

The Australian

Neo-liberalism: a few corrections

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Henry Ergas and Robert Manne clash on capitalism

Dear Henry,

As I see it, this correspondence is about three things. First, the influence of the ideology that is often called neo-liberalism on the advanced economies since the late 1970s, and especially where its importance has been greatest, in the US and Britain. Second, the degree of responsibility the ideology must accept for the global financial crisis that brought the world economy to its knees after the collapse of Lehman Brothers in September 2008. And third, whether the GFC is likely to discredit neo-liberalism in the way stagflation discredited Keynesian social democracy in the latter half of the 70s and, if so, what is likely to take its place.

There are, of course, a number of assumptions built into the questions I have posed with which I am sure you will disagree. I am interested in seeing what they are. But before I begin, I hope we can clear away a very common sleight-of-hand made by the defenders of neo-liberalism: the imputation that criticism of neo-liberalism amounts to criticism of capitalism. During the Cold War, as you may be aware, I was utterly opposed to communism on moral, political and economic grounds. I believe the future belongs to one or another form of capitalism. The question is of which kind.

Rather than proving the supremacy of capitalism to communism, a somewhat sterile exercise as almost everyone agrees in advance, in my view the real contemporary debate ought to involve a comparison of the two most important ideal types of "really existing" contemporary capitalist society: the neo-liberal variant seen in its purest form in the US, and the more social democratic version as seen in northwest Europe.

Let me then begin by stating my case in telegraphic and necessarily un-nuanced form. I claim, first, that while neo-liberalism has undoubtedly increased per capita gross domestic product in the countries where it has taken root, it has also had two extremely negative and interconnected effects: a radical increase in social inequality and an altogether unhealthy bias in those economies towards the financial sector, a process commonly called "financialisation". I claim, second, (influenced by economists such as Joseph Stiglitz and financiers such as Warren Buffett) that the most important explanation for the GFC was not, as some claim, the imbalance between China's savings and US borrowings, but the explosion in the trade in the derivatives market in the US and beyond -- and especially in those products based on subprime mortgages -- whose dangerous lack of regulation is best explained by the alliance between the greed of those profiting from the finance industry, and the ideology of the neo-liberal true believers with their faith in the magic of the self-correcting market.

I claim, third, that with the arrival of the GFC, the economic illusions and naked ethical narcissism of the neo-liberals are now finally obvious for all to see. Markets are not self-correcting: greed is not good. And I claim, fourth, that while the future is unknown, the collapse of the illusions associated with neo-liberalism will mark a major cultural advance. It will allow us to see the strengths of the more egalitarian northwest European version of capitalism. And it will allow us, if we are willing, to tackle in earnest the problem of climate change, the greatest market failure in history, in which the scientifically irrational disinformation campaigns of the vested interests supported by the neo-liberal think tanks have played a calamitous role.

Sincerely, Robert

Dear Robert,

The facts, one must look at the facts. They are stubborn and inconvenient. To see why, translate your argument into (even vaguely) testable propositions: the statement of claim in *Manne v Mammon* (trading as von Hayek Associates). Three

elements define that claim.

First, a political philosophy called neo-liberalism was adopted by some countries but not others.

Second, those countries that adopted this philosophy had curses of biblical proportions cast upon them: their financial institutions collapsed, inflicting such grievous loss as to lead them to give a "great cry, such as there was none like it, nor shall be like it any more" (Exodus, 11:6).

From which it follows, third, that the first fact caused the second, and that had those countries instead imitated their northwest European cousins, "not a dog would bark against them, man or beast, for thus the Lord distinguished between the Egyptians and the Israelites".

Now, John Stuart Mill (a liberal, but generally viewed as reasonably clever), had a thing or two to say about causal inference: that is, how to sensibly connect the dots. Working through his five methods of induction would take too long. But he broadly suggested this: in testing whether the neo-liberal cocktail (a Manhattan, one assumes, served on the skids) caused the delirium tremens, one should look at whether those who imbibed the demon drink suffered the malady, while those who did not, did not. (Now you know why he was thought to be clever.)

This is not so easy to do, as your claim lacks specificity. For starters, it is unclear which countries committed the offence, and which did not. But let's assume the defendants are the countries that in the 80s and early 90s most publicly swallowed what you used to describe as the economic rationalist line: say Britain, Australia, New Zealand, Canada, Sweden and Spain. Let's toss in Switzerland (pretty market-oriented) and even the US (despite its long-standing record of intrusive, adversarial regulation, often deeply and intentionally market-distorting).

Additionally, let's assume the harmful consequence is the meltdown associated with the GFC. Then two points are apparent.

First, one can have taken to the Kool-Aid like mother's milk without suffering the claimed consequences: see Australia, NZ, Canada, Sweden and Switzerland.

Second, one can suffer the claimed consequences even while stoutly resisting the temptation: for example, Iceland, Ireland, the Netherlands and Germany.

At least among hypothesis testers (a pernicky lot), this would raise the odd eyebrow. Indeed, the prudent may look for alternative explanations.

For example, could it be that meltdowns occurred where there were severe distortions in credit markets, unduly expansionary monetary policy and inadequate prudential regulation of financial institutions? And might those countries that avoided the difficulties have had cautious monetary settings, less distorted credit markets and (perhaps because they had suffered in the recent past from serious financial crises) high-quality prudential regulation?

In short, the liberal butler has a pretty good alibi. There were serial murders but, in many cases, he was nowhere near the scene of the crime. And he still serves a mean cocktail, with proven prosperity inducing consequences.

But is present policy perfect? No. Are there things to learn from others, including the Scandinavians (assuming, geography notwithstanding, that is what you mean by northwest Europe)? Yes, and vice-versa too.

So let's talk about what, but this time please, with facts in hand.

Regards, Henry

Dear Henry,

Your letter brought to mind a great Victorian, but it wasn't J. S. Mill. The greatest satire on economic liberalism is Charles Dickens's *Hard Times*. It begins with the words of Mr Gradgrind: "Now, what I want is, Facts. Teach these boys and girls nothing but Facts. Facts alone are wanted in life."

What count as facts and what role they play in human understanding is a lot more complicated than you seem to

understand.

To judge by your letter you are a logical positivist for whom knowledge in human affairs can only be gained by the testing of hypotheses. In the area of most human sciences this view is a half-century or more out of date. Let me show why by taking an event in history that interests both of us: the Holocaust. Probably the finest general history is Saul Friedlander's. You can read its hundreds of pages without finding even one hypothesis to test.

But even if it were true (and it is not) that I had suggested a series of hypotheses, every one you impute to me is an invention based on a sloppy reading of my letter.

As space is tight, one example must suffice. I did not argue that countries where the influence of neo-liberalism was greatest were necessarily the most deeply affected by the GFC, nor conversely that those affected most deeply by the crisis were necessarily the most in the thrall of neo-liberalism. What I argued was that the GFC was born in the US and that it was (in large part) a product of the marriage there of material greed and neo-liberal ideology. Once it hit, it released wave upon wave of catastrophe, in often unpredictable ways.

Even though Australia and Canada had been affected in many ways by neo-liberalism, they were less affected by the GFC because they had nevertheless retained sensible bank regulations. Even though it was less affected in general by neo-liberalism, Iceland was vulnerable because of its government's mad romance with finance capitalism.

Let me say something about neo-liberalism and the role I believed it played in the GFC. Neo-liberalism is a number of things. In part, as in the writings of F. A. Hayek, it is a formidable but narrow political philosophy.

In part, as in the so-called Washington Consensus, it is a universal economic policy recipe, sometimes good, sometimes not, depending on particular circumstances. And in part it is an ideology, a set of simple axioms that purport to solve the economic problems of society and to provide the blueprint for a better world.

In my view it is the ideological dimension of neo-liberalism that has done the greatest harm. One does not have to be a Marxist to realise that ideology frequently serves interests. One of the deepest ideological biases of neo-liberalism is the virtue of deregulation. During the long explosion in the derivatives market, time and again the US finance industry spent millions of dollars resisting regulation, most importantly the Congressional attempt in 1994 and the Commodity Futures Trading Commission attempt in 1998. (Today it is doing so once more.) The argument the lobbyists advanced was the neo-liberal anti-deregulation mantra about the magical, self-correcting property of the free market.

Why were these arguments put? Because there were billions of dollars on Wall Street to be made. Why did they succeed? Because ideological neo-liberalism had by then become our era's version of common sense.

Once Wall Street had invented one form of derivatives contract -- the Collateralised Debt Obligation -- and once Wall Street began to make ever vaster fortunes from the (scandalously) AAA-rated CDOs based on toxic subprime mortgages -- in Warren Buffet's terms, "financial weapons of mass destruction" -- global economic catastrophe loomed. When it came, this failure of neo-liberal ideology left the world's most powerful derivatives cheerleader, Alan Greenspan, in a state of "shocked disbelief".

Of course, I am not sure whether for you this historical sketch -- based on scores of articles and books -- will count as facts.

Perhaps, Henry, unlike Greenspan, you saw the catastrophe that was coming. If so, your next letter would be a convenient occasion to remind us of what you said before 2008 about the fatal collision of the US housing bubble and the wild market in derivatives.

Sincerely, Robert

Dear Robert,

Well, I owe you an apology. You see, I'm like Pavlov's dogs. Faced with the claim that A (neo-liberalism) causes B (financial crises), I can't help wondering whether where one finds A, one finds B (and vice-versa), and if so, whether some mechanism connects them. But you're right. This logical positivism must stop; it's time the illogical variety got a fair

shake.

Here's how, in three easy steps. (1) Define countries as more or less neo-liberal, depending on whether they proved (ex post) to have "bad" financial regulation or "good"; (2) note that the countries that had "bad" financial regulation experienced financial crises, while the ones that had "good" financial regulation did not; and, hey presto, (3) conclude that financial crises are due to neo-liberalism.

Now, you don't need to curl up each night with Kant's Critique of Transcendental Reason to realise that if this scrapes into the great class of sequiturs, it's as a non. But still, it is a thing of beauty. Who would have guessed, for example, that John Howard was less afflicted by neo-liberalism than Bill Clinton (who repealed the Glass-Steagall Act)? Clearly, they hid it well. But both, one presumes, were influenced by what you describe as the malady's most pernicious aspect, its ideology or "simple axioms".

What are those axioms, one asks? Are they truly inconsistent with sound financial regulation? If so, why did it persist in countries where the illness was so far advanced?

None of these questions you address. Poor old Hayek would be unimpressed.

After all, he was no anarchist. Rather, his emphasis was on the rule of law, a crucial component of which is effective, predictable and transparent enforcement. Sloppy regulation would have him turning in his grave. So would lax monetary policy and populist laws forcing banks to make loans to borrowers with no hope of repayment. Difficult then to pin the GFC on him.

Not that Hayek got everything right: I admire what he wrote, I don't worship it. But you would still do well to read (or reread) the classical liberals. Why?

Because you would learn, first, that no sensible person believes markets are invariably efficient. Plainly, they are not.

Yet competitive markets have powers of self-correction, and an ability to induce economic progress that is greater than any other means of resource allocation known to man. And they are less vulnerable than governmental decision-making to persistent error, cronyism and squalid deals that rob Peter to pay Paul.

A careful balance therefore needs to be struck between market failure on the one hand and government failure on the other.

You would also learn that in striking that balance there are no solutions, only trade-offs. You want a more stable economy and a fairer society? So do I.

Yet the magic pudding is more elusive than ever. Little wonder that European social democracy is in intellectual free-fall.

What, then, is your recipe for squaring the circle? Protection all-around, with lashings of heavy-handed regulation? Disclose it, and show us why its benefits would exceed its costs.

There I go again: asking for evidence! But you see, that is the other thing you would learn: that intellectuals are in the stringency business.

The refusal to accept assertions that are woollyminded and half-baked; to let errors of logic lie; or to kow-tow to mere citations of authority: that is what ensures reason, however flickering its light, remains the source of human progress.

This is why it is a shame you refuse to carefully define terms, frame testable propositions and assess them against facts. Indignation, no matter how loudly repeated, is not explanation.

It is also why the injustice you do to the great Saul Friedlander is so lamentable.

Friedlander, you claim, was not interested in carefully comparing hypotheses with evidence. The opposite is true, as his texts on alternative explanations of the Holocaust make clear. From so towering a figure of contemporary history, would one expect less?

Finally, you challenge me to disclose what I said in the past. Well, from the earliest days of Australia's process of liberalisation, I said that economic reform, of which better regulation is a key part, would allow us to return to low unemployment and sustained growth. And what did you say?

Regards, Henry

Dear Henry,

I am happy to accept your apology for misreading my first letter, even if it is uttered in a sarcastic tone and through gritted teeth.

Unfortunately, the misreading has continued. I did not argue that neo-liberalism was an illness. I argued rather that it was in part a formidable political philosophy, although as I will now try to show, one perfectly suited to serve the rich; in part a universal economic policy recipe, sometimes good and sometimes not; and in part a simplistic ideology.

Twenty years ago I did not see things this way. By concentrating mainly on the ideological dimension (and believing that Australia would be vulnerable to its vast current account deficit) I mistakenly opposed parts of the Hawke-Keating reforms.

In reading your letters I have begun to wonder whether you have read the early histories of the GFC. I am amazed that you reassert your faith in the self-correcting powers of the free market as if nothing has occurred. It was because of the spectacular failure of market self-correction that Alan Greenspan, an honest man, spoke of his sense of "shocked disbelief".

And it was precisely because of the failure of this neo-liberal article of faith that Nobel laureate Joseph Stiglitz concluded his brilliant sketch of the coming of the GFC with these words: "Most of the individual mistakes boil down to just one: a belief that markets are self-adjusting and that the role of government should be minimal. The embracing by America -- and much of the rest of the world -- of this flawed philosophy made it inevitable that we would arrive at the place we are today."

There is another astonishing error in your letter. You claim that in part the GFC was caused by "populist laws forcing banks to make loans to borrowers with no hope of repayment".

The suggestion that the Wall Street banks reluctantly created CDOs on the basis of toxic sub-prime mortgages in obedience to populist laws is absurd. They created them because of the tens of billions of dollars of profits, salaries and bonuses they delivered. Even hybrid government-private enterprise entities Fannie Mae and Freddie Mac joined the racket. Their investigator, Armando Falcon, told Congress their problems did not arise from their pursuit of affordable housing: "The firms would not engage in any activity unless there was profit to be made."

The chief executive of Fannie Mae, Franklin Raines, earned \$US90 million (\$99m) from 1998 to 2003. In your letter you say you support a "fairer society". Since the discrediting of the Keynesian-social democratic consensus in the mid-70s, the new neo-liberal consensus, especially in the US and Britain, has created advanced industrial societies more unequal than we have seen since the Great Depression. While in the 70s the richest 1 per cent of Americans owned 20 per cent of their country's assets, today they own 40 per cent. American chief executives today earn up to 500 times the salary of their workers. Do you regard this as fair?

By attacking trade unions, blessing tax cuts for the wealthy and helping erode what one scholar has called "the outrage factor", neo-liberal ideology is implicated in the rise of inequality. In the war declared on the idea of "social justice", Hayek and his followers rationalised the self-interest of the uber-rich.

Fairness is not the only issue. Recently a very important book, *The Spirit Level*, was published. It showed that on almost every indicator -- health and social problems; the wellbeing of children; mental illness; homicide; levels of trust; social mobility -- the more equal societies of northwest Europe performed much better than the less equal societies of Britain and America. With the discrediting of ideological neo-liberalism, the quest for more equal societies may now return. This is not an argument against markets.

In your letter you speak with some pathos of your defence of "reason, however flickering its light". This brings me to my

final point. Ideological neo-liberalism must be judged extremely harshly precisely because of its betrayal of reason. More than 99 per cent of qualified climate scientists and every scientific academy in the world accept that, primarily through the burning of fossil fuels, human beings are imperilling the future of the Earth through global warming. Yet, for various reasons, the most important neo-liberal "think tanks" -- such as the American Enterprise Institute or the Centre for Independent Studies in Australia -- have been pressed into the service of the fossil fuel corporations and are in the vanguard of the most important outburst of scientific irrationality since the 19th century Christian attack on Charles Darwin.

Henry, I do not know whether you are a climate change "sceptic". If not, now is the time to distance yourself from at least this dimension of the propaganda of your neo-liberal friends.

Sincerely, Robert

Dear Robert,

What have we learned?

First, that the relation between financial crisis and neo-liberalism (still undefined, but let's say the process of economic reform that began in the 80s) is tenuous at best. Several countries you would unambiguously term neo-liberal had financial systems that performed well, even in the midst of the GFC, while financial systems in others that could hardly be so described performed very poorly.

Second, that a more plausible explanation for the observed outcomes lies in the quality of prudential regulation, the extent of policy-induced distortions in credit markets, and the degree to which the macroeconomic settings were unduly lax.

From which follows, third, a prescription that governments act to ensure that effective regulation is in place, distortions to credit markets are removed, and monetary and fiscal policy are placed on a prudent, sustainable basis.

None of this is inconsistent with market-oriented economic reform. In fact, it is thanks to two decades of reform that Australia was well-placed to weather the crisis.

That said, you are unwilling to let the defendant out of the dock. Rather, neo-liberalism's alleged offences stretch beyond the GFC to responsibility for greater income inequality and for global inaction on climate change.

Let's deal with the second offence first. Economic liberals are not good at group think. It is consequently unsurprising that (to the best of my knowledge) there is no such thing as a party line on climate science.

I expect, however, that economic liberals would share two convictions. The first is that scepticism is a virtue, not a vice. The second is that we live in a world where desirable ends invariably outstrip available means. It is therefore quite proper to question whether the case for action has been made out; and even if one believes it has, to demand that the specific actions that are proposed yield benefits that exceed their costs: for example, that we would do better to allocate resources to reducing emissions than to improving the life chances of many millions of people worldwide who suffer desperate poverty.

It is the failure to clear this second hurdle, especially among those who would bear the cost, that explains Copenhagen and the difficulties of the carbon pollution reduction scheme, not a conspiracy by the devotees of an obscure Austrian professor.

As for fomenting inequality, it simply won't do to cite instances you think make your case, while ignoring those that contradict it. Income inequality in Australia declined under the Howard government that you denounced as being the neo-liberal scourge at its most pestilential. In contrast, it has increased substantially in Sweden, Finland and, since the end of the 90s, in France.

As for the US, economists measure income inequality using an index that goes from zero, for complete equality, to one, for complete inequality. Calculated over pre-tax earnings (including those of chief executives), that index stands at 47 for the US, compared with 51 for Britain, 47 for Germany, 46 for Sweden and 43 for Denmark: differences that are small.

What happens, however, is that some countries, including the Scandinavians, engage in especially extensive income redistribution. But two points stand out.

First, even taking welfare payments into account, the absolute disposable income of the poorest 10 per cent of Americans exceeds that of their counterparts in Sweden or Finland, not to mention Britain or France. Second and perhaps even more important, extensive redistribution, whatever its benefits, is far from costless, not merely in reduced work incentives but especially in fanning the rising flames, now raging in Europe, of racism and xenophobia.

It is that ugliness, not a reinvigorated social democracy, that has emerged out of the GFC, with the demagogy of the market-bashers adding sticks to the kindling. It portends a future for the dispossessed, in the very countries you idolise, that is anything but cheery.

Ultimately, there are no earthly paradises out there, in whose image we should recast our destiny: trying to convert Australia into a New Sweden is as sensible as wanting to transform Australians into Martians. Yes, we have much to learn and a lot to mend. And yes, the GFC does remind us of just how important it is to have an economy that is resilient, well-governed and flexible. Does that require a retreat from the reforms that secured our prosperity? Far from it. Rather, it requires the determination to stay the course, and the wisdom to preserve gains that were every bit as hard won as they are easy to squander.

Yours, Henry

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