



The  
University  
Of  
Sheffield.

SPERI Paper No.1

# The British Growth Crisis: a Crisis *of* and *for* Growth.

Colin Hay

---

speri.

Sheffield Political Economy  
Research Institute.

## About the author



### Colin Hay

Colin Hay is Professor of Political Analysis and Co-Director of the Sheffield Political Economy Research Institute at the University of Sheffield. He is the author, co-author or editor of a number of books, including, most recently *The Political Economy of European Welfare Capitalism* (Palgrave, 2012), *New Directions in Political Science* (commissioned by the PSA to mark the 60th anniversary of the association, Palgrave, 2010), *The Role of Ideas in Political Analysis* (Routledge, 2010), *The Oxford Handbook of British Politics* (Oxford, 2009), *Why We Hate Politics* (Polity, 2007), *European Politics* (Oxford University Press, 2007), *The State: Theories and Issues* (Palgrave, 2006) and *Political Analysis* (Palgrave, 2002). He is co-founder and co-editor of the journals *Comparative European Politics* and *British Politics* and currently lead editor of *New Political Economy*. He was elected an Academician of the Academy of Social Science in 2009, a year in which he was also awarded the WJM Mackenzie Prize for his book *Why We Hate Politics* and the Richard Rose Prize for his 'outstanding contribution to the understanding of British politics and political economy'.

ISSN 2052-000X

Published in January 2013

The global financial crisis which first began to make itself apparent in 2007 and then broke with full force in the autumn of 2008 has generated an intense debate in academic, business, journalistic and political circles alike about what went wrong and how operational faults in the prevailing Western model of political economy might best be repaired. More importantly, it has at last also begun to stimulate a deeper, albeit slower moving, consideration of whether the Anglo-American world in particular was working with the right model of political economy in the first place. It is the view I seek to defend here that if we are to address properly the former set of concerns – with what went wrong and how we might start to put it right – it is with the latter that we must start. For it is only by acknowledging the complicity and culpability of a decidedly and distinctly Anglo-American conception of capitalism in the inflation and then bursting of the bubble, that we can begin to see the full extent of what is broken and what now must be fixed. It is to this agenda that the present paper speaks. It draws on a now substantial body of empirical research, but it seeks to do so in a rather novel way – to argue that the crisis is best seen as a crisis *of* and indeed *for* growth and not as a crisis of debt. It is, moreover, a crisis *of* and *for* an excessively liberalised Anglo-American form of capitalism and the Anglo-liberal growth model (as I will call it) to which it gave rise. This is a form of capitalism and a growth model that was inherently unstable and threatened the entire world economy – its excesses cannot be tolerated again.

Comparative political economy as a field of study has long understood that, even within a globalising world economy, different ‘models of capitalism’ can exist, compete and indeed overlap in their institutional features. The once dominant Anglo-American model, which can be said to have been moulded during the 1980s, flowered during the 1990s and ultimately run to excess in the 2000s, had certain obvious distinguishing features. Accounts vary, but most frequently identify the following:

- the hegemony of an assertive neoliberal ideology;
- an elite policy community increasingly trapped in its thinking within this narrow ideological framework;
- substantial deregulation of markets and privatisation of financial management;
- huge dependence on the supply of cheap hydrocarbons, with seriously damaging environmental consequences;
- the systemic build-up of debt incurred principally to fuel consumption;
- an accumulation of risk within the economic system, with growth over time increasingly associated with accelerating exposure to that risk;
- the absence of a coherent theory of society, or social well-being, beyond the sum of individual, supposedly rational goal-seeking;
- the consequent embedding of inequalities between and within countries; and
- a limited view of global governance as requiring little more than rules to manage competition between national economies.

This model was prevalent in the US and the UK and strongly shaped the contours of the global economy through the increasingly hold it came to exert over a range of international institutions, from the World Bank to the International Monetary Fund. Other export-oriented growth models, even if structured on a different basis as in Scandinavia, Germany and East Asia, thus became dependent to a significant degree on demand generated within the Anglo-American liberal model of capitalism.

The problem is that it was this model that crashed so catastrophically in 2008 – and in a manner that was entirely predictable given its inherent structural instability. What follows is an attempt to explain the sources of that instability as a prelude to a consideration of what might now be done to fix our present predicament.

## A crisis of growth not debt

It is a necessary but not in itself sufficient condition of getting the responses to the crisis right that we get our diagnosis of the crisis right. And this is not easy. For the crisis has been understood in a variety of rather different ways – most of them credible in at least some respect. Is this Britain's crisis or a global financial crisis or a crisis of the west or, perhaps, a crisis of the Eurozone and its immediate hinterland from which Britain is largely exempt? There is a great deal at stake in our answer to these questions.

For if this is an external or exogenous crisis and Britain is and has been exposed to it only through contagion effects, then the solution is as much about managing exposure to future shocks as it is about managing the transition to a different model of political economy. Yet, if Britain's crisis is indeed an internal or endogenous crisis, albeit clearly exacerbated by contagion effects from other afflicted economies, then a much more serious dose of domestic reform may be required to address the crisis.

It is perhaps unsurprising that policy-makers, from all parties, have been so keen to emphasise the external character of the crisis – appealing to Britain's affliction as the local manifestation of a global phenomenon. But they have been in very good company in doing so. Indeed most journalistic and broader public commentary on the crisis has assumed it to be largely external in origin – even if it has exposed some domestic frailties. This, I suggest, is wrong.

For in a way this is both an internal and an external crisis – a British crisis, a Eurozone crisis (of sorts), a crisis of the west, even a global crisis. But, from a British perspective, it is also far worse than that. Why? Because the origin of *all* of these associated crises lies in the Anglo-American capitalism of which Britain, since at least the 1980s, has been perhaps the key architect. It is a crisis of Anglo-liberal excess and of a globalisation couched in this image. In what follows I will explore in some considerable detail the various aspects of this. But for now consider just one example - the mortgage-backed securitisation which went so horribly wrong in the US. This is, and with some justification, fixed in the public imagination of the crisis as the moment of bubble burst in the US economy – and that, in turn, is invariably seen as the point source of a global firestorm. But what is often missed is that, although mortgage-backed securitisation was pursued to an even more aggressively horrendous extent in the US than in the UK, that it emerged as a practice in the US in the first place was the result of the deregulatory impulses of consecutive British administrations. For mortgage-backed securitisation in the US was, quite simply, the product of US regulators fearing a British competitive advantage in the market for securitised assets if they did not match the deregulatory disposition of their trans-Atlantic equivalents. It was the ensuing deregulatory arbitrage in which, in effect, US and UK regulators sought to outdo one another in how far they could liberalise market rules that led to the sub-prime lending that imploded in the bubble burst.

In this way, and although scarcely acknowledged in the public debate nor even the academic literature, there is considerable domestic complicity and culpability in the origins of the *global* financial crisis and not just its local manifestation. To see this solely as a story of contagion from the US and now, perhaps, the Eurozone is a convenient travesty and, in effect, an appalling disavowal of responsibility (even if it arises from a misunderstanding rather than from any conscious attempt to deceive). A model of capitalism and an associated model of growth built in Britain, as least as much as in the US, is responsible. Moreover, both major political parties are implicated – over a considerable period of time, certainly since the 1980s. It is crucial in getting the crisis right and putting it right that we understand and acknowledge this, however painful it might be.

In sum, then, this was an endogenous crisis yet one also reinforced by the exogenous contagion effects to which the crisis is more conventionally attributed. The irony is that such contagion effects were in effect things returning to haunt the British economy – since the source of the problems which proved contagious to Britain (through, for instance, financial interdependence with the US) were the product of home grown pathologies which had become part of model of Anglo-liberal capitalism in whose image globalisation has been constructed.

## The unfolding of the crisis – in three waves

The case for the endogenous character of the bubble burst is easily made if we look at the unfolding of the global financial crisis chronologically between economies. As soon as we engage in such an exercise, it is easy to see that different economies entered the crisis at different moments – and they did so because they were exposed to the crisis in different ways. Indeed, the crisis has unfolded over time in three discrete and distinct waves – radiating outwards from an Anglo-liberal epicentre in each case. These I associate with three different transmission mechanisms - one endogenous to those economies subject to it, the other two largely exogenous. Each wave I associate with a different mechanism of transmission of the crisis with a distinct temporal footprint. This is presented schematically in Figure 1.

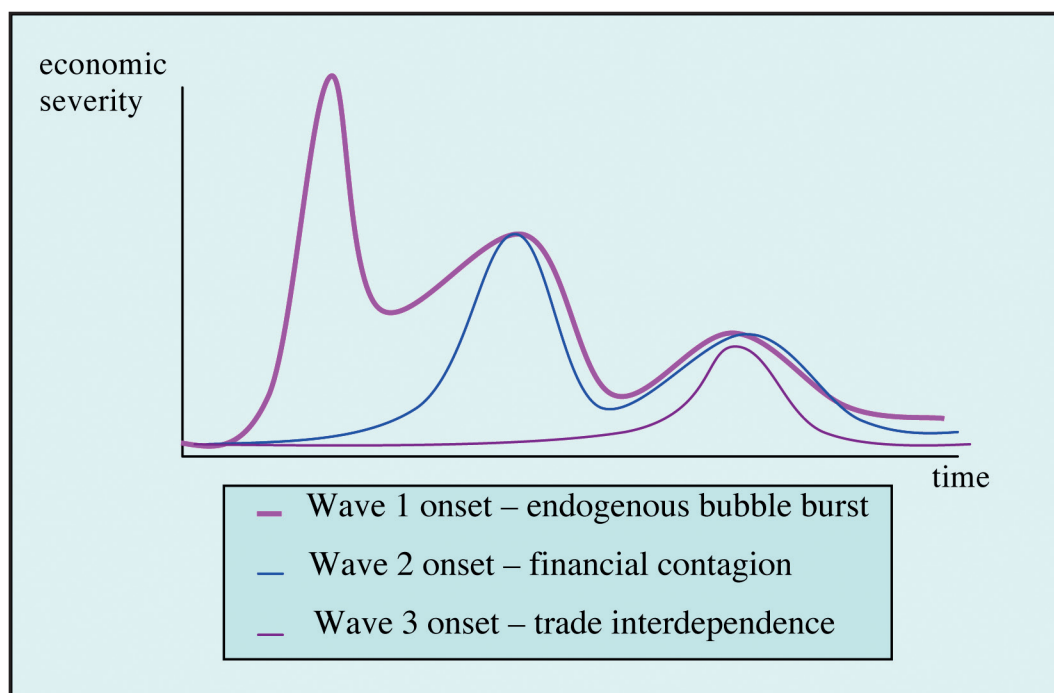


Figure 1: The unfolding of the crisis in three waves

The first, and the sole endogenous mechanism, was the puncturing of a housing (and related asset-price) bubble. This, as we have already seen, was reliant for its persistence on continued low interest rates. It was always likely to be threatened by inflationary pressures (whether endogenously or exogenously generated). Economies might be seen to have been prone to a crisis induced in this way in proportion: (i) to the extent of the bubble in their housing (and other asset-price) market(s); and (ii) the extent to which their growth models rested on consumer demand generated through private debt secured against appreciating assets. The Anglo-liberal economies and a number of the Baltic and East Central European accession states were exposed to the crisis principally through this route – and were typically amongst the first to feel its effects.

The second, the first of two exogenous mechanisms for the transmission of the crisis, was through contagion born of financial interdependence. In order to suffer from such an effect, economies did not need to have experienced any housing or other asset-price bubble, but simply to have (or have had) a system of financial regulation sufficiently liberal to allow banks (commercial or investment) and other financial intermediaries to hold securities, assets and derivatives which exposed them to US (or, indeed, wider Anglo-liberal) mortgage default risk. It was largely through this route that economies such as Germany, which had experienced virtually no increase in house prices since the 1990s, were exposed to the crisis. In general, economies were exposed to the fallout of the crisis in this way in proportion to the relative size of their banking sector, the extent of their financial interdependence and, in particular, the direct and

indirect exposure of their financial institutions to US mortgage and housing-linked assets, securities and debt. A number of European economies, including Britain, already reeling from the implosion of their own asset-price bubbles and from the damage this was inflicting on their own banking sectors, were also extremely vulnerable through such financial interdependence to crisis contagion generated in this way.

The third and final mechanism for the transmission of the crisis was through trade interdependence. As the US economy slid into recession so, almost inevitably, did aggregate demand in the world economy for exported goods and services – both through the direct effects of reduced demand in the US economy and as credit conditions tightened around the world. The effect, unremarkably, was a global recession and, with it, a pronounced decline in the volume of world trade. Around the world, cash-strapped consumers' shopping baskets shrank in size whilst the space taken in those baskets by imported luxury items relative to locally-sourced staples also tended to fall. In this way, trade volumes actually fell more dramatically than economic output – as the world economy became less integrated in terms of trade for the first time since the 1930s.

This was a particularly hefty blow for a number of export-oriented European economies that had weathered the storm of the financial crisis relatively well up to this point – the extent of their exposure to contagion effects of the crisis transmitted in this way being in proportion both to their trade openness and their (initial) balance of trade position. Though contagion through trade interdependence proved a rather slower transmission mechanism, with a downturn in world trade volumes only becoming evident from the second half of 2008, its effects have been considerable.

As we have seen, the housing bubble burst first in the US and it was the US economy that was the first to experience recession. This makes it tempting to see the diffusion and onward transmission of the crisis to Europe (and elsewhere) solely as a product of contagion. But, as I have been at pains to demonstrate, that does not make such an account – the conventional account - correct. The crisis, as I have argued, is better seen as one precipitated by the demise of a specific ('Anglo-liberal') growth model, a model certainly present in the US but also present in Europe - most obviously in the UK and Ireland, but also in some of the Baltic and East Central European accession states and in the Iberian Peninsula (albeit in somewhat different forms).

As this suggests, it is possible to differentiate between those European economies whose first experience of the crisis was endogenous – arising from an internal puncturing of their own model of growth – and those whose first (and, indeed, only) experience of the crisis was exogenous – a product of contagion effects radiating outwards from the US, Britain and other centres of Anglo-liberal growth.

One way of doing this empirically is to examine the timing of the onset of the crisis in different economies. If we do this, three waves of the unfolding crisis can be identified – the first pitching a number of economies into recession in the first two quarters of 2008; the second producing recession in the third quarter of 2008; and the third precipitating recession in the final quarter of 2008 or later. Each, I suggest, can be associated with one of the three different transmission mechanisms identified above.

### **The 'first wave' – the demise of Anglo-liberal growth**

In the first wave, entering recession in the first half of 2008, we see those economies – amongst them Britain - whose initial experience of the crisis was essentially endogenous. These were typically those with the most over-inflated housing bubbles and with models of growth most reliant upon demand sourced by consumer debt secured against the housing market. In terms of timing, the US, of course, belongs in this category. Yet, as the data in Tables 1-3 show, in terms of the aggregate economic fundamentals it is in fact something of an exception or outlier – with rather lower levels of house-price inflation and rather more modest increases in both mortgage debt and overall household indebtedness in the decade prior to the onset of the financial crisis.<sup>1</sup>

<sup>1</sup> Yet it is important to note that a number of US states (notably California, Massachusetts and Florida), experienced rather more of a housing bubble than the US economy as a whole – they look rather more 'first wave' in character (Dymski 2010; Martin 2011).

This in itself is intriguing. For it suggests that the US was amongst the first wave of countries to enter recession not so much because of the extent of its financial and broader economic imbalances, but because of the severity and timing of the Federal Reserve's recalibration of interest rates. In no other leading economy did interest rates move so early nor so swiftly in an upward direction – and no other leading economy experienced a five-fold increase in the base rate.

First wave (recession in Q1 or Q2 2008)		Second wave (recession in Q3 2008)		Third wave (recession in Q4 2008 or later)	
Estonia	7.74	France	1.62	Austria	1.72
Hungary	9.14	Germany	0.89	Belgium	1.36
Ireland	2.38	Italy	2.01	Denmark	1.38
Latvia	19.8	Luxembourg	1.48	Finland	1.51
Lithuania	14.2	Netherlands	1.44	Norway	1.60
Spain	2.05	Portugal	1.49	Sweden	1.50
Britain	1.74				
US	1.10				
<b>Mean*</b>	<b>8.14</b>	<b>Mean</b>	<b>1.49</b>	<b>Mean</b>	<b>1.51</b>
<b>Standard Deviation*</b>	<b>6.89</b>	<b>Standard Deviation</b>	<b>0.36</b>	<b>Standard Deviation</b>	<b>0.14</b>

Table 1: Ratio of residential mortgage debt (as % of GDP) in 2007 to 2000

Source: calculated from European Mortgage Federation (2010)

Note: \* - excluding US

First wave (recession in Q1 or Q2 2008)		Second wave (recession in Q3 2008)		Third wave (recession in Q4 2008 or later)	
Estonia	4.80	France	1.28	Austria	1.14
Hungary	--	Germany	0.91	Belgium	1.19
Ireland	2.31	Italy	1.38	Denmark	1.30
Latvia	17.0	Luxembourg	--	Finland	1.48
Lithuania	10.4	Netherlands	1.56	Norway	--
Spain	1.91	Portugal	1.38	Sweden	1.36
Britain	1.53				
US	1.32				
<b>Mean*</b>	<b>6.33</b>	<b>Mean</b>	<b>1.30</b>	<b>Mean</b>	<b>1.29</b>
<b>Std Dev*</b>	<b>6.19</b>	<b>St Dev</b>	<b>0.24</b>	<b>St Dev</b>	<b>0.14</b>

Table 2: Ratio of outstanding household debt (as % of disposable income) in 2007 to 2000

Source: calculated from Eurostat Household Financial Assets and Liabilities Database (various years)

Note: \* - excluding US

First wave (recession in Q1 or Q2 2008)		Second wave (recession in Q3 2008)		Third wave (recession in Q4 2008 or later)	
Estonia	3.15	France	2.06	Austria	1.09
Hungary	1.95	Germany	1.04	Belgium	1.82
Ireland	1.65	Italy	1.22	Denmark	1.86
Latvia	--	Luxembourg	--	Finland	--
Lithuania	--	Netherlands	1.44	Norway	1.74
Spain	2.33	Portugal	1.12	Sweden	1.81
Britain	2.04				
US	1.53				
<b>Mean*</b>	<b>2.22</b>	<b>Mean</b>	<b>1.38</b>	<b>Mean</b>	<b>1.66</b>
<b>Std Dev*</b>	<b>0.57</b>	<b>St Dev</b>	<b>0.41</b>	<b>St Dev</b>	<b>0.32</b>

Table 3: Ratio of house prices in 2007 to 2000 (own currency, constant prices)

Source: calculated from European Mortgage Federation (2010)

Note: \* - excluding US

But in terms of such aggregate data the other first wave economies were certainly much more alike. Predictably, they included Britain and Ireland, Spain, Hungary and the Baltic States. These economies were characterised, in the period leading up the crisis, by high and steeply rising mortgage and general household debt and rapid house price appreciation. They also tended to witness amongst the highest European rates of growth (suggesting the presence of asset-price bubbles), to have banking sectors more reliant on wholesale funding (and hence more susceptible to the freezing of inter-bank lending which immediately followed the crisis) and to have larger current account deficits (for a more in-depth statistical treatment, see Claessens, Dell'Ariccia, Igan and Laeven 2010).

### Waves two and three – a genuine story of contagion

These first-wave economies would almost certainly have endured deep and damaging recessions even in the absence of contagion effects from the US. Yet this did not make them exempt from such effects. If anything, the profound fragility of their growth models and the financial and broader economic imbalances that they exhibited made them even more exposed to the contagion effects now radiating outwards from the financial epicentre of the crisis. These economies, in effect, suffered in a three-fold way – first, through the immediate effects of the bursting of their own housing and consumer booms (and through the direct consequences for their own banking sectors arising from this); second, through the contagion affects associated with their financial exposure to US assets and particularly their reliance on international lines of credit; and, third, through their exposure to a downturn in global trade volumes.

Consider Britain, perhaps the most exposed of the first-wave economies to the effects of financial contagion by virtue of the sheer size and the distinctive character of its financial services sector and the reliance of its growth model on access to personal credit. The highly securitised nature of the US mortgage market and the international diffusion of such securities meant that any bursting of the US housing bubble was always going to result in significant losses for British financial institutions. But this was compounded by a second factor - the freezing up of both international and domestic inter-bank lending that followed as financial institutions licked their wounds, counted their losses and down-graded their expectations as to whom they might profitably lend. The brutal reality was that, given its levels of consumer debt and the dependence of growth on access to more of the same, the British economy was always going to be more exposed to such a credit crunch than almost any other leading economy. No less significantly, the size and centrality of financial services to the economy left its government with little option other than to underwrite the entire sector with public funds. The total funds committed were estimated by the National Audit Office, in December 2009, at £850 billion –



a major contribution to a looming public sector deficit. Yet the rationale for a bailout of the banking sector on this scale was clear – to insure depositors and, rather more significantly, to try to re-secure the supply of credit on which the growth of the consumer economy for over a decade had been predicated.

These contagion effects were, however, by no means confined to the first-wave economies. Indeed, financial contagion associated in particular with losses arising from US mortgage-backed securities was responsible for the initiation of a second wave of the crisis. This engulfed economies, like Germany, that had (as indicated earlier) seen virtually no increase in mortgage or total household debt nor any appreciable rise in house prices in the preceding decade. As the data in Tables 1-3 show, the second-wave economies were very different in the character of their housing and credit markets, with much more limited evidence of private debt secured against property acting as an agent of growth. Yet they were certainly no less exposed to financial contagion by virtue of this. Indeed, the converse almost certainly applies – with the absence of a domestic housing bubble contributing to the attractiveness of holding high-yielding US mortgage-backed securities. This meant that, when it came, the crisis in the US housing market proved rapidly contagious to the German and other banking sectors - with IKB Deutsche Industriebank, for instance, being the first major European bank to be threatened because of its high levels of exposure to the US sub-prime market. The eventual bailout of the German banking sector by its government committed 480 billion Euros of public funding and seems likely to end up costing the German state around 50 billion Euros in non-recoupable losses.

The contagion effects of financial interdependence were, of course, transmitted very rapidly – with the bursting of the bubble in the US housing market leading almost immediately to a dramatic fall in the value of the income streams previously arising from mortgage securitisation (as default rates rose and mortgage repayments dried up). This, in turn, led to mortgage-backed securities being swiftly reclassified as 'toxic assets', to major losses for financial institutions around the world and, in the process, to a global credit crunch, with the effective suspension of inter-bank lending. But the contagion effects arising from the crisis were by no means limited to those transmitted through financial interdependence. The effects on trade, as noted above, have been no less significant – though there was undoubtedly more of a time-lag between the onset of the crisis and the sharp deterioration in world trade volumes that occurred from the third quarter of 2008 (Chor & Manova 2012).

The effect was to deepen further the recessions already underway in many first- and second-wave economies and, in the process, to initiate a third wave. This pushed over the brink into recession a number of Northern European economies (such as the Nordic states) which had certainly experienced rapid house-price inflation in the preceding years but without a pronounced increase in household indebtedness and whose banks were amongst the least exposed to the losses arising from US mortgage default risk and securitisation. Though they had, for a time, seemed largely immune to the crisis, they now suffered considerably by virtue of their economic openness and, in particular, the dependence of their export-oriented growth models on international demand for high value-added goods. It was precisely such luxury-product markets that were most hit by the overall reduction in world-trade volumes, with Sweden suffering between the second quarter of 2008 and the first quarter of 2009 a loss in the value of its exports equivalent to 22 per cent of GDP. Though export volumes have recovered steadily since then, by the end of 2010 the value of Swedish exports was still lower (by some 10 per cent of GDP) than their pre-crisis level.

Britain's exposure to a third wave of the crisis transmitted through trade interdependence was, by contrast, not nearly as great as that of Sweden – with British exports falling by some 10 per cent of GDP over the same period as Sweden's fell by 22 per cent. But the point is that, like other first-wave economies, Britain – unlike Sweden – was exposed to all three of the transmission mechanisms of the crisis. They proved mutually reinforcing. As this suggests, contagion born of financial interdependence is responsible for much of the damage inflicted on the British economy since 2007. But it is not responsible for it all – and, crucially, Britain and other first-wave economies were already in recession before such effects started to take hold. To understand why we need only remind ourselves of the link between oil prices, inflation and interest rates.

From the second quarter of 2006 all three rose in parallel – in Britain, the US and in the Eurozone. Interest-rate rises in Europe were, of course, much less pronounced than they were in the US. Yet, unremarkably, the increases in mortgage repayments to which they gave rise, combined with a reduction in disposable income associated with rising prices, led to a squeeze on consumer demand and an increasingly sharp fall in the number of housing transactions – followed soon thereafter by a no less sharp and accelerating depreciation in house prices. Having grown at around 12 per cent per annum since 1992 residential property prices in Britain were, in the final quarter of 2008, falling at around 20 per cent per annum. This brought about a quite brutal transformation in personal fortunes. In late 2006 the average British earner living in the average home was seeing a wealth effect associated with house price inflation equivalent to three quarters of her pre-tax annual average earnings (Watson 2010). In other words, were she to release all the equity in their home she could effectively double her spending power. The equivalent figure in Ireland was in fact higher still, around 120 per cent of pre-tax annual average earnings. Yet, two years later, with property prices in free-fall, annual house price deflation in Britain was equivalent to over 120 per cent of the pre-tax earnings of the average citizen (Hay 2009: 471). Any residual equity was seeping away at an alarming rate.

The housing market was no longer a source of growth but an impediment to it – because the low inflation-low interest rate equilibrium upon which its rise had depended had been disrupted, reducing demand for property and cutting off at source the equity which had drip-fed consumption for a decade and a half. The result was a highly corrosive combination of falling house prices and equity depreciation which, in combination with high interest rates and high and rising commodity prices, led directly to falling demand and, in due course, to rising unemployment. It has also led to a most dramatic decline in taxation revenues and the most significant deterioration in the condition of the public finances since at least the 1930s. It is to this that we now turn.

## A fiscal crisis of and for the state?

From the perspective of the state the crisis has manifest itself first and foremost as a severe constriction in the taxation base from which it is funded. And, in seeming confirmation of the truism that it never rains but pours, this occurred at precisely the moment at which the recapitalisation of the banking sector placed an almost unparalleled call on the public purse.

In this respect the crisis might well be argued to have precipitated a full-scale fiscal crisis of the state – or, perhaps more accurately, a fiscal crisis *for* the state (cf. Gough 2010). The distinction might seem narrowly academic, but it is important. For to suggest that this is a fiscal crisis of the state would be to implicate the state directly in the generation of the fiscal shortfall that now threatens the public programmes with which we associate it. To appeal to a fiscal crisis *for* the state is to make no such assumption. Indeed, it is to suggest that the fiscal deficit which now threatens public expenditure cannot be attributed to any dynamic internal to the state itself since its origins lie elsewhere. That is far more accurate.

The origins of such a fiscal crisis for the state are, in fact, readily comprehensible and can be traced very clearly to the global financial crisis. They arise from the worsening of the condition of the public finances associated with: (i) the decline in fiscal revenue (the 'tax take') arising from the sharp downturn in economic output (GDP); (ii) the decline in fiscal revenue associated with (any) tax reductions designed to stimulate demand (temporary VAT reductions, stamp duty 'holidays' and the like); (iii) the costs of underwriting the banking sector with public funds; (iv) the costs associated with (any) sector-specific subsidies designed to support parts of the economy that were hit disproportionately (such as car scrappage schemes); and (v) the increased costs associated with meeting already sanctioned social and welfare needs as the number of those eligible for benefits rose as a consequence of the dislocating effects of the crisis.

Clearly the extent of the overall worsening in the public accounts varied considerably between economies, as did the relative share attributable to each of these elements. But, contrary to much of the public debate, by far the greatest contributory factor in each of the European cases

was not the extent of the recapitalisation of the banking sector, but the simple reduction in the tax take arising from the sharp decline in taxable economic activity.

In Britain, for instance, had taxation revenue continued to grow at pre-crisis levels, it would have exceeded the actual tax take by around £35 billion in 2008-09 and £92 billion in 2009-10. This equates to an 8 per cent reduction in taxation revenue arising directly from the crisis in 2008-09 and a 23 per cent reduction in 2009-10. Britain's budget deficit was around £49 billion in 2008-09 and £107 billion in 2009-10. In other words, approximately 70 per cent of the current account deficit in 2008-09 and 86 per cent in 2009-10 is attributable to lost taxation revenue alone (Hay 2012).

Is it not, of course, difficult to see how such a profound destabilisation of the public finances might occur. For most of the state's outgoings are, in essence, the product of long-standing commitments – citizens, after all, have a right to receive those benefits, and to consume those public services for which they are eligible, regardless of the rate of growth of economic output. If the public finances are in modest balance before the onset of a crisis of this kind of magnitude, then they are most unlikely to remain in balance during and immediately following the crisis – since it is practically impossible for the state to reduce the size of its commitments proportionally to its loss in revenue as the crisis unfolds. But the point is that any failure to match reductions in the revenue stream with an equivalent and immediate rationing of welfare and other spending commitments will result in a growing current account deficit. A further factor merely compounds the problem. As growth turns negative, unemployment is bound to rise, albeit once again with some time-lag effect. The result, inevitably, is that, without any change in the eligibility criteria, the number of legitimate welfare claimants and total welfare expenditure both rise – with increased numbers of citizens claiming unemployment and associated benefits, a variety of means-tested payments and subsidies, and access to a range of public services to which they were not previously entitled.

Moreover, in the context of the current crisis, this all happened at a time when the stability and sustainability of the entire banking system was threatened as never before and as the state was called on to shore up and underwrite the entire sector with public funds. Put these three factors together and a sharp deterioration in the state of the public finances is effectively guaranteed. Tables 4 and 5 show, for the first-wave, second-wave and third-wave economies, the size of the resulting current account deficit in 2009 and the rise in general government debt over the period 2006-9.

First wave (recession in Q1 or Q2 2008)		Second wave (recession in Q3 2008)		Third wave (recession in Q4 2008 or later)	
Estonia	-1.7	France	-7.5	Austria	-3.4
Hungary	-4.0	Germany	-3.3	Belgium	-6.0
Ireland	-14.3	Italy	-5.3	Denmark	-2.7
Latvia	-9.0	Luxembourg	-0.7	Finland	-2.2
Lithuania	-8.9	Netherlands	-5.3	(Norway	+13.0)
Spain	-11.2	Portugal	-9.4	Sweden	-0.5
Britain	-11.5				
<b>Mean</b>	<b>-8.66</b>	<b>Mean</b>	<b>-5.25</b>	<b>Mean*</b>	<b>-2.96</b>
<b>Std Dev</b>	<b>4.41</b>	<b>St Dev</b>	<b>3.06</b>	<b>St Dev*</b>	<b>2.01</b>

Table 4: Current account balance (as % of GDP) in 2009

Source: calculated from Eurostat Public Balance and General Government Debt data (n.d)

Note: \* - excluding Norway

First wave (recession in Q1 or Q2 2008)		Second wave (recession in Q3 2008)		Third wave (recession in Q4 2008 or later)	
Estonia	2.7	France	13.9	Austria	3.3
Hungary	12.7	Germany	5.5	Belgium	8.6
Ireland	39.1	Italy	9.3	Denmark	9.5
Latvia	25.4	Luxembourg	8.0	Finland	4.3
Lithuania	11.3	Netherlands	13.5	Norway	--
Spain	13.6	Portugal	12.1	Sweden	-3.4
Britain	24.6				
<b>Mean</b>	<b>18.49</b>	<b>Mean</b>	<b>10.38</b>	<b>Mean</b>	<b>4.46</b>
<b>Std Dev</b>	<b>12.03</b>	<b>St Dev</b>	<b>3.34</b>	<b>St Dev</b>	<b>5.14</b>

Table 5: Rise in general government debt, 2006 to 2009 (% of GDP)

Source: calculated from Eurostat Public Balance and General Government Debt data (n.d)

Unsurprisingly, in the context of the analysis I have thus far presented, the deterioration in the condition of the public finances is dramatic in each case, but most severe in the first-wave economies. By contrast, the third-wave economies, whose principal exposure to the crisis was through the contagion effects arising from trade interdependence, have – to date – suffered the least. Yet this may well be attributable in part to the greater time-lag effects associated with trade interdependence as a mechanism of crisis transmission. If, for instance, it takes a decade for world-trade volumes to return to pre-crisis levels, then it would clearly be wrong to gauge the severity of the impact of the crisis on different economies by simply comparing the rise in general government debt between 2006 and 2009. But, even if the crisis is far from over for these economies, it is simply not credible to suggest that those only subject to the (still ongoing) third wave of the crisis are likely to endure a deterioration in their public finances nearly as ghastly as that currently afflicting a handful of their first-wave counterparts – notably Britain.

To see quite how it could have come to be so bad in cases like the British it is crucial to examine in more detail the model of growth that sustained it for so long – and the manner of its implosion.

## The Anglo-liberal growth model

Most commentators now acknowledge that Britain had a particular kind of growth dynamic, a model even, that expired as its internal pathologies were exposed from 2006 onwards. It has been termed, variously, the ‘new financial growth model’, ‘privatised Keynesianism’ or ‘house-price Keynesianism’. My preference is for a simpler term – the ‘Anglo-liberal growth model’. This, I suggest, had its origins in the particular ‘variety of capitalism’ to which the British political economy belongs – conventionally, the liberal market economic variety (see Hall and Soskice 2001). Its emergence as a growth model can be traced to the implementation in Britain since the 1980s of a series of core market liberal reforms – though the resulting Anglo-liberal growth model is best seen as a largely unanticipated and unsought consequence rather than the product of a more conscious plan. Yet, from 2000/1 onwards one can discern within the British government, the Treasury especially, a more conscious and strategic awareness of this as a growth model. What was initially serendipitous came to be acknowledged as the basis of growth and, indeed, the premise for a series of other strategies, particularly the concerted move towards asset-based welfare.

### Establishing the preconditions of Anglo-liberal growth

It is not difficult to discern in the political decisions which set the context for Anglo-liberal growth (and, indeed, in the dispositions of those making them) a persistent market liberalism. The step-level decrease in interest rates which set the economy on the path to sustained consumer-driven economic growth occurred, of course, in the most unpropitious of circumstances - with the devaluation of sterling associated with its forcible ejection from the Exchange Rate Mechanism

in September 1992. Yet, crucially, this was further reinforced by two decisions made by the incoming Labour administration of Tony Blair in 1997. These were the granting of operational independence to the Bank of England and, perhaps more significantly still, the commitment to the stringent spending targets set by the outgoing government of John Major (arguably, at a point when the latter had already discounted the prospect of its own re-election). Although this self-imposed fiscal conservatism was almost certainly the product of perceived electoral expediency (bound up with notions of how best to be seen to be economically competent) rather than with more directly economic judgements, this latter decision led the new Labour government to run a substantial budget surplus between 1997 and 1999. The resultant rescaling of national debt served to increase the sensitivity of demand in the economy to interest-rate variations and, in the process, helped further to institutionalise a low interest rate-low inflation equilibrium. This was the altar on which Anglo-liberal growth would rest and, of course, ultimately perish – and the point is that it was one carved with market liberal intentions.

Yet, as is now increasingly acknowledged, it was not just low interest rates that served to inflate the bubble – certainly in Britain. Crucial, too, was the liberal and increasingly highly securitised character of the mortgage market in the Anglo-liberal economies (Schwartz 2008; Schwartz and Seabrooke 2008; Watson 2008). For it was this that allowed mortgage debt to be packaged in such a way that the originators of loans bore little or none of the risk associated with the credit they were extending – at least for as long as house prices remained stable or rising. And, whilst house prices were on an upward trajectory, the returns to be gained on mortgage-backed securities made them a very high-yielding investment vehicle indeed. Of course, mortgage-backed securitisation was established first in the US, with Fannae Mae, for instance, buying mortgages and selling them on as securities from as early as 1938 (Thompson 2009). It would take the liberalisation and deregulation of financial markets in the mid 1980s to bring this to London. But, once this occurred, London and New York effectively engaged in a game of competitive deregulatory arbitrage, establishing in the process the regulatory preconditions for the inflation and bursting of a bubble in mortgage debt. To be clear, policy-makers (on both sides of the Atlantic) did not seek to liberalise financial markets in order to make possible the mortgage-backed securitisation that would serve to channel credit to the housing market, driving up demand and prices. They did so more because their pro-market disposition inclined them to think this was an inherently good thing to do. But the effect was the same.

As such, a conviction as to the allocative efficiency of lightly regulated markets was a necessary if not sufficient condition of Anglo-liberal growth. Thus, it was the passing of the Financial Services and Building Societies Acts of 1986 that paved the way for US investment banks to establish mortgage-lending subsidiaries in London. They brought with them the securitisation of mortgage debt, albeit at a level far below that reached in the US. The practice was rapidly diffused throughout a retail banking sector swollen by the demutualisation of the building societies (Wainwright 2009). Once again, a liberalising disposition was responsible for establishing a core institutional precondition (here mortgage securitisation) of the emerging Anglo-liberal growth model.

As we have seen, then, the key policy choices which led to a growth dynamic sustained by escalating consumer credit were consistently liberal or market-conforming. It is for precisely this reason that I think it useful to label this an Anglo-liberal growth model. The key decisions were those relating to the austere and fiscally conservative spending plans of the incoming Labour administration in 1997, its orthodox neo-monetarist decision to cede operational independence to the Bank of England to set interest rates (and the specific remit it gave to the Bank's Monetary Policy Committee) also in 1997 and, prior even to that, the decision to liberalise UK financial markets in the 1980s. What all of these decisions shared was a profound confidence in the superiority, all things being equal, of private, market or quasi-market mechanisms over collective, public or state action or intervention – they were all, in other words, profoundly market- or neo-liberal.

### The Anglo-liberal growth model in a nutshell

It is tempting to see in the growth model which has characterised the UK economy since the early 1990s rather more conscious strategising than is genuinely warranted. As suggested earlier, policy-makers were certainly not animated from the start by a vision of the growth model they were building. The Anglo-liberal growth is best seen to have been stumbled across accidentally (Crouch 2009; Hay 2009). What is clear, though, is that it was largely consumer-led and private-debt-financed. Once established, it was undeniably supported by high levels of public expenditure - with the reinvestment of public sector wages in the housing market, for instance, playing a significant role in pushing up prices, thereby facilitating equity release and boosting consumer demand. Yet it was the easy access to credit, much of it secured against a rising property market, which was its most basic precondition. This served to broaden access to – and improve affordability within – the housing market, driving a developing house-price bubble. Once inflated, this was sustained and, increasingly, nurtured, by interest rates which remained historically low throughout the boom – and which, with the benefit of hindsight, had to remain unprecedentedly low for the boom to last.

To all intents and purposes it appeared that a virtuous cycle had been established, in which the preconditions of growth were mutually reinforcing. The features of this growth model can be relatively simply described. Sustained low interest rates and a highly competitive market for credit provided both the incentive and the opportunity for first-time buyers to enter a rising market and for established home-owners to extend themselves financially, by either moving up the housing ladder, or releasing the equity in their property to fuel consumption. There was little incentive to save; instead, consumers were increasingly encouraged to think of their asset purchases as investments which they might cash in to fuel their consumption in retirement, as the state withdrew from pension provision, or in times of economic difficulty or unemployment. This 'asset-based welfare' was, in effect, the social policy corollary of Anglo-liberal growth – and we will return to it in more detail presently.

In the academic literature the story is generally told in terms of the rise and demise of 'privatised' or 'house-price Keynesianism' (Crouch 2009; Hay, Riiheläinen, Smith and Watson 2010). The Keynesian analogy cannot, however, be taken too far, nor should it be taken too literally. But it does usefully serve to highlight the key link in the Anglo-liberal growth model between (private) debt, aggregate demand and consumption. In effect, it strips the growth model to its absolute core.

To understand why Anglo-liberal growth might be considered a form of 'privatised Keynesianism', it is first important to remind ourselves of traditional or public Keynesianism. In this conception, public spending – sustained, where necessary, through government debt – is the key to promoting demand within the economy. In other words, when the economy is in recession or, indeed, more simply when consumer spending is falling, it is deemed to be the responsibility of the state to inject demand into the economy through increased expenditure (either by expending some portion of an accumulated fiscal surplus or, where this is not possible, through public borrowing). Putting (public) money in the pockets of (private) citizens, whether through tax reductions or welfare spending, boosts demand and consumption with consequent positive effects on levels of economic activity and output. But this is not the only benefit. For such measures are also likely to prove stabilising of the macro-economy over the business cycle. They are, in other words, counter-cyclical. Demand is injected into the economy in recession and a fiscal surplus can be accumulated to improve the condition of the public finances once the anticipated growth dividend is achieved. This management and amelioration of the business cycles allows Keynesians to believe that governments can reduce peak-to-trough variations in unemployment, economic activity and growth, thereby stabilising the domestic economy.

Privatised Keynesianism works rather differently. It assigns, or at least relies upon, a similar role to that played by *public* debt in traditional Keynesianism being performed by *private* debt. In the British variant, such debt has typically taken the form of credit secured against rising property prices. For so long as a low inflation-low interest rate equilibrium persisted, a virtuous

and seemingly self-sustained growth dynamic endured. This is what drove the growth model. Consumers, in this benign environment, faced powerful incentives to enter the housing market since credit was both widely available on competitive terms (there was a liquidity glut) and returns to savings were low. The result was growing demand in the property market and house price inflation. In such a context, and buoyed by interest-rate spreads (the difference between the rate at which they themselves might borrow and that which they charged to consumer lenders), mortgage lenders actively chased new business. In the process they increasingly came to extend credit to those who would previously have been denied it (at an often punitive interest-rate premium), and to extend additional credit to those with equity to release.

The incentives thus clearly encouraged expansion in both the demand for and supply of sub-prime lending, high loan-to-value ratios and, crucially, equity release designed to fuel consumption. That consumption, in turn, sustained a growing, profitable and highly labour-intensive services sector whose expansion both masked and compensated for the ongoing decline of the manufacturing economy. This was further reinforced by low levels of productive investment as credit flows to business were crowded out by positions taken on higher-yielding asset-backed securities, other collateralised debt obligations and the like.

This, for as long as it lasted, was all well and good – though it did serve to redirect the supply of credit from the productive to the consumer economy. But arguably, it is precisely where the Keynesian analogy breaks down that that problems begin. Classical (or public) Keynesianism is predicated on the existence of the business cycle. Its very rationale, as we have seen, is to manage aggregate demand within the economy in a counter-cyclical way, thereby limiting peak-to-trough variations in output growth and unemployment.

Yet privatised Keynesianism could not have been more different in its (implicit) assumptions about the business cycle. These were distinctly non-Keynesian. Whether taken in by the convenient political mantra of the ‘end of boom and bust’ or convinced, like Robert Lucas (2003), that the “problem of depression prevention has been solved”, privatised Keynesianism simply assumed that there is no business cycle. Consequently, measures which might otherwise be seen as pro-cyclical appeared merely as growth enhancing. The effect was that the implicit paradigm that came to support the growth model neither saw the need for, nor was capable of providing, any macroeconomic stabilisers. If, perhaps as a result of an inflationary shock, the low interest rate-low inflation equilibrium were disturbed, then mortgage repayments and ultimately mortgage default rates rise, housing prices would fall, equity would be diminished and, crucially, consumption would fall – as disposable income would be squeezed by the higher cost of servicing outstanding debt and as the prospects for equity release to top up consumption diminished. But it was in fact far worse than that; for there were feedback effects too. Lack of demand translated into unemployment with further adverse consequences for mortgage default rates, house prices and so forth. The virtuous circle rapidly turned vicious. This is precisely what happened in the heartlands of Anglo-liberal growth, the US in 2006 and Britain and Ireland in 2007.

#### **Asset-based welfare**

Yet it was not just the Anglo-liberal growth model that was threatened by the bubble burst. There was internal contagion too. In Britain it was not just the growth model that lay in tatters; so too were a range of public and social policies whose development had been predicated on the assumed continuation of both growth and of this particular conception or model of growth more specifically. Chief amongst these is what is usually termed ‘asset-based welfare’. This was - and, to some extent, remains - an approach to welfare in which citizens were encouraged to acquire, as a form of investment, appreciating assets which they might later liquidate to fund their welfare needs. It became associated in particular with the idea that citizens, rather than the state, bore the principal responsibility for ensuring that they had adequate funds in retirement and/or ill-health to meet their needs without becoming dependent on their families.

In the context of an ageing population and with the projected steep decline in the per capita value of public pensions, asset-based welfare provided a means of squaring an increasingly slippery welfare circle. But the problem was that the stable and predictable asset appreciation on which it rested was, like the Anglo-liberal growth model itself, dependent on easy access to credit and the persistence of a low inflation-low interest rate equilibrium. It was, in other words, fine only for as long as the benign conditions of what economists call the 'great moderation' persisted. But with the benefit of hindsight – and perhaps even with none – these were never going to last forever. Asset-based welfare was, in effect, a way of mortgaging the future capacity of citizens to provide for themselves with dignity on the vagaries of the housing market (and markets in other appreciating assets classes).

Put in such terms, asset-based welfare looks like a rather risky and ultimately costly one-way accumulator bet. And it was. But to appreciate how it came to prove so attractive to policy-makers in the first place it is important to see it in the context of both a wider confidence that the 'great moderation' was a near permanent condition and as part of Britain's growing welfare stinginess (at least in comparative European terms). Consider each point in turn. The first is a rather simple and obvious one. In assuming the great moderation to be here to stay, policy-makers in Britain were in very good company. For this had become, and for some considerable time, the mantra of modern economic theory. As long as government was not allowed to interfere too much in monetary policy (a problem solved simply by a good dose of central-bank independence), then the business cycle was a thing of the past. Robert Lucas's telling remarks to the American Economics Association quoted above merely stated a conventional orthodoxy – the business cycle was a thing of the past; consequently, Keynesianism was dead.

The point is that to the extent that this was true – or merely accepted as true – asset-based welfare was a very sensible public policy stance. For it was almost bound to deliver a good return to those able to participate in it. As such it was perfectly rational for policy-makers to promote it as a strategy for supplementing more conventional (and less efficient) means of meeting welfare needs publicly.

It appears all the more attractive when set in the context of Britain's creeping welfare residualism from the mid 1980s. For, if we look in comparative terms at the generosity of welfare benefits (rather than at aggregate levels of welfare expenditure), then the growing residualism of the Anglo-liberal welfare state is starkly revealed. The relevant metric here is the income replacement ratio - the proportion of the living wage that benefits provide. From the late 1970s, from precisely the point at which European welfare states start to become less generous to welfare recipients, we see a divergence between European welfare regimes. From this point on, the Anglo-liberal pair of Britain and Ireland are increasingly characterised by their lack of generosity – whether in terms of unemployment benefits, pensions or sickness insurance. This is clear to see if we examine Figures 2 and 3 together.



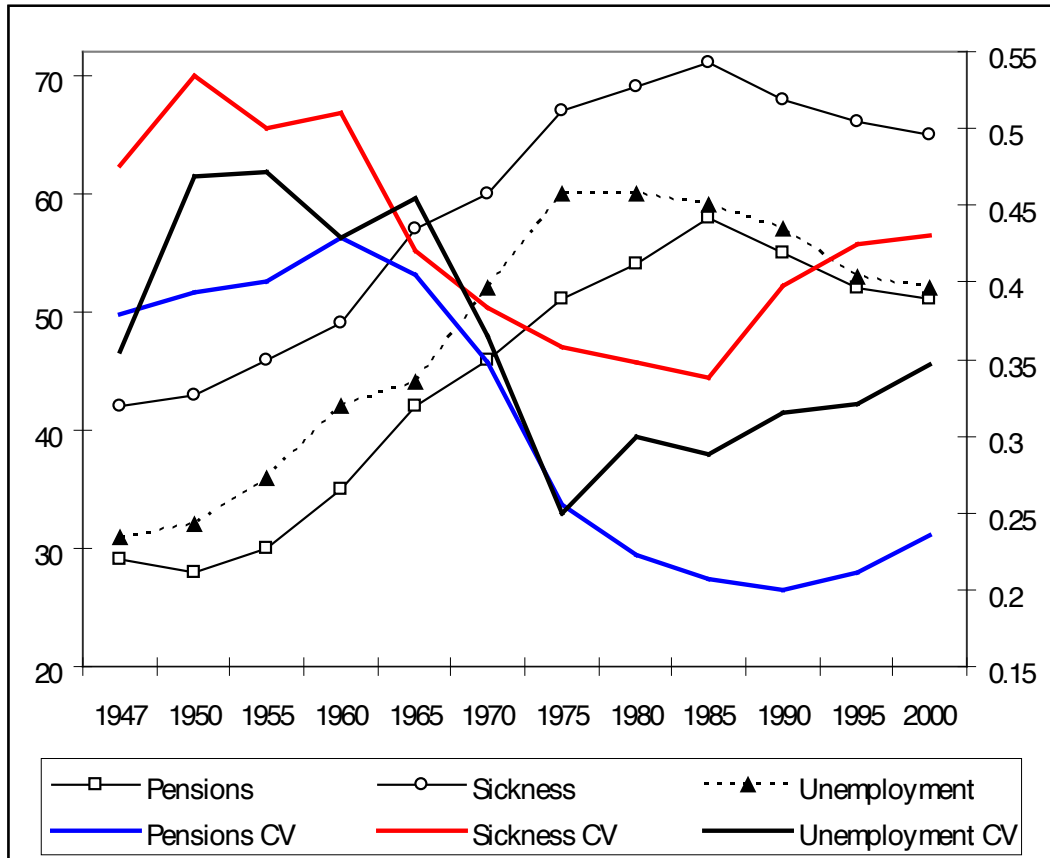


Figure 2: Net replacement ratios for social insurance programmes, 1947-2000

Source: Hay and Wincott (2012); calculated from the Social Citizenship Indicator Programme (SCIP) database (<https://dspace.it.su.se/dspace/handle/10102/7>)

Note: arithmetic means and coefficients of variation for 18 countries – Australia, Austria, Belgium, Britain, Canada, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Sweden, Switzerland and US.

Figure 2 shows the average generosity of public pensions and sickness and unemployment benefits (as income replacement ratios) for 18 European countries. It also shows the coefficient of variation for each benefit type - a simple statistical measure of dispersion. When it falls, this indicates convergence; when it rises, divergence. What the data clearly show is convergence for as long as European welfare states grow, then divergence in retrenchment. And it is not difficult to see how this arises if we look more closely at unemployment benefits as income replacement ratios.

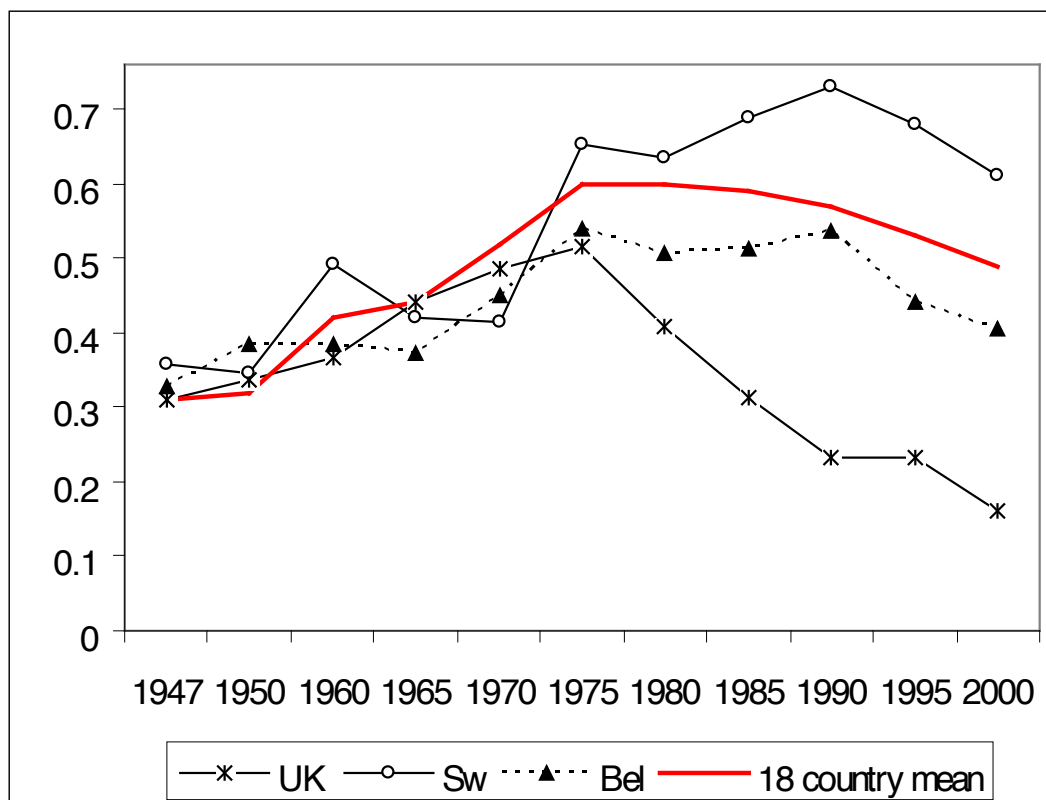


Figure 3: Divergence in retrenchment: unemployment benefits as income replacement ratios, 1947-2000

Source: Hay and Wincott (2012); calculated from the SCIP database (<https://dspace.it.su.se/dspace/handle/10102/7>)

Figure 3 shows unemployment benefits as net income replacement ratios for Britain, Sweden and Belgium in the post-war period (though similar graphs could be produced for the value of public pensions and sickness insurance). It suggests very clearly that the welfare divergence picked up in the previous figure from the late 1970s is a product of the already most residual welfare states, like the British, cutting their benefits earliest and hardest with the more generous Nordic and continental welfare states cutting later and in a far less aggressive manner. This growing residualism, we suggest, reinforced the incentive to promote asset-based welfare as a means of partially compensating citizens for the growing mismatch between the benefits to which they were entitled and their expectations of the benefits they might receive.

But the problem was that the attractiveness of asset-based welfare to policy-makers in Britain did not make it a very good bet. Indeed, despite being so widely promoted and touted, it has actually proved extremely fortunate that the transition to asset-based welfare was rather more gradual and incremental than one might have been forgiven for thinking, given its public profile. By the onset of the crisis only one major asset-based welfare programme was actually up and running – the Child Trust Fund. Indeed, even this scheme, in which the state in effect provided the opening deposit in a child's investment account maturing at 18, was only operative from 2005. Yet, despite this, close to £0.5 billion has been lost from the value of these funds since the onset of the credit crunch (Prabhaker 2009). The mortgaging of childhood futures on continued asset-price appreciation has, perhaps unremarkably, proved a further casualty of the crisis.

## Getting what went wrong right ... and putting it right

### A crisis of debt not of growth

Crises are, at least to some extent, what we make of them. For what we do in response to a crisis depends to a very considerable extent on how we perceive the problem – we respond not to the condition itself but to our diagnosis of it. What is clear is that the dominant discourse conceives of our affliction as a *crisis of debt*. But this is not the only way in which the crisis could be understood.

This may sound like a purely academic point; but it is not. For, crucially, it is our understanding of the crisis that conditions our response to it. It is our seemingly shared conviction that this *is* a crisis of debt that makes austerity and deficit reduction the logical solution. Change our sense of the crisis and we change the range of responses considered appropriate. Thus, were the crisis conceived of differently, as a *crisis of growth* not a *crisis of debt*, then austerity and deficit reduction would be no solution at all. Indeed, they would almost certainly be seen as likely to compound the problem.

Yet it is precisely the implication that I draw from the preceding analysis that the dominant account misdiagnoses the current British crisis. And, if we are to put right what went wrong, it is first imperative that we get our diagnosis of the affliction correct. Our argument is, then, that this is not a crisis of debt. To see the British crisis or, indeed, the Eurozone crisis as one of debt, is to mistake a symptom for the condition itself; and the risk is that, in mistaking the symptom for the condition, we choose a course of medicine only destined to reduce further the life expectancy of the patient.

This we saw earlier in examining the fiscal origins of Britain's current debt predicament. It is lost taxation revenue that accounts for most of Britain's current account deficit. If this is indeed the case – and it is difficult to argue with the logic – then to commit to reducing the deficit in the absence of growth is a near suicidal policy. For, if the problem is, indeed, a lack of growth, then to withdraw public spending and hence demand from the economy in order to rebalance the public finances in record time seems both unnecessary and deeply counter-productive. It can only reduce further economic output, compounding the problem it was intended to cure – all the more so given the peculiarly strong link between growth and consumer demand in the British economy in recent years. Indeed, recast in this way, deficit reduction becomes a tacit acceptance of the idea of Britain as a smaller economy – an economy which can and will no longer be able to afford the public sector to which it had previously become accustomed.

Unremarkably, this alternative vantage point generates very different expectations about the likely effects of deficit reduction – expectations, I would contend, much closer to exhibited patterns of economic performance since 2010 than, say, government or Office of Budget Responsibility (OBR) growth projections.

What makes such a hypothetical test of expectations all the more definitive is that until recently the Cameron-Clegg Coalition has in fact talked far tougher on deficit reduction than its practice would suggest. As the National Institute for Economic and Social Research pointed out at the time, the 2010 Emergency Budget's revised timetable for fiscal rebalancing in fact *delayed* already planned spending cuts (Weale 2010). Moreover, the more detailed programme of deficit reduction subsequently set out in the 2010 Comprehensive Spending Review was implemented far more slowly than was originally intended. Consequently, Britain in fact saw a relatively prolonged period of classic deficit financing (during which time there was modest economic growth) that eventually gave way to a classic bout of austerity and deficit-reduction (corresponding to the slide into a double-dip recession). Throughout, the government, the OBR and the Bank of England anticipated steadily accelerating growth.

### **Impediments to the resuscitation of the old growth model**

Wrong though it may be, it is not at all difficult to see why a crisis of debt discourse might have taken hold in Britain. It is not very threatening; it does not entail a change in economic paradigm; and it leads readily to a simple diagnosis – deficit reduction and austerity – which is arguably quite in accordance with the liberal market disposition of recent British governments. The alternative crisis of growth discourse is, in a sense, a far more challenging one. For it would entail a rejection of the prevailing economic paradigm informing policy since at least the 1980s. More significantly still, it would almost certainly require a rejection of the old growth model and the search for a new one.

As this suggests, whilst the crisis of debt discourse is paradigm-reinforcing, the crisis of growth discourse is paradigm-challenging. And, if there is one thing that we have learned from previous crises, it is that prevailing economic paradigms are not readily abandoned. They tend, if anything, to be tested to destruction. Arguably, this is what happened in the 1930s; and it may well be what is happening today. The point is that the dominant crisis of debt discourse has led both the Coalition government and, to the extent that it accepts it too, the Labour opposition to search for growth principally by seeking to revive the old (broken) model of growth.

But there are serious impediments to the resuscitation of the old growth model which we can infer directly from the preceding analysis – and which arguably explain why the resumption of growth has proved so elusive. There are essentially six of these. Together they must lead us to question the extent to which growth, even in the short- to medium-term, can be revived in this way and, in fact, the longer-term desirability of any such revivification, were it to prove possible.

1. *The heightened sensitivity of demand to interest-rate variations.* The first impediment to the return to growth by recently conventional means relates to monetary policy. The point here is simple – the dependence of the old growth model on private debt increased the sensitivity of demand in the economy to interest-rate movements and, in the process, the threat to growth posed by inflationary pressures. That problem, though temporarily suspended during the crisis itself and during 2012's double-dip recession, has plagued the economy since 2007. The Bank of England has effectively been unable to use interest rates to control inflation irrespective of its mandate. The problem has not gone away; indeed, arguably it has gotten worse. For the likelihood is that any return to growth in the world economy, whether or not Britain participates in that growth, would be accompanied by a steep rise in oil prices and the threat of inflation.
2. *Interest rate spreads on consumer and commercial lending.* This is compounded by a second factor - the size of the mortgage and commercial lending-rate spreads which opened up during the crisis. Though not much commented on, these have yet to close up again in the way that inter-bank lending rates did. It has, in short, become more costly to borrow at a given base rate; or, in other words, the monetary authorities have allowed the banks to pass on a significant part of the cost of their recapitalisation to borrowers – suppressing both consumer demand and investment in the process. The point is that, for so long as commercial and mortgage lending rates remain punitive, consumption and investment are being crowded out, in effect, by bank recapitalisation – making both the partial resuscitation of the old growth model and, indeed, the transition to a new one less likely. This is a serious impediment to growth – all the more if that growth is itself dependent on consumer credit.
3. *A looming crisis of housing affordability.* A third factor is long-standing – indeed, it is intergenerational. Sustained house price inflation at 10 per cent per annum over a number of decades was always going to create a crisis of affordability for new entrants into the housing market at some point. That point has, of course, been brought forward, dramatically, by the crisis – and the intergenerational problem of affordability is now being compounded by a step level increase in the cost of mortgage lending over the base rate, the increased levels of personal debt that will follow the withdrawal of state funding for higher education and, indeed, the comparative risk aversion of the banking sector following the crisis. But it would have come anyway. As this suggests, the housing bubble

on which so much of Britain's growth rested since the early 1990s was always going to prove time-limited, even in the absence of the global financial crisis.

4. *Likelihood of currency depreciation in the absence of growth.* A fourth factor relates, in a way, to the first – it is a feedback effect. If, for some of the reasons already discussed, growth continues to prove elusive in Britain whilst it starts to return to other leading economies, then it is likely that the exchange rate will suffer at precisely the point at which oil prices (themselves largely denominated in dollars) start to rise. The result can only be inflation and upward pressure on interest rates – in short, a return to the condition of 'stagflation' that afflicted the British economy in the 1970s and again during much of the crisis itself.
5. *Prospects for the re-regulation of financial markets.* In at least one respect, the performance of the British economy since the crisis has been better than was envisaged by most commentators. At the time, for instance, there seemed nothing terribly remarkable about Martin Weale's comments in 2009 that "it is most unlikely that the financial services industry can in the future act as the sort of motor of growth that it has done in the past ... if the sector returns to the importance it had in 2000, GDP is likely to be reduced permanently by about 1.9 per cent" (2009: 3, 8). But this step-level reduction in the contribution of financial services to British GDP has simply failed to materialise – and that is of course no bad thing. But the point is that it might yet still happen. For what Weale had envisaged by now is the systematic re-regulation of financial markets – and, in particular, limits on short-selling – which have yet to arise, but which arguably the prudential governance of global financial markets requires. Such regulations might be very good for the stability of the global economy going forward; but they would merely serve to accentuate the size of the hole in Britain's model of growth that needs filling.
6. *The cost of austerity.* Finally, however bad things may already be, if the above analysis is correct, then they are only likely to get worse before they get better. First, as we have seen, however beneficial for the world economy any re-regulation of financial markets might prove, it is likely to come at some considerable price in terms of the contribution of financial services to British GDP. And, second, with the lion's share of the public spending cuts associated with the move to public austerity still to come, demand in the economy and hence the contribution of consumer spending to economic output is almost bound to fall before it improves. As this suggests, the immediate prospects for the resumption of a model of growth resembling that which came to characterise the British economy since the early 1990s look bleak indeed.

#### **Impediments to a new growth model**

So what can be done? Well, the above analysis would seem to lead inexorably to a simple conclusion – the need for an alternative growth model. But, even assuming one could be found, there are still significant problems.

The first of these is a long-standing pathology of British capitalism - the cost of capital – and it re-emerges again as a problem today at a time when the transition to any new growth model is likely to require significant levels of (private) investment – in new plant, machinery and technologies for instance. For what applies to consumer applies also to commercial borrowers. Commercial credit (just like consumer and mortgage debt) is essentially being rationed through punitive interest rates and this is crowding out investment.

The problem is reinforced by a further factor – the drop in the value of the commercial property against which many commercial credit lines are secured. Taken together, these factors make it very difficult to envisage the transition to an alternative, say export-led, growth strategy built on the back of private investment – and the parlous condition of the public finances would seem to preclude a programme of public investment to effect a similar transition. The economy's capacity to raise capital to build a new export-led growth strategy capable of capturing new markets would seem rather limited; and the withdrawal of significant amounts of state support for human-capital formation (in the revised financial model for higher education) merely compounds matters.

### The search for an alternative

But this is no manifesto of despair. Quite the opposite. For there is much that follows from the preceding analysis by way of practical policy suggestions that can make a substantial difference in the long-overdue search for a new more sustainable and, indeed, inclusive model of growth – in which the proceeds of economic success are more evenly distributed. The following is merely an outline of the implications of the analysis I have sought to present.

1. *Politicising the cost of borrowing.* A couple of policy implications follow fairly directly from the discussion with which I concluded the previous section. First, if the economy is to be 'rebalanced', then the government and the Bank of England need to be putting concerted downward pressure on the actual cost of borrowing (independent of the base rate), particularly in sectors where a clear link to the growth strategy for the economy can be made and substantiated. The banks, I contend, have in effect been allowed to recapitalise themselves by charging commercial borrowers, mortgage holders and those servicing consumer debt a sizeable interest-rate premium, relative to the base rate to compensate them from their investment banking losses during the crisis. Arguably at least half of each British mortgage holder's monthly debt repayment at present takes the form of a tacit bank recapitalisation charge. This is both intolerable and a significant drain on the growth prospects of the commercial and consumer economy. The banks need to be named and shamed and held publicly to account for their behaviour.
2. *From private to public investment.* As this suggests, there is a strong argument to be made for not just private but *public* investment in support of a clearly articulated growth strategy built on identifying and supporting growth in a series of key export-oriented sectors. Apart from anything else, and for some of the reasons already pointed to, the cost of financing long-term public borrowing is significantly lower than for commercial lenders. Moreover, public infrastructure projects are likely to be key to any reconfiguration of the economy which might more closely align its structure to a new (and more clearly export-oriented) growth strategy. Public investment might, in other words, be a highly cost-effective way of providing the public goods on which the transition to a new model of growth relies.
3. *Hypothecated investment or growth bonds.* This is all very well, but how might it be funded? There are many options which might be considered here. But one of these is the use of public investment or growth bonds – a form of hypothecated government debt and, in effect, an ethical form of investment available to financial institutions and private citizens alike. The funds secured in this way would be ear-marked for public infrastructural projects or might be distributed through a range of national or regional investment banks, perhaps even including a green investment bank. The latter might fund investments in sustainable technologies or the human capital to utilise such technologies.
4. *Conditional deficit reduction.* A further implication of the analysis presented here is that we cannot afford to consider deficit reduction as a goal in itself – and certainly not the principal goal guiding economic policy. Indeed, a powerful implication of the preceding discussion is that deficit reduction in a context of stagnant or negative growth is suicidal and threatens only to produce a vicious circle of declining economic output. But this is not to suggest that there is a simple trade-off between deficit reduction and growth promotion – merely that deficit reduction must be made conditional on growth. Governments, in such a conception, would need to be clear about their strategy for securing growth and to make a strong public pre-commitment both to an explicit growth target and to a sliding scale of deficit reduction – in which, say, growth of X% would result in the repayment of £Y billion of public debt, but in which zero or negative growth would result in no reduction in government debt. This, I would contend, is the only way to ensure that deficit reduction writ large does not generate a global crisis into a global recession in a manner analogous to the 1930s.
5. *International coordination of debt and growth management.* The economic case for conditional deficit reduction is, I would contend, a very strong one; but it undoubtedly has its political difficulties. To announce the end of deficit reduction in one economy

alone, especially in the current global economic climate and in a context of the timidity of financial institutions, threatens a run on the currency and a steep rise in the cost of servicing (short-term) national debt. Consequently, it is imperative that steps are taken at an international (and, ideally, a global) level (under the auspices of the IMF, for instance) to agree a coordinated strategy for managing debt and growth – as well as, in time, to move away from a simple notion of output growth as the global currency of economic performance.

The above five points do not, of course, constitute a growth model for the British economy – nor are they intended to. Indeed, part of the aim of this paper has been to show precisely how difficult it is to envisage a smooth transition to a stable, let alone environmentally-sustainable and equitable, growth model. But they do suggest a way forward.

Taken together, however, they are no panacea. For even were the Britain's most dynamic export-orienting manufacturing and sectors, say, to grow at a most unlikely 10 per cent per annum for the next 5 years, we would be talking of a growth of employment of probably no more than one million. The contribution to annual GDP growth would be between 1.5 and 2 per cent (rising with the relative size of the such sectors in the overall economy) - a relatively modest figure, given the emphasis so often placed on such an export-oriented rebalancing of the economy in alternative accounts of growth. As this suggests, such a 'rebalancing' is not in itself a growth strategy; though it might well be a significant element of one.

There are clear policy implications of this. They are essentially three-fold.

First, however important an export-oriented rebalancing is likely to prove in a reorientation of the British economy, it would be naïve in the extreme to see it as a potential fount of British growth in the decades ahead. And the reorientation of the British economy in this way is, at best, a long-term strategy – which may well yield significant dividends over two or more decades but which is most unlikely to contribute significantly to British growth in the short- to medium-term.

Second, this almost certainly means that the British economy needs, in the interim at least, to make do with a growth strategy that looks rather more like the old one than might seem ideal – whilst of course preparing the groundwork and making the transition to another. That, of course, has major policy implications – not least with respect to monetary policy and the regulation of the banking sector. In terms of the former, it suggests that the Bank of England's currently highly accommodating monetary policy stance is right, but perhaps too limited in its ambition. Consumer demand sustained by personal debt played a crucial role – too crucial a role – in the generation of growth in the British economy throughout the great moderation; and, whether we like it or not, it will have a crucial role to play in any resuscitation of growth in the years ahead. But what the British economy needs is a far more selective and strategic channelling of the supply of credit – out of the housing market and other appreciating asset classes and into new sources of growth (in manufacturing and services). That entails not just an accommodating monetary stance, but a focused assault on interest rate spreads in areas identified as targets for investment in the new growth model.

Finally, the above analysis has perhaps surprising implications for the regulation of the banking sector. It suggests that, from the British perspective at least, the current focus on investment banking and the bonuses of investment bankers may in fact be a distraction. For now at least the British economy cannot do without the contribution to economic output arising from financial services. Here it is important to note that the immediate predicament of the British economy would be far worse had the global financial reregulation advocated by many reduced the volume of short-term trading in the world economy (through some form of taxation on speculative transactions). Yet the implication of this is not that British policy-makers should ease up on investment banking, whilst refocusing their attentions of commercial banking. Rather, it is that they need to reconsider the relationship between the two. The reality is that a major impediment both to the resumption of growth and to the kind of investment levels that will be required to make the gradual transition to a new growth model is precisely the crowding out of

potential investment by the punitive interest rate premiums currently demanded by commercial lenders. As I have argued, such punitive interest rates are themselves a product of the covert recapitalisation of investment banking. In short, commercial banking is subsidising investment banking in a way that impairs the capacity to build a new growth model. As this suggests, a refocusing of the public assault on the banking sector is long overdue. The banking sector now needs to be made a core part of the solution.

## Conclusion - Crisis, what crisis?

We have travelled a fair distance in the preceding pages – considering the nature of British capitalism itself, the Anglo-liberal growth model to which it has given rise since the 1990s and the culpability of both in the global financial crisis and our own domestic crisis. We then turned to consider the consequences of the crisis and the prospects for the return to growth in the years ahead, concluding with a set of proposals for the way forward in the years ahead – the potential path from crisis, as it were.

But there is one question in all this that we have not considered. And it is to this that we now turn in conclusion. That question is a simple one: it is even correct to refer to this as a crisis in the first place? And, strange though it might seem, my argument is that the more one reflects on this, the less self-evident it is that we have witnessed a crisis.

It is clear that the language of crisis has, if anything, been cheapened in recent years. Everything these days is a crisis. So surely this is? Well, it is certainly bad enough; but in a sense that is precisely the point. For if we return to the (Greek) etymology of the term, we find that a crisis is a *moment of decisive intervention* – medically, the critical point at which the doctor's intervention proves decisive, one way or the other, in the course of the illness and the life of the patient. Insofar as this is a relevant analogy, we are not yet at that point. For although the patient may well be suffering more than ever, the condition does not seem to be improving; but this is not because of the failure of any decisive intervention. For there simply hasn't been one. If this is what a crisis is - a moment of decisive intervention - then we have simply yet to get to the moment of crisis. What we have seen is instead the accumulation of a series of largely unresolved contradictions – not that the significance of this should be underemphasised. For in many respects this is far worse; it would surely be better were we able to talk about this as a moment of decisive intervention.

So what possibility is there of our situation of radical indecision becoming one of decisive intervention? For, perverse though it might seem, the best that we can hope for is a crisis – at least a crisis thus understood.

Here there are grounds for optimism and pessimism alike.

For the optimist, crises understood as moments of decisive intervention and paradigm shift are rare, though they typically post-date the emergence of the symptoms they ultimately seek to resolve, often by a decade or more. In short, we may be too impatient in expecting the crisis point to have been reached already. This was certainly the case in the 1930s – with the transition to Keynesianism taking at least a further decade from the advent of the great depression; and a similar kind of time-lag can arguably be identified in the process of change initiated in the 1970s. It seems that the transitions we now associate with crisis periods take a long time to arise – typically a decade or more. It is perhaps ever more likely the more the condition remains resistant to the current medicine – medicine, of course, prescribed by doctors trained and versed in the operation of the old paradigm.

Yet there is only so much optimism one can draw from such historical analogies. For there can be no guarantee that alternative doctors with alternative medicines will be summoned simply because the patient remains unwell and the condition is not responding to current treatments. Searching for solutions is no guarantee that they are found nor that they are implemented. But perhaps even that is too optimistic. For the argument of this paper has been that, to far too great an extent, we have either not been looking for solutions (certainly not for alternatives



to the prevailing paradigm) nor, to the extent that we have been looking for solutions, have we been looking in the right places and in the right way. My hope is that in this paper I have made a compelling case that we need first to get right what went wrong in order to put it right and to suggest at least some of what getting it right and putting it right might entail. That is a key part of the ongoing research agenda of SPERI – to develop the kind of political economy we need in Britain (and indeed beyond) if we are to build a sustainable recovery.

---

## References

- Chor, Davin and Manova, Kalina (2012) 'Off the cliff and back? Credit conditions and international trade during the global financial crisis', *Journal of International Economics*, 87 (1): 117-133.
- Claessens, Stijn, Dell'Ariccia, Giovanni, Igan, Deniz, and Laeven, Luc (2010) 'Cross-Country Experiences and Policy Implications from the Global Financial Crisis', *Economy Policy*, 62: 267-293.
- Crouch, Colin (2009) 'Privatised Keynesianism: An Unacknowledged Policy Regime', *British Journal of Politics and International Relations*, 11 (3): 382-99.
- Hall, Peter A. and Soskice, David (eds.) (2001) *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. Oxford: Oxford University Press.
- Gough, Ian (2010) 'Economic crisis, climate change and the future of welfare states', *Twenty-First Century Society*, 5 (1), 51-64.
- Hay, Colin (2009). 'Good Inflation, Bad Inflation: The Housing Boom, Economic Growth and the Disaggregation of Inflationary Preferences in the UK and Ireland', *British Journal of Politics and International Relations*, 11 (3): 461-78.
- Hay, Colin (2012) 'Treating the symptom not the condition: Crisis definition, deficit reduction and the search for a new British growth model', *British Journal of Politics and International Relations*, forthcoming, available on iFirst.
- Hay, Colin and Wincott, Daniel (2012) *The Political Economy of European Welfare Capitalism*. Basingstoke: Palgrave Macmillan.
- Hay, Colin, Riiheläinen, Jari Matti, Smith, Nicola Jo-Ann and Matthew Watson (2009) 'Ireland: The Outlier Inside', in Kenneth Dyson (ed.) *The Euro at Ten: Europeanisation, Power and Convergence*, Oxford, Oxford University Press.
- Lucas, Robert E. (2003) 'Macroeconomic Priorities', *American Economic Review*, 93 (1): 1-14.
- Martin, Ron (2011) 'The Local Geographies of the Financial Crisis: From the Housing Bubble to Economic Recession and Beyond', *Journal of Economic Geography*, 11 (4): 587-618.
- Prabhakar, Rajiv (2009) 'Asset Inequality and the Crisis', *Renewal*, 17 (4): 75-80.
- Schwartz, Herman (2009) *Subprime Nation: American Power, Global Capital and the Housing Bubble*. Ithaca, NY: Cornell University Press.
- Herman Schwartz and Len Seabrooke (2008) 'Varieties of Residential Capitalism in the International Political Economy: Old Welfare States and the New Politics of Housing', *Comparative European Politics*, 6 (3): 237-61.
- Thompson, Helen (2009) 'The Political Origins of the Financial Crisis: The Domestic and International Politics of Fannie Mae and Freddie Mac', *Political Quarterly*, 80 (1): 17-24.
- Wainwright, Thomas (2009) 'Laying the Foundations for a Crisis: Mapping the Historico-Geographical Construction of Residential Mortgage Backed Securitisation in the UK', *International Journal of Urban and Regional Research*, 33 (2): 372-88.
- Watson, Matthew (2008) 'Constituting Monetary Conservatives via the Savings Habit: New Labour and the British Housing Market Bubble', *Comparative European Politics*, 6 (3): 285-304.
- Watson, Matthew (2010) 'House Price Keynesianism and the Contradictions of the Modern Investor Subject', *Housing Studies*, 25 (3), 413-426.
- Weale, Martin (2009) 'Commentary: Growth Prospects and Financial Services', *National Institute Economic Review*, 207: 3-9.
- Weale, Martin (2010) 'Cuts Delayed?', *National Institute of Economic and Social Research* Press Release, 14<sup>th</sup> June.



The  
University  
Of  
Sheffield.

Sheffield Political Economy Research Institute  
Interdisciplinary Centre of the Social Sciences  
219 Portobello  
Sheffield S1 4DP

T: +44 (0)114 222 8346  
E: [speri@sheffield.ac.uk](mailto:speri@sheffield.ac.uk)