

Tomorrow's Capitalism



How Can Capitalism Deliver Better Outcomes for All?

Conclusions from the Tomorrow's
Capitalism programme

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www.ippr.org/tomorrowscapitalism

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How can capitalism deliver better outcomes for all?

This paper summarises the findings of the Tomorrow's Capitalism programme, organised by ippr in conjunction with Friends Provident Foundation in 2009 with the aim of exploring the future of our financial and economic system.

To do this, we presented a series of debates, seminars and papers featuring leading experts and thinkers from the world of economics, business, politics and the media. The result was a deeper understanding of the flaws inherent in the neo-liberal model of capitalism and the steps needed to correct them, together with a vision of some of the key features of 'tomorrow's capitalism' and the challenges facing policymakers as they seek to improve the current economic and financial model.

A synthesis of this understanding, derived partly from the debates and reports, is provided in this final paper. It does not attempt to cover all the terrain under this vast topic although it does draw some important conclusions.

References to the various papers and events are given throughout the paper. They can be accessed at www.ippr.org/tomorrowscapitalism

Introduction

For my part I think that capitalism, wisely managed, can probably be made more efficient for attaining economic ends than any alternative system yet in sight, but that in itself it is in many ways extremely objectionable.

John Maynard Keynes, *The End of Laissez-faire* (1926)

In the last 12 months, capitalism has, in the words of Keynes, been 'extremely objectionable'. The world has experienced its worst financial collapse since the 1930s and is in the midst of the deepest recession since the Second World War. The International Monetary Fund (IMF) expects world output to shrink by 1.4 per cent in 2009 (IMF 2009b). According to conventional economic theory, this should not have happened. The neo-liberal model of capitalism which has dominated for the last 30 years – characterised by light regulation, unfettered markets and minimal state intervention – was supposed to deliver sustainable increases in welfare but it failed to do so. Some of the model's supporters were even unwise enough to suggest that the economic cycle had been abolished and they have been proved very wrong.

Unsurprisingly, a catastrophic failure on this scale has led to speculation that neo-liberal capitalism is past its sell-by date. Despite the seriousness of the recent crisis, however, Keynes's view that capitalism in some form is a better bet than the alternatives on offer remains true. Capitalism has produced far the superior outcomes in terms of social welfare and personal freedom. It is unlikely, therefore, that capitalism will be abandoned. However, it will have to change. Just as the neo-liberal form of capitalism replaced the regulated form, which dominated Western economies from the end of the Second World War through to the 1970s, so a new form of capitalism is likely to emerge as a result of the current crisis. The neo-liberal model is destined soon to be regarded as 'yesterday's capitalism', but it is not yet clear what will replace it. This is the time to ask what 'tomorrow's capitalism' might look like.

Of course, at this stage, it is too early to answer this question with any certainty. Just as no one in the mid-1970s could have predicted accurately the way the neo-liberal model would develop to encompass privatisation, the defeat of inflation and the emergence of an economically-powerful China, so it is unlikely that we can, today, predict accurately the

course of the next 30 years. However, by identifying some of the flaws in the neo-liberal model which helped create the present crisis, looking at ways in which they can be corrected and asking what people really want from the economic system, we can, perhaps, begin to envisage what tomorrow's capitalism will look like – and what it should look like.

Neo-liberal capitalism in crisis

Economic and financial systems differ from country to country, even within the developed economies of North America and Western Europe, and they are always in flux. But historians are likely to identify two dominant economic models, in Anglo-Saxon economies at least, in the period from the Second World War up to the present day.

The first model, which lasted from the 1940s through to the 70s, was characterised by a high degree of government intervention in the economy, both directly and through the use of regulation. Macro-economic policies were geared to maximising employment, largely through fiscal policy, while recognising a trade-off between inflation and unemployment. Although this model delivered very desirable outcomes in the 1950s and early 60s, a period which saw rapid economic growth in the United States and Europe, it fell into disrepute in the stagflationary era of the 70s. However, its successor did not really emerge until the early 80s, ushered in by the Reagan administration in the US and the Thatcher government in the UK.

For the next 30 years, a neo-liberal model of capitalism dominated. This model was characterised by light regulation, unfettered markets and a much reduced role for government in the economy. Macro-economic policies were geared to keeping inflation low, largely through monetary policy, as the best means of securing economic growth and, thus, a low level of unemployment. Until 2008, its supporters were able to argue that the neo-liberal model had proved to be a great success. Inflation had been largely conquered in developed economies and in the vast majority of developing economies too. Unemployment rates were low. Former Soviet states, Eastern European countries and China were all fully engaged in the capitalist economy and world trade was expanding at a rapid pace. (Critics who pointed out unsustainable aspects of all this growth – including resource depletion and climate change – were brushed aside.) There were problems along the way – recessions in many countries in the early 1990s and the Asian crisis later in that decade – but these seemed a small price to pay for the progress that was being made.

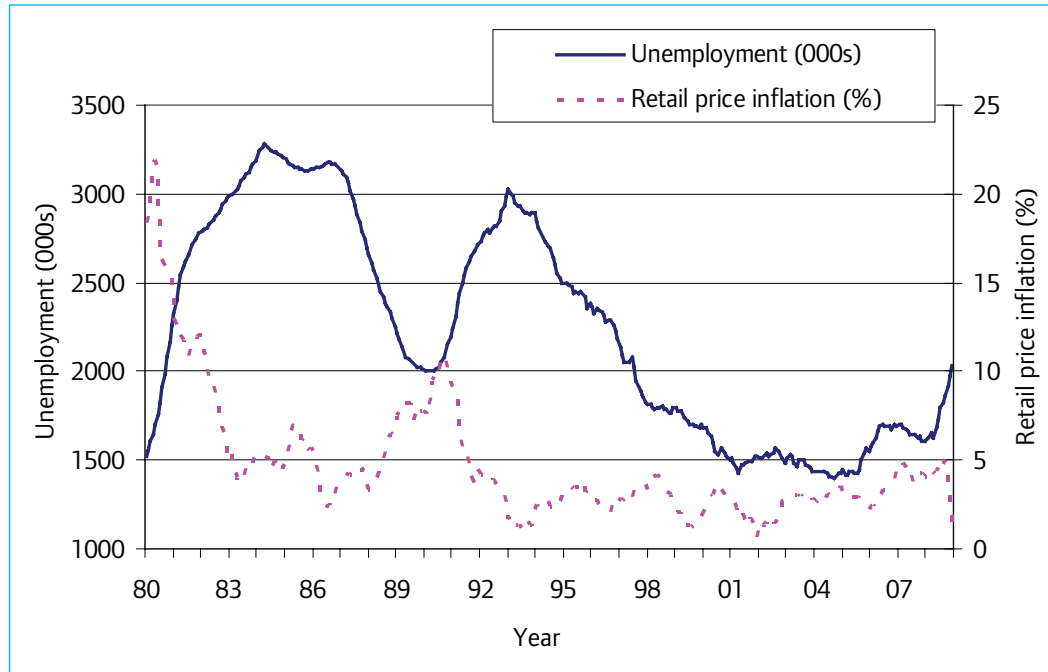
Meanwhile, in the UK, the economy expanded continuously for a record 17 years from 1992 to 2008 and unemployment fell to around 1.5 million – its lowest level since the 1970s. Following the granting, in 1997, of independence over the conduct of monetary policy to the Bank of England, inflation remained within one percentage point of its target rate for almost a decade. Although there were worries that all was not well beneath the surface, these headline numbers, on growth, unemployment and inflation, seemed too good to argue with. (See Figure 1, next page.)

It is now clear, however, that this success bred complacency. In turn this led to excessive risk-taking and ultimately to the financial collapse that engulfed the global banking system in 2008, to be followed, inevitably, by recession. As predicted by Hyman Minsky, a once forgotten US economist in whose work there has recently been a great revival of interest: 'The dynamics of a capitalist economy which has complex, sophisticated, and evolving financial structures leads to the development of conditions conducive to incoherence – to runaway inflations or deep depressions' (Minsky 1986).

Investors, companies, households and governments all came to believe that economic volatility had been conquered, that economic agents behaved rationally and that financial

Figure 1. UK unemployment and inflation

Source: Office for National Statistics 2009



markets were efficient. Rising asset prices must, therefore, be justified. As market confidence that nothing could go wrong increased, so bankers and other financial agents took bigger and bigger risks, secure – they felt – in the knowledge that any losses could be contained. This was an assumption that proved calamitously wrong.

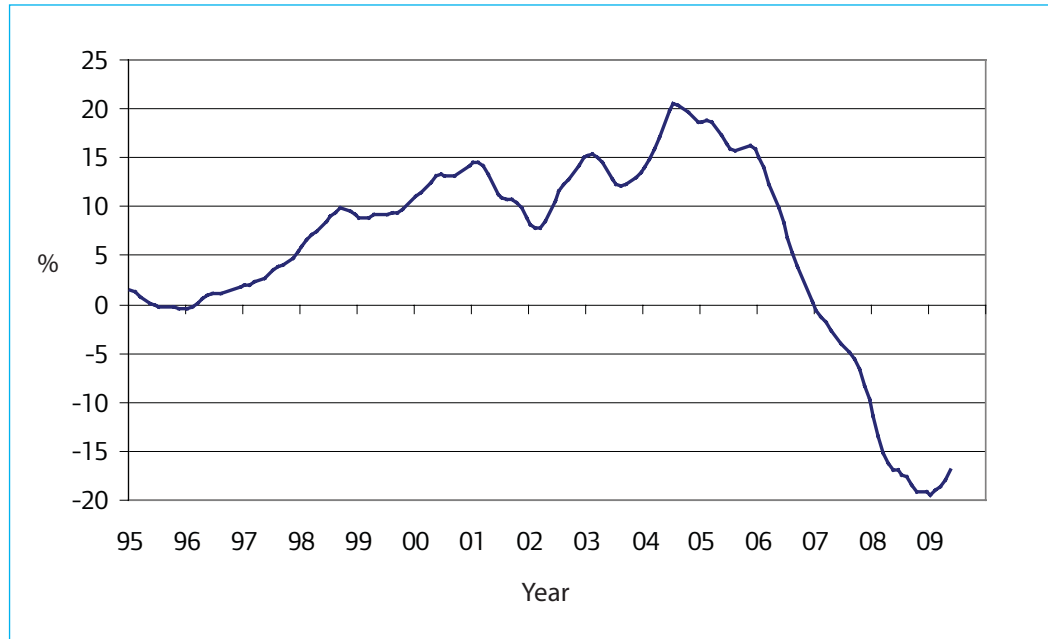
In particular, a belief began to grow that US house prices could not fall and this encouraged more and more households to become home owners (and an increasing number to buy extra properties as an investment). They were able to do so because mortgage lenders made loans available to them. Household mortgage debt outstanding in the US rose from \$5.3 trillion at the end of 2001 to \$10.5 trillion at the end of 2007 – almost doubling in just six years (US Federal Reserve 2009). New sub-prime mortgages – loans to households with poor credit records or uncertain incomes – rose from around \$200 billion in 2002 (7 per cent of the total) to over \$600 billion in 2005 and 2006 (over 20 per cent of the total) (Jaffe 2008). Many of these mortgages had low ‘teaser’ rates, meaning that interest payments were kept low for one or two years before being reset to a market rate. Sure enough, this influx of new buyers helped push up house prices, fuelling the myth that they could never fall.

Meanwhile, the lenders were busy offloading their risk by securitising mortgages – bundling them up into bonds, known as mortgage-backed securities (MBS), which could be sold to investors. In turn, financial engineers in banks and other financial institutions created another set of instruments out of these MBS, often by combining them with corporate debt (bonds issued by companies). These complex instruments – collateralised debt obligations or CDOs – were divided into different tiers, each with a rating from a credit rating agency, allowing investors to invest only in those tiers that suited their risk appetite. To enhance returns, investors often used leverage to purchase CDOs, so debt within the financial system grew rapidly alongside household debt.

Although some observers expressed alarm at the rapid growth of debt within the US economy, it did not create any problems while US house prices were going up. However, there came a point when prices had risen so far that the myth that they would keep on rising became impossible to sustain. This was quickly followed by a realisation that prices could fall sharply, particularly in some of the more ‘bubbly’ markets, such as Florida, California and Nevada.

Figure 2. House price inflation in the United States (%)

Source:
S&P/Case-Shiller
2009



For many sub-prime lenders, falling house prices created huge problems because they could not afford the higher interest payments that were required once their period of paying a teaser rate expired. They had been counting on re-mortgaging their property and found that they could not do so because it was now worth less than their original mortgage. At this point, people started returning the keys to their properties and walking away from their mortgages. As mortgage default rates started to creep up, so holders of MBS and CDOs started to worry that they would not get their money back and looked to sell. Unsurprisingly, they found few potential purchasers and prices fell. This was a problem for investors who had bought with the help of borrowed money. As well as potentially losing all of their own investment, they found they held an asset worth less than the loan they had used to buy it. In turn, this became a problem for the banks because they could not get their money back.

The problems were not confined to the US. It soon became clear that banks and other financial institutions around the world had bought CDOs and other instruments backed ultimately by the US mortgage market. A catalogue of failures and bankruptcies followed. In early 2007, specialist US subprime lenders began to report losses; in June two hedge funds run by Bear Stearns were reported to be in serious trouble; and in September there was a 'run' on Northern Rock – the first on a UK bank since 1866.

More problems followed. Major US and European banks wrote down the value of their capital by billions of dollars due to losses associated with the US subprime market. In March 2008, the Federal Reserve engineered the takeover of Bear Stearns by JP Morgan Chase and in July 2008 the US Treasury had to bail out the two large US mortgage agencies. However, when Lehman Brothers, the fourth largest investment bank in the US, got into serious trouble in September 2008, the Bush Administration decided not to support it, and it was forced to file for bankruptcy. With hindsight, this was the moment when the crisis passed the point of no return. Banks became unwilling to lend to each other. Money market interest rates rose well above the level of official interest rates and the credit crunch began in earnest.

Once banks ran into trouble of this magnitude, it was inevitable that the financial collapse would spill over into the real economy. Desperate to rebuild their capital bases, banks began to cut back on lending. Credit-worthy households and companies found that they could no longer borrow the funds they needed to purchase houses, to make investments, or simply to

keep companies afloat. Spending was cut, workers were laid off and economies fell into recession. The authorities responded by easing fiscal policy, cutting interest rates and, most importantly, introducing a series of measures to shore up banks' capital positions. However, by the time they acted the downward momentum was too great to arrest.

Confidence among businesses and households had descended, surveys showed, to the lowest levels on record (although in some cases the data only cover the last 20 or 30 years, in others records go back to the 1950s). This was, in large part, due to the financial collapse, but higher energy and food prices added to the feeling of gloom. The crude oil price, which had been rising steadily since the beginning of 2002, reached a peak of \$147 a barrel in July 2008, sending petrol prices and energy bills soaring. Meanwhile, the prices of many basic foodstuffs also rose sharply. Food price inflation in the UK reached 13 per cent in August 2008, its highest rate for over 25 years. Households found their discretionary spending power severely squeezed and cut back on non-essential items. Sales of cars in the UK, for example, fell by around a quarter. So the recession deepened.

Studies show that recessions caused primarily by balance sheet problems (that is, excessive debt) tend to be worse than recessions that result from a tightening of monetary policy to control inflation. They also show that synchronised recessions tend to be worse for individual countries than recessions in a single country. We are now experiencing a global balance sheet recession, so it is no surprise that, for the global economy, it is turning out to be the deepest since the Second World War. The IMF now forecasts a 1.4 per cent decline in global output in 2009 – the first decline in over 60 years – and a 3.8 per cent fall in advanced economies (IMF 2009b). The *Economist* magazine reports that this year output is expected to contract in 50 of the 57 countries it reports on (The Economist 2009)¹.

In the UK, output has already fallen by almost 6 per cent from its peak and further declines are expected. Unemployment, which fluctuated at around 1.5 million between 2001 and 2005, has risen to 2.38 million, and is widely forecast to reach 3 million in 2010. In the initial stages of the crisis, there were fears that the UK would fare quite badly because of its relatively heavy dependence on the financial services industry and its own housing market bubble. So far, however, this has not been the case and the biggest declines in output have been in economies, such as Japan, Germany, Singapore, Taiwan and Korea, that are heavily reliant on exports of manufactured goods for growth, and in emerging economies like the Baltic States, which depended strongly on inflows of capital from overseas. The UK Government is hopeful that growth will be restored by the end of the year, although many independent forecasters still think that the recovery will not commence until 2010.

Tomorrow's capitalism: the optimist's perspective

In the midst of the worst global recession since the 1930s, it is all too easy to be pessimistic, particularly when prominent economists such as Paul Krugman, who was awarded the Nobel Prize in Economic Sciences in 2008, are so gloomy about the economic outlook. Krugman fears the world economy over the next decade – or the US and Europe at least – will replicate the experience of Japan following the bursting of its bubble in 1990. As he puts it: 'The risk for a long stagnation is really high' (Hutton 2009). At the heart of his pessimism is a concern that it will take banks, companies and households several years at least to clean up their balance sheets. Until they do, he argues, there is no prospect of dynamic growth, and a high possibility of little or no growth.

1. The seven exceptions are China, India, Pakistan, Indonesia, Vietnam, Egypt and Peru.

For a more optimistic view, it is necessary to turn to economists who approach their subject from a completely different perspective. Some economic historians, for example, argue the financial collapse was an inevitable consequence of the way the capitalist system assimilates technical change. Their message is that, if history is any guide, the current recession could be followed by a new global golden age.

Technological revolutions² have in the past been characterised by a surge in development that comes in two phases, with a major financial collapse in the middle. The first phase, the 'installation period', is led by financial capital. A powerful cluster of new industries, centred on the new technology, develops, creating explosive growth and structural change. The second phase, the 'deployment period', is led by production capital. New multi-purpose technologies allow the revolution to percolate and modernise existing industries, creating major productivity gains. Thus, ultimately, technological revolutions transform the whole economy.

Each surge has its own unique characteristics, reflecting the specific technological change that is taking place, but also the political, social and cultural conditions of the time. However, there are also common patterns and it is the belief that these patterns recur, which underpins the idea that we may be on the brink of a global golden age. If they do, then we are currently in the difficult period between the two phases of an information technology and telecommunications revolution. The 'installation period', led by financial capital, has drawn to a close and the 'deployment period', which will be led by production capital, has yet to commence. The only significant difference, so far, from the historical pattern is that the mid-surge bubble occurred in two stages – the technology bubble, which burst in 2000, and the credit bubble, which burst in 2007.

However, these economic historians also point out that golden ages have not just happened in the past. It is likely that institutional innovation will be necessary for a return to healthy growth in the economies of the OECD (Organisation for Economic Cooperation and Development) and extensive growth across the whole developing world. To ensure this happens, governments will have to regulate to restrain financial excesses. Governments also need to support long-term investment in productive capacity and to re-establish social cohesion through more even income distribution and better social safety nets. If they do, then society will benefit from the potential of the new technologies in terms of full employment and enhanced well-being.

Correcting the flaws in neo-liberal capitalism through changes to the international order, the UK economy and financial markets, while also reassessing what capitalism is meant to deliver could, therefore, deliver far better outcomes over the next 20 years than most now imagine possible.

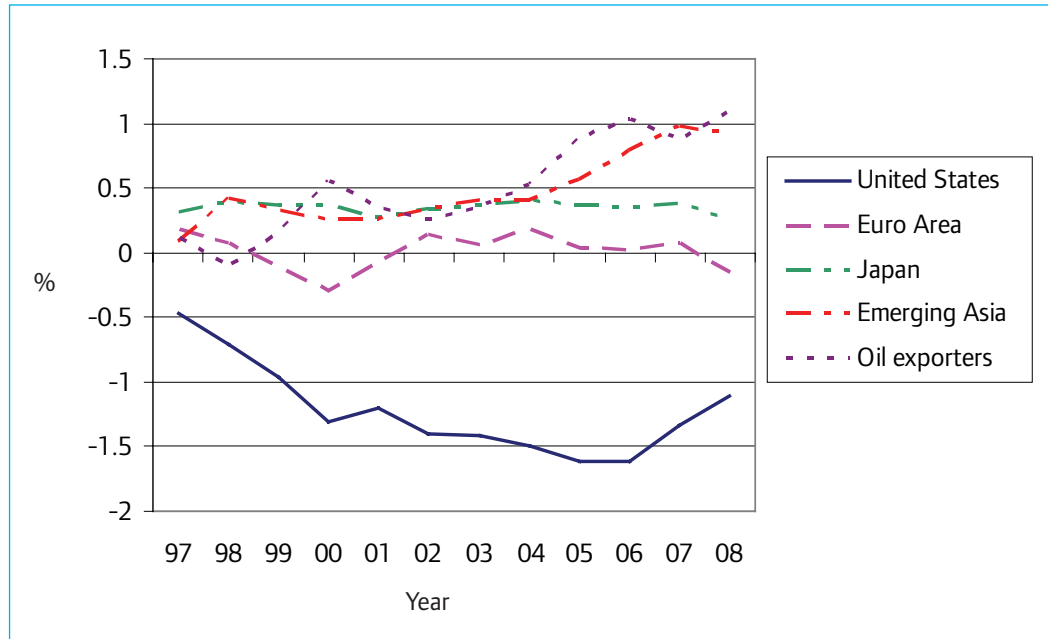
Tomorrow's capitalism: the international order

One of the causes of the global financial crisis and recession was a failure to successfully integrate China and other emerging economies into the global capitalist economy. Large amounts of capital, principally from Asian economies and oil exporting countries, flowed into the US and other Western economies, lowering long-term interest rates and helping to fuel house price bubbles. These capital flows were matched by large current account surpluses in Asia and large current account deficits in the US and other capital importing countries.

2. The rest of this section is based on a presentation entitled 'Growth After the Financial Crisis' given by Carlota Perez on 1 June as part of the Tomorrow's Capitalism programme. A recording is available at www.ippr.org.uk/tomorrowscapitalism/events.asp?id=3459&tID=3336

Figure 3.
Current account
balances (% of
global GDP)

Source:
International
Monetary Fund
2009a



These imbalances have their roots in the Asian crisis of 1997 and 1998. During this period, a number of Asian economies, which had been relying on capital flows from overseas to boost domestic spending and growth in their economies, found that they could no longer attract external funds. As a result, their currencies collapsed, spending had to be cut back sharply and they endured deep recessions. The authorities in these economies responded by adopting a new set of economic priorities. No longer would they be reliant on overseas capital for growth. Instead, they would seek export-led growth, run current account surpluses and offset them by transferring their excess savings overseas.

Meanwhile, China was adopting a similar mercantilist attitude. By retaining capital controls, it was able to prevent its currency rising on the foreign exchanges, which helped it to sustain strong export growth. This resulted in massive current account surpluses and an imbalance between domestic saving and investment. As the oil price rose, oil-exporting countries found themselves in a similar situation.

The result was what Ben Bernanke, now Governor of the US Federal Reserve, has called a 'savings glut' in Asia, and more recently in oil-exporting economies. These surplus savings were used to buy government bonds and similar instruments in Western economies, helping to hold down long-term interest rates, including US mortgage rates, and so stimulating asset prices, including US house prices.

China and other emerging economies had other effects on the global economy. In particular, China's willingness to participate in the global capitalist economy added, potentially, hundreds of millions of people to its workforce. Unsurprisingly, this had the effect of reducing the share of wages in global output (because labour was now a relatively abundant resource) and increasing the share of profits. As a result, households could only afford to buy all the available output by taking on more and more debt³. In the UK, for example, household debt increased from 109 per cent of disposable income in 1999 to 176 per cent in 2007, a trend that could not be sustained forever, as we are now finding out.

3. This point is made by Gerry Holtham in his paper for the Tomorrow's Capitalism programme: *Global Dimensions of the Financial Crisis* (Holtham 2009).

The financial crisis and recession have already been the stimulus for action at the international level. The G20 group of countries has met twice, in Washington DC in November 2008 and in London in April 2009. Another meeting is planned for September in Pittsburgh. The focus of the first two meetings was, rightly, the measures necessary to restore some sort of normality to the global banking system and to limit the extent of the recession. The London Summit in particular was judged a success after the leaders agreed a \$1.1 trillion programme of support for the global economy – mainly to be channelled through the IMF. However, at their next summit, it will be time for the G20 leaders to start looking forward: first to the Copenhagen Summit in December, when decisions need to be made on controlling carbon emissions, and second, to changes in the international order that are required to make the global economy more stable. The latter goal will require policymakers to take action both at the international level and domestically.

Internationally, the IMF and World Bank are long overdue an overhaul. They were established as part of the Bretton Woods agreement in 1944 and have remained largely unchanged ever since; they are still dominated by the US and Europe. The first change that is required, therefore, is to acknowledge today's economic realities: China is now the world's second largest economy and is on track to be its largest within fifteen years. It will have to have a greater say in the running of the world economy, as will India, Russia and Brazil, which will all be among the world's top ten economies by 2027⁴. This will require hitherto dominant countries, in particular the US and the UK, to accept a diminution in their power.

This will make it easier for the IMF, in particular, to take on a new role of monitoring economic and financial developments at a global level and bringing pressure to bear on any economy (or group of economies) that is large enough to potentially unbalance the global economy and that is pursuing policies that are actually unbalanced enough to do so (Holtham 2009). In reality, of course, this means principally the US and China (though they are almost matched in size by the European Union as a whole). By 2027, according to Goldman Sachs, the US and China will both be approximately four times the size of the world's next largest economy (India). The IMF, however, can only do so much to encourage governments to change policy. Peer pressure will be crucial. In this respect, an enhanced role for the G20 will be important, while the G8 grouping of countries, which includes Russia but not China, India or Brazil, no longer has a useful role to play in international economic matters.

The immediate imperatives for US policy are fairly clear. Once the recession has passed it will be left with a large fiscal deficit – probably of the order of 12 or 13 per cent of GDP – and a still sizeable current account deficit. Action will need to be taken to reduce the fiscal deficit, while ensuring that the private sector remains in surplus so that the current account deficit also shrinks.

China is a more complex problem. The rise of China – and of Asia more generally – is a long-term phenomenon, which was going on for decades before the current crisis and is likely to continue for many decades to come. The region's influence in global international affairs is bound to increase with its economic size but it will have to accept the responsibilities and obligations that come with that extra influence⁵. Its priority should be to stop exporting

4. Latest projections from Goldman Sachs show China will be the world's largest economy in 2027, India the third largest, Russia sixth and Brazil eighth. See Faulconbridge 2009

5. Bill Emmott and Martin Jacques both emphasised this point at the Tomorrow's Capitalism debate on the International Order, 20 May 2009. Recordings are available at www.ippr.org/tomorrowscapitalism/events.asp?id=3473&tID=3336

capital to the rest of the world, and to the US in particular. This would not just be for the good of the international order, but would be beneficial to the Chinese economy too. China has already accumulated foreign exchange reserves amounting to almost \$2 trillion, mostly denominated in US dollars. There is little sense in accumulating more. More generally, it is illogical, and counter to the normal historical pattern, for a relatively poor country like China to be exporting capital to a wealthy country like the US. It could, and should, be put to more productive use within the Chinese economy, for example in the development of public provision of healthcare and education.

The present crisis will have shown the Chinese authorities that their economy is not dependent on the US or any other economy. It is still forecast to grow by about 7 per cent in 2009 despite the deep recession being experienced by most of the rest of the world. As a result, China is likely to become more assertive in shaping the international order to reflect its own perspective. However, it will not be able to dominate in the way that the US has done since Bretton Woods. The new international order will have a number of important players: China and the US, but also the European Union and India and maybe a bloc of Latin American countries too. If they cooperate with each other, they will have a much better chance of preventing the development in future of economic imbalances like those that were at the root of the current crisis.

No one should imagine this will be simple. The US, in particular, is likely to be reluctant to accept a lesser role in global economic affairs. And individual countries have always found it difficult to put aside what they perceive to be their national interests for the good of the global economy. It is unlikely they will find it any easier in the future. There will continue to be tensions between globalisation and economic nationalisation, creating a risk that the new international order could prove just as unstable as the old one. It is a lot easier to make the case that tomorrow's capitalism should incorporate an international order based on cooperation than it is to see how such an order might be brought about.

Tomorrow's capitalism: the UK economy

Yesterday's capitalism did not just produce imbalances between countries; it also produced imbalances within them. It is now accepted that the UK economy became unbalanced over the last decade, with growth overly reliant on a handful of sectors and ultimately fuelled by unsustainable levels of debt.

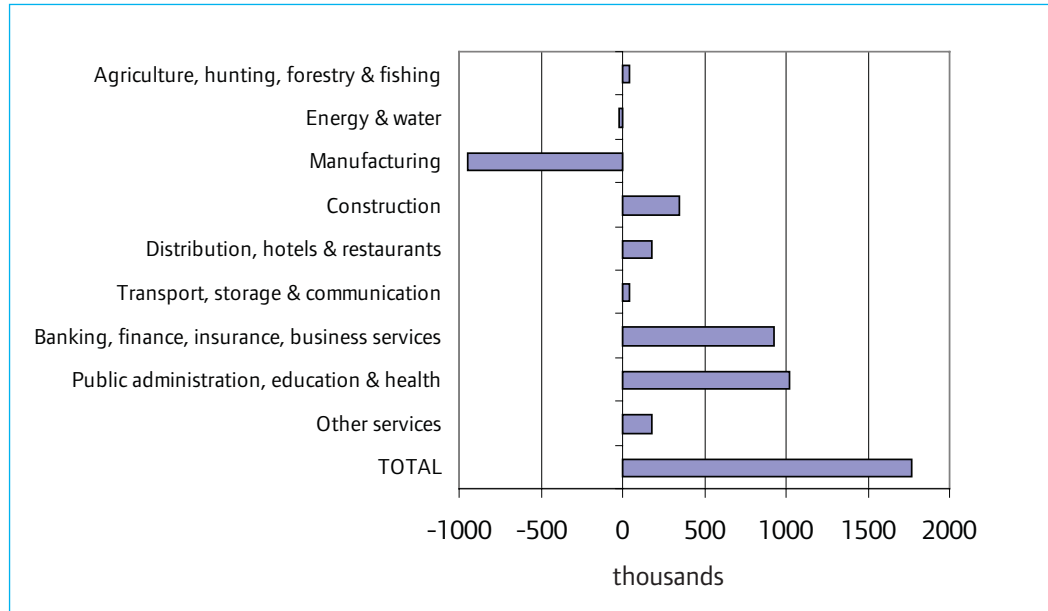
Consumer spending – fuelled by rising household debt – grew at an annual rate of 3.2 per cent over the ten years to 2008, while there was a 2.6 per cent rate of increase for real GDP. Imports grew much faster than exports in order to fill the gap. Construction also boomed in response to soaring house prices. Meanwhile, the financial firms in the City grew strongly, while manufacturing stagnated. At the end of 2007, output in manufacturing was no higher than it had been at its previous peak at the end of 2000. Output in the business services and finance sector increased by 36 per cent (an annual rate of 4.5 per cent) over the same period. And the Government was able to use buoyant tax revenues – in part from the City – to fund large increases in public spending, particularly on health and education.

These imbalances were reflected in developments in the labour market, in particular in the seven years from 2001 to 2008 when government spending was increased at a rapid pace. Over this period, employment in the UK rose by just over 1.75 million in total, but this growth was heavily concentrated in two sectors: public administration, education and health on the one hand and banking, finance and business services on the other. Employment in these sectors increased by almost 2 million – more than the total increase – while manufacturing employment fell by almost 1 million over the same period. At the same time,

there was an increase of about 2 million in the number of people employed in skilled occupations – managers, professionals, associate professionals and skilled tradespersons – and a decline of 0.75 million in the number of semi-skilled and unskilled workers, particularly in clerical and secretarial roles, and in processing and machine operation.

Figure 4.
Change in UK employment by industry, 2001 Q2 to 2008 Q2 (thousands)

Source: Office for National Statistics 2009



A deeper analysis of employment by industry and occupation suggests there were four key drivers of developments in the jobs market over the period from 2000 to 2008. Increased competition from low-wage economies and rapid technological progress led to a reduction in demand for unskilled and low-skilled workers in both manufacturing and service industries. Strong growth in public spending and the booming housing market were associated with large increases in jobs in education and health and in construction and real estate.

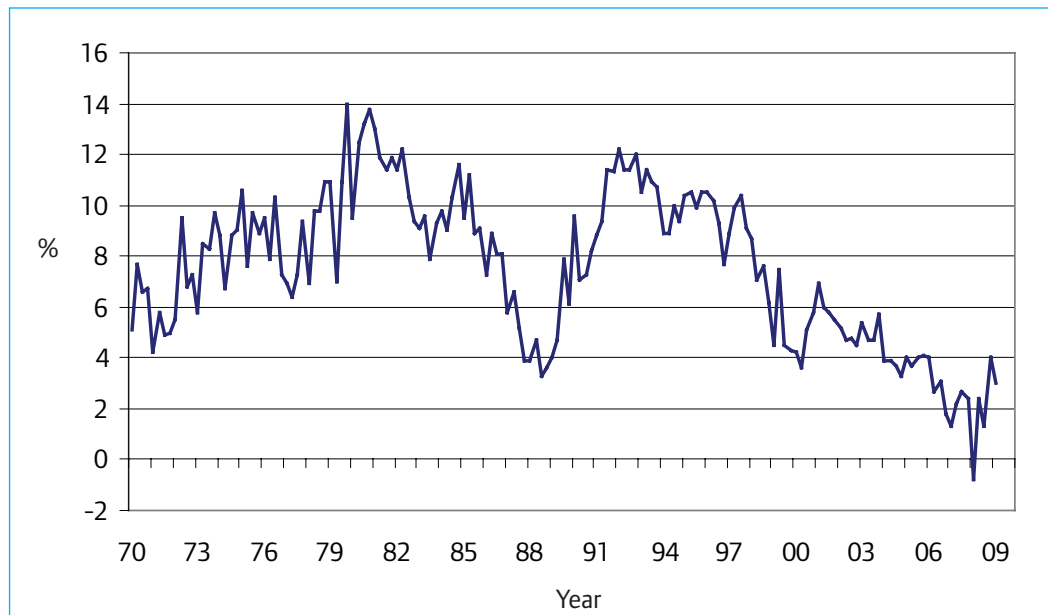
Some of these trends have already reversed as a result of the recession. For example, there has been a big decline in employment in the financial and business services sector since the middle of 2008. But there have also been large falls in employment in the retail sector and – extending the trend of the previous seven years – in manufacturing. Rebalancing the UK economy will not happen automatically.

In broad, macroeconomic terms, it is not difficult to see what is required. Consumer spending needs to grow less quickly than the overall economy, leaving room for more rapid growth in exports and in corporate investment, particularly in the export industries. This should be achieved by the household saving ratio returning to a more normal level and the household debt to disposable income ratio beginning to fall. The saving rate plummeted to a low of -0.8 per cent in the first quarter of 2008 but had already climbed back up to 3 per cent by the first quarter of this year. It probably needs to settle around the 8 to 10 per cent level (the average rate for the period from 1970 to 1999 was 8.7 per cent).

Stronger growth in exports and in business investment, relative to household spending, would tilt the balance of growth in the UK economy towards manufacturing and away from services. This should be made a little easier by the fall in Sterling over the past two years. The pound is currently about 20 per cent lower against both the US dollar and the Euro than it was in the middle of 2007. If this fall is sustained, depending on the response of companies, the competitiveness of UK industry will be boosted.

Figure 5. UK household saving rate (%)

Source: Office for National Statistics 2009



Any rebalancing of the UK economy will have profound effects on the labour market. The most significant change, compared with the last decade, will occur in the public sector. Real public spending (total managed expenditure) increased at an annual rate of 4.2 per cent between 2000–01 and 2007–08 and the number of jobs in public administration, education and health rose from 5.8 million in 1999 to 7 million in 2006 (some of these jobs are in the private sector, but the overwhelming majority of the increase occurred in the public sector). However, this year's Budget envisaged real spending growth of just 3 per cent in 2010/11, followed by three years in which spending does not increase at all in real terms (HM Treasury 2009). Furthermore, with debt interest and welfare payments set to increase rapidly, departmental spending will have to fall, in real terms, if these plans are to be fulfilled. Inevitably, this will mean lower employment in the public sector.

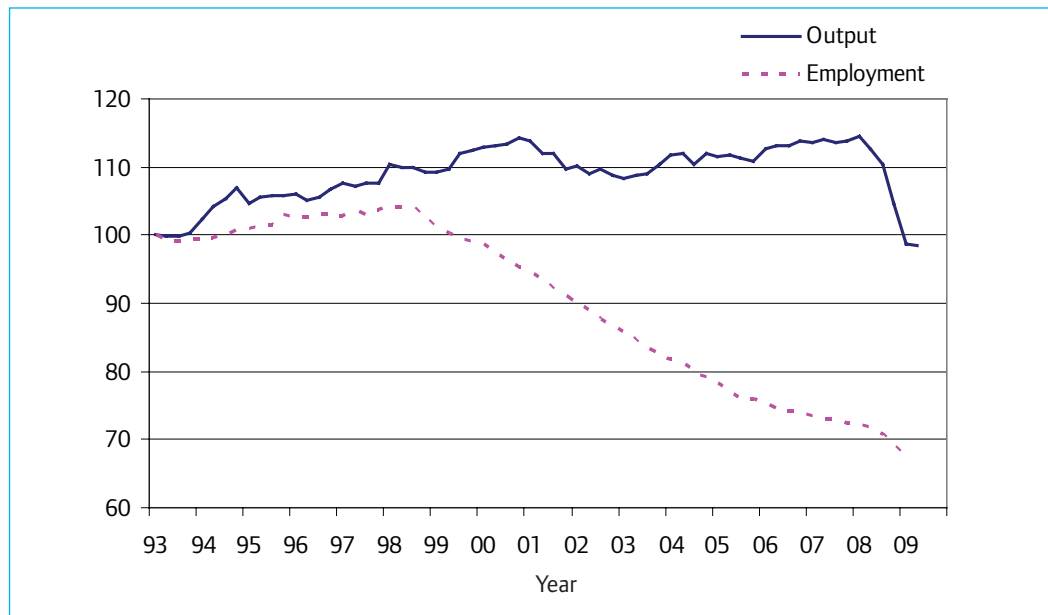
There is also likely to be little or no growth in employment in retailing and other associated sectors, if consumption is growing less rapidly than total output. The same is likely to be true of employment in the financial sector. Although the City boomed in the years up to 2007, the sector in aggregate shed jobs, particularly in retail banking and in insurance and pension funding. As financial institutions seek to rebuild their profit margins over the next few years, more job losses seem inevitable. The difference now is that the City appears likely to be less buoyant too.

There must also be some doubt about the ability of the manufacturing sector, in aggregate, to create jobs, even if the economy rebalances. From its peak in 2000 to its peak in 2008, manufacturing output did not increase at all, while employment fell by over 1 million – an annual rate of decline of 3.7 per cent. With China and other emerging economies likely to continue to increase their share in world manufacturing output, for the UK even to hold onto its present share would represent something of an achievement. If it can do so, then employment in manufacturing might be stabilised and that is about the best outcome that can be hoped for.

It seems, therefore, that most of the growth in employment in the UK in coming years will have to occur in private service sectors – other than finance and retailing. This represents a very disparate group of companies. Some are well-paid, such as management consultancy, and others are glamorous, like the creative industries. But there will also be a lot of less skilled, less well-paid and less glamorous jobs in these sectors. The ageing of the population, for example, will lead to increased demand for carers.

Figure 6. UK manufacturing output and employment (1993 Q1=100)

Source: Office for National Statistics 2009



In sector terms, therefore, tomorrow's capitalism may not see the UK economy rebalance, as much as go off in another direction. After a decade of employment growth led by the public sector, construction and retailing while manufacturing employment slumped, we should expect – or rather hope for – several years of growth led by parts of the private service sector, with employment in manufacturing stabilising.

In order to speed the economy's return to full employment, however, the Government will need to be more active. This has already been recognised, and the Departments for Innovation, Universities and Skills and Business, Enterprise and Regulatory Reform (since merged into the renamed Department for Business, Innovation and Skills) published a White Paper in April entitled *New Industry, New Jobs* to address these issues. It identifies four areas of market failure where the Government can play a role: innovation, skills, finance and infrastructure. Cynics have, however, pointed out that these market failures have been known about for some time and that they persist despite previous government efforts to correct them. The challenge, therefore, is to design specific policies that will alleviate them⁶.

If the UK is to return to full employment over a reasonable period of time – and recent history suggests it will take at least seven years – the Government and the Bank of England will have to get their macroeconomic policies right to ensure there is adequate demand in the economy. Banks will also need to be recapitalised so that they can increase lending, particularly to businesses. But the Government also needs to address failings on the supply-side of the economy. Tomorrow's capitalism requires more activist government policies in the areas of innovation, training and infrastructure, not just during the recession but persisting after the economy begins to recover.

Tomorrow's capitalism: financial markets

Developments in financial markets are central to the crisis and recession in which we now find ourselves. It is unthinkable that they will be allowed to continue to operate in future in the same way that they have in the past. Increased regulation is very likely for banks and for

6. Jonathan Clifton, Tony Dolphin and Rachel Reeves make a number of recommendations in this area in their paper *Building a better balanced UK economy: Where will jobs be created in the next economic cycle?* presented at a Tomorrow's Capitalism seminar on 19 May 2009 (Clifton *et al* 2009).

other financial markets and this should be underpinned by a guiding set of principles that can then be applied to specific markets, such as the UK mortgage market.

Over the last 25 years, the culture of financial markets has changed considerably. Financial institutions have transformed from owners of financial assets to traders of them. This shift has been accompanied by a decline in professional pride in the City and the development of a culture that is different from that of the rest of society. Providing a service to clients is now secondary to making a quick profit. This culture enabled banks and other financial institutions to create complex debt instruments, like collateralised debt obligations (CDOs), which they barely understood themselves, and sell them on to clients who understood them even less.

Financial institutions have also discovered they are not as clever as they thought they were. Keynes said, 'Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist' (Keynes 1935). In this instance, bankers, hedge funds and the rest were slaves to the economists who told them that people were rational and financial markets efficient. They built complex risk measurement systems, based on these theories, which told them that their positions were safe because they were well-diversified and they ignored the sceptics, such as Nassim Taleb (2007), who warned that these models could not cope with extreme outcomes and, crucially, that these extreme outcomes tend to happen more frequently than statistical models would suggest. However, events have proved Taleb right and the combined wisdom of the financial system wrong.

It seems obvious, therefore, that tomorrow's capitalism requires a transformation of culture in the City as well as enhanced regulation, as much to save the financial system from itself as to stop it creating another crisis for the rest of the economy. However, it will be very difficult to change this culture. Although there has clearly been a breakdown in trust between the banks and the rest of the economy, there is little to suggest that the City accepts it was responsible and that it has a major role to play in restoring trust. For example, after Goldman Sachs reported a \$3.44 billion profit for the second quarter of 2009, there was speculation that average pay (salary and bonuses) at the firm would be \$1 million this year.

However, City practitioners are not solely to blame. There has also been a massive failure of accountability, which allowed bankers to do what they did. Remuneration committees did not control bank executives through appropriate packages. Auditors did not sound alarm bells over what banks were doing. Institutional shareholders failed to question banks' behaviour – indeed they egged them on, for example supporting the RBS board's decision to buy ABN Amro. And regulators failed to appreciate the scale of systemic risk that was developing. The City's 'friends' were just as culpable as the bankers themselves.

If the City and its supporters are unwilling, or unable, to alter its culture from within, change will have to be imposed on it from without. Some changes seem obvious. Limits should be placed on remuneration packages to ensure they only reward long-term success, not short-term (and unsustainable) gains. And institutional investors, such as pension funds, should think about how they can encourage the City away from its trading mentality and back to a longer-term 'buy and hold' approach.

There will also have to be changes in regulation, since the old rules have been demonstrated to be clearly inadequate. This does not necessarily mean more regulation – the US already has the most heavily regulated financial sector, but this did not stop financial crises developing there. What is needed is better regulation.

The financial system should be underpinned by five principles: responsibility, accountability, relevant information, independence of information and oversight. The financial crisis came

about because of a lack of responsibility and accountability, a failure to produce independent information and an inadequate degree of vigilance among market participants. These five principles should now be used as the foundation on which a coherent set of regulations are built⁷. For example, regulators should understand the potential effects across the whole financial system of developments in their specific area, information gaps should be closed in derivative markets and credit rating agencies should be paid by investors rather than issuers.

It ought to be comparatively easy to agree the appropriate set of principles at a global level, for example among the G20. Individual countries could then be allowed to implement them, taking account of local circumstances, with a global body set up to ensure compliance.

In the UK, one area where the financial system has clearly failed is mortgage lending – and not just in recent years. There have been several housing market booms and busts over the last 40 years. However, what makes the latest one different is that it led to the collapse or takeover of a number of demutualised lenders, and the first run on a UK bank for over 140 years. This was the result of reckless borrowing and lending behaviour as senior executives fought for market share – and for higher bonuses⁸. Funds were raised on the short-term wholesale markets and then offered – at very generous loan-to-value and loan-to-income ratios – to prospective home buyers. In the most extreme case, Northern Rock created the ‘Together’ mortgage, which combined a standard 95 per cent secured mortgage with an unsecured personal loan of 30 per cent (up to £30,000), effectively allowing some people to borrow up to 125 per cent of the value of the property they were purchasing. Meanwhile, there was also a boom in buy-to-let mortgages. Total mortgage lending in the UK more than tripled from £115 billion in 1999 to £364 billion in 2007.

The last two years have been disastrous for the UK’s mortgage lenders. Northern Rock first got into difficulties in September 2007 and was nationalised in February 2008. Bradford and Bingley and Alliance and Leicester are now owned by Spain’s Banco Santander. The Derbyshire, Cheshire and Dunfermline Building Societies have all been taken over. Their strategy of borrowing short-term in the wholesale money markets and lending long-term in the housing market has been shown to be fundamentally flawed by the credit crunch. It has also been disastrous for the housing market and for the UK economy.

For this reason – and given the UK’s history of housing booms and busts – allowing mortgage lenders to continue to operate their own strategies is no longer an option. Mandatory lending guidelines for mortgage lenders are needed in an effort to minimise the risk of history repeating itself. These guidelines should be based on David Pitt-Watson’s five principles to underlie all regulation: responsibility, accountability, relevant information, independence of information and oversight. They should include: limits on loan-to-value and loan-to-income ratios, restrictions on buy-to-let and self-certified mortgages and changes to remuneration practices at mortgage lenders to ensure bonus payments reflect performance over several years.

There is an overwhelming case for tomorrow’s capitalism to incorporate greater regulation of the financial system. Banks and other financial institutions, led by senior executives seeking to maximise their short-term bonuses, took huge gambles – and lost. The result has been a severe credit crunch leading to a deep global recession, millions of people losing their jobs

7. This argument is set out by David Pitt-Watson and colleagues in *Towards an Accountable Capitalism*, presented at a Tomorrow’s Capitalism seminar on 26 March 2009 (Davis *et al* 2009).

8. This analysis and the recommendations for change are taken from Professor Chris Hamnett’s paper for the Tomorrow’s Capitalism programme: *The Madness of Mortgage Lenders: Housing finance and the financial crisis* (Hamnett 2009).

and massive taxpayer bail-outs of the banks. This cannot be allowed to happen again. There will have to be changes in macroeconomic policy – central banks should target asset prices as well as consumer prices. But there will also have to be changes to the financial system.

A number of writers have proposed a counter-cyclical approach to banks' capital requirements, forcing them to hold more capital when lending is high and asset prices might be overvalued while allowing them to hold less capital when the opposite is the case. There is also popular support for controls on remuneration and incentives to encourage bankers to take a longer perspective. There may also be a strong case for separating retail and investment banking. Retail banks would do the boring business of taking in deposits and making loans to households and companies and would be covered by 'lender of last resort' protection. Investment banks would be allowed to indulge in more exotic financial practices, but with no government protection.

It will, however, be difficult to make fundamental changes to regulation in one country alone. International cooperation is required to prevent some governments undercutting others in the hope of attracting financial activity to their country. This is why the G20 should, as a priority, establish the principles on which global regulation is to be based and set up an international body to ensure individual countries' regimes comply with these principles.

Tomorrow's capitalism: asset price bubbles

Few would disagree with the proposition that tomorrow's capitalism will be better if asset price bubbles can be avoided. Such bubbles, when they burst, have been central to most of the major economic crises of the last three decades.

Alan Greenspan, Chairman of the US Federal Reserve from 1987 to 2006, used to argue that central banks are poorly placed to judge when assets are overvalued and a bubble is developing. He said that they should wait and see if a bubble burst and then take action to deal with the consequences. Thus, he did not act when the 'dot.com bubble' was inflating in the late 1990s but cut interest rates aggressively when it burst in 2000.

The Greenspan doctrine has been discredited by recent events. If a bursting bubble can cause devastation on the scale seen over the last two years, then it is clearly better for central banks to prevent it inflating in the first place. If this means they might occasionally act unnecessarily – countering a rise in asset prices that was justified rather than a 'bubble' – that would seem a small price to pay for the avoidance of another crisis and recession like the current one.

It would be even better, of course, if market behaviour could be changed so that bubbles did not develop in the first place. To understand how likely, or rather how unlikely, that is, it is necessary to understand the psychology of financial markets and in particular how the co-evolution of human nature and the financial markets have created an environment in which asset bubbles can develop⁹.

Asset price bubbles require an initial idea or paradigm shift – what psychoanalysts call a 'phantastic object' – to create a sense of excitement in financial markets. This idea is always new, a bit complicated and perhaps not totally understood and it appears to offer the

9. Much of this section is based on Professor David Tuckett's paper *Addressing the Psychology of Financial Markets*, presented at a Tomorrow's Capitalism seminar on 14 May 2009 (Tuckett 2009).

potential for massive rewards. Excitement at the prospect of sharing in these rewards becomes separated from anxiety about the risk of a loss. A 'divided' mental state results, in which greed dominates fear. Across the market as a whole, as asset prices rise stories develop to support the new paradigm and the media and investors get caught up in the excitement. 'Groupthink' develops, creating pressure within the system to participate in the bubble. People who express doubts are widely mocked and risk-taking, in aggregate, becomes excessive. Emotions take over.

If human nature makes asset price bubbles possible, the structure of the fund management industry facilitates their development. Funds are advertised as delivering exceptional performance – both provoking the belief that well above-average returns can be earned and putting pressure on fund managers to outperform their peers by a wide margin. To meet these expectations, fund managers have to seek out exceptional opportunities because 'ordinary' performance is not good enough. This makes them predisposed to getting caught up in the excitement of new ideas and thinking about reward and risk in a divided state. The tendency of the industry to focus on performance over a short period of time – months rather than years – makes things even worse.

Eventually, though it is difficult to predict how and why this will happen, people realise asset price valuations can no longer be justified, even by the most optimistic assessments of supporters of the new paradigm, so prices start to fall. The flimsiness of some of the stories that have been supporting prices becomes apparent. Within the financial system, there is an emotional switch to revulsion. The bubble bursts and asset prices collapse.

The dot.com bubble is a classic example of how this psychological cycle develops. Internet retailing was a new idea that was clearly transforming the economy and the way we all live. Early movers in the industry were increasing market share rapidly and company analysts projected extraordinary future gains. The potential rewards from investing in dot.com companies seemed enormous, while the risks appeared to be minimal. How could traditional companies hope to cope with the new competition? Share prices of the new companies soared, but the majority of fund managers continued to buy them. Those who did not underperformed significantly and, in many cases, lost their jobs as a result.

Figure 7. The dot.com bubble (Nasdaq index)

Source: Yahoo! Finance, <http://finance.yahoo.com/q/hp?s=%5EIXIC>



Investors and the media bought the hype even though the stories needed to support the rise in share prices became more extreme. Fund managers' mentality was so divided, with greed completely dominating fear, that few were able to detach themselves from the hype until, in March 2000, the market finally peaked because valuations were so extreme that they could no longer be ignored. Prices began to fall. The stories that had underpinned their rise were exposed as flimsy – and in some cases fraudulent. Revulsion took over and share prices crashed.

Yet only eight years later another bubble had been inflated – this time in CDOs and related debt instruments – and it too was bursting, illustrating perfectly how bad the financial system is at learning from its past mistakes. After a crash, the system looks for someone to blame, rather than taking the opportunity to learn. The dot.com bubble was blamed on Alan Greenspan for keeping interest rates too low around the turn of the millennium, on crooked finance directors and on rogue company analysts. The CDO bubble was blamed on Alan Greenspan for keeping interest rates too low (again), on people taking out mortgages they could not afford and on China for sending its excess saving to the US. Learning requires an 'integrated' state of mind in which uncomfortable thoughts – like feeling guilt and responsibility – can be accepted and a balanced sense of reality obtained. The financial system is not good at accepting blame and responsibility, preferring instead to move on to the next opportunity. It does not, therefore, learn.

Since human nature is not going to change, tomorrow's capitalism should involve major changes to the fund management industry – and to investors' expectations. A widespread acceptance that it is not possible for everyone to beat the market and that chasing the next 'big thing' is likely, ultimately, to result in disappointment would reduce the possibility of asset price bubbles developing. This will require a major collective re-examination of the way savings are managed.

In the absence of such a change, regulators should be given extra responsibilities. First, they need to understand the psychological processes that create bubbles. Second, they need to put in place mechanisms to detect when a bubble may be in danger of forming – by identifying 'phantastic objects' and being prepared to take a view on the value of financial assets. This will require a good deal of detachment from the financial system itself, otherwise they risk being caught up in any excitement. Third, they need the powers to prick a bubble in its early stages – whether by using interest rates, irrespective of what is happening to consumer price inflation, or through some other mechanism.

It will not be easy to prevent bubbles developing in future. It is human nature to get caught up in the excitement of new ideas. But central banks and regulators should do more in tomorrow's capitalism to slow their development and limit their potential to cause the sort of damage that the bursting of the CDO bubble is now inflicting on the global economy. One of Alan Greenspan's predecessors as Chairman of the US Federal Reserve, William McChesney Martin Junior, who held the post from 1951 to 1970, described the job of a central bank as being: 'to take away the punch bowl just as the party gets going'. It is a dictum that should guide central banks and regulators when dealing with potential asset price bubbles in the future.

Tomorrow's capitalism: what does the UK want from capitalism?

Capitalism has been extremely successful in Western economies over the last century. Living standards have soared, infant mortality rates have plunged and life expectancy has increased. It is now having the same effect across large parts of the rest of the world. Given these successes, few are prepared to suggest capitalism should be abandoned in favour of a

completely different system of economic management. However, there are many varieties of capitalism – those found in the US, Japan and Scandinavia, for example, are very different from each other – and they all seem to work. Capitalism need not mean a slavish acceptance of unfettered free markets. Societies can choose which variety they prefer and policymakers should try to reflect that choice in their actions¹⁰.

Historically, the emphasis in the UK, as in the vast majority of countries, has been on maximising output growth and material living standards, and this remains a primary aim of policy today. However, some economists argue that better indicators of a country's progress are now available. They propose measuring improvements in welfare either through the use of an 'objective list' or by monitoring subjective well-being (that is, happiness). In short, the objective list approach is based on the belief that there are certain items that are obviously 'good' – food, education, health, security – and that if a country has more of them, things must be getting better, while the subjective well-being approach argues that the best way of measuring progress is by asking people how happy they are.

Advocates of this last approach cite surveys showing people in developed economies are not getting happier, despite economic growth and increased material living standards, and call for the focus of policy to be switched from output measures, such as GDP, to happiness itself. They reject the materialism of recent years, which they see as having been characterised by a 'get rich quick' mentality and hyper-consumerism, and propose a much broader assessment of the aims of society, based on factors such as health and human relationships¹¹. Some even argue that developed countries should adopt a 'steady state' policy – effectively targeting no further economic growth. If higher incomes do not make people happier, they suggest, then this would not result in a loss of welfare, relatively to a world in which economies continued to grow. At the same time, it would help address concerns over climate change and environmental degradation.

However, traditional economists are quick to point out that without economic growth in developed economies we cannot improve public services; poorer workers have less chance of earning more; and growth in developing economies, which can be the difference between life and death, is likely to be lower. More fundamentally, they argue innovation and productivity growth are inherent to capitalism, making it hard to imagine how a steady state world would work in practice. For example, if stable output is combined with improving productivity there will be reduced demand for inputs, including labour. Unless this is to result in ever-increasing unemployment, everyone would have to agree to work less. But it is not clear that this is what society wants, or how this could be achieved given our current institutional frameworks. On practical grounds, therefore, there seems little prospect that tomorrow's capitalism will abandon economic growth as a primary aim of policy.

There is a general acceptance, however, that this recession was caused, in part, by excess consumerism – and the build-up of debt that accompanied it. This should be an opportunity, therefore, to make the case for a less consumer-oriented society. Economists usually phrase this debate in terms of a move away from consumption and towards more exports and investment spending. But there is also a case for thinking about whether we want less

10. Paul Ormerod made this point at the Tomorrow's Capitalism debate 'What do we want from capitalism?', 23 April 2009, recordings available at www.ippr.org/tomorrowscapitalism/events.asp?id=3440&tID=3336

11. Professor Richard Layard, Madeleine Bunting and Kate Green all argued along these general lines at the Tomorrow's Capitalism debate, 'What do we want from capitalism?', 23 April 2009, recordings available at www.ippr.org/tomorrowscapitalism/events.asp?id=3440&tID=3336

consumption and more leisure or less consumption and more, and better, public services. It may be desirable, for example, for the UK to move away from the American model of capitalism and a little closer to the Scandinavian model. There has long been a tension in this country between a desire to have American levels of taxation (low) and Scandinavian levels of public services (high quality and expensive) but politicians have shied away from forcing people to face up to the inconsistency. The current crisis creates an opportunity to have that debate.

Scandinavian countries are notable for being more equal, and in particular for having lower poverty levels, than the UK. This has not been at the cost of lower living standards, but it does seem to have brought benefits in the form of greater social mobility and higher recorded levels of happiness. Richard Wilkinson and Kate Pickett have recently shown that societies that are more equal, such as the Scandinavian countries and Japan, have a much lower incidence of mental illness across the whole population (not just among the poor) than the most unequal societies, such as the UK and the US (Wilkinson and Pickett 2009).

The era of neo-liberal capitalism brought increases in income inequalities in the UK, together with diminished social mobility. Research such as that of Wilkinson and Pickett strongly suggests it would seem to be beneficial for society as a whole if tomorrow's capitalism could produce a more even distribution of income and wealth.

Tomorrow's capitalism: challenges for progressive policymakers

Tomorrow's capitalism will bring many challenges for policymakers but the biggest one is likely to be how to adapt to an era of public sector austerity. The crisis in capitalism might appear to be a great opportunity for progressive politicians because it offers a once-in-a-lifetime chance to redesign the capitalist model. At the same time, it is a threat because progressives have, in the past, used some of the benefits of unfettered growth to finance their policy aims. In tomorrow's capitalism, the growth of output and government revenues is likely to be slower and public spending will be constrained by the need to reduce government deficits built up during the recession.

Unless politicians are prepared to make the case for taxes to be permanently higher as a share of national income, they will have to achieve their aims without increasing real spending in most areas – and while cutting spending in some. This is going to require a concentration of resources where they can do the most good. Thus, if taxing the rich more is not an option, then they may have to pay more for some services, or receive less in state support, so that funds can be directed at the most vulnerable and disadvantaged in society.

More generally, there will be a tendency for the Government, when it has to make cuts in public spending, to express the view that the private sector is somehow intrinsically good, while the public sector is not. This will make it hard to make the case for the positive things that the public sector can do, such as deliver better schools, better hospitals and a better environment. And it will make it very hard to argue that future growth would be better used to alleviate social problems than to make the very rich even richer. The fact that opinion polls show the majority of the public support the Government's decision in the 2009 Budget to introduce a 50 per cent rate of income tax, despite widespread opposition in the press, suggests the argument may not be completely lost¹². However, this could just prove to be a short-term reaction to the crisis and the perceived role of highly-paid bankers in bringing it about.

12. Adam Lent made this point at the Tomorrow's Capitalism debate, 'Capitalism and the Challenge for Progressive Politics', 16 July 2009

A specific issue that might act as a litmus test for the intentions of the Government is child poverty. The present government pledged in March 1999 to eliminate child poverty in the UK by 2020. By 2005, significant progress had been made: the number of children living in poverty had fallen from 3.4 million in 1998/99 to 2.7 million. However, progress has slowed since then and it now seems unlikely that the Government will hit its interim target of halving child poverty by 2010. Recent research by Donald Hirsch at the Joseph Rowntree Foundation suggests that there will still be 2.3 million children living in poverty in 2010/11 and that on present policies this will increase to 3.1 million in 2020/21 (Hirsch 2009). Whether future governments are prepared to act to get the eradication of child poverty back on track will say much about their progressive intentions.

Hirsch argues that child poverty cannot be eradicated by government spending and tax credits alone and that, as the economy recovers, getting parents into jobs will be particularly important. More generally, another major challenge for policymakers will be to bring about a significant – and permanent – reduction in the number of people claiming out-of-work benefits¹³. Although unemployment fell to 30-year lows towards the end of the long economic expansion from 1993 to 2007, the total number claiming out-of-work benefit did not fall below 4.25 million.

Table 1: Key out-of-work benefits: levels (thousands)

Date	Jobseeker's Allowance	Incapacity benefits (ESA/IB)	Lone Parents on Income Support	Other	Total*
May 1997	1620	2616	1014	256	5506
Nov 1997	1432	2651	983	247	5312
Nov 1998	1325	2644	939	229	5137
Nov 1999	1036	2675	930	218	5007
Nov 2000	1184	2723	906	197	4861
Nov 2001	1036	2746	879	179	4763
Nov 2002	960	2777	856	161	4731
Nov 2003	913	2781	832	154	4680
Nov 2004	830	2772	797	158	4556
Nov 2005	901	2711	779	156	4546
Nov 2006	949	2673	776	161	4559
Nov 2007	818	2642	742	167	4369
Nov 2008	1092	2603	729	173	4326
Latest**	1560	2610	720	179	5069

Source: Department for Work and Pensions 2009

*The numbers on Jobseeker's Allowance are for the UK, while the other columns are for Britain excluding Northern Ireland, so this is something of a hybrid. **June 2009 for JSA, May for IB/ESA and Lone Parents, November 2008 for 'other'

If tomorrow's capitalism is to be more inclusive, it cannot involve over four million people in the UK effectively being segregated from the rest of the economy.

Policymakers will also have to decide how far to impinge on the actions of companies, particularly companies in the financial sector. This is not just a matter of regulating their

13. Nick Mathiasson and Fraser Nelson made this point at the Tomorrow's Capitalism debate, 'Capitalism and the Challenge for Progressive Politics', 16 July 2009.

activities to ensure that labour laws are complied with, or that banks are less likely to collapse in future. It is about the culture of business. The current crisis was brought on, in large part, by the 'get rich quick' mentality of the City, which put short-term profitability and personal gain ahead of all other considerations. However, backed by the arguments of American business schools, this mentality has spread more widely in the business sector, leading to an excessive focus on shareholders and the remuneration of senior executives and too little consideration of companies' employees and their obligations to the wider community. It may be that the 'stakeholder' approach to business governance, which places more emphasis on these wider obligations, is an idea whose time has come.

Some commentators have argued that companies will develop a greater degree of corporate social responsibility because to do so will increase profits. However, if that were the case – or more pertinently if business leaders believed it to be the case – they would have acted already. More likely, if government wants more responsible companies, it is going to have to impose constraints on them. At the simplest level this could just mean legislation to limit non-executive remuneration. More ambitiously, it could, for example, involve measures to ensure that company boards contain representatives from the workforce and society in general.

Conclusions

The aims of the ippr/Friends Provident Foundation Tomorrow's Capitalism programme were to identify some of the major flaws in the neo-liberal version of capitalism which has dominated in the United States and the United Kingdom since the early 1980s; to specify some desirable features of the capitalist model of the future; and to suggest how policymakers might begin to pursue them.

Identifying the flaws was not difficult. Among the most important, 'yesterday's capitalism':

- Failed to successfully integrate China into the global capitalist economy
- Allowed global economic imbalances to build up to an unsustainable and dangerous extent
- Failed to control credit growth in key economies and at a global level.
- Allowed economic growth in the UK to become very concentrated in a few sectors of the economy
- Generated a succession of asset price bubbles, most recently in the US and other housing markets
- Helped create a trading mentality in financial markets
- Did not incorporate adequate regulation of the financial system
- Tolerated materialism, consumerism and growing inequalities
- Did not stop over four million people in the UK remaining on out-of-work benefits.

Ultimately, these flaws combined to produce the worst financial collapse and the deepest global recession since the 1930s.

In the midst of the recession, it is easy to be gloomy about the future and it could take a number of years before the balance sheets of banks, households and businesses are repaired, allowing economies to grow strongly again. However, previous financial crises have been followed by periods of strong economic growth and the same might be true of this crisis. If the benefits of technological change are allowed to spread throughout economies, the next 20 years, as opposed to the next two or three, could be prosperous.

However, history suggests this will require changes to the current model of capitalism. Some desirable features of 'tomorrow's capitalism' are:

- Greater international coordination to monitor the global economy, prevent economic imbalances developing, tackle climate change, maintain free trade in goods and services, establish regulatory principles and ensure achievement of the United Nations' Millennium Development Goals
- Reform of international organisations, such as the IMF, to give a greater role to large emerging economies such as China and India
- Economic growth in the UK based more on exports and investment and less on consumption and ever-growing levels of household debt
- A UK government that is prepared to be active in addressing market failures in innovation, training, infrastructure and finance
- Tougher control of the financial system so that it operates for the benefit of the whole economy, not just in its own narrow interests
- An agreed set of regulatory principles and an international body with the authority to ensure individual countries comply with them
- Central banks and regulators that understand how asset bubbles start, are prepared to say when they think one is beginning to inflate and have the tools to burst them before they become dangerously large
- Greater control over the lending activities of financial institutions, in aggregate, if not individually
- A recognition that there may be better measures of progress than GDP, such as those based on subjective wellbeing
- A move in the UK towards a version of capitalism more similar to the Scandinavian model, that produces a more equal – and therefore a happier – society.

These features will not be easy to develop. Progressive policymakers face a number of challenges:

- The longer the recession lasts, the greater the risk of increased economic nationalism and the harder it will be to achieve international cooperation.
- Even if the recession ends soon, the established powers – the US and Europe – will find it hard to accept a lesser role in global economic affairs so as to make room for the likes of China and India.
- It will not be easy to break the UK public's love affair with the housing market and consumerism.
- Previous UK governments have failed in attempts to address market failures.
- Changing the culture of the City of London will be extremely difficult because the 'get rich quick' mentality has become so deeply ingrained.
- The conditions needed for a bubble to start to inflate will inevitably reappear and regulators will have to be tough enough to act rapidly to burst them, even though it will make them unpopular.
- The need to bring government deficits down over the medium term will be a constraint on what government can do.

- Developing and implementing a new economic and political philosophy is an inherently difficult and long-term project.

The success of tomorrow's capitalism in delivering better outcomes for all will depend, in large part, on how successful policymakers are in meeting these challenges. Many involve greater cooperation: between governments internationally to agree sustainable economic policies and regulatory principles; between government and the private sector to tackle market failures; between the financial sector and the rest of the economy to ensure that credit-worthy companies and households can access to the funds they need; and between all parts of the economy to secure more equitable outcomes and improved well-being for all, not just the lucky few. Neo-liberal capitalism came to be characterised by increasing self-centredness; it is to be hoped that tomorrow's capitalism will see a reversal of this trend, leading to more collaboration and better outcomes for all.

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