Lessons From the ‘Great Recession’ for Both Theory and Economic Policy

8.1 Introduction

The analysis so far in the book has suggested a number of causes of the ‘great recession’ with leverage and excessive liquidity being at the core. In this chapter we review the economic policy response to the credit crisis and subsequent events that produced the ‘great recession’, and assess its short- and long-term impact. We also analyse the consequences of the crisis, drawing a distinction between the economy and asset prices.

Section 8.2, which follows this short introduction, discusses a number of preliminary considerations, and this is followed in section 8.3 by the lessons we are able to derive from the ‘great recession’. Sections 8.4 and 8.5 discuss the reactions of the economic policy makers in the USA. Section 8.6 deals with the economic policy implications of the ‘great recession’, while section 8.7 offers new economic proposals that follow from the recent economic experience. Finally section 8.8 summarises and concludes this chapter.

8.2 Preliminary considerations

The major policy implication of the NCM prior to the ‘great recession’ was that monetary policy had been upgraded in the form of interest rate policy, while fiscal policy had been downgraded. A major objective of monetary policy was ‘maintaining price stability’ (King, 2005, p. 2). King (2005) also argued that ‘Far from being ineffective, a monetary policy aimed at price stability has proved to be the key to successful management of aggregate demand’ (p. 2). However, the experience since the credit crunch of August 2007 does not seem to validate this claim. Be that as it may, this policy was, and still is, undertaken through Inflation Targeting (IT). Fiscal policy, by contrast, was concerned with broadly balancing government expenditure and taxation. Its importance was effectively downgraded as an active instrument of economic policy. The downgrading of fiscal policy was based on
the usual arguments of the crowding out of government deficits and thus the ineffectiveness of fiscal policy was the result of that assumption (see, however, Arestis and Sawyer, 2003, for a critique and a different view).

One important assumption that permits monetary policy to have the effect as described above and within the NCM theoretical framework is the existence of temporary nominal rigidities in the form of sticky wages, prices and information, or some combination of these frictions. Therefore the central bank, by manipulating the nominal rate of interest, is able to influence real interest rates and hence real spending in the short run. In the long run, changes in interest rates affect inflation but have no impact on real spending or the level of economic activity, or indeed the level of unemployment; all of which can only be affected by the supply side of the economy.

The financial liberalisation policies pursued since the 1970s and the financial innovation, both discussed in Chapter 2, have produced excessive liquidity in the system, thereby substantially increasing debt leverage in both the banking and personal sectors. The excessive liquidity, which became apparent by the early 2000s, was not merely the result of financial innovation, itself promoted by the financial liberalisation experience as discussed in Chapter 2. It has also come about due to the type of monetary policy following the introduction of the new monetary policy framework, the focus of which is frequent manipulation of interest rates. In the USA at the time, the Federal Reserve System (Fed) Chairman, Alan Greenspan, injected liquidity and cut interest rates following the Asian–Russian crises of 1997 and 1998, which was only partially drained later on. In view of the deflation dangers in the aftermath of the bursting of the internet bubble in March 2000, Alan Greenspan cut interest rates in a sequence of steps from 6.5 per cent to 1.0 per cent and injected huge liquidity into the US economy. Moreover, he was late and slow in draining that liquidity and reversing the rate cuts. Ben Bernanke, the new Fed Chairman after Alan Greenspan, imitated his predecessor and injected further liquidity following the ongoing credit crisis that erupted in the summer of 2007.

This experience has resulted in a serious build-up of household debt and asset holdings. Looking at debt statistics, it is worth repeating (see Chapter 2) that between 1998 and 2002 outstanding household debt, including mortgage debt, in the UK was 72.0 per cent of GDP; between 2003 and 2007 it shot up to 94.3 per cent of GDP. In the same periods as above, outstanding household debt jumped from 76.7 per cent to GDP to 97.6 per cent of GDP in the case of the USA. And in the Euro Area from 48.5 to 56.6 per cent respectively (see, also, BIS, 2008, p. 29). Clearly, this has made household expenditure more sensitive to short-term interest rate changes. Consequently, the dangers with this way of conducting monetary policy are clear: frequent changes in interest rates can have serious effects: low interest rates cause bubbles; high interest rates work through applying economic pressures on vulnerable social groups. Monetary policy, therefore,