



*Colin Hay*

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## Pathology Without Crisis? The Strange Demise of the Anglo-Liberal Growth Model<sup>1</sup>

IT IS, OF COURSE, NEVER EASY TO ANTICIPATE HOW HISTORIANS WILL judge the period through which one lives. But the events which started with the puncturing of the housing bubble in late 2006 (in the USA) and 2007 (in Britain) and which led to a highly contagious banking crisis and credit crunch and, ultimately, to the public rescue of a large number of systemically significant global financial institutions from the brink of collapse can hardly fail to be seen as momentous – and it is important to emphasize that they are, as yet, far from over. In the UK, it seems, these events signal the end of debt-financed, consumer-driven growth and with it the Anglo-liberal growth model that has sustained the UK economy since the early 1990s. What was, until very recently, loudly and proudly proclaimed as the end of ‘boom and bust’ is now revealed to have been the elongation, over-inflation and ultimate bursting of a balloon economy. In the process, the careful and ever more conscious and deliberate nurturing of growth is now exposed as the injudicious stretching of the business cycle by those in the Treasury and the Monetary Policy Committee, no doubt convinced by Robert Lucas’s suggestion, in a presidential address to the American Economic Association, that ‘for all practical purposes . . . the central problem of depression prevention has been solved’.<sup>2</sup>

<sup>1</sup> This is a slightly revised version of the *Government and Opposition*/Leonard Shapiro Memorial Lecture delivered at the annual conference of the Political Studies Association, Edinburgh University, 29 March 2010. I am extremely grateful to Helen Thompson and Matthew Watson for their characteristically insightful comments and suggestions on an earlier version of this lecture. Needless to say, they should be absolved of all responsibility for the argument that I here seek to defend.

<sup>2</sup> Robert E. Lucas, ‘Macroeconomic Priorities’, *American Economic Review*, 93: 1 (2003), pp. 1–14. On the disavowal of the business cycle and the dangerously

Andrew Gamble is almost certainly right to suggest that, gauged simply in terms of their severity (the fundamentals, as it were), the events through which we are still living 'will rank as one of the three great crises of capitalism of the past 150 years, alongside those of the 1930s and the 1970'.<sup>3</sup> Yet – and as he is quick to acknowledge – crises should perhaps be judged as much by the transformations to which they give rise as by the accumulation of pathologies out of which they crystallize. And there is, as yet, no end-game to the current crisis. Indeed, for some – myself included – this raises doubts as to whether it is genuinely useful to refer to the bubble burst and ensuing crunch as a crisis at all. For if crises are understood, as in the etymology of the term, as moments of decisive intervention,<sup>4</sup> or as Erik Jones rather nicely puts it, if the crux of crisis is that change is immanent, then it may well be premature to pronounce this a crisis.<sup>5</sup>

Yet for many, I suspect, this is likely to prove a heretical suggestion. In effectively downgrading the status of our current economic and political afflictions from 'crisis' to the (mere) accumulation of economic pathologies, are we not in danger of trivializing the longest and deepest recession since the 1930s? And are we not also in danger of distracting and diverting our attention from the appropriately detailed consideration of the fundamentals of the matter – the economic pathologies themselves? That is most definitely not my aim. Indeed, if anything, the opposite is the case. What I hope to show, in what follows, is the extent of the disparity between, on the one hand, the severity of the pathologies afflicting us and, on the other hand, the political interventions made already and those we might credibly

pro-cyclical character of macro-economic management in Britain since 1997, see Colin Hay, 'Credibility, Competitiveness and the Business Cycle in Third Way Political Economy', *New Political Economy*, 9: 1 (2004), pp. 39–57; Colin Hay, 'Managing Economic Interdependence', in Patrick Dunleavy, Richard Heffernan, Philip Crowley and Colin Hay (eds), *Developments in British Politics 8*, Basingstoke, Palgrave, 2006.

<sup>3</sup> Andrew Gamble, 'British Politics and the Financial Crisis', *British Politics*, 41: 1 (2009), pp. 450–62, p. 452.

<sup>4</sup> Colin Hay, 'Crisis and the Structural Transformation of the State: Interrogating the Process of Change', *British Journal of Politics and International Relations*, 1: 3 (1999), pp. 317–44; Colin Hay 'The "Crisis" of Keynesianism and the Rise of Neoliberalism in Britain', in John. L. Campbell and Ove K. Pedersen (eds), *The Rise of Neoliberalism and Institutional Analysis*, Princeton, Princeton University Press, 2001.

<sup>5</sup> Erik Jones, 'They Have No Idea . . . Decision-Making and Policy Change in the Global Financial Crisis', *LSE Europe in Question Discussion Paper 4*, London, 2009, p. 4.

anticipate for addressing such pathologies. That disparity, I suggest, is considerable. Within the terms of the existing paradigm – or, perhaps better, the existing Anglo-liberal growth model – the pathologies afflicting us are intractable; and yet, to date at least, no alternative paradigm or growth model is on offer. That should not surprise us, but it is, in essence, the predicament we face: *the Anglo-liberal growth model is broken and we lack a perceived alternative*. If that diagnosis is accurate, then our situation is one in which the old is dying and yet the new cannot be born – a ‘catastrophic equilibrium’, in the terms of Antonio Gramsci, rather than a crisis per se.<sup>6</sup> Of course, the point about catastrophic equilibria is that they are pregnant (if you’ll excuse the gynaecological analogy) with the possibility of crisis, in that the ‘morbid symptoms’ to which they give rise provide potent ingredients for potential crisis narratives. And that, in itself, is suggestive: crises, understood as moments of decisive intervention, are not given but politically constituted. All the material preconditions for crisis are present today (and have been for some time); we lack merely the ideational cue.

In this respect, and superficial impressions to the contrary notwithstanding, the present political conjuncture resembles more closely 1973–74 than it does 1978–79. David Cameron’s Conservatives are no carriers of an alternative economic paradigm. Indeed, if anything they are more pure and pristine exponents of the old paradigm, far less willing, for instance, to countenance the use of ostensibly Keynesian techniques to shore up the ailing paradigm and altogether more queasy about the associated ratcheting up of public debt and the renewed role for the state in the provision (or at least underwriting) of collective public goods.<sup>7</sup> It is thus difficult to see them presiding over the transition to an alternative growth trajectory for the UK economy. For, apart from anything else, they disavow the kind of intervention necessary to secure any such transformation. Yet in the absence of both an alternative growth strategy and, no less significantly, the capacity to restructure and rebalance the economy around it, it is difficult not to anticipate an ever-widening gap emerging

<sup>6</sup> Antonio Gramsci, *Selections from Prison Notebooks*, London, Lawrence & Wishart, 1971, p. 276.

<sup>7</sup> In fact, for reasons that we will come to presently, I do not think these techniques are well described as Keynesian; but the point, for now, is that this is how they are typically characterized – a description which has arguably contributed to the Conservatives’ queasiness about them.

between the growth rates of the leading economies and that of the UK (for reasons we will come to presently). That, in turn, can only swell political unrest and make more likely the narration of the crisis of a now cruelly outdated Anglo-liberal growth model. This of course begs the question: who will play Margaret Thatcher to David Cameron's Harold Wilson?

But this is to get a little bit ahead of ourselves – and it is but one scenario. In order to assess its feasibility it is crucial to retrace our steps, examining in the process the origins, sustenance and puncturing of the growth dynamic the UK economy has enjoyed since 1992, the character, paradigmatic significance and effectiveness of the unprecedented interventions made in the attempt to shore up the growth model, and the prospects for the resumption of growth in the years ahead.

#### THE STORY OF A NORTH SEA BUBBLE

It is, and has undoubtedly proved, all too tempting to attribute more agency than is genuinely warranted to the development of the 'new financial', 'privatized Keynesian' or, more simply, 'Anglo-liberal' growth model which has characterized the UK, Irish and, indeed, many other Anglophone economies since the early 1990s.<sup>8</sup> In the UK case, in particular, this growth model was certainly stumbled across serendipitously.<sup>9</sup> As is now widely acknowledged, it was largely consumer-led and financed by private debt – though, once established, it was undoubtedly supported by high levels of public

<sup>8</sup> On the 'new financial growth model' see Andrew Gamble, *The Spectre at the Feast*, Basingstoke, Palgrave, 2009; and on 'privatized Keynesianism' see Colin Crouch, 'What Will Follow the Demise of Privatised Keynesianism', *Political Quarterly*, 79: 4 (2008), pp. 476–87.

<sup>9</sup> Of course, with the benefit of hindsight, we might now question whether the inadvertent chancing upon such a growth dynamic was quite as benign and fortuitous as it certainly appeared to be until 2007. On the new model of growth as a product of contingency rather than design, see especially Colin Crouch, 'Privatised Keynesianism: An Unacknowledged Policy Regime', *British Journal of Politics and International Relations*, 11: 3 (2009), pp. 382–99; Colin Hay, 'Good Inflation, Bad Inflation: The Housing Boom, Economic Growth and the Disaggregation of Inflationary Preferences in the UK and Ireland', *British Journal of Politics and International Relations*, 11: 3 (2009), pp. 461–78.

expenditure. Yet it was the easy access to credit, much of it secured against a rising property market, that was its most basic precondition. This served to broaden access to – and to improve affordability within – the housing market, driving a developing house price bubble. Once inflated this was sustained and, increasingly, nurtured by interest rates that remained historically low throughout the boom.

The origins of this low inflation–low interest rate regime, of course, lie elsewhere – and it is in this respect that the UK path to sustained if not ultimately sustainable economic growth between 1992 and 2007 must be seen as a product of contingency rather than design. The step-level decrease in interest rates which set Britain on the path to sustained consumer-driven economic growth occurred in the most unpropitious of circumstances, with the devaluation of sterling associated with its forcible ejection from the Exchange Rate Mechanism in September 1992. This was subsequently reinforced by Labour’s manifesto commitment in 1997 to the stringent spending targets set by the outgoing Major government (arguably at a point when it had already discounted the prospect of re-election). Though almost certainly the product of perceived electoral expediency rather than economic judgement, this led the new Labour government to run a substantial budget surplus between 1997 and 1999. The associated rescaling of national debt served to increase the sensitivity of demand in the economy to interest rate variations and, in the process, helped further to institutionalize a low interest rate–low inflation equilibrium.<sup>10</sup>

Yet, as is now increasingly acknowledged, it was not just low interest rates that served to inflate the bubble. Crucial, too, was the liberal and increasingly highly securitized character of the mortgage market in the Anglo-liberal economies.<sup>11</sup> Of course, this was established first in the USA, with Fannie Mae, for instance, buying

<sup>10</sup> Colin Hay, ‘What’s in a Name? New Labour’s Putative Keynesianism’, *British Journal of Political Science*, 37: 1 (2007), pp. 187–92.

<sup>11</sup> Herman Schwartz, ‘Housing, Global Finance and American Hegemony: Building Conservative Politics One Brick at a Time’, *Comparative European Politics*, 6: 3 (2008), pp. 262–84; Herman Schwartz and Len Seabrooke, ‘Varieties of Residential Capitalism in the International Political Economy: Old Welfare States and the New Politics of Housing’, *Comparative European Politics*, 6: 3 (2008), pp. 237–61; Matthew Watson, ‘Constituting Monetary Conservatives via the Savings Habit: New Labour and the British Housing Market Bubble’, *Comparative European Politics*, 6: 3 (2008), pp. 285–304.

mortgages and selling them on as securities from as early as 1938.<sup>12</sup> It would take the liberalization and deregulation of financial markets in the mid-1980s to bring this to London, for it was the passing of the 1986 Financial Services and Building Societies Acts that paved the way for US investment banks to establish mortgage-lending subsidiaries in London. They brought with them the securitization of mortgage debt, albeit at a level far below that reached in the USA.<sup>13</sup> The practice was rapidly diffused throughout a retail banking sector swollen by the demutualization of the building societies.<sup>14</sup> Ostensibly, the model was one of ‘originate and distribute’. Mortgage lenders in effect became financial intermediaries, repackaging new loans as mortgage-backed securities (MBSs) for a range of domestic and international institutional investors. The advantage of such a model, in theory at least, was that the risk of mortgage repayment default was passed downstream to the holders of such asset-backed securities, rather than being retained by the originator (the former being compensated by high yields for as long as default rates remained low). Yet, as now becomes clear, the reality was more complicated: less ‘originate and distribute’, more ‘acquire and arbitrage’.<sup>15</sup> Thus, at least in part in an attempt to circumvent the capital adequacy requirements introduced in the first Basel Accord of 1988 (which required commercial banks to retain a certain amount of capital in house, but which turned a blind eye to the siphoning off balance sheet of such capital through the accumulation of asset-backed securities), a great deal of securitized credit (and the associated assets) remained on the books of the banks themselves.<sup>16</sup> Thus, as intermediaries in one office in the

<sup>12</sup> Helen Thompson, ‘The Political Origins of the Financial Crisis: The Domestic and International Politics of Fannie Mae and Freddie Mac’, *Political Quarterly*, 80: 1 (2009), pp. 17–24.

<sup>13</sup> I am indebted to Matthew Watson for conversations on this point.

<sup>14</sup> See, for instance, Thomas Wainwright, ‘Laying the Foundations for a Crisis: Mapping the Historico-Geographical Construction of Residential Mortgage Backed Securitisation in the UK’, *International Journal of Urban and Regional Research*, 33: 2 (2009), pp. 372–88.

<sup>15</sup> See, in particular, Adair Turner, ‘The Financial Crisis and the Future of Financial Regulation’, *The Economist’s Inaugural City Lecture*, 21 January 2009.

<sup>16</sup> Wainwright, ‘Laying the Foundations’, p. 382; Markus K. Brunnermeier, ‘Deciphering the Liquidity and Credit Crunch 2007–2008’, *Journal of Economic Perspectives*, 23: 1 (2009), pp. 77–100, pp. 80–1.

bank were busily slicing, dicing, ‘tranching’ and thereby passing on mortgage default risk, down the corridor their colleagues at the proprietary trading desk were just as feverishly loading the bank up with equivalent mortgage default risk. Far from being passed downstream and diversified, risk was, if anything, being concentrated and proliferated, a process only exacerbated by the increasingly highly leveraged nature of such institutions.<sup>17</sup> But, as long as house prices rose, interest rates remained low and demand for mortgage-backed securities was buoyant, little or no consideration was given to the level of aggregate risk building within the system. Indeed, for as long as the balloon economy remained airborne, systemic risk delivered growth.

To all intents and purposes it appeared that a virtuous cycle had been established, in which the preconditions of growth were mutually reinforcing – the Anglo-liberal growth model. Stable low interest rates in Britain and the USA, allied to substantial capital inflows from China and South-East Asia in particular, allowed the Anglo-liberal economies to grow despite their large and widening trade deficits. Low interest rates and a highly competitive market for credit provided both the incentive and the opportunity for first-time buyers to enter a rising market and for established home owners to extend themselves financially, by either moving up the housing ladder or releasing the equity in their property to fuel consumption. There was little incentive to save; instead, consumers were increasingly encouraged to think of their asset purchases as investments which they might cash in to fuel their consumption in retirement, as the state withdrew from pension provision, or in times of economic difficulty or unemployment. Such ‘asset-based welfare’ was, in effect, the social policy corollary of the new growth model. That it became a conscious social policy strategy in itself, actively promoted by the New Labour government, was a clear indication that, despite its contingent origins, the growth model was now a quite conscious part of its economic thinking.<sup>18</sup> But, tragically, both the growth model and

<sup>17</sup> Brunnermeier, ‘Deciphering the Liquidity and Credit Crunch’, p. 92.

<sup>18</sup> On ‘asset-based welfare’ and the economic assumptions on which it is predicated see, in particular, Alan Finlayson, ‘Financialisation, Financial Literacy and Asset-Based Welfare’, *British Journal of Politics and International Relations*, 11: 3 (2009), pp. 400–21; Alan Finlayson, ‘Characterising New Labour: The Case of the Child Trust Fund’, *Public Administration*, 86: 1 (2008), pp. 95–110; Matthew Watson, ‘Planning for a Future of Asset-Based Welfare? New Labour, Financialised Economic Agency and the Housing

asset-based welfare were, as they remain, predicated on the assumption that asset-price appreciation will be sustained – and is sustainable. With an estimated £0.3 billion lost from Child Trust Funds alone since the onset of the credit crunch, that assumption is now cruelly exposed as a naive and costly one-way accumulator bet.<sup>19</sup>

Yet, the losses endured by Child Trust Funds notwithstanding, the transition from public to asset-based welfare has been partial at best – and that is probably a very good thing. But there is a deep and rather tragic irony here, for the pressure on the public provision of welfare is set to intensify massively, due to the public bail-out of the banking sector and the resulting deterioration of the public finances, at precisely the point at which asset-based welfare is least likely to be able to compensate.<sup>20</sup> Public and private welfare retrenchment are likely to prove simultaneous.

Yet, important though the impact of the bubble burst and ensuing credit crunch has been on the long-term prospect that asset-based welfare might come to meet the shortfall created by public welfare retrenchment, it is the rather more direct and immediate impact on consumption that should perhaps concern us most. This is the story of the rise and demise of ‘privatized’ or ‘house price Keynesianism’.<sup>21</sup> The Keynesian analogy is a helpful one. But it is important to emphasize that it is – and was only ever intended as – an analogy. It cannot be taken too far. What it does serve to do is to highlight the key link in the Anglo-liberal growth model between (private) debt, aggregate demand and consumption. In effect, it strips the growth model to its core. Where traditional Keynesianism saw public spending – sustained, where necessary, through public borrowing and targeted on low- and middle-income households through welfare benefits – as the key to raising and generalizing demand, so privatized Keynesianism assigns (or at least relies upon) a similar role being performed by

Market’, *Planning Practice and Research*, 24: 1 (2009), pp. 41–56; Matthew Watson, ‘House Price Keynesianism and the Contradictions of the Modern Investor Subject’, *Housing Studies*, 25: 3 (2010), pp. 413–26.

<sup>19</sup> Rajiv Prabhakar, ‘Asset Inequality and the Crisis’, *Renewal*, 17: 4 (2009), pp. 75–80, p. 75.

<sup>20</sup> See also Watson, ‘House Price Keynesianism’.

<sup>21</sup> Crouch, ‘Privatised Keynesianism’; Colin Hay, Jari Matti Riiheläinen, Nicola Jo-Ann Smith and Matthew Watson, ‘Ireland: The Outlier Inside’, in Kenneth Dyson (ed.), *The Euro at Ten: Europeanisation, Power and Convergence*, Oxford, Oxford University Press, 2009; Watson, ‘House Price Keynesianism’.



private debt, typically secured against rising property prices. In so far as – or, as we have recently discovered, *only for as long as* – a low inflation–low interest rate equilibrium persists, a virtuous and seemingly self-sustained growth dynamic is established. This, in essence, is the growth model. Consumers, in this benign environment, face powerful incentives to enter the housing market since credit is both widely available on competitive terms (there is a liquidity glut) and returns to savings are low. The result is growing demand in the property market and house price inflation. In Britain, for instance, in the decade before the bubble burst, house prices grew on average at over 10 per cent per annum in real terms. In such a context, and buoyed in the USA by the insatiable demand of the market for high-yielding mortgage-backed securities and the lucrative transaction fees associated with satisfying such demand and, in the UK more simply by interest rate spreads, mortgage lenders actively chased new business. In the process they increasingly came to extend credit to those who would previously have been denied it (on the grounds of the risk of repayment default they posed) and to extend additional credit to those with equity to release. The incentives thus clearly encouraged both the demand for and supply of sub-prime lending, high loan-to-value ratios and, crucially, equity release which might fuel consumption. That consumption, in turn, sustained a growing, profitable and highly labour-intensive services sector whose expansion both masked and compensated for the ongoing decline of the manufacturing economy (reinforced by low levels of productive investment as credit flows to business were crowded out by positions taken on higher-yielding asset-backed securities, other collateralized debt obligations and the like).

This, for as long as it lasted, was all well and good. But, arguably, it is precisely where the Keynesian analogy breaks down that that problems begin. Classical (or public) Keynesianism, of course, is predicated on the existence of the business cycle. Its very rationale is to manage aggregate demand within the economy in a counter-cyclical way, thereby limiting peak-to-trough variations in output growth and unemployment. Privatized Keynesianism could not be more different in its (implicit) assumptions about the business cycle. These are distinctly non-Keynesian. Whether taken in by the convenient political mantra of the ‘end of boom and bust’ or convinced, like Robert Lucas, that the ‘problem of depression prevention has been solved’, privatized Keynesianism simply assumes that there is no

business cycle. Consequently, measures which might otherwise be seen as pro-cyclical appear merely as growth-enhancing. The effect is that the implicit paradigm that has come to support the growth model neither countenances the need for, nor is capable of providing, any macro-economic stabilizers. If, perhaps as a result of an inflationary shock, the low interest rate–low inflation equilibrium is disturbed, then mortgage repayments and ultimately default rates rise, housing prices fall, equity is diminished and, crucially, consumption falls – as disposable income is squeezed by the higher cost of servicing outstanding debt and as the prospects for equity release to top up consumption diminish. Lack of demand translates into unemployment with consequent effects on mortgage default rates, house prices and so forth. The virtuous circle rapidly turns vicious. Arguably this is precisely what happened in the heartlands of Anglo-liberal growth, the USA and the UK, from 2006 and 2007 respectively. It is to the details of the bubble burst and subsequent contagion that we now turn.

#### BLOWING BUBBLES, BURSTING BUBBLES

The collapse of Anglo-liberal growth and the global contagion which followed is a now familiar tale – well described in a breathtaking variety of popular and, indeed, academic accounts in a remarkably highly conserved manner. Typically, it starts with the bursting of the US housing bubble in the second half of 2006 as interest rates soared. There is nothing wrong with this account, but arguably the effect of starting the story here is to gloss over too readily the source of such interest rate rises in the first place. The USA, of course, was not alone in raising interest rates. But, significantly, in this respect as in many others, it moved first. Indeed, the entire US business cycle over this period seems to precede that in the UK and the Eurozone by between three and four quarters. That makes an understanding of the motives of the Federal Reserve in raising interest rates all the more significant – and those motives are rather more complex than they might at first appear.

Those (few) accounts which do seek to explain the steep and sustained rise in US interest rates between 2004 and 2006 tend to attribute this to the Federal Reserve's judgement that, as Andrew Gamble puts it, 'credit conditions were too lax now that the economy

had recovered from the mini recession that it had suffered . . . after the bursting of the dot.com bubble' and needed to 'become tighter to reduce the risk of inflation'.<sup>22</sup> That is undoubtedly true and it featured prominently in the Federal Reserve's public rationale for interest rate rises. Yet it was by no means the only factor at work here. The base rate did not increase five-fold in a little under two years simply in anticipation of a potential inflationary effect. Two additional factors are key. First, as the timing of the Federal Reserve's interest rate rises suggests, a powerful motive was to support the value of the dollar, which had started to slide on international exchanges. Arguably at least as significant was the simple fact that inflation was already rising – quite steeply and at a rate faster than for any other leading economy at the time. Crucial to this was the rapid appreciation of oil, with Brent Crude more than doubling in price between the start of 2004 and the peak in US interest rates in 2006, a process undoubtedly underpinned by fundamentals but, crucially, amplified very significantly by speculative dynamics (ironically, reinforced by money flooding out of the housing market).<sup>23</sup>

Yet oil prices would carry on rising even once the Federal Reserve started slashing rates, with Brent Crude not peaking until the second quarter of 2008, by which time it had doubled in price again. This might suggest that the Federal Reserve was insensitive to exogenous oil price rises and rather more concerned with the endogenous sources of inflationary pressure within the US economy (bound up with the over-supply of credit).<sup>24</sup> Rather more realistic, I think, is that

<sup>22</sup> Gamble, *The Spectre at the Feast*, pp. 19–20; see also Paul Mason, *Meltdown: The End of the Age of Greed*, London, Verso, 2009, p. 84.

<sup>23</sup> On which see D. Sornette, R. Woodward and W-X. Zhan, 'The 2006–2008 Oil Bubble: Evidence of Speculation and Prediction', *Physica A: Statistical Mechanics and its Application*, 388: 8 (2009), pp. 1571–6; R. K. Kaufmann and B. Ullman, 'Oil Prices, Speculation and Fundamentals: Interpreting Causal Relations Among Spot and Futures Prices', *Energy Economics*, 31 (2009), pp. 550–8; Paul Davidson, 'Crude Oil Prices: Market Fundamentals or Speculation?', *Challenge*, 51: 4 (2009), pp. 110–18; Mazen Labban, 'Oil in Parallax: Scarcity, Markets and the Financialisation of Accumulation', *Geoforum*, 41: 4 (2010), pp. 541–52; see also George Soros, interview, *Financial Times*, 22 January 2008.

<sup>24</sup> This would, for instance, seem to be the argument of Patrick Minford, who suggests that European monetary authorities tend to gauge their credibility in terms of their capacity to respond to 'headline' inflation, whereas their US counterparts feel confident in focusing more narrowly on 'core' inflation. There is undoubtedly something to this, a key aspect of which is likely to be the significant influence exerted on

it became increasingly insensitive to continued oil price rises only once it became clear that interest rates were already on the verge of pushing the economy into recession – no doubt because it anticipated that oil prices would fall once a US demand shortfall started feeding into the world economy.

That is, in fact, precisely what happened, with oil prices tumbling precipitously in the second half of 2008. In this respect, and strange though it might at first seem, UK policy-makers were in fact extremely fortunate. And this is the key point. For, had the bubble not burst first in the USA, it is likely that oil prices would have carried on rising (fuelled by speculation) well into 2009. That would have generated a quite horrendous ‘stagflation’ headache for the Monetary Policy Committee of the Bank of England (with a housing market crash, negative economic growth and runaway inflation exacerbated, presumably, by a run on sterling all at the same time). My aim in drawing attention to this is not to try to make us feel better by suggesting that things could have been even worse, but instead to point to the powerful role played by oil price movements (reinforced by speculative dynamics) in both the onset of the crunch and, quite conceivably, if, as and when growth returns to the world economy. That alarming prospect is something to which we will return presently. But, before doing so, it is important that we consider in more detail the transmission mechanism from bubble burst in the USA to bubble burst in the UK.

Where the existing accounts are undeniably right is in pointing to the implications of the five-fold increase in interest rates for the US housing market. Mortgage repayments rose and, shortly thereafter, default rates started to increase. Particularly badly affected were sub-prime mortgages, which (largely because of their link to the highest-yielding mortgage-backed securities) had been the fastest-growing and most aggressively sold product class in the market. They had been offered on sub-optimal terms to compensate for the greater financial risk they posed, had involved substantial transaction fees payable to the originator of the loan and had typically been made available to those who could scarcely afford the repayments even when interest rates had been at their lowest. Inevitably, default rates on such loans were especially high. This was merely compounded by

world oil prices by US demand (and hence US monetary policy). Patrick Minford, ‘The Banking Crisis: A Rational Interpretation’, *Political Studies Review*, 8: 1 (2010), pp. 40–54, p. 50.

the fact that many of these loans had been offered, once their initial fixed-rate honeymoon period was over, at punitive variable rates and on interest-only repayment terms. This gave those in arrears and in a property whose value was falling little incentive to keep up with the payments even when they were able to do so. Moreover, what had made the punitive terms of these loans tolerable while property prices were rising was the prospect of remortgaging on more favourable terms as the loan-to-value ratio of the debt fell. In a falling market that was no longer possible. The result, predictably, was a housing crash, radiating out from the most sub-prime dense residential areas to encompass the entire housing market.

The ripple effects would prove to be not only nationally but globally contagious. This, as we now all know was due to the securitization of much of the debt (prime and sub-prime alike) associated with the expansion of the US housing market and its international diffusion. With repayment streams drying up, previously high-yielding mortgage-backed securities rapidly became recast as 'toxic assets' – not least because there was such limited information about the quality of the lending on which they were based and, hence, the genuine risk that they posed to the balance sheets (and shadow balance sheets) on which they appeared. Almost overnight triple-A rated securities became effectively worthless, exposing a staggering variety of international financial institutions and intermediaries to major losses. The casualties included any and all financial institutions holding such mortgage-backed securities, the under-capitalized and highly-leveraged investment banks and hedge funds involved in supplying the demand for such securities, the commercial banks who had lent to those purchasing them, and insurance companies, such as AIG, who had issued credit default swaps to those wishing to insure their exposure to such securities against the risk of default. Like a home insurance provider established just before the Great Fire of London, the latter found themselves cruelly exposed as all those who had hedged their position against the risk of default now sought to make a claim at the same time.

The result of all of this, as is also widely known, has been a series of bank insolvencies around the world, prompting the largest-ever bail-out of the financial sector, and a deep and prolonged global recession precipitated, in turn, by the freezing-up of inter-bank lending (as banks sought to shore up and consolidate their own positions, greatly supported by public injections of capital, while

struggling to assess the exposure to future losses of those to whom they might credibly lend).

That is the context into which we now need to insert the UK economy. Though it is tempting to see the UK's longest and deepest recession since the 1930s as a product of contagion – the consequence of financial interdependence more than anything – that, I want to suggest, is both profoundly wrong and profoundly dangerous. It is wrong because this is just as much a crisis (if crisis it is at all) of the Anglo-liberal growth model as it is a specifically American crisis; it is dangerous because it may lead us to overlook the endogenous frailty at the heart of the Anglo-liberal growth model that has been exposed.

To show that this is indeed the case, it is important to differentiate between two distinct, but nonetheless intimately interwoven, sources of the bubble burst and recession that the UK has suffered since 2007. The first of these is largely exogenous, is credibly seen as a contagion effect, and spread through the banking sector by virtue of its financial interdependence. The UK economy was undoubtedly peculiarly exposed to this by virtue of the size, the systemic significance and the comparatively lightly regulated character of its financial sector, but it would undoubtedly have been exposed to such contagion regardless of its growth model. The second, by contrast, is largely endogenous, is peculiar to the Anglo-liberal economies and concerns the relationship between monetary policy, the housing market and aggregate domestic demand. Both mechanisms might be seen to expose profound structural weaknesses at the heart of privatized Keynesianism which call into question the viability and sustainability of the Anglo-liberal growth model, but they do so in rather different ways.

The former is simpler, more familiar, and can be dealt with more quickly. In essence, it relates to, and arises from, the exposure of the UK financial system to the US market for mortgage- and other asset-backed securities (and related derivatives) and to the interdependent character of the credit market in general and the market for inter-bank lending in particular. The point is very simple. As a direct consequence of the highly securitized character of the US mortgage market and the international distribution of such securities, any house price crash in the USA was always likely to result in significant losses for UK financial institutions. Moreover, as has now become all too clear, given the extent of the exposure of major financial institutions around the world

(including those in London) to any such losses, a crisis of confidence leading to a fire sale of US mortgage-backed securities was always going to result in a global credit crunch precipitated by the freezing-up of inter-bank lending.<sup>25</sup> Given its levels of private debt and the centrality for its growth model of the relationship between the supply of easy credit, private debt and domestic demand, the UK economy was always going to be more exposed to such a credit crunch than almost any other leading economy. Moreover, and no less significantly, the sheer size of the UK financial services industry and its systemic significance for the economy and growth within it left the government with little option other than to underwrite the entire sector with public funds. In effect, it was forced, at least temporarily, to re-nationalize privatized Keynesianism, destroying in the process any reputation it still had for careful guardianship of the public purse and, in all likelihood, imposing on the public sector at least a decade of retrenchment. As this certainly suggests, contagion born of financial interdependence can quite credibly account for much of the damage inflicted on the UK economy since 2007. Strange though it might seem, the effect is perhaps best illustrated by considering the demise of Northern Rock itself.

Typically, Northern Rock is seen to have been a casualty of the quality of its lending book. But closer scrutiny reveals this to be very far from being the case. The Rock had, in fact, virtually no sub-prime lending and was, if anything, a casualty not of its own failings as a financial institution so much as of those of its creditors.<sup>26</sup> Its problem, in essence, was the highly leveraged nature of its business model and its reliance on short-term loans. As credit conditions tightened – and, crucially, in the absence of any significant rise in the default rate on outstanding loans – it simply found itself unable to rollover the short-term debt on which it relied. It faced a margin call that the very nature of its business – the provision of illiquid long-term loans – prevented it from meeting.

As this perhaps already suggests, contagion transmitted through international securities and credit markets can go some considerable way to account for many of the symptoms that have come to

<sup>25</sup> Indeed, it was also likely to result in a fire sale of mortgage-backed securities denominated in sterling.

<sup>26</sup> For a far more detailed analysis, see Hyun Song Shin, 'Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis', *Journal of Economic Perspectives*, 23: 1 (2009), pp. 101–19; see also Gamble, *The Spectre at the Feast*, pp. 25–6.

afflict the UK economy since 2007 – the unprecedented ratcheting up of public debt in particular. Presented in this way, as so often it is – and in this way alone – the UK's longest and deepest recession since the 1930s is the product of the constriction of the supply of credit that had drip-fed the economy throughout the 'great moderation' and the losses associated with exposure to US asset-backed securities and associated derivatives. Though it has much to commend it and although it is undoubtedly a very significant part of the story, it still suffers from one fundamental problem: it simply cannot account for the timing of the onset of the recession in the UK housing market. For, by the time of the onset of the credit crunch in the USA, the number of housing market transactions in the UK had already fallen by a quarter from its peak in late 2006. Thus, even if we assume an instantaneous transmission of the credit crunch from the US to the UK, this account gets the timing wrong by at least seven months.

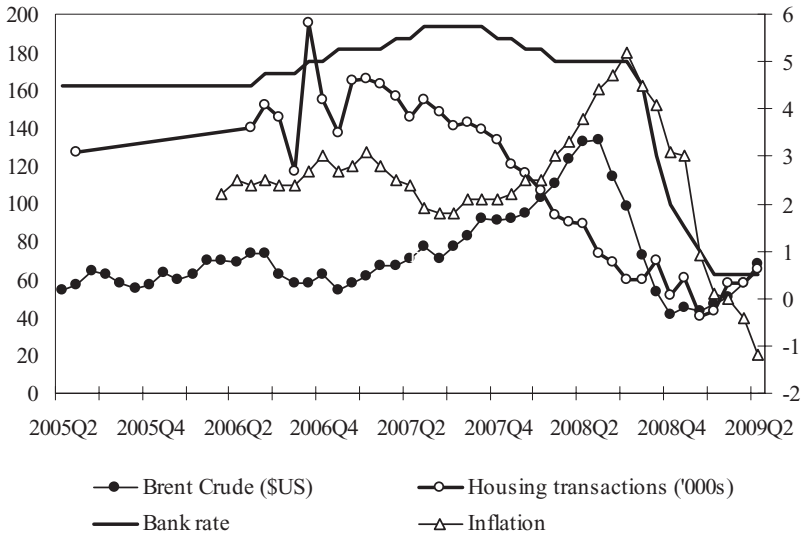
That suggests, to me at least, the importance and the value of looking for a more endogenous explanation – one that is not very difficult to find. As already noted, and as Figure 1 shows very clearly, oil prices were rising very steeply at this time – and so too were interest rates as inflationary pressures built in the economy.

It is hardly surprising that rising mortgage payments, combined with a reduction in disposable income, should start to reduce both aggregate demand in the economy (and hence levels of consumption) and demand in the housing market. It is certainly no more surprising that, as Figure 2 shows, this should lead first to a reduction in turnover in the housing market (a fall in the number of transactions), rather than to a fall in prices. House prices tend to prove downwardly sticky as sellers are typically reluctant to accept a reduction in asking price sufficient to secure a sale in a market in which demand is falling.<sup>27</sup> This effect is likely to be all the more pronounced in the immediate aftermath of a period of sustained house price inflation. At least at this point in the story of Britain's slide into recession, then, the size of the housing market was falling because of a decline in the volume of transactions rather than a fall in the value per transaction. And this, in turn, arose not because of a lack of

<sup>27</sup> On downward stickiness in housing prices, see K. E. Case, J. M. Quigley and R. J. Shiller, 'Comparing Wealth Effects: The Stock Market Versus the Housing Market', *Advances in Macroeconomics*, 5: 1 (2005), pp. 1–32.



**Figure 1**  
*Interest Rates, the Price of Oil and the UK Housing Market*



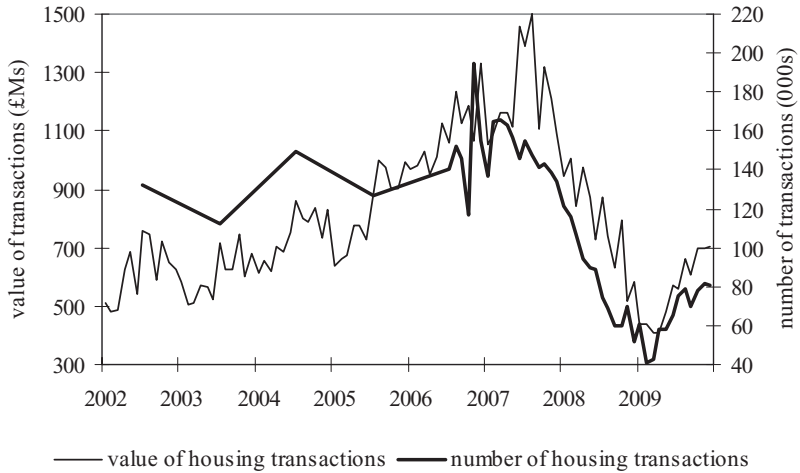
*Source:* HM Treasury Pocket Data Series (various years)

supply of credit, but from a lack of demand. That can only be explained domestically. As this suggests, the initial bursting of the UK's housing bubble was not a consequence of international contagion, but an almost inevitable effect of the attempt to control inflation arising from speculative dynamics in oil markets.

Of course, as Figure 2 also shows, it did not take long before sellers started to adjust themselves to a falling market; with the trend in the value of housing market transactions following that for the volume of transactions with a time lag of approximately six months. Thereafter, with both the volume and value of transactions tumbling, the housing market entered freefall. Having grown at around 12 per cent per annum since 1992, residential property prices were, by December 2008, falling at around 20 per cent per annum. And the situation was significantly worse in the commercial property market. By this point, a lack of demand for new lending and a lack of supply of credit were reinforcing one another. Thus, despite the growing spread between the Bank of England base rate and the effective market mortgage rate, new lending was extremely difficult to secure, since there was

**Figure 2**

*The Bursting of the Housing Bubble: Value and Volume of Housing Transactions, 2002–10*

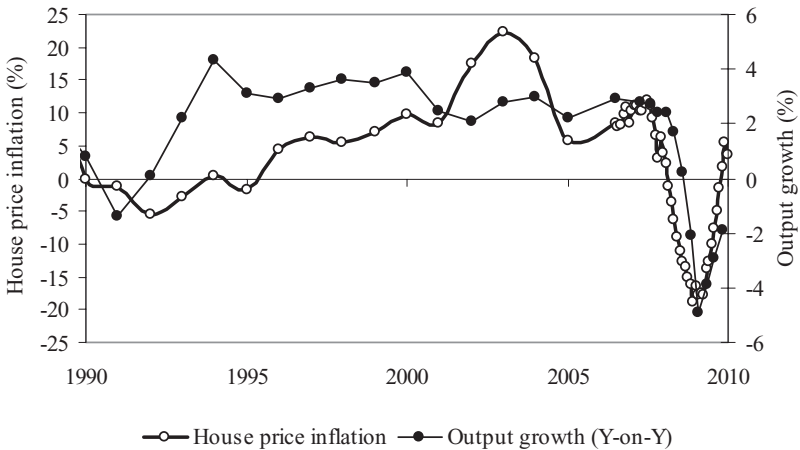


Source: HM Revenue and Customs Annual Receipts (monthly values, 000s and £M)

little or no prospect of passing it downstream through securitization, and the banks were hastily trying to shore up their balance sheets by minimizing existing liabilities as best they could. With essentially no inter-bank lending market to draw upon, that meant quite simply that most financial institutions had no capacity to extend credit even to the most credit-worthy of customers. By this point many of them had long since stopped looking for fresh credit lines that they might extend.

The effect of all of this on the wider economy is easily seen if we start to consider the transformation in personal fortunes that this kind of turnaround in the housing market represented. In November 2006, when the average house price in the UK topped £200,000 for the first time, average annual earnings were about £30,000 and house prices were increasing at an annual rate of 11 per cent. The wealth effect associated with house price inflation was the equivalent of three-quarters of pre-tax annual average earnings – a significant source of equity which might be released to fuel consumption. Indeed, at its height, a couple of years earlier, £1 in every £6 of new lending secured in the UK against property took the form of equity

**Figure 3**  
*Output Growth and House Price Inflation, 1990–2010*



Source: HM Treasury Pocket Book Data Series (various years)

release – a figure equivalent to 2.5 per cent of GDP.<sup>28</sup> Yet by December 2008, a net wealth effect had been replaced by annual house price deflation equivalent to 124 per cent of the pre-tax earnings of the average citizen. Privatized Keynesianism, in other words, was no longer delivering growth but had become, in effect, an obstacle to growth because the low inflation–low interest rate equilibrium upon which it depended had been disrupted. 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, rising unemployment, especially in a service sector whose growth had relied on the provision of services to a property-owning consumer society with high levels of (liquid) positive equity and/or disposable income. The close link between the housing market and the fortunes of the domestic economy in the slide into recession is shown in Figure 3.

As this perhaps serves to indicate, although the UK's economic difficulties were seriously compounded by the credit crunch, they were not caused by it – and the UK economy would almost certainly

<sup>28</sup> Hay, 'Good Inflation, Bad Inflation', p. 471.

have experienced a deep and painful recession without it. True, most home owners who had not entered the housing market or released all of the equity that they had accumulated during the housing boom in the two years before the bubble burst still had positive equity in their homes. That they could not access it to supplement their consumption was a product of the credit crunch. It is undoubtedly also true that the unavailability, to all intents and purposes, of credit throughout 2008 and 2009 contributed to the depth and severity of the recession. But in so doing it merely reinforced dynamics that were already deeply entrenched. The brutal reality is that, by the time the credit crunch started to impact on the UK economy, there was already precious little demand for credit – certainly in the residential and consumer economy.

Of course, this is to concentrate on domestic demand – on which, arguably, the impact of the credit crunch has been limited. But there is another, far more significant mechanism in and through which the credit crunch has cut much more directly at the heart of the Anglo-liberal growth model. That is through its impact on the size and growth prospects of the financial services industry and the damage inflicted on the state of the public finances in the shoring-up or re-nationalization of privatized Keynesianism. These effects are considerable and the damage done likely to prove extremely long-lasting. While much depends on the extent to which a new regulatory architecture emerges in the years ahead for global financial markets and the balance between prudential regulation and the prospect of finance-led economic growth that any such new regime strikes, there is little doubt that the size and value of financial services to the UK economy will suffer a step-level decrease. As Jim Tomlinson has noted, the share of GDP contributed by financial services grew, from 5.5 per cent in 1986 to 10.8 per cent in 2007;<sup>29</sup> during this time, financial services grew at just under 5 per cent per annum, while the growth rate of the economy as a whole scarcely exceeded 2.5 per cent.<sup>30</sup> As Martin Weale quite credibly suggests, ‘it is most unlikely that the financial services industry can in the future act as the sort of motor of growth that it has done in the past . . . if the sector returns

<sup>29</sup> Jim Tomlinson, ‘Sick but Not Dying’, *Political Studies Review*, 8: 1 (2010), pp. 67–72, p. 71.

<sup>30</sup> Martin Weale, ‘Commentary: Growth Prospects and Financial Services’, *National Institute Economic Review*, 207 (2009), pp. 3–9, p. 3; see also Willem Buiter’s evidence to the House of Commons Treasury Select Committee, 21 July 2009, HC767.

to the importance it had in 2000, GDP is likely to be reduced permanently by about 1.9 per cent'.<sup>31</sup> Interestingly enough, that is almost precisely the annual average contribution of credit lines arising from the release of home equity to the UK economy in the decade prior to the recession. If we put the two together, a rather cavernous hole emerges at the heart of the UK growth model. And this, of course, is to say nothing about the consequences for growth of the public sector recession that will almost certainly follow the election as attempts to drive down unsustainable levels of public debt translate into a combination of drastic cuts in public spending, redundancies and rising taxes.

#### PUTTING HUMPTY TOGETHER AGAIN: THE PROSPECTS FOR THE RETURN OF ANGLO-LIBERAL GROWTH

So where does this leave the UK economy and the Anglo-liberal growth model on which, I have suggested, it has relied since the early 1990s? It is to this question that I now finally turn, considering the character, paradigmatic significance and effectiveness of the unprecedented interventions made in the attempt to shore up the growth model, the political significance and likely legacy of the recession, and the prospects for the resumption of growth, first in the UK and then more generally, in the years ahead.

#### *The Re-Nationalization of Privatised Keynesianism: A Paradigm Shift?*

However strange it may well sound, the government of Gordon Brown, I want to suggest, has had a good recession. Indeed, there is now a developing consensus in the academic, if not perhaps the more popular, literature that this is so.<sup>32</sup> It is undoubtedly the case that the

<sup>31</sup> Weale, 'Commentary', pp. 3, 8.

<sup>32</sup> For a typically measured and balanced assessment, see Colin Thain, 'A Very Peculiar British Crisis? Institutions, Ideas and Policy Responses to the Credit Crunch', *British Politics*, 4: 4 (2009), pp. 434–49; see also Gamble, *The Spectre at the Feast*, esp. p. 108; Hugh Pemberton, 'Macroeconomic Crisis and Policy Revolution', *Renewal*, 17: 4 (2009), pp. 46–56. For a rather different view, see David Coates, 'Chickens Coming Home to Roost? New Labour at the Eleventh Hour', *British Politics*, 4: 4 (2009), pp. 421–33.

Brown government acted swiftly, decisively and with some significant degree of innovation in responding to a set of challenges that were, as in a sense they still remain, unprecedentedly difficult – and it deserves some considerable credit for this. Indeed, even commentators such as Paul Krugman are keen to emphasize the role played by Gordon Brown, in particular, in setting the agenda and defining, in effect, the tenor, tone and scale of what was to become a perhaps surprisingly coordinated international response.<sup>33</sup> The return to the language of Keynesianism is particularly striking in this context, and clearly owes much to Brown himself.<sup>34</sup> In the absence of the bubble burst and ensuing recession it is surely unthinkable, for instance, that Mervyn King, the governor of the Bank of England would start littering the text of speeches given by him in an official capacity with direct quotes from the *General Theory*.<sup>35</sup> Indeed, in a sense it is quite remarkable that it is even credible, as I think it is, to pose the question of whether the public rescue of the banking sector heralds the return to an era of Keynesian economics: a paradigm shift made in the context of crisis. But the point is that it does not – Keynesian rhetorical flourishes by those from whom you might least expect them notwithstanding. The idea that we are witnessing or have already witnessed the return to Keynesianism precipitated by a terminal crisis of neoliberalism is, I think, an attractive if fanciful delusion.<sup>36</sup>

What we have witnessed is nonetheless very interesting, and reminiscent in certain respects of UK economic policy-making in the mid- to late 1970s. What we have seen, in effect, is inter-paradigm borrowing. Thus, just as the Labour government of James Callaghan sought to deploy monetarist techniques in an attempt to shore up the prevailing Keynesian growth model,<sup>37</sup> so that of Gordon Brown has sought to make use of a quasi-Keynesian (as distinct from more classically Keynesian) repertoire of techniques in the attempt to

<sup>33</sup> See, for instance, Paul Krugman, *The Return of Depression Economics and the Crisis of 2008*, London, Penguin, 2008, p. 185.

<sup>34</sup> See also Pemberton, 'Macroeconomic Crisis', p. 46.

<sup>35</sup> See, for instance, Mervyn King, 'Finance: A Return from Risk', speech to the Worshipful Company of International Bankers, Mansion House, London, 17 March 2009; Mervyn King, 'Speech', University of Exeter, 19 January 2010.

<sup>36</sup> For examples see David Marsh, 'The Future of Politics', *British Politics*, 4: 1 (2009), pp. 117–26; Mason, *Meltdown*, p. x; and, albeit in a slightly different context, Robert Wade, 'Financial Regime Change?', *New Left Review*, 53 (2008), pp. 5–21.

<sup>37</sup> Or at least what passed for a Keynesian growth model in the UK at the time.

shore up the existing growth model. But that is the key point: both episodes of inter-paradigm borrowing are characterized by the attempt to stabilize the existing model and its attendant paradigm. As such, ultimately they are internal to the paradigm and cannot be seen to herald an imminent paradigm shift. As Andrew Gamble puts it, 'politicians are still attempting to respond to the crisis within the intellectual frameworks that defined the orthodoxies of the past twenty years'.<sup>38</sup>

In that sense, what we have here is what might be termed not 'fair weather' but 'foul weather' Keynesianism – a dipping into the Keynesian repertoire of techniques in recession, only for such techniques to be abandoned if, as and when growth returns to the UK economy. Indeed, one of the clear dangers here is that, in their perhaps understandable desire to signal to the markets a clear intention to restore balance to the public accounts, such techniques might be abandoned well before any recovery (if there is to be one) is firmly established.

### *Re-Inflating the Bubble*

That brings us to the likely political fallout of the bubble and ensuing recession. As I have argued, the Labour government has had a rather better recession than one might have anticipated, and it is by no means inconceivable that they will be rewarded for this, at least to some extent, at the ballot box. Yet it is still altogether more likely that, having failed to restore growth (certainly steady growth) to the UK economy by the time of the election, they will be replaced in office by those who would claim to be able to do better. But that, as should now be clear, is no easy task – and arguably it is not made any easier by the ideas animating economic thinking in the Conservative Party today.

Cameron's Conservatives are no carriers of an alternative economic policy-making paradigm, nor do they offer an alternative growth model – though in neither respect are they very different from their Labour counterparts. But there are nonetheless significant differences in emphasis between the parties on economic policy. First, although they have not explicitly denied that they would have engaged in the same public underwriting of the banking sector, the

<sup>38</sup> Gamble, 'British Politics and the Financial Crisis', p. 459.

Conservatives are clearly much more queasy about the Keynesian connotations of such deficit-financing, the active if not perhaps especially interventionist role for the state as financial guarantor of last resort that is implied and, of course, the ratcheting up of public debt that has been its most direct and immediate consequence. Their natural inclination, it would seem, is to invoke a ‘moral hazard’ objection to the bailing out of private institutions; though there would also seem to be a tacit acceptance that there was little or no alternative.

In this context it is interesting that they do refer to the recession as a crisis, but they do so in a very particular way. The crisis, for them, is a debt crisis, ‘Labour’s debt crisis’ – and that, of course, implies that the solution to the crisis is to restore balance to the public finances.<sup>39</sup> This does not place them significantly at odds with the government, but it is certainly a rather different emphasis. Yet it is by no means the only, nor perhaps the most significant, difference between the parties. For, somewhat surprisingly, the Conservatives are far more sanguine about the degree to which the UK’s growth model is broken. Their clearest statement to date on economic policy – widely seen as a draft chapter from their manifesto – opens with a stark question: ‘Where is the growth to come from?’ That is precisely the right question, but it is not at all clear that either party has an answer. For Labour, it seems, growth rests on resuscitating the old growth model. For the Conservatives, it is very clear that this will not suffice. As they boldly state,

We cannot go on with the old [growth] model . . . built on debt. An irresponsible public spending boom, an overblown banking sector and unsustainable consumer borrowing on the back of a housing bubble were the features of an age of irresponsibility that left Britain so exposed to this economic crisis. They cannot be the source of sustainable growth for the future.<sup>40</sup>

Again, at some level this is almost certainly correct. But sadly it does not lead to a clear sense of what is to be done. Instead we are simply told that the UK must make the transition (quite how is left unspecified) to a new growth model based on saving rather than borrowing, investment rather than conspicuous consumption, and a balance of trade surplus in place of an existing deficit – as well as a greatly

<sup>39</sup> David Cameron, ‘Our Whole Country is Crying Out for Change’, speech, 25 January 2010; Conservative Party, *A New Economic Model: 8 Benchmarks for Britain*, London, Conservative Party, 2010.

<sup>40</sup> Conservative Party, *A New Economic Model*, p. 3.



reduced role for financial services. That would, of course, be wonderful; but it sounds very much like the disavowal of Anglo-liberal capitalism in favour of *Modell Deutschland*.<sup>41</sup> Put like that, the stark disparity between the extent of the transformation implied here and the policy instruments suggested for bringing it to fruition (almost exclusively tax incentives, it seems) is cruelly revealed. The problem, in the end, is simple – the Conservatives disavow the kind of intervention and, indeed, the degree of public investment necessary to secure any such transformation and they seem to believe that it can be achieved in a single parliamentary term when, in all likelihood, it would take several decades.

But that, ultimately, is the UK's economic predicament. In the absence of both an alternative growth strategy and, no less significantly, the capacity and patience to restructure and rebalance the economy around it, it is difficult not to anticipate an ever-widening gap emerging between the growth rates of the leading economies and that of the UK. That may well make the 2010 general election not a very good election to win. If that turns out to be the case, then the best that we can perhaps hope for is for the development of a more fully fledged crisis narrative in opposition in the years ahead. Such a narrative must prove itself capable of identifying, describing and drawing together the internal contradictions of the Anglo-liberal growth model and of articulating a clear strategy capable of taking us to an alternative. But, as yet, that alternative simply does not exist. We can but hope that necessity proves the mother of invention.

### *Why All the King's Horses and All the King's Men Are Unlikely to Put Humpty Together Again*

Of course all of this rests on the assumption, which it seems the Conservatives now accept, that the Anglo-liberal growth model is

<sup>41</sup> A model whose own imminent demise was, of course, famously pronounced more than a decade ago. It is perhaps also worth noting that those economies characterized by export-led growth models, such as the German, have in fact tended to suffer deeper recessions than economies in the Anglo-liberal heartlands. This is not altogether surprising, since the demand on which they principally rely comes from the Anglo-liberal core. On the (earlier) demise of *Modell Deutschland*, see especially Wolfgang Streeck, 'German Capitalism: Does it Exist? Can it Survive?', *New Political Economy*, 2: 2 (1997), pp. 237–57.

irretrievably and irreversibly compromised. In conclusion, it is important to set out why I think that this is indeed the case. My comments here seek to draw attention to a number of impediments to the resumption of growth in the UK economy in the years ahead.

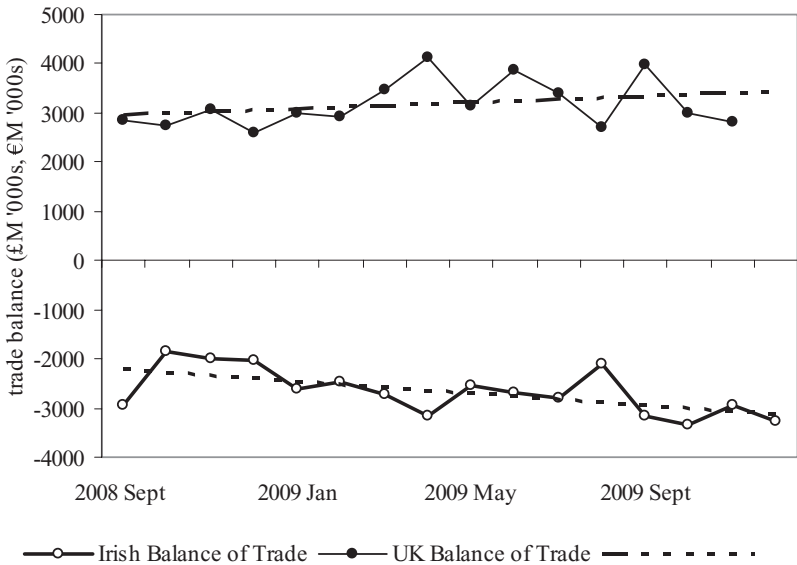
The first of these relates to the confidence invested by all of the major political parties in the prospects for a manufacturing- and export-led rebalancing of the economy in the years to come. Here, one might think, the very depth of the UK recession might offer some comfort, for it has seen an effective depreciation of sterling (between the third quarter of 2007 and the second quarter of 2009) of just over 20 per cent.<sup>42</sup> This, it might be thought, would have led to a marked improvement in the UK's balance of trade position and a strong platform from which to move to a more conscious export-led growth strategy, as UK competitiveness has been improved by a falling currency. Yet the data show this not to have been the case, with the UK's balance of trade position in fact worsening since the height of the recession. Indeed, the contrast with Ireland is particularly stark and depressing, as Figure 4 shows. Ireland has in fact seen quite a significant improvement in its already impressive balance of trade position – despite the appreciation of the euro, despite its similar exposure to the bursting of an over-inflated housing bubble and despite now widely being cast as something of a basket-case economy.<sup>43</sup>

Two additional factors make the picture bleaker still. First, the global nature of the recession has led to a step-level decrease in the volume of trade as a percentage of global GDP, as the relative share of domestically sourced commodities has tended to grow in (shrinking) shopping baskets around the world. If previous recessions are anything to go by, this is unlikely to prove a temporary phenomenon – making export-led growth strategies more difficult to sustain and reinforcing the importance of domestic demand. This makes it very difficult even to think of the UK economy retaining, let alone expanding, its global market share. Second, this is merely compounded by alarmingly low levels of productive investment in the UK economy in recent years – during a period in which there was, ostensibly, a credit glut. With the very significant tightening of credit

<sup>42</sup> Simon Kirby and Ray Barrell, 'Prospects for the UK Economy', *National Institute Economic Review*, 209 (2009), pp. 42–59, p. 43.

<sup>43</sup> On the role of the housing market in the rise and demise of the Irish variant of the Anglo-liberal growth model see Hay et al., 'Ireland: The Outlier Inside'.

**Figure 4**  
*The UK's Worsening Balance of Trade*



Source: Office for National Statistics, Balance of Trade Dataset (UK); Central Statistics Office, External Trade Dataset (Ireland)

that has occurred in the UK economy since the recession and with a 40 per cent or so drop in the value of the commercial property against which credit lines for most small and medium enterprises are secured, it is difficult to envisage the transition to an export-led growth strategy built on the back of private investment; the parlous condition of the public finances would seem to preclude a programme of public investment to stimulate export growth. As a recent Bank of England Financial Stability Report notes, 'falls in commercial property prices have raised average loan to value ratios above 100 per cent according to industry estimates'.<sup>44</sup> The economy's capacity to raise capital to build a new export-led growth strategy capable of capturing new markets would seem rather limited; and the likely withdrawal of significant amounts of state support for human capital

<sup>44</sup> Bank of England, *Financial Stability Report*, London, Bank of England, December 2009, p. 7.

formation (as higher education budgets are squeezed) merely compounds matters.

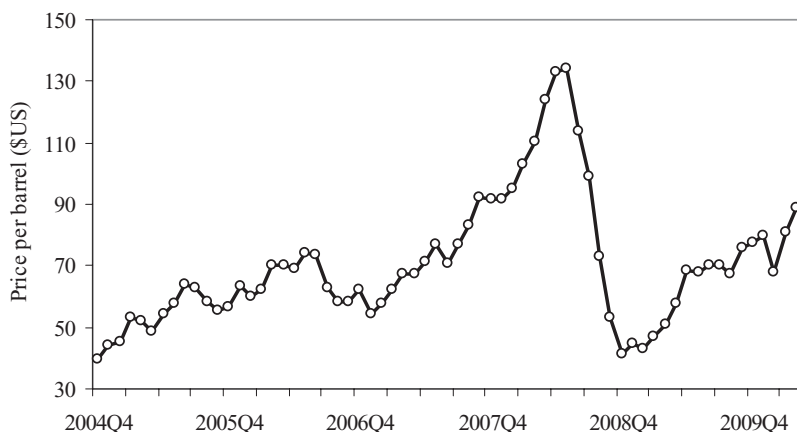
So much for export-led economic growth. What about the prospects of a domestic demand-driven resumption of consumer-led and private debt-financed growth? Arguably, it is precisely in this that the Brown government has placed its confidence – though that would seem to be more because it has little else in which to place its confidence than out of a genuine sense of optimism. If so, they would seem to have it about right, for this is no less problematic a route to growth. As I have argued elsewhere, before the bubble burst and recession, the UK economy started to enter a period of ‘stagflation’ for the first time since the 1970s. In response to rapidly rising oil prices, reinforced by speculative dynamics (and leading to a four-fold increase in the price of oil between mid-2004 and mid-2008), the Bank of England was forced to raise and to keep on raising interest rates, despite the adverse effect it was having on the housing market, consumption and growth. By mid-2007, as I suggested at the time, it was no longer capable of controlling inflation without precipitating a housing crash.<sup>45</sup> Indeed, its interest rate settings were sufficient to burst the housing bubble without controlling inflation. What ultimately brought inflation down was the onset of the US recession and the precipitous fall in oil prices (again, reinforced by speculative dynamics) that eventually and inevitably followed.

If this is true, then it is deeply worrying, for it reveals a fundamental and as yet unresolved structural frailty at the heart of the Anglo-liberal growth model in the UK. Arguably, the Monetary Policy Committee still lacks the capacity to control inflation without crashing the housing market. That would be fine if the low inflation–low interest rate equilibrium of the 1990s and early 2000s could be re-established, but the speculative character of oil price dynamics today makes that most unlikely. The point is that it would not even take the resumption of growth in the UK economy to see the price of oil rise steeply, bringing with it similar inflationary pressures to those which took us to the edge of the precipice last time. Almost certainly all that is required is the resumption of growth in the USA and that now seems established.

As Figure 5 shows, oil prices quadrupled in the years before the global recession and they have already doubled since their floor in

<sup>45</sup> Hay, ‘Good Inflation, Bad Inflation’, esp. pp. 473–7.

**Figure 5**  
*Brent Crude, Price per Barrel*



late 2008. Indeed, perhaps most worrying of all, their rate of growth in 2009 was as high as that from late 2006 until their peak in the second quarter of 2008. As more economies slowly make their way out of recession – and whether or not that includes the UK – the rate of increase in oil prices is only likely to rise.<sup>46</sup>

My story of the strange demise of the Anglo-liberal growth model in the UK is now almost complete. But there is one significant element to which I have yet to draw sufficient attention. It relates to the implications – both short term and long term – of the dislocation of public finances that the recession has brought. The point is a simple one, but painful nonetheless. The UK economy has endured the longest and deepest recession since the 1930s, but it is far from

<sup>46</sup> The impact of speculation in oil markets actually operates very much like an (albeit lagged) business-cycle-linked tax on oil use – when demand in the world economy rises, so oil prices are artificially inflated by speculative dynamics, and when demand falls they are artificially deflated by the withdrawal of such speculation. As this perhaps suggests, and perverse though it may seem, speculation in oil markets has arguably done far more to ration oil consumption in the last decade than any international agreement on energy use. That does not, of course, prevent it from being a major impediment to the resumption of Anglo-liberal growth – though it does suggest that if we were less tolerant of Anglo-liberal growth models, we might be more tolerant of speculation in oil markets (or, better still, to a form of taxation on oil use tied to the price of oil futures) as a mechanism for oil rationing (and one which also has the benefit of being counter-cyclical).

over. At best, the private sector recession is over; but the public sector recession has yet to commence. In a sense we are (at the time of writing – March 2010) experiencing the lull before the post-election storm. When it comes, as inevitably it will, unemployment will rise steeply, demand will fall and, once again, property prices will tumble. When that recession and the period of austerity to which it is likely to give rise is over, the UK will have lost a growth model and, in the attempt to save it, much of the welfare state that it built to support and nurture the previous one. We can but hope that by then it will also have discovered a new growth model and the strategy to negotiate a long and inevitably difficult transition; for that to happen we will need, not just the further accumulation of pathologies, but crisis too.

## CONCLUSION

What of the prospects for the resumption of Anglo-liberal growth elsewhere? Here there are at least some crumbs of comfort in the preceding, otherwise unremittingly bleak, analysis. The first comes from Ireland where, despite a similarly over-inflated housing bubble and a similarly catastrophic bubble burst, a rebalancing and reorientation of the economy is arguably already underway (see Figure 4). But although this is certainly encouraging, it is not altogether surprising, for the Irish growth model was always more complicated and multifaceted than its more narrowly Anglo-liberal UK counterpart.<sup>47</sup> The Irish economy would undoubtedly have grown in the absence of house price inflation throughout the ‘great moderation’ (and at a pretty decent rate). That, alas, simply cannot be said for the UK economy.

And what of the USA – the home and heartland of Anglo-liberal growth? Here, too, there are at least some grounds for optimism going forward – certainly in comparison to the UK case. Much, of course, will depend on the degree to which a new global financial architecture emerges in the years ahead and the balance between prudential regulation and risk/growth that it strikes. But it is

<sup>47</sup> See Colin Hay, Nicola Jo-Ann Smith and Matthew Watson, ‘Beyond Prospective Accountancy: Reassessing the Case for British Membership of Single European Currency Comparatively’, *British Journal of Politics and International Relations*, 8: 1 (2006), pp. 101–21; Hay et al., ‘Ireland: The Outlier Inside’.

unthinkable that US securities will again be allowed to pose the same degree of risk to the global financial system as they did in 2007. Moreover, stripped of some of its excesses, there are reasons for thinking that the US variant of the Anglo-liberal growth model can be revived – albeit in a way that will almost certainly deliver lower growth. Two factors are key here. First, though the contagion did spread from US mortgage-backed securities, the US housing market was far less central to US growth and rose far less steeply than its UK and Irish counterparts. Second, as I have sought to show, because of its sheer size and systemic significance, the US economy is somewhat less exposed (though of course far from immune) to inflationary shocks arising at least from speculative dynamics in oil markets, since the signals to which such speculation typically responds are so closely aligned to US demand. If there is, then, a general lesson that can be drawn from the preceding analysis, it is surely this. Anglo-liberal growth is an inherently risky business; but the less closely aligned one's business cycle is with the US economy, the more risky it is likely to prove.