the

financial crisis and recession, according to an OECD measure, the United Kingdom structural budget deficit stood at 3.1% of the national income in 2007. However, from 2008 to 2009, government borrowing has jumped to a total of 6.7% of national income, this amount includes 5.2% of national income to fund a structural gap between government receipt and spending, 0.6% of national income was attributable to meeting the temporary fiscal stimulus implemented during the recession. Further borrowing from 2009 to 2010, shoot up government borrowing to about £165.5billion, that is, 11.8% of national income with the Treasury forecasting a further rise in structural borrowing post-2010. The amount of government debt post-2007 is a direct reflection of expansionary fiscal policy measures implemented to manage the crisis. The Bank of England commenced the policy of Quantitative Easing (QE)¹⁴ in 2009, a policy will which the government borrowed money to fund the coupon payments to the Bank of England.

The Monetarist would argue that Quantitative Easing, fiscal stimulus and other policy measures such as bank bail-outs implemented to curtail the crisis have contributed to the massive public net debt which rose from £337 billion in 2000 to £1 trillion in March 2011. As at the last quarter of 2014, the total public net debt in the UK stood at £1.26 trillion.¹⁵

¹² The unemployment rate is the proportion of the economically active population (those in work plus those seeking and available to work) who were unemployed. (ONS) - http://www.ons.gov.uk/ons/dcp171778_378901.pdf

¹³ For more detail, see UK Public Sector debt and borrowing 1975 to 2013 (Office for National Statistics) <http://www.ons.gov.uk/ons/rel/psa/public-sector-finances/july-2013/sty-public-sector-debt.html>

¹⁴ Quantitative Easing (QE) reached £375billion as at November 2012 over the original limit of £150billion.

¹⁵ This amount does not include the cost of Bank bail-outs

Data Source: Office for National Statistics (ONS)

Figure 5: GDP, GDP per capita, and Net National Disposable Income per capita, seasonally adjusted

Data Source: Office for National Statistics (ONS)

Figure 6: United Kingdom Unemployment Rate (% Economically Active)

Data Source: Office for National Statistics (All data excluding the temporary effects of financial interventions)

Figure 7: Public sector net debt as a percentage of GDP, 2000/01 to 2012/13

Conclusion

The impact of the recent financial crisis on the real economy, the financial system and on ordinary people is still being felt in different part of the globe. The nature and the severity of the effect on the economy prompted policy makers and Central Banks around the world to navigate an uncharted territory of policy measures to curb the rampaging global crisis. In addition to other policy measures implemented by the British government, the Bank of England adopted a plurality of macroeconomic policies including expansionary fiscal policy, and traditional monetary policy of cutting the policy rates. Lowering the BOE policy rates help to stimulate demand which would provide a basis for economic recovery. The nature and duration and complexity of the crisis made it difficult for BoE to continue to rely on this tool as the policy rates soon hit the zero lower bound. The premier bank was forced to rethink their monetary policy strategy for combating the crisis, the bank adopted a more aggressive and unconventional monetary policy of large-scale asset purchases or Quantitative Easing (QE). There is a broad agreement between our review and the empirical evidences found in this paper that both the expansionary fiscal and the unconventional monetary policies adopted by the Bank of England were effective and played a significant role in re-directing and stimulating the economy during the crisis. These policy tools and other measures have helped the UK to shorten the duration of the crisis, stimulate economic growth and promote financial stability.

However, the evaluation of the expansionary fiscal policy and unconventional monetary policy

implemented by the Bank of England has shown that these policies do have their limitations. Just as the traditional monetary policy of lowering interest rates could not be relied on to add more value to the economy when it reaches its effective lower zero lower bound, so also is the unconventional quantitative easing policy. Policy makers should not regard these unconventional policies as the new norm, as their prolonged use could cause other problems in the economy. For example, continued use of quantitative easing in a low interest-rate regime could promote excessive risk-taking and increase moral hazards. As noted in this paper, expansionary fiscal policy cum aggressive asset purchase could add to the public debt woe.

It is important that further studies continue to research into the framework of implementing unconventional policies with a view to balancing their usefulness and the inherent risks associated with them. In particular, future studies should attempt to answer the following questions:

What are the impact of implementation lags on efficiency of monetary policy

What is the full impact of implementing quantitative easing in an environment of low interest-rates?

What are the real cost of "Crowding effect", of increase in government spending, on long- term growth of an economy.

What is the impact of excessive government spending in an aging population?

What are the ramifications of implementing asset purchases and how its benefits are distributed in the economy?

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