The global financial crisis of 2007 was the most serious economic shock since the Wall Street Crash of 1929. It led to a severe recession in the UK and many major countries. It has highlighted the exposure of the British economy to global financial changes and the need for banking reform.

What happened and why?
The years leading up to the crisis saw a period of rising economic growth, low inflation and falling interest rates. This created a mood of optimism among investors underpinning a marked increase in borrowing. Low interest rates encouraged investors to look for investments that earned more money, which led to excessive risk-taking.

The trigger was the bursting of a bubble in US house prices that had drawn new and less wealthy homebuyers into what became known as the sub-prime market. Investors around the world were able to invest in the boom via a financial innovation called securitisation. This created new products by bundling up lots of individual mortgages into a new product that included both poor-quality and high-quality mortgages. As house prices fell and mortgage borrowers could no longer afford their interest payments, institutions that had borrowed and invested heavily were left with large losses.

This caused a series of banking failures leading to the bankruptcy of Lehman Brothers in September 2008. In the UK, the Government had to step in to rescue Northern Rock, Bradford & Bingley, Lloyds TSB, HBOS and the Royal Bank of Scotland.

One day in August
When French bank BNP Paribas closed two of its funds that were exposed to the sub-prime sector on 9 August 2007, the world’s financial markets seized up. Adam Applegarth, then CEO of Northern Rock bank, described it as “the day the world changed”. Banks that relied on global money markets found that they simply could not borrow money to keep going because banks no longer trusted each other to repay their debts. This ultimately pushed several banks to the brink of collapse and required government bailouts.

Why was the UK so badly affected?
Financial institutions are much more closely connected to each other since governments removed barriers to moving money around the world. As banks found they were running short of money to meet their losses, problems spread very quickly to other institutions. This was known as a liquidity crisis as banks need money in the form of cash – known as liquid assets – to meet their immediate needs.

This was a big problem because all businesses rely on finance to function – when the banking sector contracts, it pulls down the rest of the economy with it. Crises in other industries are painful – car manufacturing, for example – but not fatal to the health of the economic system.

The strong presence of financial institutions in London and the city’s role as a global financial centre meant that it became the global magnet for capital flows for risky or semi-risky investments. This made the UK especially vulnerable when risks failed and governments had to intervene.

Bill for the banks
By February 2009, the UK had provided bailout funds equivalent to almost 20 per cent of GDP, compared with six per cent in the US. The protection of lenders during and prior to the crisis gave them an incentive to take more risks. It is known as the ‘too big to fail’ problem and leads to what economists call “moral hazard”.

Economics
The global financial crisis

Social Science for Schools
Recession in the UK
The financial crisis led to a global recession, and in 2008 and 2009 the UK suffered a severe downturn. Over that period hundreds of thousands of businesses shut down and more than a million people lost their jobs.

The fall in the UK’s GDP was greater than any other since the Great Depression of the 1930s, and at the start of 2013 was over three per cent below its 2008 peak. Professor John Van Reenen, director of the ESRC-funded Centre for Economic Performance at the London School of Economics, said: “Since the crisis broke we have suffered a period of depressed national income that has lasted for even longer than in the inter-war period. Poor growth is the number one economic problem facing Britain today.”

As the economy has shown virtually no growth, house prices have fallen and unemployment has risen. However, the employment rate in the UK fell by much less than anyone expected given the fall of GDP and has recovered to a much greater extent than output. This seems to be because the UK labour market is more flexible now than in previous recessions: wages have fallen in real terms, reducing the pressure on employers, and the employment service has been better at helping people into jobs.

What are ‘real terms’?
When looking at things like growth in economic output and wages, economists often try to look through the impact of inflation. This is because if wages are rising at four per cent a year but inflation is also rising at four per cent a year, then workers cannot buy any more with their wages than they did a year earlier since prices have also gone up. If wages rise more slowly than prices this is known as a fall in real terms, as wages are effectively worth less.
Tackling the recession
The outgoing Labour government provided a fiscal stimulus during the 2008-2009 crisis that included a cut in VAT and extra spending. They planned to meet the problem of higher public debt by cutting spending and increasing taxes. Economists call this fiscal consolidation while politicians and journalists call it austerity. In 2010 the Coalition Government accelerated this fiscal consolidation. Most economists agree that this austerity programme has led to lower economic growth.

Professor Van Reenen said: “The Coalition overestimated the ability of the UK economy to withstand its tough programme of fiscal consolidation. The impact of these cuts is much worse in deep recessions when interest rates are near zero, when our main European trading partners are also locked into similar austerity programmes and when the cuts are loaded on to investment rather than current spending.”

In co-operation with its European partners and other major global economies, UK financial regulators have taken steps to ensure that financial institutions reduce the amount of risk they take on and have a greater protection against future crises in the form of higher capital reserves and more liquid funds to cover sudden funding gaps.

The UK also plans to ring-fence high street banks from their higher-risk investment banking arms. The question is whether this regulation will be adequate or not. Will banks find ways around the rules? Should there be a structural separation between the investment and high street arms of banks? Should high street banking be made more competitive by reducing the size of the existing banks and encouraging new entrants?

The size of the debt
As a result of the depth of the economic slowdown and the amount of public money needed to shore up failing banks, the UK racked up multi-billion pound deficits and had a debt of £2,205 billion at the end of 2012 (or £1,111 billion excluding the bailouts).

British households also hold a large amount of debt. According to the Office for Budget Responsibility, the Government’s independent forecaster, household consumer debt totalled £1,560 billion in 2010 and is expected to grow to £2,015 billion by 2015. Measured as a share of households’ disposable income – the amount of money they have left after paying taxes and National Insurance, it will grow from 160 per cent to 175 per cent over that period. The UK has the second largest amount of household debt, measured as a share of economic output, of the ten largest developed economies.