The Great Stagnation: Briefing 1

The Never-Ending Credit Crunch

By Tyler Goodspeed

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Summary

- The UK is now around 40% poorer per person than the US, having been on course for near economic parity as recently as 2007. If it were a US state, the UK would be the poorest in the union, ranked below Mississippi.
- Britain has not always been outpaced by the US. Between 1955 and 2008, the UK experienced an annual trend rate of real growth per person of 2.3%, slightly faster than the US at 2.1%.
- After the Global Financial Crisis, the US suffered a drop in the level of economic activity but then essentially returned to trend growth. In contrast, the UK experienced both a sharp drop in the level of economic activity and a decline in the subsequent rate of economic growth.
- Austerity cannot explain the UK's underperformance: the US pursued a similar policy over the same period.
- The real cause was post-2009 banking regulation, which required banks to substitute perceived low-risk lending to governments for lending to business.
- The effects of regulation fell disproportionately on the UK's bank-dependent economy, and undermined lending to small and medium-sized businesses, inhibiting their ability to grow. The US was less affected due to its greater reliance on non-bank credit and the abundance of small banks subject to fewer regulatory requirements.
- Whereas US lending to non-financial businesses recovered by mid-2013, in the UK bank lending remains 15% below its early 2008 level.

About the author

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About the publication

This briefing is a version of a chapter that will appear in a forthcoming IEA book, *The Great Stagnation: Why Britain Stopped Growing*, along with contributions from other authors. Each chapter presents and analyses a distinct explanation for the decline in British economic growth over the last two decades.

This briefing updates and extends a lecture Dr Goodspeed delivered at the Institute of Economic Affairs on 9 December 2024 (see Goodspeed 2024). The views and opinions expressed are those of the author and are not intended to represent the views or opinions of any other person or entity.

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The UK economy never really recovered from the Global Financial Crisis (GFC).

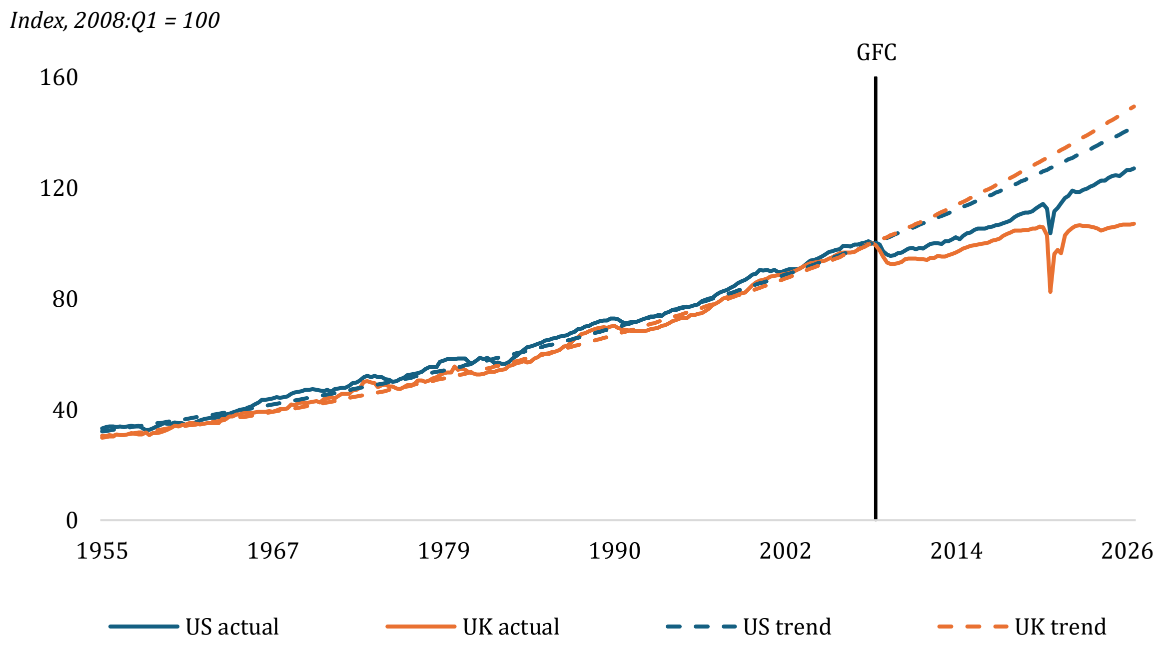
Though economic output and employment did eventually surpass 2007 levels, they never got to where they would have been had the recession never happened and the UK economy simply continued to grow at its pre-2008 trend.

The consequence of that disappointing economic performance is that after achieving near-parity in 2007, the UK today is approximately 40 per cent poorer per person than the US. A US worker could stop producing in August and still produce more in the year than the average UK worker working through to the end of December. The poorest state in the US is Mississippi; if the UK were a US state, it would be poorer than Mississippi.

For years, policymakers have insisted that this was typical – that long, slow recoveries follow longer, deeper recessions, and that recoveries from financial crises are particularly weak and protracted. But the reality is that the UK's record of economic stagnation after 2009 was both atypical, and a policy choice, specifically, a financial policy choice.

To illustrate the magnitude of the economic deceleration in the UK after 2009, in Figure 1 I plot real gross domestic product (GDP) per capita in the US and the UK since 1955 relative to estimated long-run trends. For both economies I index the level of real GDP per capita to their 2008:Q1 levels.

Figure 1: Real GDP per capita, 1955–present



Sources: BEA; U.S. Census Bureau; ONS, OECD; World Bank; BOE; author's calculations.

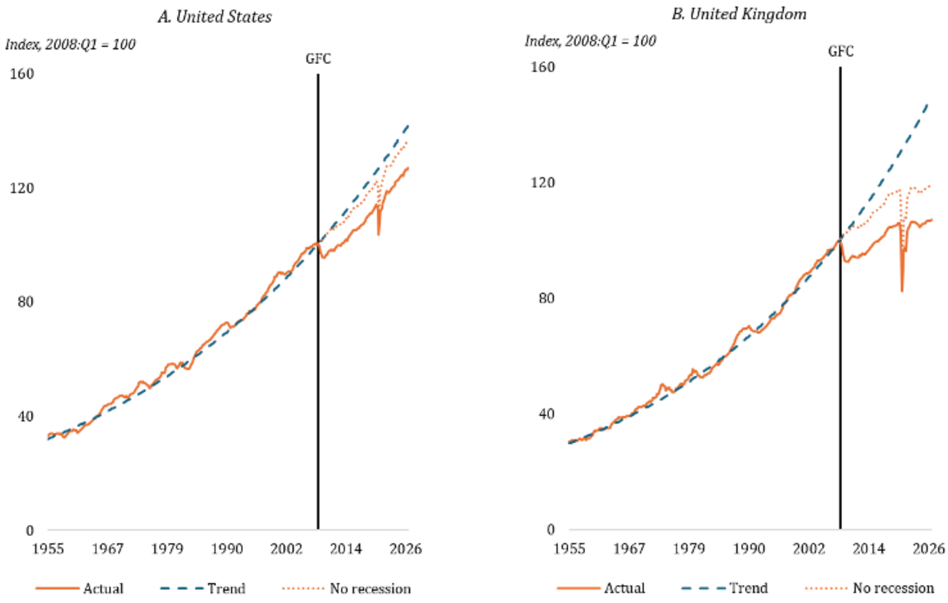
The figure reveals that both economies exhibited remarkable fidelity to similar long-run trends in real GDP per capita through the first half of 2008. Despite multiple recessions, from 1955 until 2008 both economies adhered closely to trend, with growth in real GDP per capita virtually indistinguishable between the two (slightly less than 2.3 per cent in the UK versus slightly more than 2.1 per cent in the US).

However, after the 2008/09 recession, real GDP per capita diverged sharply from long-run trend in both economies. Specifically, there was a persistent, negative level effect on real GDP per capita experienced by both economies. But the effect of 2008/09 was much worse in the UK because it was also associated with a persistent change in the rate of growth. The US suffered a drop in the level of economic activity but then essentially returned to trend growth. In contrast, the UK experienced both a sharp drop in the level of economic activity and a decline in the subsequent rate of economic growth.

Indeed, the effect is even more pronounced if one considers a counterfactual scenario in which there was no recessionary economic contraction in 2008/09. In Figure 2, I plot real GDP per capita in both economies assuming that, instead of contracting in 2008 and 2009, both the US and UK economies simply expanded at historical trend and then thereafter grew as they did. As can be seen in the figure, if there was no recessionary contraction in 2008/09, the US economy would essentially have continued to expand at long-run trend. But the level effect during the recession can only explain about a third of the deficit of UK real GDP per capita relative to trend; the rest is attributable to a change in the subsequent rate of UK economic growth.

One explanation for this sharp divergence from long-run trend is that deeper recessions – particularly those coincident with a financial crisis – are characterised by slower recoveries. But the differential recoveries in the US and UK already rebel against that hypothesis. After all, both economies experienced contractions in 2008/09 of roughly similar magnitude (approximately 5–7 per cent), both of which were coincident with a financial crisis.

Figure 2: Real GDP per capita assuming no 2008/09 recession, 1955–present



Sources: BEA; U.S. Census Bureau; ONS, OECD; World Bank; BOE; author's calculations.

Moreover, though oft repeated, it is simply not true that economic recoveries perennially violate Newton's third law of motion that for every action there is an equal and opposite reaction. Examining 132 recessions in the UK and US over the past four centuries, in a new book I find that the conventional narrative about slow recoveries following worse recessions is inconsistent with the historical record (Goodspeed 2026). On average, longer, slower recoveries do not follow longer, deeper recessions.

For both economies, the duration of a recession has no effect whatsoever on either the height or speed of the subsequent recovery. Though the depth of a recession does indeed have a large effect on the height of the subsequent economic recovery, it is precisely the opposite effect to that postulated by apologists for the weak recovery from the GFC. In both the UK and US, deeper recessions are typically followed by higher, not shallower, rebounds. The same holds for the speed of recovery: faster, steeper declines in economic output are typically followed by faster, steeper rebounds. So far from perennially violating it, economic recoveries in fact typically obey Newton's third law.

Over the broad sweep of history, nor are financial crises in either economy associated with slower recoveries. On average, since 1700 the UK economy recovered no faster or slower from the 16 recessions involving financial crises than from the 44 recessions that did not. Scholars have recently found a similar result over the past 150 years for the US (Bordo and Haubrich 2017).

The myth that long, slow recoveries must invariably follow long, deep recessions is a convenient one for economic policymakers over the past 15 years because it acquits them of any responsibility for the anaemic growth that followed the 2008/09 recession. But as I demonstrated in my 2024 lecture at the Institute of Economic Affairs, UK policymakers are not innocent with respect to the poor performance of the UK economy since 2008, though the true culprit is often mistaken (Goodspeed 2024).

One policy candidate for the UK's sharp divergence from trend is that the slow recovery is attributable to relatively contractionary fiscal policy between 2010 and 2015. But without debating its purported merits or demerits, fiscal austerity cannot explain the relatively poor performance of the UK economy post-2009 because the US effectively did austerity too between 2010 and 2016 as Congress enacted budget sequestration and state and local governments retrenched after 2009. Indeed, government expenditures contributed negatively to real GDP growth in the US from 2010 through 2014, inclusive.

Another candidate is that suboptimal policies toward land, labour and capital have resulted in the UK economy operating well within the frontier of production possibilities. Under this thesis, the UK – and most of western Europe – are now so far from the frontier of technologically feasible production possibilities that the real change over the past two decades has been a degradation in the ability of the economy to fully employ existing inputs, let alone learning how to utilise those inputs more productively.

For example, land is an important factor of production. While there is no such thing as a free lunch, there are some cheap lunches. One cheap lunch is simply allowing people and businesses to move from where productivity growth is relatively low and unemployment relatively high to where productivity growth is relatively high and unemployment relatively low. Unfortunately, in the UK that movement is constrained because the Town and Country Planning Act effectively constrained the outward growth of the UK's most productive urban conurbations.

Capital is another key factor of production. In the UK, businesses – and particularly small and medium-sized enterprises – derive at least 60 per cent of their external financing from banks. In the US this number is less than 40 per cent, with the majority of external financing coming from venture capital, private equity, angel investors, and other non-bank sources of capital. In addition, thousands of regional banks engage in relationship lending.

This matters because smaller, younger enterprises looking to expand may struggle to access credit through conventional bank loans because they lack credit history and physical assets that they might pledge as collateral. To illustrate this point, one might consider tech companies, whose primary assets are intangible, namely, their ideas. Without non-bank sources of credit, many such firms may be unable to access external financing, and instead be forced to rely on cash flow and retained earnings.

Finally, there is the most important factor of production, namely, labour. The UK faces stronger demographic headwinds than the US, with a population that is on average older and expanding more slowly. Yet, the UK maintains a higher average tax rate on labour income. Moreover, whereas in the US one has to earn 8.7 times the average wage before paying the top marginal tax rate, in the UK, one need only earn 2.2 times the average wage before paying the top marginal rate (OECD 2026). This compounds challenges of labour force participation because older workers tend to respond more to changes in marginal personal income tax rates than younger workers.

Thus, land, capital and labour are not being fully, efficiently employed.

However, the challenge for the thesis that the UK's poor economic performance since 2008/09 is attributable to its distance from the frontier of production possibilities is that all these impediments to the full utilisation of land, capital and labour have been longstanding.

The Town and Country Planning Act has been law since 1947. One could surmise plausible reasons why those restrictions could become more binding over time as network economies and agglomeration effects have become more important over time. But there is little rationale for why a 60-year old law should have become discontinuously more binding after 2008.

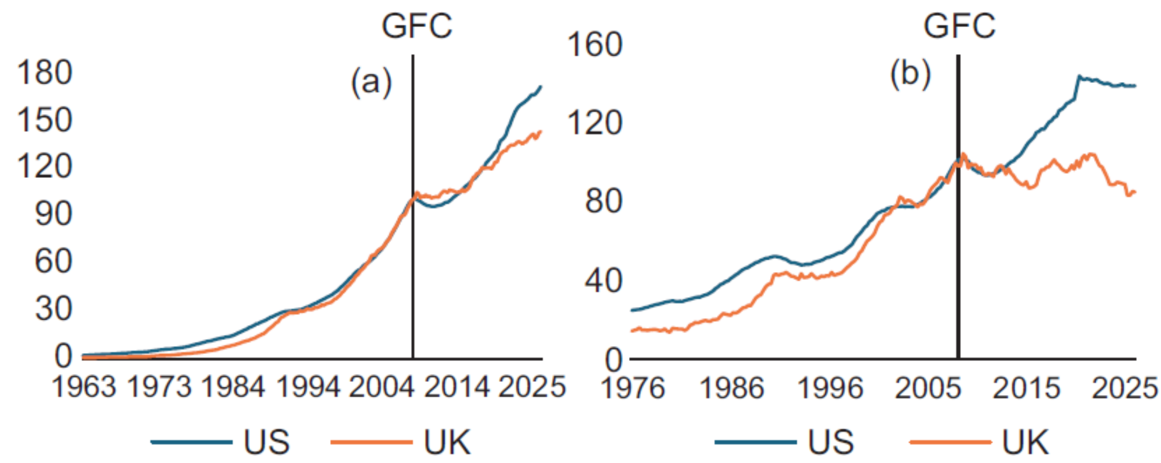
Moreover, though economically harmful, building restrictions in the US did not forestall productivity advances there. Indeed, the region around Silicon Valley has been one of the top performers in productivity growth in the US, despite the Bay Area maintaining among the most stringent zoning restrictions in the country.

While the UK maintains higher tax rates on labour income, that was not a novel development in the aftermath of 2008. Though labour force participation in the UK was historically lower than in the US, since 2013 labour force participation in the UK has been higher than in the US.

Finally, though UK businesses may be disproportionately reliant on conventional bank lending for external finance, that is similarly a feature of longstanding provenance. In 1931, a parliamentary committee report even identified what subsequently became known as 'the Macmillan Gap', named after the committee's chair, Hugh Pattinson Macmillan. The report found that, compared to that of the US, the British financial system historically did not do a good job channelling investment into small and medium-sized enterprises. That was simply not what the City of London specialised in.

Rather, the main reason the UK economy recovered so slowly after 2008/09 was that post-2009 regulatory changes on both sides of the Atlantic effectively made it harder and more costly for banks to lend to private households and businesses, changes that were simply much more binding on the more bank-intensive UK economy.

Figure 3: Real credit to the private sector, 1963–present; index, 2008:Q1 = 100: (a) total private sector; (b) private business sector



Sources: BEA; ONS, BIS, IMF; author's calculations.

Figure 3 reports the total supply of credit to the private non-financial sector, adjusted for inflation, in the UK and US since 1963 (a), as well as the inflation-adjusted total supply of credit to the private non-financial business sector in both economies (b). While total credit to the private sector initially declined by more in the US after 2008, it also rebounded much more strongly and, relative to early 2008 levels, by mid 2015 had already surpassed private sector lending in the UK (a). By the end of 2025, in real terms lending to the private sector was 70 per cent above its 2008 level in the US, versus just 43 per cent in the UK.[1]

[1] Though this reflects changes in both credit supply and credit demand, in preliminary econometric analysis exploiting cross-country variation in intention-to-treat with post-GFC financial regulation, I find that it is primarily a function of changes in credit supply.

The contrast is even more stark when one examines total lending to the private business sector specifically (b). Whereas real credit to the private business sector in the US recovered to its early 2008 level by mid 2013, in the UK it is still 15 per cent below its level in early 2008.

Why might the 2008/09 recession have had a more persistent effect in the UK than in the US? In my 2024 IEA lecture and book, *Recession: The Real Reasons Economies Shrink and What to Do about It* (Goodspeed 2026), I demonstrate that the real reason the UK economy violated Newton's third law of motion after the 2008/09 recession was an economic policy regime change.

Specifically, through changes in financial regulation, policymakers on both sides of the Atlantic effectively mandated that their economies produce with less of a critical input for which over any economically meaningful time horizon there is limited ability for households and businesses to find substitutes; namely, the provision of bank credit.

Following implementation of successive rounds of Basel banking accords, on both sides of the Atlantic after 2009 banks exceeding certain asset thresholds had to hold more regulatory capital and be subjected to enhanced stress testing, failure of which required either reduction in the size of their balance sheets or else the substitution of lending to sovereign governments – carrying a risk weight of zero – for lending to higher-risk-weight lending to the private sector. After 2010, the UK also imposed a bank levy on the size of bank balance sheets, which exempted liabilities that were backed by UK government bonds. Post-2009 financial regulations also mandated liquidity coverage ratios for banks, requiring that banks hold enough high-quality liquid assets – namely, government bonds – to cover 30 days of liquidity needs in excess of cash flow.

These regulatory changes had a much bigger impact on the UK, first, because British businesses were historically more reliant on banks for external financing and, second, because the UK has fewer banks that are on average larger and therefore were more likely to be treated by the new regulatory regime. Indeed, there are fewer than 300 banks in the UK serving approximately 29 million households, compared to about 5,000 banks serving approximately 134 million households in the US.

So British banks were more likely to exceed the size thresholds above which financial institutions were subject to the new regulatory requirements. Moreover, with fewer non-bank alternatives to the provision of private credit, a greater share of UK lending was subject to a regulatory regime that effectively penalised lending to perceived higher-risk small and medium-sized businesses versus lending to the perceived lower-risk public sector.

For small and medium-sized UK businesses in particular, the effects of the post-2009 regulatory regime have been substantial, resulting in higher – and still rising – barriers to credit access (UK Finance 2025; Ernst & Young 2024). Indeed, my back of the envelope calculations suggest that as much as 30–50 per cent of the decline in UK credit to the private business sector can be accounted for by the substitution of public for private sector lending by UK banks. And this is not unique to the UK:

European economies with similar reliance on banks for external business financing and fewer but on average larger banks experienced similar outcomes after 2009.

Though the decline in credit reflects shocks to both credit supply and credit demand, it is nonetheless a searing indictment of UK financial policy over the past 15 years. Before 2008, approval rates for new bank loan applications by small and medium-sized UK businesses were often 80–90 per cent; by 2024 that had dropped to fewer than half. The latest instalment of new rules – so-called Basel 3.1 – is likely to create an even more challenging environment for UK businesses seeking external financing (Ernst & Young 2024).

Sadly, the evidence from four centuries of economic history is that the disappointing UK recovery after 2009 was both atypical and unnecessary. Economies typically rebound sharply from deeper recessions. That the UK economy has not is the consequence of policy choices. No economic policy is without trade-offs.

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