# What happened to the economic recovery in the West? The case of the UK

## INTRODUCTION

In issues 18 and 19 of *Aufheben* we presented a two part article on the financial crisis that had begun with the credit crunch in the summer of 2007 and culminated with the near meltdown of the global financial system a year later. In the first part of this article - 'Return of the Crisis: Part 1' - we focused on the immediate causes of the crisis. In the second part of the article - 'Return of the Crisis: Part 2' - we located the crisis in the context of the long upswing in global capital accumulation since the 1980s. For the most part this article was retrospective. However, we did put forward in the conclusion of Part 2 the view, albeit rather tentatively, that the crisis did not necessarily mark the beginning of a new downswing in capitalist development

> '...there seems little to suggest we have entered a long downswing, or that capitalism is now mired in stagnation other than the financial crisis itself. Indeed the rapid recovery in profits, and the confidence of much of the bourgeoisie in the long term prospects of renewed capital accumulation, would seem to suggest otherwise.'

Hence we went on to conclude:

> '...we might tentatively conclude that the nature and significance of the financial crisis is not that of a decisive turning point leading to an economic downturn or the end of neoliberalism as many have supposed, but more of a point of inflection pointing to a new phase in the long upturn.'

It is true that in a footnote we did hedge our bets:

> '...the rapid recovery in profits following the crisis has yet to result in a surge in investment and thus real capital accumulation. Even if capital accumulation does take off the austerity measures imposed by governments across Europe is likely to mean economic recovery will be slow for several years.'[1]

Nevertheless we did not quite expect that five years after the crisis the output of the UK economy would still be below its pre-crisis levels.

So did we get it wrong? From the perspective of those in the UK, and indeed much of the old capitalist heartlands of Europe, Japan and North America, the last five years have certainly been a period of slow economic growth, if not stagnation. There has been no rapid recovery from the recession that followed the financial crisis. What is more, what economic growth there has been has only been sustained by the unprecedented and exceptional monetary policies of the Bank of England and the US Federal Board in creating vast quantities of money and maintaining ultra-low interest rates.

Certainly from this perspective there would seem to be a good case for seeing the financial crisis as marking the beginning of a long downswing in the course of capitalist development, if not the beginning of capitalism's final demise. But this ignores the rest of the world.

For more than a hundred and fifty years world capital accumulation has been concentrated in a core of the advanced capitalist economies located in Europe and North America. Over the course of the twentieth century little changed except for the consolidation of the USA as the world's economic superpower, the rise and decline of the USSR and the inclusion of Japan in the 'rich nations club'. The rest of the world remained peripheral. It has therefore become long established that the fate of world capitalism is located in the US and the old capitalist heartlands. However, since the 1990s the long established structure of world capitalism has changed with the rise of China and the 'emerging economies of the global south' that now account for nearly half the world's GDP. The importance of this was brought home in the midst of the global financial crisis when the US did not summon the old rich nations club of the G8 to deal with the crisis but called the enlarged G20 so as to include China and most of the prominent members of the emerging global south.

In assessing the fate of world capitalism we can no longer simply look to what is happening in the USA and the old capitalist heartlands. Thus although the last five years have seen an exceptionally slow recovery from the crisis in the west, there has during this period been a rapid economic recovery in the emerging economies of the global south.[2] As a result, whereas the annual growth of the global economy before the financial crisis of 2008 had been between 4%-5%, in the

[1] 'Return of the Crisis Part 2', *Aufheben* #19, p.26.

[2] Between 2008 and 2012 the nominal GDP of US grew from $14.2 trillion to $15.7 trillion (i.e. an increase of 10% that was mainly due to inflation). In stark contrast China's nominal GDP has increased by over 80% from $4.5 trillion to $8.4 trillion.

last five years it has been between 3%-4% mainly due to the lack of growth in the old capitalist heartlands. Such rates of growth can hardly be considered as indicating economic stagnation or the beginning of a long term economic downswing.

On a global scale we could claim that we were right: the crisis of 2008 marked a point of inflexion rather than a turning point in the long term development of capitalism.

Furthermore we did suggest, albeit in a footnote, that

> 'The crisis could be seen as an earthquake caused by the shifting tectonic plates of global accumulation as the centre of accumulation shifts away from the USA and the old advanced capitalist economies towards China and Asia."

But we must admit we did not foresee this bifurcation of global accumulation. We did not expect that China would be able to become, at least temporarily, the locomotive of the global economic recovery in the wake of the crisis. Nor did we expect that the extent of the slow recovery would be in much of the old capitalist heartlands.

In this article we shall focus on the failure of the economic recovery to take hold in the old capitalist heartlands by examining the case of the UK economy. We shall seek to see if the failure of the economic recovery in the UK can be sufficiently explained by conjunctural factors such as the imposition of austerity measures or the impairment of investment due to the impairment of banking in the aftermath of the banking crisis; or whether there is room for more long term structural factors that have come to the fore since the crisis.

By far the most prominent explanation for the 'flat-lining' of the UK economy has been that the imposition of austerity measures in order to balance the government's budget simply 'killed off' the economic recovery. In the first section of the article we shall look at the austerity programme that was introduced by the Tory-led coalition government in 2010. In the following section we shall consider how far these austerity measures can account for the slow economic recovery. In the third section we shall consider the alternative conjunctural explanation of the failure of the economic recovery that sees the problem as a constraint on productive investment due to the impairment of the banking system following the financial crisis.

## OSBORNE'S PLAN A

Well before the May 2010 election all three major parties had made it clear that they accepted the recommendations of the IMF with regard to fiscal policy.[3] First of all it was generally agreed that the time to set out firm plans for 'fiscal consolidation' had arrived. Over the duration of the next parliament 'tough decisions' it was said 'would have to be made'; taxes would have to be raised and public spending would have to be drastically cut back.

Secondly it was accepted that cuts to public spending would have to bear the lion's share of the efforts to cut the government deficit in order to 'rebalance the economy'. During the crisis of 2009 the private sector had sharply contracted while public spending had continued to expand. Hence the relative size of the public sector had grown substantially. It was therefore argued, that if the private sector was not to be 'crowded out' by public spending, then the proportion of public spending to GDP would have to be cut back to at least pre-crisis levels.

Thirdly, if the programme of deficit reduction was not to be blown off course, fiscal policy – i.e. decisions regarding how much the government should spend, tax and borrow - could no longer be used to promote economic growth. If the economy required further stimulus, then this would have to be provided by the Bank of England in the form of lower interest rates and further 'quantitative easing'.

Of course, it was tacitly agreed by all that the bulk of the burden of reducing the government deficit caused by the 'bankers' crisis' would have to be borne by the working class.

As Chancellor of the Exchequer, Alistair Darling set out in detail Labour's 'exit strategy' in the March 2010 budget. Darling proposed a seven year programme of austerity that aimed to restore the government's finances by 2017. The programme had two key targets. Firstly, the rapid rise in the burden of government debt - as measured by the public debt to GDP ratio - would

[3] Gordon Brown – the prime minister at the time – can claim to have played a major role in averting both the meltdown of the global financial system and a 1930's-scale economic depression by pressing for Keynesian-style expansionary policies. He had been wary of following the IMF's advice for an early 'exit strategy' for fear that the premature adoption of 'fiscal consolidation' would risk killing off the economic recovery. By the autumn of 2009 Brown had come into conflict with his chancellor over both the timing and the extent of the programme of austerity that was required to restore the 'nation's finances'. But in the face of growing discontent in the Labour party concerning his leadership, Brown needed Darling's political support. As a result, Darling's views won the day and became the Labour party's official position.

be halted by 2015, and then, by the end of the austerity programme, would be firmly set on a downward path. Secondly, by the end of the programme - the 'golden rule' of government finance - that over the course of an economic cycle current government spending should be covered by tax receipts and that the government should only borrow to finance investment in long term assets (such as hospitals, school buildings, roads and other infrastructure) – which had been suspended during the crisis, would be restored.

To achieve these two targets Darling's austerity programme proposed to reduce the government's deficit by £88 billion by the financial year 2014-15. Of this around 70% (£60 billion) would take the form of cuts to public spending, with the remainder being made up by raising taxes rates and national insurance contributions. With the bulk of the 'fiscal consolidation' being achieved in the first five years, further deficit reduction measures were pencilled in for the following two years that were to be firmed up closer to the time when the fiscal and economic situation would be clearer.

Darling's plan, backed as it was by the statistical power and authority of Her Majesty's (HM) Treasury, set the parameters for the debate over fiscal policy in the subsequent election campaign that began soon after. The Tories indicated that they would seek to go further and faster in cutting the deficit, but apart from outlining suggestions of bringing forward £7 billion of cuts to the current financial year (2010-11) they remained rather vague as to how fast or how far they would go. The Liberal Democrats, of course, faced both ways. On the one hand they sought to stress that they were a serious and responsible party fit for government by siding with the Tories in criticising Darling's plan for not going far enough to ensure the restoration of the nation's finances. On the other hand they expressed concerns that 'fiscal consolidation' should not begin too early for fear of 'killing off the fragile economic recovery', and as such agreed with Darling's programme that cuts to public spending and tax increases should not begin in earnest until 2011-12, when it was expected that the recovery would be well established.

During the election campaign all the three parties were keen to impress on voters how they were prepared to take the 'tough and potentially unpopular decisions' necessary to reduce the national debt and restore Britain's financial position. Yet they were far less keen in making clear what they would actually cut in any detail for fear of losing votes from those likely to be affected. Indeed, all parties were far more concerned with telling the electorate what areas of public spending they would *not* cut and what taxes they would *not* raise. Labour reaffirmed its now long-standing commitment not to raise income tax in order to avoid the Tories accusing them of returning to the 'tax and spend socialism of old Labour'. The Tories, equally anxious not to be painted as the 'Thatcherite nasty party' by Labour, promised to ring fence spending on health, schools, overseas development and pensioners. For their part Liberal Democrats promised to raise the personal allowance threshold for income tax above £10,000 a year – thereby taking most of those earning less than the full time minimum wage out of income tax. They also made what was to prove the popular but also ill-fated pledge not to raise university tuition fees.

As a result, the more cynical bourgeois commentators had serious doubts regarding the politicians' commitment to following through on the scale of austerity that they proposed. However well-intentioned they may be, the politicians of any of the three mainstream parties could be expected to baulk at the scale of the spending cuts and tax rises once they had to face up to the real political implications of implementing them. Past experience, it was argued, showed that short term political expediency would always trump 'sound finance'. Concerns that the next government would be unable to make the 'tough decisions necessary to restore sound finance' was further reinforced during the election campaign as it became clear that no party would gain an overall majority. There now emerged serious concerns within the British establishment that there would be either a coalition government that would be too riven by conflicting political priorities and party advantage to agree in detail on a coherent austerity programme; or, even worse, there would be a minority government, which would be too involved in day-to-day political survival to worry about implementing a seven year austerity programme.

As it happened the UK general election of May 2010 coincided with the dramatic unfolding of the Greek sovereign debt crisis that was to result in the first 'euro bailout'. Less than a week after the fraught negotiations between the Greek government and the troika of the European Central Bank, the European Commission and the IMF had been completed, and amidst fevered speculation in the global bond markets as to which government would be next in facing a sovereign debt crisis, the British election had resulted in a hung parliament.

There was, of course, no imminent possibility of the UK facing a sovereign debt crisis on the scale facing Greece, despite what was implied in the lurid coverage of the crisis in much of the bourgeois press. First and foremost Britain, unlike those countries in the eurozone, had control over its own money. If necessary the Bank of England could always print money, as it was already doing in the form of 'quantitative easing', to buy up an unlimited amount of government bonds if speculators attempted to dump them. Secondly, Britain was in a far stronger financial position than Greece, or any other of the countries facing the possibility of a sovereign debt crisis. Although Britain's government debt was rising fast, it was by no means near the levels of those of the eurozone economies threatened with a sovereign debt crisis. What is more the average maturity of British government debt was 14 years compared with 18 months for Greece. Hence the proportion of debt falling due and requiring refinancing was far smaller than that of Greece, or any other eurozone country for that matter.

Indeed, the euro crisis, at least in the short term, made it easier for the government to refinance its debt. British government bonds were seen as a safe haven. With the economic and financial uncertainty caused by the Greek bailout, international financiers were more than willing to buy up British bonds as a safe and secure form to park their funds.


Nevertheless, it could be argued that if public debt continued to rise some time down the line Britain could face a serious crisis, and that it would be better to act now rather than wait until the government's financial position became worse. After all, the Bank of England could only 'print money' due to the exceptional financial situation following the banking crisis. Once the banking system had returned to normal, if the Bank of England responded to a speculative attack on government bonds by simply 'printing money' to buy up these bonds, then this would risk triggering collapse in the value of the pound and hyperinflation. The debt crisis would thereby manifest itself not in a bond market crisis, but in the form of a crisis in the foreign exchange markets and rapid price inflation.

The vivid prospect, even if it might be several years down the line, of having to endure the humiliation of going cap-in-hand to the IMF like their Greek counterparts was sufficient to concentrate the minds of British politicians of all the mainstream parties. The Greek crisis was an opportunity too good to miss for those who were concerned to firm up the next government's commitment to austerity measures. The British establishment, led by the Bank of England and the mandarins at HM Treasury, backed by the bourgeois press, swung into action. Pressure was put on the Tories and the Liberal Democrats to put aside their differences and form a coalition government founded on the overriding imperative to restore the country's finances.[4]

Nick Clegg, the 'Orange Book' leader of the Liberal Democrats,[5] was more than willing to sign up to such a coalition. Any qualms that the Tories' proposals to cut the deficit faster and further might 'kill off the recovery' were cast aside. Against those in his party that were uneasy in taking part in government with their old enemies, Clegg insisted that it was necessary for 'the national interest' that there was a strong government that was able to sort out the country's finances. By the next election the worst would be over and the nation's finances would be more or less back on track. Normal politics could be resumed and the Liberal Democrats and the Tories could go their separate ways.

In June, George Osborne, the new Tory chancellor of the exchequer, put forward an emergency budget that outlined his austerity plans. The Greek crisis certainly provided Osborne with the opportunity to go substantially further and faster in what became known as Osborne's Plan A than the austerity programme Darling had proposed in his March budget. Over the next five years Osborne proposed to cut the deficit by an extra £40 billion over and above the £88 billion that had been put forward by Darling. This would come from a further £32 billion in cuts to public spending and a further £8 billion by the way of tax increases. Thus giving a total deficit reduction over the next five years of £128 billion (approaching 7% of GDP, compared with the approximately 5% of GDP deficit reduction outlined in Darling's March budget), with 80% coming from cuts to public spending and only

[4] The make-up of the new parliament meant that the only viable coalition was that between the Liberal Democrat party and the Conservative party. If the Labour party had won it is unlikely that they would have put up much resistance to the British establishment's insistence that it was now necessary to go further and faster in reducing the deficit that had been proposed by Darling in his March budget

[5] In 1928 Keynes, amongst other Liberal party intellectuals, published what became known as the as the Yellow Book which put forward policy proposals that marked a decisive shift in the party from the old classical liberal economic and social views towards those of Keynes and social democracy. Mirroring the Yellow Book, Nick Clegg and other prominent Liberal Democrats, published the Orange Book in 2007. This manifesto sought to shift party policy towards neoliberal orthodoxy.

20% from tax increases. By cutting faster and further, Osborne was able to bring forward Darling's twin targets by a year or so. The halt to the rise in government debt to GDP was now projected to occur sometime during the financial year 2014-15 (i.e. well before the date of the next general election); while return to the 'golden rule' of the government 'borrowing only to invest' would be more or less achieved by the following year 2015-16 rather than 2017. In addition, by shifting the emphasis of deficit reduction onto public spending cuts, the size of the public sector relative to the economy as a whole would be restored to pre-crisis levels within five years.[6]

Alongside the budget, Osborne announced the formation of the Office of Budget Responsibility (OBR). There had been long-standing criticisms of HM Treasury for bending too far to the will of their political masters in their economic and fiscal projections. Treasury forecasts had tended to err on the optimistic side both in the economic forecasts concerning economic growth and in the size of government deficits and debts that allowed successive governments to justify higher public spending or tax cuts. The OBR was to be an official statutory body, run by reputable economists independent of the treasury, which would be responsible for making its own fiscal and economic forecasts. These official forecasts could then be used to verify the veracity of the government's austerity plans. With the establishment of the OBR, it was argued, the politicians would no longer be able to fudge the figures.[7]

Osborne's Plan A was certainly far tougher than that outlined by Darling less than three months before. Furthermore, with the plan embedded at the heart of the coalition agreement, with the two parties' commitment not to cut and run but to rule for a full five year term, and overseen by the OBR, it was a plan that seemed far more likely to be carried out in full. If nothing else it achieved the immediate aim of helping to calm the global financial markets after their volatility following the Greek debt crisis.

However, many on the Tory right protested that Osborne was being far too timid! The Greek crisis had offered Osborne a golden opportunity to roll back the state and force through radical neoliberal policies. Instead, as they pointed out, under Osborne's austerity plans total public spending, even after taking into account the general rate of inflation, would still be higher at the end of five years that it was at the beginning. This was because the headline cuts to public spending put forward by both Darling and Osborne were cuts to planned spending that had been originally pencilled in by the previous Labour government before the crisis of 2008. At that time, Labour had assumed that the economy would grow at an average of around 2.5% a year. As the economy grew incomes would increase, sales would increase and employment would increase. As a result, even if tax and contribution rates were held constant, tax revenues from income tax, VAT, National Insurance and other taxes could be expected to increase more or less in line with growth in the economy. With tax revenues rising at more or less 2.5% a year on average it was then possible to finance an increase in public spending at the same annual rate without raising tax rates or borrowing more.

But of course Gordon Brown's infamous claim to have abolished 'boom and bust' proved to be wrong. The economy had sharply contracted after the 2008 financial crisis while public spending had continued to grow leading to the large deficit and a rapidly growing government debt. Darling's plan had been to drastically reduce the rate of growth of public spending to well below the expected rate of growth of the economy for seven years. Rising tax revenues due to economic growth, the 'proceeds of growth', would then mostly serve to reduce the gap between spending and tax revenues. Osborne's plan went further. It aimed to more or less freeze total public spending for five years. As a result the entire 'proceeds of growth' would serve to reduce the deficit.

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[6] Osborne's austerity plan also provided room for a few sweeteners for the party faithful that were to be achieved during the five years of austerity. For the Tories there was the promise of a cut in corporation tax, for those corporations who could be bothered to pay it, from 28% to 24% and a reduction in the temporary 50% income tax rate band, which had been introduced by the previous Labour government as a token gesture towards 'taxing the rich'. For the Liberal Democrats there was the promise to advance their 'fair tax agenda' by honouring their election pledge to raise the personal income tax allowance to £10,000 a year.

[7] Although the OBR was intended to be independent, in its early stages it was closely tied to the government. The economists appointed to run the OBR were selected by Osborne. In the first few months of its existence the OBR was run from the Treasury and was dependent on Treasury facilities, computer models and officials to draw up its forecasts. Indeed the newly established OBR was closely involved in drawing up the June 2010 budget so as to ensure that Osborne Plan A would be given its stamp of approval.

Now this is not to deny the severity of Osborne's austerity plans that have been highlighted by the anti-cuts movement. First, many public services have to grow in real terms just to stay still. In the case of the NHS, for example, it has for a long time been recognised by health economists that more sophisticated drugs and medical technology, together with an aging population, means that spending on the health service has to grow by at least 3% in real terms (i.e. over and above the general rate of inflation) if it is to maintain its commitment to provide comprehensive and universal health care free at the point of use. Likewise for defence. The continued development of ever more technologically sophisticated weapon systems in the international arms race means that if the armed forces are to maintain their current fighting capacities and international commitments to NATO and the UN then the defence budget also has to grow in real terms.

In other areas of public spending current demographic and other factors are placing upward pressure on costs over the coming few years. In education the mini baby-boom of the last ten years means an increased demand for school places, which means more or expanded schools and hence more teachers and other staff to run them. In the area of welfare spending there are the extra demands being made by the retirement of the postwar baby boomers. The bulge in numbers reaching retirement age means that the government is committed to spending more over the coming years on state pensions and occupational pensions for former state employees, together with the numerous concessions to the elderly, such as free bus passes, free TV licences and winter fuel payments. In addition, the failure of house building to keep up with the demand for more housing has meant rapidly rising house prices and thus higher rents. With rents rising far faster than the general rate of inflation the total housing benefit bill paid by the government – effectively a huge subsidy to private landlords – has been ballooning in real terms. Furthermore, the policy of subsidising employers that pay low wages through the 'tax credit' system has also been pushing up the welfare bill in recent years. As more employers find that they can push down wages and then expect the government to top them up to something more like a living wage, the cost of tax credits has been steadily rising in real terms.

Second, to the extent that some areas of public spending are 'ring fenced' for legal, contractual or political reasons, then a freeze on overall government expenditure necessarily implies that there must be actual real cuts in spending in the remaining areas of state spending. Indeed, David Cameron's promises to ring fence spending on health, schools, overseas development and pensioners made during the May 2010 general election campaign were to present Osborne with serious problems a few weeks later when drawing up the details of his plan to rein in public spending.

First up was the problem of paying the interest on government debt, which in 2010 constituted around 7% of total annual public spending. Of course, no 'responsible' government could even contemplate not having enough money to honour its debt commitments. Now it is true that the Bank of England was keeping interest rates at exceptionally low levels. However, this state of affairs could not be expected to last forever. Sooner or later interest rates would rise. This, together with the rapid rise in government debt, would mean that Osborne would need to put aside a substantial increase in the amount of money in his austerity plans to ensure he could cover rising interest bills.

If the interest fund had to increase where else could Osborne find savings? The obvious target was the welfare budget, which constituted more than a third of total annual public spending. However, there had been a long-standing consensus amongst policy makers that the basic levels of welfare benefits were more or less the absolute minimum that people could be expected to live on. Furthermore, it had been accepted by successive governments that it would be politically unwise to be seen cutting the living standards of the poorest in society on any great scale, particularly at a time of high unemployment. There may have been scope for cutting or withdrawing certain premiums and additional benefits that top up basic levels of benefits, but any such measures could only be expected to make little more than a marginal reduction in the total benefits bill. It was therefore generally accepted that benefit rates would have to rise with the general rate of inflation.

With the level of benefits paid to individual claimants more or less fixed, the size of the welfare budget was mainly determined by the numbers of people making claims. Successive 'welfare to work' reforms pushed through by the previous Labour government, which culminated in the abolition of incapacity benefit and its replacement by the far more restrictive Employment and Support Allowance for the sick and disabled, had already gone as far as was then thought feasible in restricting eligibility for benefits and imposing more onerous conditions on claimants. These 'welfare to work' reforms had been primarily aimed at making claimants compete for work and as such often involved greater costs. More had to be spent on 'capability to work tests', 'back to work schemes' and workfare programmes, particularly since most of these schemes were outsourced to private companies on lucrative contracts. These extra costs could be expected to offset most of any savings that might have been made by reducing the numbers of people claiming benefits, either through making less people eligible or deterring them from claiming by imposing more onerous conditions on claimants.

Thus the number of claims, and thus the total welfare bill would be determined for the most part by demographic and economic factors that were largely out of the government's control. Thus it was thought there was little scope for cutting back on the projected increase in the welfare budget.

The next largest area of government spending, after welfare, was the NHS. The NHS constituted more than 16% of total government expenditure and its budget had experienced rapid growth under the previous Labour government. As such there was perhaps a certain scope for cutbacks. But convincing the electorate that the NHS was 'safe in his hands' had been central to Cameron's five year attempt to rebrand the Tories as the 'compassionate Conservative party' thereby making them electable once more. Therefore Osborne had little alternative but to ring-fence the health budget.

Next up was education, which constituted around 12% of total government expenditure. Yet here again Cameron had pledged to ring-fence spending on 'schools' - which was generally interpreted as being spending on primary and secondary education. This left only pre-school, further and higher education budgets outside the ring-fence. The lion's-share of the education budget was therefore also protected from cut backs.

Thus, with spending on interest and other contractual commitments set to sharply increase, and the pre-austerity plans for increased spending on welfare, the NHS and most of the education budget ring-fenced, more than two thirds of government spending was set to rise over the next five years. If overall government spending was to be kept constant, then there would have to be draconian cuts to the remaining areas of public spending. There would have to be devastating cuts to both defence and 'law and order', neither of which would go down well with the Tory party faithful. There would have to be drastic cuts to local government, which would upset many Tory local councillors, and there would have to be cuts as well to important social and economic areas such as housing, the environment and transport.[8]

Osborne's solution to this problem was firstly to separate off that half of the welfare budget that paid benefits to pensioners. This was to be ring-fenced. This left the other half of the welfare budget, which went to working age claimants, available for cuts. Following a relentless propaganda campaign against 'welfare scroungers' backed not only by much of the mainstream press but also by the Labour party with its concern for the 'squeezed middle of hard working families', Osborne was able to win public support for cutting benefits. By the time of the 2010 autumn spending review Osborne had announced more than £18 billion of cuts to the planed annual welfare budget over the following five years.

Secondly, Osborne effectively made large cuts to capital spending: that is spending on building schools, hospitals, roads and other social and economic infrastructure. Following the financial crisis the previous Labour government had brought forward planned capital spending as part of its efforts to sustain demand in the economy and prevent a great economic depression. Construction projects that had been due to begin in 2010 and 2011 were, where possible, started in 2009. This meant that capital spending rose sharply in 2009 but was due to start falling sharply by the autumn of 2010. Rather than restoring capital spending to levels prior to the crisis, as Darling had proposed, Osborne proposed to freeze capital spending in real terms over the following five years at the reduced levels of the end of 2010.

Thirdly, following the example of Thatcher's governments of the 1980s, Osborne took a large swipe of the axe to the grants paid to local government. This neatly shifted the responsibility, and hence the blame, for making public spending cuts from the government to local politicians.[9] Furthermore, by tweaking the formulas used to calculate the grants paid to each local council Osborne was able to ensure that it would be Labour councils that would be responsible for making a disproportionate slice of the cuts.

[8] If we assume that the areas ring-fenced would have grown by an average of 2.5% a year then over Osborne's five year plan the level of spending would be more than 12.5% higher. If total spending was to be the same in real terms at the end of the plan as in 2010 then the remaining one third of public spending would have to be cut in real terms by more than 25%! Could Osborne really countenance cutting the number of police by a quarter?

[9] Of course this ruse to shift the blame for public spending cuts on to local government worked for a while. However, it eventually led to the poll tax that was to play a part in the downfall of Thatcher.

As a result Osborne was able to claim that, unless Labour was prepared to remove the ring-fencing of the NHS, his plans for spending cuts on the remaining non ring-fenced central government departments – such as defence, law and order, housing, transport and the environment – would be more or less the same as those implied under Darling's austerity programme. Thus Osborne was able to box the Labour party into a political dilemma: if they were to criticise 'Tory cuts'; they either had to support ring-fencing the NHS, or the welfare budget.

**Whatever happened to Osborne's Plan A?**

By the autumn of 2012 it was evident that Osborne's plan for restoring the nation's finances had been seriously blown off course. Osborne was obliged to admit that despite two years of austerity, little progress was now being made in reducing the government's budget deficit. Indeed, Osborne was rapidly running out of plausible ruses to cover up the fact that the reduction in the government's budget deficit had more or less stalled; he had also been obliged to concede that both the target to halt the rise in the government debt to GDP ratio and to restore the golden rule of balancing taxes and current spending over the course of the economic cycle would have to be put back by two years.

The failure of Osborne's Plan A had not been due to any failure of political will. On the contrary, the coalition government had been able to see off the opposition to its austerity measures with surprising ease. It is true that less than six months after the election, the coalition government had faced a wave of mass protests against both the tripling of university tuition fees and the scrapping of the Education Maintenance Allowance. But, although these protests by school kids and university students had gained widespread public support, they quickly petered out after a few short weeks. Their only lasting achievement was to discredit Nick Clegg and the Liberal Democrats who had been pushed to the front by Cameron to defend these policies and explain why they were breaking their pre-election promises.[10]

It is also true that in August 2011 the dire warnings made by concerned liberals that Osborne's austerity measures would lead to riots and social disorder reminiscent of the 1980s appeared to be borne true with a wave of riots across towns and cities in England. But again they were a fleeting phenomenon that has had no lasting effect other than rallying the 'respectable law abiding majority' behind the government.

Late 2010 had also seen the rapid growth of the 'stop the cuts movement', which was to culminate in the quarter of a million strong national demonstration called by the TUC in March 2011. This mass protest had then played an important role in galvanising support in June and November for the two unprecedented co-ordinated one day strikes of public sector workers against the government's proposals to raid public sector pension funds. But the government did not flinch. They were quite prepared to suffer the nuisance of public sector workers going on strike for the day every three to six months. Furthermore, given that most private sector workers had lost most of their pension rights long ago and had accepted cuts to wages and conditions due to the recession, the government was no doubt confident that if the trade unions tried to escalate the dispute they could win the propaganda war by pitting private sector workers against public sector workers.

In the face of the government's intransigence over their pension proposals, the leadership of the public sector trade unions capitulated. Having wagered almost everything on the power of the public sector unions to defeat the government over pensions, the anti-cuts movement was dealt a devastating blow from which it has yet to recover.

Not only had the Tory-led government managed to win the political argument that austerity was necessary, and that Osborne's Plan A was the only way to do it, they had also succeeded in their administration of the austerity measures. Indeed they had been so successful that several government departments had been so efficient in making spending cuts that they had reported significant underspends by the end of both the 2010-11 and 2011-12 financial years. What had blown Osborne's Plan A off course was not a failure to make cuts and raise taxes, but a failure of the expected growth of the economy to materialise.

The sharp contraction in the output of the economy that had followed the financial crisis at the end of 2008 had more or less come to an end in the closing months of 2009. By the time of Osborne's first budget six months later the UK economy appeared to have been in the early stages of recovery, with growth, although still rather erratic from quarter to quarter, running at an annual rate of about 1%. Although it was still rather 'fragile' in 2010, it was widely expected, on the basis of the experience of previous recessions,

[10] The discrediting of Nick Clegg and the Liberal Democrats has in fact only served to strengthen the Tories. With the Liberal Democrats still languishing in the opinion polls they have no other option but to stick with the coalition and hope that by the next election memories of their 'betrayal of the students' will have faded. Without any realistic threat of abandoning the coalition government they have lost much of their bargaining power with the Tories. Indeed the main threat to the continuation of the coalition has come from the Thatcherite right. Labour, of course, chose to back cuts to the welfare budget.

that at some point during 2011 the economic recovery would begin to take hold and gather momentum. By 2012 the economic recovery was expected to be well on the way to turning into an economic boom as the economy raced to make up lost ground.

Yet by the end of 2010 the economic recovery had begun to stall. From the beginning of 2011 until well into 2013 the economy barely grew at all. As a result, more than five years after the 'great recession', the level of output still remains well below its peak on the eve of the crisis - giving rise to the slowest economic recovery in modern times, longer even than that of the 1930s.

So how has the failure of economic growth blown Osborne's Plan A off course? A key argument for dealing with the deficit early had been that if austerity measures were put off until there was a serious 'Greek scale' crisis then there would be no option but to make rash cuts to public spending. By acting early it would be possible to impose austerity in a more measured way. There would be far more time for government departments and local authorities to identify spending priorities and make more rational and deliberative plans for their more restricted budgets. Indeed if the rolling back of the state was to be sustainable it was argued that long term decisions had to made concerning what public goods and services the state should provide directly, what could be commissioned from private providers and what could be abandoned entirely to the private and charitable sectors. Such decisions could not be made in the midst of hasty slash and burn cutbacks.

Thus Osborne's Plan A had allowed for a moderate increase in total public spending through 2010 and 2011, before then being pegged back down again to the 2010 levels in 2012 and 2013.

Yet Osborne had been determined to act early on to reduce the government's budget deficit in order to head off what he saw as the alarming rise in the government's debt to GDP ratio and to 'maintain the confidence of the bond markets'. If Osborne was to allow time to slow down and then halt the growth of public spending, then the initial burden of reducing the deficit would have to fall on tax increases. By raising the standard VAT rate to 20% at the beginning of 2011, Osborne had been able to bring in a significant increase in government revenues, which had not only served to cover the continued increase in public spending but also to bring about a significant reduction to the budget deficit. As a result, in the March 2011 budget Osborne had been able to claim that he had made an early, if rather modest start in reducing the government's budget deficit, and hence the growth in government debt, and was therefore well on track in meeting the twin targets of his Plan A.

Now of course, by themselves, increasing tax rates only bring about a once and for all increase in the annual 'tax take'. Thus by the beginning of 2012 the reduction in the budget deficit due to the increase in the rate of VAT would be more or less complete. But, by then, the cutbacks in the overall level of public spending would be beginning in earnest and could be expected to take up much of the strain in reducing the budget deficit figures.

Yet once the process of pegging back public spending to 2010 levels was itself complete, Osborne's deficit reduction plans became entirely dependent on the increased tax revenues arising from economic growth. Of course, it had been expected that by then the economy would be well on the road of recovery, and as a result tax revenues would be flooding in. But as we have seen, the economic recovery had stalled in 2010; the expected 'proceeds of growth' had failed to materialise. The VAT rate increase and the subsequent pegging back of public spending may have served to mask the growing shortfall of tax revenues due to the failure of the economic recovery for a couple of years, but by the end of 2012 it was fast becoming clear that the reduction of the government's budget deficit had come to a grinding halt due to the lack of economic growth. Osborne had to admit that he would not come anywhere near to hitting his twin targets of halting the rise in government debt to GDP ratio by the end of the financial year 2014-15 and balancing the current budget deficit over the course of an economic cycle by 2015-16. Osborne's Plan A, as originally formulated, had failed due to a failure of the expected economic recovery to materialise.

As we have already noted, there had been right from the beginning many Keynesian-inspired critics of Osborne's plan that by cutting the budget deficit 'too far and too early' it risked killing off the fragile recovery. As it became increasingly clear that the economic recovery had stalled, these critics gained increasing support from both left and right. Osborne, it was argued needed a Plan B – a plan that would include measures to stimulate the economic recovery. From the left it was argued that the best way out of the government's financial predicament was through economic growth. The government should relax its austerity plans and take advantage of the ultra-low interest rates to finance much needed state investment in updating transport infrastructure, house building, the long overdue refurbishment of schools and electricity generation. Many on the right, particularly leading businessmen and industrialists agreed that a major public investment programme was needed to 'kick start the economic recovery' but no doubt encouraged by the ease at which Osborne had been able to roll back the state through his austerity measures, proposed that such public investment should be financed by another round of cutbacks to current public expenditure, with cuts to the welfare budget being the prime target.

Osborne's response has been to stick to his guns. As a result Plan A has morphed in to what has been dubbed 'Plan A plus'. On the assumption that the economic recovery has somehow been delayed for two years or so, Osborne has for the most part simply put back the dates for achieving his twin targets by two years. To ensure these target dates are met austerity has been both extended and deepened through an extension of the period of zero growth in total public spending by two years and the announcement of further rounds of cutbacks to public spending for the financial years 2013-14, 2014-15 and 2015-16.

In response to the criticism from both left and right that he has no growth strategy Osborne has moved on from merely politely asking the banks to lend more to small businesses to various schemes aimed at boosting private investment. But despite much hype all the schemes that have been announced amount to little in the way of boosting economic growth. The overriding aim of reducing the government debt and a reluctance to go too far in cutting current public spending beyond what was needed to reset Plan A has meant that there is little money available for large scale public investment.[11]

The success of Osborne's Plan A plus, as his original Plan A, depends on the eventual arrival of the now long-awaited economic recovery. But haven't those Keynesian-inspired critics, who warned at the time that by cutting too fast and too early Osborne risked killing off the economic recovery, been proved right? Is it not the case that Osborne's own austerity measures have been responsible for killing off the economic recovery. Certainly Osborne and the host of policy wonks, economic forecasters and SPADs (special political advisors) that surround him seem to be prime suspects.

[11] Proposals by the more Keynesian-minded Vince Cable – the Liberal Democrat secretary of state for business, innovation and skills – to boost the economy through public investment have been hamstrung by the tight spending limits imposed by Osborne's Plan A. However, Osborne has been more successful in engineering the beginnings of another housing price bubble through his Funding for Lending scheme in which the government guarantees a proportion of the value of mortgages allowing the banks to substantially reduce the deposit prospective homebuyers have to put down before banks will lend them money to buy a house.

## SO WHAT DID HAPPEN TO THE ECONOMIC RECOVERY IN THE UK?

In their defence, the policy wonks, economic forecasters and SPADs that worked on formulating Osborne's Plan A can claim that they were far from being alone in their expectations of a strong recovery in the UK economy. On the basis of the experience of previous recessions, in both the UK and other advanced capitalists economies, the prevailing view of informed mainstream economic opinion in 2010 had been that, even taking account of the scale of 'fiscal consolidation' proposed by Osborne's Plan A, there would be a vigorous and robust rebound from the 'great recession'. If anything the OBR forecasts were decidedly on the 'pessimistic' side, when it came to projections for economic growth over the following five years, compared with most other mainstream economic forecasts of the time. Indeed, the OBR had deliberately erred on the side of caution in making its economic and fiscal forecasts in order to demonstrate its independence from HM Treasury and its perennially over-optimistic predictions.

Of course it had been generally conceded that following the 'traumatic shock' of both the near meltdown of the global financial system and the consequent sharp contraction of the UK economy there might be a period of slow and uncertain economic growth before the recovery finally took hold. After all, it was argued, it would take time for the financial system to regain confidence and for the banks to repair their 'balance sheets' and begin lending again; and it would also take time for companies and individuals to work off their excess debt before they could begin borrowing to finance investment and consumption once more. Indeed, as was pointed out, empirical evidence from past recessions seemed to suggest that recoveries following recessions caused by financial crises, particularly those centred on the banking system, tended to take significantly longer to get going again compared with recessions caused by other factors.

Nevertheless, the consensus view was that such a period of uncertain growth would not last much more than a year. Therefore it had been widely expected that, after some delay, the economy would eventually 'take off' sometime in 2011. Such expectations were duly incorporated in to the OBR's growth forecasts. Hence, as can be seen from Table 1 (below), the OBR had forecast that with the contraction of the economy having been halted in 2009 the economy would grow by slightly more than 1% in 2010, gather pace in 2011 and be growing at nearly 3% by 2012 – significantly above the OBR's estimate of the long term average rate of growth of the UK economy of 2.25%.

**Table 1. OBR's forecasts for economic growth**

| | 2009 out-turn | 2010 forecast | 2011 forecast | 2012 forecast | 2013 forecast | 2014 forecast | 2015 forecast |
|---|---|---|---|---|---|---|---|
| OBR's forecasts for the rate of economic growth* | - 4.9 | 1.2 | 2.3 | 2.8 | 2.9 | 2.7 | 2.7 |

*Source: OBR June 2010 Table C3

Yet, as we have pointed out, since late 2010 to early 2013 the economy has barely grown. So what did happen to the predicted recovery; and how did the OBR, and indeed most other mainstream economic experts, get it so wrong?

**Was it austerity that killed off the recovery?**

Keynesian and anti-austerian commentators may well argue that it was their very adherence to the ideologically blinkered neoliberal mainstream in economic theory that had led the architects of Osborne's Plan A, along with most other mainstream economic forecasters, to seriously underestimate the impact of their proposed austerity measures on the rate of economic growth. Thus it has been said that 'by cutting too far and too early' Osborne's austerity measures have served to kill off the very recovery that the plan had depended on for its success.

So what grounds are there for suspecting that the ideological bias of the mainstream economics might have led the architects of Osborne's Plan A to seriously underestimate the impact on economic growth of their proposed plan of 'fiscal consolidation'?

In the heyday of the old Keynesian consensus of the 1950s and '60s it had been widely accepted amongst both economists and policy makers that the government had the power not only to maintain near full employment but to 'fine tune' the economy through the use of both fiscal and monetary policy to manage the growth of 'aggregate effective demand'. Indeed it was widely thought that within fairly precise limits governments could make the political choice as to whether they were prepared to tolerate a higher rate of inflation, so as to have a lower rate of unemployment; or a higher rate of unemployment, so as to have a lower rate of inflation.

Thus, for example, if the government wanted to 'stimulate' the economy in order to reduce the dole queues it could adopt a 'looser' monetary policy. Short term interest rates could be cut and credit controls could be relaxed so as to make it cheaper and easier for firms and individuals to borrow money to finance increased spending on investment and consumption. The consequent increase in demand for consumption and investment goods would then lead to an increase in supply. Output would increase, and hence more labour would be required to produce it. On the other hand, if the government wanted lower rates of inflation it could 'tighten' monetary policy by raising short term interest rates and by imposing more restrictive credit controls. By making it harder and more expensive to borrow, a tighter monetary policy could then be expected to reduce the growth of spending power in the economy. There would therefore be less demand for goods and services and consequently less demand for labour. As a result, firms would find it more difficult to raise prices, and trade unions would be in a weaker position to bargain for higher wages.

However, monetary policy was seen as a rather indirect and thus a rather unreliable instrument for managing aggregate demand. Firstly, the effectiveness of monetary policy depended on the changes to short term interest rates giving rise to a corresponding change to the longer term interest rates that actually determine the costs of borrowing for firms and individuals. Secondly, even if a change in short term interest rates brought about a corresponding change in longer term interest rates, there was no guarantee of how far this would result in either an increase or decrease in the amount of debt-financed spending in the economy. This would depend on a number of factors other than merely the cost of borrowing that determine both willingness of lenders to lend and of potential borrowers to borrow. Monetary policy was therefore seen as playing a rather secondary role in the managing of aggregate demand in the economy. The primary instrument for 'fine tuning' the economy was seen as fiscal policy.

Fiscal policy was seen as a far more direct and reliable means of managing aggregate demand since it involved the use of the government's own powers to raise taxes and to spend on public services to directly increase or decrease demand in the economy. If the government wanted to increase the spending power in the economy in order to reduce unemployment it could adopt an 'expansionary' or 'reflationary' fiscal policy that would reduce the spending power taken out of the economy in the form of taxes, and increase the amount put in to the economy by increasing its own spending on welfare and public services. Contrawise, if the government saw rising prices as the pressing problem it could adopt a 'deflationary' fiscal policy that would take out more spending power by reducing the government's budget deficit through tax rises and cutting public spending.

However, the idea of sustaining near full employment and 'fine tuning the economy' through the management of aggregate demand came unstuck with the emergence of the phenomenon that became known as stagflation – that is the co-existence at one and the same time of both rising rates of inflation and rising unemployment – that accompanied the economic crises of the 1970s. This was to open the established Keynesian consensus to attack from the early shock troops of neoliberalism – the monetarists led by Milton Friedman and his 'Chicago boys'.

The immediate objective of the monetarists' assault on the old Keynesian orthodoxy had been to overthrow the contention, which had been a corner- stone of the postwar social democratic settlement, that the government had both the power and the responsibility to maintain high levels of employment through Keynesian-style management of aggregate demand. The ideological basis for this assault had been the presumption that free markets, left to themselves, provide the optimal and most efficient means of allocating resources that would ensure the maximisation of profits for companies and the maximisation of 'utility' for individuals and households. Through the free play of supply and demand, the markets for both the multitude of goods and services, together with the markets for the labour required to produce them, would determine the optimal relative price of each good or service, the optimal amount of it that should be produced, and hence the optimal amount of labour employed, and the relative wages that would be paid to the workers producing it. Any attempt on the part of the government to meddle in these workings of the market could only end up being detrimental to the efficient functioning of the economy. As Thatcher is reputed to have said 'you can't buck the market'.

The first line of attack was to deny the efficacy of fiscal policy that as we have seen was central to the old Keynesian orthodoxy. The monetarists did not deny that by running a budget deficit the government could bring about an immediate increase in aggregate demand in the economy. But as they pointed out, the government would have to borrow money to finance this deficit. Given that the amount of money available to borrow was determined by the Bank of England's monetary policy then the more the government borrowed the less there would be left to finance private investment and consumption. Hence the extra demand injected into the economy through an expansionary fiscal policy would end up being cancelled out by the 'crowding out' of private sector borrowing. Thus, by itself, fiscal policy could at best have only a limited and temporary impact on levels of output and employment in the economy.

However, if fiscal policy was too weak, for the monetarists monetary policy was too strong. Now, although *relative* prices and wages were determined by markets for goods and labour, in the absence of a commodity money like gold, the *absolute* level of prices was determined by the supply of money, and hence by the monetary policy pursued by the authorities. Thus, it was argued, if the authorities were to adopt an expansionary monetary policy that doubled the supply of money in the economy, this would eventually lead to a doubling of nominal wages and prices. But since all prices and wages had doubled, relative prices and wages would end up the same as they had been in the first place.

But the process of an increase in the supply of money brought about by an expansionary monetary policy might take some considerable time to work itself out. In the meantime there could be a substantial impact on the levels of output and employment. Thus in the short to medium term monetarists did accept that an expansionary monetary policy could bring about an increase in output and a fall in unemployment, but it could only do so by tricking firms and households into mistaking a rise in the price of the goods or labour that they sold due to the general rise of prices and wages for a real or relative increase in their own price or wage.

Thus for example, if the monetary authorities loosened monetary policy and thereby increased the money supply, the amount of spending power in the economy would increase. Businessmen would find that trade was brisk and sales were buoyant. They would soon learn that they could raise their prices without losing too many sales to their competitors, and that their competitors would soon follow suit. With prices rising relative to costs, and with increased sales, businessmen would soon be enjoying rising profits. With the expectation of growing demand and rising profits, many businessmen would then be induced to borrow to expand production, thereby giving a further twist to the spending power in the economy as they hired more workers and purchased new equipment and more raw materials. But the increased demand for raw materials and equipment would soon allow the businessmen that produced and sold them to raise their prices. Costs would as a result begin to rise. As prices across the economy rose, the cost of living for workers would rise. With labour in short supply workers would be able to start demanding higher wages to compensate for rising prices. Profit margins would then become squeezed and profits would begin to fall. Those businessmen that had borrowed on the expectation of ever rising profits would find themselves facing bankruptcy. Production would be cut back and workers laid-off in order to cut costs. Ultimately, after producing this cycle of boom and bust, the loosening of monetary policy would result in output and employment returning more or less to their previous levels.

Thus it was that ultimately the only result of a one-off expansion in the money supply would be an increase in the level of wages and prices. It was therefore not only that monetary policy was too uncertain in its effects to be used as means of fine tuning levels of output and employment; but that it held the danger of triggering a disruptive cycle of boom and bust, and that it would eventually prove to be futile anyway.

So, for the likes of Milton Friedman, attempts to use fiscal policy to manage aggregate demand so as to ensure high levels of employment during the post-war era had largely ended up simply displacing productive private sector investment with profligate public spending, which had resulted in an over-bloated state sector – which Thatcher then promised to prune back. To the extent that high levels of employment had been sustained through manipulating aggregate demand, then this had been the result of loose monetary policy, which the Keynesians had assumed had been playing only a supportive role to fiscal policy. But, as we have seen, to sustain a level of employment above that determined by the markets, it was not enough merely to allow a one-off expansion of the money supply. It had been necessary to repeatedly expand money supply. This had resulted in a continuous rise in the level of prices – i.e. price inflation. What is more, as firms and individuals had come to expect a given rate of inflation, then the impact of monetary policy on levels of employment and output diminished. High levels of employment could only then be maintained by an ever increasing growth of the money supply and as a consequence ever rising rates of inflation, together with ever more volatile cycles of boom and bust. Hence it had been the misguided policies inspired by Keynes, and his mistaken notion that the state could 'buck the market', that had led to the crises and stagflation of the 1970s.

Many of Freidman's younger followers, that were later to become known as the new classical school, went further. They protested that it was patronising for economists and policy makers to believe that they could trick ordinary people running businesses and managing their household budgets into buying or selling more or less than they would otherwise have chosen to do. They would soon learn, not merely to expect a certain level of price inflation on the basis of past experience; but - presumably armed with the knowledge provided by our rather modest economic theorists - they would, at least in theory, be able to anticipate the outcome of monetary policy and adjust prices and wages accordingly. Thus they concluded that it was not just fiscal policy that was ineffective but also monetary policy, even in the short term. Indeed, the last thirty years have seen a steady stream of theoretical articles in mainstream economic journals purporting to demonstrate how demand management can have no effect on output and employment.

However, policy makers and economic forecasters cannot entirely remain within the fantasy world of modern neoclassical economic theory, where all markets are perfect and everyone has perfect information and foresight. They have to deal with the real world.

The 'new macro-economic policy making consensus' - which emerged in the 1990s after the long drawn out polemics between the Keynesians and monetarists of the previous decade - certainly enshrined the victory of the monetarist 'counter-revolution' concerning the role of fiscal and monetary policy. The pre-Keynesian view was to be reinstated: the role of monetary policy was to ensure price stability, or at least a low rate of inflation, fiscal policy should merely be concerned with balancing the

**Table 2. OBR's forecasts for economic growth and for the impact of Osborne's planned austerity measures**

| | 2009 out-turn | 2010 forecast | 2011 forecast | 2012 forecast | 2013 forecast | 2014 forecast | 2015 forecast |
|---|---|---|---|---|---|---|---|
| Implied OBR estimate for the rate of growth of real GDP in the absence of 'fiscal consolidation' as measured by the % annual increase of GDP* | - 4.1 | 0.9 | 3.0 | 3.4 | 3.5 | 3.3 | 3.1 |
| OBR's estimated reduction of the annual economic growth rate due to austerity measures** | 0.8 | 0.3 | - 0.7 | - 0.6 | - 0.6 | - 0.6 | - 0.4 |
| OBR's estimated rate of economic growth* * | - 4.9 | 1.2 | 2.3 | 2.8 | 2.9 | 2.7 | 2.7 |

*Derived from OBR June 2010 Table C3 **Source: OBR June 2010 Table C3 government's books. However, it was accepted that fiscal policy could have a significant short-term impact on levels of output and employment – although this impact was weaker and of far less duration than the old Keynesian orthodoxy had once believed.

Schooled in mainstream economic theory, and adherents of the 'new macro-economic policy making consensus', the policy wonks, economic forecasters and SPADs that devised Osborne's Plan A no doubt were inclined to discount the impact that their proposed 'fiscal consolidation' would have on the economic figures for growth and unemployment, let alone the impact it would have on people's lives outside their well-remunerated circles. But they did not ignore it altogether. As can be seen from Table 2 (above), the OBR was able to calculate the impact of the proposed austerity measures on economic growth with great precision.

Indeed, the impact of Plan A on growth was part of, what at the time, must have appeared a rather cunning plan.

**The cunning plan**

In 2010 there had certainly been growing concerns over the continued weakness of the economic recovery. However, buoyed by the confidence born of the experience of the long upswing and the great moderation, it was widely accepted amongst mainstream bourgeois economic opinion that once the recovery did begin to gain momentum it would rapidly reach the point of take-off. Indeed, for mainstream economists at least, within Plan A's time horizon of five or more years, the danger was not that economic growth would be too weak, but that it might be too strong.

**Table 3. Output gap without austerity (forecasts)**

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Implied OBR estimate for the rate of growth of real GDP in the absence of 'fiscal consolidation' as measured by the % annual increase of GDP* | 3.0 | 3.4 | 3.5 | 3.3 | 3.1 |
| Year's reduction in output gap as % of GDP if natural rate of growth is 2.25% per year | 0.75 | 1.15 | 1.25 | 1.05 | 0.85 |
| The 'output gap' as % of GDP (assuming an output gap of 4% in 2010) | - 3.25 | - 2.1 | - 0.85 | **0** | + 1.5 |

*Derived from OBR June 2010 Table C3

The economy could be envisaged as a weight on a spring that had been pulled down by the banking crisis. Once the banks had recovered from the crisis the 'weight' would be released and, given the vigour of UK capitalism, would then sharply spring back. Indeed, the more the economy had been pulled down by the crisis the faster it could be expected to spring back. Since the crisis had caused such a sharp contraction, the danger was that the consequent expansion of the economy could be so strong that it could seriously overshoot its equilibrium position thereby giving rise to dangerous oscillations.

So how much of a danger was this? To see how the adherents of the 'new macro-economic policy consensus' approached this issue we must consider two of their key notions: firstly, what we may call the 'natural rate of growth' and secondly the so-called 'output gap'.

It was generally assumed amongst mainstream economists that the continued growth in the working population, combined with the introduction of new technology, organisation and equipment into the production of goods and services, meant that there was a fixed 'natural' rate of growth in the productive capacity of the economy. Of course, it was argued, in the long run the economy cannot grow faster than its potential capacity. Therefore the natural rate of growth could be seen as placing an upper limit to the long term average rate of economic expansion.

However, it was also assumed that the drive of firms to maximise profits and for individuals to maximise the 'utility' would ensure that the actual rate of the growth of the economy in the long term would be pushed towards this upper limit. Thus, it could be concluded, the 'natural rate' of growth would determine the average long term rate of the economy. Hence, by working backwards, the OBR calculated the long term average rate of growth over recent decades and then concluded that the natural rate of growth of the UK economy was a remarkably precise 2.25% per year – as opposed to the 2.5% that had been calculated by HM Treasury.

Now of course the sharp contraction in the UK caused by the crisis had left the economy operating far below its potential. With shops and factories lying idle, 2.5 million unemployed and many more working short time there was plenty of spare capacity. There was therefore ample room for rapid expansion once the economic recovery got underway. At first the economy would be able to grow at a rate far faster than the natural rate of growth. But sooner or later a point would be reached where the spare capacity in the economy would begin to run out. Capacity limits would mean output would not be able to keep up with demand leading to rising prices. At the same time, falling unemployment would strengthen the bargaining position of workers and lead to rising wages. As a result inflationary pressures would start to mount. To head off the threat of rising inflation the Bank of England would be obliged to slam on the breaks by tightening monetary policy.

This would then cause a sharp slowdown in economic growth, if not an outright recession. Indeed, the faster the economy was growing at this point, the harder the Bank of England would have to slam on the breaks. The danger then was if the economic recovery was too strong it could lead to a disruptive cycle of boom and bust.

The crucial question then was how much room was there for economic expansion before inflationary pressures would begin to become a problem? According to the OBR's calculations in 2010 the difference between the maximum level of output the economy could produce before inflationary pressures would start to become a serious problem and the actual level of output – what is known as the 'output gap' - was equivalent to around 4% of GDP. The economy could therefore be allowed to grow faster than the natural rate of growth until this 'output gap' was used up.

In Table 3 (above) we present again the implied OBR forecast for economic growth, in the absence of 'fiscal consolidation', based on the evidence of previous economic recoveries in the UK. Now, as we have previously pointed out, in making their estimates for economic growth the OBR had deliberately erred on the side of caution, and their growth forecasts were widely considered by most mainstream commentators to be a bit on the low side.

As can be seen the OBR had expected that, without the fiscal consolidation, the economy would be growing at over 3% a year – well above the natural rate of growth – leading to a substantial reduction in the 'output gap'. As a result, in 2014, if not earlier, the 'output gap' could be expected to be eliminated. By the following year actual GDP would be 1.5% larger than that necessary to maintain a stable level of inflation. The UK economy would then be rapidly overheating. What is more, with the economy then growing at 3.3% the Bank of England would have to slam the breaks on hard if was to slow the economy down to below the natural rate in order to hit its inflation targets.

But the architects of Osborne's Plan A had their cunning plan. Their proposed 'fiscal consolidation' would be sufficiently large that it would act as a drag on the overall growth of the economy. By keeping the growth of the economy to little more than ½% above the natural rate of growth the scale of 'fiscal consolidation' proposed in Plan A, it could be claimed, would serve to both avert the danger of the economy overshooting and prolong the economic recovery. As can be seen from Table 4, the OBR's estimates for the impact of the austerity measures proposed in Plan A on economic growth would mean that by 2015 there would still be plenty of spare capacity in the economy with little more than half of the original output gap having been used up.

Everyone who mattered could not help but be pleased by the OBR's figures. Mervyn King – who as we have seen had been one of the prime advocates of Plan A - was no doubt well satisfied. As the governor of the Bank of England, he faced two formidable problems over the coming few years. The first was how to manage the government's growing debt. The second was how to unwind the unprecedented monetary policies that had been necessary to save the global financial system, without either plunging the economy back into recession if he moved to unwind too fast, or trigger a huge credit boom if he waited too long. The last thing Mervyn King wanted was the prospect of the Bank of England having to intervene to cool off a rapidly overheating economy. The OBR's figures not only promised an eventual halt to the growth in government debt, but, in doing so, also suggested that the Bank of England's management of monetary policy would not be further complicated by an inflationary boom anytime soon.

The mandarins of the Treasury, no doubt, were also well pleased that the 'fiscal consolidation' proposed by Osborne's Plan A set out a firm plan for halting the rise of public debt but would also would serve to mitigate, if not avoid, the recovery from the 'great recession' ending up propagating a vicious economic cycle of boom and bust.

**Table 4. Output gap with austerity measures (forecasts)**

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| OBR's estimated rate of economic growth taking into account 'fiscal consolidation' | 2.3 | 2.8 | 2.9 | 2.7 | 2.7 |
| Year's reduction in output gap as % of GDP if natural rate of growth is 2.25% per year | 0.05 | 0.55 | 0.65 | 0.45 | 0.45 |
| The 'output gap' as % of GDP (assuming an output gap of 4% in 2010) | -3.95 | -3.4 | -2.75 | -2.3 | -1.85 |

But there is perhaps little doubt that it was the political masters of the policy wonks, economic forecasters and SPADs that were most pleased by the OBR's figures. David Cameron and Nick Clegg could now expect to go in to the 2015 general election not only able to claim that they had made the 'hard and difficult' decisions necessary to put the nation's finances back on track, but they would be able to do so in the middle of a mini economic boom.

So it cannot be said that the architects of Plan A simply denied that their proposed austerity measures would have any impact on economic growth. But the question still remains as to what

**Table 5: The immediate impact of fiscal consolidation on the OBR's estimates for economic growth**

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Implied OBR estimate for the rate of growth of real GDP in the absence of 'fiscal consolidation' as measured by the % annual increase of GDP* | 3.0 | 3.4 | 3.5 | 3.3 | 3.1 |
| Fiscal consolidation as % of GDP (to one decimal place)** | - 1.5 | - 1.3 | - 1.3 | - 1.3 | - 0.9 |
| Resulting estimate for the immediate impact of fiscal consolidation for the annual rate of economic growth | 1.5 | 2.1 | 2.2 | 2.0 | 2.2 |

*Derived from OBR June 2010 Table C3

**Derived from (assuming a fiscal multiplier of 0.45) OBR June 2010 figure C.3.

extent did they seriously underestimate the effect of their plan for 'fiscal consolidation'.

**OBR and the little matter of the 'fiscal multiplier'**

As we have seen, the cut backs to public spending and increase in taxes proposed in Osborne's Plan A amounted to £128 billion – close to 7% of GDP - over the course of five years. Now it might be supposed that by taking this amount of money out of the economy the growth of the economy would be correspondingly lower. So, if 'fiscal consolidation' amounts to 7% spread over five years then, other things being equal, we might expect the average annual rate of growth would be about 1.4% points lower than it would otherwise have been. This we might call the immediate impact of Plan A's impact on economic growth.

Table 5 shows the 'fiscal consolidation' for the five years of Plan A and the immediate impact this might be expected to have on the OBR's estimates for economic growth. If we compare Table 5 with Table 4 two important observations can be made.

The first observation is that the OBR's estimate for the effect of Plan A's 'fiscal consolidation' on the annual economic growth rate is less than 50% (45% to be exact) of what we might expect from its immediate impact. The second observation is that even with the immediate impact of 'fiscal consolidation' economic growth should have been close to 2% a year for most of the period. Instead the economy actually grew at barely over 1% in 2011 and by a meagre 0.6% in 2012.[12] So why might this be?

When the government either injects or withdraws money-demand into the economy through fiscal policy it does not simply add to, or subtract from, the existing total amount of demand. The injection or withdrawal of money-demand has further knock on effects – that is things do not remain equal. These secondary effects may be divided into those that amplify the change in fiscal policy and those that tend to diminish it.

The most important of the amplifying effects that have been identified is what might be called the Keynesian multiplier effect. The original notion of the multiplier was first put forward by Keynes's student, Richard Kahn, and was specified in terms of employment rather than in terms of income or output. Keynes then deployed Khan's notion of the employment multiplier as part of his arguments against the then orthodox 'Treasury view' that public works schemes aimed at reducing unemployment were futile. As a rather beguilingly simple argument 'Khan's multiplier' has often been central to the more popularised presentations of Keynes's economic ideas.

Using an example more in keeping with the UK economy in the 21st century rather than the 1930s, Keynes's argument goes as follows: if the government spends say £100m to employ the unemployed on public works schemes then this does not simply increase the national level of employment by the numbers employed, and with this the national income by the wages paid to the workers. The workers will soon go out and spend their wages. If the entire £100m has been paid out in wages, then perhaps 5% of this on average might be saved, 40% might go in income tax, national insurance, VAT and other taxes and 30% might be spent on imported goods. The remaining 25% would then be left to be spent on goods and services produced in the national economy. This would produce income in the form of profits, wages and rents for those supplying these goods and services, as well as producing a corresponding increase in employment. Thus the original £100m injected in to the economy would lead to an increase in the national income by £125m. But this is not all. The recipients of the extra £25m would in turn spend a proportion of their augmented income. If this process was repeated, and in each successive round the same proportion of income ended up being spent on nationally produced goods or services – i.e. the 'marginal propensity to consume' remained at 25% - then the original fiscal expansion of £100m would end up increasing the national income by £133m. What is more the amount of employment created could then be expected to be more or less a third greater than that employed on the public works.

So, in this example, a £100m in extra public spending could be expected to increase national income by £133m. Contrawise, if public spending was cut by £100m the reduction in total income could also be expected to be £133m. The 'fiscal

[12] Source: *The Guardian*. www.theguardian.com/news/datablog/2009/nov/25/gdp-uk-1948-growth-economy

multiplier' would then be 1.33 – i.e. for every £1 injected into, or withdrawn from the economy, national income would change by£1.33.[13]

Now, as we have seen, against the importance ascribed to fiscal policy by the old Keynesian orthodoxy, the monetarists had argued that any tax cut or increase in public spending aimed at increasing aggregate demand would necessarily lead to an increase in the budget deficit and therefore to more government borrowing. Given well-functioning financial markets, and competition for relatively scarce loanable funds in these markets, any increase in the amount of public sector borrowing would end up 'crowding out' private sector borrowing. With less private sector borrowing there would be a fall in private sector incomes and demand. With private spending having its own multiplier, the reduction in national income due to this 'crowding out' effect would eventually more or less cancel out any increase due to fiscal expansion. Contrawise with a 'fiscal consolidation'. A 'crowding *in* effect', it was supposed, would mean that the private sector would soon tend to expand to offset the short fall of national income due to tax rises or public spending cuts.

As a consequence, it had become generally accepted within the 'new macro-economic policy-making consensus' that all these secondary effects of fiscal policy could be expected to have worked themselves out in not much more than a year. At first it might be supposed that the immediate impact of any fiscal expansion or contraction would be augmented by the 'Keynesian multiplier effect', and as a result the fiscal multiplier might briefly become greater than one. But soon the 'crowding-out' or 'crowding-in effect' would start to kick in. Over the course of a year or so the fiscal multiplier would decline towards zero. The average fiscal multiplier over the year – and hence its impact on that year's annual rate of growth figures – could be expected to be well below one.

The OBR's estimate of the average 'fiscal multiplier' over the course of a year was 0.45 – that is, in terms of GDP, 1% of fiscal contraction, or as they put it 'fiscal consolidation', would lead to the annual rate of growth of the economy being reduced by 0.45%. So how did they actually arrive at this figure for the 'fiscal multiplier'? The OBR tell us that their estimate for the fiscal multiplier for the UK economy was derived from a number of empirical studies that have been made over recent years. These studies had resulted in various estimates for the fiscal multiplier that ranged from close to zero to 0.8. The OBR had then picked 0.45 as being somewhere in the middle.

In fact, the actual fiscal multipliers over the last two years have turned out to be 1.2 in 2011, rising to 2.15 in 2012. So why did the OBR get it so wrong?

Now it is true that the OBR had admitted that there could be a significant variation in the fiscal multiplier depending on what tax rates were raised and where the proposed public expenditure cuts were actually to be made. This was because the marginal propensity to consume can be expected to vary significantly between different groups of people. Thus, for example, because poor people tend to save less out of any increase in income than the rich, they can be expected to have a higher marginal propensity to consume. Hence, it might be supposed that cuts to welfare benefits will result in a higher fiscal multiplier than that resulting from an increase in the higher rates of income tax.

In June 2010 the OBR knew the total amount that tax rises were planned to bring in, and the total amount government spending was planned to be cut in each year of Plan A. But, although they knew that the bulk of the tax increases would come in the form of a higher rate of VAT, they would not know in any detail where the cuts to public spending were to fall until the spending review due in the autumn. Therefore, it might be argued that Osborne's subsequent decision to target the welfare budget meant that the OBR could have significantly underestimated the fiscal multiplier.

However, the OBR's estimate of what we might call the composite multiplier of 0.45 had in part been derived from estimates of the various disaggregated fiscal multipliers for changes to different areas of public spending and for different taxes that were likely to occur as a result of Plan A. As was revealed in their re-evaluation of their original forecasts, the OBR estimate for changes to welfare spending was 0.6.[14] What is more the welfare cuts only accounted for less than a sixth of the total public spending cuts. Thus, even if the OBR had assumed the welfare budget would be ring-fenced in the subsequent spending review; their estimate for the composite fiscal multiplier for Plan A would not have been much more than 5.5. Thus Osborne's unexpected attack on welfare benefits is unlikely to have made a substantial error in the OBR's estimate for the fiscal multiplier – particularly if it is assumed that the Keynesian multiplier effect is relatively short lived.

The anti-austerian critics of the OBR might well question the empirical studies on which the OBR's estimate for the fiscal multiplier was based. Certainly there is plenty of scope for ideological

[13] Of course this is based on the assumption that the reaction to an increase in income is proportionately the same as a reduction in income, which is by no means the case.

[14] OBR, *Forecast Evaluation Report,* autumn 2012, p.52.

bias in econometric studies in terms of both the assumptions made in the statistical analysis and in the interpretations of the results. But even taking this bias into account it would seem unlikely that it can fully explain the degree to which the OBR underestimated the impact of fiscal consolidation on economic growth. Indeed, even at the height of Keynesianism, when the proportion of foreign trade was significantly smaller as a proportion of the UK economy and thus the leakage of demand due to purchase of imports was less, the fiscal multiplier was usually considered to be around 1.5, and rarely believed to be higher than 2.

But more fundamentally, there is evidently a problem with the very concept of the fiscal multiplier that is supposed to be a constant but can vary so much. Of course the fiscal multiplier is merely a *post hoc* empirical observation that claims there is an observed regularity between changes in the government's budget deficit and the rate of economic growth. It can only be assumed as a constant on the grounds that everything else remains the same, but the fact that it was estimated to be well below 1 before 2010, then increased to well over 1 in 2011 and then over 2 a year later only proves things have not remained the same.

### So what was austerity's accomplice?

So we may conclude that by itself the impact of fiscal consolidation would seem to be an insufficient explanation for what waylaid the economic recovery. The problem then is not so much that the OBR and other economic forecasters underestimated the fiscal multiplier, and hence the impact of fiscal consolidation on economic growth, but that they overestimated the underlying economic growth of the UK economy in the first place. So what caused this slowdown in underlying economic growth?

Although in the short term the state can increase or decrease the growth in the economy by means of fiscal and monetary policy, in the long term the rate of economic growth is determined by the rate of capital accumulation. The rate of capital accumulation depends on the proportion of surplus value that is expropriated from the working class that is re-invested into the expanded reproduction of capital – that is it depends on productive investment. In short it is productive investment that drives the growth of the real economy.

In this respect what has been notable in the period following the financial crisis is the persistence of low levels of investment. As might have been expected, the immediate impact of the crisis on the real economy had been a sharp fall in both profits and investment. However, through a concerted class offensive capitalists have been able to go a long way towards restoring their profit rates by shifting the costs of the crisis on to the working class. However, although profits have increased following the immediate aftermath of the crisis, productive investment has remained well below pre-crisis levels. Indeed, gross fixed capital formation has fallen by more than £50 billion in real terms since it peaked in the first quarter of 2008.[15]

So what has caused this shortfall in investment? This brings us to the second of our conjunctural explanations for what killed off the economic recovery that locates the lack of growth to the persistence of the after-effects of the great financial crisis of 2008.

## SO WAS IT THE BANKERS WHAT DONE IT?

As we pointed out earlier, the architects of Osborne's Plan A, along with most of mainstream economic opinion at that time, had come to recognise that due to the after-effects of the banking crisis there might be a period of slow and uncertain growth. Yet they had assumed that this period would not last that long. So it might be argued it was not merely that the mainstream economic forecasters had underestimated the impact of their proposed austerity but that they had also seriously underestimated how long the hangover from the crisis would last.

So did the OBR underestimate after-effects of the crisis? To answer this we must look at how the financial crisis, and in particular its impact on the banking system, may have resulted in a prolonged period of low investment on the part of UK businesses.

### Where did all the bankrupts go?

One of the remarkable things about the recession that has followed the financial crisis in 2008 is the surprisingly low level of company bankruptcies. Despite the largest contraction in the economy since the 1930s, the British economy has seen the lowest rate of company liquidations[16] of any recession since at least the 1960s. Now it is true that changes to commercial law due to the Enterprise Act (2002) have made it far easier for companies in financial trouble to avoid being declared bankrupt. As a consequence, the proportion of companies going bust each year

[15] See a discussion of this fall in investment on the Socialist Economic Bulletin blog: http://socialisteconomicbulletin.blogspot.co.uk/2013/06/why-do-we-have-austerity-and-what-is.html

[16] 'The rate of liquidation' is the number of companies over a given period that have been declared bankrupt and have had their assets sold off to meet the claims of their creditors expressed as a proportion of the total number of registered companies.

had almost halved in the period following the implementation of the 2002 Act. Yet even taking this into account, the rise in the rate of liquidations following the onset of crisis has been, as the Old Lady of Threadneedle Street has put it, 'modest' compared with previous recessions – particularly given the scale of contraction of the economy.[17]

What might have been the reasons for such a relatively low level of bankruptcies? Was it simply because fewer companies had ended up in financial difficulties due to the impact of this recession compared with previous recessions?

Now it is true that, taken as a whole, the 'non-financial corporate sector' in the UK had been in fine financial health on the eve of the financial crisis. Profits had in general been high and, in the years since the millennium, the 'non-financial corporate sector' had become a net saver - and had thereby accumulated substantial financial reserves. Although profits fell sharply across the board in the months following the financial crisis, for the majority of companies profits had not fallen far enough to put them in the red. There were of course sectors, such as construction, property and high street retailing, which had been particularly hard hit by the contraction of the UK economy, and had as a consequence seen profits fall far further than the average fall in profits across the economy as a whole. There were also companies in declining industries, or with 'outdated business models', that on the eve of the crisis had already been earning profits well below the average rate of profit, and therefore had far less distance to fall before going into the red. However, even in such circumstances many companies could still rely on their ample financial reserves to absorb any losses they did suffer.

Furthermore, as we have already mentioned, the crisis had provided an opportunity for capital to launch a class offensive. With surprisingly little resistance, through large scale redundancies, short time working, wage cuts and the imposition of new terms and conditions of employment (including the explosion of zero hour contracts), capital had managed to shift the costs of the recession onto the working class. As a result, in little more than a year following the near meltdown of the global financial system, profit rates were already well on the way to being restored to their pre-crisis levels. Many of those firms that had slipped into the red due to the contraction of the economy were able to quickly restore profitability by slashing costs. For them the period of loss making had therefore been relatively short. The extent to which such firms did have to dip into either their savings or borrow to cover their losses was therefore limited.

Thus it might be supposed that, due to the particularly strong financial resilience of the non-financial corporate sector on the eve of the crisis, the numbers of commercial or industrial firms finding themselves facing bankruptcy would have been substantially lower than might otherwise be expected given the scale of the contraction of the economy.

However, even though British industrial and commercial capital as a whole may have been in fine financial fettle, it is also true that company debt had grown to exceptionally high levels in the years leading up to the financial crisis. As could be expected during such a prolonged period of stable and steady economic growth, many firms in the run up to the crisis had borrowed heavily in order to invest in the expansion of their businesses in the then seemingly reasonable expectation that once the returns from such investment came in they could easily pay off their debts. Other firms, particularly in the construction and property sectors, had borrowed heavily to make profits out of speculation on rising land and property prices generated by the housing bubble.

However, the sharp fall in sales and hence profits that followed the crisis meant that in many cases the profits that these firms were still making were insufficient even to cover the interest they were obliged to pay on their debts. What is more, the downturn meant that these firms might have to scale back the returns they could expect to make in the future from which they had hoped to eventually pay off their debt.

In addition to these firms that had borrowed to finance investment or speculation, there had also been those that had been burdened with high levels of debt due to the craze for 'leveraged buyouts' and the conversion of Public Limited Companies (PLCs) into private equity firms that had taken off in the years prior to the financial crisis. This had left firms burdened with excessively high levels of debt that had been used to finance the buying up of PLC shares. With the fall in profits due to the economic recession many of these firms also found themselves facing problems keeping up with their debt obligations.

As a consequence, on the eve of the crisis, there had been a substantial minority of firms – the 'fat tail' as they have been called – that were highly indebted, and thus in a potentially precarious financial position. Following the impact of the recession, even though they might still be making a profit, many of these firms could be expected to have found themselves on the verge of bankruptcy. Indeed at the time of the culmination of the financial crisis in autumn of 2008, there had been very real fears that stricken

[17] See the discussion of these phenomena in the Bank of England, *Financial Stability Report*, June 2010, pp. 32-33.

banks, in a desperate attempt to stave off their own financial collapse, would slash their lending and call in their loans to this 'fat tail' of firms. This could then lead to an avalanche of bankruptcies, pulling the rest of the more financially sound parts of corporate UK down with them.

So, although the numbers of companies in financial distress due to problems of profitability may have been far less than in previous recessions, this would seem to have been more than offset by the numbers in distress due to problems arising from excessive burdens of debt. So it would seem that the exceptionally low rate of liquidations was not due to fewer firms finding themselves in financial trouble.

So what else may have caused such a low rate of liquidation?

**To liquidate or not to liquidate?**

It is perhaps generally accepted that it was only the prompt action of governments and central banks across the world following the collapse of Lehman Brothers investment bank that had averted a complete meltdown of the global financial system. The implementation of unprecedented measures of slashing interest rates to unprecedented low levels, 'monetary easing', the nationalisation and 'recapitalisation' of vulnerable banks deemed 'too big to fail' and government guarantees to bank depositors, had all served to stabilise the banking system.

As we shall consider in a little more detail later, in stabilising the banking system, these measures had also enabled banks to sustain existing levels of lending to the 'real economy'. This had allowed banks to exercise a considerable degree of 'forbearance' in dealing with those of its customers, particularly firms in 'the fat tail', in serious financial distress. Instead of demanding their 'pound of flesh', banks could roll over debt that was falling due, allow missed interest payments to be added to the principle of the debt, allow a restructuring of debt to give companies more time to make their debt repayments or even write off a part of the debt to make it easier for them to pay off the rest. As a result, companies in financial difficulties could be kept afloat, thereby reducing the risk of an avalanche of bankruptcies. Thus it was that the vicious cycle of a contraction in the 'real economy' leading to a further crisis in the financial system which would then lead to a further economic contraction and so on, and ultimately leading to a great depression on the scale of the 1930s, was arrested.

Now it should be said that it is quite normal for banks early on in a recession to exercise a considerable degree of 'forbearance', particularly with regard to loans to companies that owe them a substantial amount of money. There are two main reasons for this. First, at the beginning of a recession there is great uncertainty as to how deep and how long it will be. There is therefore considerable difficulty on the part of banks to distinguish between those companies who can be expected to eventually recover sufficiently to be able to pay back their debt more or less in full; and those that are simply going to fall deeper and deeper in debt and are never likely to be able to pay back what they owe.

Second, it often makes sound commercial sense for banks to keep even those firms who are clearly unlikely to be able to pay off the debts alive. If the bank were to force such a company into liquidation immediately, in the middle of a recession, then the sale of the company's assets, from which the bank would hope to recoup some of the money lost on its loans to the company, is unlikely to bring in as much as if they waited until the economy began to recover and the price of the firm's assets had begun to rise.

Indeed, it is for these reasons that the rate of liquidations usually peaks two or so years after the beginning of a recession, that is usually in the early stages of the recovery, by which time the sheep can be sorted from the goats and when the goats will be fattened enough to be slaughtered.

However, in the wake of the near meltdown in the financial system there had been a further and very important reason for banks to exercise a considerable degree of 'forbearance'. At a time when it was still unclear how far governments and central banks had been successful in stabilising the banking system, and how much they had 'left in the locker' if they had to deal with a further round in the financial crisis, banks were under intense scrutiny from the financial markets for any sign of weakness. The last thing the banks wanted to do in such a situation was to record a rising number of loan defaults by forcing companies into liquidation. So long as they were able to more or less pay the interest on their loans, it was far better to keep a failing company going by rolling over its loans, and thereby postpone the 'realisation' of the losses on the debt, until confidence in the banking system had fully recovered.

So it seems more likely that it was the exceptional 'forbearance' that had been exercised by the banks in the wake of the financial crisis, which had been made possible by the measures taken to save the banking system, that has been the main reason for the unusually low rate of liquidations, rather than a low number of firms in financial distress. Indeed, despite interest rates being at very low levels, more than 25% of the total number of registered companies with a turnover of more than £1 million reported that their gross operating profits were lower than the interest due on their debt – implying that they were dependent on the forbearance of their banks and creditors.[18]

As we have seen, this low rate of liquidation played an important part in preventing the recession from deepening into a 1930's-scale depression; but as we shall now see, in doing so it has played a part in delaying the recovery.

**The banking crisis**

During the period of what became known as the 'Great Moderation' that immediately preceded the onset of the financial crisis, when no doubt financial and economic turbulence seemed to the up and coming financial whiz kids to belong to another century, banks, and indeed most other financial institutions, had become dangerously 'over-extended'. In order to maximise their profits, particularly at a time when profit margins were being squeezed, banks had sought to greatly expand the volume of their operations. The big commercial, or 'high street', banks had not only sought to expand their commercial operations by increasing the availability of loans to businesses and individuals, but also, through their investment banking arms, had greatly enlarged the volume of their trading on the rapidly expanding global financial markets. However, the banks drive to expand their operations had been limited by the need to hold reserves; both in the form of 'cash' (that is notes and coins plus money held on account at the Bank of England) and safe financial assets, such as government bonds, that can be easily turned into cash.

Cash and 'near cash' reserves are needed by banks for two reasons. First, to cover any shortfall in cash that might arise from the day to day fluctuations in inflows of cash (such as firms or individuals depositing money into the bank or repaying their debts); and outflows (such as firms or individuals withdrawing money or demanding repayment of loans made to the bank in question). Second, a bank needs reserves to cover the risk of incurring losses on both their commercial and investment banking operations, due for example, to 'counter-parties' or their customers defaulting on all or part of their debt, or to falls in the prices of assets held by the bank. Other things remaining equal, the greater the volume of its operations, the more reserves a bank needs to hold.

The problem for banks is that holding cash and reserve assets is not very remunerative. Cash pays no interest, while the returns on government bonds and other reserve assets are relatively small compared with the profits that can be made through commercial and personal loans, let alone from wheeling and dealing on the global finance markets. There is therefore always a tendency for banks, particularly during periods of economic stability when the risk of losses seem minimal, to minimise the amount of reserves held relative to the volume of their commercial and investment banking operations, and thereby become 'over-extended'. Indeed, in order to prevent them from becoming over-extended, a complex set of banking regulations have evolved that require banks to maintain at least a minimum ratio between their volume of lending, and other operations, and their reserve assets - that is their 'capital ratio'.

However, the period of the 'Great Moderation' had seen the development of a number of ingenious financial instruments and banking practices that allowed banks to circumvent such banking regulations in order to expand their operations. The development of 'securitization' of debts and complex derivatives, the growth of shadow banking and special investment vehicles, and expansion of inter-bank lending and 'wholesale funding', had all allowed banks to extend their operations to the far beyond of what would have traditionally been seen as prudent. As a result, the global financial system had become increasingly fragile.

In the summer of 2007 this fragility of the global financial system, together with its opaque complexity, was brought home to everyone when what had appeared as rather minor troubles in an obscure corner of the US mortgage market spiralled out of control leading to what became known as the 'credit crunch'. As we have pointed out elsewhere, the amount of losses due to rising defaults in the US sub-prime market had been relatively small. However, because sub-prime loans had been 'diced and spliced' with other mortgages and then sold to banks and other financial institutions across the globe in the form of Residential Mortgage Backed Securities (RMBS) no one knew where or when losses due to mortgage defaults would appear. The market for RMBS froze, since no one could know if the RMBS they might buy would turn out to be toxic debt. Banks had used RMBS to supplement their reserve assets, since they had been generally viewed by both bankers and regulators as being 'safe as houses', and could be turned into cash at short notice. But now, unable to sell them, there were fears that, with their capital ratios already so low, banks would not be able to find enough cash to settle their debts or deposit withdrawals that were falling due. As a consequence, there had been a serious 'liquidity crisis'. The money markets, where banks lend to each other over very short periods seized up, as banks desperately sought to hold on to as much cash as they could by refusing to lend to other banks.

Having come to the rescue of the banks by 'flooding the banking system with liquidity' in the form of short term loans, the monetary authorities

[18] Bank of England, *Financial Stability Report,* December 2011, Chart 2.21, p.28.

across the world had urged the banks to start raising their 'capital ratios'. This could be done from both ends. First, the amount of reserves held by the banks could be increased. This could be done by reducing the amount the banks paid out of their profits in the form of dividends to their shareholders and bonuses to their directors and star traders. The money saved could then be deposited as reserves in their accounts with the central banks or used to buy reserve assets. Alternatively, the banks could raise capital on the stock market by issuing more shares and use the proceeds to increase their reserves. Second, the banks could raise their 'capital ratios' by reducing their lending and trading operations.

However, the banks were rather reluctant to carry out either of these ways of raising their 'capital ratios'. As far as raising their reserves was concerned, they certainly did not want to cut their bonuses. Cuts to dividend payments or the issuing of new shares risked a fall in the share price. This would reduce the value of bankers' share options and could increase the risk of a hostile takeover by rival competitors. The banks were equally reluctant to rein in the volume of their potentially lucrative lending and trading operations. After all, why should the banks worry when they know that if anything went wrong they had the virtual guarantee that the authorities would bail them out?

As a result, the banks dragged their feet, much to the growing alarm of governments and central bankers who feared that the banks had far too little reserves to weather a further financial storm. In the autumn of 2008 the situation came to ahead when the US Treasury secretary, Hank Paulson, in a remarkable act of brinkmanship, refused to provide state aid to bailout Lehman Brothers – one of the top five investment banks – triggering the near meltdown of the global financial system.

The collapse of Lehman Brothers set off a tidal wave of losses in the banks' investment banking operations, as financial companies went bust, defaults rose and asset prices fell. As a result, the banks' reserves were becoming seriously depleted and their capital ratios began to fall to dangerous levels. As they stared into the abyss, the bankers now had little option but to fall in to line behind the monetary authorities' efforts to shore up the capital ratios of the banks without at the same time triggering a sharp contraction in their lending to the real economy.

First of all, those banks teetering on the edge of bankruptcy, and deemed 'too large to fail', were given the ultimatum of either somehow raising money from somewhere, or else face the ignominy of having to issue and sell shares to the government in order to increase their reserves – and in doing so accept their effective nationalisation. In this way the government and the monetary authorities were able to raise the capital ratios of the weakest banks so they could continue to absorb losses without having to slash their lending.

This was then followed up by what has become known as 'quantitative easing'. The Bank of England set out to effectively create unlimited amounts of money in order to buy up government bonds that were the banks' core reserve assets. The first effect of 'quantitative easing' was therefore to shore up the price of government bonds, and thereby the market valuation of the banks' core reserve assets. This helped stabilise the banks' capital ratios. The second effect of 'quantitative easing' was to reduce long-term interest rates that determined the cost of borrowing for 'companies and individuals' in the real economy. This reduction in long-term interest rates made it far easier for heavily indebted firms and individuals to manage their debt obligations, and thereby avoid default, and it also made it far easier for banks to exercise an exceptional degree of forbearance.

The measures taken to shore up the financial position of the banks played a major part in averting the meltdown of the global financial system, as well as limiting the impact of the financial crisis on the real economy by allowing the banks to sustain their lending to companies and individuals. However, they did not resolve the formidable problem of the huge and uncertain losses the banks had suffered on their investment banking operations as a result of the crisis. For the most part, all these measures had done had been to buy time.

**The squeezing of the SMEs**

By greatly expanding its role as 'lender of last resort', the Bank of England, along with other central banks across the world, had ensured that the banks had sufficient funds to roll over to meet their immediate obligations. This had allowed the banks to postpone the day of reckoning when the losses would have to be realised for months, if not years. This gave the banks time to build up their reserves to meet both the losses they had incurred on their investment banking operations due to the crisis, and any further losses they may eventually incur on their commercial banking operations due to the contraction in the real economy. It also gave the banks time to raise their capital ratios in order to both improve their financial position and to meet the substantial increase in the minimum regulatory levels that might be expected from the international negotiations concerning the urgent overhaul in banking regulations aimed to prevent a repeat of the financial crisis of 2008.

The banks now had little alternative but to begin in earnest to raise their reserves in order to cover the eventual realisation of losses and to raise their capital ratios. At first there had been little prospect of raising money by issuing and selling bank shares on the stock market. After all who was going to buy shares in banks that had only recently nearly gone bust, and which were unlikely to be able to pay out very much in dividends for some considerable time? Instead the banks had sought to make savings by cutting their operating costs through large scale redundancies, and by pruning back their branch networks. With dividends and bonuses cut back, the savings from this cost cutting could then be funnelled into the banks' reserves.

However, the scope for making operational cuts without impairing the banks' operations and profitability were limited. With the reserves of the banks being steadily depleted in order to cover the stream of losses deferred from the crisis, the attempts by the banks to increase their reserves from the flow of savings made by such cost cutting was like trying to fill a bath when you've lost the plug. If they were to raise their capital ratios at anything like the rate demanded by the monetary authorities it soon became clear that they would also have to curtail the volume of their commercial and investment banking operations.

For much of 2009 the banks had little problem in curtailing their operations. With so many fingers getting burned in the crisis, trading on the global financial markets had fallen well below pre-crisis levels, and the volume of business carried out by the investment arms of the banks had dropped accordingly. Thus there had been little need for the banks to curtail the commercial operations of lending to the real economy. However, by late 2009 the situation had begun to change. As China and the rest of the global south bounced back from the global recession there began to emerge highly profitable investment opportunities in these buoyant emerging economies. Money-capital now began to flow out of the UK along with the rest of the western world towards these regions of dynamic capital accumulation. With much of this trans-global movement of capital flowing through the global financial markets, the previously slow recovery of the business transacted by investment banking became greatly accelerated.

The exceptionally low interest rate policy pursued by the Bank of England and other central banks in order to prevent a sharp contraction of the real economy, had the side effect of reducing the profit margins of the banks' principal commercial banking operation: lending to firms and individuals. This helped to make the profits that could be made by expanding their investment banking operations even more attractive than that of their commercial banking operations. As a result, much to the concern of the Old Lady and her sisters around the western world, the banks began to curtail their lending to the real economy so that they could both expand their investment banking trading and continue to improve their capital ratios. After all, the bankers could argue, in answer to the concerns of both the authorities and their now numerous critics, that by increasing their profits they would be able increase the rate that they were able to put money aside to swell their reserves.

Of course, as their critics were keen to point out, with the revival of casino-style investment banking, all the old practices and attitudes began to re-emerge. The bankers declared that their period of contrition for reckless and extravagant behaviour, which had nearly caused the collapse of the global economy, was over. Bankers' bonuses, and obscenely high rates of remuneration, were soon back, gobbling up a substantial slice of the increase in the banks' profits.

As a consequence of both the recovery of investment banking operations, and the closely associated return of 'bonus culture', the banks have been obliged to curtail their commercial banking operations. As a result, bank lending to both firms and individuals in the real economy has continued to decline over the last four years. The effects of such constraints on bank lending to individuals have been readily apparent in the housing market. By insisting home buyers put up a large proportion of the value of their prospective home as a deposit before they can obtain a mortgage, the banks have been able to strictly ration the demand for residential mortgages. This has meant the housing market has largely remained moribund - with prices stagnant and sales sluggish. The proportion of first time buyers has fallen to record lows, and there has been an unprecedented reversal in the remorseless rise of home ownership.

But perhaps more significant is the continued decline in bank lending to businesses. As we have seen, by exercising an exceptional degree of forbearance for companies in financial trouble the banks were able to play an important part in preventing an avalanche of bankruptcies that could have led to a 1930's-scale depression. But in doing so the banks became locked in to lending to these companies until the economic recovery either floated them out of debt or minimised the losses the banks might have had to realise by pulling the plug. Thus a considerable amount of bank lending was committed to sustaining financially impaired firms. This meant that if the banks were to curtail their lending to businesses then it had to come from companies that were not financially impaired. The main target for the reduction in business lending has focused on 'small to medium sized enterprises' (SMEs) - since smaller firms are usually a more risky proposition than larger ones. When combined with more than a quarter of firms being 'financially impaired' due to high levels of debt, this constraint on lending for new investments is quite considerable.[19]

Therefore there has been something of a double whammy when it has come to the impact of the banking crisis on business investment and therefore capital accumulation. Firstly, those companies that have come out of the crisis highly indebted and dependent on the banks to keep them going are in no position to borrow any more to invest in expanding their business. Secondly, there are those SMEs that are financially sound but are unable to borrow from the banks. Indeed, over the last four years the most persistent complaint coming from small businesses and their representatives has not been the usual moaning about government 'red tape', but the refusal of banks to lend to fund investment. With SMEs employing 60% of the UK's private sector labour force and accounting for 50% of total business turnover this restraint on investment has been quite considerable.

Thus we can see that that the response of the banks to the financial crisis and its aftermath has continued to act as a significant drag on investment and hence on the growth of the economy. However, the question remains as to why these after-effects of the financial crisis have been so prolonged? Indeed, why did the OBR and other mainstream economists seriously underestimate how long these after-effects of the crisis on the real economy would last?

**Zombie capitalism?**

In the immediate aftermath of the financial crisis of 2008 there had been many doomsters, from both the far right and the far left of the political spectrum, who argued that the very measures that governments and central banks had taken in order to avoid a great depression had merely created the conditions for a prolonged period of economic stagnation. After all the banks were technically insolvent[20] and were only being kept going by the Bank of England taking the unorthodox and unprecedented step of creating vast sums of money *ex nihilo* in order to lend them the money to pay their debts. In turn these banks were propping up effectively bankrupt companies that were too indebted to invest. The result was a 'zombie capitalism' in which central banks kept zombie banks going so that they could in turn keep 'zombie companies' ticking over. With little investment there could be little capital accumulation and therefore little economic growth. Post crisis capitalism was therefore doomed to a slow march of the zombies.

The neoliberal faith of mainstream economists and policy makers in the efficiency of the 'markets' had been severely shaken by the unexpected enormity of the financial crisis of 2008. In the immediate aftermath of the crisis the notion of 'zombie capitalism' could not be entirely dismissed even by the stalwarts of the neoliberal mainstream. However, by 2010 the OBR and the architects of Osborne's Plan A could take a more sanguine view. The banks had made considerable progress towards raising their capital ratios and had so far been able to absorb the stream of losses on their investment banking operations that had been deferred from the financial crisis. Most banks had not become zombie banks, but were merely convalescent.

Indeed, it could be claimed, that although the total amount of losses that would have to be realised still remained uncertain – given the distribution of maturities of deals made to defer losses which the banks had undertaken in the wake of the crisis were more or less known – the stream of these deferred losses could be expected to peak two or so years after the crisis, i.e. at the end of 2010 or early 2011. Once this stream of losses had peaked, the pressure on banks to curtail lending would then begin to abate. The banks would then soon be able to resume paying dividends, and with their financial position well on the mend, they could start raising money to 'recapitalise' by issuing shares and selling them on the stock market. It was therefore expected that after 2011 the problems of the banks would recede and the drag on economic growth caused by the aftermath of the banking crisis would be significantly lessened.

So what about the zombie companies? Would not the need to keep the zombie companies going still deprive the innovative SMEs of the lending needed to fuel new investment and thus economic

[19] It should be noted that this is a quarter of the total *number* of companies that are financially impaired. This does not mean that 25% of British capital in terms of value (as measured by say turnover) is financially impaired. Companies that find themselves financially impaired are far more likely to be small enterprises involving small amounts of capital. Unfortunately we do not have the figures that might indicate the proportion of British capital that is 'financially impaired'.

[20] In the immediate aftermath of the crisis most banks could be viewed as being 'technically insolvent' in the sense that if they were to be wound up immediately then the amount raised by selling all their assets would not be enough to meet all their liabilities. This was largely due to the high level of uncertainty as regards to the future prospects of both the financial system and the real economy. No one could be sure whether loans would be paid back or other financial obligations would be honoured. As a result, bank assets, such as loans, bonds and other securities, would either have to be sold at a massive discount or would not be able to be sold at all. Thus the potential value of a bank's assets would fall well below the total value of its liabilities.

growth? The answer to this was that not all financially impaired companies were zombies that would never be able to pay off their debts. Indeed, we might divide the financially impaired into three types.

Firstly there were those companies that had found themselves in financial trouble, and in need of forbearance from the banks had done so because they were in new fast growing industries and had borrowed heavily to rapidly expand their business. With the contraction of the economy having been halted by the end of 2009, they could be expected to be back on track soon. With demand rising faster in their ascendant industries than in the economy as a whole, they could soon expect increasing sales and profits that would then lift them out of debt. The bank lending that had been necessary to keep them going through the recession would therefore be released and could go to relax the squeeze on lending to the SMEs to finance investment. Then, sooner or later, these firms will have restored their finances to the point where they themselves could begin to borrow to invest.

Secondly there were those financially impaired companies that belonged to mature industries that, although essentially profitable, had been caught out by the sharp contraction in the economy. These companies could expect sales revenues to grow broadly in line with the rate of growth of the economy. Thus once the economy began to take off these financially impaired firms would also be able to lift themselves out of debt. In doing so they would also release bank lending to the SMEs and eventually reach a position where they could borrow to invest.

Thirdly there were those companies that would never be able to pay off their debt – the true zombies.

The issue then becomes what the proportions of the financially impaired companies were in each type. The scenario of zombie capitalism was only likely if the financially impaired companies turned out to be predominantly zombies. If, in contrast, most turned out to be of the first type then the problem of financially impaired companies weighing down investment and hence real capital accumulation would simply cure itself. As the first type lifted themselves out of debt on their own accord, this would raise investment and economic growth and thereby drag the second type of financially impaired companies out of debt. This would then leave a small rump of zombie firms that could finally be put out their misery without the banks incurring too much in the way of losses. The funding that had kept these zombie firms going could then be diverted to the SMEs and other firms needing to borrow to make new investments.

However, if, as seemed most likely, financially impaired companies turned out to be of the second type, then the problem of financially impaired companies weighing down investment would only be cured with economic growth. This would seem to present us with a conundrum. If the recovery of the financially impaired companies depended on the recovery of the economy, but the economic recovery depended on the recovery of these very same financially impaired companies, then it would seem that the situation would not be all that different from the zombie scenario. The recovery would be stuck.

However, this was to ignore the big engine of investment and economic growth. Not all productive investment is funded by borrowing from banks. Bank lending is certainly the primary source of investment for SMEs, and it plays an important role for medium to large companies, but this is not the case for large corporations that are responsible for a sizable proportion of investment and hence capital accumulation in the economy. Large corporations fund most of their investment plans either through retained profits, or through the issuing of shares and corporate bonds sold on the global financial markets. They are therefore not dependent on the lending policies of the banks.

There is perhaps little doubt that the OBR *et al* had assumed that investment by the large corporations would lead to the revival of investment in the real economy and thereby break the logjam. After all with their profits rising, together with ample financial reserves, the large corporations seemed to have the means and the incentive to start investing on a large scale. However, as it turned out, they didn't. The large corporations have been content to sit on their massive financial reserves – which are estimated to be around £750 billion, i.e. going on for half the Britain's annual GDP. As a result, although profits have largely recovered their pre-crisis levels, investment in the real accumulation of capital has remained well below pre-crisis levels thereby severely restricting the underlying growth of the economy.

So why have the large corporations refrained from investment? The stock answer to this question is summed up in two words – 'business confidence'. Although this is rather a nebulous subjective term that is often used as a fiddle factor to cover up a gap in explanations, it does have a certain element of truth. So how far can it explain why the large corporations have failed to invest?

Now it can be expected that at the onset of recession, when most businesses will be facing falling sales, the response of capitalists will be one of retrenchment rather than expansion. They will seek to cut costs and prune back their operations, rather than invest in expanding their business by hiring new workers and buying new means of production. However, once the recession begins to bottom out and their sales revenues begin to stabilise this period of frantic retrenchment will draw to a close and a point will come when their thoughts will turn once more towards expansion.

But each capitalist will only decide to commit themselves to making large scale investments in the expansion of their business if they are confident that they will be able to sell the consequent increase in output at a profit. So where does this extra demand come from to ensure the capitalist can sell their increased output. To a large extent it will come from the investment from other capitalists in other industries. If the capitalist is producing wage goods, then the increased demand will come from the extra workers hired by other capitalists. If they produce means of production, the extra demand will come from other capitalists buying new means of production for expansion. Thus the decision on the part of each capitalist to invest in the expansion of their businesses depends to a large extent on their confidence that other capitalists are also intending to invest.

Thus it may be argued that the general level of investment in the economy, and hence the rate of economic growth, depends on the degree of 'business confidence'. If businessmen are pessimistic, or at least believe other businessmen are pessimistic, then investment will be subdued and their pessimism will become self-fulfilling. Contrawise if businessmen are optimistic then they will invest and their optimism will be vindicated. For an economy coming towards the end of a recession, when there still remains a considerable degree of economic uncertainty, the role of business confidence may play a crucial role in either promoting or delaying the economic recovery.

The 'traumatic shock' of the financial crisis, and the consequent sharp contraction of the real economy, undoubtedly shattered the certainties built up during the long upswing concerning the inevitability of continuous uninterrupted economic growth. Indeed, there were huge uncertainties in the months that followed of what might happen not only in the UK but also to the world economy. This uncertainty would no doubt have undermined the 'business confidence' of large corporations and led them to postpone or scale back their large scale investment projects. As the economy began to stabilise towards the end of 2009, the 'business confidence' of the large corporations would have been subdued by the knowledge that large swathes of businesses were unable to invest because they were either too much in debt or else were unable to borrow from the banks. This pessimism about the prospects of a rapid economic recovery would have then been reinforced when it became clear that the government was proposing an unprecedented period of economic austerity that would further depress demand. Then just as the large corporations were overcoming this gloomy outlook they were hit for six by the unfolding of the euro crisis and the impact this would have on their trade with Europe. Hence the depressed 'business confidence' of large corporations can then be seen to have amplified the effects of both austerity and the after-effects of the banking crisis on bank lending in reducing economic growth and delaying the economic recovery.

Yet the problem with this argument is that once the economy had bottomed out at the end of 2009, and it had become clear that there would not be a deep depression on the scale of the 1930s, there was a widespread optimism amongst the bourgeoisie that there would be a rapid economic recovery. This as we have seen was reflected in the views of mainstream economists. Why should the perceptions of the economic situation by large corporations – who usually employ their own economic experts - diverge so much from the sanguine view being put forward by academics and official economists?

More generally, even if 'business confidence' may have an adverse effect on the investment of the large corporations in the short term, it is doubtful to have a prolonged enough effect to explain the delay in the economic recovery for five years. Capitalists do not only invest due to the prospect of making extra profits in the future. They are compelled to invest to defend their capital and their existing level of profits. First, sooner or later, capitalists have to make large investments to replace capital equipment that is wearing out. Such investments might be postponed for a while until the economic situation becomes clearer, but they cannot be put off forever. Second, capitalists are obliged to invest in new and more efficient equipment, production processes or more innovative products in order to head off potential competition. If they do not make such investments then they risk being undercut by their competitors, who are prepared to make such investments, and thereby lose market share.

Thus, although as a subjective factor its impact is hard to quantify, we would conclude that 'business confidence' is insufficient to explain the failure of large corporations to invest. Therefore the delay in the economic recovery cannot be fully explained by 'business confidence' amplifying both the impact of austerity, and the post-crisis constraints on bank lending and investment, on economic growth.

So, if these conjunctural factors are insufficient to explain the delay in economic recovery, are there longer term structural causes that, by depressing the rate of capital accumulation, have depressed economic growth and exacerbated the delay in the recovery of the UK economy? We do not have the space here to consider all the possible long term structural causes that may have helped depress post-crisis growth rates in the UK and elsewhere in the old capitalist heartlands. But there is one, however, that is closely associated with the rise of China and the emerging economies of the global south that we shall briefly consider.

**Outflow of investment to the emerging economies**

As we have already seen, the rapid recovery of investment banking, which led to the curtailment of commercial banking and hence lending to the SMEs, was to a large extent due to the profitable financial investment opportunities offered by the booming emerging economies. However, the rapid recovery of China and the emerging economies of the global south did not merely serve to restrict banking lending to SMEs to fund investment, it also affected the investment decisions of the large corporations. The prospect of making vast profits from the rapid growth of emerging economies stimulated large corporations to shift productive investment away from the UK. But this has not only occurred directly by means of UK-based large corporations setting up business operations in Asia, Africa and South America but indirectly through their financial investments.

As we have mentioned, the large corporations are said to be 'sitting on £750 billion of cash reserves'. Now of course they do not actually hold their reserves in cash. A large part of the reserves of large corporations will be simply deposited in their various bank accounts. But a significant proportion of these reserves are now being held in the form of financial assets that allow them to appropriate part of the surplus value generated by productive investments in the emerging economies. The Bank of England's ultra-low interest rate policy means that these emerging economy-based financial assets have been offering far better returns than that which the corporations can obtain from depositing money in the banks or buying government bonds.

As a result money that might otherwise have been invested in the UK by the large corporations has been used to finance the rapid growth in the emerging economies of the global south. Thus, to some extent, the rapid accumulation of capital in China and the other emerging economies has been at the expense of slower economic growth in the UK and indeed much of the rest of the old capitalist heartlands. This can be seen as part of the shift in the tectonic plates of the global accumulation of capital. But that is another story.

## CONCLUSION

So what has happened to the economic recovery over the past five years? Was the recovery simply held up due to conjunctural factors, such as misguided policy or the hangover from the excesses of the pre-crisis boom; or have there been long term structural factors at work? As we have pointed out, the obvious explanation for the delay in the economic recovery has been the implementation of austerity measures. By cutting too far and too early, it has been argued, Osborne's Plan A killed off the economic recovery. This is an argument that has been consistently been put forward by the Labour party. Osborne's austerity measures have certainly involved unprecedented cuts to public services and the welfare budget. Osborne's Plan A has succeeded in ensuring the working class has taken the brunt of the crisis and has facilitated the acceleration in privatisation and commercialisation of the public sector and the imposition of more 'flexible' labour markets.

However, the scale of the austerity measures in the UK has been nothing like that suffered by the working class in Greece, Spain, Ireland and Portugal - where austerity has led to a downward spiral of falling economic growth, falling government revenues and further austerity. As we have shown, although Osborne's Plan A has undoubtedly acted as a drag on economic growth, it is far from sufficient to explain why the UK economy has more or less flat-lined over the past few years.

This would seem to be supported by looking across the Atlantic. As Keynesians and anti-austerians have often pointed out, the US, unlike the UK, postponed its 'exit strategy' and therefore has not had to endure the three years of austerity. This was due as much to accident as design as the gridlock between President Obama and the Republican-controlled Congress has made it almost impossible to reach an agreement as to how the ballooning government deficit can be brought under control. Nevertheless the result has been that over the last two or three years there has been something of an economic recovery. Yet what the Keynesians and anti-austerians usually overlook is that by historical standards this economic recovery in the US has been exceptionally weak.

In both the UK and US the financial sector plays a major role in the economy. As a consequence, both the UK and the US economies were badly hit by the global financial crisis. So has the economic recovery been held back by the hangover following the financial crisis of 2008? As we have seen, the continued impairment of the banks and heavily indebted companies has served to restrict the level of productive investment vital to economic growth. But while constraints on bank lending may explain the low levels of productive investment in SMEs and medium sized companies it doesn't explain the 'investment strike' on the part of large corporations.

Thus we may conclude while these conjunctural explanations may go a long way towards explaining why the economic recovery has been so long delayed, they still fall short. There is still room for more long term factors. As we have suggested an important factor has been the rise of China and the emerging economies of the global south. Consideration of such long run factors raises the issue of the long term trajectory of capitalist development. Did the crisis reveal the inherent stagnation of modern capitalism, or did it mark the beginning of a long downswing in capital accumulation? Are we witnessing not the decline of capitalism or merely the decline of the US and old capitalist heartlands? Such issues are unfortunately beyond the remit of this article.

What then of the more immediate future? At present there are signs that the period of slow economic growth in the west is drawing to a close. In the US the economic recovery appears to be picking up speed, in Europe the euro crisis has abated and even in the UK there are early signs of recovery. As the economies of the west pick up speed, China and the emerging economies of the global south have begun to slow down. Hence, with the US once more taking up its traditional role as the locomotive of the world economy, the bifurcation of the global economy may also be coming to an end.

However, it is still uncertain how sustainable the recovery in the west will be. In the US there is still the problem of the 'fiscal cliff'. Sooner or later the US government will have to deal with its ballooning debt. There is always the danger that the brinkmanship between Obama and the Republican Congress will end up leading to the imposition of drastic indiscriminate austerity measures that will derail the economic recovery. In Europe there still remains the danger that the euro crisis could re-emerge.

Meanwhile in the UK there are certainly doubts as to how well-founded the economic recovery will be. The putative recovery in the UK seems is largely being driven by the government reigniting a debt-fuelled property boom through its 'Funding for Lending' scheme that encourages banks to offer easier mortgages. Indeed, the extra lending to homebuyers has so far been simply funded by the banks reducing lending to SMEs. Now given that around a third of firms still in financial trouble are in the construction and property sectors, it is possible that a property boom will lift them out of debt and thereby release bank lending to other firms for productive investment, which might then underpin economic growth. Yet it seems more likely that this 'Alice in Wongaland' recovery will merely provide Osborne with a short pre-election boom that will soon burst.

Furthermore, there is the unprecedented problem of how unwind 'quantitative easing' and ultra low interest rates. With a substantial number of companies still finding it difficult to make sufficient profits to pay off the interest on their debts, a premature rise in interest rates could trigger an avalanche of bankruptcies plunging the economy back into recession.

Thus there are still big question marks over the sustainability of the recovery in the west. At the same time there are concerns that there might be a 'hard landing' amongst the emerging economies of the global south. It seems certainly the case that the rapid growth in both China and the other emerging economies over the past four or five years has started to become increasingly speculative. In China the continued state control over the Chinese financial system has so far been able to engineer a soft landing. But this is not the case in many other emerging economies. There are growing fears that there might be a repeat of the financial crisis that hit southeast Asia in 1997. Such fears came to the fore in the summer of 2013 when even mere hints that the US would begin to unwind its policy of 'quantitative easing' prompted a reflux of 'hot money' from emerging economies such as India. It is clear that any such financial crisis would be on a far greater scale than that of 1997 and could easily trigger another global financial crisis – particularly given that most of the world's banks have yet to fully recover from 2008.

So, in short, what we can say is that the future holds many dangers for the development of global capitalism.