NEW PARADIGMS IN PUBLIC POLICY

Economic futures

by Andrew Gamble

POLICY CENTRE

ECONOMIC FUTURES

A REPORT PREPARED FOR
THE BRITISH ACADEMY

by Andrew Gamble

NEW PARADIGMS IN PUBLIC POLICY

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FOREWORD

Governments face many challenges and, after all, this is what they are there for. Commentators identify problems facing public policy in the UK on many levels. Two themes are perhaps striking in the current context. One is the assumption that radical changes are needed. For a number of reasons we can't go on as we are. The other is that we are failing to find new ways forward that offer the potential to solve our problems. Public policy is stuck and it is much easier to state the problems than to answer them.

The economic crisis of 2007-8, the subsequent recession and the sluggish recovery set the overall context for much current political debate. In this paper Andrew Gamble analyses the uncertainties surrounding future economic developments. It is unclear whether the crisis and its aftermath will lead to shifts in assumptions about the role of government and the regulation of the financial system as did previous crises in the 1930s and 1970s. Underlying immediate debates is controversy over future growth strategies: should the government seek to restore the current model, basing growth on finance, retail and state sector services or should it pursue more direct interventions? Professor Gamble argues that the issues surrounding the crisis and the options facing policymakers are best understood through political economy. This approach sets economic developments within the broad context of the political forces which determine the constraints on different courses of action and can help in identifying the range of possible ways forward.

The papers in this series, *New paradigms in public policy*, to be published throughout 2011, review some particularly difficult issues in public policy: climate change, recession and recovery, population ageing, neighbourhood problems and the Third Sector, rebuilding democratic engagement and managing the demands of an increasingly assertive public. The series reviews

current understanding of the issues, situated within academic theory-building, and discusses possible ways forward. Rather than advocating one best solution to these problems, we analyse a range of feasible scenarios. We also consider how the framing of an issue in current debate affects the chances of success in tackling it. Some problems benefit from being approached in new and different ways. The guiding assumption is that analysing and re-framing is what academics do best, and is the most helpful contribution they can make in the policymaking process.

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KEY MESSAGES

The financial crash of 2007-8 has created great uncertainty about the economic future of the UK. Does the policy framework which was associated with the strong performance of the British economy between 1992 and 2008 require radical amendment or just patching? How significant was the crash and why was it not foreseen? Social science cannot predict future events with any exactitude and should not try, but a political economy approach can provide deeper understanding of the way economies work and the choices which democracies face.

Deep though this crisis has been, it has not so far produced a major shift in the policy framework. The coalition government continues broadly to follow the market-led model pursued by its predecessors, in the hope that recovery will soon take hold. But the crisis shows no signs of abating, and has mutated from a banking crisis to a fiscal crisis and now to a sovereign debt crisis.

Against this background three major debates have developed about Britain's economic future. How should the deficit be reduced? What should be the future size of the state? Does the British economy need to be rebalanced? Associated with these debates are different scenarios for the economic future. The optimistic scenario expects growth in the international economy to facilitate the UK recovery and help make reducing the deficit manageable. The pessimistic scenario foresees a long period of slow growth in the UK, amidst political deadlocks and fragmentation in the international economy.

The scale of the challenges ahead suggests the need for an enhanced, rather than a diminished role, for government. Many of the problems we face are political not economic, and government action is needed to find the rules and frameworks which can enhance political co-operation at national and international levels, and maintain popular consent.

EXECUTIVE SUMMARY

- Although political economic analysis cannot offer precise predictions of particular future events, it can alert policymakers to a range of potential outcomes, and encourage a deeper debate on the alternatives that are feasible in particular contexts.
- Many of the simple frames used by politicians and the media to discuss economic policy often obfuscate rather than illuminate. A political economy approach provides a more sophisticated understanding of how government works, or how markets work, and the interdependence of the two.

THE CRASH AND THE DEFICIT

- The financial crash of 2007-8 brought to an end a long period of growth and stability in the British economy, as it did in many other national economies. This report focuses on the crash and its consequences in the UK.
- Much commentary has blamed the banks and their lending practices for the crisis. It also questions whether the regulators could have possessed greater foresight, or whether the nature of modern financial markets makes this impossible. The significance for policy lies in how far the regulatory regime can be blamed for the crash and whether a regulatory regime can be devised which could avoid the same mistakes in the future.
- Work by those such as Minsky (1982), and Reinhart and Rogoff (2008), demonstrates that the latest crash fits into a pattern of financial and economic behaviour. But it is still not possible to know the timing of a collapse and no regulatory authority will want to put its own financial sector at a disadvantage.

- The sovereign debt crisis of 2011 appears to confirm fears that neglecting to address the underlying causes of the 2007-8 crisis will lead to further financial crashes.
- It has been argued that the current crisis is of the same magnitude and potential significance as the crises in the 1930s and 1970s. Both decades were characterised by a long period of political and economic restructuring which facilitated a paradigm shift in economic policymaking. In the area of financial regulation, there is not yet evidence to suggest that events of 2008 will lead to such a shift.
- Much of the political debate in the UK since the crisis has been dominated by the issue of public sector deficits. While it has renewed the debate over Keynesian versus Hayekian theory, the main disagreement in the British policy debate was over timing and the period over which the budget deficit should be eliminated. No party in Britain has advocated a classical Keynesian approach to the deficit.
- The policy stance of the coalition government is only marginally tougher than the one to which Alastair Darling committed Labour before the election. Public spending in real terms is planned to go on increasing over the Parliament and the coalition's intended balance of 78% spending cuts and 22% tax increases is likely in practice to involve a higher percentage of tax increases, or to result in high borrowing and a higher deficit.

THE SIZE OF THE STATE

- The debate on the deficit and how it should be handled focuses on an immediate problem, but it also raises much larger issues about what size of state is desirable and achievable. The question is relevant to economic futures since the British state has grown considerably in recent history. For instance, the

state was below 10% of GDP before 1914, between 20% and 30% between the wars, and has averaged 38-41% since 1945.

- There are currently three popular positions on the size and role of the state.
    1. There are those who advocate a larger state, funded by increased taxation to support existing services and to improve and extend them, with the level of provision in Scandinavian countries as the main model.
    2. The second position in the debate favours maintaining public spending in a steady state; not seeking to roll back public provision, but not seeking to increase it either.
    3. The third position in the debate argues for a much smaller state, between 25% and 35% of GDP. This could not be achieved by spending restraint and economies; it requires the suppression of major programmes, the cutting out, or at least drastic reduction, of whole areas of public provision. This has become the explicit aim of sections of libertarian opinion in the US, for example.
- Despite recent cuts by the coalition government, the size of the state in Britain appears to be following the status quo. While the cuts are severe, there is no intention, at least in this Parliament, to reduce public spending below 41% of GDP. The reason why the cuts are severe is because GDP has dropped 5-6%, a reduction in national wealth that must be financed in some way, and the coalition is committed to a reduction in borrowing.
- If the coalition government or its successors continue to cut public spending at the same rate through the next Parliament then there would be a substantial change in the size of the British state, and a potential shift to a new policy paradigm.

GROWTH MODELS

- The financial growth model adopted in the 1980s, with the main drivers of financial services, retail, property and

construction in the private sector, and education, health and education in the public sector achieved remarkable success for the UK economy in the 1990s and up to 2007. Whether this growth model can be repaired or whether it needs a radical redesign will become an important question.

- The coalition government is aiming to rebalance the economy and restore growth. However, the outcomes of this aim will depend on two contrasting scenarios:
    1. By 2014-15 the government expects the global economy to be growing at 4-5% and the UK economy by 2.9% per annum, which will reduce the deficit. A large part of the government's deficit reduction plan (£84 billion) depends on its growth forecast being accurate.
    2. In contrast, a number of analysts increasingly argue that this is no ordinary recession, and there is unlikely to be a quick recovery from the 2008 crash. As a result, the UK economy will not be able to generate the rates of growth it needs to pay off debts quickly and will struggle to cope with an increasing debt burden.
- There is no certainty as to which scenario is more likely, but the recent downgrading of growth forecasts for the British economy in 2011 underline a narrowing of the government's options. All sides of the UK debate acknowledge that without growth it will be much harder to manage debt and there will be an increasing focus on policies which might secure faster growth, making the economy more competitive and more flexible.
- The coalition government broadly follows a mix of market-led and state-led elements in growth policy. They are relying on spontaneous private sector growth while continuing strategic investment to create a more favourable climate for growth.
- Critics of their approach argue that the British economy requires major institutional changes instead, such as a greatly expanded Green Investment Bank and a return to a more

interventionist state-led economic policy. Suggestions for state-led strategic investment in skills, infrastructure, science and social initiatives are less controversial.

- Advocates of this type of strategic state-led investment admire the German model of high investment, high productivity, high wages and high exports. But to restructure Britain's economy along these lines would be long and painful; also difficult because of its deep institutional and cultural roots.
- In the event that UK economic growth is low, then some argue that growth in the international economy will not lift the UK economy with it, and there is a risk that markets, trade, investment and population flows could all stall or go into reverse. From this perspective, there is a strong case for maintaining an open international economy and full membership of the EU to ensure cooperative international economic policy.

CONCLUSION

- The scale of the challenges ahead suggests the need for an enhanced, rather than a diminished role, for government in terms of enabling rules and frameworks which can change attitudes and behaviour and gain popular consent.
- The range of strategies governments need to deploy are not likely to require just one approach – and political economy can help, by making policymakers reflect on the range of policies that are available and the different kinds of knowledge that are relevant in different contexts.

1 INTRODUCTION

The future of the British economy has an impact on many aspects of public policy. It is a vital concern for government. Yet our intellectual resources for thinking about it often appear limited. The Queen's reproach to the economics profession in 2008 after the financial crash ('If these things were so large how come everyone missed them' (Pierce 2008)) reflected a widespread scepticism about economic forecasting. It is often seen as unreliable, inconsistent, able to detect trees, but not woods. This is to mistake the kind of knowledge that economic forecasting can provide (Lawson 1997). Forecasting the future of the economy is only superficially similar to forecasting the weather or volcanic eruptions. There is a reasonable prospect that with greater understanding, better techniques and more sophisticated models, the accuracy of forecasts of natural events will improve. Economics, however, is different. There is no such prospect because the nature of what is being studied is fundamentally different.

One reason for this lies in the distinction between risk and uncertainty (Knight 1921). Some forms of uncertainty are measurable – these are what we call risks – but others are not. Economic forecasting seeks to establish probabilities about future events and trends in the economy and, in doing so, to assess the risks attached to different courses of action, and the costs and benefits associated with them. Cost benefit analysis has, as a result, become a standard technique in government in the evaluation of policy programmes (Sunstein 2002). But although all modern societies have put enormous effort into the management of risk (Bernstein 1998), in order to narrow down the scope of uncertainty, they cannot eliminate it. There is radical uncertainty at the heart of social systems because decision-making never takes place with full information. Knowledge is fragmented and dispersed (Hayek 1949). A priori

reasoning cannot eliminate indeterminacy from the future, neither can using the past as a guide. History does not repeat itself, because social events are unique.

Predicting the future of the British economy is complex, not just because it is made up of many different sectors, but because it is part of networks and relationships that are regional, international and global – it is not a self-contained unit. The very concept of a national economy which can be managed by policymakers is contested, and although during the twentieth century government came increasingly to think in terms of the 'national economy', it is an artificial construction, even if a necessary one. This is also true of many of the terms which litter debate on the economy, such as the concepts of the public and the private sector. The state is involved in so many different ways in the economy that attempts to define the boundaries of the state or policies to expand or to shrink the state are often highly ambiguous. Many of the simple frames used by politicians and the media to discuss economic policy often obfuscate rather than illuminate, because of the categories they persist in employing. Social science provides more sophisticated understanding of how government works, or how markets work, and the interdependence of the two (Lindblom 1977), but popular and public discourse rarely reflects it. This makes a political economy approach the most appropriate one for thinking about different futures for the British economy and the ideas which frame major issues in economic policy for the medium-term future.

2 THE CRASH AND THE DEFICIT

The financial crash of 2007-8 brought to an end a long period of growth and stability in the British economy. After the forced exit of sterling from the exchange-rate mechanism in 1992 and the spending cuts and tax increases which that made necessary, the British economy grew steadily and uninterruptedly for the next 15 years, allowing politicians to proclaim incautiously the end of boom and bust (Brown 2004). The growth was not just a British phenomenon, although for other countries it was at times interrupted by recessions and the collapse of financial bubbles, such as the Asian financial crash of 1997 and the dotcom crash of 2000. Yet no sooner had one bubble burst, than another was found to take its place. The general movement of the markets was upwards and the general sentiment was optimistic. Underlying this buoyancy was the impact of the entry of China and other rising powers into the global economy. The flood of cheap imports which they made possible, helped to keep inflation at low levels, and sustained the consumer boom, as well as encouraging the development of ever more sophisticated financial instruments to finance it (Glyn 2006; Frieden 2006).

The boom ended in the crash of 2007-8 and many parts of the international economy, including Britain and the United States, were plunged into recession, although China and the other rising powers continued to grow. The severity of the financial collapse has produced a flood of analysis of its causes and its implications. Is this crisis comparable to those in the 1930s and 1970s, or is it primarily a financial crisis created by asset bubbles, similar to the Asian financial crisis and the dotcom crisis, but having little long-term significance for the real economy? Was the crisis caused by too much or too little regulation? Much commentary blamed the banks for the crisis, and in particular the lending practices and the culture

which many of the investment banks had developed during the boom (Tett 2009; Shiller 2008; Schwartz 2009; Turner 2008; Sorkin 2010). This was encouraged by the enthusiasm for the deregulation of finance, which was such a hallmark of the new financial regime established on Wall Street and in the City of London from the 1980s onwards. In this way, the crash has been depicted as the nemesis of the neo-liberal doctrines which had gained such ascendancy over economic policy (Wade 2008). But others have argued that the primary failing was the regulatory system for not restraining the increasingly dubious lending practices of some parts of the banking sector (Davies 2010), and that governments and regulators were complicit in the bubbles and in promoting the euphoria and the feeling that the boom could go on forever (Thompson 2009).

One interesting question is whether the regulators could have possessed greater foresight, or whether the nature of modern financial markets makes this impossible (Roubini 2010). Even if they had possessed the information that a crisis in the financial markets was fast approaching, would they have possessed the political capacity to do anything about it? It seems that many market agents were aware of the risks that were being run, and took steps to protect themselves, but the knowledge that is available to market agents, and which is sufficient for them to take action, is different from the knowledge which is available to regulators who are responsible for the whole system. Market agents only need to consult their own interests, but regulators must take a view of the interest of the system as a whole. Econometric models proved ineffective in anticipating the crash, but there were other theoretical models, for example the work of Hyman Minsky, first developed in the 1970s, which did anticipate the general form of the crisis, even though it could not predict its timing or its precise details (Minsky 1982). Minsky charts the nature and pattern of financial crises in the modern economy in ways which made the events of

2007-8 instantly recognisable within his framework. There is also a great deal of historical work on past crises (Kindleberger 1978) and since the recent crisis much of this work has been helpfully compiled by Carmen Reinhart and Kenneth Rogoff (Reinhart and Rogoff 2008). One of the things this literature demonstrates is how much the latest financial crash fits into a familiar pattern of financial and economic behaviour which has become established over the last 300 years, and how forgetful each new generation of politicians and regulators are of history. But that is different from saying that there are 'lessons of history' which, had policymakers learnt, would have helped them avoid this latest crisis. The problem for regulators is that even when armed with the knowledge that all financial booms eventually collapse, it is still not possible to know the timing of the collapse and, given the competitive nature of financial jurisdictions, no regulatory authority will want to put its own financial sector at a disadvantage. So this becomes a collective action problem. It is the dispersed character of regulation which can lead to the toleration of unsafe practices, even when it is known that a financial collapse will take place. It is also true that certain kinds of economic reasoning persuaded some regulators, notably Alan Greenspan, that although regulators did not understand the complexity of the financial markets, the financial markets themselves possessed a higher intelligence than the regulators and therefore could be trusted to solve any problems that arose spontaneously. Greenspan has since acknowledged that he was mistaken (Greenspan 2008).

There is also a lively literature over whether it would have been possible to contain this bubble in the way in which some previous bubbles had been contained and defused. Those who think it should have been possible point in particular to major mistakes which they believe were committed by politicians and regulators, notably the decision of secretary of the treasury, Henry Paulson, not to bail out Lehman Brothers

(Kaletsky 2010; Williams 2010; McDonald and Robinson 2009). Others are more sceptical believing that by 2008 the crisis was unavoidable, and any number of particular triggers could have set it off (Harvey 2011; Mason 2009). The significance of this debate for policy is the extent to which the regulatory regime can be blamed for the crash and whether a regulatory regime can be devised which could avoid the same mistakes in the future. Different kinds of regulation are involved however. One argument has been that changing the responsibilities of some of the key players – the Bank of England, the Financial Services Authority and the Treasury – is sufficient because the fundamental problem was that no one was taking responsibility for ensuring that banking was being conducted safely. This approach argues for keeping regulation light-touch and in the background so as not to damage the vitality and competitiveness of the financial sector in London, but making sure that the authorities are more alert to the dangers of a financial meltdown than they proved to be in the run-up to 2008. A more radical argument has focused on the character of financial services themselves and has argued that regulation is needed to reconstruct the nature of these services, for example, by imposing much higher capital ratios or splitting investment from retail banking, in effect breaking up the larger banks, and removing the possibility that in future any bank is too large to fail (Hutton 2010; Arestis and Sobreira 2010). This kind of regulation would be intrusive and interventionist, reshaping the way banks were organised and the way they operate.

In the UK the coalition government established the Independent Commission on Banking under Sir John Vickers to report on regulatory reform for the banks. The Commission issued an interim report in April 2011, pending its full report in September 2011. Parallel discussions have been going on at the international level about changing the Basel Accords, and moving to Basel III (Wolf 2009; Goodhart 2010b). The

G20 document of 2009 under the British Presidency set out an ambitious vision for a new international regulatory order (HM Government, 2009). However, expectations in 2010 and 2011 were not high that international agreement on a radically different set of rules for finance could be agreed. Without agreement, national jurisdictions with large financial sectors will be wary of imposing tougher regulation than is being imposed elsewhere, for fear of damaging their own status as a leading centre. There was a widespread international consensus immediately after the crash that a similar crisis should not be allowed to happen again, but three years on, that enthusiasm had abated and there were strong pressures for going back to business as usual. Attention had shifted from the problems of the banking system to the problems of sovereign debt. Critics argued that if the underlying causes of the banking crisis of 2007–8 were not addressed, the international economy could suffer further financial crashes in the years ahead (Hutton 2010; Roubini 2010; Eatwell and Milgate 2011). The sovereign debt crisis of 2011 on both sides of the Atlantic appeared to confirm those fears.

A second important debate arises from the many attempts to analyse the nature of the crash of 2007–8, to determine what kind of economic event it was, and what the implications are for policy. It has been argued that this crisis is of the same magnitude and potential significance as the crises in the 1930s and 1970s (Reinhart and Rogoff 2008). Both decades were characterised by a long period of political and economic restructuring and, in policy terms, both former crises are said to have facilitated a 'paradigm shift' in economic policymaking, in the first case from classical liberal political economy to Keynesianism, and in the second case from Keynesianism to monetarism. This interpretation was applied to the British case by Peter Hall in his theory of policy paradigms and social learning (Hall 1993). Hall distinguished between first order

change, affecting the settings of the policy instruments, but leaving the overall goals the same; second order change, affecting the instruments of policy as well as their settings; and third order change, in which the goals as well as the instruments of policy and their settings are changed. In this third case the whole framework of policy discourse shifts.

Is the crisis of 2007–8 a third order change of the kind Hall describes, or might it lead to such a change in the future? Some are already suggesting that it will not, and therefore that it is wrong to label the events of 2008 a crisis at all (Hay 2010). On this view a crisis is only a crisis if it leads to a paradigm shift – if it makes it impossible to carry on in the old way. As argued above, in the area of financial regulation there is not yet much evidence that the shock of the events in 2008 by themselves will lead to significant policy change, certainly not of a third order kind; at most there will be some change to settings and to instruments. The dominant market liberal paradigm has not been displaced and this is partly because, as yet, there is no very convincing intellectual or political alternative to it (Wilson 2012). Paradigm shifts take place when the breakdown in the existing system is so severe that something else must be put in place. New circumstances are often more compelling than new ideas. The ideas come later. The economic and financial collapse between 1929 and 1932, which included the end of the gold standard, forced radical policies of adjustment – such as the New Deal – to the fore. But the responses varied considerably between countries and were justified differently.

In the debates considered here, the issue of whether the crisis of 2008 requires a rethinking of the policy paradigm which has dominated British politics since 1976 is often implicit or explicit. Paradigm shifts in policymaking are rare since whenever there is an external shock, the normal reaction is to find ways of responding as effectively as possible but then returning to the way in which things were being done before. Adaptation is generally

easier for human organisations than radical breaks. But sometimes the latter occur despite the best efforts of those seeking to keep the ship afloat. One difficulty faced by national policymakers is that they may think that after a crisis they can restore policy at a national level to where it was before. It may be much harder to do so at an international level, but the international level may be critical for the success of the national policy (Thompson 2008, 2010). Some of the uncertainty arises because of the number of national jurisdictions and their different aims and interests, and the difficulty of finding coordinated ways to address common problems and dangers. This is particularly evident in long-term threats, such as the response to climate change.

Much of the political debate in the UK since the crisis has been dominated by the issue of public sector deficits which were created both by the collapse of economic activity following the crash and by the way governments responded by lowering interest rates, nationalising banks and pumping money into the economy though fiscal stimulus and quantitative easing. The banking crisis of 2008 quickly mutated into a fiscal crisis and then for many states became a sovereign debt crisis. A number of positions have emerged in these debates, between market fundamentalists and market realists and between deflationists and inflationists. There are technical issues involved but the more interesting questions linked to different economic futures, are whether deficits are bad or good in themselves, and what they imply about the size of the state, the functions it should perform, and models of economic growth.

The first question can be framed in traditional terms as a dispute between Keynesian and Hayekian modes of economic reasoning. This way of thinking about the choices on offer makes little sense to many contemporary economists, but it retains its force in public debate. Hayekians argue that in a recession deficits are a barrier to recovery and must be removed as quickly as possible. The Keynesians argue that in a recession governments

should be prepared to run deficits in order to make recovery happen. Immediately after the crash Keynesian arguments were in the ascendancy, developed by Paul Krugman, Joseph Stiglitz, Paul Davidson and David Blanchflower among others (Stiglitz 2010; Krugman 2008; Davidson 2009). There was a brief flurry of speculation about 'the return of Keynes' (Skidelsky 2009), but Hayekian arguments were soon in the ascendancy in the policy debate in the countries of the European Union and increasingly in the United States and in the United Kingdom. The main disagreement in the British policy debate was over timing and the period over which the budget deficit should be eliminated – whether in the lifetime of one Parliament, or longer.

There is no party in Britain, as Robert Skidelsky has pointed out (Skidelsky 2010), advocating a classical Keynesian approach to the deficit. A Keynesian approach would involve taking no steps to reduce it until the recovery was firmly established. Skidelsky argues that there is a fundamental divergence between the Keynesian and Hayekian arguments in their assumptions about how the economy works, and in particular whether public spending crowds out private spending. The Keynesian argument is that it only does so when there is full employment of resources, the Hayekian argument is that it does so at all times (Eatwell & Milgate 2011). Hayekian arguments have been buttressed by academic arguments claiming that debt over 90% of national income reduced economic growth (Reinhart and Rogoff 2009), and that reducing deficits by cutting spending rather than increasing taxes was much more beneficial to recovery (Alesina & Ardagna 2010).

Economists are right in arguing that the Keynesian/Hayekian dichotomy is in many ways too simple. The current position is very different from 1930-1 because all governments since then have accepted the automatic stabilisers associated with Keynesianism as well as the extension of the state which rules out a pure Hayekian stance to the deficit. The actual policy

positions adopted by the main political parties in the UK are nuanced, and quite close together. They reflect the mainstream approach in the Treasury and the Bank of England, which has been criticised for being too focused on macroeconomic management, and insufficiently sensitive to the role of financial markets in the economy (Goodhart 2010a). Despite all the adversary rhetoric between the parties, the policy stance of the coalition government is only marginally tougher than the one to which Alastair Darling committed Labour before the election. The headline figures of 20–25% cuts in many departments, rising to 40% in some departments because of the protection afforded to others, are misleading because the cuts will be spread over a number of years. Public spending in real terms is planned to go on increasing over the Parliament. What changes is that it falls back as a percentage of gross domestic product (GDP) (although only to 40% or 41%) because of the assumptions made about economic growth and inflation in the government forecasts. The headline figures of cuts and the displays of public anger towards some of them (such as the withdrawal of child benefit for higher earners) seem to have been sufficient to reassure the markets that the government's stance was tough enough. Yet, despite appearances, the markets did not regard the UK in 2009 and 2010 as a high credit risk, because of the way the UK debt was structured, with low bond yields on long term loans. This position may change in the future, particularly if the growth forecasts underpinning the coalition government's deficit reduction plan are not met, but in the immediate aftermath of the crash the UK could in principle have afforded to borrow a great deal more and let the exchange rate take the strain (Wolf 2011). The market constraint is often invoked, but as in the case of the supposed constraint in 1976, the real reason for the decisions on public spending lies with policy decisions by the government rather than external pressure. The academic literature on the 1976 IMF crisis using the public records now

available has made that clear (Ludlam 1992; Rogers 2010), and the same is likely to be true in future research on the current budget cuts. The re-assertion of fiscal conservatism as the default position of the Treasury in the response to the recent crisis reflects both deep-seated preferences of state managers, and also the popular understandings of political economy to which politicians habitually appeal, in particular by comparing the national budget to the budget of an ordinary household, and the national 'credit card' to an individual's credit card.

There is a large literature showing the cyclical nature of many public spending programmes, as well as the long-term trend for public expenditure to increase (Peacock and Wiseman 1961; Mullard 1993). Periodic cuts in public spending form an essential part of this cycle. They slow the upward rise of public spending, but studies show that they do not reverse it. At best they contain it. The pressures making for higher public spending are highly resilient, and even the most radical governments have not actually succeeded in altering the level of public spending. What they can affect is the distribution of public spending between different programmes and the balance between tax increases and spending cuts. Even here, however, appearances can be deceptive. Sometimes the difference between a spending cut and a tax increase is rather tenuous. Cuts in child benefit or the trebling of student fees are presented as spending cuts, but in their impact on individuals are experienced much more like tax increases. So are other cuts in subsidies which lead to price increases. The final balance of a cuts package between spending cuts and tax increases can only be analysed retrospectively. The intention of the coalition for the balance to be 78% spending cuts and 22% tax increases is likely in practice to involve a higher percentage of tax increases, or to result in high borrowing and a higher deficit (NIESR 2011). The government has already retreated on a number of cost-cutting measures, including high profile (although low expenditure) issues such as its plans for selling off the forests still in

public hands, and it is in trouble on several other fronts, including public procurement, libraries, the national health service, and reducing the prison population.

An interesting question for social science is why it is so difficult even for governments that are ideologically committed to cut public spending to do so in a way that delivers a permanently smaller state (Pierson 1994). The state shrinks periodically but then grows back. This is because the popular way of understanding public spending in terms of a constant battle between an unproductive public sector and a wealth-creating private sector misunderstands the relationship between the two. A large part of the public sector active is centrally involved in wealth creation, but preserving the fiction of the unproductive state helps make periodic cuts legitimate. In terms of economic futures what is of interest is how different states have public sectors which are fixed within fairly narrow bands. Some advanced economies have much higher public spending and higher taxation than others. The political economy of these welfare states has long been a major subject for analysis, probing the extent to which the different levels of spending arise from political choices or from deep-rooted structural biases (Gough 1979; Esping-Andersen 1990).

Despite the persistence of very clear patterns of spending in different economies, this does not stop major changes taking place over time. The contraction of British defence spending through a series of major defence reviews in the last 70 years is one such example. Another is the decision of the coalition government to change radically the balance of the cost of higher education between the state and the student. An earlier British example was the sale of council houses. Decisions by governments as to what constitutes the agenda and the non-agenda of government can be extremely important in framing public policy debates, and small incremental decisions can have very large subsequent impacts as spending programmes contract or expand (Mullard 1993).

3 THE SIZE OF THE STATE

The debate on the deficit and how it should be handled focuses on an immediate problem, but it also raises much larger issues about what size of state is desirable and achievable. The question is relevant to economic futures, since in the economic past, the British state was much smaller than it is today. By the GDP measure (which includes transfer payments) it was below 10% before 1914, between 20% and 30% between the wars, and has averaged 38-41% since 1945. The two periods in which there was a step change in the size of the state came during the two world wars. It rose to 56% during World War One and 70% during World War Two (Peacock & Wiseman 1961). It fell back once the war ended but in each case not to the level at which it had been before the war. There was a permanent upward ratchet in state spending. There have been periods in peacetime when public spending has also shown an upward secular trend, notably in the 1960s and in the 2000s. During recessions in 1974-5 and 2008-9 public spending ballooned as output and tax receipts collapsed, but these were strictly temporary. What is noticeable is that overall the secular trend for public spending to increase as a share of GDP has not been sustained. It has tended to fall back, often in response to a crisis in the public finances. On the other hand the share of spending and taxation in GDP has been very resilient, and has tended to rise in line with economic growth. Governments disposed to favour a smaller state have not been successful in pushing the percentage lower.

Despite this history, the present debate over the deficit reveals three clearly articulated positions on the size and role of the state. There are those who advocate a larger state, funded by increased taxation to support existing services and to improve and extend them, with the level of provision in Scandinavian countries the main model (Toynbee and Walker 2010; Hutton 2010). Tony Blair's pledge in 2000 to raise spending on health

to the European average was an example of this aim, and it had been substantially realised by 2007. The arguments for moving to a Scandinavian style welfare state are partly about internal redistribution and social justice, but they also reflect a desire to build a strong, dynamic economy. One of the conditions for this is held to be a society with high levels of trust and social cohesion and low inequality (Rothstein 1998; Wilkinson and Pickett 2009; Arestis and Sobreira 2010).

The second position in the debate favours maintaining public spending in a steady state; not seeking to roll back public provision, but not seeking to increase it. This still allows for considerable reshaping and reordering of priorities, but no radical overall shifts. The political economy of this model is fairly clear. Support for maintaining public provision comes from users and public sector workers, while support for limiting its increase comes from taxpayers and consumers, many of them the same people. The political judgement that the limits of taxation have been reached plainly varies from country to country, but the politicians treat it as a real constraint rather than an imagined one. This position is politically difficult because, as cost inflation tends to be higher in public service provision than elsewhere in the economy, constant economies are needed, even in good times, simply to keep a lid on spending. This risks lowering the quality of service provision, which loses governments' popularity.

The third position in the debate argues for a much smaller state, between 25% or 35% of GDP. This could not be achieved by spending restraint and economies; it requires the suppression of major programmes, the cutting out, or at least drastic reduction, of whole areas of public provision. This has become the explicit aim of sections of libertarian opinion in the United States, particularly those associated with the Tea Party, and the cap, cut and balance deficit reduction plan. Specific reductions are clearly possible, as the Thatcher government showed with public housing, and as the coalition government is planning

with higher education. The problem is that other programmes of public expenditure are often expanded to fill the gap, so that no net contraction is delivered. The defence budget has been steadily reduced over a long period, but a smaller state has not been the outcome. The argument for a smaller state, like the argument for a larger state, is associated with certain core values of justice and liberty and also with a model of growth. An economy with a substantially smaller state, and therefore substantially lower taxation, it is suggested, might be more unequal but would be more dynamic, more entrepreneurial, and would achieve a faster rate of growth if that is what its citizens chose. As a result there would be more resources ultimately to pay for a social minimum, or for the arts, or for environmental protection, or for whatever other public goods were thought desirable (Pennington 2011). There have always been Conservatives attracted by the prospect of a much smaller state (Redwood 1993), and some of them are influential within the coalition government. In political economy terms the idea of the Big Society can be interpreted as implying a much smaller state, with much lower spending and taxation, and a much larger role for the voluntary sector in providing public services and raising funding directly from the citizens rather than spending tax funded government grants.

If a paradigm shift in public policy was taking place as a result of the financial crash, then a significant move to raise or reduce the overall size of the public sector would be strong evidence of it. At present that does not seem to be happening despite the political rhetoric on all sides claiming that it is. The status quo appears too strong, on both the tax and the spend side. There are claims that these are the deepest cuts of a generation aimed at a substantial rolling back of the state, while supporters of the coalition claim that the cuts, if implemented, will only return public spending to the share of GDP it had in 2007. Both have some truth. The cuts are severe, but there

is no intention, at least in this Parliament, to reduce public spending below 41% of GDP. The reason why the cuts are severe is because GDP has dropped 5-6%, a permanent reduction in British wealth which is unlikely to be made up. Cutting public services restores the status quo by permanently reducing some of the things the state has done in the past, with the brunt of the cuts being borne by local government. Some of the activity will grow back, but some will disappear forever. The real test, however, will be if the coalition government or its successor continue to cut public spending at the same rate through the next Parliament. If it were to do that, then there would be a substantial change in the size of the British state, and a potential shift to a new policy paradigm. Such a shift would require a return to normal or above average growth to make it politically palatable.

4 GROWTH MODELS

The debate on economic growth is a third component of the debate on the future of the economy. The financial growth model adopted in the 1980s, whose main drivers were financial services, retail, property and construction in the private sector, and education, health and universities in the public sector achieved remarkable success for the UK economy in the 1990s and up to 2007. A critical question is whether this growth model can be repaired and relaunched after some minor modifications, whether it needs a radical redesign, or whether a quite different growth model is required. Critics have suggested that this model was heavily reliant on ever increasing levels of private and public debt, and that the extent of debt deleveraging that is now required of firms and households, and the extent of deficit reduction by government means that none of these sectors can be major drivers of growth in the immediate future. There has been much talk of the need to rebalance the economy, a phrase which has been used in at least three senses, firstly to suggest a rebalancing between public and private consumption and investment, secondly between the service sector, particularly financial services, and manufacturing, and thirdly between regions. The coalition government has embraced all three in its plans for growth (BIS, 2010; 2011) but has paid most attention to the first two. It seeks to promote recovery firstly by re-establishing fiscal discipline and sharply reducing the size of the public sector, and secondly by encouraging a major increase in private sector investment and in exports.

Whether the economy can be rebalanced and growth re-launched as the government hopes will depend on which of two contrasting scenarios about the consequences of the crash turns out to be more accurate. The more optimistic scenario, which at least until the sovereign debt crisis erupted in July 2011 reflected

mainstream thinking, is that the economy will bounce back in the normal way from the unusually deep recession in 2008-9. By 2014-15 the government expects the global economy to be growing at 4-5% and the UK economy by 2.9% per annum. If such rates of growth can be achieved then the deficit will fall rapidly, both because of a fall in the numbers of unemployed claiming benefit, and because of the increase in tax receipts. A large part of the government's deficit reduction plan (£84 billion) depends on its growth forecast being accurate (Morgan 2011).

The second scenario is much gloomier about the prospects of growth, at least for the developed western economies. A number of analysts increasingly argue that this is no ordinary recession, and that there is unlikely to be a quick recovery from the 2008 crash as seemed possible in 2010 and the early part of 2011. As a result, the economies of the US, the UK and the eurozone will not be able to generate the rates of growth they need to pay off their debts quickly. Their economies will struggle to cope with an increasing debt burden, and the longer this persists the more likely it becomes that they resort either to defaults or to inflation in order to manage the pressures on them (Rogoff 2011; Hutton 2011). In either case this may mean a long period of stagnation in prospect, and relative decline in relation to other parts of the international economy. Many analysts and commentators had come to believe, even before the political deadlocks in the US and the eurozone in the summer of 2011, that the UK economy would not recover quickly and that incomes will be stagnant or falling over the next few years as the UK economy seeks to come to terms with the effects of the crash and the wiping out of so much value that was artificially created in the boom (Goodhart 2011; Warner 2011). The political implications of a long period of stagnation are naturally unwelcome to the government which during the crisis in 2011 stuck to its claim that the British economy

had turned the corner and was 'showing the way to recovery' to the rest of the world (Osborne 2011). The downgrading of growth forecasts for the British economy during 2011 pointed in a different direction, and underlined the narrowing of the government's options.

There is no certainty as to which scenario is more likely. Up until 2011 the optimistic scenario had been gaining ground, but the sovereign debt crisis in 2011 drew attention to the weakness of growth in many economies, including the UK. All sides of the debate in the UK acknowledge that without growth it will be much harder to manage UK debt, and there is an increasing focus on policies which might secure faster growth, making the economy more competitive and more flexible. Such policies however are not new, and their effects are not necessarily long-term. Politicians operate on much shorter timescales and need results in the next two or three years. Recovery depends on the health of the economies of Britain's major trading partners, and if most economies are contracting demand simultaneously and seeking to lower their exchange rates, British performance is bound to suffer.

In the short term, the UK's options are determined by past decisions, and there are severe institutional constraints on what the government can do. Bold plans to rebalance the economy, for example, and shift from finance to manufacturing run up against the obstacle that financial services comprise 10% of UK GDP – a higher portion than in most other major economies. The sector employs more than one million people, generated a trade surplus of £40 billion in 2009, and contributed £53 billion to the Exchequer, 11% of UK tax receipts (TheCityUK 2011). Placing major restrictions on the operations of the City would further damage UK short-term economic growth prospects. Any significant rebalancing of the economy is therefore likely to be slow and take place over many years. Any sudden contraction of the role of financial services is likely to

depress growth, and in the short term there are not obvious alternatives to fill the gap.

The high growth scenario for the international economy assumes that global economic growth will continue to be a positive sum game for the OECD (Organisation for Economic Co-operation and Development) economies. The underlying factors are deemed to be positive. This is based on three assumptions: that demand will go on growing rapidly in the emerging economies, that the rate at which new technologies are deployed will increase, and that the international economy can successfully adapt to climate change. The last two are the least certain and most often questioned (Cowen 2011; Gough 2011). The scenario implies that the present check to incomes and wealth will prove temporary, that growth will revive strongly in the next few years, and that as world economic growth continues, all states, including those which already possess advanced and mature economies, will be flexible enough to find ways to continue to increase their wealth. Not all the gains from global growth will be appropriated by rising powers. The UK as part of the international economy will benefit from global growth as it has in the past, so long as it takes steps to maintain its competitiveness. The mainstream consensus on economic growth is articulated by the World Economic Forum (WEF). It defines competitiveness as 'the set of institutions, policies and factors that determine the level of productivity of a country' (WEF 2011: 4). It identifies twelve pillars of competitiveness – institutions, infrastructure, macro-economic environment, heath and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication, and innovation. The UK is currently 12th on this index, firmly within the top group and has been as high as fourth, scoring particularly highly on labour market efficiency, business sophistication, innovation and market size,

and least well currently on macro-economic environment (due to the build-up of private and public debt in the last ten years). In its published growth strategy the coalition government has stated four main aims: to create the most competitive tax system in the G20; to make the UK one of the best places in Europe to start, finance and grow a business; to encourage investment and exports as a route to a more balanced economy; and to create a more educated workforce that is the most flexible in Europe (BIS, 2010). It has begun to develop policies to realise these goals by improving various incentives to shape economic behaviour. These include phased cuts in corporation tax from 2011 to 2014, reductions in the regulatory burden, relaxation of planning laws, creation of new apprenticeship schemes, and specific tax reliefs to encourage investment and innovations such as the creation of local enterprise partnerships and the new Enterprise Zones (BIS 2011).

The mainstream consensus on growth policy combines market-led and state-led elements. Market-led policy is laissez-faire in approach. Laissez-faire is wrongly caricatured as a do-nothing policy, but in fact it is an activist policy focused on removing obstacles to competition, innovation and enterprise by reducing state activity as much as possible. It assumes that free markets are the main engine of growth and that policy must be designed to maximise that freedom at every level, both national and international. Supply side policies of reducing taxes to encourage enterprise, and competition to encourage innovation, are regarded as the surest way to generate new jobs and new economic activities, which cannot be guessed or planned in advance. This approach has been dominant in British policymaking since the 1980s when Nigel Lawson dismissed the case for strategic investment in manufacturing that was made by a concerned House of Lords Committee (Lawson 1992), in favour of allowing the market to decide which sectors should contract and which expand. But it has always been

supplemented, and in particular during the Blair government, by strategic investment in human capital, infrastructure and the science base to help improve long-term competitiveness.

The coalition government broadly follows this approach. Although it talks of rebalancing the economy in favour of manufacturing and building a strong export-led recovery, it lacks specific tools to make either happen, and is relying instead on spontaneous private sector growth emerging once the deficit has been brought under control. To assist this main driver of growth the government proposes continuing strategic investment in certain areas to create the most favourable possible climate. The growth strategy published at the same time as the 2011 budget exemplified this approach. Developing the themes set out in 2010, it promised to facilitate a shift to exports and investment by making the tax system more competitive and the regulatory framework less burdensome, by removing barriers to global trade, by targeting new emerging economies such as India and China, by investing £40–50 billion a year in key infrastructure projects, by improving the skills of the workforce, by improving access to finance and by encouraging entrepreneurship (BIS 2011).

This approach continues the main lines of policy established in the last fifteen years. Critics of this approach argue that the structural weaknesses and imbalances in the British economy revealed by the financial crash cannot be remedied by spontaneous rebalancing but require major institutional reforms (Hay 2010; Hutton 2010) to alter the structure of economic incentives. The main institutional changes canvassed include radical reform of the financial services and corporate governance, separating retail from investment banking and creating new financial institutions to provide lending for innovative businesses and new technologies. Institutions like the coalition government's Green Investment Bank, which has funds of £3 billion to dispense, would be greatly expanded.

Such plans involve a return to a much more interventionist, state-led economic policy, in which government bodies direct investment by identifying priority sectors. Such strategies have been followed successfully in several countries which have made export success in advanced manufacturing their key objective. The difficulty for Britain is that it lacks many of the institutions for such an approach, and previous attempts to create them were not very successful (Grant 1995). The institutions it does have are part of a very different market-led model. It has been a long-running debate in British economic policy, as to whether relying on a market-led policy can enable the UK economy to continue to develop new sectors which produce internationally tradable output, as its older industries decline. This was a major theme in the tariff reform campaign at the beginning of the twentieth century (Semmel 1960) and also in the deindustrialisation debate of the 1970s and 1980s (Blackaby 1978). However, in comparison to England, the other constituent nations of the UK, Scotland, Wales and Northern Ireland, have always been subject to greater state economic control. In the future, as more powers are devolved to the other three nations and to Scotland in particular, very different priorities and models of economic development may emerge within the United Kingdom.

State-led strategic investment in skills, infrastructure, science and innovation, as well as initiatives to promote a diverse culture and a resilient civil society, in order to help economies to remain globally competitive, is less controversial. The disagreement between the laissez-faire and the strategic investment approaches is not over the need for state policies to create the environment for economic success, but over the degree of intervention in investment decisions.

A second issue is the scale of strategic investment that is required to remain competitive. Over the last ten years there has been substantial strategic investment in the science base in universities and manufacturing. This policy has been continued

by the coalition, but there is a sharp contrast with Germany which during the recession has provided a 20% uplift in its spending in this area. Advocates of strategic investment argue that market-led assumptions make British strategic investment often too little and too late, and seek major institutional change to give priority across Whitehall to the requirements of manufacturing and enterprise, downplaying the role of financial services and the City of London, and the hold that it has on the thinking and policies of the British government (Ingham 1984). This would imply a significant contraction in the size of the financial sector in the UK, because the sector would no longer be treated as having the regulatory freedom which it has enjoyed over the last three decades and which made it the leading sector of the UK economy. The Independent Commission on Banking when it reports in September is very unlikely to propose a regulatory regime which will seriously undermine the current role of the City, but it is expected to increase regulatory oversight of the City, in particular in relation to the relations between the retail and investment arms of the same bank, and this may lead over time to a reduced role for the City. It is not however the radical change of direction which the critics want.

For the advocates of strategic investment, the German model of high investment, high productivity, high wages and high exports is once more ascendant and preferable to the Anglo-Saxon model. All parties once again dream of Britain becoming more like Germany. But it would be a long and painful process of restructuring for Britain to move from a predominantly liberal market economy model to a coordinated market economy (Hall and Soskice 2001). It would require sustained investment in skills and science over a long period, a major change in the organisation of the financial system and of the civil service, and permanent increases in spending and taxation. Some sectors of the British economy already work like this, and always have, notably defence, (Edgerton 2005), but these

are relatively few in number. The cultural and institutional shift required is considerable (Grant 2012), and is unlikely to occur unless the crisis became much more severe.

One of the difficulties in moving from the present model is its deep institutional roots. The British growth model as it developed in the 1990s was characterised by the increasing prominence of finance and financial services in everyday life (Langley 2008) and by a permissive attitude to the build-up of private debt, a form of 'privatised Keynesianism' as Colin Crouch has called it (Crouch 2009). The increasing prominence of finance in everyday life involves the treatment of citizens as financial subjects, obliged to make financial calculations of the assets they need or want over their lifetime, including education, health, housing and pensions, and how to fund them. It gives a major role to financial services and has wider implications for the way in which societies and economies are organised, how individuals relate to the state, and the balance between public and private sectors. It links naturally to the Big Society vision of energising communities and voluntary activity, decentralising economic activity (Blond 2010), and developing new private sector companies to deliver public services as a means of containing the cost pressures of the public sector in an increasingly competitive international economy. This increasing prominence of finance helps lock the political economy into a particular path of development.

The low growth scenario is much gloomier about the prospects of western growth, including UK growth. Tyler Cowen, for example, has argued that the western economies are facing a long period of stagnation, because all the easy sources of growth over the last two hundred years have been used up, and these economies are failing to innovate fast enough to increase their wealth (Cowen 2009). As a result living standards for the majority have been stagnating even during the boom years, and the economy was kept afloat through public and private debt,

funded by the surplus economies. Realigning entitlements and incomes to what the economy can afford will be a long and painful process, because cuts will have to be much larger and last longer than currently envisaged. Other parts of the world will be able to continue to grow because they are catching up technologically and organisationally with the advanced economies, but everywhere else will stagnate at best.

This scenario removes the assumption that growth in the international economy will lift the UK economy as well. Either the UK economy may lose comparative advantage and many of its sectors cease to be competitive, or the international economy may stall, and with growing conflict over trade, resources, and currencies between the leading economies, international co-operation may weaken and countries may turn in on themselves.

In the low growth scenario, the greatest risk is that the assumption of expanding markets and the liberalisation of trade, investment, and population flows will all stall or go into reverse. Trade protection, immigration caps and competitive devaluations might all multiply. The complex network of global and regional governance could at best become deadlocked and at worst might start to unravel. In all countries, including the UK, economic nationalists from different parts of the political spectrum have begun to emphasise the necessity of protecting national interests and disengaging from international bodies, starting with the European Union. They tend to favour much stricter control of immigration and a commercial policy which protects local jobs and makes the economy less open. The case for maintaining an open international economy and full membership of the European Union even in a time of low growth will continue to be advocated strongly by those who perceive the need for more effective coordination and cooperation at all levels of the international economy. Forums such as the WTO, the G20, and the UN Climate Conference are all regarded as essential vehicles for achieving international

agreements on trade, financial regulation and carbon emissions, just as the EU is for many regional issues. From this perspective the UK's national interest, even in economic dark times, would be to seek co-operative solutions to provide a new set of rules for the international economy, in the hope of providing a secure foundation for future growth and stability. This debate raises the question of the relative openness of the British economy, how far this can be a matter of policy, and how far it is dictated by the way in which Britain is integrated into the international economy. The mainstream consensus since 1945 has been that Britain's interests lie in a stable international liberal order. But the arguments for a different kind of economic future for Britain – mercantilist, protectionist, nationalist, and isolationist – are already embedded in British politics, although still for the moment on the margins. They have been influential before, particularly in the 1930s, and under certain conditions could become so again (Jones 2011).

5 CONCLUSION

Returning to the Queen's question, if the problem was so large, why did no-one foresee it? The problem was large, and many had given warnings, but in retrospect no-one fully understood it and no one person or government or agency had overall responsibility for it. The cause is political rather than economic, and this is why social science, in the form of political economy as outlined here, does have something to offer policymakers for the future. It cannot offer precise predictions of particular future events, but thinking in terms of paradigms and scenarios can alert policymakers to a range of potential outcomes, and encourage a deeper debate on the alternatives that are feasible in particular contexts, rather than simply confining discussion within the assumptions of the ruling orthodoxy. The different approaches in political economy provide rival understandings of how the economy works, they analyse the patterns of action which constitute it, and they map out the different pathways and landscapes associated with them. At their best, political economy approaches can draw on some of the extraordinary richness in social science and humanities research, only a small amount of which is presently captured in discussion of economic futures in public policy.

One of the tasks for public policy in thinking about economic futures is to build the kind of resilience and institutional flexibility that can safeguard the economy against a range of possible shocks and developments. It is the scale of the challenges ahead (Rees 2003), most obviously, but by no means exclusively, in the uncertain effects of climate change, that suggests the need for an enhanced rather than a diminished role for government. It does not imply that a larger share of national income has to pass through its hands, or that government has to become more centralised, but it does suggest that the role of government in enabling rules and frameworks which can change

attitudes and behaviour and gain popular consent will become more pressing rather than less. The collective action problems which governments are called upon to solve are greater than ever, and this is particularly true in the economic sphere at both national and international levels. The range of strategies governments need to deploy are not likely to require just one approach. This again is where political economy can help, by making policymakers reflect on the range of policies that are available and the different kinds of knowledge that are relevant in different contexts. Nothing of course guarantees that the knowledge will be used wisely, or that good political judgements will be made, but it helps prepare the ground.

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GLOSSARY OF KEY TERMS

Basel Accords: Recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision (BCBS), a committee formed from representatives from the G-20, with the objective of improving understanding of banking worldwide.

Basel III: The third Basel Accord, strengthening bank capital requirements and introducing new regulatory requirements on bank liquidity and bank leverage.

Green Investment Bank: UK bank created as part of the coalition government's commitment to a green economy, dedicated to investing in environmentally-friendly infrastructure projects while encouraging economic growth.

Keynes versus Hayek debate: John Maynard Keynes and Friedrich Hayek were two prominent economists of the Great Depression era with sharply contrasting views.

Hayek promoted the idea that private investment, rather than government spending, would promote sustainable growth.

Keynes advocated that governments could control the business cycle, and that governments should increase spending in times of economic recessions to offset declining public spending, even if it meant running a deficit.

Monetarism: The theory that stable economic growth can be assured only by control of the rate of increase of the money supply to match the capacity for growth of real productivity.

Political economy: An interdisciplinary approach which, drawing on different aspects of the social sciences, studies how political institutions, the political environment and the economy interact.

Trade protection: Imposing restrictions on imports to limit foreign competition against domestic products.

Quantitative easing: An unconventional monetary policy employed by central banks to stimulate the national economy. It consists of purchasing a pre-determined amount of bonds or other assets from financial institutions to increase the money supply rather than to decrease the interest rate, which cannot be decreased further.

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