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The Rise and, Hopefully, the Fall of Economic Neo-Liberalism in Theory and Practice

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I count it a great privilege to contribute the opening essay to this issue of *The Economic and Labour Relations Review*, which is celebrating its first 20 years. Over that time, the journal has been an outlet for independent and outspoken, often unfashionable views, upholding traditions steeped in the thoughts of Michal Kalecki and Maynard Keynes, and some of Australia's wisest economists. (Even Karl Marx gets a mention.) I am most grateful to the editors for asking me to be their opening bat.

Since the 1970s, we have seen the rise to dominance in theory and policy of what Joan Robinson (1964) aptly dubbed 'Pre-Keynesian theory after Keynes'. In the economics profession, these phenomena have been especially associated with the writings of Milton Friedman, Friedrich von Hayek and Robert Lucas, Jnr. They have spawned many surrogates in the USA, the UK, Continental Europe, Latin America, parts of Asia and, sadly, in the Antipodes as well. In the political sphere, President Reagan, Mrs. (as she then was) Thatcher and, in Australia, first, Bill Hayden and then Malcolm Fraser were instrumental in implementing monetarist policies and, more widely, backing deregulation of financial markets, freely floating exchange rates, lowering tariff barriers, and the removal of domestic and international capital controls. Nor did Bob Hawke, Paul Keating and their successors in the ALP avoid the virus. An era of international capitalism, red in tooth and claw, was ushered in. Ruthless swashbuckling capitalists (industrial, commercial and financial) combined with cowed and quiescent workforces often arising from labour markets euphemistically described as flexible, came increasingly to dominate economic and social life.

Commitment to full employment was downgraded or dropped altogether. (I have mentioned before the infamous meeting at Melbourne University in the late 1970s of eight or so Australian professors of economics, called by the late Heinz Arndt, in order to do just this in Australia.) On the surface, control of inflation through monetary policy became the dominant policy. Worship of the free market as *the* institution for all seasons and activities became the modern equivalent of the Golden Calf; Moses, the Law and the prophets (read

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Keynes and Kalecki) were argued to be discredited; they were despised or, at best, neglected.

Why did all this happen? There are many interrelated causes and events, intellectual, political and social. At the level of theory, a major factor in my view was the tragedy that post-war generations of students of economics, especially in the USA, were brought up on Paul Samuelson's (and Alvin Hansen's) textbook versions of Keynesian economics instead of on Lorie Tarshis's textbook, *The Elements of Economics. An Introduction to the Theory of Price and Employment* (1947).

Lorie's book was the first in the USA to contain an account of the economics of Keynes: about 250 pages which were true to Keynes's lectures when Keynes was writing *The General Theory* (Lorie, then an affiliated student at Trinity College, Cambridge, attended these lectures of Keynes in the early to mid-1930s). Lorie's account was true also to *The General Theory* itself. In particular, the central core of Keynes's analysis was presented in terms of Keynes's aggregate demand and supply analysis.

Lorie's book was cruelly done (almost) to death by right-wing forces led by Merwin K. Hart and, later, William Buckley, Jnr. so that many departments that had initially proposed to set it as the text got cold feet and reneged.[1] While the first edition of Samuelson's textbook (1948) still received the tail end of the right-wing backlash, it did not prevent his textbook from dominating economics courses for the next 30 years and more.

Had Lorie's book been the base on which the teaching of Keynes's ideas was erected, the stagflation episode of the 1970s could not have been said to have discredited Keynes's system. For an imported cost-price shock (or an autonomous rise in money wages) could have been shown to have so affected the position of Keynes's aggregate supply function that, *cet. par*, both the general price level would have been raised, and the levels of activity and employment reduced. The former rise could have precipitated a price-wage (and a wage-wage) spiral to go with the rise in unemployment. Nor could the Phillips Curve have been regarded as an integral part of Keynes's system (Friedman's so-called Keynesian missing equation). Indeed, as we know from Keynes's critique of Jan Tinbergen's econometric work on investment expenditure in the 1930s, the very idea of a dependable long-run relationship, lasting over long periods of time, which could be used as the basis for policy proposals, was thoroughly alien to Keynes's thought (and, I suspect, to Bill Phillips's also) (Harcourt 2001: 183–187).

The subsequent attempts to derive Keynes-type results within a Walrasian framework — by Don Patinkin and early Bob Clower, for example — led attention away from Keynes's own essentially Marshallian approach to economic theory and policy and made possible the rise of the neoclassical synthesis which still receives some space in textbooks even today. (Clower and Axel Leijonhufvud, to their great credit, changed tack to think again in a Marshallian context and, as a result, have written fine papers which interpret and expand deeply Keynes's ideas.) But also in the wake of Friedman's and especially Lucas's influence, we find modern macroeconomics done more and more in terms of

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representative agent models of the economy, or by an inappropriate application of Frank Ramsey's benevolent dictator model, or through real business cycle 'analysis', or through so-called New Keynesianism. In the last, microeconomic theories of the reasons for 'imperfections' existing in goods and labour markets are used to derive systemic results which are argued to look Keynes-like. In the process, the fallacy of composition and Keynes's stress that the whole is often more than the sum of the parts, have been removed by assumption from analysis (in the first three approaches) and inadequately tackled, if at all, in the fourth. Moreover, in the fourth approach, there is the quite unKeynes implication that the removal of imperfections could make economies function in socially optimum ways. The final irony is that the dominant model that is used in graduate courses to discuss monetary matters and policy logically cannot find a role for money and its characteristics within its formal construction, as Colin Rogers in a number of devastating critical papers has shown us (Rogers 2006).

Of course, there were more than purely intellectual (or even academic scribbling) reasons for what has happened. In the years of the Long Boom (as the Marxists dubbed it) or Golden Age of Capitalism (more the left-Keynesian description) from the 1950s to the early 1970s, major social and political as well as economic events were occurring. Their combined effect was to aid cumulatively the rise to dominance of the anti-Keynesian intellectual forces itemised above. There was growing hostility to 'big government' and stroppy labour behaviour, uncannily reminiscent of the events which Kalecki predicted in his remarkable 1943 article, 'Political aspects of full employment'. There, he analysed the great differences between, on the one hand, the political economy of getting back to full employment after a deep slump, and, on the other, the political economy of sustaining full employment, what I like to call the Kaleckian dilemma. Thus, Kalecki wrote of the second situation:

> the *maintenance* of full employment would cause social and political changes which would give a new impetus to the opposition of the business leaders [to full employment]. Indeed, under a regime of permanent full employment, the sack would cease to flag its role as a disciplinary measure. The social position of the boss would be undermined and the self-assurance and class-consciousness of the working class would grow. Strikes for wage increases and improvements in conditions of work would create political tension … true … profits would be higher under a regime of full employment than they are on average under *laisser-faire*, and even the rise in wage rates resulting from the strong bargaining power of the workers is less likely to reduce profits than to increase prices, and thus affect adversely only … rentier interests. But "discipline in the factories" and "political stability" are more appreciated than profits by the business leaders. Their class instinct tells them that lasting full employment is unsound from their point of view, and that unemployment is an integral part of the normal capitalist system. (Kalecki 1943; *C.W.* Vol. I 1990: 351, emphasis in original)

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Add on to this the growing unpopularity of the Vietnam War in the USA (especially when it was realised that it could not be won), Australia and New Zealand (the only respectable allies of the Americans in this most immoral war, even more immoral than the recent adventures in Iraq), and in Europe and Asia. The effects of these social movements were compounded by President Johnson's attempt to finance the war without increasing taxes, so that the US economy tended to overheat even prior to the oil price rise shocks which amplified inflationary tendencies. The consequent rise of protest movements and student revolts all round the world associated with the war and much needed reforms in the institutions of higher education, together with civil rights and feminist movements and these other events brought the conservative forces in society to rally around what were previously thought to be the odd ball approaches of Friedman, for example.

In addition, as the new wave of globalisation spread, international capitalism became more and more determined to increase the potential surpluses available for national and international accumulation. This desire fed neatly into support for Monetarist policies, aptly described by the late Tommy Balogh (1982: 77) as 'the incomes policy of Karl Marx'. Friedman's arguments revolved around the concept of the natural rate of unemployment; he argued that away from the natural rate prices would either fall or rise cumulatively, reflecting excess supplies or demands in individual competitive markets. This implied that control of inflation, for example, was to be implemented by aiming at the establishment of the natural rate through monetary policy (short sharp shocks) until it was reached by control of the money supply such that the rate of inflation would now remain constant. This reflected the fact that in the real sector, the pattern of relative prices in both goods and labour markets were market-clearing ones (allowing for actual imperfections which created a divergence from the underlying pure Walrasian system that modelled the economy).

What this really meant, though, was that contractionary policies were employed to raise levels of unemployment (the reserve army of labour) in order to make the sack an effective weapon again. This would provide the cowed and quiescent labour forces associated with the reversal of the cumulative movement of economic, social and political power to labour from capital which had occurred in the Golden Age of Capitalism, back to capital which could then create a larger potential surplus for profits and accumulation.

If all this is taken to be the ravings of an unreconstructed Marxist (which I am not!), let me remind you that it is basically and independently a paraphrase of arguments in a lecture given by Paul Samuelson at the Bank of Italy in his ninth decade (Samuelson 1997: 6–7; Harcourt 2006: 127). In comparing the different experiences of the (then) present day American and European economies, he stressed 'two main factors … One: In America we now operate … the Ruthless Economy. Two: In America we now have a Cowed Labor Force … '.

What was forgotten (possibly never known) was the existence of a basic contradiction — to wit, that creating larger potential surpluses by these measures, i.e., through high sustained unemployment and sluggish aggregate demand, simultaneously adversely affected the accumulators' 'animal spirits',

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so that in the event the potential surpluses often failed to be realised. If we examine the performances of many economies in this era, it will be found that, often for long periods, rates of accumulation were sluggish relatively to those achieved in the Golden Age of Capitalism.

Moreover, as finance capital came to dominate industrial and commercial capital, Minsky-type effects emerged. With finance capital out of kilter with the other two, the inescapable growth cycles of capitalist economies had their amplitudes enlarged by the impact of Minsky-type effects. The latter arise from the non-realisation of expected cash flows from investment projects which are needed to back up the extra financial commitments that financed investment and which were already written into the liability sides of balance sheets (Harcourt 2000, 2001). In addition, the cumulative extension of credit to all, while obviously an individual 'good', became more and more a public 'bad' at the systemic level as changes in borrowing and lending rates to consumers, combined with wealth effects, served to make the Keynesian consumption function as unstable and volatile as investment expenditure traditionally was known to be: hence, the enlarged amplitudes of trade cycles and deeper and more prolonged slumps.

Accompanying the rise to dominance of finance capital and the emergence of new sophisticated financial instruments, the workings and effects of which became increasingly hard to understand, were technical advances that shrank the historical length of short runs from months or even years to days or even hours. The steady movement towards an obsession with obtaining maximum short-term results, regardless of their longer term effects both on the decision-makers directly concerned and the industries and economies in which they occurred — that is to say, the rise of what John Hicks (1954, 1983) called snatching behaviour, built more and more potential sources of instability into economic systems. Alfred Marshall's insistence that there are three periods of equal importance in economic analysis — market, short and long periods — was increasingly neglected in actual economic behaviour and decision-making, even if it lingered on, a pale shadow of its former prominence, in academic teaching and research. Behaviour in more and more important markets — the foreign exchange markets, the stock exchanges, the housing markets, for example — came increasingly to resemble the behaviour of casinos. As Maynard Keynes reminded us many moons ago: 'When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done' (Keynes 1936; *C.W.* Vol. VII 1973: 159).

Yet policy advisors and academics alike were still urging us to trust the workings of 'freely competitive markets' and arguing that, overall, governments should remain in the background. Bubbles emerged in key markets and now, as we know, the whole box of tricks has been exposed and a major crisis, both financial and real, has emerged. Our pre-Keynesian advisors are unable to tell us either why, or what should be done. Fortunately, common sense has prevailed in many countries and old-fashioned Keynesian and post-Keynesian policies are emerging. Whether they are of great enough magnitude to succeed remains, alas, to be seen. If they do, the 'hope' in my title will surely be fulfilled and

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the editors of, and contributors to, *The Economic and Labour Relations Review* should surely be praised for their role in the outcome.

Notes

[1] See Harcourt (1982: 372–373) for the details of the attack on Lorie's book.

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