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Making the same mistake again—or is *this time* different?

Lawrence King, Michael Kitson, Sue Konzelmann and Frank Wilkinson*

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1. Introduction

The world faces an economic crisis of unprecedented proportions. But much of the policy response has certainly not lacked for precedent. National governments and international organisations, including the International Monetary Fund (IMF), have looked to crises of the past for solutions to the present—and austerity has become a familiar theme. The inability to effectively resolve the current crisis, however, gives rise to the question: 'Is *this time* different?'

This article provides a broad overview to the origins and development of the recent economic crisis and the resort to policies of austerity. Although there is historical precedent for the resort to austerity—such as the UK 'Treasury view' during the 1920s and 1930s—this time, things are different. Many of the current problems are deeply rooted and reflect the impact of the shift towards free-market economics that started in the 1970s.

2. The origins of the crisis

Since the beginning of the 1970s, the private sector—finance, in particular—has reorganised on an increasingly global scale. It has innovated in terms of both structure and products, and it has experienced significant growth. As Tridico (2012, this issue) shows, this 'financialisation' was characterised by a ballooning of stock exchanges, as many firms decided not only to list their shares but also to become involved in speculative finance. In response to pressures on firms to maximise shareholder value, together with the progressive erosion of worker and trade union rights and influence, labour markets became more flexible and real wages stagnated. Concurrently, profits rebounded, leading to burgeoning inequality. In this context, aggregate demand and consumption were bolstered by easy credit and the wealth effects of speculative bubbles—first in stocks and shares, and then in housing.

Address for correspondence: Sue Konzelmann, Birkbeck, University of London, Department of Management, Malet Street, Bloomsbury, London WC1E 7HX, UK; email: s.konzelmann@bbk.ac.uk

* Department of Social Science, University of Cambridge (LK), Judge Business School, University of Cambridge (MK), School of Business, Economics and Informatics (SK) and Centre for Business Research, University of Cambridge (FW). We thank members of the Editorial Board of the *Cambridge Journal of Economics* for comments and suggestions on earlier versions of this paper. The usual disclaimer applies.

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In contrast to capital's increasing global reach, political, legal and regulatory systems have remained for the most part resolutely national. International agreement has been intermittent, short-lived and relatively slow to mobilise. This mismatch has been accompanied by ideological uniformity, with the neoliberal paradigm virtually unchallenged among policymakers and mainstream economists, despite recognition of its contribution to the current crisis (Watkins, 2010; Montgomerie and Williams, 2009). The resulting consistency, in terms of both the policy message and its demands, has resulted in low levels of official opposition to—or even questioning of—the primacy of markets. This pattern is reflected in the evolution of political and economic responses to the current financial crisis, which began in 2008, but has so far proven stubbornly resistant to all efforts to resolve it.

3. Responses to the crisis

The evolving political and economic responses to the developing crisis have demonstrated that *this time* the situation is, indeed, different. The collapse of Bear Stearns and its subsequent sale to JP Morgan at a knockdown price of $2.00 a share was reminiscent of the swift action taken to avert a wider collapse during the UK's 1970s secondary banking crisis and the USA's Savings and Loan crisis of the 1980s and 1990s. However, the consequences of allowing an internationally significant bank, Lehman Brothers, to collapse in 2008 ushered in a new era. Unlike previous occasions since World War II, when financial crises were more or less contained, the international markets' reaction to the Lehman Brothers' collapse spilled over into the real economy. This resulted in an unprecedented package of internationally coordinated emergency monetary and fiscal stimuli, followed by a series of massive government bailouts of banks and other financial institutions.[1] As Mervyn King, Governor of the Bank of England, observed: banks are 'global in life but national in death' (Financial Services Authority, 2009, p. 36). The money markets' gratitude to their rescuers was, however, brief. Regardless of the fact that the high level of sovereign debt was, to a large extent, attributable to bank bailouts and their economic consequences, the financial markets soon resumed speculation against nation states, creating a growing 'sovereign debt crisis'.

The neoliberal economists' response to high levels of public debt was to revive the 'Treasury view' that public sector deficits are economically damaging (Barro, 2009; Cochrane, 2009; Fama, 2009) and within 20 months of the emergency stimulus measures, this view came to dominate the public debate. But as Carrick-Hagenbarth and Epstein (2012, this issue) show, in the run-up to the crisis many prominent financial economists that had actively lent their academic prestige in support of deregulation and financialisation—and that now support austerity—had substantial undeclared conflicts of interest with the financial establishment. These conflicts of interest were so extensive, yet so rarely disclosed by the leading financial economists, that it would seem the norm is for financial economists to acquire financial affiliations. Parallel to its capturing of the academy, the financial industry's money has co-opted much of the US political elite in both parties. As pointed out by Callinicos (2012, this issue), between 1999 and 2009 the financial industry spent $3.5 billion on lobbying and $2.2 billion on campaign donations.

[1] On the causes of, and responses to, the financial crisis see the contributions in the Special Issue of the *Cambridge Journal of Economics* published in June 2009, including the overview by Blankenburg and Palma (2009).

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This does not, however, represent the high water mark of financial influence over politics and the nation state. The still evolving eurozone sovereign debt crisis has seen further and even more unsettling developments. In Greece, the elected head of state and in Italy, the entire cabinet were removed by international influence through a combination of pressures from larger European Union (EU) economies and the IMF. As Julian Coman (2011) observed:

> Democratic accountability has become a secondary virtue, desirable but expendable. In Italy and Greece, the former Goldman Sachs bankers, Mario Monti and Lucas Papademos, having been parachuted into highest political office, are set to raise retirement ages and cut state spending without having to canvas for a single vote . . .

He went on to quote a senior EU official:

> We have seen democracies outstripped by the markets, which have forced decisions on elected governments. So that democratic freedom has been curtailed. How do you respond? Do you let that continue, or do you move towards stronger economic governance? And which is more legitimate, the rule of the markets or economic governance by representative institutions in which governments have a say?

The continuing civil unrest in both countries suggests that there is a significant body of opinion opposed to the summary imposition of unelected 'technocrats' to push through packages of austerity measures and, unsurprisingly, there is much suspicion of these former bankers, who are seen to have contributed significantly to the development of the crisis in the first place.

Whilst the task at hand is usually described as 'bailing out sovereign states' by the media, the uncomfortable reality is that it is, for the most part, the *investors* in sovereign bonds who are being bailed out. Whereas much has been written about fiscal profligacy and a lack of fiscal discipline in both Italy and Greece, this did not stop investors from purchasing large amounts of their sovereign debt, attracted by the higher returns on offer. This—and the subsequent market nervousness that pushed rates up to unaffordable levels—could, without too much difficulty, be regarded as behaviour reminiscent of that which produced the American subprime real-estate bubble. Further, like the debt resulting from that bubble, the austerity drive following the eurozone sovereign debt crisis effectively means that private risk has again been underwritten by the public sector.

A strong case can be made that the turn to austerity only makes sense if it considered as part of the evolution of capitalism and the balance of class power within it—towards wealthy households, economically dominant firms (chief among them being financial firms), conservative politicians and right-wing populists. Since the comparative and historical economic evidence strongly supports the Keynesianism over the Treasury view, austerity is not easily interpreted as a rational response to deficits. It is far more explicable as a class project that seeks to roll back the welfare state (Crotty, 2012, this issue; Callinicos 2012, this issue). Grimshaw and Rubery (2012, this issue) argue that in the UK the Coalition's austerity programme represents a deliberate attempt to transform the 'liberal collectivist' model that characterised the UK during the earlier postwar period into a neoliberal model.

The process of financialisation and the economic interests that drive it are perhaps most observable in the microstate of Iceland. Wade and Sigurgeirsdottir's (2012, this issue) narration of the evolution of the political economy of Iceland demonstrates the social forces leading up to the financial crisis. Their analysis shows how well-organised elites made use of neoliberal ideology to not only liberalise and financialise the markets in which they held

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dominant positions; they also used it to justify the advantages they subsequently derived. However, when the inevitable crisis arrived, a new left-wing government (a coalition of social democrats and a left-green movement) came into power and the banks were allowed to go bankrupt. There were cuts in public spending, but this was relatively less severe than in other postcrisis countries because of a very sharp devaluation of the krona, which lead to a growth in natural resource exports. Iceland's future remains uncertain, as the old political elite waits in the wings, eager to resume the strategy of becoming an international financial centre and exporter of raw materials.

Coates (2012, this issue) argues that the neoliberal interpretation has misrepresented the causes of the financial crisis and resulting world recession, and in so doing it has captured the foreground of the current policy debate. The initial return to Keynesianism, which steadied the world economy in the wake of the crisis, was short-lived. Further—largely in response to the financial markets' increasingly negative attitude towards high levels of sovereign debt—there was a sharp change in policy tack, from stimulus to austerity. However, as is frequently the case with markets, the negativity had self-fulfilling consequences: it translated into higher borrowing costs, which in turn made debt increasingly burdensome, further fuelling the markets' nervousness and feeding the vicious speculative cycle. The neoliberal, or 'New Treasury', view gives priority to the reduction of fiscal deficits as the route to recovery. This, it is argued, soothes the sensitive bond markets and keeps the cost of borrowing down, encouraging private *productive* investment whilst cutting back on such *unproductive* public sector spending as transport, education and health.

The Keynesian versus neoliberal policy debate continues as global growth slows and export markets are increasingly hard to find. However, there are other voices in the debate, challenging what has increasingly become the political and economic status quo.

4. Society responds to the effects of austerity

Since austerity, by its very nature, involves a sharp contraction in public spending and services, its effects are inevitably felt first by those who depend on those services—especially if the austerity package is not balanced by significant redress to the growth of income inequality. The view of the UK Chancellor of the Exchequer, George Osborne, on austerity is that 'we are all in this together'. This is manifestly untrue (Kitson *et al.*, 2011). Whilst the causes of the 2011 riots that swept across many cities in the UK have been hotly debated, the contributory role of the austerity programme is frequently raised (Apps, 2011). Yet from officialdom and the mainstream media, there is a general denial that the civil unrest is in any way part of a response to the worsening social and economic conditions experienced by a growing segment of the population (Abbas and Croft, 2011). Rather, those taking part have been dismissed as the 'feral underclass' by Ken Clarke, the Secretary of State for Justice in the current Coalition government (Clarke, 2011).

The general sense of outrage at the effect of austerity programmes in increasing inequality has found an increasingly influential voice in the worldwide 'Occupy' movement.[2] The Occupy protests are a societal reaction to a popular recognition that society's economic problems are attributable to profligacy of the financial sector and consequential social and economic disparities. However, the Occupy protesters initially found it difficult to find a credible media outlet for their message. In the late autumn of

[2] For further information, see http://www.occupytogether.org/.

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2011 this began to change, especially when they protested outside St Paul's Cathedral in the City of London. The main agent for change, in both the share of voice and eloquence of the protest, came, perhaps unexpectedly, from the Roman Catholic and Anglican Churches.[3] The Vatican's Pontifical Council for Justice and Peace (2011) called for the creation of a global system for managing a global economy and strongly backed the introduction of a Financial Transaction Tax. More recently, the Archbishop of Canterbury's letter to the *Financial Times* (2011) argued that the societal unrest, evident in the Occupy protests, has deeply social, moral and economic causes. He went further to suggest that:

> The protest at St. Paul's was seen by an unexpectedly large number of people as the expression of a widespread and deep exasperation with the financial establishment that shows no signs of diminishing. There is still a powerful sense around—fair or not—of a whole society paying for the errors and irresponsibility of bankers; of impatience with a return to 'business as usual' . . . It isn't easy to say what we should do differently. It is time we tried to be more specific.

Whilst the financial sector has chided the Church for its involvement, it is well worth noting that, unlike politicians, the influence of the financial sector over the Church is relatively weak, and it is hard to dismiss the Church's overall objectives and policy proposals.

Unfortunately, the burgeoning crisis is yet to generate new thinking amongst policymakers. They remain locked into narrow, nationally defined political silos, with only loosely held interests in international political and economic events, beyond those that directly affect their perceived national self-interests. Insular national governments are hardly a match for internationalised global business and finance. Yet, whatever scorn may have been directed at the protests, these movements have demonstrated an ability to globalise, to innovate, and to develop and articulate ideas that are putting most governments to shame. If *this time* is indeed 'different', then there may still be hope that solutions to the global financial and economic crisis will be found.

5. The debate about austerity

In the economic and political debate about austerity, neoliberal proponents argue that government deficits are economically damaging because governments, like households, have to balance their budgets. If they do not, onerous fiscal burdens will be imposed on future generations. The neoliberals argue that government borrowing to fund the deficit 'crowds out' private borrowing to fund investment and drives up interest rates, further reducing private investment. Public spending is seen to be wasteful of scarce resources, since the government is not subject to 'market discipline'; and since governments are able to print money to finance the deficit, there are also inflationary implications. Austerity advocates favour 'expansionary fiscal contraction' on the grounds that they believe that cutting public spending will induce more private spending. This is because a tight fiscal policy is theorised to raise expectations of lower tax liabilities and interest rates, which boost the confidence of bondholders and investors. This, in turn, is expected to spur

[3] It is interesting to note that there is a precedent for the Church's response. During the 1980s the effect of Thatcherite policies served to aggravate the plight of those in 'urban priority areas' who were suffering the immediate effects of reductions in public spending and taxation and the withdrawal of state welfare provisions. The Anglican Church's response was the 1985 *Faith in the City* report (Archbishop of Canterbury, 1985). Financial deregulation took place the following year, with 'big bang' liberalization.

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economic growth by encouraging consumption, investment and exports, and by stimulating confidence in the financial markets.

In reality, the historical record provides very little evidence that austerity measures will be effective, particularly in a context of recession. Whilst austerity proponents have argued that the 1920–21 depression in the USA provides confirmation of the positive impact of deflationary policies, Kuehn (2012, this issue) argues that using 1920–21 to justify austerity during a Keynesian downturn is inappropriate because that depression was preceded—and no doubt caused—by austerity. With reference to the current downturn, Pollin (2012, this issue) demonstrates how neoliberal claims—that the 2009 economic stimulus programme in the USA led to rising interest rates and inflation as well as an excessive government debt burden—are unsupported by the facts. Federal government interest payments are, in fact, at near historic lows, and the reason why the stimulus programme did not lead immediately to a strong recovery was because of the severity of the financial crisis and resulting recession, which led to the collapse of household wealth and the seizing up of credit markets for smaller businesses. Further, Taylor *et al.* (2012, this issue) show that over the last 50 years in the USA, fiscal *expansion* has repeatedly resulted in higher economic growth, especially during recessions.

On the other side of the debate, opponents of austerity, including Sawyer (2012, this issue), argue that fiscal retrenchment will only deepen and extend the recession. Efforts to reduce the deficit should therefore be postponed until the recovery is fully underway because it is only then that such efforts can succeed. This is as the consequence of multiplier effects of additional government spending when the economy is operating significantly below capacity. During a period of economic expansion, employment and income grow together, contributing to increasing tax receipts relative to public expenditure and reducing national debt as a proportion of GDP. In the case of Ireland, for example, Kinsella (2012, this issue) argues that it was able to reduce its fiscal deficit between 1987 and 1990 only as a result of favourable macroeconomic conditions, including growth in the international economy, fiscal transfers from the European Union and currency devaluation in 1986.

Reducing public expenditures during a recession, in contrast, can be expected to increase the national debt as increasing unemployment and falling incomes lower tax revenues and increase social welfare payments. Such mechanisms are known as 'fiscal stabilisers' since the impact of a negative demand shock—such as a reduction in discretionary government expenditure—can be at least partially dampened by the subsequent induced increase in non-discretionary government expenditure (e.g. social welfare payments) and falling tax revenues. The analysis by Ghilarducci *et al.* (2012, this issue) shows that in the USA the Social Security Acts, retirement plans, disability insurance, unemployment compensation, Medicare and federal income taxes all have powerful stabilising effects. However, major concern surrounds the privatisation of social security because individual financial market-based retirement plans have pro-cyclical—and hence destabilising—macroeconomic effects. Thus, the privatisation of American social security is removing its beneficial 'fiscal stabiliser' macroeconomic properties.

The blight of austerity is being acutely felt in the EU. As discussed by Laski and Podkaminer (2012, this issue), policy in the EU has been constrained by the deflationary bias of the Stability and Growth Pact, which limits the ability of individual governments to respond to domestic recessions. This is particularly problematic for countries confronting economic challenges associated with business cycles, but which are locked into a single currency without supporting fiscal integration and a shared commitment to demand

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management. Given this reality, Petit (2012, this issue) argues that Europe is confronted with a major challenge in rehabilitating the *European Project* and maintaining an enduring social model.

Considering the historical record in Europe, Boyer's (2012, this issue) analysis reveals that the approach of the European Central Bank, driven by Germany, fails to recognise that German austerity and Southern Europe's debt-led consumption are two sides of the same coin. Since the advent of the euro, Europe has experienced cumulative increases in Germany's trade surpluses, and resulting deficits in Spain, Greece, France and Portugal. Over the same period there has been a very modest increase in aggregate demand in Germany of 5%, resulting from tight fiscal policy and the slow growth in real wage rates relative to productivity increases. Germany's export-led growth was realised by importing by the rest of eurozone, where increases in aggregate demand expanded by 30% in 2007, much of which was accounted for by consumption financed by debt and the wealth effect of asset bubbles—in much the same way as consumption was maintained in the USA. 'Overconsumption' in the rest of Europe therefore plays an important part in realising the surplus generated by 'under consumption' in Germany. However, this balance is threatened by the negative demand effects of generalised austerity, when all countries are required to cut back demand and to attempt to improve competitiveness by making labour cheaper and more flexible.

Boyer goes further to suggest that there is no way that Greece can duplicate the successful exercises in fiscal consolidation in Denmark (1983–1990), Ireland (1987–89), Finland (1992–98) and Sweden (1993–98), because the conditions facing Greece are so different. Unlike these successful cases, Greece cannot devalue its currency. It has no history of social bargaining and any attempt at wage austerity can be expected to lead to further social unrest. Domestic producers are reluctant to invest, since they believe that further austerity will only dampen demand. At the same time, significant reductions in investment and innovation expenditures have rendered the Greek economy even less competitive than it was before. This is bad news for austerity's chances of success in Greece, since the four success stories benefited from dynamic expansion in the world economy—and the confidence of international finance (and hence declining interest rates)—the opposite of which Greece is currently facing.

What is the worst-case scenario if austerity is implemented? According to Popov (2012, this issue) there is much that be learned about the dangers of reducing government spending across the board from the socio-economic experiment carried out during the transition from socialism to capitalism. Popov's analysis reveals the significant extent to which the former Commonwealth of Independent States[4] liberalised—and as a consequence experienced skyrocketing inequality, poverty, crime, homicide, mortality rates, corruption, technological downgrading and state failure. In contrast, the former communist states of Central Europe avoided such problems, and realised economic growth and increasing life expectancy rates. Popov concludes that the factor explaining most of the differences in the two experiences is 'ordinary' government expenditure that preserves the functioning of key institutions.[5]

[4] The Commonwealth of Independent States included the former Soviet Republics, formed during the breakup of the Soviet Union.

[5] That is, government expenditure minus debt service costs, defence, subsidies and investments.

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6. The historical record in the UK

To understand the relationship between national debt and economic growth, it is useful to review the UK's experience since the early twentieth century. Figure 1 (based on data from HM Treasury) shows the trend in UK national debt as a proportion of GDP from 1900 to the present.

During World War I the UK national debt increased from 25% of GDP in 1914 to 135% in 1919. In an attempt to pay this off the Treasury adopted a restrictive fiscal policy that resulted in a stagnating economy for much of the 1920s, so that the national debt/GDP ratio increased. In 1931, in a deficit-reducing attempt to decrease the interest charge on the national debt, the government cut the rate of interest to 2%. This unwittingly triggered a house-building boom and growth of new consumer goods industries in the South and East of the UK. Furthermore, the UK withdrew from the Gold Standard, leading to a devaluation of sterling, and introduced a tariff on competitive imports. The cumulative impact of the resort to this 'Plan B' in the early 1930s was a significant boost to economic growth and a reduction in the national debt from 177% of GDP in 1933 to 110% by 1940. World War II increased the national debt to 216% of GDP in 1945 and 238% by 1947. From 1948 to 1973, however, strong economic growth contributed to a reduction in the national debt to 50% of GDP, as the fiscal effects of GDP growth and full employment exceeded the increase in government spending associated with the extended role of the state, with the creation of the National Health Service and the welfare state.

During the 1970s and 1980s there was a retreat from the welfare state, extensive privatisation and the replacement of Keynesianism with Monetarism. Stagflation in the 1970s and major recessions in the early 1980s and early 1990s caused the rate of debt reduction to slow. From 1992, however, economic recovery and a determined effort to reduce public expenditure contributed to a reduction in the national debt to 26% of GDP in 1991. But by 2006 it had once again risen to 35% of GDP and by 2010 to 55% of GDP,

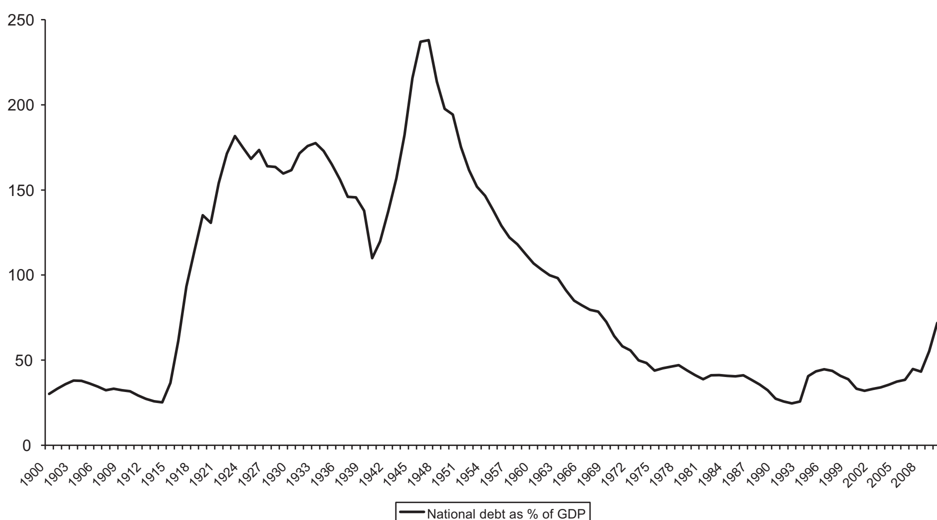

Fig. 1. *National debt as a percentage of GDP, 1900–2010. Source: HM Treasury, 2011, http://www.ukpublicspending.co.uk/uk_national_debt_chart.html.*

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well above the level it had been during the mid 1970s. Treasury forecasts are that it will rise to 70% by 2014.

The historical record, therefore, shows the effectiveness of strong economic growth in reducing the national debt. In recessions, the fiscal intentions of austerity are overwhelmed by the tax and social welfare consequences of the economic downturn, so the ratio of public sector debt can be expected to rise sharply.

7. The current economic reality

In the debate about austerity it is important to note that the currently rising fiscal deficits are not a result of increasing entitlement programmes. Rather, they are a consequence of the combined effect of (i) rescue packages to bail out failing financial institutions;[6] (ii) temporary emergency stimulus packages; (iii) global recession (resulting in reduced tax revenues and increased public sector expenditures on automatic stabilisers); and (iv) risk premia on the sovereign debt of weaker countries.

Furthermore, the economic fundamentals that the proponents of austerity point to as drivers of economic recovery are absent. Worldwide consumer and business confidence is severely depressed, and households and companies are prioritising debt repayment over expenditure. Despite historically low interest rates, unemployment is high and increasing, and consumption and investment are languishing. Until consumers have repaid their debts and seen an improvement in prospects for employment, they are unlikely to increase spending. But without seeing an increase in demand, industry cannot be expected to increase investment and start hiring again. Inflation remains low in most of the world, and where prices are increasing it is a result of rising food and energy costs rather than excessive demand. According to Chen and Galbraith (2012, this issue) the rising cost of energy will act as a constraint on future growth and an impediment to the return to full employment. In short, the global economy is stuck in a recession-focussed vicious cycle, which can only be made worse by austerity.

8. Making the same mistake again?

The 2008 financial crisis revived memories of the Great Depression, which was made deeper and longer by the Treasury view that governments should always operate with a balanced budget. So are they 'making the same mistake again' by reviving the idea that austerity is a reasoned response to the current crisis? A review of the experience of the USA and the UK during the intervening years is informative.[7]

In the USA the 1920s experienced what Arndt (1944, p. 15) described as an 'astonishing boom', which was unprecedented, if unequally distributed. Prosperity was characterised by a revolution in industrial techniques and organisation, and rapid progress in new industries, especially motor cars and consumer durables. This was fuelled by a hitherto unparalleled upsurge in consumer demand, which can be seen as the birth of modern consumerism. Early in 1929, however, growth in the US economy slowed as the boom in consumer spending subsided and later in the year, the stock market crash exacerbated the downturn. By 1933 wholesale prices had fallen by 30%, and industrial production and employment were down by 54% and 25%, respectively. The spring of 1933 also saw

[6] The National Audit Office reported in December 2009 that government support for the banks had reached £850 billion (*The Independent*, 4 December 2009).

[7] For a fuller discussion see Konzelmann *et al.* (2010), from which this section is largely drawn.

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a financial crisis and the collapse of a number of banks. In response, the Roosevelt administration's New Deal represented the most comprehensive recovery package initiative by any democratic government (Arndt, 1944). Nevertheless, the US economy was less than fully responsive and it was not until the additional boost to manufacturing created by World War II that the US economy fully recovered. In contrast, the UK economy followed a different path. It remained in the 'doldrums' throughout the 1920s as the Treasury followed a restrictive monetary policy in support of the restoration of the Gold Standard at its 1914 parity (Howson, 1975, p. 30) and a balancing of the budget. In 1931, however, there was policy regime change including a cut in interest rates ('cheap money'), devaluation and protectionism. The impact of these policies was to boost consumer demand, especially in the South and East of the UK, and to stimulate economic growth.

Thus, in both the USA and the UK following the Depression, the government assumed a role in stabilising the business cycle by fine-tuning demand. Policy innovations that were consolidated in the UK by the adoption of Keynesian demand management following World War II. During this period, especially 1952–60, macroeconomic performance was characterised by full employment, non-inflationary growth and rapidly rising living standards, and this was considered 'the golden age' of postwar economic history.

But with the rise of neoliberalism during the 1970s, the focus of economic theory and policy shifted to the monetary causes of inflation and the efficiency and welfare benefits associated with free markets (Friedman, 1977). There was a reversion to the pre-Keynesian view that rather than being a systemic problem, the responsibility for unemployment and poverty lies with the jobless and the poor. Since 1979, macroeconomic policy has been dominated by attempts to control inflation by monetary means whilst responsibility for increasing employment has been delegated to market forces. Trade unions have been weakened, legal control of labour standards relaxed, out-of-work benefits reduced and subject to more onerous conditions, and wage subsidisation has been introduced with the express purpose of making the labour market more 'flexible'. Concurrently, other markets have been deregulated, restrictions on the money supply have been lifted, large sections of the public sector have been privatised and taxes on the rich have been cut to encourage enterprise.

The neoliberal takeover has not been limited to macroeconomics, but is also evident in the theory and policy prescriptions emanating from many studies in industrial organisation and corporate governance (Deakin and Singh, 2008). When industry was mainly small scale, the theory and policy presumptions were that industrial concentration was in restraint of trade and as a consequence in opposition to the public interest. But as the scale of industry increased, the conventional wisdom evolved to contend that large firms had a comparative advantage in terms of fostering innovation in production and marketing. With developments in the stock market—in particular, the initiation and diffusion of hostile company acquisitions—theory supported the notion that the stock market serves as an efficient market for corporate control that monitors potentially malfeasant managers (the 'agents') on behalf of shareholder 'owners' (the 'principals'); this is despite the fact that in legal reality their ownership status has no foundation (Deakin, 2005). By this reasoning, the share price is interpreted as measuring the value of the company as an economic entity and in so doing links the worlds of production and finance.

From the 1970s, with the strengthening of the Anglo-American style 'shareholder model' of corporate governance, inflation in the stock market was fuelled by managerial efforts to increase share prices by whatever means possible. Managerial capitalism took

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advantage of deregulation and complicated institutional arrangements, such as special purpose entities, by which securitised financial assets were used to disguise debts and inflate the market prices of shares above their real values. But when the underlying reality was revealed, confidence evaporated, causing the collapse of stock market prices. This brought down leading players, including such organisations as Enron, at enormous cost to its stakeholders and to the broader social and economic system in which these companies were embedded.

Since these corporate collapses, financial market liberalisation and the relaxation of regulation have greatly increased both the amount of finance available and the rate at which financial market innovations have outpaced the capacity to be supervised and regulated. Rapid development in information technology made possible both the creation of complex and often dubious financial instruments and their rapid distribution to underinformed investors around the globe; it also allowed global markets to react much more quickly. As a consequence, when confidence in collateralised debt obligations and other such derivatives was shaken, their markets rapidly unravelled, at ruinous cost to many of the financial institutions involved. The knock-on effect was a freezing up of liquidity, collapse of security prices and inability of financial institutions to put a value on their holdings. As stock market prices fell, financing from the banking sector dried up and confidence disappeared.

This rebounded on real economy, causing a collapse in effective demand as debt-laden consumers, and others fearful of the future, cut spending. In the UK, from the final quarter of 2007 to the second quarter of 2009 real GDP fell by 3.2%, employment fell by 455,000 and unemployment increased by 786,000. By the first quarter of 2011, real GDP remained almost 1% below its final quarter 2007 level, employment remained 115,000 lower and unemployment was 806,000 higher.

Adding to these costs, the UK government's rescue of the banks and the increase in social welfare expenditure and reduced taxation accompanying the recession have increased the national debt by an estimated £260 billion between 2007 and 2010. In response to mounting sovereign debt, the current debate among governments around the world is how it is to be recouped over the next few years by cutting government expenditure. At the time of the bank bailouts the UK Labour government had sweetened the pill with forecasts that the public money involved would be recovered, perhaps with a small profit, when the banks in question were returned to the private sector. But that now seems a hollow promise with the selling off of the *good part*[8] of Northern Rock, which was taken into public ownership at the height of the financial crisis that featured a run on this bank. Northern Rock was sold to Virgin Money at a reported loss to the public purse of £400 million.[9]

Given the significant relative contribution that the financial sector makes to the UK and US economies, and the influence it has, punitive regulation seems unlikely since both the government and the banks have a shared vested interest in a return to strong profit growth in the financial sector. So far, the banks have been successfully resisting attempts to tax the very highly paid bank employees more, even in those banks that failed and were bailed out by public funds. They are also vocal in their opposition to a tax on financial transactions, a Tobin tax, for which they have full support from the British government. As a result, the real cost of the bank bailouts is to fall on the recipients of government expenditure and

[8] That is, stripped of its toxic assets.
[9] *The Guardian*, 17 and 20 November 2011.

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workers in the public sector. But it will not end there. The multiplier effects of this level of cuts in public spending will be substantial and long-lasting.

9. The alternatives to austerity

Despite millions remaining jobless and poverty rates rising, governments around the world have claimed that there is no alternative but to impose austerity and cut budget deficits in response to a burgeoning 'sovereign debt crisis'. This is despite the worldwide Occupy Movement, which has demonstrated the widespread societal discontent with the current state of social, economic and political affairs, and the Church's articulation of the problem as being one of growing economic inequality, which will only be made worse by worldwide austerity measures. But austerity is not the only alternative. The world faces deeply structural problems, and the key to recovery lies in encouraging economic growth and moving beyond a single-minded focus on fiscal discipline. Policies aimed at monetary stability should therefore be accompanied by policies aimed at long-term growth. Public investment in such areas as house building and infrastructure would be a good place to start, particularly given the current low rates of interest. Such initiatives, however, will of themselves do little to rebalance an economy that has been heavily skewed towards services and, in particular, finance.

Whilst much criticism has been levelled at the private sector for excessive short-termism, the reality is that policymaking suffers from a similar dilemma. Politicians are primarily concerned about re-election. As a result they tend to favour policy initiatives that generate quick results. This has influenced the evolution of the relationship between politics and finance, especially since the 1970s. In comparison to industry, finance was better placed for delivering rapid returns. However, it proved prone to the highly destabilising speculation that led to the crisis. Thus, the time has come to identify ways of rebalancing the economy away from finance. An economy with more than one driver of growth stands a much better chance of surviving a crisis reasonably intact. Important in this respect is the promotion of growth prospects for small- to medium-sized businesses, capable of responding quickly to changes in competitive conditions. This will require identifying new ways of financing, evolving new systems of corporate governance and changing attitudes towards education—especially vocational education—and, above all, time horizons. The changes that have taken place since the beginning of the 1970s cannot be ameliorated in the space of one or even two governments. Effective reform will be no small task to accomplish and new thinking will be required.

To complement these efforts, regulation of the global financial sector, the reigning in of speculative activity and the channelling of liquidity to the productive sectors of the economy are also crucially important. Governance reform would, however, need to be congruent with the market. Both Wall Street and London's Square Mile acquired and built their influence as a result of 'light touch' regulation—resulting in what is known in The City as the 'Wimbledon Effect', a great British tradition but almost all the players are foreign. Initially attracted by the lack of regulation, they would be likely to move on should London, New York—or any major financial sector—tighten regulation independently of the others. The likelihood of regulatory arbitrage necessitates a globally enforceable set of rules. The current overreliance on the financial sector, by the largely post-industrial British and American economies, underscores the imperative of such a system and the ineffectuality of independent national regulation.

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10. Concluding comments

The current financial crisis is the culmination of the progressive freeing-up of the banking sector following the switch from Keynesianism to neoliberalism during the 1970s. The evolution in monetary policy and in the banking sector meant that the supply of money became unlimited whilst the principal motive for money demand became speculative—and the principal speculators became the banks (Wilkinson, in press). The bubble created by an unlimited supply of money and unregulated speculation by banks burst in 2008. Governments intervened to shore up the banks and head off the burgeoning world recession by adding to the supply of money, and their own indebtedness. But rather than recognising the extent to which these interventions had saved their bacon, the banks took advantage of the problems governments encountered in rolling over their debts and withheld financial support to those governments that they judged to be in difficulty. Austerity measures were imposed and countries were required to balance their budgets by cutting public expenditure and raising taxes.

The consequences of these measures have been the further impoverishment of the poor and a growing popular opposition to austerity, which has exacerbated the dilemma faced by governments trapped between the disapproval of international financers and the righteous anger of voters. The resulting impasse and the threatened bankrupting of nation states has led to intervention by the IMF and other such bodies offering financial bailouts, which amount to paying off the bankers on the condition that elected governments step aside in favour of unelected committees of technocrats, imbued with the banking ideology—that the rights of money have precedence over *human* rights.

So 'this time' is fundamentally different than before. The problems in Western economies are deeply structural and ideological, resulting from nearly 40 years of economic liberalisation and financialisation. Reversing their effects will require a fundamental reorganisation and reorientation of both national economies and the global economic system of which they form a part.

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