The Political Origins of Our Economic Discontents: Contemporary Adjustment Problems in Historical Perspective

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The financial crises and great recession that began in 2008-09 have been the worst experienced by the developed democracies since the Second World War. What are the problems facing these political economies in the wake of recession, and what adjustment paths can they be expected to take in the coming years? These are economic questions, about the sources of demand and supply in a chastened world, and political questions, about how the will to adjust is generated. Such issues can be approached in various ways, but my premise is that, in the political economy as in the forest, if we want to know where we are going, it is useful to know where we are coming from. Therefore, this chapter places the dilemmas of the present in the context of an analysis of how the OECD economies addressed parallel challenges in the decades after 1945.

My account is grounded in a perspective emphasizing the architecture of the political economy, which sees the political economy as a set of interdependent institutional structures, encompassing organizational relations among economic actors, the policy regimes supporting those relationships, and the international regimes underpinning them (cf. Eichengreen 1996). The chapter takes up three issues. Drawing on a well-established literature, I outline the institutional architecture of the developed political economies during the 1950s and 1960s. But we do not have parallel accounts for the 1980s and 1990s. Therefore, I ask: what are the principal features of the architecture of the developed political economies over the last thirty years? The analysis yields a set of claims about the economic formulas underpinning economic growth in the recent era but generates another issue, namely, on what political conditions did these new growth models depend? The institutions of the political economy do not spring full-blown from the head of Zeus. My objective is to go beyond accounts that treat the success of national economies as matters of effective institutional engineering to inquire into the politics that makes such models possible. Finally, I ask: what are the implications of this analysis for the trajectory of economic and political adjustment today?

The Institutional Formulas of the Keynesian Era

The operation of the developed political economies during a post-war era that stretched from the 1950s into the 1970s provides a baseline against which subsequent developments can be assessed. These were decades of high growth, when the size of the German economy quintupled, the French quadrupled, and the British tripled. Of course, post-war growth had many sources, including a transition from agricultural to industrial production (Crafts and Toniolo 1996). But there are strong grounds for thinking that the economic success of these years also depended on a set of institutional frameworks and supportive policy formulas, nicely described by the regulation school of economics (Boyer 1990, Boyer and Saillard 2002)

Modifying their formulations slightly, we might say that the success with which a political economy secures economic growth and social peace depends on arrangements in four institutional fields. The first is that of the production regime, reflected in the organization of firms, of work relations and of the production process more generally. The second is the industrial relations regime, marked by the ways in which trade unions and bargaining over wages and working conditions are organized. The third is the socioeconomic policy regime, which distributes the fruits of production, including who secures work on what terms and what social benefits go to those who do not get paid work. The fourth is composed of the international regimes relevant to the operation of domestic political economies, including those regulating trade, exchange rates, and international finance.

During the 1950s and 1960s, mass production in industry was at the heart of the production regime. Using Fordist techniques, the production of complex goods was divided into simpler tasks, often accomplished by semi-skilled workers on automated production lines. One result was rapid productivity gains, as laborers who had been only marginally productive on the farm could be mobilized to create products of higher value (Boyer 1990). The expansion of industrial production was crucial to the resolution of the unemployment problem following the Second World War.

However, mass production requires high levels of long-term capital investment likely to be forthcoming only if profits are high enough to provide a good return and investors are assured that aggregate demand will rise steadily over the long term. For these purposes, reforms that established regularized collective bargaining in this period were crucial. By giving the trade unions an assured role in wage determination, these reforms empowered the unions to win steady wage gains, which fueled aggregate demand, but gave them incentives to leave room for profits because they had the strength to punish firms that did not translate those investments into subsequent wage gains (Przeworski and Wallerstein 1982, Boyer 1990, Howell 1992, 2005).

The socioeconomic policy regimes of this era, built around the development of a Keynesian welfare state, were also crucial to sustaining aggregate demand. Although countercyclical fiscal policy was practiced actively in only a few countries, and with more fanfare than effectiveness, the Keynesian principle that governments would 'manage the economy' underpinning policy regimes across the developed world, including indicative planning in France, the social market economy of Germany and the Rehn-Meidner model of Sweden, increased the confidence of investors and consumers about the trajectory of employment and aggregate demand (Hansen 1968, Hall 1989, Sally, 2007, Martin 1979). The increasingly-generous social benefits of the Keynesian welfare state gave workers enough assurances about their incomes during retirement or periods of unemployment to persuade them to invest in skills and to spend, rather than save, their income, thereby sustaining demand (Estevez-Abe *et al*. 2001).

As Eichengreen (1996) has observed, the international regimes established after the Second World War were equally important. The General Agreement on Tariffs and Trade and the European Economic Community made possible steady increases in demand through trade, while the European Payments Union and Bretton Woods monetary regime provided a stable monetary framework for that trade and limited the extent to which nations could secure protection via exchange-rate manipulation. In contrast to their inter-war predecessors, these regimes were designed to accommodate the social benefits and activist fiscal policies of Keynesian welfare states (Ruggie 1982).

Of course, this is a stylized portrait that emphasizes similarities across countries in order to highlight the subsequent changes that took place, deemphasizing important national variations (Piore and Sabel 1982, Streeck 1991, Hall and Soskice 2001) However, the developed political economies had a distinctive institutional architecture during the 1950s and 1960s, marked by Fordist production regimes, organized collective bargaining, a Keynesian welfare state, and outward-looking international regimes.

Where did this institutional architecture come from? What made it possible? Its origins are complex and inflected by national histories (Shonfield 1969, Manow 2001, Streeck and Yamamura 2001, Thelen 2004, Iversen and Soskice 2009). However, to see this institutional architecture as economically-determined, as some do, is to miss important parts of the picture. The collective bargaining arrangements, socioeconomic policies and international regimes of the Keynesian era had explicitly political roots. Three sets of factors, each quite political, made the development of these regimes possible during the 1950s and 1960s

The first was a historical memory, still fresh in the public mind during the 1940s and 1950s, of the intense class conflict that had polarized electoral competition in the 1920s and 1930s, in the shadow of mass unemployment and a Bolshevik revolution, , often with disastrous consequences manifest in the collapse of the Weimar Republic (Abraham 1988). The political elites of Western Europe and America left the Second World War concerned to avoid the social unrest of the inter-war years, and a new Cold War reminded them of its continuing relevance (Maier 1981). Thus, concerns about class conflict provided much of the initial *motivation* for the construction of the Keynesian welfare state.

The *means* were provided by Keynesian ideas applied in diffuse forms across a wide range of countries. Those ideas gained economic credibility, as they were taken up by post-war economists, and they had political appeal, because they provided the rationale for a class compromise that had eluded interwar governments (Hall 1989, Fourcade 2009). At the heart of this compromise was the notion that, through active fiscal or industrial policy, governments could ensure full employment, the key demand of the working class, without depriving businessmen of control over the means of production, the key demand of capital. At conferences from Brighton to Bad Godesberg, this formula encouraged mainstream parties of the left to make peace with capitalism, and it allowed parties of the political right to accept responsibility for employment without alienating their business allies (Offe 1983).

However, the *motor* driving the construction of the Keynesian welfare state was the logic of partisan electoral competition in the 1950s and 1960s. At a time when social class still structured much of the vote and parties of the political left claiming to represent the working class were ranged against middle-class parties seeking cross-class appeal, class-based distributive issues held center stage, and parties on both sides of the spectrum began to offer social benefits and assurances about active economic management in return for political support. The result was a new kind of political convergence around the managed economy and welfare state from which only those at the margins of the political spectrum in Europe and America dissented (Lipset 1964, Shonfield 1969, Beer 1969).

The institutions of collective bargaining were built for similar reasons and in much the same way. Governments of both the left and right supported the extension of collective bargaining partly in order to move class conflict out of the political arena into an industrial relations arena where it could be contained (Pizzorno 1964, Goldthorpe 1984). By enabling trade unions to secure better wages and working conditions, they hoped to weaken the abilities of more radical arms of the left to exploit issues of class in electoral politics. Even the shape of the international institutions built in this era was influenced by such concerns. The architects of those regimes designed them to accommodate the policies of the Keynesian welfare state, precisely because they faced a Cold War mindful that communist parties were important actors in the politics of some leading western democracies (Ruggie 1982, Maier 1981).

In short, the institutional architecture of the post-war political economies rested on a particular set of political conditions defined by the prominence of class in the politics of the day. If concerns to avoid class conflict provided the initial impetus and Keynesian ideas the means, class-oriented electoral competition drove the development of those institutions forward.

From the perspective of this analysis, the 1970s were years of transition, when the institutional architecture of the Keynesian era broke down, partly under the weight of its own liabilities and partly in response to international developments of which large increases in commodity prices and the collapse of the Bretton Woods monetary regime were the most important.[1] The result was stagflation, characterized by high levels of unemployment and inflation. In response to it governments turned to more interventionist measures. In coordinated market economies, where wage bargaining could be coordinated by relatively powerful trade unions and employer associations, governments turned to neo-corporatist bargaining to contain inflation, often with favorable results (Schmitter and Lehmbruch 1979; Goldthorpe 1984). In liberal market economies, where decentralized systems of wage bargaining threatened wage-price spirals, governments often resorted to incomes policies that imposed direct controls on wages and prices. As a result, distributional conflict shifted from the industrial to the political arena. Many governments increased social spending and subsidies to industry (Berger 1981).

However, the failure of Keynesian policies to restore previous rates of growth discredited existing policy formulas and set governments in search of new ways to cope with what was often described as ‘Eurosclerosis’ (Hall 1993). The result was was a profound backlash against state intervention. In liberal market economies, where unwieldy attempts at incomes policies fostered political conflict over wage differentials, the authority of the state suffered amidst crises of governability soon linked to apprehensions of national decline (Crozier *et al*. 1974, Krieger 1986). This was the tide that Margaret Thatcher and Ronald Reagan rode to power. The impact of this political backlash was immense. The climacteric of the 1970s would become for the 1980s and 1990s the analogue to what the interwar years had been for the postwar generation, a totemic set of events that would condition the course of policy for another generation (cf. Kingdon 1995, Sewell 1996).

The Institutional Formulas of the Neo-Liberal Era

Can we identify an analogous institutional architecture for the subsequent ‘neo-liberal era’ from the 1980s to the 2000s, whose component parts reinforce one another to produce distinctive aggregate and distributive economic outcomes?[2] In broad terms, this architecture is visible.

With respect to the production regime, this era is defined by two central developments. One is a shift in employment and production away from industrial manufacturing to services, including high-end sectors supporting some well-paid employment, such as health care and finance, and low-end sectors, such as retailing, restaurants and tourism, where many positions are low-paid. The second is a shift away from Fordist modes of production toward methods that make more intensive use of knowledge, embodied in skilled labor, new information technologies and global supply chains (Womack *et al.* 1991).[3] Enterprises once interested in vertical integration have turned to outsourcing, often to global supply chains that exploit advances in transport and information technology (Berger 2005). In the developed democracies, the traditional Fordist enterprise is now largely a thing of the past and semi-skilled industrial labor in less demand.

These changes in the production regime were promoted by developments in international regimes, which led to greater flows of goods and capital across national borders (Berger and Dore 1996; Keohane and Milner 1996). One of Margaret Thatcher's first acts was to eliminate currency controls and other nations soon followed suit. The Single European Act of 1986 and new trade agreements, such as the Uruguay Round, promoted the movement of low-cost manufacturing off-shore, thereby inducing a shift to services and knowledge-intensive manufacturing in Europe and America (Wood 1994, Leamer 1996, Antras *et al*. 2006).

Collective bargaining arrangements changed in tandem with these developments. More intense global competition opened up cleavages in some bargaining systems, between more and less competitive firms and between the traded and sheltered sectors (Pontusson and Swenson 1996, Thelen and Kume 1999). As a result, the locus at which bargaining is coordinated shifted downwards in many countries, and firm-level bargaining became more important, as firms sought lee-way to reorganize production in the face of global competition (Iversen 1999; Lallement 2007). The power of trade unions declined, as average trade union density in the OECD dropped from 33 percent in 1980 to 18 percent in 2008. These developments helped firms adjust to international competition at the cost of leaving many workers outside the scope of collective agreements.

The socioeconomic policy regime also changed dramatically in the 1980s and 1990s. If Keynesians had treated unemployment as a demand-side problem requiring active macroeconomic management, the new policy formula treated unemployment as a supply-side problem that could be addressed only by structural reforms to labor, capital and product markets. Industrial policies targeted on promising industries gave way to manpower policies designed to push people into employment. Symbolic of these shifts were steps taken in the 1990s to make many central banks independent of political control.

In many respects, these developments fit the circumstances of more open economies, where the effects of a fiscal stimulus would leak abroad, as the governments of small northern European states had long realized. While governments made modest efforts at macroeconomic management, under the aegis of a 'new Keynesianism' on which economic doctrine gradually converged, most pinned their hopes for growth on the expansion of trade and services. There was some variation in national strategies. The Nordic countries made extensive use of public employment to create jobs in services without lowering wage floors, while structural reforms that promoted low-wage employment in services by making part-time work, temporary employment, and lay-offs more feasible were more prominent features of liberal market economies and subsequently continental coordinated economies (Esping-Andersen 1990, 1999, Iversen and Wren 1999; Scharpf and Schmidt 2000). In the latter, manpower policies were also used to expand employment in services via large subsidies to employers. Measures that weakened the trade unions lifted profits in the liberal market economies, while coordinated wage bargaining was used to restore profits and competitiveness in the coordinated market economies.

In short, the production regime, industrial relations regime, policy regimes and international regimes of the neo-liberal era reinforced one another, much like those of the earlier Keynesian era. However, the economic results were quite different. Wage inequality rose significantly in the 1980s and 1990s, especially in liberal market economies, and rates of growth were slower than in previous decades, partly because productivity gains are harder to secure in services than in manufacturing.

The Political Formula of the Neo-Liberal Era

How is this shift in institutional architecture to be explained? Most accounts cite the inexorable pressures of globalization, which played a role, but the international regimes that opened up emerging markets were created by governments. Global competition put enormous pressure on firms to change their business practices, and those firms lobbied governments for supportive policies (Keohane and Milner 1996, Berger and Dore 1996). In an era of slower growth, governments saw many of these policies as the most feasible way to create jobs in services. However, to view the institutions and policies of this era as a 'natural' response to economic circumstances is to neglect the extent to which they had to have a political underlay. The institutional reforms and policy formulas of this era were not simply reflexive responses to economic conditions but artifacts of a certain kind of politics. Therefore, we need to ask: what were the political conditions that made this new architecture possible?

The answer is not obvious. I have argued that the Keynesian welfare state can be seen as a class compromise, but from this perspective the neo-liberal era is paradoxical. It has not delivered benefits in anything like equal measure to both sides of the class divide. Across most of the developed political economies, the incomes and well-being of the affluent have risen significantly faster than those with incomes below the median, and in many countries even median real income has been stagnant (Hall and Barnes forthcoming). If it is difficult to see the policies of the neo-liberal era as a class compromise, how were they inspired and on what did they depend? To answer these questions, it is useful to look back at the political conditions that underpinned the construction of the Keynesian welfare state. I have argued that it was motivated by a historical memory of the interwar years, given shape by Keynesian economic ideas, and put into place by electoral competition around a class cleavage. The same kinds of elements were central to the transition to neo-liberal policies, but in new forms dictated by the historical circumstances of the 1980s.

If the Keynesian welfare state was inspired by the specter of class conflict in the 1920s and 1930s, the neo-liberal policies of the 1980s and 1990s were, in the first instance, a reaction to the traumatic events of the 1970s, marked by stagflation, sharply-reduced rates of growth and, most important, more assertive government intervention, whose failure discredited state intervention more generally. Disillusioned by what was widely seen as the failure of activist policies, political elites emerged from the crises of the 1970s looking for alternative policies and inclined to think that renewing market competition might be a better way of reviving economic growth than further state intervention. Across the OECD, the crisis of the 1970s provided the initial *motivation* for the shift to neo-liberal policies. Of course, structural reforms of the sort then implemented often entailed assertive state action and measures presented as 'deregulation' were effectively reregulation, but the common denominator behind these policies was their objective, which was to intensify market competition and increase the role of markets relative to states in the allocation of resources (cf. Gamble 1994; Vogel 1998)

The *means* for this shift were supplied by a 'new classical economics' built on monetarist foundations. Although available in some form since the 1960s, monetarist economic perspectives remained a minority view in economics until the 1980s, when, bolstered by a wave of work built on rational expectations frameworks, they were assimilated into mainstream economic doctrine. By the middle of the 1980s, the result was an economic orthodoxy skeptical about the value of active macroeconomic management and convinced that countries face a 'natural rate of unemployment' reducible only by structural reforms (Crystal 1979; Cuthbertson 1979). These doctrines gained economic credibility as they secured traction within the economics profession, and they had considerable political appeal for politicians interested in shifting the blame for high levels of unemployment from governments to markets and the behavior of market actors. During the 1980s and 1990s, party platforms on both the left and right of the political spectrum shifted in neo-liberal directions (Iversen 2006, Cusack and Englehardt 2002).

In democracies, however, changes in the views of elites are rarely enough to explain major changes in the direction of policy (Hall 1993). We also have to ask: what changed in the realm of electoral competition to make the market-oriented policies of the neo-liberal era feasible? In particular, because the effects of those policies were so adverse for large numbers of workers, whose jobs became more insecure, social benefits were reduced, and incomes rose only slowly, we have to explain why parties running on platforms opposed to them in the name of working class defense did not emerge and win elections.

The answer is that those policies were made possible by a fragmentation of the electorate. In the years after 1970, the electoral space in most of the western democracies became disorganized, in ideological and institutional terms. Longstanding divisions, typically rooted in class or religion, that had been important to electoral politics for almost a century lost their hold over the attitudes of the electorate. The most obvious indicator was a decline in the class alignment of the vote, but the important change was one in consciousness – in how people thought about politics (Dalton *et al*. 1984, Clark and Lipset 2002).[4] The result was a permissive electoral dynamics, in which effective electoral coalitions for neo-liberal policies were rarely formed, but the opposition that parties of the working class might have mounted to such policies was effectively undercut, allowing governments with neo-liberal agendas to take office.

To what can the declining electoral salience of class be attributed? Three kinds of factors lie behind this development. The first are a familiar set of socioeconomic changes identified by Lipset (1964) and others some years ago. Thirty years of prosperity and more generous social benefits improved the living standards of ordinary workers enough to undercut the sense of grievance many once felt toward the upper classes. Shifts in occupational structure eroded class boundaries further, as deindustrialization decimated cohesive working class communities and the growth of employment in services blurred the lines that once separated blue and white-collar workers.

However, political developments were equally important. In some ways, the Keynesian welfare state was a political accomplishment that sowed the seeds of its own demise. Contemporary analyses of social programs emphasize the sense of entitlement they create, which sustains them, but neglect the ancillary effects on social democracy (cf. Pierson 1996). As social programs became more generous, they eroded the material insecurity and corresponding sense of grievance central to working-class mobilization. Moreover, the welfare state was the historic achievement of post-war social democratic parties, even if they were not always its authors; but, once its programs were in place and accepted across the political spectrum, social democracy was left without a distinctive political mission around which to mobilize.[5] The reaction against state intervention that followed the 1970s also discredited the traditional stance of social democratic parties. In many respects, the decline of the class cleavage was the reflection, as much as a cause, of the exhaustion of social democracy.

The third important factor was the appearance of a new cleavage, cross-cutting the traditional left-right spectrum. This is the right-authoritarian/left-libertarian divide identified in various forms by Inglehart (1990) and Kitschelt (1997). On one side of it are those who embrace the post-materialist values promoted by decades of post-war prosperity, reinforced by the new social movements of the 1980s. On the other side are those attached to more traditional values, not only because of lingering material concerns but because they saw the cultural revolution of the 1960s as a threat to those values. Of course, this cleavage is about more than values (Martinez-Alier 2003). During the 1980s and 1990s, the numbers on one side of it were swelled by a reaction against immigration and the market initiatives of the European Union, which many saw as threats to their material well-being (Kriesi *et al*. 2008). In American politics, this cleavage ranges those who embrace post-materialist values against others who associate those values with unpatriotic opposition to the military, disregard for religion or sympathy for waves of immigration that are changing the racial complexion of the country (Frank 2004, Carmines and Layman 1997).[6]

This new cleavage is politically significant because it cross-cuts the class cleavage in two ways. Because working-class voters are more likely to be right-authoritarian, this cleavage drove a wedge through the working class support that might otherwise have been mobilized in opposition to platforms of neo-liberal reform. In Europe, significant proportions of the working class now vote for parties of the radical right. In the U.S., many have been drawn away from the Democratic party and segments of the Republicans sympathetic to activist government. Moreover, by drawing a middle class constituency to social democratic parties and the American Democrats, this cleavage has undercut the inclination of those parties to operate as parties of working class defense, because many middle class voters are beneficiaries of neo-liberal reforms.

In sum, if the policies of the post-war era reflected a class compromise, born of electoral competition around the agendas of working class parties, the policies of the neo-liberal era have rested on a different politics, made possible by class dealignment, rising electoral volatility, and the emergence of a cleavage that dilutes the class character of political contestation.

Cross-National Variation

In order to make comparisons over time, I have emphasized the commonalities of the neo-liberal era across the developed democracies. In all of them, social and economic policy became more market-oriented during the 1980s and 1990s. However, there were also important cross-national differences in what might be described as the 'growth models' adopted by OECD countries in this period. Central to these differences were the ways countries mobilized demand for their products and political consent for their policies. Although there are some important national variations as well, we can identify four types of growth models with significance for the dilemmas facing countries today.

The first is a liberal growth model adopted with some variation in virtually all the liberal market economies described by Hall and Soskice (2001) but exemplified by the U.S. and U.K. Neo-liberal reform went farthest in political economies already dominated by market competition (Hall and Gingerich 2009). Margaret Thatcher and Ronald Reagan took pioneering steps to intensify competition in many sectors, privatized national enterprises, and contracted out public services (Thatcher 2004). In high-profile battles with the British miners and American air controllers, they broke the power of trade unions, and their successors tightened controls on social benefits with a view to turning 'welfare' into 'workfare'.

These measures kept average real wages low, thereby promoting employment growth in low-wage services in retailing, restaurants, tourism and child-care, while loose regulatory environments for finance and health promoted job growth there in the U.S. By 2008, the financial sector was responsible for almost a third of the profits in the American economy. Education and health became priority areas for British government spending in the late 1990s. The result was a 'jobs miracle' much envied in continental Europe, but the distributive consequences were stark. At one point in the 1990s, almost a fifth of the American labor force worked for wages and benefits lower than those available at the minimum wage in France; and real median income has been virtually stagnant in the U.S. since 1980, while below-median incomes have declined (Hacker and Pierson 2010). More than half of total growth in American GDP over that period went to the top ten percent of income-earners.

The danger was that this approach would depress aggregate demand and make the mobilization of political consent for neo-liberal policies difficult. However, the Anglo-American model spoke to these problems with deregulatory measures that promoted housing booms, an influx of consumer goods from emerging economies, and an unprecedented expansion in consumer credit. Thanks to federal support for Freddie Mac and Fannie Mae, the proportion of people owning their own home peaked at 69 percent in the U.S. in 2008, and house prices in the U.S. and U.K. doubled between 1990 and 2008, giving many people the sense that their wealth was increasing even if their incomes were stagnant (Schwartz and Seabrook 2009; Rajan 2010).

An influx of cheap consumer goods from Asia helped sustain the purchasing power of workers, and the opportunity to borrow freely was a crucial complement to the 'privatization of risk' that became a feature of Anglo-American policy in this period (Hacker 2004). For those exposed to the vicissitudes of highly flexible labor markets, credit cards and home equity loans were crucial safeguards that carried many people through fluctuations in the economy and adverse life events. For these economies, loose financial regulation was a supplement to social policy (Schelkle 2010). Britain and the U.S. had been pioneers in the use of consumer credit, since the establishment of the Household Finance Corporation during the 1930s, but the neo-liberal era saw an unprecedented expansion in American household debt from $2 trillion in 1980 to almost $14 trillion in 2008 (Trumbull 2010). This formula allowed these countries to run growth models led by consumer demand, even when median incomes were rising slowly, and the wealth effects of these policies, however illusory, mobilized political consent for a series of neo-liberal initiatives whose acceptance is otherwise hard to explain.

In the coordinated market economies of continental Europe, these formulas were not available. Trade unions were more powerful and the wage coordination to which they contributed often so central to the strategies of firms that it made no sense to try to break the power of the trade unions, aside from marginal steps, such as the French Auroux laws (Howell 1992). Moreover, stronger traditions of social solidarity made it more difficult for governments to mobilize political consent for neo-liberal reforms than in the Anglo-American world.

The solution, on which the governments of the European Community agreed, was to inflect their institutional architecture for a global age. The decisive innovation was the Single European Act of 1986 that transformed the European Community from an association to promote free trade and agricultural protection into an agent for market liberalization in its member states. Although the member governments were always in the driver's seat, the move to 'qualified majority voting' for measures related to the single market ensured that governments could take shelter from the political flak generated by their neo-liberal initiatives behind the protective shield of Community action (Hall 2006).

Facing relatively powerful trade unions willing to defend wage floors, the European governments also had to find another approach to the creation of employment in the service sector. As Esping-Andersen (1990, 1999) has observed, two divergent approaches emerged. The Nordic countries expanded public employment in services, such as healthcare, education and childcare, funded by high tax rates whose effects on disposable income also limited the growth of private services (see also Iversen and Wren 1998). In keeping with a policy legacy going back to the Rehn model, they also operated 'flexicurity' systems in which low levels of employment protection were combined with generous wage-related unemployment benefits to encourage firms to rationalize to meet global competition, while providing workers with incentives to invest in skills (Martin 1978, Estevez-Abe 2001, Campbell *et al*. 2006). These strategies were highly successful.

The strategies initially pursued by the continental coordinated market economies, such as France and Germany, encouraged exit from the labor force through early retirement, but soon proved so costly that they were abandoned in favor of active labor market policies, which subsidized the social charges of employers to lower the costs to firms of taking on new workers. By the 1990s, France was spending almost four percent of GDP on such policies and active labor market policy had become one of the mantras of the EU's Lisbon strategy (Levy 2005). However, employment expanded significantly only when these countries developed secondary labor markets, by relaxing restrictions on part-time work and temporary contracts. Much as Japan did earlier, these countries have developed dual labor markets, divided into spheres of stable employment in the industrial or public sectors and precarious employment, often in private sector services (Visser and Hemerijck 1997, Palier and Thelen 2010).

To mobilize political consent and respond to concerns about social solidarity that such initiatives aroused, in moves seemingly counterintuitive to apostles of neo-liberalism, these countries extended generous programs of social benefits. By the end of the 1990s, social spending in France had risen to Nordic levels, and, even after the Hartz reforms, the German welfare state remains relatively generous. One of the features distinguishing European from Anglo-American growth models is the extent to which taxes and transfers are used to offset the effects of wage inequality on the distribution of disposable income (Kenworthy and Pontusson 2005).

The other constitutive feature of European growth models was the Economic and Monetary Union (EMU) established in 1999 to which sixteen countries now belong. EMU was designed to bind Germany to Europe and eliminate exchange-rate depreciation in the Eurozone in response to protectionist pressure from producer groups (Dyson and Featherstone 1997, Eichengreen 1997). In the run-up to monetary union, efforts to meet its 'convergence criteria' put pressure on many firms in France and elsewhere to adopt more competitive practices, as they faced the pressures of the single market in the context of relatively-high exchange rates (Hall 2002).

Once established, however, EMU induced a further bifurcation in growth models, between the countries of northern and southern Europe. At issue was the familiar question of how to ensure levels of demand sufficient to sustain investment and economic growth. Designed along neo-liberal lines that gave short shrift to fiscal policy, EMU provided no institutional mechanisms for the long-term coordination of fiscal policy across Europe aside from a Stability and Growth Pact limiting national deficits to 3 percent of GDP. In principle, this meant that the member states would have to depend on growth in exports to sustain demand. To do so, they would have to restrain wage growth, a strategy of competitive deflation that the small states of northern Europe were well-placed to implement given their capacities for coordinated wage bargaining (Katzenstein 1985). Over the ensuing decade, Germany, Belgium and the Netherlands pursued just such a strategy with considerable success.

However, the countries of southern Europe were not well-equipped to pursue such a strategy. With labor movements divided into competing confessional groups, they could not readily coordinate wages, and many such as Portugal and Greece, lacked strong export sectors. But entry into what seemed like a strong currency area, awash in funds generated by Germany's trade surpluses, brought them an unanticipated bonanza of cheap. Led by the public or private sectors, cheap credit was used to fuel domestic growth, based on an asset-boom in property in Spain, commercial lending in Portugal and public sector spending in Greece. In the short-term, these strategies were an eminently rational response to the prevailing incentive structure. In the long term, they left those economies vulnerable to the kind of credit squeeze induced by the recession of 2008.

The Implications for Adjustment

The global recession of 2008-09 marks an inflection point in the neo-liberal era. As large financial institutions collapsed and unemployment rose, many governments rediscovered the value of what Claus Offe has called 'emergency Keynesianism' and stepped in with massive support for the financial sector and various stimulus packages, but official rates of unemployment in Europe and the U.S. still average about ten percent of GDP. Governments face a common set of adjustment problems that pose political as well as economic challenges. How will they respond and how are national variations in that response to be explained? This problem can be approached in three parts, as one of understanding the initial response to the crisis, the medium-term response, and the long-term prospects for radical change in the political economy.

The initial response to the crisis should be conditioned by the existing national institutional architecture. If recession has flooded the basement and financial crises set fire to the roof, the initial reaction of governments will not be to tear the edifice down, but to address the problems with the building materials they already have on hand. Thus, in liberal market economies, long dependent on domestic demand to drive growth, the initial response of governments was to expand consumer demand through increases in public spending and cuts in taxation, letting flexible labor and capital markets reallocate resources. Cuts in taxation figured prominently in their responses, while coordinated market economies were more likely to use public spending to stimulate their economies (OECD 2009).

By contrast, the emphasis of the stimulus in many coordinated market economies was on preserving existing jobs. In manufacturing regimes dependent on employees with high levels of industry-specific skills, firms attach importance to retaining skilled labor and, once lost, such jobs are difficult to recreate. Thus, key components of the German response included a pioneering subsidy for automobile purchases (soon copied by other countries) that sustained employment in metalworking and a large program of subsidies for short-time working so that employees in the core manufacturing sector could be retained. Although widely-criticized in the Anglo-American media, the German response was highly successful at preserving jobs.

Even in the medium term, governments are likely to revert to the strategies on which they have relied in the past. This is one of the lessons of the 1970s. In the face of stagflation with which Keynesian policies could not cope, governments struggled to make those policies work for half a decade or more, before moving to different economic strategies (Hall 1986, 1993). We see confirmation in the strategies the American and German governments are currently pursuing.

The American government is desperately trying to revive the housing market, arguably the sources of the financial crisis. Following a generous subsidy to first-time home buyers, it has poured billions of dollars into Freddie Mac and Fannie Mae. The Federal Reserve Bank has mounted two programs of 'quantitative easing' worth more than $1 trillion to increase liquidity and lending in the U.S. Despite prominent calls for fiscal discipline, Congress has extended major portions of the Bush-era tax cuts. These moves were accompanied by statements from the Federal Reserve indicating a tolerance for higher rates of inflation, which have historically been one way to erode the national debt burden.

The institutional infrastructure of the U.S. encourages such a strategy. Although nominally independent of political control, the Federal Reserve Bank is sensitive to political pressure, and hence historically inclined to target unemployment as well as inflation. Although financial regulation is being tightened in the wake of the crisis, American political institutions give business enough influence to ensure those regulations do not significantly reduce the centrality of consumer credit to the American growth model (Hacker and Pierson 2010).

In international terms, the American economy is also well-placed to pursue growth led by consumer demand. A floating exchange rate allows the government to erode the real value of its debt and cushion adjustment through depreciation rather than depending on domestic deflation to make such adjustments. The principal threat to such a strategy stems from the large reserves of American securities other countries have built up. If they develop a sudden reluctance to hold American assets, a precipitous decline in the dollar could make adjustment painful. However, China has few incentives to pursue such a policy and few substitutes for American securities. The more likely scenario is one in which a gradual depreciation of the dollar erodes the purchasing power of American consumers without plunging the economy into another recession.

Across the Atlantic, the German government has also reverted to a familiar strategy, built in this case on export-led growth in manufacturing that takes advantage of strong demand for capital goods from emerging economies and its capacities for wage coordination. Inflecting this strategy slightly, the government encouraged a relatively-large wage settlement in metalworking that fuels domestic demand. But, in the context of an unparalleled crisis in EMU, the striking feature of continuity is the German government's insistence on fiscal discipline across the Eurozone and its refusal to treat Germany's trade surplus as a source of the problems. Still focused on competitive deflation, the German government remains hostile to proposals for coordinated European expansion.

As Carlin and Soskice (2009) have observed, while of dubious value from a European perspective, this stance is conditioned by the institutional structure of the German political economy. It is difficult for the government to operate a fiscal expansion in an economy dominated by workers with high levels of industry-specific skills. The difficulties such workers have finding equivalent jobs if they become unemployed promotes a high savings rate, especially during recessions; and expansionary policies might encourage wage settlements that erode the competitiveness of the export sector on which the German growth model depends. German policy has been driven more strongly by the structure of its own political economy than by considerations about Europe.

What does my analysis of the transition to the Keynesian and neo-liberal eras imply about the prospects for radical changes of policy in the longer term? I have argued that those transitions required motivation, means and a motor. Do we see those elements in the current conjuncture?

The policies marking the advent of the Keynesian and neo-liberal eras were motivated by widely-perceived failures of policy with high social costs. In some countries, such as Greece, Spain, Ireland and Iceland, the effects of the current recession have been devastating enough to motivate a search for new policies, but they are constrained by deflationary packages forced on them by international bond markets. Elsewhere, it remains to be seen if the effects are traumatic enough to motivate dramatic shifts in policy. Although Americans are troubled by 9 percent unemployment, several European countries experienced similar levels during the 1980s and 1990s without more than incremental changes to policy. Much will depend on rates of growth in OECD countries over the next few years. If the U.S. settles into a decade of deflation or the sovereign debt crisis in Europe sparks another financial crisis, pressures will mount for more radical shifts in policy. Otherwise, the broad character of economic policy may not shift much. The exception is in European monetary union, where the crisis has been profound enough to inspire major changes, whose dimensions will depend on the political wherewithal assembled to make them.

Equally important here is the issue of means. The transitions to Keynesian and neo-liberal policies were made possible by the availability of new policy paradigms – with credibility among economists and political appeal. Comparison of the British governments led by Edward Heath and Margaret Thatcher is illuminating. Both entered office determined to make radical changes to the course of policy, but Heath soon retreated, partly because he lacked the alternative policy paradigm of monetarist economics available to Thatcher by the time she became prime minister. Although the current recession has discredited some of the economic doctrines that underpinned neo-liberalism, including the efficient markets hypothesis, there are still no alternative doctrines available with sufficient credibility among economists to constitute clear alternatives to the watered-down 'new Keynesianism' that has been guiding policy for some years (Fox 2009). In particular, doctrines that might mandate more assertive state intervention on something other than an emergency basis do not yet command significant bastions of economic opinion.

The appearance of new doctrines cannot be ruled out, especially since the oft-repeated injunction that the only way to promote higher growth is to implement 'structural reforms' seems increasingly empty. Making competition in product markets more intense and employment less secure may improve the competitiveness of some kinds of economies, but it is unlikely to build a strong export base in countries currently lacking one. However, a return to full-blown Keynesianism, except in emergency circumstances, seems unlikely, since economies are now so interdependent that the effects of a fiscal stimulus soon leak out of them. Instead, the dominant motif of policy-making today is confusion, among officials torn between the desirability of sustaining demand and the dictates of international bond markets urging fiscal prudence on them.

Nothing illustrates that better than the divergence between American and British policy. The default option appears to be fiscal tightening amidst monetary easing, which might ultimately inspire enough inflation to ease debt burdens but is a risky policy at best and possibly impotent at a time when interest rates are already low.

I have also argued that radical shifts in policy depend on the character of partisan electoral competition. What are the coalitional possibilities today? Many hope that economic recession will swing the political pendulum to the left, ushering in more interventionist policies in the name of working class defense, as the depression of the 1930s did in the United States and Sweden (cf. Gourevitch 1986). In politics, however, there is no Say's law: economic crisis does not necessarily inspire political mobilization, let alone effective mobilization on the political left. Moreover, electorates blame governments as well as markets for economic crises and high unemployment. This is a lingering legacy of the Keynesian era. Virtually every government in place during the recessions of the 1970s was turned out of office in the next election. Recessions also inspire distrust in government, already high in Europe and rising in the U.S. That distrust is evident, not only in the Tea party movement in the United States, but in Britain where a government committed to social justice was turned out for one committed to fiscal austerity. In this context, the electorate's appetite for more assertive state intervention is at best uncertain.

Moreover, the socioeconomic conditions that eroded the class cleavage have not disappeared, and neo-liberal policies have inspired new conflicts of interest inside the working class between 'insiders' and 'outsiders' and older and younger generations (Chauvel 1998, Rueda 2005). These are not insuperable divisions and, in countries where austerity cuts a wide swathe across the electorate, coalitions in reaction to it may materialize. However, some elements of that reaction are taking a different form. Refracted through the values cleavage I have described, the crisis has inspired renewed hostility to immigration and nativist reactions that have historically also been features of the politics of recession.

In this context, electoral rules matter. In recent years, those with progressive political opinions have applauded systems of proportional representation because they are more likely to bring coalitions favoring redistributive policies to power (Iversen and Soskice 2005). However, those are the politics of good times. Amidst hard times, proportional representation is no longer so clearly an advantage for social progressives, as the Weimar republic demonstrated (Abraham 1988). As people react against the governments presiding over crisis, voters drift to the radical right and left of the political spectrum. In majoritarian electoral systems, the effects of this protest vote are muted by first-past-the post electoral dynamics, although the American primary system amplifies those effects. Under systems of proportional representation, however, the increasing popularity of small parties makes it more difficult for mainstream parties to retain control of the government and respond decisively to the crisis. Many European governments, in particular, are likely to have to cobble together fragile coalitions, sometimes including parties on the radical right or left, as the current Dutch regime does.

These developments do not bode well for the European Union because many parties on the radical right or left are hostile to the EU. However, the European Union is one of the institutional arenas most likely to see durable change as a result of this recession. The financial crisis and subsequent sovereign debt crisis have exposed fault lines in EMU formerly obscured by a climate of growth and laxity in the application of the Stability and Growth pact (Schelkle 2010). In this context, the European central bank has emerged as a more flexible actor than it once appeared to be, and the EU has provided unprecedented assistance to member states facing pressure from international bond markets.

However, the limits of what is now clearly a monetary, but not economic, union have become manifest. EMU lacks well-institutionalized means for the kind of concerted fiscal response to recession that might have cushioned the adjustment paths of the member states and moderated the political reaction to them. As a result, the EU has resorted to measures that impose most of the adjustment costs on a few countries around its rim, where the effects of financial crisis were already the most severe, in the form of harsh deflations that carry only the merest pretense that future growth might issue from them.

More important yet are the political fault lines revealed in the EU. The crisis has exposed the reluctance of many countries, seemingly committed to Europe, to countenance redistribution across Europe, even when measures of that sort could augment the future well-being of all, as the automatic stabilizers built into American federalism do. This recession has become a crucible out of which the future shape of the European Union will be forged. The institutional strains it is under resemble those that stagflation put on the institutions regulating distribution in the developed economies of the 1970s (Goldthorpe 1978). Ultimately, their governments found new ways to regulate distributional conflict, sometimes through significant institutional adjustments, but not without a great deal of intervening political turmoil.

Something similar could be said of contemporary international regimes, whose importance to domestic adjustment paths is profound. On an international plane, however, countries are not locked into anything like the steely embrace of the European Union. The main issue is whether they can resist the protectionist temptation that recessions always present. Higher levels of global interdependence and a robust World Trade Organization make trade protection less likely (Milner 1988). However, the absence of clear agreement on a monetary regime makes competitive devaluation a threat, especially when the country commanding the principal reserve currency is fixated on resolving its domestic economic problems.

Conclusion

I have argued that we can discern, in both the Keynesian and neo-liberal eras, an institutional architecture whose interdependent parts have contributed to the success of the developed political economies, and I have explored the political conditions that made the development of those institutions possible. This exercise in stylized economic history yields an explanation for cross-national variation in the initial response of various governments to the great recession and some telling observations about how that recession might affect the course of policy in the coming years. Behind the exceptional measures taken to deal with the immediate crisis, I find broad continuities in policy that are conditioned by the institutional architecture of each country. Asking whether the current crisis will inspire deep ruptures in policy, I find potential in some countries but reasons for general skepticism, rooted in the absence of alternative policy paradigms and the political dynamics of crisis.

As Peter Gourevitch (1986: 239-40) reminds us, however, there is an intrinsic openness to politics, especially at such conjunctures. The politics of the 1940s and 1970s were marked by intense experimentation, as governments struggled to deal with new problems in new ways, and the current crisis should inspire parallel experimentation. In the European Union, this process is manifestly underway. The ultimate lesson of this account, however, is that, if those experiments are to yield durable new paths for policy, they will have to address, not only the economic problems of our time, but the dilemmas of assembling political support in electoral arenas beset by fissiparous tendencies and the tides of economic discontent.

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Notes

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[1] For more detailed studies of this period, offering different perspectives, see Ferguson and Maier (2010) and Sandbrook (2010).

[2] For insightful reviews bearing on this topic, however, see Glyn (2006); Eichengreen (2007).

[3] I am indebted to discussions with David Soskice for this point.

[4] Whether the extent to which social class structures voting has declined is an issue hotly debated. Much depends on how class is measured and decline defined. My reading is that there has been decline in the respects relevant to this argument, but, for a range of alternative views, see: Manza *et al*. (1995), Evans (2000), Elf (2007), Oesch (2008).

[5] For an alternative view that ascribes more importance to religious cleavages, see Manow (2001) and Van Kersbergen and Manow (2009).

[6] Of course, there is a lively debate about just how significant this values cleavage is to electoral outcomes in the United States (cf. Frank 2004, Bartels 2008).