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How the UK economy weathered the financial storm

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A B S T R A C T

Prior to the global financial crisis of 2008, the UK had the largest banking sector asset to GDP ratio among large countries, and had experienced rapid real property price increases as well as a persistent current account deficit in the preceding decade. These factors, together with its role as an international financial centre, made the UK economy particularly vulnerable to the onset of the global financial crisis. Although the initial drop in real GDP was steep, we provide evidence that the economy has weathered the financial storm better than many feared, and has fared no worse than its peer group of major economies. In this paper we assess the reasons underlying this outcome, including the possibility of exaggerated vulnerabilities, global economic recovery, the flexible supply side of the UK economy, as well as fiscal, financial and monetary policy interventions. Our analysis suggests that all of these factors played a role in cushioning the impact on the UK real economy, leading to a more benign outcome than most observers expected.

1. Introduction

At the onset of the global financial crisis, in the second half of 2007, the UK looked to be more heavily exposed to the emerging problems in the banking sector than its peer group of large industrialised countries. There were a number of reasons for this. First, its financial sector was

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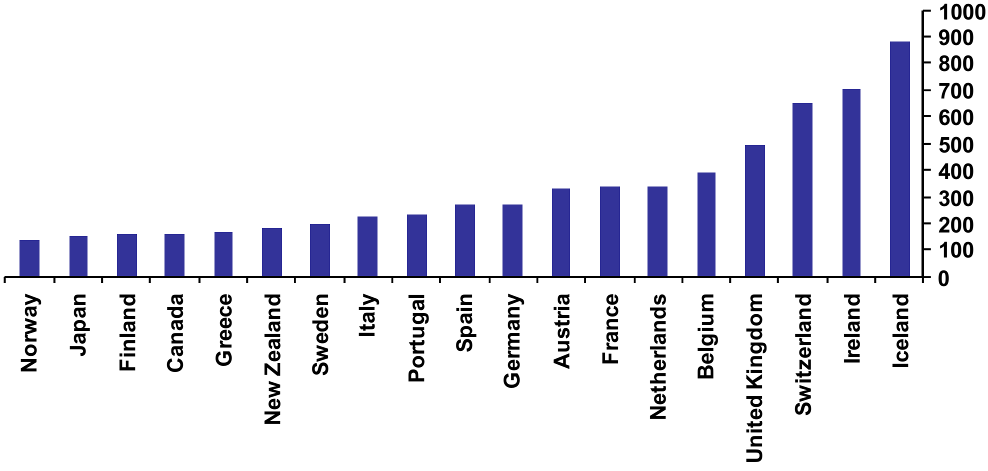

Fig. 1. Banking sector size across OECD economies. Banking sector assets as percentage of GDP. Source: OECD.

much larger in relation to the size of its economy than any other G7 economy (Fig. 1). Second, there were worries that the UK housing market might share some of the vulnerabilities that had afflicted the US housing market through the rapid expansion of sub-prime lending, adding to the weaknesses in the UK's financial system (Fig. 2). Third, a British Bank – Northern Rock – was one of the early major casualties of the financial crisis. And fourth, the UK was running a current account deficit of around 3% of GDP and was potentially vulnerable to a cessation of capital flows to finance the deficit (Fig. 3).

But more recent trends point to a more optimistic outcome for the UK real economy. The initial rebound in output in the UK was stronger than previous recoveries, and also outpaced a number of

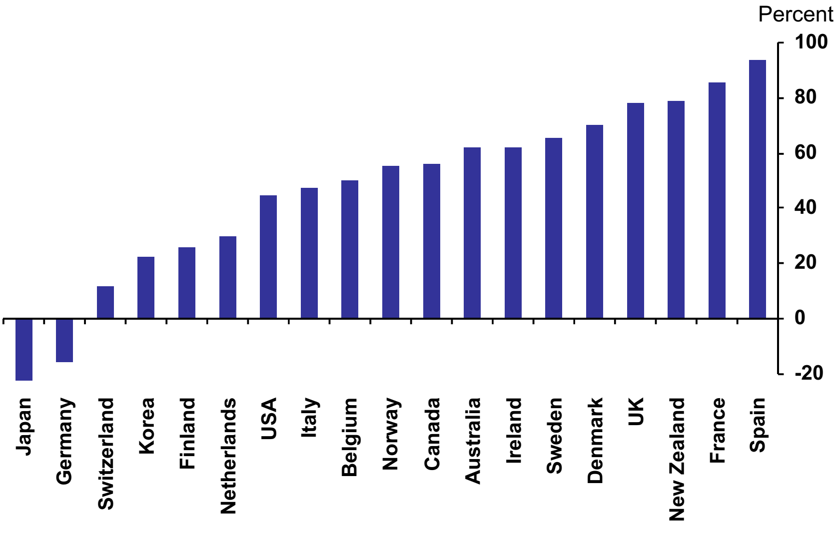

Fig. 2. Real house price growth in OECD countries. Percentage change in real house prices between Q1 1999 and Q4 2006. Source: Bank for International Settlements.