Efficacy of Policy Response to the Financial and Economic Crisis: A Case Study of the United Kingdom

Kazeem O. Salaam
Cracow University of Economics, Krakow, Poland

Abstract
This piece of work seeks to perform detailed review and analysis of those factors that precipitated global financial and economic crises in 2008 with a focus on the United Kingdom economy. Impacts of the crises from both micro and macro economy perspectives are also analysed in conjunction with the sudden change in government policies from less rigid fiscal prudence, price stability, unsupportive employment policies as well as weak financial services supervision to unconventional stiff fiscal and monetary policies as well as hard core financial regulations with a primary aim to cleaning up the economic and the financial mess that characterised the meltdown. To finalise this work, it is concluded that efficiency of policy actions to address the economic menace to a large extent, helped British Economy to get out of the crisis despite that all the measures adopted were not considered to be perfect in its entirety. Other potential areas of study are also identified.

Key Words: Gross Domestic Product (GDP), Quantitative Easing (QE), Consumer Confidence, Economic Crisis, Fiscal Policies

JEL classification: E52, E58, E66

Introduction
The genesis of 2007-2009 economic recession were many and varied, long and deep, which was considered by many analysts and various indicators confirmed it as most severe economic crises since the 1930s’ Great Depression. The crises triggered first run on a UK bank since 1866. UK house price bubble became burst within 12 month of the crises; The country’s GDP contrasted by at least 4% in 2009 only; Unemployment level exceeded 3 million (increase of over 60%) before recovery started coming up; and a fall of 1.7% in retail price index in the year 2009 (NIESR, 2009).

It is worth noting that some banks were the creator of their demise, resulting from unprecedented and poorly monitored and managed risk taking which was a predominant culture within UK banking sub sector prior to the crises. Many actually blamed the bankers for the huge bonus they get in return for the astronomical risk taking attitude, their fraudulent, corrupt and greedy speculations in trading was not exonerated from the causes of this systemic failure.
Others posited that the crisis was a consequence poor financial crises management in the system such as refusal to bail out Lehman Brothers which resulted in spiral and humongous failure of financial institutions.

With many factors already researched and analysed in the past, with a hard fact conclusion of neither right or wrong, one thing that is certain was that the systemic crises witnessed was caused by many interacting factors which were intricately interwoven which Alan Greenspan called “hundred year flood” which was hard to avoid (Greenspan, 2010). The questions we keep on seeing in different papers are – how could such greed emerge that we did not notice or thought of before the crises? How could crisis within a fraction of the financial sub sector (i.e. subprime mortgages) led to a historic global recession, with drop in gross domestic product (GDP) nearing 10 per cent of global output in 2008−2010, (IMF 2010a report)? How could the shareholders of financial organisations with primary objective of maximising profit tolerate high bonus payment?

This paper will critically delve into the causes of the crisis as mentioned above and the impact of this crisis on the UK economy. Evaluation of the government responses to address the consequential economic hiccups will also be performed. In particular, monetary policy responses, fiscal policy responses, regulatory policy responses as well as macro prudential policy responses will be reviewed.

The Roots of the Crises

Prior to the financial crisis, UK economy experienced sustained economic growth over a period of more than a decade. According to Mervyn King, Governor of the Bank of England (2003), he described this period as “NICE” (Non-Inflationary Consistently Expansionary) decade. This was not different in the US. Many writers described pre crisis period as “The Great Moderation Decades” when there was substantial decline in the macroeconomic volatility in the US.

The recession in Britain and across the world was a direct result of the credit crunch that began in August 2007 and which worsened dramatically into a global financial crisis in the autumn of 2008. As elsewhere in the world, notably in the United States, the central problem was Britain’s banks, which had invested their reserves in assets that turned out to be ordinary paper due to their illiquid characteristic, thus making them worthless.

One of the questions that arose was that “What could have turned assets to a worthless piece of paper?” Alan Greenspan (2010) argued that one of the trigger of the financial crisis is the global proliferation of toxic US subprime mortgage. However, John Taylor (2008) was of the view that the financial crisis was caused majorly by monetary excesses which led to a boom and later into a bust. In other words, he argued that the cause of the crisis was centred on loose monetary policy. Another cause of the crisis identified by Caballero et al (2008) was the global financial imbalances as a result of large current account balances in the emerging financial markets such as China, thus leading to financial flows to developed economies such as US and UK therefore forcing down the interest rates in the recipient economies.

Rapid growth in the off balance sheet exposures in poorly understood financial products have also been identified as a cause of the crisis. Borio (2008) argued that this situation was possible due to loose financial regulation. This therefore precipitated the humongous deterioration experienced in the financial market at the start of the crisis.

Considering various argument put up by commentators and analysts to support their beliefs on the causes of the financial crisis, it is comfortable to agree to the fact that the causes of the financial crisis were multi-facet and intricately interwoven. This is because each of the causes are more often than not, depends on the other before crisis could emerged.

Effect of the Crisis on the UK Economy

The financial crisis was considered a global crisis due to its unpalatable effects on the global economy in which UK is a major participant. Among other effects that the crisis infected on the UK economy include the following:

Decline in Gross Domestic Product (GDP): One major impact of the financial crisis on the UK economy was a sharp drop in the GDP experienced in the early 2008. This of course is the main measure of economic performance.

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1 Where financial markets were still under developed compared to US and UK markets
2 Developed economies where large financial flows were received due to the global imbalances
UK economy was officially declared to be in a recession in January 2009, when the Office for National Statistics (ONS) announced that the preliminary estimate of gross domestic product (GDP) showed a fall of 1.5 per cent in the last three months of 2008 after a 0.6 per cent drop in the previous quarter\(^3\). They represented the biggest quarter-on-quarter decline since 1980, and the first time the economy had been in recession since 1991. ONS figures 1 below shows that GDP fell by 2.4 per cent in the first quarter of 2009 compared with the last quarter of 2008, the sharpest contraction of output since the second quarter of 1958. GDP fell by a further 0.7 per cent in the second quarter of 2009.

Prior to this period, UK GDP recorded steady growth for almost a decade from 2000 until early 2008. Figure 1 below shows the sharp drop in GDP from Q1 2008 all through to Q3 2009, UK GDP dropped by 7.2%. This was contrary to previous economic downturn experienced in 1980s and 1990s when GDP fell by 2.9% and 4.6% respectively\(^4\).

![Figure 1: GDP (£millions) and quarter on quarter growth, Q1 2014](source: Office for National Statistics)

Figure 1: GDP (£millions) and quarter on quarter growth, Q1 2014

Detailed analysis of the figure 1 above showed that the crisis hit the construction and production industries the most. This was because prior to the crisis, construction activity growth was very strong particularly in the early years of the decade. Table 1 below shows the growth in the UK economy, year on year, for the output components of the GDP from 2009 to 2013. This is further depicted graphically in figure 2 below. Construction industry contributed -13.3% to the economy. This was followed by manufacturing industry which contributed -10.2% to the economy. In a nutshell, out of 12 industries measured in the table below, only the government and other services actually contributed positively to the economy, this underscoring the magnitude of the effect created by the crisis on the economy.

It should be noted that GDP and all of its components are referenced to 2010, making the average index in 2010 equal to 100. This is why Figure 2 shows all components converging in 2010.

Table 1: Growth, year on year, for the output components of GDP- UK 2009-2013

\(^3\) These figures indicated that the widely accepted definition of a recession – two consecutive quarters of ‘negative economic growth’ (contraction of the economy) – had been met

\(^4\) Data used in this paper are obtained from ONS bulletin and according to them, they are seasonally adjusted estimates and have had the effect of price changes removed (in other words, the data are deflated)
Effect on UK House prices: In the year preceding 2008, housing market in the UK reached one of its highest peak since the record began. However, reverse situations was experienced within the two years when the financial crisis erupted UK economy. Average house prices experienced sharp decrease between 2008 and 2009. In the figure 3 below, average house price changed from 11.3% in the last quarter of 2007 to -13.5% at the beginning of 2009 Q2. Brissimis and Vlassopoulos (2009) argued that the demand for properties is positively correlated with credit availability. In support of this argument, the financial crisis actually resulted in lenders being reluctant to take the risk of giving out credit facilities in the form of mortgage to individuals who are particularly characterised with lower credit score, thus drove the demand for properties down and consequently the house prices. The Council of Mortgage Lenders (2009) posited that mortgage lending declined from £108 billion in 2007 to £8 billion in 2009 and gross advances dropped by £222 billion between 2007 and 2009.
The drop in the house prices during the crisis did not only limit to England but across the whole United Kingdom (Figure 4). The England index dropped from 180.8 in January 2008 to 159.5 in January 2009. In the same vein, index for Northern Ireland (222.1) in January 2008 dropped to 198.8 in January 2009. Scotland and Wales also recorded decline of 6.25% and 10.75% respectively.

Source: Office for National Statistics

**Figure 3:** Annual house price rates of change, UK all dwellings from January 2004 to February 2014

Effect on UK Employment Rate: It is no doubt that job loss is one of the symptoms that characterised the financial crisis in the UK. This is not different when reviewing the three previous financial crises witnessed in the UK. Figure 5 below shows the trend of employment rate during previous financial crises in the UK. The crisis triggered the need for firms to down size the existing workforce as well as laying embargo on employment of the employees. Figure 6 below shows the effect of the crisis on the employment vacancy in the UK. Total vacancies dropped from 698 in the first
quarter of 2008 to 441 in the same period of 2009. This represent 32.82% drop in vacancy as a result of the financial crisis.

Source: Labour Force Survey - Office for National Statistics

Figure 5: Unemployment rate (aged 16 and over), seasonally adjusted

Source: Vacancy Survey - Office for National Statistics

Figure 6: Vacancies, seasonally adjusted

UK Government Responses to the Financial Crisis

UK government was very swift in its response the financial crisis. Various measures were taken to address the economic anomaly that came with the crisis. These range from various monetary policies to fiscal policies. Some of these policies are discussed below:

Reduction in interest rate: In March 2009, UK government through Bank of England reduced interest rate from 5.0% in September 2008 to 0.5%. Figure 7 below shows UK interest rate level from a decade prior to the crisis period.
The aim rationale behind reduced interest rate was to provoke recovery from the crisis. This targeted increase in consumers as well as firms and government spending since incentive to save had been eroded. This measure not only increased aggregate demand, it also aid commitment to new investments. Additionally, monthly cost of mortgage repayment was witnessed which in turn, provided more disposable income and make investment in property market more lucrative.

Since reduced interest rate made it unattractive to save money, currencies were less demanded thereby causing fall in the currency values. This therefore had a multiplier effect on export and import. This explains why during post crisis period, UK exports became more competitive.

The challenging part of this measure was that during the crisis, banks had limited liquidity which necessitated their longing for more deposits from the customers. As a result of this, banks did not reduce their interest rates in the proportion at which the base rate was reduced therefore had little effect on consumers.

**Introduction of Quantitative Easing:** This unconventional measure was adopted by Bank of England with the aim of boosting economic activities in the UK. This measure became imperative due to little scope of further interest rate reduction. Using this measure, the bank of England creates money to buy government bonds with the primary aim of increasing money in circulation thus boost economic activities by encouraging banks to lend and consumer to spend.

Major concern of the use of this measure was inability to determine the extent of QE that would be required to boost the economy such that higher inflation would not occur.

**Overhauling of Fiscal Policy:** Under this measure, UK government adopted both types of fiscal measure (discretionary and automatic). The chancellor when delivering his 2008 PBR statement hinted that the VAT rate would be temporarily reduced from 17.5% to 15% from December 2008 until 31 December 2009 as part of the discretionary measures with the aim of preventing the recession from becoming deep. This therefore reduced both businesses and households’ tax liability by around £11 billion. Hence, this had direct impact on the consumers and also supported the businesses and jobs by strengthening cashflow and profits. However, the VAT was increased from 17.5% to 20% in 2014/2015 budget. This measure was referred to as fiscal tightening by the coalition government in the UK.

Other fiscal measures introduced by the government include introduction of 50% income tax on income over £150,000 as well as increase in national insurance contribution by 1%.

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5 The initial level of QE was set at £75 billion but this has been increased on several occasions to a total of £200 billion in November 2009.
Effectiveness of the Policy response on the UK Economy

In order to assess the effectiveness of UK government responses to the crisis, it is imperative to identify the government objectives which constituted the drivers of these policies as discussed above. Among these include curbing large deficit on current account balance of payment, reduce employment rate, achieve economic growth without risking high inflationary growth to mention a few and prominent ones.

**Economic Confidence level:** Considering the above mentioned objectives of the UK government, one good metric to evaluate the effectiveness of policies adopted towards achieving the objectives is the confidence level in the economy. As shown in figure 8 below, investors’ confidence improved during the when quantitative easing was being implemented. Figure 8 shows option-implied distribution around FTSE 100 equity index 12 months ahead from February 2009 to February 2010. In this figure, the shift was not just horizontal shift but also marked narrowly, implying that investors were not bothered with large downside risks. This behaviour confirmed that investors were more confident about the outlook for future equity prices during the introduction of the QE.

![Figure 8: Option-implied distribution of the FTSE 100 index Feb '09 to Feb '10](image)

*Source: Research & analysis- Q3 2011 quarterly bulletin*

In the same vein, household and firms confidence recorded remarkable improvement following introduction of QE in 2009. Prior to QE introduction, confidence level of both consumers and firms dropped below historical average. This immediately changed during 2009 when QE came into effect (see figure 9 below).

**Economic Confidence level as a driver:** Due to improvement in market confidence level, which was credited majorly to quantitative easing by commentators as well as the fiscal policy measures adopted by UK government to address the downturn, other economic indicators such as employment rates (see figure 5), rate of vacancy in the economy (see figure 6) and overall GDP (see figure 1) as well as house prices (see figure 3) also have their share of improvement. As a result of these, UK was first to be out of economic recession in Europe.
a) Consumer confidence.

b) Total prosperity index from the answers to questions 1, 2d, 4 and 5 of the YouGov survey.

c) This aggregate confidence index is derived by averaging the answers to questions 2, 4, 7 (with inverted sign) and 11 in the GfK NOP survey carried out on behalf of the European Commission. Data are seasonally adjusted.

d) Business confidence.

e) CIPS/Markit services business expectations. Note that data are seasonally adjusted

Conclusions

The effects which the global financial crisis levied on the UK economic were humongous. These cut across all sectors of the economy including banking, manufacturing as well as public spending. Consequently, GDP was down, unemployment rate was at its peak and the overall economic confidence level was low. This paper has therefore reviewed the response from policy makers to address these economy anomalies. Regulators particular in the UK sought to address the economic and financial decadence that characterised the crisis period. UK government scale and speed of response to the financial crisis was targeted to ensure that risk of inflation falling below target in the medium term was curtailed. More importantly, deteriorating confidence level could not be tolerated in the economy. Hence, this paper concludes upon our review of various economic parameters, that government actions and interventions resulted in boosting confidence level in the economy. This conclusion is in line with previous studies on the UK policy response. Empirical evidence gathered and reviewed in this paper also showed that while most of the economic policy objectives have been achieved, UK economy is still being monitored with a view to ensuring sustainability. Study area that requires future analysis is how UK government must balance unconventional monetary policy with both automatic discretionary fiscal policies such that sustainable economic growth is achieved.

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