The crisis: an historical perspective

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Introduction

As a student at Cambridge in the mid-1970s I was fortunate enough to be taught by a great medieval historian – Walter Ullman. Ullman liked to say that the task of the historian was to explain 'how and why we came to be where we are today'. So what I would like to do in this piece is to attempt an historical explanation, in other words one rooted in a study of the past, of the crisis we are living through now.

The crisis has been characterised by a massive failure of the financial system at home and abroad – the life blood of capitalism – and by low growth (at best), recession, contraction of spending by the state and the individual (both seeking to run down debt), mass unemployment and deepening poverty – especially in Greece, Spain, Portugal and the USA, for example. It is an epoch-making event and its consequences will be profound.

If we want to see how and why this crisis has developed, then I think we need to go back to the late 1970s. Why? Because what we are experiencing is rooted in changes within the post-war politico-economic order, both international and national, which became obvious in that decade; and it is these changes and their impact we must therefore examine.

I

It seems to me that the key to understanding what has happened is to be found in two different versions of liberalism. We can call these 'embedded liberalism' and 'neo-liberalism'. During the period from the end of World War Two until 1979-80, it can be argued, western societies and states operated on the principle of *embedded liberalism*, a term developed by an

American political scientist called John Ruggie in the early 1980s. What this expression means is a politico-economic system based on a compromise between planning and the free market. The post-war state, seeking to avoid a return to the conditions of mass unemployment and social and economic insecurity whose consequences had proved so destructive, committed itself to sustaining through its own spending an overall level of economic activity ('aggregate demand') capable of generating the full employment of labour and capital. This was supplemented by support for welfare states financed by progressive taxation and the proceeds of economic growth. Workers enjoyed job security and good pensions while successive governments sought co-operation with both sides of industry – in other words management and unions – to promote new investment, innovation, productivity improvements and support for new and emerging industries (for example IT, aerospace technology and nuclear power).

This model was visible here in the UK as well as throughout much of Western Europe, whatever political parties were running the government. It was also present, albeit in less pronounced form, in the USA. Although key industries (such as coal, steel, the railways, gas and electricity in the UK) tended to be publicly owned, these were not socialist politico-economic systems since there was a large space for the free market and private enterprise within all of them. However the market was *embedded* within a set of rules, regulations and norms whereby the true purpose of government was dedicated to the preservation of what President F. D. Roosevelt identified as the 'Four Freedoms' – freedom of speech and expression, freedom of worship, freedom from want and freedom from fear.[1] Note that there was no place for 'freedom of enterprise', which was seen as a servant of society, a *means* to progress and not an end in itself. And I suppose one could add that this philosophical position was materially embodied in the widespread existence of controls on the movement of capital between nations, in the interests of social and economic stability.

1 David Thomson, *World History from 1914 to 1950* (Oxford: Oxford University Press, 1954)

This 'embedded liberalism', or social democracy as it was more commonly known, had several founding fathers (including Roosevelt); but perhaps the most important of them all was the economist John Maynard Keynes, whose work had shown that the state could manage economies to preserve full employment and growth. And indeed the record of this Keynesian social democratic order was startlingly good for the best part of thirty years. Western societies enjoyed years of prosperity. Unemployment all but disappeared. Living standards improved dramatically and millions of working class people were able for the first time to afford material comforts and conveniences – a car, a telephone, a fridge, a washing machine, a television set, foreign holidays – which had been the preserve of the rich and of the professional middle class. This was the age of affluence.

II

In the thirty-odd years since 1979 this form of political economy has to a greater or lesser degree been replaced by one based on *neo-liberalism,* or 'economic liberalism' (the ability to continue describing the system as 'liberal' is important, as I shall argue later). In my view it is in this metamorphosis that we can see the origins of the current crisis.

Why did the old system break down? It ran into crisis in the mid-1970s. For example there was the phenomenon of 'stagflation', meaning a combination of minimal growth and high inflation, in the USA and the UK. Unemployment started to climb to levels not seen since the war (it reached one million in the UK in 1975). These pressures on living standards ignited a debate which had been bubbling away among economists for several years. One set held that the cause of social democracy's woes was the jump in the oil price in 1973/4, an event which simultaneously pushed up costs for industry and the consumer while causing a sharp reduction in purchasing power (the availability of money to spend). Another took the view that the problems lay within the system rather than coming from outside it. The first of these groups could be called, loosely, 'Keynesian'. The second group was, however, loyal to different mentors. Their inspiration was the Austrian-born economist and philosopher F. A. von Hayek and the Chicago-based economist Milton Friedman.

The followers of Hayek and Friedman said that social democracy (embedded liberalism) was fatally flawed. The state could never possess enough information to run a modern economy. If it tried to erect a system of knowledge and values to this end it would end up as either a Communist or Fascist dictatorship. It could not allow people to think and act as they wished since it would be claiming a superior wisdom. Moreover its efforts to manage the economy at full employment levels of output had generated inflation because it had consistently been spending more money than justified by the nation's capacity. The followers of Hayek and Friedman – calling themselves economic liberals and monetarists (the latter because of the importance they attached to the role of money in the economy) – argued that inflation had continued to mount since the early 1960s despite the attempts of governments in the USA and the UK to suppress rising costs through price controls and agreement with both sides of industry on appropriate levels of pay and dividend increases ('incomes policy'). Why? Because prices had been forced up as a result of too much money chasing not enough goods. The excess of money had been caused by governments, which had bought support from lobbies in business, the public sector and the unions by funding industries which were unproductive, welfare programmes which were too expensive and pay settlements which would not have been affordable had the negotiations been based on what companies could actually afford. When the government of Edward Heath had tried to break out of this cage by resisting the demands of the miners for a rise which exceeded what was allowed under his pay policy, there was a bitter industrial dispute and a three day week, followed by a General Election which he lost. Finally, the willingness of governments to mediate in disputes between employers and unions had undermined the power of managers and entrepreneurs to take key decisions relating to location of industry, appropriate wage and salary levels, plant closures and rationalisation.

The British Wilson-Callaghan governments of 1974-79 had tried to deal with the problem of stagflation in a way consistent with social-democratic norms – planning and incomes policy. For a time this seemed to be working, but the pay policy failed to command union backing after the summer of 1978. Municipal and hospital workers rejected it, and the winter of 1978-9 saw a series of stoppages which caused great inconvenience to the public while suggesting that the government had (like Heath five years before) lost control of events. The fallout cost Labour the 1979 General Election and let in Mrs Thatcher's Conservatives.

This is where the great change really started. The Thatcher governments, in power from 1979-1990, were increasingly dominated by disciples of Hayek and Friedman. Leading Cabinet Ministers such as Chancellors Sir Geoffrey Howe (1979-83) and Nigel Lawson (1983-89) and Industry and then Education Secretary Sir Keith Joseph (1979-86), believed that the crisis of stagflation and ungovernability (as they saw it) could only be resolved if the state were to be scaled down in size and function and the power of the unions dramatically reduced. At the same time they sought to free the market (in other works un-embed it) from the network of regulations and practices within which it had operated since 1945. Both the Thatcher government and the Reagan administration in the USA, elected in 1980, wanted to liberate entrepreneurs and capitalists so that they, and not the state in conjunction with managers and unions, would be the drivers of the modern economy, deciding what to produce, where to produce it, how much to invest and how many workers to employ at a rate which would leave space for profit.

It followed that there was a distinct trend to de-regulation, especially in the financial sector. Britain saw the abolition of hire purchase controls, the de-mutualisation of building societies, the removal of controls on bank lending and the opening up of the City of London to foreign capital (a consequence of the so-called Big Bang in 1986). Both the UK and the USA sharply reduced taxes: in Britain the top rate fell from 83 per cent in 1979 to 40 per cent in 1988, while in the USA the highest personal tax rate was reduced from 70 per cent to 28 per cent between 1981 and 1986. In both countries government strove to reduce the influence of the trade unions over decisions regarding macroeconomic policy and industrial strategy. This led to bitter confrontations which the unions lost – most famously in the case of the air traffic controllers in the USA (1981) and the miners in the UK (1984-5). In each case, the defeat of the unions was followed (not always immediately) by privatisation.

The outcome of the conflicts with the air traffic controllers in the USA and the miners in the UK was indicative of the tendency of economic power to shift away from labour and the state towards capital. The unions were usually unable (except with the Post Office in Britain in 1994) to prevent governments from privatising key industries and from reducing financial support and subsidies for others. This process was justified by the argument that in order to ensure the economy modernised it was essential that capital be allowed to move freely into the sectors providing the best rate of return. Large swathes of industry, especially in coal, steel and engineering, contracted sharply. The new strategy saw the abandonment of the post-1945 commitment to the maintenance of full employment, joblessness rising by the mid-1980s to 10 per cent of the workforce in the USA and to almost 12 per cent in Britain.

The contraction of industry and rise of unemployment led to a marked fall in labour's share of the national product. In the USA 'the ratio of the median compensation of workers to the salaries of CEOs increased from just 30 to 1 in 1970 to nearly 500 to 1 by 2000'. [2] In the UK the share of wages in GDP fell from a peak of 65.1 per cent in 1975 to 53.2 per cent in 2007.[3] Profits have risen as a share of the GDP even as manufacturing industry contracted along with wages – the

2 David Harvey, *A Brief History of Neoliberalism* (Oxford: Oxford University Press, 2007) p. 16

3 Stuart Lansley, *Life in the Middle* (London: TUC Touchstone pamphlet no. 6, 2009) p. 25

former dropping from almost 30 per cent of all UK output in 1979 to just over 11 per cent by 2010.[4]

As industry shrank so the proportion of economic activity derived from financial services started to rise. In Britain it grew from less than 6 per cent in the 1980s to over 10 per cent in 2007, expanding at a rate of 6 per cent a year in the decade before the crisis (faster than in most developed economies) while overall GDP growth over this period averaged 3 per cent.[5] This rise of the financial sector in the UK and the USA can be traced to the expansion of footloose capital flowing between the USA and Western Europe in the 1960s. Initially fed by the profits of multinational corporations and known as the Eurodollar market (dollars banked in Europe, especially in London with its light regulations and rewarding deposit rates), this was expanded during the 1970s by the governments of oil-producing states seeking remunerative outlets for their new found wealth. A further surge in the volume of these funds occurred in the 1980s, driven by the profits arising from the corporate merger wave of that decade. The need to ensure good returns to the owners of this wealth and to the banks (mostly international) which handled it, led to the development of 'financial derivatives'. These are at the heart of what is called the 'shadow banking system' of non-bank financial intermediaries often located in tax havens and composed of hedge funds, money market funds and structured investment vehicles. They trade most commonly in the property and currency markets, insuring these deals through credit default swaps; bet via the futures market on exchange rates, pollution rights, commodity prices and the weather; and it is now clear, handle funds arising from criminal activity.[6]

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4 Scott Newton, 'UK Manufacturing Decline is the Real Story of the Budget', *History and Policy Opinion*, 5 May 2009.

HM Department for Business, Innovation and Skills, *Manufacturing in the UK: Supplementary Analysis*, Economics Paper no. 10B (December 2010) figure 1, p. 2

5 Stephen Burgess, 'Measuring Financial Sector Output and its Contribution to UK GDP', *Bank of England Quarterly Bulletin*, Q3, 2011, Charts 1 and 2.

6 Nicholas Shaxson, *Treasure Islands: Tax Havens and the Men who Stole the World* (London: Vintage, 2011)

These markets were trivial at the start of the 1990s but by 2005 they were circulating nearly £250 trillion (global output being just $45 trillion), and, according to one estimate $600 trillion by 2008.[7] The increasing dynamism of this sector of financial services even led manufacturing companies to shift to financial operations, frequently linked to property development. A case in point is M and B – once Mitchells and Butlers Brewery, located in Birmingham. Ten years ago they divested their brewing activities and went into the buying and selling of pub, hotel and catering chains.

III

The freedom for capital which is at the heart of neo-liberalism led, through the taxation system, profits, share options and bonus payments, to vast inequalities throughout the developed world as those who invested and managed money in the derivatives market amassed great fortunes. Of course, had the shift from embedded liberalism to neo-liberalism been just about the transfer of wealth it may have generated a lively and widespread popular reaction. It did not however do this. Just as post-war liberalism appealed to a significant fraction of society – workers, farmers, managers and the professions, for example – so neo-liberalism had its attractions. It drew support not just from bankers and business owners but from many in the middle class aspiring to an affluent life style. It offered them 'freedom' – not Roosevelt's Four Freedoms but freedom from high taxes and inflation on the one hand and on the other freedom to own property and to realise one's own idea of the good life whether this was in the form of shopping (which also helped to drive consumer spending) or sexual self-expression. The core ideological appeal of neo-liberalism therefore lay in its identification with 'individualism', a concept it elevated over 'society' (as Mrs Thatcher did when she said, 'There is no such thing as society, only individuals and their families.') The

7 David Harvey, *The Enigma of Capital and the Crises of Capitalism* (London: Profile Books, 2011) p. 21

problem facing neo-liberalism, therefore, was not how to generate popular consent. It was how it could continue to reproduce itself beyond the time-limits of electoral cycles so that its assumptions became the automatic 'common sense' by which the state, the media, civil society and ordinary people operated.

The fundamental requirement was for consumers to buy all the products, real and financial, now pouring onto the market. Where were they to be found in large enough numbers to sustain the profitability of the system, given labour's falling share of the national product, growing inequality and the persistence of high unemployment (by the standards of 1945-75) for much of the time since 1980? The difficulty was resolved by the availability of credit and its elaborate refinement in the products offered by banks and financial vehicles. The global market which had developed in finance facilitated significant inflows of foreign capital into the USA and Britain (masking the trend to trade deficits in both countries). The vast sums of money washing round London and New York as a result flowed via corporate tax and asset and bond purchases to governments (so helping to finance the expansion of the welfare state under Blair and Brown) and, via banks, building societies and finance companies, both to businesses and to millions of private citizens. Lending expanded, personal and corporate borrowing mushroomed. The most spectacular examples of this occurred in the UK, where debt rose more rapidly than in any other developed nation between 1990 and 2011, by which time it accounted for 507 per cent of GDP (second only to Japan, where the overall figure had been over 400 per cent for more than twenty years).[8] Four-fifths of this debt was in the *private* sector. The process had been built largely on the belief that asset prices, notably property, would continue to rise indefinitely. And indeed the returns from speculative ventures were so lucrative that a giant inverted pyramid of lending developed, in the UK, USA, Ireland and Spain for example.

8 Charles Roxburgh, Susan Lund *et al, Debt and Deleveraging: Uneven Progress on the Path to Growth*, (New York: McKinsey Global Institute), January 2012, p. 5, Exhibit E4

IV

The era of debt-driven growth stalled in 2007-8, following the development of problems in the US housing market. Asset prices started to fall, in the process revealing individuals and corporations to be carrying obligations they were in no position to discharge. Money and credit disappeared from the system as mortgage foreclosures and bankruptcies started to multiply. Building societies and banks were nationalised, wholly or in part, in order to prevent the breakdown of the entire financial system. The cushion of lending which had sustained living standards in the UK, for example, deflated fast. Resources in and the output of the manufacturing sector were simply inadequate to compensate, and from late 2010 until last year growth was very sluggish. There has been a return to more robust growth in the last twelve month but this has been underpinned in part by yet another spike in asset prices, driven by the 'Help to Buy' scheme. The government talks about the need to 'rebalance the economy', towards the production of goods rather than of money, but little progress has so far been made in what is bound to be a long and difficult exercise.

Britain's crisis is one shared by countries throughout much of the developed world. The events of the last five years are the outcome of a process which started between thirty and thirty-five years ago. It was during that time that the social democratic norms of embedded liberalism which had lasted since World War Two were replaced by ones consistent with neo-liberalism. The transformation was not of the same intensity in every case, the outcome of these reinventions of state and society being dependent on local traditions. For example, the entrenched power and international connections of the financial sectors in the UK and the USA guaranteed that the changes there would be more dramatic than in much of Western Europe.

What is the way back from this crisis? Whatever the mix of policies and strategies required it seems that one essential will be a return to the embedding of the market within state and society. Let me end by quoting the political philosopher A. D. Lindsay, who wrote (and it is no accident that this was in 1942):

> 'We have to recognize that the connection between democracy and *laissez-faire*, or what is sometimes called a negative conception of the State, is accidental and arises from historical circumstances. The purpose of the State in a democratic society is to maintain the democratic nature of that society, to remove the disharmonies and dangers which threaten its democratic life. If democratic life is strong and healthy, the State need do little; but if that democratic life is threatened not just by plain disorder and crime within or hostile attack from without, but by more subtle and insidious forces, whether social or economic, the State is called upon to assume a much more positive function.' [9]

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9 A. D. Lindsay, *Toleration and Democracy* (1942) p. 8