10 Years Since The Crash: Causes, Consequences and the Way Forward

PEF Progressive Economy Forum

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References can be found as hyperlinks in the online edition of the pamphlet, available to download as a free PDF from our website.

The Progressive Economy Forum has been formed out of sheer frustration that the best policy solutions are being ignored, the wrong policies still in place. It brings together a Council of distinguished economists and thinkers with the aim to develop a progressive macroeconomic programme and to foster wider public engagement with economics.

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Introduction

Patrick Allen,
chair and founder of PEF

The crash

The 2008 Global Financial Crisis was a cataclysmic event, the worst to befall the global economy since the Great Depression of 1929. This pamphlet marks 10 years since a key turning point in the proceedings: the collapse of Lehman Bros on 15th September 2008, the biggest bankruptcy in history.

The crash came as the conclusion to decades of financial deregulation, beginning in the 1970s and intensifying in the 1980s. There were many major financial crises over this period, while the years between the end of WW2 and the 1970s were virtually free of such turmoil. The most recent crisis, however, dwarfed its predecessors in both its scope and its scale.

Alan Greenspan, former Chairman of the US Federal Reserve has now admitted that that the thinking behind the regime of the deregulation he oversaw was flawed; he had overestimated the ability of a free market to self-correct and had missed the self-destructive power of de regulated mortgage lending. In 2009 he said: "The whole intellectual edifice… collapsed in the summer of last year."

This intellectual edifice was built up by neoliberal economists from the 1930s onwards. They intensely disliked the very idea of government intervention, and so devised economic theories designed to 'prove' that markets – including financial markets - would achieve optimal outcomes if left alone with minimal regulation. To do so required a set of assumptions breathtaking in their detachment from reality. These were the intellectual underpinnings that led to the Global Financial Crisis.[1]

1. The Financial Services Authority's Turner Review, published after the crash, gives an excellent account of these assumptions and how they led to inadequate policy (especially pp. 41-51).

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Austerity

After the crash, the UK economy inevitably went into freefall. But after the stimulus programme of Gordon Brown and Alistair Darling, we were on the road to recovery.

Most of the time economies bounce back after recessions and make up for lost time. This time it was different. The recovery was stopped in its tracks by the implementation of misguided austerity policies instigated in 2010 by Chancellor George Osborne.

These led to the UK's slowest economic recovery in 300 years of recorded history, caused irretrievable loss of output and national income, and harmed the most vulnerable in our society. The effects of austerity have now also been shown to be linked to the vote to leave the EU in the 2016 referendum in the referendum. The threat of Brexit has caused yet more damage to the economy, with much more to come if we leave the EU.

Austerity has been tried many times in the past in many different countries, usually with catastrophic effects that only come to an end once austerity ceases. As Einstein remarked: "The definition of insanity is doing the same thing over and over again, but expecting different results." Does this mean that the current policies of the government are insane? Far more likely is that austerity policies have been used as a cover for the true motive – to permanently shrink the public sector.

What is tragic is that we know exactly how to prevent long-term slumps. The brilliant work of John Maynard Keynes - in particular his *General Theory*, written after the Great Depression – shows that governments have to decisively step in to stop the economy from sliding into further recession and to bolster recovery. But these lessons were ignored, causing unnecessary pain and suffering.

The Progressive Economy Forum

The Progressive Economy Forum has been formed out of sheer frustration that the best policy solutions are being ignored, the wrong policies still in place. It brings together a Council of distinguished economists and thinkers with the aim to develop a progressive macroeconomic programme and to foster wider public engagement with economics.

This first publication is the opening shot in our campaign. Here, we hope to provide activists and thinkers with an understanding of the causes and consequences of the Global Financial Crisis, and to chart the beginnings of an alternative economic course.

Our pamphlet is based around four essays from some of our Council members:

→ **Ann Pettifor** explains the historic causes of the crash, the running theme being forty years of deregulation of financial markets.

→ **Progressor John Weeks** lays bare the damage that the crisis and subsequent austerity has inflicted on the economy.

→ **Dr Johnna Montgomerie** explains the devastating consequences of the UK's "debt economy", in which many members of society rely on debt to get by in the face of stagnant wages.

→ **Professor Stephany Griffith-Jones** outlines how a National Investment Bank could be used to finance the investment necessary to rebuild the British economy and prepare for challenges such as climate change, forming a vital part of a progressive policy programme.

Interspersed with these essays are a number of resources: a timeline of the crisis, summaries of the consequences of the crash and austerity, a history of failed austerity experiments and an analysis of the changing Conservative narrative around Labour's handling of the crash.

At the back of this pamphlet, you can find more information about our Council. References can be found as hyperlinks in the online edition of the pamphlet, available to download as a free PDF from our website.

We hope that this publication proves useful to you. I invite readers to keep in touch with us through our website (progressiveeconomyforum.com), mailing list and Twitter (@pef_online), and to watch out for our forthcoming projects.

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The crisis: causes and consequences

Ann Pettifor

> *"To fix things we need to first tell ourselves the correct story about how we got here. Financialization is easily the least studied and least explored reason behind our inability to create shared prosperity – despite our being the richest and most successful nation in history."*
>
> **Rana Foroohar**, in *Makers and Takers: the rise of finance and the fall of American business.*

After forty years of financial liberalisation, a progressive government will face many challenges. Some of the biggest will be management of Britain's finance sector and, together with partners, stabilisation of the anarchic and potentially catastrophic international financial system.

The 'globalisation' or deregulation of finance since the 1960s has 'liberated' financial capitalism from democratic oversight and regulation by accountable governments. It has led to the creation of global markets in money, as well as property, trade and labour. Quinn Slobodian in his book *Globalists* argues that the creation of global markets, remote from democratic oversight, this was no accident; it was the clear intention of neoliberal economists to 'encase' financial and other global markets and to 'protect' them from accountability to democratic governments.

As a result of financial globalisation, a great wall of money, unregulated by governments, is today aimed at the world's finite resources (assets). These include land or property. Global flows of money have inflated the prices of property and assets like stocks, bonds, works of art, brands, vintage cars. These assets are largely owned by the already-rich. Post-crisis economic policies have simultaneously lowered wages in real terms. As a result, global wealth inequality has exploded.

Rising inequalities have led to the return of so-called 'populist' political parties worldwide. These all give expression to the anger and discontent of those 'left behind' by financial globalisation, and have led to the rise of nationalisms, authoritarianism and, in parts of Europe, even fascism.

The aim of a progressive government must surely be to resist these ugly forces and restore social and economic stability and justice. To do this will mean management of a globalised financial system that currently fuels inequality and causes regular financial and economic failures, sovereign debt and austerity crises, and associated falls in living standards and job losses. Management of the financial system – at both domestic and international levels – will end regular bank failures and bailouts. It will bring an end to the relentless rises in asset prices and other international imbalances in both trade and capital flows. Management of cross-border capital flows will enable governments to tax big corporations.

The era of deregulation

Financial deregulation came about as monetarist policies turned Keynesian theory and policies on their head. John Maynard Keynes was above all a monetary theorist and not, as he is routinely derided by both friend and foe, 'a tax and spender'. He regarded fiscal policy as an emergency backstop, to be used in cases of crisis. But most important of all, he argued it was the responsibility of the public authorities to avoid and prevent crises, especially financial crises.

Keynes's overwhelming concern with monetary theory and policy had evolved during and after the crisis of the Great Depression. From that he learned that managing the financial system was vital if the economy is to thrive, and if private and public debts are to be affordable and balanced. His enemies were, and are today, supporters of *laissez-faire* policies for 'light touch regulation' that left management of the financial system to the 'invisible hand' – to unaccountable investors in capital markets.

Central to the management of both the domestic and international financial system, Keynes argued, was *the management of cross-border capital flows.*

> *"Nothing is more certain that the movement of capital funds must be regulated; - which in itself will involve far-reaching departures from laissez-faire arrangements."*
>
> (Collected Works Vol XXV, p. 31, 8 September 1941: memorandum: 'first shot at post-war currency policy').

The Nixon Shock and the revolt of the 'Globalists'

Monetarists and other orthodox economists disagreed vehemently with Keynes. In the 1960s and 70s they capitulated to the interests of Wall St and the City of London and lifted controls over cross-border flows of capital. In 1971 President Nixon unilaterally dismantled the international financial architecture constructed by Keynes and other economists at Bretton Woods.

Decades earlier, President Roosevelt had convened a conference of economists from countries in both the North and South, and was determined to exclude bankers from the deliberations. The economists present had all lived through and learned the lessons of the

Great Depression and a devastating World War. They were determined to construct an international financial system that would end the dominance of bankers in determining economic policy, guarantee stability and that would end imbalances in trade between nations.

Those lessons were quickly undone by 'the globalists'.

The 1970s inflation: blaming the workers

After 1971, the international financial system was gradually deregulated and skewed towards speculative, rent-seeking activity. This resulted in successive inflations and deflations of asset prices, and in the massive inflation of debt at a global level – both private and public.

The cause of the inflation was and is financial deregulation.

Under a 1971 scheme known as *Competition and Credit Control*, British bankers were freed up by the Heath government to lend 'easy money' at *high real rates of interest*. They took the opportunity to increasingly lend for speculative activity, including lending aimed at property. Bankers preferred to lend to these as only the riskiest, most speculative ventures commanded high rates of interest, and were most profitable.

This expansion of commercial bank credit led to "too much money chasing too few goods and services". Loss of control over bank lending became a key factor in the rise of inflation, and the simultaneous switch to flexible exchange rates another. Credit expansion between 1971 and 1974 fuelled consumption and led to a 35% rise in consumer prices, and to a fall in sterling. Import prices rose by 79% and wages tried to keep up. This inflation was and still is blamed on workers – and on the economist most opposed to loss of regulatory management of the exchange rate and credit creation, John Maynard Keynes. While wage rises exacerbated inflation, workers were not *the cause* of spiralling inflation. Bankers, central bankers, neoliberal economists and weak politicians were.

The result was as Keynes had predicted: rampant inflation of prices and of debt, followed by the inevitable deflation of debt, wages and prices, and increasingly frequent financial crises.

Have lessons been learned?

Despite the recurrence of financial crises since 1971, and despite the 2007-9 Global Financial Crisis and its aftermath of sovereign debt crises, austerity, recession and rising inequality, nothing has been done by governments or regulators to transform the system. The deregulated, international financial architecture is as volatile and dangerous as it was before the crisis. Rising interest rates, and the massive inflation of private and public debt once again pose a threat to the global economy. Countries like Argentina, Turkey, South Africa and Indonesia are already battling volatile currency moves and sovereign debt crises. Commentators once again see the emerging market crises as a harbinger for countries at the core of the global economy – i.e. the Anglo-American economies.

Thanks to the maintenance of a system of unfettered financialisation, global debt rose by over $8 trillion in the first quarter of 2018 to more than $247 trillion or 318% of GDP. That is almost double the level of debt which imploded and caused the crisis of 2007-9. Then, global debt stood at $142 trillion in 2007 and at 269% of GDP, according to McKinsey. The scale of the world's debt is frightening.

The *Financial Times'* Gillian Tett has documented how the power of bankers is today increasingly concentrated in the hands of the few. America's top five banks (and all banks are global in their activity) control 47% of banking assets compared to 44% in 2007 (28% in 2000), while the top 1% of mutual funds hold 45% of the industry's financial assets.

The "shadow banking" sector operates beyond the reach of regulatory democracy. Unlike traditional high street banks, shadow banks remain unregulated, even while they lean increasingly on the resources of taxpayer-backed central banks. In 2010, and on a conservative definition, the shadow baking sector controlled 13% of the world's financial assets: $28 trillion. Today the sector controls a whopping $45 trillion of the world's financial assets – in other words the world's pensions and savings.

Finally, while financial institutions have had to cough up fines of more than $321 billion since the crash, the only bankers who have done jail times are those that committed crimes unrelated to the crisis – like the traders who rigged the Libor rate.

Because of the failure of governments to restructure and re-regulate the international financial architecture after the Global Financial Crisis of 2007-9, and thanks to massive taxpayer-backed bailouts and guarantees, business is better-than-usual for global financiers. As Professor Vogl of Humboldt University has argued:

> "…the crisis has proved itself as a way to solidify the existing economic order… one can thus argue that the financial and economic state of emergency in recent years has given rise to a form of government action that resembles a continuous *coup d'Etat.*"

Bankers in both the traditional and shadow banking system continue to lend speculatively to the riskiest borrowers (both at home and internationally) at *high* real rates of interest. They gamble with the world's savings and pensions in the shadow banking system; and both banks and big corporations dodge regulatory democracy by moving profits across borders into tax havens.

Back in June 1944, Labour's National Executive Committee demanded that "finance must be servant, and the intelligent servant, of the community and productive industry, not their stupid master". A truly progressive government can and must remove financiers from their gilded pedestal as stupid masters of the global economy. By re-regulating, re-structuring and reforming the international financial system, finance must be restored to the role of servant to the real economy.

To restore stability both to Britain and to the global economy will require a progressive government to comprehensively tackle the "financial causes" of economic failure.

The Global Financial Crisis — what happened when?

Ann Pettifor

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1990s-2007: the sub-prime market

According to the St. Louis Fed, sub-prime mortgages totaled $65 billion in 1995. This rose to $332 billion in 2003. By 2007 the sub-prime mortgage market was worth a profitable $6 trillion to lenders. As interest rates rose, 'sub-prime' borrowers found debt repayments unaffordable. As they defaulted on debts, the bubble in sub-prime mortgages began to burst and property prices started to fall. As asset prices fell, bankers and investors *lost confidence in the value of the full range of assets* (collateral) parked on the financial statements of banks and financial institutions.

1990s–2007: Derivatives, or 'financial weapons of mass destruction'

In the late 1990s, Wall St and City of London financiers hit upon the wheeze of bundling up a mixed group of mortgages, including sub-prime, into new financial products, and selling them on to investors as 'derivatives'. (Derivatives, dubbed "financial weapons of mass destruction" by the billionaire Warren Buffet, are financial products. They derive their value from an underlying asset – a property, car or indeed another financial asset.)

The model on which the new derivatives were constructed was known as the *Originate-to-Distribute Model*. In other words, bankers did not just *originate* loans; they began to bundle up, re-package and *distribute* the new loans (securities) to other investors for additional financial gains. The resulting degrees of separation and ever-increasing complexity of derivatives obscured the building risk in the system.

Central bankers and Treasury officials in both the US and Europe had turned a blind eye to this new form of 'financial engineering'. They did not understand how *deeply intertwined financial and sub-prime property markets had become.* They did not understand that risks were being distributed more widely. Fed governor Alan Greenspan argued that these new financial products did the very reverse: they made the system *safer!* In a speech on 5 May, 2005 he had argued that (emphasis my own):

> "The use of a growing array of derivatives and the related application of more sophisticated approaches to measuring and managing risk are key factors underpinning *the greater resilience of our largest financial institutions*, which was so evident during the credit cycle of 2001-02 and which seems to have persisted.
>
> *Derivatives have permitted the unbundling of financial risks.*"

2003-7: interest rates ratcheted up

Interest rates had risen steadily over the period 2003-2006. In July 2007 the UK Bank rate was fixed by the MPC at 5.75%. The Federal Open Markets Committee (FOMC) had raised the Federal Funds rate to 5.25% where it remained until June, 2007. Steadily rising interest rates came to resemble a sharpened 'dagger' pointed at a massive bubble of 'easy' private debt. The puncturing of these debts was to lead to a 'credit crunch'.

2007: the first dominoes fall

The collapse of the housing market caused the crisis to rumble on from 2006 and into 2007. In April 2007 a US bank specialising in sub-prime mortgages, New Century Financial, filed for bankruptcy and cut half its workforce. Because it had sold many of its toxic mortgages to banks around the world, its failure and the collapse of the sub-prime market began to undermine the *global* financial system.

Then Bear Stearns, a global investment bank heavily involved in the securitisation of sub-prime mortgages, announced in July 2007 that investors in their two hedge funds would make substantial losses from the collapse of the sub-prime market. This was the beginning of the end for Bear Stearns which, valued at $18 billion in 2007, sold a year later for just $240 million to its rival, JP Morgan Chase.

9th August 2007: 'Debtonation day'

BNP Paribas, a French international investment bank, warned investors that "the complete evaporation of liquidity" in securities markets "made it impossible *to value* *certain assets fairly*, regardless of their quality or credit rating." As a result investors would not be allowed to withdraw their funds from BNP Paribas. This announcement – that assets could not be valued fairly and investors faced a wipeout - was a major shock to the international banking system, and caused private bankers *to freeze their lending* to other banks. This was unprecedented. Trust in the system had evaporated. Bankers were not prepared to accept as true the valuation of assets held on balance sheets by other bankers.

It was at that moment taxpayer-backed central bankers intervened. The European Central Bank (ECB) was the first, and pumped €95 billion (£63bn) into the global banking system, adding another €108.7bn over the next few days. The US Federal Reserve, the Bank of Canada and the Bank of Japan also began to intervene.

At that point the private commercial bank rate of interest (known as the London Interbank Offer Rate (LIBOR) and governed by the British Bankers Association) rose to a whopping 6.79% - way above the Bank of England's rate of 5.75%. This was the clearest indication that fear was driving private lending rates up.

September 2007: Britain's Northern Rock relied on borrowing from international capital markets to fund its own lending. As the cost of borrowing rose it became unaffordable for Northern Rock to borrow, and liquidity quickly dried up. The bank had to turn to the Bank of England for emergency financial support. Panic ensued, and the day after, on 13th September 2007, depositors withdrew £1 billion from Northern Rock and caused the biggest run on a British bank in a hundred years.

October 2007: Remarkably the Royal Bank of Scotland, apparently oblivious to the crisis in the international system, negotiated as part of a consortium the £58 billion takeover of a Dutch bank ABN Amro – riddled with sub-prime assets – *in the biggest deal in financial services history*. That did not take long to unravel. Central banks began to cut interest rates, but still acted too slowly.

January 2008: On 21 January, global stock markets crashed. £77bn was wiped off the value of the City's blue-chip stocks in the biggest one-day points fall in London's history. The next day (22 January), the Fed cut rates by three quarters of a percentage point to 3.5% - the biggest cut in 25 years. And still the crisis rumbled on.

February 2008: On 22 February, the Labour government announced the nationalisation of Northern Rock.

April 2008: Nearly a year after 'debtonation day', the Bank of England began the far-too-slow process of cutting rates - to 5% - and announced that it planned to provide £50 billion to banks through a scheme where financiers could swap mortgage-backed assets for safe government bonds.

August 2008: Ten months after the ABN/AMRO takeover, RBS announced a half-year loss of £691 million – the biggest loss in its history.

By August, house prices in the UK had fallen by 10.5% in the preceding 12 months, according to Nationwide.

September 2008: Unemployment in the US had risen to more than 6%.

On 10th September 2008, Lehman Brothers posted a loss of $3.9 billion for the three months to August. On the following day, the US Federal Reserve announced an $85 billion bailout package for the US's biggest insurance company, AIG (which, as an insurance company, should never have had an account with the Fed).

On 15 September, Lehman Brothers filed for bankruptcy protection, the first major global bank to collapse. The crisis of the self-regulating, market-based financial sector had now pushed the global financial system to the brink of collapse. There was real doubt in the halls of power in Washington and London that banks would open to the public on the following Monday.

On 17 September, Prime Minister Gordon Brown defied competition rules and helped facilitate a Lloyds TSB takeover of the UK's biggest mortgage lender, HBOS – which created a banking giant.

On 29 September, mortgage lender Bradford & Bingley was nationalized, with the government taking control of the bank's £50 billion mortgages and loans, while its savings operations were sold to Spain's Santander.

October 2008: RBS shares had plunged by 40%. Gordon Brown announced the biggest bailout of a private corporation in Britain's history. The UK Treasury purchased £37 billion of shares in RBS and Lloyds Banking Group (£2.5 billion of preference shares in Lloyds Banking Group were subsequently redeemed) and in November 2009, agreed to purchase up to an additional £39 billion of shares in both of these banks.

Government support for Britain's banks reached a staggering £850bn and the eventual cost to taxpayers remained unknown.

In the US, after the shock rejection by Congress of an earlier demand for bailouts, and after stock market investors staged a strike, the US House of Representatives agreed a $700bn taxpayer-backed rescue plan for Wall St on 3rd October 2008. In the UK, the government used taxpayer resources to raise the limit on bank deposit guarantees to £50,000.

November 2008: On 24 November, the British Chancellor Alistair Darling announced a £20 billion fiscal stimulus for 2009/10, highlighting his fears that "the current recession could turn out to be deep and extended".

December 2008: The Federal Reserve cuts its interest rate to 0.25% in an attempt to stem the deepening recession. It is the lowest rate in the history of the Fed. The central bank also begins to consider a programme of quantitative easing.

More US workers lost jobs in 2008 than in any year since World War II, with employers axing 2.6 million posts and 524,000 in December alone.

January 2009: The Bank of England cuts the Bank Rate to 1.5%, the lowest level in its 315-year history.

February 2009: The US Congress passes a $787bn fiscal stimulus package. Nationalised RBS announces massive losses for 2008, totaling $34.6 billion. The results are the worst in British corporate history.

March 2009: The Governor of the Bank of England, Mervyn King, warned in evidence to a Treasury Select Committee that the government's deficit was rising, and cautioned against any further stimulus in the forthcoming budget.

On the same day, Gordon Brown had a tense meeting with José Manuel Barroso, arguing against him that Europe had not done enough to revive the EU economies, and that the upcoming G20 Summit may have to make further decisions on stimulus. (Today Barroso is a non-executive Chairman of Goldman Sachs.)

The Bank of England began a programme of asset purchases known as quantitative easing. Financed by digitally created central bank money, the Bank bought government bonds from private sector institutions like high street banks and pension funds, with the aim of injecting a large monetary stimulus into the economy. Between March 2009 and the end of January 2010 the Bank purchased a total of £200 billion assets, an amount equivalent to about 14% of UK GDP.

April 2009: At a G20 Summit on 2 April convened by Prime Minister Gordon Brown, world leaders pledged an additional $1.1tn (£748bn) in to help emerging market countries and promised coordinated action to fight the slump and improve regulation. "This is the day that the world came together to fight back against the global recession, not with words but with a plan for global recovery and reform and with a clear timetable." Gordon Brown declared the summit a turning point in the crisis, and said the meeting marked the emergence of a "new world order". Stock markets begin to revive. However, not all the money pledged is actually delivered.

On 22 April the UK Chancellor Alistair Darling reveals that the Global Financial Crisis led to the largest budget deficit in UK financial history of £175bn, with total government debt set to double to £1 trillion by 2014.

July 2009: At a G8 summit, leaders of the world's richest countries were divided over a concerted strategy to boost the global economy. Germany's Chancellor Angela Merkel expressed concerns about rising borrowing and future inflation. Gordon Brown argued that such concerns were premature when the world still faced economic failure as rising oil prices, protectionism and high unemployment could undermine a fragile world economy. President Obama hedged his bets: his administration made provision for further stimulus measures, but he argued spending more borrowed money was "potentially counterproductive".

August 2009: Deflation raises its ugly head as the Eurozone's annual rate of inflation turns negative for the third consecutive month.

September 2009: The world's largest economies have spent $10,000 for every person in a bid to fix the financial meltdown of the past year.

October 2009: The IMF announces that the global economy is expanding again and financial conditions have improved significantly.

Consequences of the crash

Michael Davies

Photo: Lena Vasiljeva via Flickr (CC BY 2.0)

The following is a list (not intended to be a comprehensive) of the harms that can reasonably be attributed to the Global Financial Crisis and ensuing Great Recession. We focus here on the macroeconomic effects of the crash and slow recovery.

Worldwide:

GDP: "[T]he lost growth resulting from the crisis and ensuing recession has been estimated at over $10 trillion (over one-sixth of global GDP in 2008). The year 2009 became the first year on record where global GDP contracted in real terms." (Chatham House)

→ **Employment:** Between 2007 and 2009, there was an unprecedented global increase in the number of unemployed people from 164m to 188m. The quality of employment also deteriorated, in both the Global North and South.

- **Finance sector:** Over $2 trillion of assets from financial institutions had to be written down in the aftermath of the crisis. A number of financial institutions either had to be bailed out by governments or went bankrupt, not least Lehman Bros.

United Kingdom:

GDP: Between the first quarter of 2008 (2008 Q1) and 2009 Q2, the UK's GDP shrunk by more than 6%. The imposition of austerity in 2010 nipped a nascent recovery in the bud. GDP only reached its pre-crisis levels in 2013 Q3. This constitutes the slowest recovery from recession in over 300 years.

- GDP per capita, a better indicator of living standards, only recovered to pre-crisis levels in 2015 Q2.

- Activity in some sectors hasn't yet recovered to pre-crisis levels, e.g. manufacturing.

Employment: The number of unemployed people in the UK rose from 1.6m in 2008 to almost 2.7m in late 2011. The unemployment rate only reached its pre-crisis level in 2015. Despite further falls in the unemployment rate since then, real wages have still not reached their pre-crisis peak, marking the longest period of wage stagnation in two centuries.

The increase in employment since the crash has largely been driven by a rise in low-paid, insecure work. Between 2011 and 2015, for example, the number of people on zero hours contracts quadrupled.

Similarly, *underemployment* (people working fewer hours than they would like to) remains high. In short, job quality has diminished.

Investment and productivity: The UK experienced the largest proportionate fall in gross fixed capital formation (a measure of investment in non-financial assets) in the G7. It has recovered since, but continues to have the lowest private sector GFCF share in GDP in the whole OECD.

The (partially historic) lack of investment in the UK has contributed to our productivity problem. Productivity (output produced per hour of work) is an important indicator of an economy's health, but productivity growth has flatlined in the UK since the Great Recession. Had the pre-recession trend continued, productivity would be 20% higher.

The Office for Budget Responsibility severely underestimated the effect the recession and austerity would have on business investment and productivity, and therefore on the long-term effects of a slow recovery on the UK economy.

Double jeopardy: the crash plus austerity

Professor John Weeks

The crash

Towards the end of the 2000s, after a decade of expansion, the gathering storm of financial instability plunged the major market economies into a severe downturn. In 2009, the US economy was almost 3% smaller than in 2008, as was France's; Japan's was almost 5.5% down; Germany's over 5.5% smaller; and Britain's contraction over 4%. The recession was the most severe in the sixty years since the end of WWII.

This crash of output and employment had clear cause: the deregulation of financial capital, most extreme in the United Kingdom and the United States, and less but sufficient in the other large economies to provoke destabilising speculative booms. Equally clear was the trigger mechanism that set free the underlying causality: speculation on so-called sub-prime mortgages in the United States, contracted by financial corporations in North America and Europe without sufficient attempt to identify the risk inherent in these derivatives (financial paper well removed from the underlying real asset).

For half a decade heterodox economists had warned of the ticking bomb of financial deregulation, warnings unheeded by mainstream economists and policy makers who spoke of the "Great Moderation" (putative end of boom and bust) and "The New Economy" (the alleged stability of services replacing manufacturing).

This belief that the rise of financial activity creates stability and moderation brings to mind what J M Keynes wrote at the end of *The General Theory*: "Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back."

The deficit

As one familiar with basic economic causality would predict, the crash drove down corporate revenues and household incomes. As incomes and profits declined, the taxes paid out of those profits and incomes also declined. From 2008 to 2009 total public sector revenue (in nominal terms, excluding public sector banks) dropped by over 5%, corporation tax revenue by almost 25%.

While revenues fell, public spending rose automatically as a result of more payments to the newly unemployed, increased demand for means-tested subsidies for accommodation, and other recession-related social support. This recessionary combination, falling revenue and rising social support, represented the economy's counter-cyclical reaction, the automatic process by which our economy seeks to moderate a severe downturn.

As a result of these 'automatic stabilisers' (and the aggressive efforts to counter the collapse, as discussed below) the fiscal balance of our central government, spending minus revenue, dropped from minus 2.8% of GDP during fiscal year 2007/2008 to minus 9.9% during fiscal year 2009/2010. This change in the fiscal deficit was not a problem requiring a policy solution; on the contrary, it was part of the solution that prevented even more extreme economic collapse.

The contraction of the economy was the overwhelming policy problem from the beginning of 2008 to the middle of 2009. The growing fiscal deficit helped to solve that problem, because it meant that private expenditures fell less than tax revenue, and expenditures by government rose. These expenditure effects sustained demand. To put it simply, income losses by households and businesses were partly transferred to the public sector, appearing in the expanding fiscal deficit.

In addition, the Labour government of Gordon Brown increased public investment in real terms by over 50% between 2007/8 and 2008/9. Thanks to this stimulus package and the functioning of the automatic stabilisers, economic decline ended in the third quarter of 2009 and recovery continued through to the second quarter of 2010.

Austerity

A terrible blow struck the British economy in 2008, triggered by the speculation by banks and other corporations that financial deregulation facilitated. By the end of 2009, sensible Keynesian fiscal and monetary policies and automatic adjustment mechanisms had turned decline into recovery. The election of May 2010 brought a government to power that implemented contractionary fiscal policy, "austerity", stifling the emerging recovery.

The new Conservative Chancellor George Osborne 1) terminated the public investment expenditures that fostered recovery, 2) through tax changes weakened the automatic adjustment mechanisms that contributed to stability, and 3) justified these dysfunctional policies with rhetorical appeals to "living within our means". He proved successful in all three tasks, together the implementation and advocacy of austerity.

Osborne justified his fiscal austerity as necessary for reviving the British economy. In fact, it had the opposite effect; the UK's recovery from the recession has been the slowest in modern history. In retrospect it is difficult to avoid the conclusion that the devastating economic crash, with all its human suffering, was used by Conservative governments over eight years to pursue an ideologically-driven attack on our system of social protection.

One of the major functions of that system is protection of citizens against the instabilities inherent to market economies. However, Conservative governments have misrepresented this social protection as a burden on taxpayers, whereby the hard-working employed support the feckless unemployed. Conservative governments used this misrepresentation to justify the policies that both delayed recovery and undermined programmes that support the vast majority of people, many of whom were directly victimised by the Crash as a result of unemployment, falling and stagnant wages, mortgage bankruptcies and gathering household debt.

Photo: Angel Torres via Flickr (CC BY 2.0)

A progressive future

The failure of austerity policies to achieve their stated goals of recovery and stability clears the way for a progressive re-formulation of macroeconomic policies. The keystone of the progressive macroeconomic programme will be active monetary and fiscal policy to achieve full and productive use of our national resources with strong wage growth and well-funded public services.

The consequences of austerity in the UK

Michael Davies

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Austerity policies have had disastrous consequences wherever they have been applied. The most egregious recent example is Greece, where austerity measures imposed from without have strangled the economy and torn apart the country's social fabric. More examples can be found in the following section; here we focus on the UK's experience of austerity.

→ **Economic cost:** PEF Council member and Oxford Professor Simon Wren-Lewis has estimated the cost of austerity in itself to be ~15% of present-day GDP, or £10,000 per household.

→ **Healthcare:** Public health experts writing in the peer-reviewed BMJ Open journal have linked cuts to health and social care to 120,000 excess deaths between 2010 and 2017.

- Between 2011 and 2016, the UK experienced one of the largest slowdowns in improvements in life expectancy compared to similar countries.

→ **Prisons:** Spending on prisons fell by 22% between 2009/10 and 2016/17; the number of prison officers fell by 25% over the same period.

- Meanwhile, the number of incidents of self-harm and assault in prisons has risen by approximately 80% since 2013.

- This August, the Ministry of Justice had to take emergency control of HMP Birmingham after an inspection found it to be in a "state of crisis".

→ **Inequality and poverty:** An analysis of tax and welfare policy changes between 2010 and 2018 has found the costs of these to be disproportionately borne by the poorest households, women, ethnic minorities and the disabled. By 2021, an extra 1.5m children will be pushed into poverty. Homelessness has risen by 169%.

→ **Local government:** Funding for local authorities has been cut by 49% since 2010. This has put enormous pressure on councils, especially those with social care responsibilities.

- The consequence has been wide ranging cuts to local services. An estimated 1,000 Sure Start Centres and 478 libraries have closed since 2010.

- Northamptonshire county council (Conservative-led) has been "forced to declare effective insolvency" and can now only "provide a legal minimum of service". Up to 15 other councils risk the same fate.

→ **Political consequences:** Austerity has been linked to the vote to leave the European Union. In his paper, Thiemo Fetzer (Associate Economics Professor at the University of Warwick) finds a significant statistical correlation between an area's exposure to austerity and the UKIP vote share, suggesting that cuts to public services had a substantive impact on the referendum outcome.

→ **Future impacts:** Though austerity has already caused unnecessary social harm, the pace of 'fiscal contraction' is set to rise sharply in 2018-19 and 2019-20 due to planned cuts to spending.

→ **Public finances:** trying to cut expenditure in a recession to 'strengthen the public finances' is counterproductive. As a result, the Conservatives have repeatedly missed their deficit targets and public sector net debt has increased by approximately 20% of GDP since 2010.

- The issue is not the rise in public debt - if the government had borrowed for a major green infrastructure programme and in doing so the debt increased, this would have been great. The problem is that there is nothing to show for it; the debt has risen largely because economic activity has stagnated, not because of productive investment.

The failures of austerity: a brief history

Patrick Allen

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Mark Blyth, Professor of Political Economy at Brown University, gives the following account of austerity:

> *"Austerity is a form of voluntary deflation in which the economy adjusts to restore competitiveness through the reduction of wages, prices, and public spending, which is (supposedly) best achieved by cutting the state's budget, debts, and deficits. Doing so, its advocates believe, will inspire 'business confidence' since the government will be neither 'crowding-out' the market for investment by sucking up all the available capital through the issuance of debt, nor adding to the nation's already 'too big' debt."*

Unfortunately for its advocates, it has been tried many times in history and never succeeded. The following is a précis of part of Blyth's book *Austerity: the History of a Dangerous Idea*, focussing on countries' experiences of austerity in the interwar years.

USA

Between 1929 and 1931, tax receipts dwindled and government expenditure rose in the aftermath of the stock market crash. President Hoover saw austerity as the only way to restore business confidence and balance the budget. As the UK abandoned the gold standard, capital flowed out of the USA, interest rates rose and bank failures soared. Hoover raised taxes saying "we cannot squander ourselves into prosperity". By 1932 the unemployment rate was 23%, up from 8% in 1930.

The Roosevelt administration took a reflationary road and devalued the dollar in 1933. Unemployment was brought down to 17% by 1936 but a second round of austerity commenced in 1937 with demands to balance the budget. This again increased unemployment and caused a recession in 1937 and into 1938.

In October 1937, Roosevelt finally abandoned austerity but the US did not fully recover until wartime expenditure reduced unemployment to 1.2% in 1944.

In summary, the US economy suffered each time austerity was applied – in 1931 and 1937.

UK

Austerity commenced in 1921, before the UK returned to the gold standard in 1925. This was to preserve the value of overseas assets at the expense of the domestic economy. The squeeze on wages led to the General Strike in 1926. Unemployment rose from 10.4% in 1929 to 22.1% in 1932. There was a vicious cycle; the gold standard and austerity policies depressed the economy, which made further austerity necessary in the Treasury's eyes.

Official reserves were depleted, and the UK was eventually forced off the gold standard by 1931. The resulting devaluation helped recovery – unemployment had fallen to 15.5% by 1935 – but the economy continued to suffer. Debt went from 170% of GDP in 1930 to 190% by 1933. Unemployment remained high until rearmament. The result of austerity: real output in 1938 was barely above the level of 1918.

Germany

The hyperinflation of 1923 was a deliberate policy by the German state, in particular its central bank, to make the payment of reparations to France impossible. It was successful in this aim and was ended with the issue of a new reichsmark in 1925. The German economy performed well in the following four years, but was dependent on US capital inflows. These were switched off in 1929 with the crash.

The Germans raised interest rates in response, while their official reserves fell. The Social Democrat Chancellor Brüning introduced austerity policies – large budget cuts. The social democrats (SPD) began to lose support to the national socialists, who opposed austerity, yet they persisted. At the 1932 election, the Nazis' policy platform was firmly anti-austerity, e.g. "job creation stimulates the economy". The SPD vote collapsed, Nazis got 37.3% of the vote and in 1933 43.9%.

In 1932 unemployment was 30%. By 1936 full employment had been restored. Real wages did not increase due to labour repression. Work creation schemes were just propaganda; in reality, the economic boom came from the ending of austerity, abandonment of the gold standard and especially the drive to war. The crucial point, though, is that austerity was a key factor enabling the rise of the Nazi party – far more so than the spectre of hyperinflation from a decade before, as is often claimed.

France

During WW1, France suffered the most widespread destruction of persons, property and wealth. Germany would not pay reparations, and after the hyperinflation period did not pay. Political differences within the government and the Bank of France prevented any reflation or expansion of the economy. France went back on the gold standard in 1926.

After the Wall Street crash, GNP fell 7%. The Bank of France (then a private institution) demanded cuts and a balanced budget. From 1932 to 1936 spending was cut by 20%. France abandoned the gold standard in 1936, but spending was not increased to assist the devaluation. The Bank of France vetoed budget increases, including those which would have allowed the French military to modernise and mobilise to meet the German threat. Defence spending between 1934 and 1938 was one tenth that of Germany. Defence cuts were called for in 1940. Austerity thus contributed to the defeat and occupation of France.

Japan

Japan suffered relatively little from WW1, but had a fragile banking system and much pent-up inflation. It was also dependent on imports, and so ran the risk of further inflation if it devalued.

In response, austerity was applied with high interest rates, leading to a crash in 1920. Growth vanished, successive rounds of austerity made it worse. Japan returned to the gold standard in 1930 as the rest of the world was contracting, causing the greatest peacetime collapse in economic activity in Japan's history: -9.7% in 1930 and -9.5% in 1931.

Interest rates were raised again and government spending was cut by 20%, with military spending cut the most. In 1930 the Prime Minister was assassinated. In 1931, there was an army plot to overthrow the government. In 1932, a new government left the gold standard, and government spending increased. The economy rocketed forward, growing 4% a year from 1932 to 1936. But the Japanese military were convinced they were at war with the political elite after 10 years of austerity. There were several high profile banker and political assassinations, and eventually the military took over. In summary, austerity created the worst depression in Japanese history, led to an assassination campaign against bankers and politicians, and empowered the military that brought about Pearl Harbour.

Sweden

The post-WW1 economy was difficult for Sweden. There was strong deflation, a 25% decline in industrial output, and a rise in unemployment. Real wages fell 35% between 1920 and 1922. The social democrats (SAP) proceeded with austerity, seeing no alternative. Then in 1924 Sweden returned to the gold standard. GDP fell and unemployment rose further, each by a third. There was huge industrial unrest. Unemployment stood at 25% in 1932.

The SAP were re-elected and abandoned austerity. A new policy - spending on public works – was applied with price stability and full employment targeted. There was a 1936 commission to use surpluses to reduce government deficits - the arrival of countercyclical fiscal policy. Taxation was fixed to stimulate investment. It worked. The economy recovered. Swedish austerity disappeared.

Conclusion

More recent examples of the failures of austerity can be found across Europe. Indeed, there appears to be no recorded case in history where austerity policies – cuts to public spending, increased taxation and attempts to balance budgets – have succeeded in bringing about prosperity.

The reverse is true. Austerity appears to predictably harm economies, and to be a cause of civil unrest and instability; in extreme cases, it can lead to takeovers by far right or populist governments, as shown above. When austerity ends, economies return to prosperity. And so in implementing austerity, the Conservative government demonstrably acted in ignorance of history.


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Debt, households & the crash

Dr Johnna Montgomerie

Ten years on from the Global Financial Crisis, we are still in the grip of the "debt economy" that caused the crash, without any end in sight. Britain's debt economy is characterised by an overlapping set of dependencies on private debt - of financial institutions (as a major source of profit), of households (to sustain their standard of living), and of governments (to expand economic activity). Households are a central pillar of debt-led growth due to their monthly remittance of present-day income into global financial markets, through payments on their mortgages and consumer loans. Meanwhile, wealthier households have income claims on financial securities backed by the debts of poorer households.

From this constellation of forces, private or household debt has become a vehicle for governments seeking to bolster economic activity, for financial institutions seeking capital gains, and for the wealthy who want high returns on their financial assets. At the same time, private debt has become a poison pill for an ever-growing number of households by destroying their financial security. As incomes stagnate, the burden of debt becomes more onerous.

Austerity and low wages have cemented this private debt dependence, yet there is a strategic silence around it - everyone knows household debt is a major cause of entrenched economic malaise but no one currently in a position of power is willing to do anything about it. Rather, in a cruel political sleight of hand, household debt is reduced to a personal problem or failing, ignoring the stark reality that the UK economy is as dependent on household debt as individuals are. Instead, public debt is framed as the key concern for policy makers, distracting from the perils of historically high private debt levels.

Looking at the basic measures of household debt in the UK shows a clear trend (graph 1). Debt levels grew fastest in the first years of the millennium driven by residential mortgage debt, then levelled off in the crisis years, before growth in debt picked up again in 2014. The total stock of household debt grew as a proportion of GDP from

62% in 2000 to 96% in 2010 (its peak relative to GDP) only to slowly slacken over the next eight years to 87% of GDP today. The latest research by the Office for National Statistics reports that UK households have seen their outgoings surpass their income for the first time in nearly 30 years; on average, each UK household spent or invested around £900 more than they received in income in 2017. This imbalance isn't evenly distributed – only the poorest 20% are net borrowers on average.

Debt is not a problem for everyone. The top 5% have done very well from their highly-leveraged investments. For this group, debt is a source of wealth (for example, buy-to-let landlords). For a growing number of people, debt allows them to participate in the economy; for the young to get a university education or buy a first home, very high debt levels are a necessity. For them, debt is the means to achieve a middle-class lifestyle. For some people, debt is how they pay their bills from month to month; debt is for consumption. For others - elderly households, those living alone, single-parents, and low- and middle-income households - debt is a safety-net.

In the UK, debt incurred during unemployment is a leading cause of financial distress. People with relatively small debts struggle and are most likely to experience harm from debt, which stems from the material and emotional sacrifices required to meet their repayments. Stagnating incomes compound the strain of servicing debts.

Most households have no direct financial investments and, instead, use their primary residence (a non-financial asset) as their main source of wealth. Debt linked to wealth generation via the primary residence is a major source of legitimacy for finance-driven growth because it connects a large segment of the population (~65% of Britons are homeowners) to credit-fuelled asset bubbles. Mortgage debt is excused as long as house prices continue to rise. The problem is that prices cannot increase forever, especially without wage growth. This is the leading cause of the housing crisis.

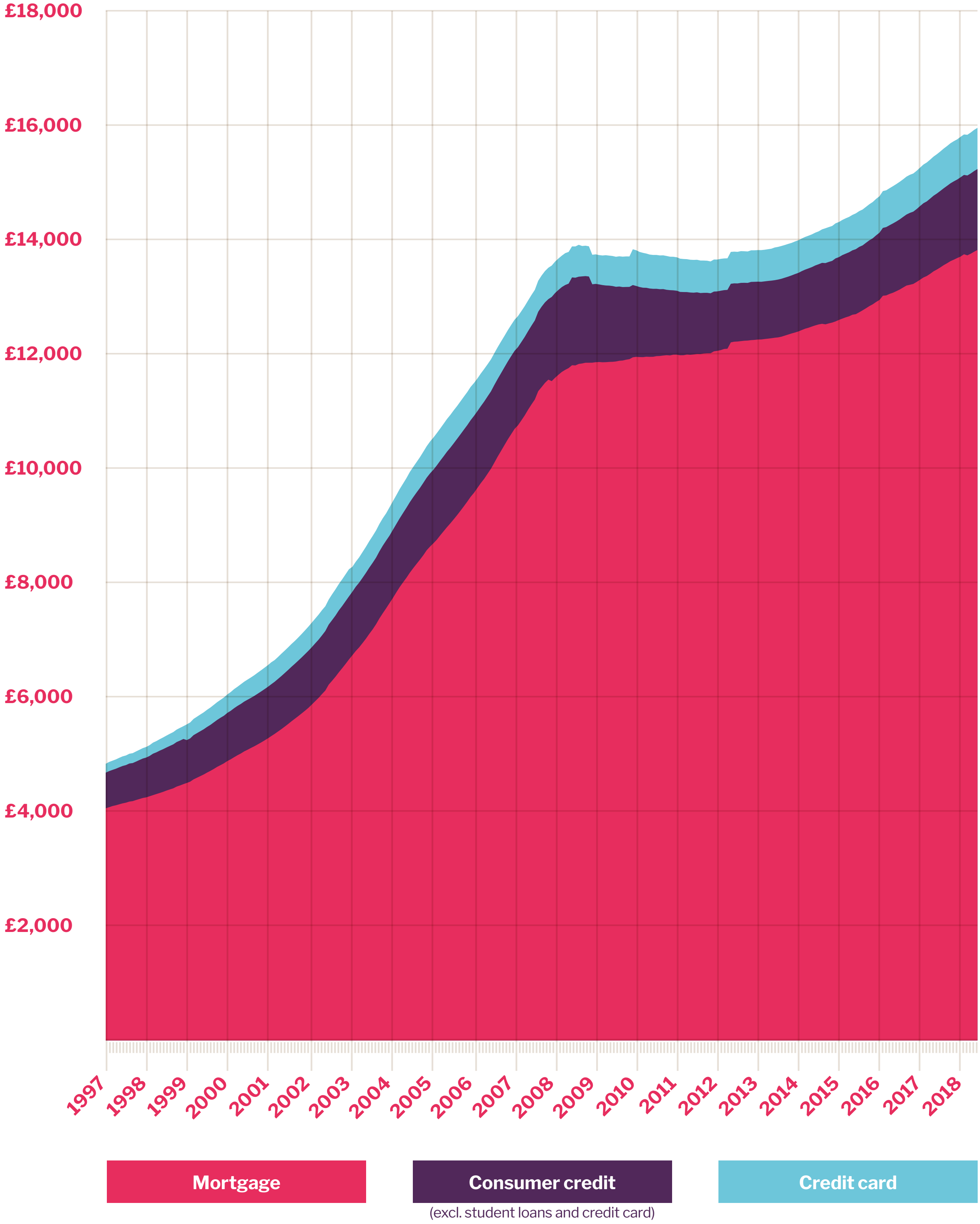
Debt is not universally a bad thing for households if it can be serviced without financial distress. There is no use trying to find a precise point at which a 'good' amount of credit becomes a 'bad' amount of debt. Bad debt results from high rates of interest, and sudden declines in household income. What is more important to understand is that debt benefits (or hurts) segments of the population unevenly.

Private debt dependency cannot last

The debt economy creates a vice-like grip of countervailing forces. For example, if everyone struggling with debt decided to pay down outstanding debts, the reduction in expenditure would plunge the national economy into a depression, with the global economy likely to follow closely behind. However, if every person struggling with debt continues to take on more debt to maintain a certain standard of living, soon there will be rising insolvency rates.

Currently, most households keep up debt repayments. By doing so, they bleed today's economy of its vitality by regularly remitting a growing portion of their current income to pay debts that have fuelled past economic activity. If, or when, the same people who are today able to service their debts become (for whatever reason) unable to make these regular repayments, a worse scenario unfolds. Rising default rates on any one of

Graph 1: Levels of UK household debt (1997—2018)



Source: Bank of England: LPMVTXK outstanding lending secured on dwellings, LPMB4TS outstanding consumer credit (excluding student loans and credit card), LPMVZRJ outstanding credit card lending. (All seasonally adjusted.)

the many types of loans households have adds to the portfolio of non-performing loans on bank balance sheets.

As the 2008 financial crisis revealed, the elaborate network of financial claims flowing through the global financial system is fragile, and vulnerable to defaults on even small-scale retail loans, as exemplified by the fallout from the US subprime mortgage crisis. Rising default rates on a small portfolio of retail loans could, once again, spark another firestorm that would blaze across global markets.

A progressive government must choose to break the strategic silence about private debt and act to end the chronic dependence on household debt in economic policy making. There must, finally, be better regulation of retail credit markets and household debt or it will continue to be an easy source of big profits for lenders, without regard for the harm it causes the economy and society. By doing so another economic future becomes possible.

Again, consumer debt is not all bad; it has its role to play in an expanding economy. The problem is that consumer debt is being incurred because wages and salaries are insufficient to cover day-to-day needs. People are going into debt simply to exist, to pay bills such as rent and food. This is unsustainable.

To move to a sustainable position, we need proper investment in our economy, which would allow real incomes to rise. Stagnant or falling incomes will inevitably encourage or require people to go into debt to make ends meet. This debt cannot be sustained and will become unaffordable with any significant increase in interest rates.

Twists, turns and hypocrisy: the false Tory narrative

Patrick Allen

The Conservatives have on many occasions stated that the 2008 crash was caused by Labour's profligate spending. PEF council member Simon Wren-Lewis responds to these claims as follows:

> *"The idea that fiscal policy under Labour was profligate (as opposed to mildly imprudent) would not be something that most economic journalists would sign up to. They know that the 2007-8 budget deficit of 2.7% of GDP is only about 1% of GDP away from the sustainable deficit with a 40% GDP target, and 1% of GDP is very little given the errors involved in predicting deficits. They also probably recall that in 2007 the consensus view was that the UK economy was pretty close to trend. So the profligacy charge is nonsense."*

In this appendix, we see how the Conservative narrative on Labour's handling of the Global Financial Crisis has mutated and twisted over time.

What were the Conservatives saying before the crash?

To suggest that the world wide Global Financial Crisis, a worldwide banking crash which came as the conclusion to decades of financial deregulation, was in fact caused by the UK Labour government and its public spending is manifestly absurd.

Moreover, this is quite the departure from the Conservatives' overtures to the electorate before the financial crisis, in which they promised to match Labour's spending. From the Telegraph in September 2007:

> *"The Conservatives sought last night to destroy Labour claims that they would cut public services by issuing a formal pledge to match Gordon Brown's spending plans.*
>
> *In an echo of New Labour's own 1997 manifesto promise to match the Tory Government's projected spending levels, George Osborne vowed last night to stick to Gordon Brown's plan of increasing public spending by 2 per cent in real terms over the next three years.*
>
> *"Today, I can confirm for the first time that a Conservative government will adopt these spending totals," the Shadow Chancellor said."*

Still, the Conservatives might hold Labour at least partially responsible for the crash – after all, they were in power while risk in the financial sector was allowed to build up to crisis levels. Of course, the Blair government is to be criticised for its light touch approach to financial regulation.

But as late as 2007, the Conservatives were calling for even less regulation of banks and the financial system than Labour. A report produced by the Conservative Party - endorsed by Cameron – called *Freeing Britain to Compete* recommended that a vast range of regulations on the financial services industry should either be abolished or watered down, including money-laundering restrictions affecting banks and building societies. Some selected quotes from the report:

> *"We see no need to continue to regulate the provision of mortgage finance, as it is the lending institutions rather than the client taking the risk…"*
>
> *"The (Labour) government claims that this regulation is all necessary. They seem to believe that without it banks could steal our money… "*
>
> *"A Conservative government should relax banking regulation, allowing a new breed of venture/micro-credit institutions…"*

What did they say during and after the crash?

This all stands in stark apposition to their rhetoric just a year later. From the Telegraph in 2008:

> *"While defending his decision to approve Mr Brown's rescue package for Britain's banking sector, Mr Cameron added that he wanted to make "crystal clear" that this was as far as his party's support would go.*
>
> *"This crisis has highlighted just how mistaken Labour's economic policy has been," Mr Cameron said in a speech in the City of London.*
>
> *Accusing the Prime Minister of spending and borrowing "without restraint", Mr Cameron said: "The economic assumptions that Gordon Brown made in the last decade now lie in ruins."*
>
> *He accused the Prime Minister of making disastrous decisions in two key areas: first, encouraging a debt-fuelled bubble in the private sector, the bursting of which had caused the downturn and second, a failure to control public spending which had left Britain unable to deal with the downturn when it struck."*

Elsewhere, Cameron relied on misleading analogies between household and government spending and appeals to 'responsibility' to push his plans to cut public services, for example:

> *"This government has maxed out our nation's credit card—and they want to keep on spending by getting another. We believe we need to get a grip, be responsible and help families now in a way that doesn't cost us our future."*

Later, in 2015, Michael Gove said the following, in apparent ignorance that the expanded structural deficit was a result of Gordon Brown's emergency fiscal stimulus, itself responsible for stopping the UK from sliding further into recession (see John Weeks' essay in this volume):

> *"Gordon Brown piled up debts, took us into the recession when we had a structural deficit that was out of control."*

What Conservatives say about the crash now

In 2017, Andrew Neil interviewed George Osborne on the causes of the crash, and specifically on Labour's culpability. The change of tack is astonishing. To quote:

> **Andrew Neil:** Are you clear now looking back 10 years on the causes of the financial crisis and the crash that followed?
>
> **George Osborne:** I won't pretend that we foresaw it. It was driven by a combination of overly lax regulation, under-capitalised banks, build-up of leverage in banks…
>
> **Andrew Neil:** Can we agree that Gordon Brown and the Labour Government were not culpable for the crash?
>
> **George Osborne:** Britain was not well prepared for what happened. Public finances were not as strong as they could have been after 10 years of expansion. Did Gordon Brown cause the sub-prime crisis in America? No. And although I would have questions about some of the decisions taken in 2007-8, broadly speaking the government did what was necessary in what was a very difficult situation."
>
> **Andrew Neil:** You say the government's fiscal position after ten years of expansion going into the crash was not as strong as it could be. But as Shadow Chancellor you had promised to match Labour's spending plans. You had promised to ape their fiscal position, so there was no difference between the two front benches on this, and indeed you and many Tories were calling for even lighter regulation of the banks."
>
> **George Osborne:** It was our intention to keep financial services competitive. On spending plans... we had been criticised by Labour for cutting spending - so we agreed to match their spending. I am not critical of Alastair Darling, I am full of admiration for the way he responded.

The notion that Labour caused the crash was never sincerely held by the Conservatives; rather, this narrative allowed them to make the most of a 'political inflection point' and to embark on a programme of cuts to public services – shrinking the state in the guise of 'prudence'.

It is tempting to let sleeping dogs lie, but progressives and economists of all party allegiances should seek to defend Labour's economic record and counter the right's disingenuous rhetoric, lest there be another lurch towards austerity when the next crisis hits.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Financing investment: one way forward

Professor Stephany Griffith-Jones

The Labour Manifesto proposes the creation of a National Investment Bank (NIB). This institution would be key to major needed reform of the UK's financial sector, to increasing investment, and to making the UK economy more dynamic, fairer and greener. As a publicly capitalised institution, the NIB would be a central element of Britain's financial system. It would lend to and invest in private companies and public bodies, whilst co-financing with private banks and investors.

In many countries, NIBs (or development banks, as they are also called) provide an important instrument for implementing and funding investment for economic transformation. This ought to make them an especially attractive prospect for the UK, where the investment rate is extremely low. A British National Investment Bank could help fund, for example, green infrastructure investment and lending to small and medium enterprises (SMEs), particularly those on the forefront of technological innovation. The NIB would be an essential part of the implementation and financing of an industrial policy, which would increase economic dynamism.

Private finance: poor servant of the real economy

Besides its tendency towards instability, as witnessed by the devastatingly costly (both in economic and welfare terms) 2007-2009 financial crisis, a purely private financial system on its own does not adequately support the productive economy, nor does it fund much needed structural transformation.

Even before the crisis, British private and public investment was historically low. After the crisis, the British financial sector further reduced its support for private productive investment. The decline in public investment resulted from the fiscal austerity of Conservative governments.

Now, Britain has the lowest investment to GDP ratio amongst both G7 and OECD countries. Gross fixed capital formation (GFCF, a measure of investment in non-financial assets) as a share of GDP has been the lowest in the G7 since at least 1995. Over the same period, the UK's private sector GFCF as a share of GDP has been the lowest across the entire OECD.

Low levels of investment in the UK are a major cause of its recent stagnation in productivity, contributing to weaker growth of wages and living standards for the majority of people.

Public development banks serve the economy well

Public development banks have been effective in fostering a productive economy. In the wake of the Global Financial Crisis, support by policy makers worldwide grew for national development banks. The private financial system has been pro-cyclical, lending too much in the boom, and rationing credit during and after crises. It is this weakness that contributed to lower and slower economic recovery. The failure of private financial markets to deliver adequate funding for productive purposes has prompted many governments to rely on public development banks.

National development banks have been an important feature of the financial sectors of most developed and middle income countries, especially the most successful and dynamic ones – Germany, China, India, South Korea and Japan. Britain has been an exception in not having such a public development bank, despite its evident need.

The lesson of Germany's KfW

Germany's national investment bank KfW demonstrates that in order to be effective, a development bank must operate on a large scale. KfW is the most successful and effective national development bank in Europe, with assets of over €470bn as of 2017, and Germany is a very dynamic and diversified economy.

The KfW approves new loans per annum of around €50-55 billion for domestic purposes. A comparable lending capacity for Britain would be around €42 billion annually, or £37 billion. The total loan exposure of the KfW is around €500 billion, which is approximately £440 billion. If we assume a similar scale for the UK, in proportion to its population, total exposure of the NIB should reach £350 billion after several years of operation.

Scale of a National Investment Bank

With a leverage ratio of 1:9 (consistent with achieving the highest credit rating), the NIB would require equity of around £40bn, which would consist of capital from the public sector. If the NIB generates profits from lending, these could be reinvested as equity, enabling an expanding lending volume without further public capital injections.

German government guarantees to the KfW, even during the financial crisis and after some losses, maintained the bank's AAA credit rating. This rating allowed an equity of about a third of what would be considered necessary without such a guarantee. The figures given above on potential size of capital for the NIB could be reduced significantly in practice with a government guarantee.

Development banks and public debt

KfW loans that have a government guarantee do not count towards the 3 percent public deficit to GDP ratio specified in the Maastricht Treaty. Similarly, loans made by the NIB should not count as government expenditure, and thus not enter the fiscal deficit or the public debt. This approach has a clear economic rationale in that these loans would be to fund growth-promoting investments, thereby reducing - not increasing - future public debt service.

It is important to stress that though the British NIB would be publicly owned, it could fund its operations on the national and international private capital markets. Furthermore, it could co-finance many of its operations with private lenders and investors. Though implying close collaboration with the private sector, this is clearly different from private finance initiatives (PFIs).

Like the German KfW and other development banks, the British NIB would be in close collaboration, rather than competition, with the private financial and non-financial business sector. This collaboration creates leverage, catalysing lending and investment on a far larger scale than its public contribution alone could do.

Partnerships: learning from other development banks

After the Global Financial Crisis, EU governments increased the role of public development banks, especially that of the European Investment Bank (EIB). The EIB saw its paid-in capital doubled and its role further increased by the Juncker Plan, by which the EIB is planned to generate, directly and indirectly, €500 billion of additional loans in the 2015-2020 period. One of the important mechanisms of the Juncker plan is for the EIB to collaborate with national development banks.

The EIB has expertise in lending for key infrastructure projects, and for support to SMEs, including through venture capital. The EIB seems an ideal partner for the future UK NIB, complementing and supporting its activities. So if the UK leaves the European Union, it would seem very important to remain a full member of the EIB if possible, or have as close an association with it as feasible. This would be ideal to help the NIB benefit from all the EIB accumulated expertise, as well as its important financial resources.

Conclusion

Labour's proposed National Investment Bank will play a transformative role in our economy by funding projects that private finance would consider too risky or insufficiently profitable in short-term commercial terms. The NIB could guide industrial policy, especially one that takes appropriate account of environmental priorities, as well as the needs of the many.

Concluding remarks

Patrick Allen

It is clear from these essays about the crash and its effects that deregulation of finance was the root cause, and that austerity policies introduced from 2010 have made matters even worse for the UK economy, which was struggling to recover in the aftermath.

Gordon Brown and Alastair Darling implemented a fiscal stimulus package in 2009 and 2010 in response to the crisis, which was working. Tragically it was reversed for doctrinaire reasons by George Osborne under the Coalition Government.

The scale of assistance to the financial sector, not least the bank bailouts, is mindboggling. Financiers reaped the profits of casino-like gambling, while the taxpayers assumed the losses. Yet bankers have escaped economic pain and prosecution. Regulators have been lax in restructuring and reforming the system to prevent future crises. There is insufficient new regulation or control to prevent the next crash. Meanwhile, the poorest and most vulnerable in our society have borne the brunt of austerity, and now all of us have suffered from the damage done to the public realm: the collapse of public services, the strain on local authorities and the increase in poverty and destitution.

Progressive economists and politicians must gain confidence to challenge the obvious failures of both deregulation and austerity.

The task is to convince the public of the true causes of the crash: to learn from the lessons of history - especially those taught by Keynes - about the fragility of the international financial system and the need to manage the system in the interest of domestic stability, full employment and prosperity. Above all, to show that:

1. The budget of a country of 65 million people cannot be compared with the budget of one household.

2. Government debt is not a burden, but rather a valuable asset for the private financial system, especially pension funds. It is also the way all governments have funded investment to create productive and sound income-generating economic activity.

3. Government management of the economy and regulation of the financial sector is essential to create full employment and promote stability. Failure of this joint task of management and regulation leads to economic failure, which in turn opens the door to populism. Populist politicians use the opportunity to implement their agendas, offering simplistic solutions to complex problems based invariably on scapegoats such as immigrants or the EU.

The Progressive Economy Forum (PEF) is embarking on a bold programme of lectures, public education in economics, and drafting of economic policy for a future progressive government.

PEF seeks to bring about a sea change in the understanding and implementation of macroeconomic policy. We aim to transform our economy to make it socially and economically just, dynamic, equitable, sustainable and prosperous. We will counter the false narrative which says that our public debt is unaffordable and unsustainable.

We will explain how the economy works, and in whose interests, and make it intelligible and accessible.

Whilst we are not aligned or affiliated to any party, we would stress that the argument that Labour has less credibility to run the economy than the Conservatives does not stand up to examination of this or any Conservative government over the last 40 years.

I invite readers to keep in touch with us through our website (progressiveeconomyforum.com), mailing list and on Twitter (@pef_online), and to watch out for our forthcoming projects.

PEF Council

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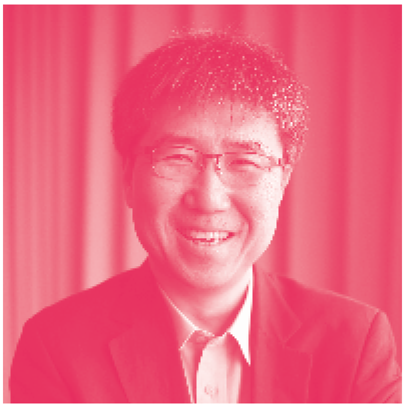
PEF Chair



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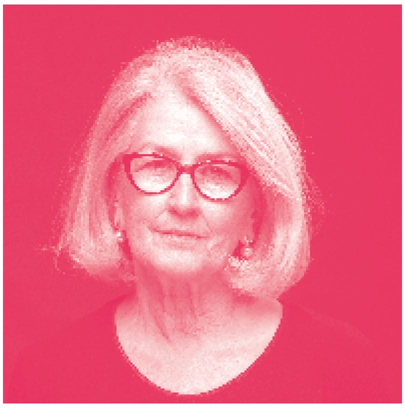

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The views, policy proposals and comments in this pamphlet do not represent the collective views of PEF, but the views of the author of each respective contribution.

References can be found as hyperlinks in the online edition of the pamphlet, available to download as a free PDF from our website. Our document can be cited as Allen et al. (2018) *10 Years Since The Crash: Causes, Consequences and the Way Forward*, PEF.

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