THE SIGNIFICANCE OF POLITICS

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Chapter based on an interview appearing in *Aftershocks: Economic Crisis and Institutional Choice*, edited by Anton Hemerijck, Ben Knapen and Ellen van Doorne, eds., (Amsterdam: Amsterdam University Press): 93-102.

"My first indication of the risks of potential crisis came when the financial press began to speak openly about the 'bets' that international financial institutions were making, whether on the direction of the markets , on takeovers, or the like. Banks were no longer making investments; they were making bets. It was commonly understood that the character of banking had changed over the past 15 years, as financial institutions dramatically increased their leverage using new derivatives. But the level of risk taking described by Susan Strange as 'Casino Capitalism' was a new phenomenon.[i] *A few years prior to the crisis, respected financial publications began explicitly using the word 'bet' to describe the investments institutions were making. That was when I began to worry, realizing that this had become a fundamentally different banking sector than the one I grew up with."*

The Political Face of the Crisis

In order to understand what the economic crisis will mean for the future, some analysis of history is in order. And although the crisis is economic in nature, the significance of economic developments cannot be understood separately from the political context that brackets them. Historically, the post-war period can be subdivided into three distinct periods: an era of embedded liberalism, the transitions of the 1970s, and a period of neo-liberalism. Only by understanding each period as one marked by distinctive formulae designed to respond to the economic and political challenges of the periodcan one fully appreciate how political economies change.

The period of embedded liberalism, in John Ruggie's felicitous phrase, spanned roughly 30 years, beginning with the close of WWII and ending around 1975. These years have been described as *les trente glorieuses*. Through the 1950s and 1960s, Western countries were still highly industrial economies, and Fordist modes of mass industrial production were prominent. The biggest economic challenges the developed economies faced were ones of sustaining demand and securing efficiency under this mode of production. The political challenges of this era were rooted in concerns about class conflict, specifically ones of finding ways to secure compromise between capital and labour. Class conflict is, to this day, rooted in memories of the political conflicts of the 1920s and 1930s, and over time its pertinence has eroded. However, in the period of embedded liberalism, the prospect of such conflict was still the foremost political challenge in the minds of policy-makers both in Europe and the United States, where electoral politics was visibly organized along a class cleavage.

In response to these economic and political challenges, the dominant policy formula created by the western economies can be described as the Keynesian welfare state. It was marked by the regularization of collective bargaining, Keynesian macroeconomic policies, and the gradual development of extensive systems of social support. In broad terms, those policies were implemented in both Europe and, to a lesser extent, the US. They addressed the political challenge by fostering class compromise and the economic challenge by sustaining demand. Keynesian demand management helped to generate the macroeconomic stability required by mass production systems, and collective bargaining distributed the gains from the rapid productivity increases available in such systems, so as to sustain consumer demand for the products the system manufactured.

The second period, which I see as one of transition, is a difficult time-span to delineate, but lasted roughly from 1968-1983. Economically, the biggest challenge of this period was stagflation: price inflation was accompanied by rising unemployment and general economic stagnation. Politically, the reorganization of class boundaries posed a significant challenge, as the potential for class conflict gradually waned. Thus, the old formula for political and economic cohesion broke down in this period, and few strategies were immediately available to replace it. Stagflation was itself the result of intensified distributive conflict. By this time the service sector was becoming more important, opening up new cleavages in labor and offering lower rates of productivity growth that called into question the post-war economic formula..

This period of transition set the stage for what I see as the third post-war period: the neo-liberal era. This era began in the early 1980s and lasted until the current economic crisis began. The economic challenge of this new period was defined by the sharply lower rates of growth that began in the 1970s: how could societies create new jobs in the service sector under low-growth conditions? As good jobs in the core manufacturing sector became scarcer, an insider/outsider dichotomy emerged, with workers in the core economy having relatively secure positions, but those on the margins, including the young and many women, finding few such employment opportunities. Increasing competition in more open international markets intensified these challenges..

Politically, the neo-liberal period saw the completion of a shift dating back to the 1970s, namely the declining political salience of class conflict. This shift was reflected in weakening political affiliations, a phenomenon that elections experts describe as ‘dealignment’, as ordinary citizens no longer voted so frequently along class lines, and there was growing cultural fragmentation in the electorate. To borrow the typology of Herbert

Kitschelt, overlaid on the traditional left/right cleavage was a left-libertarian/right-authoritarian cleavage.[ii] The latter was reflected in the growing political salience of post-materialist values –in many ways a legacy of the 1960s counterculture – which became a prominent theme in the new 'culture wars' characterizing the 1980s. Thus, over the past three decades, social-democratic parties have secured much of their support from the middle classes and left-leaning libertarians. Centre-right parties, their traditional counter-parts, have been increasingly challenged by factions or parties on the radical right who appeal to right-authoritarian and anti-immigrant sentiments as well as to anti-EU voters in Europe. This shift in the character of political cleavages helped move the entire political spectrum towards the right in the US and Europe.

The policy formula concocted to cope with these challenges can be described as a move away from state intervention toward the allocation of resource through markets, which was writ large in Europe by the project to create a single European market with the Single Europe Act of 1986. At the domestic level, the objective was to render markets more competitive through privatization and deregulation. At the international level, it was to open up global markets to more intense competition. The European policy response was marked by a shift away from the use of active demand management toward the use of supply-side policies to address employment issues. On the supply side, there was a corresponding shift away from industrial policies toward active labour market policies, which became the centrepiece of economic programs in continental Europe. In the US and UK, efforts to expand consumer demand were at the heart of policy-making, and governments encouiraged financial innovation. The ready availability of debt was used to help people whose incomes were stagnating cope with economic fluctuations in this post-Keynesian era. Although median wages grew modestly in the US, higher prices for housing and rising equity markets combined with cheap imports of goods from Asia to create an illusion of wealth that fuelled the expansion of consumer demand.

In sum, each historical period has had a distinctive set of policy prescriptions, which can be understood as the governmental response to the economic and political challenges of that era. What lessons can be drawn from this analysis for the current period? Most important, this account suggests we should not neglect the role that politics will play in the development of new economic policies. The European and American electorates are still fragmented along multiple lines, which will limit the extent to which we see a return to class conflict in the electoral arena. In the context of this ambiguous fragmentation, electoral outcomes will depend heavily on electoral rules.

Conventional wisdom in comparative political economy holds that electoral systems based on proportional representation are more likely than majoritarian electoral systems to promote redistribution . Coalitions between social-democratic and centre parties are more likely to form under proportional representation systems, and they tend to provide more generous social benefits than the governments elected under majoritarian systems that are forced to compete for the allegiance of the median voter. Thus, political progressives on both sides of the Atlantic tend to prefer PR over majoritarian systems. During good times, there is much to admire in the politics of proportional representation.

During bad times, of the sort associated with economic crisis, however, proportional representation is less attractive, as the case of the Weimar Republic famously illustrates.
Splinter parties, on both the right and left, also tend to prefer proportional representation because they are more likely to secure seats in the legislature under proportional representation. Even large parties carrying 30% of the popular vote cannot win elections in majoritarian single-member constituencies. And in the midst of economic crisis, splinter parties – including both radical right anti-immigration groups as well as radical left socialist groups – are likely to gain support . Because most European states have PR systems, their mainstream parties will be forced to deal with the difficult challenge of incorporating such groups or maintaining support in the face of them, as the recent European elections have demonstrated. By contrast, under majoritarian systems, discontent arising from economic crises tends to lead to alternation in government between mainstream center-left and center-right parties. The US has witnessed this, as the economic crisis helped bring the Democratic Party back to power, and, in the UK, Gordon Brown will likely soon be defeated by the Conservatives. Developments in the US may have sparked the crisis, but it is Europe that is likely to have to pay the political price.

When speculating about how systems will change as a result of the current crisis, therefore, it is imperative to bear political considerations in mind: Although the current economic juncture may call for specific policies, whether those policies are implemented or not will depend on the character of the political cleavages that mark a particular era and on the ways in which national institutions organize those cleavages into politics.

European Integration

In the short term at least, European integration is also a casualty of this crisis. Given the electoral rules outlined above, radical right-wing groups (which tend to be nationalist and anti-EU as well as anti-immigrant) are likely to gain influence in Europe. Although these parties will not muster the strength to take office in most countries, their growing support will put pressure on existing governments to expand nationalist responses to the crisis and limit their commitments to European integration.

Economic crises tend to exacerbate existing tensions, invariably decreasing satisfaction with existing governments. During the recession of the 1970s, nearly every government that was in power going into the crisis was overturned during it. Over the past two decades, one of the most prominent sources of tension in Europe has been immigration. Anti-immigrant sentiment has been growing across Europe for at least 25 years, and most opinion polls indicate that between 20-25% of the European electorate is, broadly speaking, resentful of immigrants. Therefore, it would not be surprising if citizens turned to radical right parties to give voice to their current frustrations and those parties demanded that brakes be put on the process of European integration.

Political integration has been a challenge for the EU since its inception. With enlargement to 27 member-states, moving ahead with political integration will be even more difficult. Moreover, Europe's response to the economic crisis has left many citizens questioning the value of the EU. Whereas the European central bank carried its weight admirably during the post-crisis period, finding innovative ways to loosen monetary policy, political leaders failed to find parallel innovations in the fiscal domain. National governments were wary of introducing robust fiscal stimulus measures because the closely intertwined continental economies are prone to spill-over effects. Instead, many promoted mildly protectionist measures, playing into the hands of nationalist parties. The EU's inability to coordinate fiscal measures was a serious failure. This issue provides a classic example of the kind of coordination problem that can best be solved by a supra-national body, yet the only such body in Europe failed to rise to the challenge. National governments jealously guarded control of their domestic spending, and as a result, many EU countries had sub-optimal and uncoordinated policy responses.

European countries currently find themselves on the horns of a dilemma. On the one hand, to maintain their generous welfare state expenditures, they require significant long-term economic growth. To achieve this, they urgently need to re-establish the prosperity of their economies, even if this requires fiscal stimulus measures that may lead to domestic deficits or inflationary pressures. On the other hand, bail-outs to the troubled financial sector, which cannot be avoided, are usurping funds that might be used to sustain vocational skills or invest in technology-led growth. As many European voters have observed, the current situation has turned the re-distributional ambitions of European welfare states upside-down, as social expenditures are restrained to free up resources for financial bail-outs.

Nevertheless, the European welfare states are likely to weather the storm. If European countries can restore even 2% per year of GDP growth, they will be able to sustain their welfare-systems in the long-run. Although the crisis has thrown some sand in the wheels of redistribution, it has highlighted the need for those wheels to keep turning. The crisis has reminded many Europeans of the importance of social programs to support the unemployed, the disabled, and others negatively affected by the crisis. In this respect, the economic crisis may reinforce, rather than undermine, the legitimacy of the welfare state as well as the Lisbon strategy, by strengthening demands for more active labour market policies.

Not all EU states are fully-developed welfare states, however, and one of the biggest challenges the EU faces in the coming period will be to rescue the newly acceded member states of Eastern and Central Europe. The economic crisis has had disproportionately damaging effects in these new member-states, which have not been widely appreciated even in the rest of Europe. As Wade Jacoby has noted, these countries made the transition from communism at the height of the neo-liberal era, and were sold the most radical version of the market model.[iii] Their governments truly believed that markets could work miracles, and now they are suffering more than other countries as a result of this irrational exuberance.

To its credit, the EU has taken significant steps to shore up the Eastern and Central European economies. Both the ECB and the European Bank for Reconstruction and Development have been important players in the immediate aftermath of the crisis in this region. However, many of the accession countries are undergoing a serious adjustment, similar to the 1980s debt crisis in Latin America, and the levels of defaults occurring in this region are already putting a significant strain on the EU. Under these conditions, it is unclear how much more the EU will be willing to contribute to an urgently needed second round of recovery assistance in the region.

Despite the problems it has posed for the EU, however, the economic crisis is likely to increase the international standing of the euro. Because the aspirations of the EU have been so high, there is a tendency to judge its performance harshly, as it forever falls short of extraordinary goals. It could have done more in the realm of fiscal policy coordination and integrated the new member statesmore effectively. . Nevertheless, the establishment of the euro was an incredible feat: in less than two decades, the EU has created a currency that has integrated the economies of continental Europe.

In global terms, the euro is likely to emerge from the crisis stronger – both in prestige and in economic value – as a result of the American dollar's post-crisis tribulations. The American economy has lived for several decades on debt and loose monetary policy. Ordinary Americans maintained their consumption through borrowing, decreasing the savings rate ratio virtually to zero over the past two decades. However, the crisis has brought the inherent imbalances of this system – especially vis-à-vis China – to light, and the model has begun to appear increasingly unsustainable. After losing several trillions of dollars in household wealth over the past year, Americans have dramatically increased their savings and decreased their consumption. As a result, the attractiveness of investment in the US is declining and, over time, that may reduce the global demand for dollars. As the dollar exchange rate falls, the euro is likely to strengthen against it and to join the dollar as a desirable reserve currency.

The State-Market Standoff

Can we expect the crisis to usher in a more active economic role for governments? As we compare and evaluate the policy response to the crisis, it is important to remember that different types of political economies demand different types of policy responses. Many continental European governments have faced criticism – especially from the US and the UK – for adopting labour preserving programs. What critics in liberal market economies fail to appreciate, however, is that in these coordinated continental economies, it is essential to try to preserve industrial or service sector jobs, because the organization of labour and capital markets in these countries makes it difficult to re-establish these jobs once they have been lost. Conversely, critics of the British and American focus on stimulating consumer demand need to appreciate that this is appropriate for economies in which the primary engine of growth is consumption.

That said, however, one caveat remains pertinent to all countries as we anticipate the long-term policy response to the economic crisis: although market optimism has dwindled, a new era of optimism about what states can do will not necessarily follow. Neo-liberalism's recipe for resource allocation might have turned out to be catastrophe-prone, and government regulation of financial markets will certainly increase as a result. However, citizens currently have as little faith in states as they have in the market. Because they are presiding over recession, whatever governments do during an economic crisis is usually seen as a failure, so states should expect some popular backlash whatever governments do in the crisis period.

This is true on both sides of the Atlantic. The US was founded on a fear of big government, and scepticism about government's capacities runs deep in the American psyche.

The popular saying, ‘In God we trust, all others pay cash,’ still resonates with the American people and brings to mind recurrent states rights movements. Scepticism about Obama’s stimulus plan is already on the rise in the media and among conservative political circles and, although these voices remain in the minority, an extended economic downturn could tip this balance. In Europe, the problems are more institutional. Any ‘return of the state’ would have to happen at the EU level: national governments already play a larger role than they do in the US and the problems of economic coordination stretch well beyond the borders of each member-state. Since the EU is currently the scapegoat-of-choice for anti-immigrant and Eurosceptic complaints, its legitimacy may be too low to rise to such a significant challenge.

As we consider the post-crisis rebalancing of state versus market power, however, the role of firms should not be neglected. They are critical actors in the development of political economies. Economic adjustment is driven by both by governments and by firms, each guided by different incentive structures. The post-crisis strategies of Ford, Siemens and EADS have already had more effects on the lives of their thousands of employees than any single government intervention.

Towards a New Legitimizing Narrative

As we contemplate what might happen to the balance between state and market power, we should also recall the importance of developments in the realm of political discourse. If they want to move to heightened levels of intervention, governments will have to find new legitimizing narratives for that role. The narratives of the past no longer suffice. Throughout the era of modernization in the West, the democratic state was often presented in grand historical terms as the political vehicle for the establishment of enlightenment ideals. As Samuel Beer observed, democratic states were seen as the reflection of a voluntarist impulse: their actions reflected the will of the people. And, as creatures of the enlightenment, they were thought to be able to harness the power of science and technology on behalf of citizens.[iv] In this respect, the democratic nation-state was seen as the legitimate vehicle for technological and ultimately economic progress. One of the most striking features of the contemporary era, however, has been the questioning of enlightenment values inspired by post-modernist thought. At a popular level, that has gone hand in hand with increasing distrust in governments.

If governments hope to take on a more activist role in the economy, therefore, they will have to re-establish the terms on which such a role can be said to be legitimate. This will not be easy, even in North American and Western Europe, which have long democratic histories. However, the task is also challenging in Eastern and Central Europe, where the historical experience with democracy has been shorter and the legitimizing narratives of the distant past are mediated by a half century of communist experience. Despite the declining legitimacy of neo-liberal governments, these countries have few sound alternatives: On one side of the political spectrum are parties committed to market fundamentals; on the other side are nationalist parties that are often protectionist, anti-immigrant, and Eurosceptical.

Moreover, if governments are to take on a substantially larger role in the economy, they will need some successful projects to restore popular confidence in governmental capacities. In the short run, it may be easier to engineer some changes of this sort in the US than in Europe. The Obama administration was elected, in large measure, as a backlash against eight years of a Republican administration devoted to market competition. Therefore, the new administration has plenty of room in which to generate new policies for which it can claim credit. Obama's campaign platform included innovative measures to tackle energy shortages, climate change, healthcare, and education. To his credit, he has continued to pursue these policies despite the setbacks presented by economic crisis. This is not to say that Democrats are going to win the next election, but they are in a position to restore some faith in government in a country where it has been deeply eroded.

In Europe, where governments have long devoted considerable resources to social support, there is less room for novel projects that might inspire new confidence in government. Few of the mainstream parties in any country include innovative planks in their platforms, and many contenders for power are simply waiting for the crisis to bring down existing governments. Successful though this strategy may be, it does not promote new ideas or innovative programs that can revitalize the body politic. In more than a few cases, political leaders have demonized 'globalization' while using the EU to expand competitive markets. Electorates understand this hypocrisy, and it has left them jaded about the candor of politicians and the credibility of governments. As a result, the challenge these governments now face is not simply a technocratic one –of finding more effective economic policies. The contemporary challenge is more political: governments must articulate moral visions capable of restoring their legitimacy in difficult times, and ideally visions that breathe new life into a European Union discredited by the role it took on as the agent of market competition. This will not be easy and is rendered more difficult by the absence of EU officials elected by Europe as a whole. There are grounds for hope, however, in the fact that, time and time again, the EU has reinventeditself, showing the creativity and dynamism neededto overcome the myriad challenges it has faced since its inception.

The economic crisis has brought the world to a new policy crossroads. Deciding which direction to take from here entails not only economic, but also political, choices. The relevant developments will require international cooperation but national implementation.. As a result, no government will be able to forge ahead without shoring up its domestic legitimacy, and, after two decades of neo-liberal excess, that will require some fundamental re-imagining of the role of the state in the economy. Nowhere is this challenge more apparent than in Europe, where the tasks of national economic and political reform are compounded by the necessity of coordination within an ever-changing European Union.

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[i] Susan Strange, *Casino Capitalism* (Manchester University Press, 1997).
[ii] Herbert Kitschelt, *The Radical Right in Western Europe: A Comparative Analysis* (University of Michigan Press, 1997).
[iii] Wade Jacoby, *The Enlargement of the European Union and NATO* (Cambridge University Press, 2004).
[iv] Samuel H. Beer, *Modern Political Development*. (Random House, 1974).