

## Chapter 7

### **European Welfare Capitalism in Hard Times**

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If there a single core theme that has run throughout this volume it is the centrality of political economy – the attempt to capture the interaction between political and economic factors – to our understanding of welfare trajectories in Europe, as elsewhere. And if there is a central theme that has run through the wider literature on welfare reform in recent years it is surely the extent of the time-lag effects involved in translating political economic change into substantive welfare outcomes (see especially Korpi 2003; Pierson 1994, 1996, 2001, 2004).

Taken together these two insights present something of a problem when it comes to gauging the likely trajectory of European welfare reform in the years ahead – a core part of our task in this concluding chapter. For it is difficult not to see the times through which we are currently living as almost unprecedentedly challenging for the European political economy, mired as to some extent it still remains in the longest and deepest recession since the advent of the modern welfare state. Indeed, core European institutions and the Eurozone itself (certainly in its current form) may yet prove to be casualties of the crisis. It is, in other words, difficult not to see such challenges as central to European welfare trajectories in the years ahead. Yet, as students of the new institutionalism, we are also acutely aware that the consequences of such challenges for European welfare trajectories may well take many years to become clear. In effect, we know that something potentially crucial for the future of European welfare capitalism is afoot, but we still have relatively little substantively to go on in assessing its likely implications.

That makes much of what follows in this concluding chapter necessarily prospective. In it we seek to establish the significance of the financial crisis that has engulfed the

world economy since 2007 for European welfare regimes, considering the extent to which a global financial crisis might be seen to prompt a crisis of the European tradition of welfare capitalism and the public institutions with which it is so intimately linked. In the process, we revisit many of the themes of previous chapters in the light of the global financial crisis, reassessing in particular the fine balance between the competitiveness-enhancing and competitiveness-corrosive effects of welfare expenditure and re-evaluating arguments for European welfare convergence, divergence or continued diversity in the light of the differential turn to austerity which the crisis has prompted. We suggest that European welfare trajectories remain more politically contingent, even in the wake of the global financial crisis, than is typically assumed. But, on the basis of the limited available evidence to date, we nonetheless anticipate the continued diversity or even further divergence of European welfare regime clusters as the effects of the differential exposure to the crisis and the turn to austerity in response to the crisis serve to reinforce existing welfare reform trajectories. If all European welfare states face hard times, some undoubtedly face harder times than others.

The argument of the chapter is developed in three core sections. In the first of these we seek to describe and explain the origins of the crisis. We point in particular to the significance of oil price rises in puncturing the low inflation-low interest rate equilibrium that had persisted since the early 1990s. Such benign conditions, we argue, were conducive to the development of a variety of asset price bubbles on which the distinctive ‘Anglo-liberal’ growth model had been built. Higher interest rates burst these bubbles, profoundly destabilising the Anglo-liberal growth model, with catastrophic consequences for those economies reliant on such a growth model directly or, indeed, indirectly, through financial or trade interdependence. As this suggests, the crisis was prompted by a combination of internal (or endogenous) and external (or exogenous) factors – and different European economies were exposed to these (and hence to the crisis) in different ways. In the second section, we seek to describe and map such patterns of exposure. Here we distinguish between three sources of crisis dynamics: (i) those associated with the direct bursting of asset price bubbles and the exhaustion of what we term ‘Anglo-liberal growth’ (an endogenous factor); (ii) those relating to contagion arising from financial interdependence (a first exogenous factor); and (iii) those relating to contagion arising from trade

interdependence (a second exogenous factor). We consider the differential exposure of European economies to each, distinguishing in the process between the ‘first wave’ economies (whose exposure was largely endogenous and typically the greatest), the ‘second wave’ economies (whose exposure was initially financial) and the ‘third wave’ economies (whose exposure has principally through trade interdependence). In the final section of the chapter we proceed to map this analysis of the crisis’ unfolding in three waves onto the European welfare regimes clusters identified in the preceding chapter. This mapping is by no means simple, but what we tend to find is that liberal welfare regimes and a variety of Southern and East Central European cases were most directly implicated in the crisis and hence most acutely exposed to its effects. In contrast, the exposure of the Continental and Nordic welfare regime clusters has been more attenuated, principally indirect and much more a product of contagion effects (associated with financial and trade interdependence). In the conclusion we reflect on the implications of such differential exposure to the crisis for European welfare diversity in the years ahead – in the new climate of region-wide austerity that is the most immediate legacy of the crisis.

### **The global financial crisis: an exogenous shock or an endogenous pathology?**

Yet if we are to establish any of this, it is to the details of the global financial crisis itself that we must first turn. For if we are to gauge the potential implications of the crisis for the future of the welfare state in Europe we must first establish its nature as a crisis and the exposure of European economies to it. Above all, it is important to consider whether the welfare state might be seen to be implicated directly in the crisis itself or whether it is more accurate to see the welfare state as an indirect (perhaps even an innocent) casualty of the broader political and economic damage the crisis has wreaked (see also *Social Policy & Administration*, 2011). It is important to get this right. For whether we see the crisis as the product of an exogenous (external) shock or of an endogenous (internal) pathology is likely to have major implications for our assessment of the continued viability, resilience and sustainability in the years ahead of the welfare institutions to which European societies have become accustomed.

That, however, is no simple task – and opinions on a series of key issues, not least the appropriate response to the crisis, still remain divided. Nonetheless, with the benefit

of a little hindsight a perhaps surprisingly highly conserved account of the unfolding and transmission of the crisis is now beginning to emerge. It begins, typically and, from our perspective, correctly, with the US case – more particularly with the puncturing of the US housing bubble in late 2006 (Gamble 2009: 19-20; Mason 2009: 84). This followed a steep rise in interest rates in response to the sliding value of the dollar on international markets, a build up of domestic inflationary pressures as the economy eventually recovered from the bursting of the dot.com bubble and 9/11 and, crucially, a sharp rise in oil prices. Of these factors it is the third, the tripling of the price of oil in three years, that we suggest is the most important (Hay 2011a; Taylor 2009). This was driven at least in part by economic fundamentals – specifically anxiety about the capacity of oil supply to keep pace with escalating demand from the US and from the rapidly developing BRIC economies (Brazil, Russia, India and, especially, China). But the basic price signal in the market for oil was reinforced significantly by speculative dynamics (on the speculative character of the process of price formation in oil markets see Davidson 2009; Kaufmann and Ullman 2009; Sornette, Woodward and Zhan 2009).

In an attempt both to defend the dollar and to control inflation the Federal Reserve raised US interest rates almost five-fold between mid 2004 and early 2006, precipitating a major crisis of affordability in the US housing market. Unremarkably, mortgage default rates rose steeply as the higher repayments associated with the dramatically increased cost of borrowing proved simply beyond the means of those who had been enticed into the housing market by years of stable and low interest rates and rapidly appreciating property values. Predictably, the highest default rates were in the so-called ‘sub-prime’ mortgage market, which had risen from less than 5 per cent of mortgage lending in the US in 1994 to more than 20 per cent by 2006 (Martin 2011: 10). Such sub-prime mortgages had typically been offered to those who would not normally be considered creditworthy, who lacked a deposit (and were thus seeking a mortgage of close to 100 per cent of the value of the property) and who thus posed the greatest risk of mortgage default. To compensate lenders for this greater default risk, such loans were offered (often after a short honeymoon period at an attractive lending rate), at punitive rates of interest and with very high administration fees (payable to the initiator of the loan and added to the capital outstanding). Yet, however punitive their terms, in a rapidly rising housing market such loans did make

sense – as a route into the (potentially lucrative) housing market for those who would not otherwise have one. In a rising housing market, sub-prime borrowers could expect to re-mortgage on far more favourable terms within a few years. For, even if they were only servicing the interest on their loan, with every day that passed the value of their property was rising and, crucially, the debt/equity ratio of their mortgage was falling. At some point this would drop below the sub-prime threshold, allowing them to re-mortgage on standard or ‘prime’ terms.

As this suggests, US mortgage lending was well configured to provide access to a rising housing market for those with low and middle incomes – and the additional demand for private property that this generated undoubtedly contributed to impressive house price inflation. But this seemingly virtuous cycle was only sustainable so long as interest rates remained low. The Fed’s near quintupling of the base rate in a little under two years was almost bound to prove catastrophic. The majority of sub-prime mortgagees now had little or no chance of meeting their repayments and, as house prices started to fall precipitously, little incentive to attempt to do so. For, far from falling, the debt/equity ratios of their loans were now rising, trapping them seemingly indefinitely in the sub-prime snare. With no prospect of escape from the punitive terms of their loan, nor of holding onto their property in the absence of such an escape, their very strong incentive was to cease making any mortgage repayment and to cease doing so immediately.

Yet it would be wrong to see the unprecedented rise in interest (and hence mortgage lending) rates as posing a problem solely for sub-prime lenders. For if there had been powerful incentives for those at the fringes of the housing market to take on sub-prime loans whose repayment terms they could scarcely afford even when interest rates were at their lowest, the incentives for prime lenders to extend (indeed, to over-extend) themselves in the housing market were arguably greater still. Much of the US housing market was, then, cruelly exposed to any step-level increase in interest rates (Schwartz 2009).

A further factor merely compounded the high level of systemic risk building in the US residential and consumer economy in the run up to the crisis. For one of the principal ways in which US home owners had come to use the rising property market to their

advantage was to re-mortgage regularly. This, in effect, allowed them to release much of the equity accruing in their homes to fuel their wider consumption. Private debt was thus closely aligned, as we shall see in more detail presently, with demand in the wider economy. The effect was to make demand and hence growth highly – and increasingly – sensitive to interest rate variations. A near five-fold increase in the base rate was thus likely to precipitate not just a crash in the housing market, but a full scale US recession, with knock-on consequences for global demand.

This goes some way to explaining the wider significance of all of this for the world economy – and hence, at least indirectly, for European welfare capitalism. But it overlooks one key feature. For it was neither first nor principally through trade interdependence, but in fact through financial interdependence, that the crisis proved contagious. To see why we need to return to the US housing market and to ask ourselves how it could possibly be that high mortgage default rates amongst sub-prime lenders in the Mid West might threaten to precipitate a global depression?

The answer – mortgage securitisation – might seem neither immediately intuitive nor immediately illuminating. But it is, in fact, a key part of the crisis' transmission mechanism (Helleiner 2011). From the 1980s onwards in the US and a number of other Anglo-liberal economies, mortgage lenders were able, in effect, to sell on to domestic and international financial intermediaries the income streams associated with their lending (Langley 2006; Watson 2010). This they did, typically, by passing on their mortgage debt to investment banks who repackaged it in the form of mortgage-backed securities (MBSs). These in turn were sold to international investors keen to hold high-yielding assets denominated in dollars. In the process US mortgage risk was passed 'downstream', with the initiator of the loan invariably bearing none of the risk. Whilst the housing bubble continued to inflate such MBSs, particularly those associated with the sub-prime portion of the market (with the highest transaction fees and the least favourable lending terms), generated a very healthy return for investors. Consequently, demand for such assets soared, with the effect that mortgage brokers and initiators (whom, of course, bore none of the downstream risk) became less and less scrupulous in certifying as credit worthy potential mortgagees whilst their administration fees per transaction grew significantly. At the same time, hedge funds and investment banks started to respond

to the growing international demand for mortgage-backed investment vehicles by issuing a range of financial derivatives, thereby effectively magnifying the exposure of the global economy to any systemic risk associated with the US housing market.

A complex mechanism was now in effect in place to ensure the global diffusion and transmission of any crash in the US housing market with an economy's exposure to the crisis being in almost direct proportion to the density of its financial interconnections with the US. As this suggests, when the crisis hit, its effects radiated outwards from its epicentre in the US financial sector, travelling down lines of financial interconnectedness to topple like dominos those banks and other financial institutions around the world exposed through downstream debt diversification to US mortgage default risk. The result, as we now know, has been an unprecedented wave of bank insolvencies around the world, prompting the largest ever bailout of the financial sector, and a deep and prolonged global recession.

Thus far we have presented a pretty conventional account of the unfolding and onward transmission of the crisis. This is very much the story of a crisis borne in the US which has proved globally – or at least, internationally – contagious (Krugman 2008; Rajan 2010; Roubini & Mihm 2010; and, for a useful review, Helleiner 2011). From the perspective of European welfare capitalism, it is also, of course, an account of the crisis as an external shock. After all, if the crisis had its origins in the US, it is difficult to see European welfare capitalism as implicated directly in it in any obvious way.

But things are in fact rather more complicated than this simple if conventional account implies - and in ways that challenge the idea that the crisis can be seen, simply and unambiguously, as an exogenously generated shock to the European political economy. A number of points might here be made.

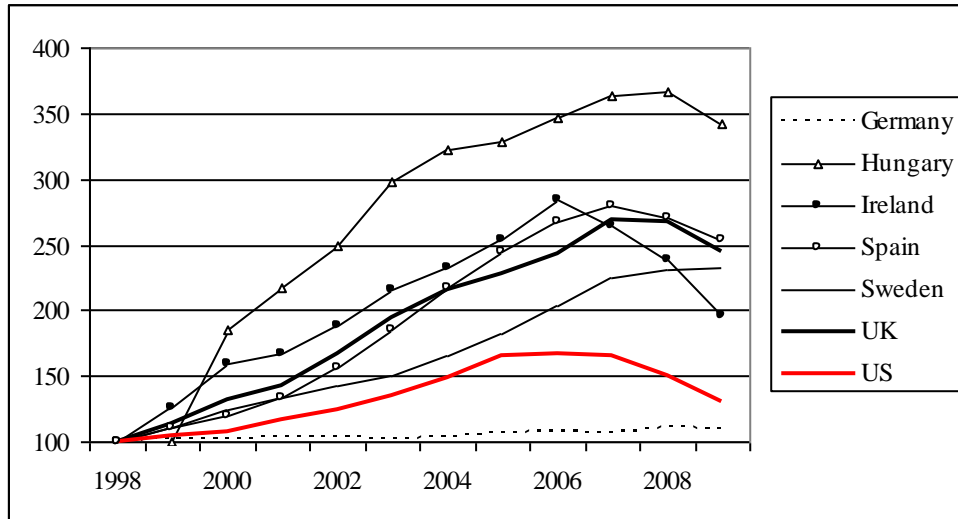


Figure 7.1: Nominal house price inflation in Europe and the US (1998=100)

Source: calculated from European Mortgage Federation (2010)

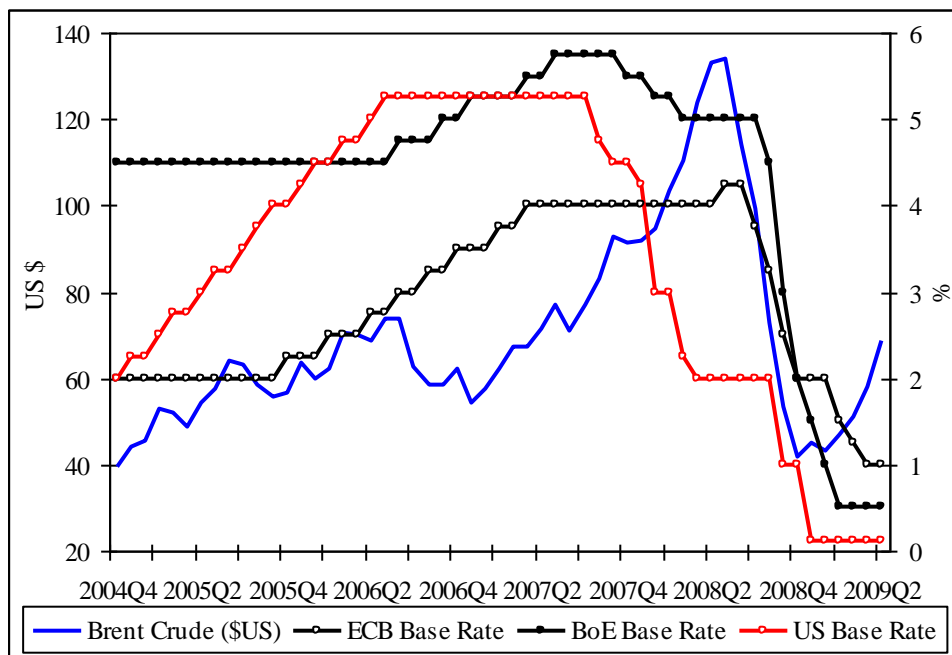
First, the US was by no means the only economy to have experienced the inflation and puncturing of a housing bubble. As the data in Figure 7.1 show very clearly, relative to many European economies (and, indeed, even to the Eurozone average), house price inflation in the US since 1998 has in fact been quite modest. Moreover, although the US housing market was the first to crash (in late 2006), the UK, Spain and, in particular, Ireland have all experienced rather sharper falls in house prices, from much higher initial peaks.

Such data indicate the (albeit differential) participation of European economies in the inflation and puncturing of a house price bubble – or, in other words, a strong endogenous element to the crisis. That is borne out by a further observation – that there is little in the account developed above of the puncturing of the US housing bubble which might not apply equally to a number of European cases. Indeed, if - as we have argued – the key factor in accounting for the crisis of affordability in the US housing market that developed between 2004 and 2006 is the sharp rise in interest rates associated with a three-fold increase in the price of oil, then this begins to look less like a specifically US crisis. For whether one paid for one’s oil in dollars, Euros or sterling, the price was rising with worryingly inflationary effects to which monetary policy authorities responded with interest rate rises.



This, again, is clear from the evidence. Figure 7.2 shows (on the right hand axis) interest rate settings by the Federal Reserve, the Bank of England and the European Central Bank in the run up to the crisis and (on the left hand axis) the price of oil. It might, at this point, be objected that oil prices continued to rise well beyond the point at which US (and, indeed, ECB and Bank of England) interest rates peaked. This is certainly true but, we would contend, is a simple reflection of the damage that such interest rate hikes had already done to the US, Eurozone and UK economies by the time they peaked (a point to which we return in more detail presently) and the fact that interest rate settings followed more closely oil futures prices than actual prices.

As this suggests, and certainly for those economies most exposed to the bursting of a housing bubble, this was as much an endogenous crisis of growth as it was for the US. Indeed, this is in turn suggestive of the crisis as one of a rather more prevalent growth model (the ‘Anglo-liberal’ growth model) present, albeit to different degrees and in subtly different variants, in a number of European cases (Hay 2011a, 2011c). To be clear, though such a growth model was undoubtedly present in the European liberal cases (the UK and Ireland), elements of it can also be detected in a number of Southern and East Central European cases (such as Spain and Hungary, respectively). As this implies, there was certainly no simple one-to-one correlation between welfare regime cluster and growth model.



*Figure 7.2: Oil prices and interest rates*

That, at least, is the argument we seek to develop through a more detailed examination of a number of these European cases. But before turning to these directly, it is important first to deal with a potential objection to the depiction of this as an endogenous crisis, even for the US case.

That objection is a very simple one – and one rather familiar to political economists of the advanced industrial economies in the post-war period. It is that this can hardly be said to be a very endogenous crisis if it is precipitated by a tripling in the price of oil. For the determinants of the price of oil are surely external to the political economy of individual country cases? What makes this a familiar argument is that much the same point was made about the crisis of the mid to late 1970s – itself widely held to have been precipitated by an ostensibly similar quadrupling in the price of oil associated, this time, with the Arab-Israeli War (Cairncross 1992: 182-7; Gourevitch 1986; Hall 1986; Zysman 1983).

On the face of it, the objection would seem to be a sound one. For the crisis of the 1970s - or, indeed, that today - is exogenous insofar as it is seen to arise from factors beyond the parameters of our conventional understanding of the system in question. If the crisis of European welfare capitalism in the 1970s is seen as a knock-on effect of the Arab-Israeli conflict and the Arab-Israeli conflict is acknowledged to lie outside of the core of comparative European political economy, then it is surely right from such a perspective to see the crisis as the product of an exogenous shock. Similarly, if today's crisis – a potential crisis of European welfare capitalism too – is seen as a knock-on effect of the tripling of the price of oil, then surely it too is rightly seen as the product of an exogenous shock? But things are not quite as simple as this suggests. For the crisis can be viewed differently – less as a discrete event precipitated by specific external or exogenous shocks and rather more as the longer-term product of a series of endogenous frailties and pathologies exposed by a change in the context. Such frailties might include the dependence of growth on asset-price bubbles, over-reliance on demand for exports generated in economies in turn dependent for their own growth on such bubbles, exposure through financial interdependence to the bursting of such bubbles, or the running of substantial budget

deficits. In the end it is an analytical choice whether to emphasise the specific change in the external environment prompting the crisis or the incapacity of the domestic economy to deal with any such change. But the point is that we do not need to be nor become experts in the determinants of oil prices in order to see that, whether in the 1970s or today, the growth models of some European (and other) economies were likely to struggle to cope with an inflationary shock, whatever its specific source. That frailty is endogenous rather than exogenous.

If this is accepted then it has important implications. For if the incapacity of an economy's existing growth model to deal with an inflationary shock is seen as an endogenous factor, as we have argued it should be, then the balance between endogenous and exogenous factors in the present crisis varied between European cases – with potentially highly significant implications for their respective welfare trajectories in the years ahead. The crisis was, in short, more endogenous for some European economies than it was for others.

### **Endogenous and exogenous factors in the unfolding and transmission of the crisis**

To see this, it is useful to differentiate between three rather different mechanisms through which potentially crisis-inducing effects were generated, one (largely) endogenous, two (largely) exogenous.

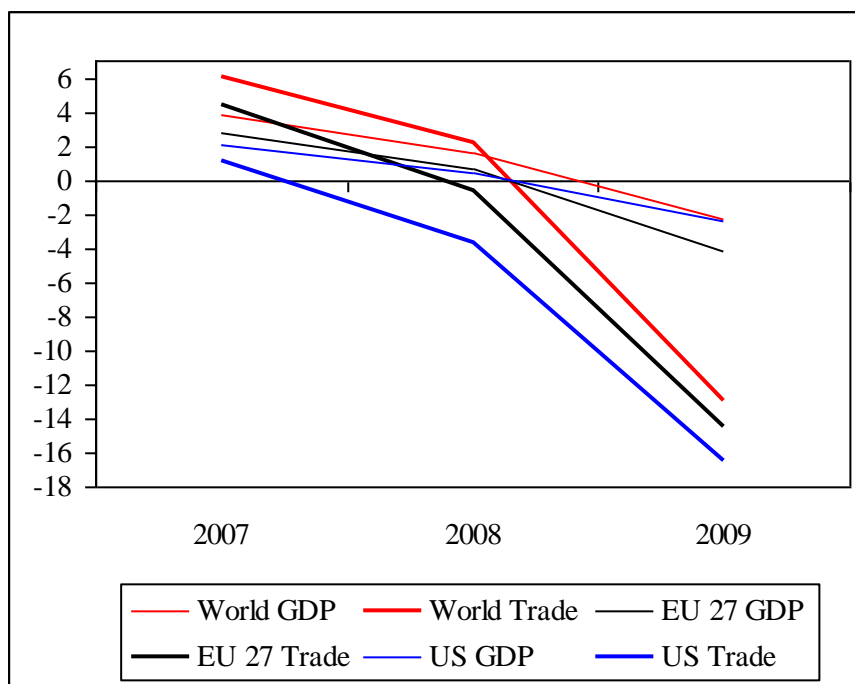
The first, and the sole endogenous mechanism, was the puncturing of a housing (and related asset-price) bubble reliant for its persistence on continued low interest rates and hence likely to be threatened by inflationary pressures (whether endogenously or exogenously generated). Economies might be seen to have been prone to a crisis induced in this way in proportion: (i) to the extent of the bubble in their housing market; and (ii) the extent to which their growth model rested on consumer demand generated through private debt typically secured against a rising property market. The Anglo-liberal economies and a number of the Baltic and East Central European accession states, as we shall see presently, 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 borne 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. As this suggests, a number of European economies 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 via this route.

The third and final mechanism for the transmission of the crisis, or at least the effects to which it gave rise, 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, even gauged relative to world economic output. 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.

The consequences of this are clearly seen in Figure 7.3, which shows year-on-year changes in GDP and merchandise trade for the world economy as whole and for the US and EU 27 economies separately.



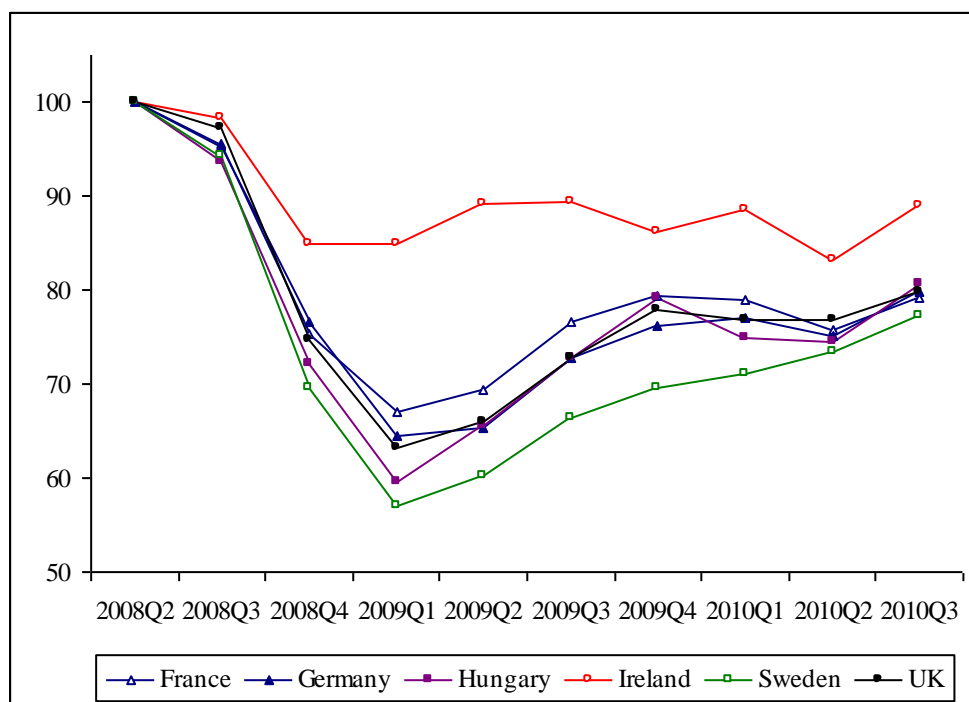
*Figure 7.3: The de-globalisation of trade in recession, 2007-2009 (% annual change at constant prices of GDP and trade volumes)*

Source: calculated from WTO (2010)

What it demonstrates is that although world, US and EU economic output all fell alarmingly between 2007 and 2009, trade volumes fell at a far greater rate in each case. In other words, though economic output was itself falling, the proportion of such economic output that was traded was also falling. Or, put slightly differently, the world was becoming less integrated in terms of trade for the first time since the 1930s.

Whether or not this decline in world trade volumes proves temporary it is has already exacted a high price from a number of the more export-oriented European economies in particular – 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 then been considerable.

The extent and uneven distribution of the damage inflicted on European economies by shrinking export markets is shown clearly in Figure 7.4.



*Figure 7.4: The declining value of European exports*

Note: standardised data (2008Q2 = 100); raw data in \$ billions, seasonally adjusted  
Source: calculated from OECD Trade Statistics (2011)

This shows the volume of exports for a number of European economies with figures standardised at 100 for the second quarter of 2008. Such standardised data allow us better to compare trends between different country cases. For the most part, the data reveal a pattern that is remarkably highly conserved between European economies. Interestingly, it is Ireland that stands out as something of an exception to the general trend; the impressive improvement of its balance of trade position is clearly not simply a product of a haemorrhaging of demand for imports. Crucially (and encouragingly), Ireland's share of world export markets has held up rather well - certainly far better than for many of its European neighbours. Indeed, given the extent of the decline in world trade volumes described in Figure 7.3, Ireland has undoubtedly increased its share of world export markets during the crisis.

But despite this impressive performance, revenue from exports still fell by the equivalent of just over 6 per cent of GDP between 2008 and 2009. The point is, though, that this still compares very favourably with Ireland's nearest neighbours. In the UK exports fell by the equivalent of just under 10 per cent of GDP, in Germany

by 17 per cent, in Sweden 22 by per cent and in Hungary by a whopping 38 per cent. This is worrying indeed. Yet perhaps more alarming still is that although export volumes have recovered quite significantly since their trough early in 2009, those that have stabilised would appear to be doing so considerably below their pre-crisis levels. That suggests a step-level reduction in European exports (matched, it should also be noted, by an equivalent reduction in European imports) equivalent to lost revenue of between 5 and 15 per cent of GDP. Given the link between such receipts and the revenue streams out of which the welfare state has typically been funded, especially in the smaller and more open export-oriented Northern European economies, this is troubling indeed (see also Vis, van Kersbergen & Hylands 2011).

Such figures are already powerfully suggestive of a mechanism – transmitted through trade interdependence and, more specifically, through declining world trade volumes - linking the global financial crisis to a potential fiscal crisis of the welfare state. Yet, as we have argued, it is but one of three key mechanisms. If we are to identify and evaluate the contribution of the others, it is important that we return to the internal workings of the European growth models which the crisis exposed.

### **The bursting of the bubble and the transmission of the crisis**

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 we have been at pains to demonstrate, that does not make such an account – the conventional account - correct. The crisis, as we have argued, is perhaps best 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, whose

only) experience of the crisis was exogenous – a product of contagion effects radiating outwards from the US 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 or 2008 or later . Each, we suggest, can be associated with a rather different transmission mechanisms with its own distinctive temporality.

#### *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 whose initial experience of the crisis was essentially endogenous – 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 7.1-7.3 show, in terms of the aggregate economic fundamentals it is in fact something of an 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.

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 Fed'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. It might also be noted that a number of US states (such as California, Massachusetts and Florida), if analysed separately, would look much more 'first wave' in character (Dymski 2010; Martin 2011).



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

*Table 7.1: Ratio of residential mortgage debt (as % of GDP) in 2007 to 2000*

Source: calculated from European Mortgage Federation (2010)

Note: \* - excluding US

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

*Table 7.2: Ratio of outstanding household debt (as % of disposable income) in 2007 to 2000*

Source: calculated from Eurostat Household Financial Assets and Liabilities Database

Note: \* - excluding US

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

*Table 7.3: 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 the UK 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), tended 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).

These 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 systemic 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 the UK, 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 UK 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 re-scaled (downwards) 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 UK 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 significance of financial services to the economy left the 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 contributor 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 re-secure the supply of credit on which the growth of the consumer economy for over a decade had been predicated.

As this suggests, contagion borne of financial interdependence is responsible for much of the damage inflicted on the UK economy since 2007. But it is not responsible for it all – and, crucially, the UK 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, established earlier, between oil prices (increasingly reinforced by speculative dynamics), inflation and interest rates.

From the second quarter of 2006 all three rose in parallel – in the UK 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 the UK were, in the final quarter of 2008, falling at around 20 per cent per annum. In Ireland the figures were more staggering still – having risen at over 25 per cent per annum since 1992, house prices were, by the end of 2008, falling at close to 30 per cent per annum. This brought about a quite brutal transformation in personal fortunes. In late 2006 the average UK earner living in the average home was seeing a wealth effect associated with house price inflation equivalent to three quarters of their pre-tax annual average earnings (Watson 2010). In other words, were they to release all the equity in their home they could effectively double their 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 freefall, annual house price deflation in the UK was equivalent to over 120 per cent of the pre-tax earnings of the average citizen (Hay 2009: 471) and closer to 150 per cent in Ireland. 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.

Things were arguably worse still in a number of the new accession states in Eastern Central Europe and the Baltics. The reason for this was simple – a combination of high levels of personal debt compounded by the exchange rate risk associated with the high proportion of such debt denominated in foreign currencies. Consider the Hungarian case. Here, partly in anticipation of eventual Eurozone membership and partly resuscitating an earlier practice of many of its predominantly Austrian-owned banks, a growing proportion of new Hungarian mortgage lending came to be

denominated in Euros and Swiss Francs (Becker 2007; Bohle 2010). It is not at all difficult to see why foreign currency denominated loans might prove highly attractive to aspirant home-owners in Hungary and, indeed, in many other accession states preparing themselves for Eurozone entry. As Dorothee Bohle puts it,

“The significance of foreign currency consumer credits and mortgage lending has to be seen against the background of the policy of the National Bank. Preparing for Eurozone entry, it pursued a policy of high interest rates to fight inflation and the growing fiscal deficit. This made borrowing in Hungarian forint almost prohibitive. The much lower interest rates of the Swiss Franc denominated credits and the ensuing house price rises, however, relieved middle class consumers from the impact of restrictive domestic monetary policy, and simultaneously extended available credits” (2010: 7).

Access to loans denominated in currencies other than their own thus served to fuel the consumer economy in the absence of a domestic low inflation-low interest rate equilibrium. This was the East Central European variant of the Anglo-liberal growth model. The irony, of course, was that Eurozone entry was itself made more likely by virtue of the pursuit of a hawkish anti-inflationary policy, the inevitable effect of which was a growing interest rate differential between the forint, on the one hand, and the Euro and the Swiss Franc on the other. This served further to incentivise borrowing in foreign currencies, thereby exacerbating Hungary’s exposure to exchange rate risk. Yet financial institutions were only happy to offer loans denominated in currencies other than the forint so long as it was credible to believe that Eurozone entry was an inevitability – an index of which was the interest rate differential between the forint and the Euro.

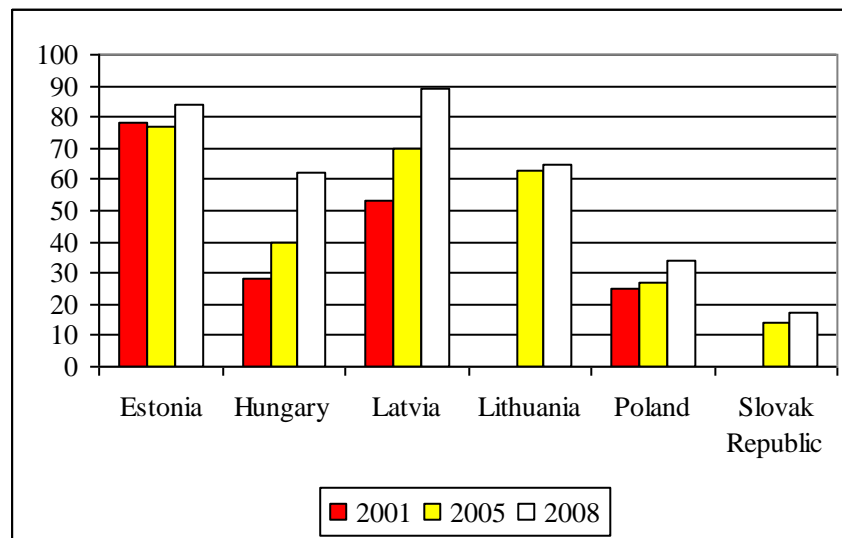
Such a model delivered consumer growth and house price inflation, even in an economy saddled by high levels of public debt and a lack of external competitiveness, until 2006. But the precarious state of the public finances and the rejection by the European Council of the government’s first convergence programme in 2005 led it to adopt a much more severe austerity package from 2006. This combined a short term attempt to tackle the budget deficit with a longer term programme of structural reform of the public sector (Bohle and Greskovits 2009). Yet its effect was also to drive

down real wages, growth and consumption. This merely reinforced the already considerable vulnerability to the global financial crisis arising from the foreign-ownership of so much of Hungary's public debt and the associated exchange rate risk this posed. Predictably then, in autumn 2008, at the height of the credit crunch and with financial institutions around the world seeking to de-leverage, there was a sharp run on the forint. To the horror of those whose mortgage lending was denominated in Swiss Francs the forint lost a third of its value in a little over a month. As in the UK and Ireland, private debt secured against property had switched from providing the impetus to growth to become an impediment to growth. The currency was ultimately stabilised by a three base point increase in interest rates by the Monetary Council of the Central Bank, the Magyar Nemzeti Bank, and by the negotiation of a 20 billion Euro loan from the IMF, the World Bank and the EU – conditional on further and yet more punitive austerity (Hodson and Quaglia 2009).

Yet although Hungary was the first European economy to seek external assistance in the crisis, it was by no means alone in witnessing a catastrophic implosion of its 'transnationalised' variant of the Anglo-liberal growth model. Indeed, as Figure 7.5 makes clear, although Hungary saw the most rapid increase in foreign currency denominated lending amongst the 2004 accession states, exchange rate risk was in fact significantly greater in the Baltic states.

The story of the Latvian case unfolds in a very similar way to that in Hungary – though if anything the inflation and puncturing of its housing bubble was even more pronounced. Between 2000 and 2006, Latvia was in fact the EU's fastest growing economy – with GDP growth per annum over well over 8 per cent. This was driven by the very strong link between foreign-currency denominated lending, house price inflation and domestic consumption. This, however, brought inflation and with it rising interest rates – reinforcing both the incentive to borrow in foreign currencies and the resulting exchange rate risk. As in Hungary, the global financial crisis led to speculation against the lat, with the Bank of Latvia consuming nearly a fifth of the country's reserves in an ultimately unsuccessful attempt to protect the currency, and with it indebted home owners. National bankruptcy was only averted by a complex series of bailouts from the IMF, the EU, the World Bank and a number of bilateral

creditors. These totalled some 5.8 billion Euros – over 2600 Euros per Latvian citizen (Bohle 2010; Bohle and Greskovits 2009).



*Figure 7.5: Proportion of outstanding household debt denominated in foreign currencies*

Source: calculated from European Bank for Reconstruction and Development (2011)

#### *The 'second' and 'third' waves – contagion effects*

As we have seen, the first wave of the crisis was largely associated with the puncturing of the housing and consumer bubbles that had emerged in a number of predominantly Anglo-liberal and East Central European economies and in the Baltic states. In the former cases this was principally a domestic story of the ending of the low inflation-low interest rate equilibria on which growth had been predicated in response to the inflationary shock of a three-fold increase in the price of oil. In the latter cases, things were a little more involved – since, in the absence of their own low inflation-low interest rate equilibria to draw upon, access to the comparatively cheap lending which might fuel a consumer and housing boom required access to credit markets denominated in other currencies. This ‘transnationalisation’ of the growth model (see also Bohle and Greskovits 2009) brought with it mounting exchange rate risk which was cruelly exposed by the credit crunch following the first phase of the crisis.

In this respect, the Baltic and East Central European economies, though already in recession before such effects took hold, were also amongst the worst casualties of the contagion effects borne of financial interdependence. Yet their exposure to such contagion effects - through exchange rate risk – was of a rather different kind to that of most leading European economies. For the Baltic and East Central European economies in fact had very little exposure to losses arising from US mortgage backed securities. This was by far the most prevalent mechanism of financial contagion and was responsible for the initiation of a second wave of the crisis, engulfing economies, like Germany, that had 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 7.1-7.3 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, as for instance in the German case, one might plausibly argue the converse – with the absence of a domestic housing bubble contributing to the attractiveness for German banks 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 banking sector - 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 the 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 deteriorating in world trade volumes that would occur from the third quarter of 2008 (Chor & Manova 2011).

The contagion effects borne by trade interdependence, as well as deepening the recessions already underway in many first and second wave economies, initiated 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 recent 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 would now suffer 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 her 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.

### **The consequences for the welfare state in Europe**

Having sought to establish the nature of the crisis, the mechanisms of its transmission, and the degree of exposure of different European economies to it, we are now in a position to begin to assess its likely implications for the future of the welfare state in Europe. Yet, as should by now be clear, this is no simple task, involving the careful weighing up of a number of factors which pull in rather different directions. In what follows we seek, first, to identify those factors – drawing these out of the preceding analysis and reflecting on their potential implication for European welfare trajectories – before drawing them together to provide an overall assessment in a final, brief and necessarily tentative conclusion. Our aim in so doing is less to provide a series of bold and heroic predictions so much as to seek to identify the key factors likely to determine European welfare trajectories in the decades to come.

But before turning to these issues directly, it is perhaps useful first to describe our general approach to the crisis and to the implications of the crisis for the welfare state more specifically. The global financial crisis, we suggest, is perhaps best seen as a crisis of *growth* – arising from the disintegration of a number of the growth models that sustained the world economy throughout the so-called ‘great moderation’. This may not seem especially controversial. But it is important to emphasise that it is in fact at some considerable odds with much of the political discourse of crisis that has emerged since 2007 (see also Hay 2011c). For, invariably, insofar as this has been appealed to in public discourse as a crisis, it has been appealed to as a *crisis of debt* (generally public debt) rather than as a *crisis of growth*. This may not seem especially significant; indeed, it might even seem like hair splitting. What makes it extremely significant, we would contend, is that the solution to a crisis of (public) debt is austerity – the rebalancing of public finances through some combination of cuts in spending and tax rises – whilst the solution to a crisis of growth is to identify and to make the transition towards an alternative growth model. It need hardly be pointed out that, to date at least, there is rather more evidence of the former than there is of the latter.

What is more, viewed through the lens of the ‘debt crisis’ discourse, the welfare state, as the largest single call on the public purse, stands between us and crisis resolution – and, as such, is almost bound to become the principle target of public austerity. Yet viewed, as it might be, through the lens of an alternative ‘growth crisis’ discourse, the welfare state might even be seen as part of the solution itself. As this suggests, the stakes for the welfare state of the terms in and through which we have come to define and thereby respond to the crisis could scarcely be higher (on the broader significance of crisis constructions, see Hay 1996, 2001, 2011c).

What this also suggests is the importance of assessing the potential sources of growth in the European economy and in the world economy more broadly in the years ahead if we are to gauge likely European welfare trajectories. It is for this reason that we turn first to trade.

*World trade volumes – de-globalisation or re-globalisation?*

It is clear from the preceding analysis that trade has been central to European growth throughout the great moderation, as it has in fact been during the entire post-war period. But, as we saw in Figure 7.4, the global financial crisis has led to a sharp reduction in global trade volumes at a time of falling world economic output. Crucially, it has also led to the world economy becoming less integrated in terms of trade (with the proportion of economic output being traded falling for the first time since the 1930s). This is alarming indeed, especially for the Nordic economies, whose capacity to develop and sustain the most generous and inclusive welfare states the world has ever known has typically been attributed to the success of an export-led model of growth – a reward to citizens, in effect, for the export success their (skilled) labour has wrought (Cameron 1978; Katzenstein 1985; Garrett 1998).

It is important to be clear about what is being said here. The problem is not the capacity of Europe's traditionally largest net exporters to continue to capture their share of world export markets – we have seen no evidence of this and, in the case of Ireland, for instance, some evidence to suggest that world market share has risen. But what we do see is unequivocal evidence that world export markets have contracted. Thus, even in the absence of the 1930s-style return to protectionism that many still fear, the value of the Nordic economies' export markets has shrunk by the equivalent of some 10 per cent of GDP – and it is by no means clear that this export shortfall is likely to prove a temporary phenomenon.

Yet this is not just a problem for the most export-oriented of European economies; it is arguably no less a problem for those European economies, like the UK for instance, whose Anglo-liberal growth model in effect compensated them for a significant and growing trade deficit. For, in the absence of a confidence in their capacity to resuscitate their old growth model, they have typically placed their faith in a 'rebalancing' of the domestic economy – in effect, in their capacity to discover or rediscover the secret of export-led growth. That is no simple task, especially at a time when it is by no means clear that global export volumes are set, any time soon, to return to pre-crisis levels.

Whether ultimately they do will depend on a great many factors – but perhaps most crucially the rate of growth of the US economy in the years ahead and the extent to

which growth in China, in particular, translates into the increased purchasing power of China's citizens. We return to the prospects for the resumption of Anglo-liberal, and hence US, growth presently. But what is clear is that the US's nervousness about its own growth prospects in the years ahead has led it to place increasing pressure on China to allow the renminbi to appreciate against the dollar (see, for instance, Cohen 2012; Krugman 2009). The effect of any such exchange rate realignment would be an effective financial recalibration of the world economy, with the US's balance of trade deficit with China (and hence the rest of the world) reduced and with an equivalent reduction in its financial dependence on China. For Europe's beleaguered exporters there would be much to welcome in this, since any appreciation of the renminbi would be akin to a competitive devaluation of the Euro and other European currencies in a potentially key export market.

*Growth, output and taxation – a fiscal crisis of, or for, the welfare state?*

This focus on trade perhaps already reminds of us the importance of the tax base to the funding of the welfare state – in the future just as now and in the past – and the significance of the crisis in such terms. From the perspective of the welfare state the crisis has manifest itself first and foremost as a severe constriction in the taxation base from which it is funded – though this should not lead us to overlook the increasing calls made on such limited public funds with the recapitalisation of the banking sector.

In this respect the crisis might well be argued to have precipitated a full scale fiscal crisis of the welfare state – or, perhaps more accurately, a fiscal crisis *for* the welfare 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 welfare state would be to implicate the welfare state directly in the generation of the fiscal shortfall that now threatens it. To appeal to a fiscal crisis *for* the welfare state is to make no such assumption. Indeed, it is to suggest that the fiscal deficit which now threatens welfare state expenditure cannot be attributed to any dynamic internal to the welfare state itself. That, we would contend, is far more accurate.

The origins of such a fiscal crisis for the welfare 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 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 the UK, 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. The UK’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 (Hay 2011c).

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 for which they were previously ineligible.

Moreover, in the context of the current crisis, this all happens at a time when the stability and sustainability of the entire banking system is threatened as never before and as the state is 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 7.4 and 7.5 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.

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

Table 7.4: Current account balance (as % of GDP) in 2009

Source: calculated from Eurostat Public Balance and General Government Debt data

Note: \* - excluding Norway

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

*Table 7.5: Rise in general government debt, 2006 to 2009 (% of GDP)*

Source: calculated from Eurostat Public Balance and General Government Debt data

Unsurprisingly, in the context of the analysis of this chapter, 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 principle 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.

### **Conclusion: Austerity, welfare and growth**

This brings us to the crux of the matter. With such a profound destabilisation of the state of the public finances throughout Europe and with the welfare state invariably consuming at the onset of the crisis a higher proportion of state expenditure than ever before, it is not at all surprising that it should emerge as the prime target for budget cuts in the turn to austerity that has typically followed the crisis.

Yet, as the discussion of the preceding section already starts to suggest, certainly when combined with some of the broader themes of this volume, there may well be great dangers associated with an austerity-induced targeting of the welfare state.

First, there are clear macroeconomic advantages to running a budget deficit during and for some time after a profound economic crisis. As we discussed in some detail in chapter 4, welfare state expenditure is, in effect, a natural macroeconomic stabiliser. Since a significant proportion of such expenditure is needs-related and since levels of need clearly vary across the business cycle, welfare spending tends to rise (whether as a percentage of GDP or in real terms) as the economy enters recession and to fall as it recovers. As this suggests, welfare expenditure is quite strongly counter-cyclical. But, as we also argued in chapter 4, it is also counter-cyclical *in a very efficient way*. For it is the poorest in society who benefit the most from welfare benefits, certainly those such as unemployment benefit and means-tested income support which vary most in response to changing levels of need. Consequently, the potentially macroeconomically stabilising injection of demand into the economy that comes with the rise in welfare spending in a recession is strongly targeted on the poorest, the most needy and those most dislocated by the effects of the crisis. It restores, in effect, a proportion of the consumption potential of those whose capacity to spend (and hence whose potential contribution to aggregate demand in the economy) has been most depleted. Moreover, those in receipt of unemployment benefit and/or income support are also far more likely to spend what they receive in benefits than, say, a middle income consumer given a tax rebate. Accordingly, with perhaps one exception - the far more regressive policy of injecting demand into the economy by reducing VAT or other sales taxes - this is about the most efficient mechanism imaginable for stimulating demand within the economy. For so little of the state's demand stimulus is 'lost' in savings. Finally, those with the lowest levels of income tend also to consume a proportionately greater share of locally sourced staple goods relative to luxury imported items. Thus, in contrast say to a VAT reduction, this is a most efficient mechanism for generating demand without effectively subsidising imports.



There is much to this broadly Keynesian argument. But, in the face of levels of general government debt in many European economies in excess of 50 per cent of GDP, there is little evidence of it tempering the perceived need for austerity and the associated downward recalibration of welfare commitments.

This makes a second argument all the more important. That argument builds from the observation, above, that the principal source of the public deficit that European economies now face is lost taxation revenue associated with reduced economic activity. The implication we draw from this is that the crisis is one of growth rather than of debt – or, perhaps, more precisely, that current levels of debt are a symptom, rather than the source, of a more deep-seated crisis of growth. That, in turn, suggests the potential dangers of austerity – a form of symptom amelioration, at best, rather than a form of crisis resolution.

The point, in a way, is a very simple one. The welfare state and the public sector more broadly undoubtedly contributes very significantly to economic output – both directly, in terms of the value of the goods and services it provides, and indirectly, in terms of the provision of a healthy, well-educated and appropriately skilled workforce, a public infrastructure and legal system which work, and in terms of the broader contribution to economic competitiveness discussed in detail in chapter 4. If this is accepted, then austerity, understood in this context as the scaling back of the public sector, directly threatens the capacity to generate economic output. As such, it is only if the crisis is seen as one of debt and deficit alone, that austerity in the absence of growth can be seen as any kind of solution. For if the crisis is seen to have been precipitated by the exhaustion of a distinct growth model leading through contagion to a global crisis of growth then, almost by definition, reducing the capacity to generate economic output by reducing the size of the public sector can only compound the problem – threatening to throw the world economy back into recession and threatening to prompt a global depression.

Yet that is perhaps an overly bleak assessment. For although it might well apply to the Anglo-liberal economies and many of those Baltic and East Central European economies that grew so rapidly throughout the great moderation, it would be wrong to extrapolate from the exceptional experiences of these economies. Austerity, in most

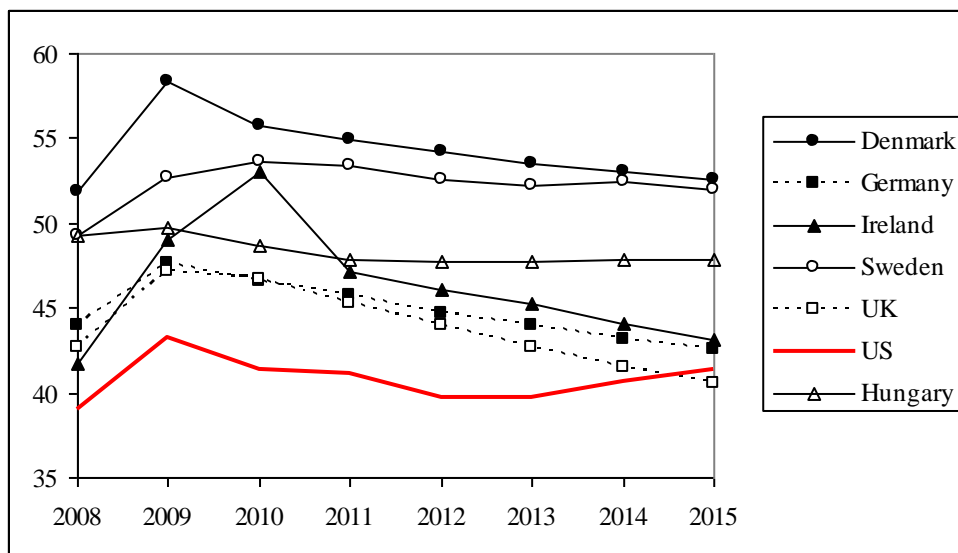
of the first wave economies, is already firmly established and institutionalised – whether (as in the UK) through the product of a conscious political choice or (as in Hungary, Ireland and Latvia) through the stringent and binding terms of a bailout package. Either way, it seems, any meagre growth which temporarily returns as the deficit widened will be sorely tested by a wave of public sector retrenchment and redundancies with further serious knock-on consequences for the consumer economy and the housing market. What is more, if our analysis is correct, these economies have all lost a growth model and they have yet to discover another. The partial exception is Ireland which, as we have seen, grew throughout the great moderation by combining elements of an Anglo-liberal growth model with a more traditional export-oriented growth strategy. It has witnessed amongst the most brutal of all recessions as the housing and construction bubble that it inflated burst spectacularly. But bolstered by the terms of its joint EU-IMF bailout it may yet manage to make the transition to a rather purer form of the Northern European export-oriented growth model. For that to succeed, the transfusion of credit that it has received must be used not to reinflate the housing market but to reinforce the transformation.

Beyond the ‘first wave’ economies, however, things do not look quite so bleak. In general terms, the depth of the recessions they have faced was not so pronounced. Such economies were exposed to the crisis not principally through the frailty of their own growth models, but through a series of contagion effects radiating outwards from the implosion of the Anglo-liberal growth model elsewhere. These revealed, in effect, how parasitic they had become on the demand generated by Anglo-liberal growth. This is perhaps the principal problem they face going forward – sustaining an export-led growth strategy in the absence of the contribution of Anglo-liberal consumer debt to world consumption. Most significantly, though, austerity is far less entrenched politically in these economies and it is rather more credible to think that they will be capable of rebalancing their public finances, albeit slowly, without a drastic reduction in the size of their public sectors.

If that is correct, then it generates a tentative prediction – of continued welfare regime divergence in Europe in the years ahead. The most generous welfare states the world has ever known – the Nordic and Continental European welfare states – are here to stay and they are likely to retain their distinctiveness. But they are unlikely to remain

as generous as they have been. For, as we have seen, the Europe-wide turn to public austerity has come at a time when even these economies were already engaged in cutting the generosity of welfare benefits and toughening eligibility criteria. That, as we have also seen, was a product to a considerable extent of an anticipated crisis of affordability associated, in particular, with an aging population and rapidly rising health care costs. The inevitable conclusion is that, even in the Nordic countries, benefit levels and eligibility criteria will be toughened still further.

Yet, when compared with their Liberal, East Central European and Southern European counterparts, they will nonetheless look increasingly generous. This is most clearly evident if one looks at official government projections for public spending in the years ahead. These are shown in Figure 7.6.



*Figure 7.6: Public spending projections, 2008-15*

Source: calculated from IMF World Economic Outlook Database (2011)

Like all projections, of course, these need to be treated with some caution – all the more so since these indicate the aspirations of elected administrations for the years ahead and since, typically, the figures themselves are highly sensitive to the assumptions such administrations make about growth. But such caveats notwithstanding, such data undoubtedly give an indication of the extent to which planned deficit reduction will translate into cuts in public spending. And the picture they present is entirely in keeping with the analysis we have offered.

Retrenchment and austerity, it would seem, are now very much the order of the day. But retrenchment implemented at different paces in different regimes through the differential imposition of austerity is likely to continue to produce divergent not convergent outcomes.