Britain and the Global Financial Crisis:  
The Return of Boom and Bust

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The political salience of economic policy, and the economy more generally, rises and falls as growth rates fluctuate. For almost a decade and a half from 1992-2007, and particularly once New Labour took office in 1997, sustained economic growth served in effect to reduce the political significance of the economy in Britain – as an unspoken economic policy consensus emerged between the parties and as a low inflation, low interest rate equilibrium served to produce stable growth, cheap credit, a buoyant housing market and high levels of consumer demand. This undoubtedly contributed to New Labour’s longevity in office and the almost palpable sense of economic competence and confidence that it exuded.

That was then … As is so often the case in politics, just when all appears tranquil and calm the hurricane strikes. In a little over two years the political salience of the economy has returned with a vengeance, pitching the British economy into its longest and deepest recession since the 1930s and shattering the illusions of those who had became increasingly wedded to the convenient fiction that sustained economic growth signalled an ‘end to boom and bust’.

Though the global financial crisis provided more the background than the focus of the 2010 General Election, the advent of the Cameron-Clegg Coalition may well come to be seen as marking the dawn of a new age of British austerity. Thus, whilst all three of the principal parties committed themselves during the election campaign to a halving of the public deficit in a single parliamentary term, it is the Conservative-
Liberal Democrat Coalition that has the perhaps unenviable task of being the first to attempt to put this into practice. Their first (‘Emergency’) Budget, promised in the Conservative manifesto and delivered within fifty days of taking office, and the Comprehensive Spending Review concluded in October 2010 give an early indication of what the future might hold – though the devil will undoubtedly lie in the details of implementation. For the Coalition, deficit reduction is the most pressing and urgent priority; and there can be no waiting for the recovery to be established before this takes effect. This puts them significantly at odds with their Labour predecessors in office. Indeed, before and during the election campaign both Labour and the Liberal Democrats had committed themselves to the broadly Keynesian view that cuts in public spending and/or raising taxes in the absence of evidence of a sustained economic recovery would guarantee, at best, a ‘double-dip recession’ and, at worst, threaten to precipitate a decade or more of economic decline - in short, a depression. Labour remains the sole party wedded publicly to such a view. Yet this is not the only significant difference between the new government and the opposition on the handling of the recession. For improving the state of the public finances is always a juggling act, requiring a balance to be struck between raising increased revenue through tax increases on the one hand and cutting public spending on the other. And the point is that this balance would be struck very differently by the opposition than by the government. For the Conservatives and their Liberal Democrat coalition partners, the proposed ratio between tax rises and spending cuts is one to four (i.e.: for every £1 raised in new taxation there will be £4 of public spending cuts). For Labour, the ratio would have been very different – probably around to one to two. The significance of this difference in emphasis is seen when we consider the June 2010 Emergency Budget. Through increases in VAT (from 17.5 to 20 per cent from January 2011), capital gains tax (from 18 to 28 per cent for higher earners) and a balance sheet levy on banks and building societies, the Budget raised an estimated £8.2 billion per annum (HM Treasury 2010). But at a ratio of tax rises to spending cuts of one to four this committed the government to finding almost £35 billion per annum in public spending cuts – equivalent to a cut of around one quarter in the budget of unprotected government departments. These figures were largely confirmed by the Comprehensive Spending Review. Such spending cuts have not been seen in Britain outside of wartime emergency planning.
From boom to bust

So how did the growth prospects of the British economy and the associated state of the public finance turn quite so sour quite so quickly? To begin to answer that question it is useful first to return to the idea, prevalent in policy-making circles for almost a decade, that the era of boom and bust was over.

However naïve such a view might now seem, those who held it had been in very good company. Nobel Laureate Robert Lucas was merely capturing the mood of the times when, in his 2003 Presidential address to the American Economic Association, he suggested that “for all practical purposes … the central problem of depression prevention has been solved” (2003: 1). How wrong he now turns out to have been. But the point is that Lucas from was far from alone in presuming that the business cycle was dead so long as central banks were independent of political influence and policy-makers observed a few basic principles of sound economic management. Indeed, crucially, the new economy orthodoxy that he was articulating had already extended to policy makers, with ideas like his own influencing decisively the course of macro and microeconomics policy. This meant that British policy makers entered what we now tend to call the ‘global financial crisis’ committed to a set of economic policies, a supporting economic policy paradigm and, indeed, a set of institutions for economic governance predicated on the assumption that such events simply couldn’t happen. In short, they were not well prepared for what was happening.

What makes this all the more remarkable (and all the more depressing) is that although the precise chain of events was, of course, almost impossible to foresee, that something like this would happen was far less difficult to predict. Indeed, and if only to show just how easy it was to anticipate ‘the great recession’ as it is now being termed, consider the final lines of the equivalent chapter to this in Developments in British Politics 8, written in the wake of the 2005 General Election.

“New Labour’s third consecutive electoral victory is a major, and historically unprecedented, achievement … Yet, as in 1974 and 1992, this may not be a terribly good election to have won … The economic prospects look, for the first time in a long time, far from benign … [and] New Labour’s political economy is
rather better equipped to deal with phases of the business cycle that may now have passed. In short, its economic policy record … is flattered by the phase of the business cycle in which it has thus far been achieved. The real test is yet to come” (Hay 2006: 271).

That test, arguably, it failed. But the point is that it is a test that any of the major political parties in Britain was almost bound to fail, since all of them were committed – as, in effect, they remain - to a set of economic orthodoxies which neither prepared them for what was to happen nor provided much guidance on what to do in such an (unanticipated) scenario.

In this chapter I examine how this came to pass, considering the advent and consequences of the great recession, assessing the origins of the growth dynamic that the British economy enjoyed between 1992 and 2007, its systemic vulnerabilities and its exposure to financial instability in particular, and the nature, causes and likely consequences (economic and political) of the recession itself. In the process, I seek to gauge the character, significance and effectiveness of the interventions made in the attempt to shore up Britain’s growth model during the recession and the prospects for the resumption of growth in the years ahead. I argue that the Anglo-liberal or ‘privatised Keynesian’ growth model that Britain stumbled across somewhat fortuitously after 1992 is, indeed, fatally flawed and that, in the absence of a new growth model, it is difficult to see how sustained economic growth can be achieved. This may well make 2010 no better an election to win than 2005, 1992 or 1974. And insofar as that proves to be the case, the heightened salience of the economy is likely to endure until sometime after the next election.

**The great moderation and the emergence of the Anglo-liberal growth model**

To see why, it is necessary to retrace our steps, examining first the impressive economic performance of the British economy throughout the 1990s and for most of the first decade of the new millennium. Figure 1 places recent economic performance in a longer term historical context, showing the government’s own data on unemployment, long term interest rates and inflation since the mid 1980s until just before the onset of the global credit crunch (which began first in the US in late 2006).
Figure 1: British economic performance 1986-2006

Source: Data from HM Treasury, Pocket Book Data Series (various years)

It tells a simple and, on the face of it, an encouraging story – of consistently falling unemployment (from a peak in 1992-1993), of consistently falling long term interest rates (from a peak in 1990) and of inflation falling rapidly following Britain’s ejection from the European Exchange Rate Mechanism in September 1992 (on ‘Black Wednesday’) to stabilise at around the 2 per cent official target (as set for the Monetary Policy Committee of the Bank of England by the government). Indeed, it is difficult to imagine a more benign macroeconomic context.
Figure 2 compares Britain’s rate of economic growth over the same period with that for the G7 leading economies. After a mini-recession in 1990, the British economy recovered well and, from 1994 to 2006 enjoyed a period of impressively consistent economic growth of around 3 per cent per annum. Moreover, its growth rate over this period of time was both higher than that for the G7 economies together and, more significantly perhaps, less volatile. Again, the picture was encouraging and it offered no hint of what was to follow.

What data like do show, however, is that New Labour was fortunate in the economic legacy bequeathed to it by the outgoing Conservative administration of John Major in 1997. Whatever else it is, this is not a story of an economic transformation that postdates New Labour’s election. For the low inflation-low interest rate equilibrium from which it benefited for so long once in office was already established when it took office in 1997. Indeed, the key moment here is undoubtedly September 1992 - the key factor being the devaluation of Sterling that occurred with its forcible ejection from the European Exchange Rate Mechanism (the precursor to Monetary Union). From this moment onwards the government and Bank of England no longer had to use interest rates to defend an overvalued currency on foreign exchanges – they could, in short, use monetary policy to manage demand in the economy and allow the exchange rate to float. The result was that interest rates fell, consolidating the recovery from the mini-recession that had begun in 1990. The devaluation served additionally to reduce the effective size of the public deficit – and certainly the payments required to service it - whilst also providing a much needed boost to the (cost) competitiveness of British exporters.

This was New Labour’s economic inheritance and pretty favourable it was too. But although the new government did little to establish the low inflation-low interest rate equilibrium in the first place, its actions once in office certainly served to consolidate this – albeit arguably more by luck than judgement. For whilst still in opposition the party had committed itself to matching the stringent spending targets set by the outgoing Major government (arguably, at a point when the latter had already
discounted the prospect of its re-election). Though this was almost certainly more the product of perceived electoral expediency rather than economic foresight, it led the new Blair government to run a substantial budget surplus between 1997 and 1999. This in turn led to quite a significant reduction in national debt and, in the process, served to increase the sensitivity of demand in the economy to interest rate variations. In other words it allowed the newly independent Bank of England to control inflationary pressures as they arose without pushing interest rates back to anything like the levels they had reached in the 1980s and early 1990s. As such it served further to institutionalise the developing low interest rate-low inflation equilibrium (see also Hay 2007). And that in turn reinforced growth and with it the rising taxation receipts out of which a significant investment in the public sector – particularly the NHS – was funded.

‘Privatised Keynesianism’ – the new growth model

But what, you might well ask, is so fantastic about a low inflation-low interest rate equilibrium anyway? To answer that question we need to turn our attentions more directly to the character of the new growth model that Britain inadvertently stumbled across from 1992 onwards. Various labels have been attached to it in the academic literature. Andrew Gamble (2009a) refers to the ‘new financial’ growth model, Colin Crouch (2008) to ‘privatised Keynesianism’, Matthew Watson (2010) to ‘house price Keynesianism’, whereas in my own work I have tended more simply to refer to it as the ‘Anglo-liberal’ growth model (Hay 2011). Yet, whilst such authors are divided, as it were, by the absence of a common language, the account that each provide of the determinants of growth is essentially the same. But before considering that account directly, it is important to sound a couple of notes of caution. First, there is a danger that in appealing to the language of growth models, too much conscious choice and agency is attributed to the largely unwitting architects of such a growth strategy. As already noted, insofar as it is useful to suggest that Britain developed in the 1990s a coherent and distinctive model of growth, that model was stumbled across serendipitously – it was not a product of conscious choice, far less of design or planning. Second, memorable, striking and useful though they undoubtedly are, terms like ‘privatised’ and ‘house price Keynesianism’ are potentially misleading – certainly if they are not used carefully. For, strictly speaking, there is nothing at all Keynesian
about the new British growth model; in a sense that is the point, as we shall see presently. Indeed, Keynes is no more the inspiration for ‘privatised Keynesian’ growth than he was the architect of monetarism. It is thus important to emphasise from the outset that the concept is based on an analogy (and a pretty loose one at that); and, like all analogies, it shouldn’t be stretched too far.

Terminological difficulties and differences notwithstanding, the literature is united in seeing the growth model that sustained the British economy from Black Wednesday until the great recession as consumer-led and financed from private (rather than public) debt. Its most basic precondition was easy access to personal credit, much of it secured against a rising housing market. And that, in turn, was made possible by the simultaneous combination of low interest rates and low inflation – or, more precisely, inflationary pressures that could be ameliorated without posing any threat to historically low interest rate settings. For as long as this persisted, credit was easily accessible on favourable terms. This served to broaden access to - and to improve affordability within - the housing market, driving up prices and leading to both a developing house price bubble and, on the back of that, a consumer boom. Once inflated this was sustained and, increasingly, nurtured, by interest rates which remained historically low throughout the boom.

To all intents and purposes it appeared that a virtuous circle had been established in which growth would pretty much take care of itself – the basis of a distinctively British (or, at least Anglo-liberal) growth model (one also evident in the US and a number of other Anglophone liberal market economies). Stable low interest rates allied to substantial capital inflows from China and South-East Asia allowed the British and US economies to grow despite their large and widening trade deficits (their rapid consumer growth led them to import far more than they exported and this could only be balanced by large capital inflows). Low interest rates and a highly competitive market for credit provided both the incentive and the opportunity for first time buyers to enter a rising market and for established home owners to extend themselves financially, by either moving up the housing ladder, or releasing the equity in their property to fuel consumption. There was now little incentive to save, as reflected in the dwindling household savings ratio (the value of new household savings expressed as a proportion of gross household disposable income). This fell
precipitously from around 12 per cent in 1992 to an all time low of less than 3 per cent by 2007 (HM Treasury Pocket Book Data, 2010).

Indeed, this switch savings to investment in appreciating asset classes (including property) was consciously promoted by the government, with consumers increasingly encouraged to think of their asset purchases as investments which they might cash in to fuel their consumption - in retirement, or as the state withdrew from pension provision, or in times of economic difficulty or unemployment. Such ‘asset-based welfare’ was, in effect, the social policy corollary of the new growth model (see Finlayson 2009). That it became a conscious social policy strategy in itself, actively promoted by the New Labour government, was a clear indication that, despite its accidental origins, the growth model was now becoming quite a conscious part of its economic thinking.

It is at this point that the Keynesian analogy becomes helpful. For what it serves to highlight is both the delightful simplicity of this growth model and, more significantly perhaps, its fundamental fragility. In particular, what it draws our attention to is the key relationship at the heart of the model between private debt, domestic demand and consumption. In so doing, it arguably strips the growth model to its core.

If we are to understand privatised Keynesianism it is first important that we remind ourselves of the essence of Keynesianism itself. A rather stylised account will suffice – indeed, arguably the analogy really only works if we treat Keynesianism in stylised terms. Genuine Keynesianism (the Keynesianism of Keynes, for instance) sees public expenditure as key to the management of demand within the domestic economy. In particular, when demand and hence growth falls in the economy, it sees it as the responsibility of the state to intervene by engaging in public spending (sustained, where necessary, by borrowing). In this conception, public debt is no bad thing if such debt is used to inject demand into the economy in the service of stimulating growth. Thus, at the heart of traditional Keynesianism is a link between public debt, demand and growth – and it is this relationship that authors like Colin Crouch are pointing to when they label the new growth model ‘privatised Keynesianism’.
For privatised Keynesianism also sees debt as crucial to demand and hence growth. But the role that traditional Keynesianism assigns to public debt, privatised Keynesianism assigns to private (and, invariably, personal) debt, typically secured against a rising housing market. If credit is cheap and access to credit is widespread, then there is a powerful incentive for consumers to borrow – either to acquire property or, indeed, to fuel their consumption. Debt, in other words, generates demand which would not otherwise be there – driving up property prices and drip feeding the consumer economy. And, if interest rates remain low or even fall whilst property prices are rising then a further set of incentives take hold. For consumers who do not fully stretch themselves in the housing market are missing out on the potential return on their investment that property offers. Moreover, with house prices rising, consumers are able to re-mortgage their property, releasing the equity built up in their homes to fuel additional consumption. For as long as inflation is manageable without compromising the low interest rate regime, growth in consumer demand (serviced by rising private debt) is almost guaranteed. As this suggests, the state need no longer take responsibility for managing demand through public debt and the public expenditure such borrowing makes possible, since personal and hence private debt made possible by a credit glut is now capable of taking care of that function - so long as interest rates remain stable. In other words, the borrowing function previously performed by the state has, in effect, been privatised – hence privatised Keynesianism.

In theory at least, this sounds all very attractive. Insofar as – or, more realistically perhaps, only for so long as – the low inflation-low interest rate equilibrium persists, demand is likely to be fuelled by private debt secured against a rising housing market. Such demand is likely to generate a consumer boom. And that, in turn, is likely to sustain a growing, profitable and highly labour-intensive services sector whose expansion might both mask and compensate for the ongoing decline of the manufacturing base (a decline reinforced by low levels of productive investment as credit lines to business are crowded out by the supply of personal credit). A final factor completes the growth model. It relates to the incentives, not for consumers, but for financial institutions, investors and intermediaries. With credit cheap, demand for credit is likely to be high – a set of market conditions which strongly favour the banks and other financial intermediaries. They are well placed to benefit, in such a model, from the somewhat higher transactions fees they can charge for issuing and renewing
credit lines, particularly for those – like sub-prime mortgage holders – at the fringes of the system. In a rapidly rising property market they are also well placed to benefit from repackaging and selling on mortgage debt to international investors – by issuing mortgage-backed securities (MBSs), for instance. In the process they pass the debt associated with their mortgage lending ‘downstream’ and, in theory at least, off their own balance sheets – ostensibly reducing their exposure to default on mortgage repayments in the process (for a more detailed account of the complexity of mortgage securitisation, see Hay 2011). But the key point is that the financial incentives of privatised Keynesianism, however complex they may have been, clearly encouraged the demand for and supply of sub-prime lending, high loan-to-value ratios and, crucially, equity release which might fuel consumption.

For as long as it lasted, this was all well and good. But arguably, it is precisely where the Keynesian analogy breaks down that that problems begin. The whole point of Keynesianism was, of course, to manage the business cycle (the periodic alternation between growth and recession, boom and bust). By borrowing to injecting demand into the economy when economic growth was falling, it was argued, the business cycle could be softened, such that ‘bust’ did not inevitably follow ‘boom’. But privatised Keynesianism, in effect, takes no account of the business cycle. Indeed arguably, in so doing, it tends to accentuate it, contributing to the inflation of bubbles in the housing market for instance, but being incapable of providing any macroeconomic stabiliser when such bubbles burst.

Thus, if perhaps as a result of an inflationary shock, the low interest rate-low inflation equilibrium is disturbed, then mortgage repayments and ultimately default rates rise, housing prices fall, equity is diminished and, crucially, consumption falls – as disposable income is squeezed by the higher cost of servicing outstanding debt and as the prospects for equity release to top up consumption diminish. Lack of demand translates into unemployment with consequent effects on mortgage default rates, house prices and so forth. The virtuous circle rapidly turns vicious. Arguably this is precisely what happened in the heartlands of Anglo-liberal growth, the US and Britain, from 2006 and 2007 respectively. It is to the details of this process and to their lasting implications that we can now eventually turn.
The bursting of the bubble: the re-nationalisation of ‘Privatised Keynesianism’?

The housing bubble burst first, as is widely known, in the US. Indeed, it is tempting – if, ultimately, wrong – to see the British recession of 2007-2009 as a product solely of contagion from the US. In fact the British economy would almost certainly have endured a deep and damaging recession even in the absence of contagion effects from the US. Yet, chronologically, the story starts with the bursting of the US housing bubble in late 2006 as interest rates soared in response to the sliding value of the dollar on international markets, a build up of domestic inflationary pressures as the economy eventually recovered from the bursting of the dot.com bubble and 9/11 and, crucially, a sharp rise in oil prices. Of these three factors it is the third, the doubling of the price of oil in a little over two years, that is the most important – not least because the threat of oil price rises reinforced by speculation is likely to return.

In response to this inauspicious combination of factors, the Federal Reserve raised US interest rates almost five-fold between mid 2004 and early 2006. The shock to mortgage holders was palpable, with mortgage default rates predictably soaring. No less predictable was that default rates would prove highest amongst sub-prime mortgagees, whose mortgage terms were typically punitive in the first place to compensate for the greater financial risk they posed and who could scarcely afford the repayments even when interest rates had been at their lowest. The result was a housing crash which radiated outwards from areas of greatest sub-prime density eventually to encompass the entire US housing market.

But the ripple effects would not stop there. Because of the highly securitised character of the US mortgage market, a breathtaking variety of international financial institutions that had been siphoning up whatever US MBSs they could get hold of now found themselves exposed to major losses – as these previously high-yielding securities were rapidly reclassified as ‘toxic assets’. Major banks, insurance companies and other financial institutions around the world starting toppling like dominoes, prompting the largest ever bailout of the financial sector as the world economy slumped into its longest and deepest recession since the 1930s and as inter-bank lending and hence the global supply of credit seized up altogether. In the process private debt was, in effect, re-nationalised with horrendous consequences for
the state of public finances around the world and the credit lines which had lubricated the world economy dried up altogether, cutting off at the point of supply the principle source of consumer demand in economies like Britain.

This is the context in which we now need to insert the British economy. Consider first the contagion effects associated directly from the bursting of the US housing bubble. The first thing perhaps to note here is that the British economy would have been exposed to such contagion effects regardless of its growth model – but the magnitude of such effects was all the greater because of the sheer size and character of its financial services sector and the reliance of its growth model on access to personal credit. That said, simply by virtue of the highly securitised nature of the US mortgage market and the international diffusion of such securities, any bursting of the US housing bubble was always going to result in significant losses for British financial institutions. But what compounded matters was the freezing up of both international and domestic inter-bank lending that followed as financial institutions licked their wounds, counted their losses and re-scaled (downwards) their expectations as to whom they might profitably lend. The brutal reality was that, given its levels of consumer debt and the dependence of growth on access to more of the same, the British economy was always going to be more exposed to such a credit crunch than almost any other leading economy. No less significantly, the size and significance of financial services to the economy left the government with little option other than to underwrite the entire sector with public funds. The total funds committed were estimated by the National Audit Office, in December 2009, at £850 billion, destroying at a stroke the state of the public finances – and, in all likelihood, condemning the public sector to at least a decade of retrenchment. Yet the rationale for a bailout of the banking sector on this scale was clear – to insure depositors and, rather more significantly, to re-secure the supply of credit on which the growth of the consumer economy for over a decade had been predicated.

As this suggests, contagion borne of financial interdependence can account for much of the damage inflicted on the Britain economy since 2007. But it cannot account for it all – and, no less significantly, it cannot explain the timing of the onset of the British recession. To explain that we need to turn to rather more domestic considerations.
Crucial, once again, is the link between trends in oil prices (driven at least as much by speculative dynamics as by the laws of supply and demand) and domestic interest rates.

![Graph showing Brent Crude $US, Housing transactions, Bank rate, and Inflation from 2005Q2 to 2009Q2.](image)

**Figure 3: Interest rates, the price of oil, inflation and the housing market**

*Sources*: HM Treasury Pocket Book Data Series (various years); HM Revenue and Customs Annual Receipts (monthly values, 000s)

*Notes*: Inflation and interest rates are plotted on the right-hand axis.

As figure 3 shows clearly, from the second quarter of 2006 oil prices, inflation and British interest rates rose in parallel. Interest rate rises were, of course, much less pronounced than they were in the US. Yet, unremarkably, the increases in mortgage repayments to which they gave rise combined with a reduction in disposable income associated with rising prices led to a squeeze on consumer demand and an increasingly sharp fall in the number of housing transactions prices – followed soon thereafter by a no less sharp and accelerating depreciation in house prices. Having grown at around 12 per cent per annum since 1992 residential property prices were, in the final quarter of 2008, falling at around 20 per cent per annum. This brought about a quick staggering change in personal fortunes. In late 2006 the average earner living in the average home was seeing a wealth effect associated with house price inflation equivalent to three quarters of their pre-tax annual average earnings. In other words,
were they to release all the equity in their home they could effectively double their spending power. Yet two years later, with property prices in freefall, annual house price deflation on the same property was equivalent to over 120 per cent of the pre-tax earnings of the average citizen (Hay 2009: 471). Any residual equity was seeping away at a very alarming rate.

As this suggests, privatised Keynesianism had now started become not a source of growth but an impediment to growth – because the low inflation-low interest rate equilibrium upon which it depended had been disrupted, reducing demand in the housing market and hence cutting off at source the equity which had drip-fed consumption for a decade and a half. The result was a highly corrosive combination of falling house prices and equity depreciation which, in combination with high interest rates and high and rising commodity prices, led directly to falling demand and, in due course, to rising unemployment. The close link between the housing market and the fortunes of the domestic economy is clear to see from figure 4.

![Figure 4: The link between the housing market and British growth, 1990-2010](image)

*Sources: HM Treasury Pocket Book Data Series (various years)*

What it also suggests is that although Britain’s economic problems were reinforced by the credit crunch (in that it is difficult to see steady growth returning to the economy in the absence of the resumption of lending), Britain would almost certainly have experienced a deep and painful recession without out. The unavailability of credit to
consumers throughout 2008 and 2009 undoubtedly deepened the recession. But it cannot hide the fact that, by this point, there was very little demand for personal credit anyway.

Having differentiated between the domestic and external sources of Britain’s slide into recession in 2007, we are now in a position to take stock of the damage that has been inflicted on the British economy by the bursting of the housing bubble and the ensuing credit crunch and to turn to the likely implications of this for any return to growth in the years ahead. But before doing so, there is one key factor which we need to note. It refers back to figure 3 and relates to the Bank of England’s interest rate settings in response to rising oil prices and other inflationary pressures. What the data show very clearly is that, although the Bank of England initially acted swiftly and decisively in raising interest rates as inflationary pressures built in the economy, it stopped doing so as soon as the housing market stalled – despite the fact that, if anything, inflation and the price of oil rose even more steeply once interest rates had reached their ceiling. This is very interesting – and it has potentially significant and alarming implications for the prospects of a return to growth in the years ahead. For what it suggests is that in 2006 and 2007 the Bank of England was unable to control inflation without bursting the bubble in the housing market. Yet inflation did eventually fall – not because of the interventions of the Bank of England but because the US economy was, by this time, already sliding into recession. And that, in turn, served to tame the speculative dynamics that has been driving up oil prices. In this respect, and strange though it might seem, Britain’s monetary authorities were, arguably, rather fortunate. The point is that, had the bubble not burst first in the US it is likely that oil prices would have carried on rising (fuelled by speculation) well into 2009. That would have generated a quite horrendous ‘stagflation’ headache for the Monetary Policy Committee of the Bank of England (with a housing market crash, negative economic growth and runaway inflation exacerbated, presumably, by a run on sterling all at the same time). And the problem is that it would not take much to recreate such conditions if, as and when growth returns to the world economy – an alarming prospect to which we return presently. 

**The political fallout and the prospects for the return to growth**
So where does leave the British economy and the privatised Keynesian model of growth on which it has relied since the devaluation of sterling in 1992? It is to this question that we can now turn directly, considering in turn the character and effectiveness of the interventions made by the government of Gordon Brown to shore up the growth model, the likely political legacy of the recession, and the prospects for the resumption of growth in the years ahead.

**Brown’s recession**

Perverse though it might seem in the immediate wake of its electoral defeat, the government of Gordon Brown arguably had a good recession (see especially Thain 2009; and, for similar judgements, Gamble 2009a: 108; Pemberton 2009; for a contrasting view see Coates 2009). It acted swiftly, decisively and with some degree of creativity in responding to a set of challenges that they had not anticipated in any way and which cut to the heart of the growth model on which they had come to rely. Brown in particular played a key role in setting the tone and temper of what proved a perhaps surprisingly coordinated international response. Indeed, that it is even possible to suggest the public rescue of the global banking system from the precipice marks the return to an era of Keynesian economics owes much to the influence of Brown himself (Krugman 2008: 185). But that does not make it true.

Though we did not see the return of the Keynesian economic paradigm, we did see something very interesting – and strangely reminiscent of economic policy-making, at least in Britain, in the mid to late 1970s. For just as just as the Labour Government of Jim Callaghan sought to deploy monetarist techniques in an attempt to consolidate the prevailing Keynesian growth model, so that of Gordon Brown engaged in a bout of inter-paradigm borrowing – in using a repertoire of at least quasi-Keynesian techniques to shore up the existing growth model. But the point is that both episodes of inter-paradigm borrowing were characterised by the attempt to stabilise, rather than to replace, the existing model; as such, neither marked a paradigm shift (Gamble 2009b: 459). Insofar as this was Keynesian at all, it was a form of ‘foul weather Keynesianism’ – a dipping into the repertoire of Keynesian techniques in recession only for such instruments to be abandoned as and when growth resumed. Indeed, a legitimate concern of many was that in a perhaps understandable desire to signal to
international markets the intention to restore balance to the public accounts, such
techniques would be abandoned well before any recovery were firmly established.
Those concerns have not gone away.

Indeed, that Cameron’s Conservatives emerged as the largest party in the 2010
General Election almost guaranteed such an outcome – an impression only confirmed
by their Emergency Budget in June 2010. For, as they repeatedly emphasised before,
during and after the election campaign, their priority in office would be to make
immediate cuts in public expenditure to appease market sentiment. In this respect, as
in many others, Cameron’s Conservatives and their coalition partners are no more
carriers of an alternative economic paradigm than the government of Gordon Brown
they replace - nor do they offer an alternative growth model. But there were during
the election campaign - as there remain today - significant differences in emphasis
between the parties on economic policy. First, although they did not explicitly deny
that they would have engaged in the same public underwriting of the banking sector,
the Conservatives were clearly much more uneasy about deficit financing and the
associated ratcheting up of public debt.

In this context it is interesting that they did, and still do, refer to the recession as a
crisis, but they do so in a very particular way. The crisis, for them, is a debt crisis,
‘Labour’s debt crisis’ – and that, of course, implies that the solution to the crisis is to
restore balance to the public finances through a combination of tax raising and
unprecedented cuts in public spending. Yet it is by no means the only significant
difference between the parties. Interestingly in their 2010 election manifesto, the
Conservatives were far more sanguine about the degree to which the British growth
model was broken than Labour. Its economic chapter opened with a stark question:
‘where is the growth to come from?’ What is less clear is that either party offered
much of an answer. For Labour, it seems growth rested, as it still rests, on
resuscitating the old growth model. But for the Conservatives, it is very clear that this
will not suffice. As they boldly state,

“ we cannot go on with the old [growth] model … built on debt. An irresponsible
public spending boom, an overblown banking sector and unsustainable consumer
borrowing on the back of a housing bubble were the features of an age of
irresponsibility that left Britain so exposed to this economic crisis. They cannot be the source of sustainable growth for the future”.

Yet this does not lead to a clear sense of what is to be done. Instead we are simply told that Britain must make the transition to a new growth model based on saving rather than borrowing, investment rather than conspicuous consumption, and a balance of trade surplus in place of an existing deficit – as well as a greatly reduced role for financial services. The problem here is that the new coalition government simply disavows the kind of intervention and, indeed, the degree of public investment, necessary to secure any such transformation and it also seems to believe that this transition can be achieved in a single parliamentary term when, in all likelihood, it would take several decades. Whilst this remains the case, the new growth model remains almost entirely aspirational – and, in all likelihood, elusive.

Conclusion

So what are the prospects for the resumption of growth in the years ahead? The preceding analysis suggests three key impediments to growth, each of which would need to be overcome before it is credible to think that the British economy might grow again at anything like the rate to which it became accustomed in the 1990s and the first five years of the 2000s.

The first of these relates to the confidence invested by all of the major parties in the prospects for a manufacturing and export-led rebalancing of the economy in the years to come. Here, one might think, the very depth of the recession might offer some crumbs of comfort – for it has seen a significant depreciation of sterling in key export markets. This, it might be thought, would have led to a marked improvement in British competitiveness, the economy’s balance of trade position and a strong platform from which to move to a more conscious export-led growth strategy. Yet the data show this not to have been the case, with the balance of trade position in fact worsening since the height of the recession.

Two further factors compound this already depressing state of affairs. First, the global nature of the recession has led to a sharp decrease in the level of world trade as
a percentage of global GDP. This makes it very difficult even to think of the British economy retaining, let alone expanding, its global market share. And second, this is merely reinforced by alarmingly low levels of productive investment in the economy in recent years – during a period of easy credit. With the very significant tightening of credit that has occurred since the recession and with a 40 per cent or so drop in the value of the commercial property against which most small businesses secure their credit, it is difficult to envisage the transition to an export-led growth strategy built on the back of private investment – and the parlous condition of the public finances would seem to preclude a programme of public investment to stimulate export growth.

So much for export-led economic growth. What about the prospects for a resumption of consumer-led and private debt-financed growth – a return to privatised Keynesianism in effect? The problem here is Britain’s fragility in the face of any inflationary shock – and the likelihood of such a shock in a context of significant speculation in oil markets. As we have seen, by mid 2007 British interest rate settings were sufficient to burst the housing bubble without controlling inflation. What ultimately brought inflation down was the onset of the American recession and the fall in oil prices that followed.

If this is true, then it is deeply worrying. For arguably the Monetary Policy Committee still lacks the capacity to control inflation without crashing the housing market (at the time of writing, inflation is well above target and rising, yet interest rates remain at 0.5 per cent). This would be fine if the low inflation-low interest rate equilibrium of the 1990s and early 2000s could be restored. But the speculative character of oil price dynamics today makes that most unlikely. The point is that it would not even take the resumption of growth in the British economy to see the price of oil rise steeply, bringing with it similar inflationary pressures to those which have already taken us to the edge of the precipice once. Almost certainly all that is required is the resumption of growth in the US and that now seems established.

Oil prices quadrupled in the years before the global recession and they have already doubled since their floor in late 2008. Indeed, perhaps most worrying of all, their rate of growth in 2009 was as high as that from late 2006 until their peak in the second quarter of 2008.
This leaves just one significant factor which we need to consider. The British economy has endured the longest and deepest recession since the 1930s; but it is surely credible to think that it is far from over. At best, the private sector recession is over; but the public sector recession has scarcely begun. In a sense Britain has experienced something of a pre-election lull before the post-election storm. When it comes in early 2011, as the 2010 Comprehensive Public Spending Review starts to be implemented and as the rise in VAT to 20 per cent takes effect, unemployment will rise steeply, demand will fall and, once again, property prices will tumble. That is not an enticing prospect and it suggests that, rather like 1992 and 1974, 2010 may well be remembered as not a very good election to win. Britain’s new coalition government is likely to be sorely tested.

References


Gamble, Andrew (2009a) The Spectre at the Feast, Basingstoke, Palgrave Macmillan.


**Further reading**

The literature on the ‘great recession’ is still very much in its infancy. Gamble (2009a) offers an excellent portrait of the events themselves and their implications, despite being written as those events were still unfolding. The first and final chapters are particularly valuable. Crouch (2008) and Watson (2010) provide helpful overviews of ‘privatised’ and ‘house price Keynesianism’ respectively, whilst Finlayson (2009) gives an excellent account of ‘asset based welfare’ and the assumptions on which it is based. Hay (2009, 2011) and Pemberton (2009) provide more detail on the economic and political implications of the bursting of the housing bubble. Thain (2009) and Coates (2009) provide diametrically opposed judgements of New Labour’s handling of the recession.