

CRISIS AND RECOVERY: HISTORICAL PERSPECTIVES ON THE COALITION'S ECONOMIC POLICIES

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Executive Summary

- The current economic crisis, originating in the international financial crash of 2007-8, bears comparison with those of the 1890s and the 1930s.
- The UK Coalition Government's economic strategy, centring on public spending cuts amounting to £100 billion by 2014-15, is designed to boost investor confidence and create space for a rise in domestic investment by the private sector, leading to growth in manufacturing and exports.
- The likelihood of a positive outcome resulting from this strategy can be tested by comparing the current crisis with those of the 1890s and 1930s, since both share its global dimensions.
- Recovery in the UK during the 1890s and 1930s was led by activity in the domestic rather than the international economy.
- Although the international economic climate today is more benign than it was in the 1890s or 1930s, its buoyancy is threatened by potential for currency wars, spreading protectionism and the choking of the fiscal stimulus in the USA.

- The Coalition's strategy has parallels with the one adopted by the Lloyd George Coalition in the early 1920s. Given the uncertain international outlook and the fragile state of the British economy, the implementation of 1920s-style cuts in a context of 1890s and 1930s-style crises threatens to lead to historically low rates of growth for many years.

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The Current Crisis

The current economic crisis is the outcome of an international financial meltdown in 2007-8 that occurred as the result of vastly over-inflated expectations, symbolised by the sub-prime mortgage crisis that originated in the United States and by the extraordinary hubris of the investment banking sectors of both the European and American economies over several years. Much of the over-confidence was based on assurances from the monetary authorities that monetary management was now sophisticated enough to prevent meltdowns, ignoring Keynes's warning about the unavoidable uncertainty that must dog any attempt to forecast the future.

In the wake of the 5% fall in output in 2008-9 resulting from the financial crisis, and faced with a public sector borrowing requirement equivalent to 10% of GDP in 2009-10, the Coalition government has decided on a strategy of reducing the budget deficit to zero by 2015. They intend to accomplish that mainly by cutting expenditure – around £100bn in total – rather than raising taxes. Their assumption is that cutting the deficit and reducing the PSBR rapidly will raise investor confidence. Opposition politicians such as Alan Johnson and his successor as Shadow Chancellor, Ed Balls, have accused the government of taking 'an unprecedented gamble with the future of the economy', implementing measures likely to curtail demand and hold back growth just as expansion was returning after the recession of 2008-9. Their anxieties have been shared by critical economists such as David Blanchflower, recently a member of the Bank of England Monetary Policy Committee, and Nobel Prize winner Joseph Stiglitz. Chancellor George Osborne has rejected this charge, arguing that the spending cuts are essential, in order to 'take the country back from the brink of bankruptcy'.

The government's response to the critics is that the strategy will work because it will reduce uncertainties about the financial future, make room for domestic investment previously 'crowded out' by public expenditure, and help 'rebalance' the economy in favour of manufacturing and exports. In support of their contention they point to the latest OBR (Office of Budget Responsibility) forecast that under these conditions, output growth of 1.8% is to be expected in 2010-2011, rising to 2.7% - 2.9% per annum from 2013 onwards. Whereas the average growth rate of 2.6% achieved between 1999 and 2008 was largely driven by domestic consumption aided by government spending, they look to growth based more on private investment, exports and import substitution. Exports, which are predicted to rise at 5-6% per annum across the five-year period, are expected to carry much of the burden of growth in 2011-12. On the other hand, the growth rate of imports, which according to the British Chamber of Commerce Economic Forecast 2010 was 7.1 per cent in 2005 and over 8 per cent in 2006, is expected to fall to around 2% a year in 2011 and 2012 before rising to just over 4 per cent in 2014 and 2015. It is clear, too, that given projections for inflation, real wages are expected to fall in 2011 and 2012, keeping down the growth of domestic consumption, but to rise thereafter as growth takes hold, tax revenues increase and the deficit disappears.

In order to reach a view about whether events are likely to support the critics' anxieties or justify the government's optimism, one useful exercise is to compare the present crisis with similar ones in the past. Although there have been plenty of economic downturns since 1945 none of them compares well with the present one in terms of origins or scale. Our contention is that the crises of the early 1890s and the decades between the twentieth century's two World Wars offer more meaningful comparisons in terms of origins, impact and recovery because both of them were of world dimensions. Also, given the Coalition's determination to cut public expenditure severely, a comparison with the early 1920s when similar policies were adopted, is particularly relevant.

The Crises of the 1890s and 1930s

The origins of the crisis of the 1890s had similar features to those recently experienced. The huge international investment boom of the late 1880s was based on soaring expectations about the economic prospects for newly-settled countries such as the US, Argentina and Australia. Investments were often based on very limited knowledge and vast sums were

placed in land, railways and urban construction that could not possibly produce the profits necessary to fulfil expectations. The crisis of 1890 was triggered in the Argentine by an extravagant government's growing inability to pay its debts and the impact of this on the London merchant bank, Baring Brothers. Barings had underwritten two large government-sponsored loans which they found they could not offload to increasingly sceptical investors and in November 1890 were unable to meet their obligations. They turned to the Bank of England for support. The Bank arranged loans in London that prevented Baring from collapse. But the shock to the international investment community of the near-collapse of one of the most prestigious investment banking houses in the world drained confidence in the international financial system and had global knock-on effects. International lending was severely cut for the next decade.

With slow growth in the UK during the 1920s the United States rather than Britain was central to the great investment boom of that decade, which produced the famous Wall St crash in 1929. However, the British economy was severely affected by the downturn in world economic growth that began in 1928-9 and was also caught up in the subsequent financial panic that first engulfed Germany and Austria. With confidence in international finance collapsing, fears about Britain's short-term indebtedness then forced the country off the gold standard in 1931. The financial crisis only began to work itself out after the United States' banking system collapsed in 1933 and a new order in international finance was not established until Bretton Woods in 1944.

Depression and Recovery

In the wake of the Baring crisis the British Gross Domestic Product (GDP) expressed in terms of 1900 prices fell by about 1% per annum between 1891 and 1894. Thereafter growth resumed swiftly, although beneficial effects on living standards took longer to become apparent. GDP increased at a yearly rate of over 3% from 1894 to 1900 and the 1891 GDP level was achieved again as early as 1895. On the other hand, while income per head (at current prices) also reached 1890 levels by 1895, it did not reach the sustained annual level achieved between 1885 and 1890 until after 1905. The fall in output in the 1930s was heavier: GDP was 5% less in 1931 than 1929. Recovery began in 1932, growth between 1932 and 1937 averaged 3% per annum, and only by the latter date were both GDP and income per head significantly higher than in 1929.

What were the springs of recovery in the 1890s and the 1930s? This needs to be analysed in terms of a) exports and the international economy and b) the domestic environment.

a) The international context of the recovery in both the 1890s and 1930s was difficult. In the 1890s international investment tailed off and world trade growth was slow partly because the American economy was in the doldrums for several years after its own banking crisis in 1893 and the collapse of the Australian banking system in the same year also knocked international confidence. British exports only recovered 1890 values in 1899 and grew in volume terms at only 1% per annum in the 1890s, the lowest decadal rate of growth achieved between 1850 and 1914. The situation in the 1930s was even worse. In the wake of the sharp falls in world trade and financial collapse, most major trading nations hid themselves behind trade barriers. World export prices fell heavily until 1934 and the value of British exports was much reduced. But, discounting that, even world trade volumes failed to recover and Britain's export volumes were only about 85% of their 1929 levels in the peak year of 1937. In both cases, therefore, recovery had to take place in an unhelpful international environment though problems in the 1930s were greater than in the 1890s despite the fact that in the 1930s the British export economy had the benefit of both devaluation (which was not cancelled out by competitive devaluations until 1933-4) and protection from 1932 onwards.

b) In the early 1890s domestic investment grew only slowly as foreign investment fell off, which, along with stagnant exports, accounts for the decline in GDP to 1894. Growth quickened in the mid-1890s and investment grew rapidly in domestic manufacturing despite the fact that Bank Rate, which had fallen from a peak of 6% in 1890 to 2% in 1894-5, had begun to rise again. The 'home boom' as it is called by economic historians was also sustained by a house building surge from 1896 onwards. In the 1930s, the domestic recovery was much quicker to take off. Devaluation may have done little for exports but it certainly encouraged import substitution on a substantial scale: imported manufactures in 1933 were about half the levels of 1930 and fell from 30.3 per cent of imports in 1931 to just below 23.4 per cent in 1934. Protection also encouraged import substitution, though its overall effects on growth are a matter of dispute among historians. Despite devaluation, the prices of many imported commodities fell and that boosted real wages for those in work and contributed to a rise in manufacturing investment and output in so-called 'new industries' such as domestic electrical goods. Bank rate fell from a high of 6% in September 1931 to 2% in June 1932 and stayed at that level until 1939. Lower interest rates encouraged domestic investment and also helped significantly to set in train a boom in house building that was probably the single biggest item

in the surge in growth up to 1937 and which had benign knock-on effects on a number of associated industries and services.

In summary, the fall in output in the crisis after 1890 was small relative to the 1930s, and to that in 2008-9 when GDP fell by over 5% compared with the previous year. But the economy was more or less stagnant until 1895 and recovery was then largely driven by an upsurge in domestic manufacturing investment and output, transport improvement (tramway development) and housing. Only in the late 1890s did exports begin to make a significant contribution to growth. In the 1930s, the fall in GDP between 1929 and 1931 was around 2.5% per annum. Exports were a drag on recovery: but devaluation and heavy falls in interest rates made important contributions to recovery which was again led by domestic manufacturing growth and housing development.

The Current Prospect in Historical Perspective

In the light of the above information, it may be useful to compare the prospects for recovery as set out in the OBR report by examining their assumptions under the same headings.

- a) The international economy seems to offer a more benign aspect than it did in the 1890s and the 1930s. In Asia, the current financial crisis is seen as a North American and a European affair; and the rapid growth of China and India does give some substance to the optimistic assessments contained in the OBR reports. Devaluation in 2008 has also boosted Britain's manufactured exports and may continue to do so. However, with the experience of the 1890s and 1930s in mind, it may take the financial system a long time to stabilise. There is now, for example, the possibility of further financial crises in the Eurozone that could have serious effects on investor confidence in Britain, since so many British banks have invested heavily in countries like Ireland and Portugal that investors fear may be unable to meet their maturing obligations. Moreover, the fiscal stimulus given to the American economy by the Obama administration may cease now the Republicans control Congress, with global effects in reducing demand. Besides that, some sort of currency war could soon break out between the USA and China which would lead to protectionism and harm international trade and investment growth. So, although prospects in this area at the moment are undoubtedly better than in the historical crises examined, there is a great deal of uncertainty around and the OBR projections may be overtaken by Harold Macmillan's 'events' and prove to be overly optimistic.

b)

Domestic investment and output stagnated after the Baring crisis until the middle of the decade. In the 1930s domestic recovery was rapid from 1932 onwards. In both cases, growth was led by manufacturing and by housing. By contrast, the present crisis was precipitated by the collapse of a long-running property boom and there is little prospect of revival within the 5-year time frame outlined by the coalition. Manufacturing will grow under the stimulus of devaluation, import substitution and the very low interest rates introduced since 2008. But it should be noted that manufacturing only accounts for 13% of GDP compared with 35%-40% in the 1890s and 1930s, so its impact on overall growth is now of much less significance. Growth in the 1890s and 1930s was boosted by rising real wages as prices and interest rates fell. Given the development of competition for resources from Asia, the pressure on primary product prices is likely to be upward in the next few years at least. This may also push up interest rates in order to curb inflation, with serious effects on the incomes of all those with mortgages, and curb investment more generally. Recovery in both the 1890s and 1930s took place quite spontaneously and a growth surge now may well come from projects as yet only maturing in the minds of entrepreneurs. However, services account for the bulk of employment and output in Britain today so the major stimulus to growth internally will have to come from them and it is not clear at this time where are the springs of growth in that sector.

The Role of Government in Historical Perspective

In the 1890s, central government expenditures were held steady at around 8% of GDP. Public expenditures were therefore too small to have any significance for the private economy except for suppliers of defence equipment. During the inter-war years, despite the cuts of the early 1920s, public spending as a proportion of GDP was higher than prior to 1914, staying around 24 per cent until the mid 1930s. But it was not used as a counter-cyclical weapon and varied little until 1936-7 when re-armament began in earnest and added a new element of demand in the British economy. Expenditures by local governments, whether on capital or current account, were also neutral in effect until the late 1930s. The impact on the economy of changes in central government and local authority spending was thus small in both decades.

Government spending today, at 47% of GDP, is well in excess of pre-1914 and inter-war levels. The spending cuts outlined by the Chancellor in the latest Comprehensive Spending Review are intended to shrink this to 41% by 2015. The scale and ambition of these reductions bear comparison with the policies adopted in the early 1920s. Although there was no enveloping world financial crisis until the end of that decade, the governments of the day adopted a policy of cutting public expenditure at a time when the economy was suffering a severe slump. Measured at 1938 prices, GDP fell by 5-6% between 1920 and 1921 as the post-war re-stocking boom collapsed. In the same year, the coalition government of the time decided to cut public expenditure severely with the aim of restoring the gold standard that had been abandoned in 1919, partly to stem inflationary pressures that had built up in 1919-20 and partly to restore Britain's credit with the international financial community.

Government spending (including payments on the National Debt which had risen massively during the war) was roughly 10% below 1920 levels in 1923-4, measured in 1900 prices, and fell from 30% of GDP in 1920 to around 24% in 1924. The cuts had the desired effect in driving up the price of the pound close to its pre-war level of \$4.86 in 1923-4 and making it possible to return to gold in 1925.

Under the combined impact of the slump and the government's cuts, GDP recovered its 1920 level in 1923 and growth to 1929 was a little over 2 per cent per annum. Industrial production, measured by 1913 standards, fell by one-fifth between 1920 and 1921 but managed to reach 1920 levels again by 1923. The growth was mainly in domestic manufacturing in the Midlands and South of England: the revaluation of sterling hit industrial exports, and employment in the traditional export areas in Scotland, Wales and the North of England, severely. Manufacturing imports rose sharply and exports did not recover 1913 levels for three decades! (until after 1945). The North-South divide we are familiar with emerged at this time.

Conclusion: an 'unprecedented gamble'?

Hegel once said that the point of studying the past was to find out what was really different about the present. From that standpoint what differentiates the present crisis markedly from either of the pre-1945 financial crises we have examined, and from anything that has happened since 1945, is that the coalition is adopting 1920s-style cuts in the context of 1890s and 1930s-style international financial crises. Severe cuts in public spending are planned to occur while the economy is still fragile. This programme could eliminate up to 500,000

public sector jobs and an equivalent number from the parts of the private sector that depend on government spending at a time when the springs of a lasting revival remain obscure, and when the international environment is highly unstable. The evident risk is the possibility that these cuts will so lower demand as to make too large a hole in the investor confidence which it is the government's primary strategy to boost. Only time will tell whether the government have evaded this risk.

Furthermore, even if the government strategy avoids this worst outcome, it needs to be recalled that the effects of the crises of the 1890s and the inter-war years were slow to clear. On both occasions there was a legacy of global financial uncertainty that impeded world growth and slowed British recovery, which was mainly domestic in inspiration. The 1920s experience suggests that if government cuts are added to the cyclical downturn in the global economy, even though recovery may occur fairly rapidly, some sectors of the economy may become permanently damaged in the process. Today those most closely geared to the level of domestic demand are the ones at risk. This category includes the areas identified by economists as central to employment generation and prospects of more buoyant future growth, such as services, small and medium-size enterprises, and 'green' industries. There is therefore some justification for the critics' argument that the government is taking a gamble of unprecedented proportions that could result in historically low rates of growth for many years.

Further Reading:

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