The economic crisis of 2008 and the uk government response

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Introduction

The current economic crisis which had its roots in the US sub-primes market produced a profound shift in UK economic policy, Hodson et al (2009). The latter suggests that prior to this crisis UK economic policy centred on three principles which included fiscal prudence, low inflation and inadequate regulation and supervision of the UK banking sector. However, the result of the crisis was so severe that the government refocused economic policy such that large public sector borrowing was necessary. This was due to the fact that a number of large UK banks were in trouble having had exposure to the troubled sub-primes market with subsequent bad debts on their balance sheets, Hodson et al (2009). Therefore, in order improve the health of the banks the UK government became effective shareholders using tax payer's money. The banks which were assisted include Northern Rock, HBOS and Lloyds TSB as well as the Royal Bank of Scotland. However, the principle reason for government intervention was to provide liquidity to the interbank loans market and facilitate banks to lend to firms and consumers, Hodson et al (2009). It was envisaged that once sufficient liquidity had been provided to the interbank market, then the banks would be willing to lend to each other and then the banks would be able to lend to the wider economy. The total cost of government action to avert a collapse in the financial markets amounted to 28% of GDP, Furceri et al (2009).

The Economic Crisis of 2008

The roots of the financial crisis which surfaced in July 2007, and which became worldwide after the collpase of Lehman Brothers on 14th September 2008, Guillen (2009), lay in the sub-prime mortgage market in the United

States, Lapavitsas(2009). It was between 2001 to 2003 that mortgage lending in the US rose significantly until 2006. At the heart of the financial crisis lay the fact that loans for homes were being made to those who would not be able to continue to make repayments on the mortgages either because they lost their jobs or interest rates increased. The latter may be a result of the government trying to stem a short term increase in inflation.

Thus, the global economic crisis of 2008 had its roots in 2007. In the US, financial institutions were lending money to borrowers whose income was insufficient for them to comfortably keep up the payments on mortgages, Hodson et al (2009). However, as house prices were going up more and more bad loans for mortgages were being made. It was due to the fact that these mortgages were valuable because the prices of houses were increasing that US investment banks took the mortgages and securitised them to form CDO’s. Nevertheless, the problem started when US house prices began to fall, Hodson et al (2009). In this case, as the price of US houses began to decline the securitised debt also began to lose value.

However, by this time the securitised debt had been cut up into smaller chunks and siphoned off to banks around the world, ending up as liabilities on their balance sheets, Hodson et al (2009). Some banks had larger chunks of securitised debt on their balance sheets than other banks while some banks had no exposure to securitised debt at all. In the period 2004-2006, US$ 1. 4 trillion worth of mortgages had been securitised. This represented 79. 3% of all sub-prime mortgages, Lapavitsas(2009). Moreover, according to the latter securitisation was the process whereby morgages were parcelled into small amounts placing them into other financial structures and selling

the lots as new securities. These new securities or CDOs' were to be held by financial institutions around the world. However, as interest rates began to rise after 2004, mortgage foreclosures increased. The result of the increased foreclosures was that the securities became worthless and banks were unable to sell or trade them and increase their cash assets, Lapavitsas(2009). The fact that banks had worthless, untradeable liabilities on their balance sheets put into doubt the solvency of UK as well as other global banks. These financial institutions preferred to collect liquid assets instead of ensuring that liquidity to other banks was maintained through the interbank market. The resulting liquidity shortage was characterised by the movement between the interbank lending rate and the 3 month Overnight Indexed Swap rate. The Overnight Indexed Swap rate was exceeded by the interbanklending rate after August 2007 with the difference reaching a peak in the last quarter of 2008, Lapavitsas (2009). Thus, liquidity dried up with banks unwilling to lend to each other; and consequently to firms and consumers.

It is now clear that the problems in the US housing market started when interest rates rose and house prices began to fall. At the same time the cost of borrowing to firms began to increase, making it more expensive for them to be able make productive investments which maintained current employment and generated further employment. In this case people began to be laid off and unemployment in the UK began to increase, Hodson et al (2009). Furthermore, in the UK people began to lose their jobs demand for goods and services fell and in the US as the number of housing foreclosures began to increase significantly as people were laid off. Once people began to

get laid off they lost their capacity to pay for the mortgages which they had taken out, Hodson et al (2009). As the number of foreclosures soared and house prices to sink even deeper, the values of the securitised debt which was sitting on the balance sheets of banks around the world also began to fall in value. A consequence of this was that the liabilities side of the bank's balance sheet began to increase. As rumours began to spread in the market that some banks were more exposed than others to bad securitised debt, banks became fearful of lending to each other through the interbank market. The impact of this was reduced consumption, increasing unemployment and overall contraction of the economies of developed countries, including in the UK.

The UK government was thus facing an economic crisis which was not unique to this country but part of a far wider global contagion whose spread was facilitated by the mechanics and linkages of globalisation, Lapavitsas (2009). However, the government in its response to the crisis had to ensure that the banks did not collapse, continued to lend to each other and to consumers and firms in the wider economy. The next section will look at the UK government policy response in more detail.

The UK Government Response

The UK was one of the European countries to be hit the hardest by the global economic crisis which began with the US sub-primes crisis. The crisis led to the first run on a UK bank since the latter part of the 19th century with the whole banking sector facing near meltdown 12 months later with the collapse of Lehman Brothers on the 18th September 2008, Hodson et al (2009). Furthermore, the latter suggest that the resulting credit crunch and

the bursting of the UK housing bubble have had a profound impact on the UK economy which has required a UK government policy response which has had to be not only substantial but also has had to set aside rules such as those associated with competition policy which would not normally have been done, Hodson et al (2009). It has also been suggested in the literature that the UK economy will contract by about 4% in 2009 with inflation falling by 1. 7% and unemployment reaching 3 million before a sustained recovery kicks sets in, NIESR (2009). Furthermore, the economic crisis has led to unprecedented economic policy co-ordination at an international level with policy formulation at the national and international level constantly evolving, Pauly (2009).

Hodson et al (2009) suggests that the policy paradigm which was followed by the UK Labour Party following its 1997 election victory was essentially the New Keynesian consensus on macroeconomic policy, the composite of policies which changed after the crisis. Specifically, the UK government relied on fiscal policy and monetary policy although undoubtedly, the latter was dominant. With regards to fiscal policy, the main drivers included the reduction in the VAT rate from 17. 5% to 15%; and an increase in government borrowing. Indeed the government’s borrowing requirements increased 5 fold from its level in 2007-2008 to its level in 2008-2009 with the borrowing requirement moving from2. 3% of its GDP in 2007-2008 to 11. 3% in 2008-2009. The increase in government borrowing was not due to the work of automatic stabilisers and was in fact outside the work of the automatic stabilisers which caused the government to suspend its normal fiscal rules for borrowing. On the other hand with the use of monetary policy

the government was able to do far more extensive surgery to the UK economy. Firstly, the Bank of England dropped bank base rates from 5. 75% in November 2007 to 0. 5% in April 2009. This procedure was meant to make borrowing cheaper in the interbank market and facilitate general bank lending to the wider economy allowing firms to borrow to invest, while the reduction in VAT was meant to cut the costs of firms so that they would not lay off staff, Hodson et al (2009). In terms of an IS-LM analysis the increased lending by the banks due to lower bank base rates would be reflected by the LM curve shifting downwards with national outcome theoretically increasing. However, the lowering of bank base rates did not work in the manner dictated by theory, Hodson et al (2009). The latter characterise the neutral impact of the lowering of bank base rates on interbank lending by observing that neither did the volumes of interbank lending increase or interbank rates fall. Moreover, because inflation also fell, the Bank of England was unable to manipulate the real interest rate. For example, if inflation is high and the nominal rate of interest is low, then it is possible to have negative levels of the real interest rate, Hodson et al (2009). However, this may not be possible when the level of inflation is falling or very low. This is indicative of the fact that perhaps the pre-crisis policy of targeting inflation was set at too lower rate and a higher rate of perhaps 5% should have been operational to give more flexibility to the Bank of England when using monetary policy. The failure of the use of interest rates to resolve the crisis led to the Bank of England bringing into action new policy instruments such as quantitative easing and the Asset Purchasing Facility (APF), Hodson et al (2009). The former policy instrument allowed the Bank to lend against securities using its discount window in order to increase liquidity. Furthermore, the APF allowed

the bank not just to lend against securities but to purchase them from other financial institutions.

Conclusion

This paper has evaluated the causes of the global economic crisis of 2008 and the subsequent policy response of the UK government. It has been shown that the crisis began the US sub-primes market and spread globally due to the securitisation of sub-primes mortgages which thus entered the circulation of the global financial system. The subsequent busting of the US housing bubble made the securitised debt worthless and as a consequence lending in the interbank lending market dried up with banks waiting to fail with disastrous consequences. The government's policy response to the crisis was at first to use both monetary and fiscal policy with fiscal policy focusing on an increase in government borrowing and a reduction the rate of VAT. Monetary policy at first relied on the use of lowering bank base rates to stimulate interbank lending. However, this did not work because inflation was at a low and so the government resorted to using unorthodox techniques such as quantitative easing and the Asset Purchasing Facility to increase liquidity in the market. The government still faces the problems associated with the need for co-ordinated action amongst nation states to deal with the crisis as well as the prospect that there may be a second credit crisis which involves not banks or firms but consumers and sovereign states.