

# Course 3: The Neoliberal Paradigm

## Stagflation of the 1970s (in the old industrialised countries) profound search for new policies

- Monetarist critique of Keynesianism
- Tax cuts – Middle class tax revolt
- Free-market critique of regulation (domestic and international)
- Public choice theory > broad critique the political process (in the US) and government
- “Class war”: Warren Buffet

“There's class warfare, all right, but it's my class, the rich class, that's making war, and we're winning.”

*(As quoted in "In Class Warfare, Guess Which Class Is Winning" by Ben Stein, in The New York Times (26 November 2006))*

# The struggle to control inflation

# (Why) Is inflation a bad thing?

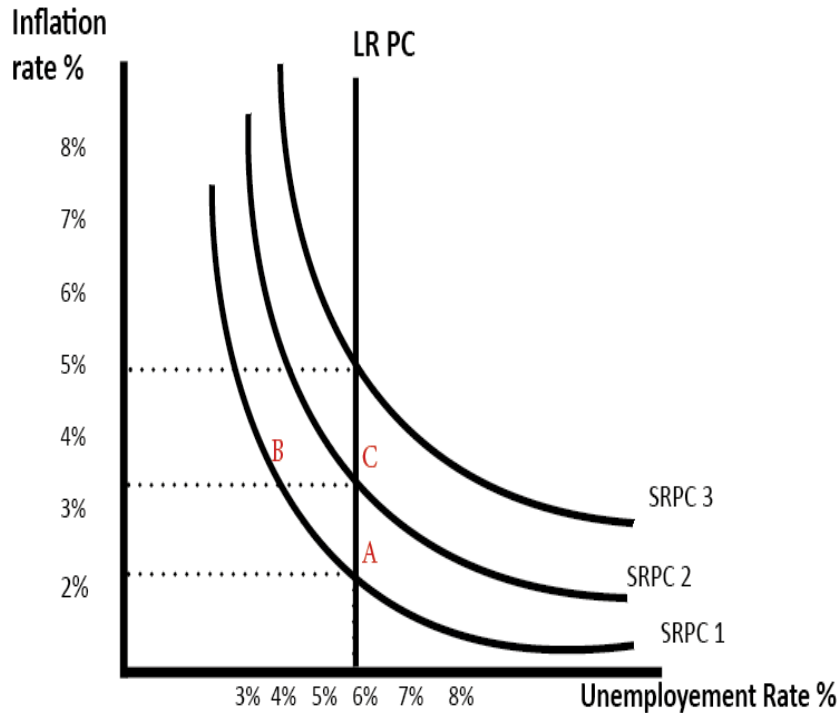


## Some problems with excessive inflation

- Reduces purchasing power for people whose incomes do not rise
- Transfers of wealth: erosion of savings
- Increase market frictions as agents regularly need to adjust prices, spend time checking prices
- Distorts investments – into commodities and out of economic activities
- Hard to control once it accelerates (even leaving aside hyperinflation)

# Money cause of inflation

Natural rate of unemployment



- Rational expectations hypothesis: policy experts cannot fool people (morally wrong)
- Fine-tuning of demand does not work, because of time lags (political business cycle)
- $MV = PT$

# Application: a mixed success

- **Volcker Shock (1979)**
- Fed funds rate: 20% in 1980 (inflation 10-12%)
- Unemployment rose to 10.8% in 1982
- Inflation came down relative quickly
- Reagan (1981) fiscal policy boom (tax cuts and defence spending)
- Labour market more flexible, unions weakened quickly
- **UK: MTFS**
- Surge in interest rates, and pound (oil backed)
- Magical monetarism
- Financial market deregulation (end capital controls 1979, end of credit controls 1980) > rise in V
- 1981: fiscal contraction during recession

# “It’s all very difficult”

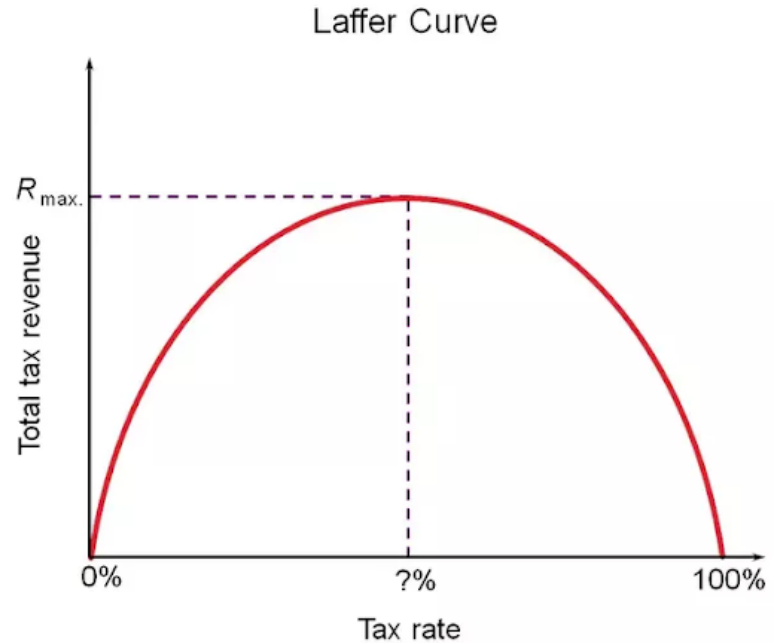
- **Goodhart’s law:** “When a measure becomes a target, it ceases to be a good measure.”
- **Lucas critique:** "Given that the structure of an econometric model consists of optimal decision rules of economic agents, and that optimal decision rules vary systematically with changes in the structure of series relevant to the decision maker, it follows that any change in policy will systematically alter the structure of econometric models."
- **Alan Budd:** “When we set off with various Barber-like experiments [fiscal expansion 1972] in the early and mid-70s, I did not think the effect would be inflation. The monetarists said it would be. They were right. I was wrong. Obviously, it was good Popperian stuff... And of course politicians like simplicity... There were a few of us... who normally say “it is all very difficult”, who became converted to a rather simpler idea... it was peculiar in a way, I agree.”



# Changes in fiscal policy

# The Tax Revolt > Supply-Side Economics

- California (1978)  
*Proposition 13*
- Thatcher elected May 1979 > top tax rate cut from 83% to 60% (higher VAT)
- Reagan elected 1980: tax cuts – top rate cut from 70% to 50%; to 28% in 1986 - 3% of GDP

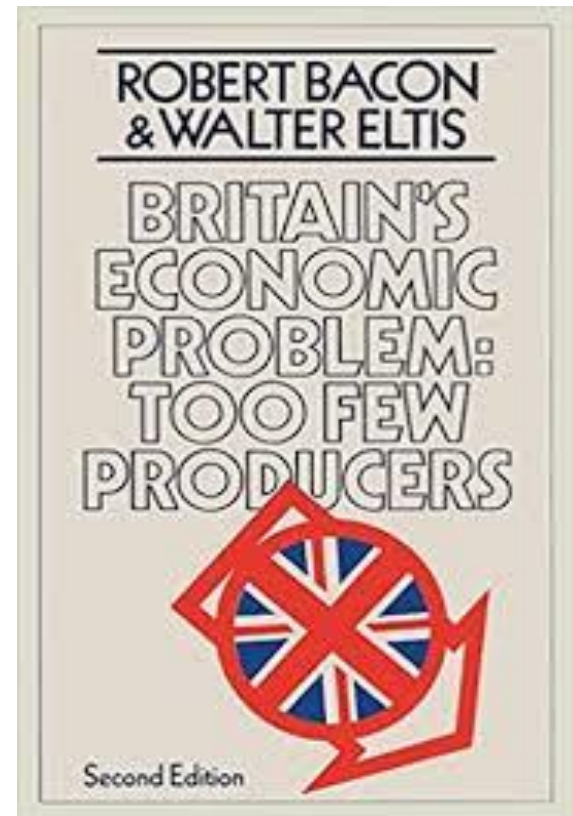


The new Republican narrative: tax cuts pay for themselves and deficits do not matter.

Rober Shiller: Narrative economics 2017

# “Crowding out”

- Government spending “crowds out” private investment, by causing interest rates to rise.
- Government crowds out labour



# Nigel Lawson: Mais lecture, June 1984

## *The Roles of Macro and Micro Policy*

The conventional post-War wisdom was that unemployment was a consequence of inadequate economic growth, and economic growth was to be secured by *macro*-economic policy – the fiscal stimulus of an enlarged Budget deficit, with monetary policy (to the extent that it could be said to exist at all) on the whole passively following fiscal policy.

Inflation, by contrast, was increasingly seen as a matter to be dealt with by *micro*-economic policy – the panoply of controls and subsidies associated with the era of incomes policy. The conclusion on which the present Government's economic policy is based is that there is indeed a proper distinction between the objectives of macro-economic and micro-economic policy, and a need to be concerned with both of them. But the proper role of each is precisely the opposite of that assigned to it by the conventional post-War wisdom. It is the conquest of inflation, and not the pursuit of growth and employment, which is or should be the objective of macro-economic policy. And it is the creation of conditions conducive to growth and employment, and not the suppression of price rises, which is or should be the objective of micro-economic policy.

# Mitterrand's Socialist Experiment (1981-1983)



- Keynesian stimulus
  - Many nationalisations – including banks
  - 10% rise of min. wage
  - 5<sup>th</sup> week of holiday
  - 39-hour week
  - Retirement at 60
- => Exploding deficits (govt & current account)

# The second *Bataille de Poitiers*

« *En l'an 732, Charles Martel écrasa les Arabes à Poitiers* »



- October 1982  
Customs clearance for all video-cassette recorders in Poitiers



# “La rigueur” cometh 1982-83



The French franc devalues by 8% in the European Monetary System (EMS)

*La désinflation compétitive*

Social unrest

Mitterrand pursues European integration:

Single European Act 1986  
(market liberalization)

Maastricht Treaty 1992  
(enshrines monetary orthodoxy)



Remembering Verdun (1984)

## The Jackson Hole Consensus: 1990s onwards

- Monetary policy > inflation targeting (New Zealand 1990)
- One instrument > one target (Tinbergen's rule)
- Policy should be forward looking (lags)
- Policy should be consistent, clearly communicated to agents and markets > credible
- Central banks independent > policy set by committees of experts and not politicians



# Taylor Rule , The Great Moderation & economic problems solved

$$\dot{i}_t = \pi_t + r_t^* + a_\pi (\pi_t - \pi_t^*) + a_y (y_t - \bar{y}_t).$$

$\dot{i}_t$  target short-term nominal interest rate

$\pi_t$  rate of inflation (GDP deflator)

$\pi_t^*$  the desired rate of inflation

$r_t^*$  the assumed equilibrium real interest rate

$y_t$  log of real GDP

$\bar{y}_t$  Log of potential output

**The Great Moderation:** mid-1980s until GFC (2007-2008) – especially from early 1990s onwards.

**Robert Lucas January 2003:** “My thesis in this lecture is that macroeconomics in this original sense has succeeded: Its central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades.

Less government

# Deregulation and Privatisation

- Neoliberal critique (Hayek and others)
- US – transport deregulation 1970s
- Financial market deregulation: 1980s onwards especially
- End of price and income controls
- British “export” in 1980s (early measures in Chile)
- At first piecemeal: big change with BT (1984)
- Privatisation of network industries (natural monopolies) – government regulators

# Public Choice Theory

James Buchanan and Gordon Tullock, *The Calculus of Consent*, 1962.

Methodological individualism (Thatcher “no such thing as society”)

“Pork-belly politics” and “Log rolling”

Political process always pushes up government spending: special interests can mobilise more effectively than the general public

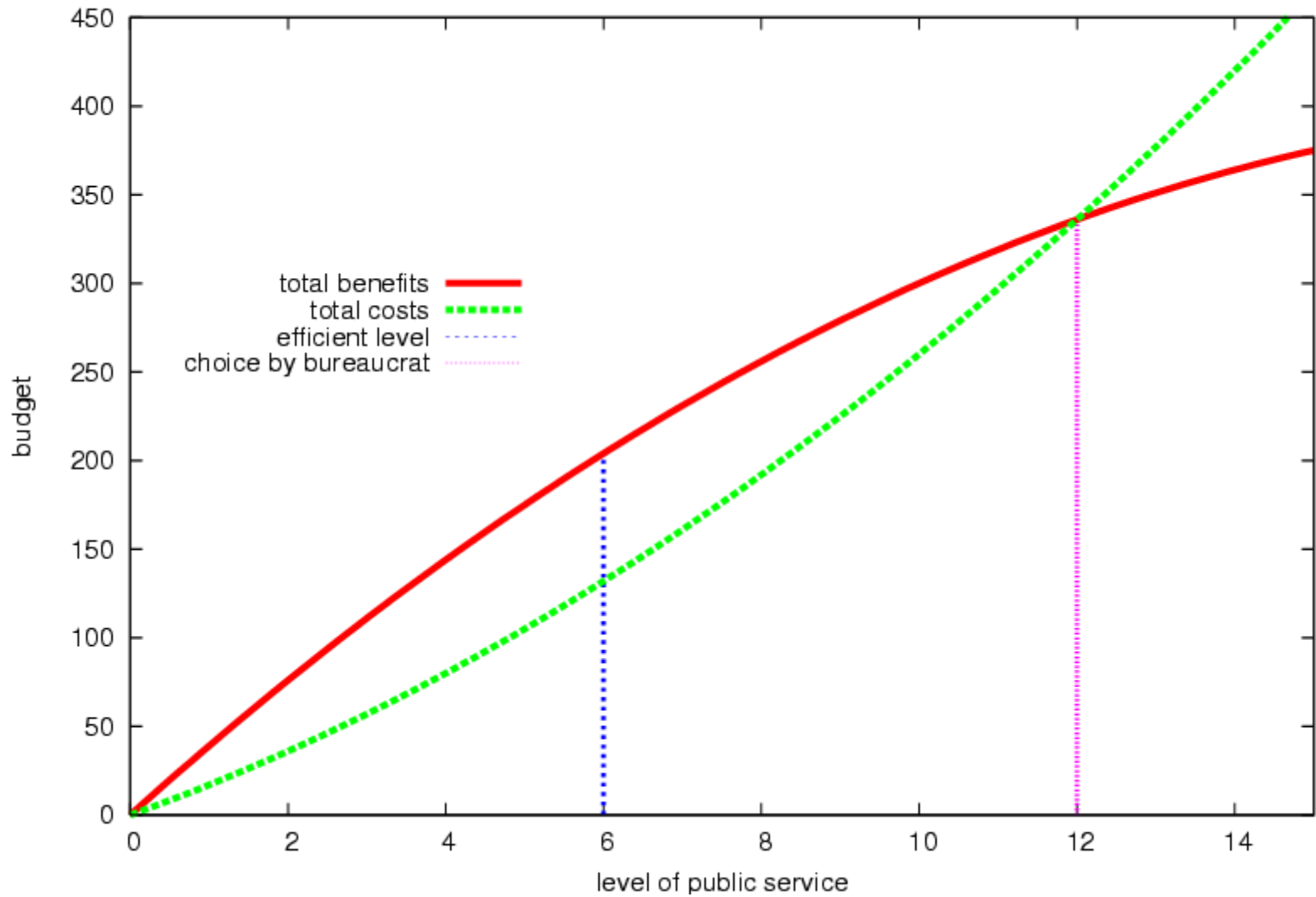
Tip O’Neill: “all politics is local” (Speaker 77-87)

(Is this true in the UK, say? Dunleavy: Treasury control)

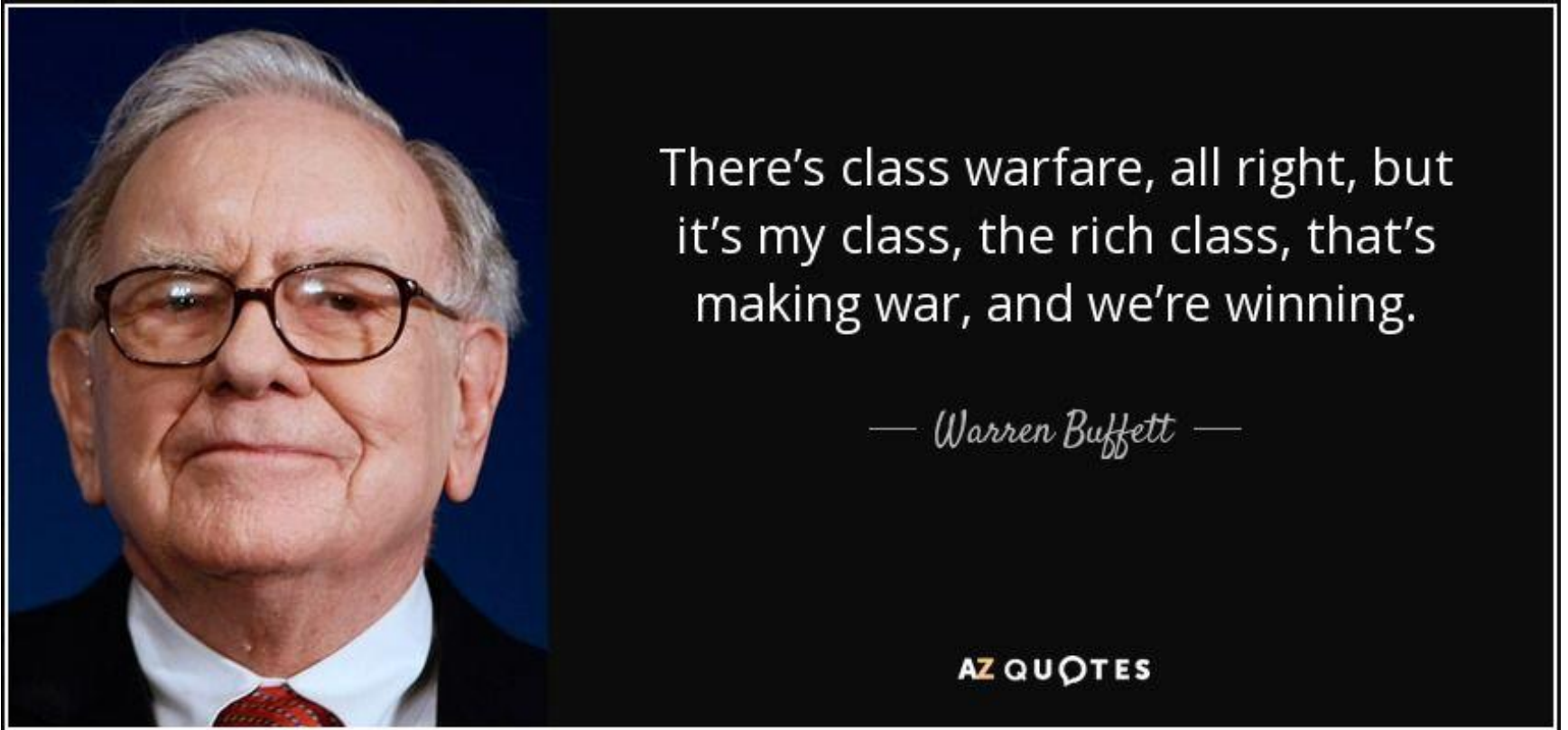
## W. Niskanen: budget maximizing bureaux

- Government agencies (and some non-profits) do not sell their products and services.
- They obtain budgets from a sponsor
- Their utility is linked to salary and size of bureau
- Not necessarily corrupt > pursue professional considerations
- They will always push for greater production/output
- Marginal cost will exceed marginal utility: structurally inefficient

Figure 8 : Niskanen's Model of Bureaucracy



# Weakening Labour



There's class warfare, all right, but  
it's my class, the rich class, that's  
making war, and we're winning.

— *Warren Buffett* —

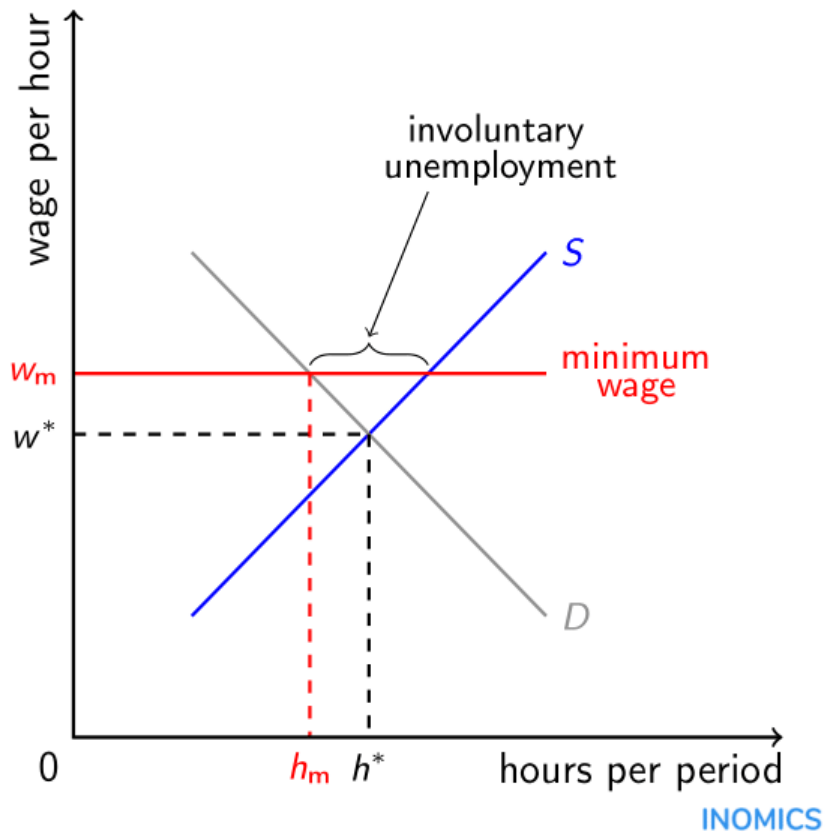
AZ QUOTES

# The weakening of labour

- **In the US, Ronald Reagan:** in August 1981 Reagan fired 11,345 striking air-traffic controllers
- US business relocated to “Right to Work States” (in South, Mid-west and the West) – Sun Belt
- Later off-shoring
- Pressure on Federal minimum wage: \$7.25
  
- **In Britain, the Conservatives** ended “social dialogue”;
- used privatisation to weaken unions;
- reduced union legal rights;
- pursued major confrontations (1984-1985 Miners’ strike);
- reduced benefits;
- made labour market function like any other commodity market.
  
- **In Chile (1973 onwards),** the Pinochet dictatorship also weakened labour as part of its free-market policies



# Freeing the market and commodifying labour



US federal minimum wage  
\$7.25 (2020)

UK “zero hours contracts”  
>900,000 (9/2017, ONS)

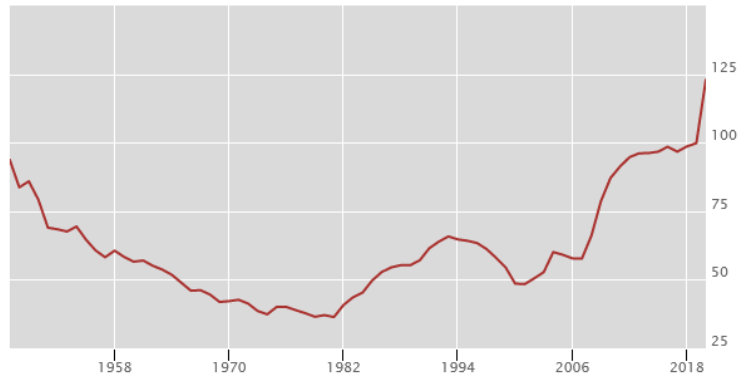
Much less regulation  
elsewhere

No unemployment  
because salaried labour  
is limited

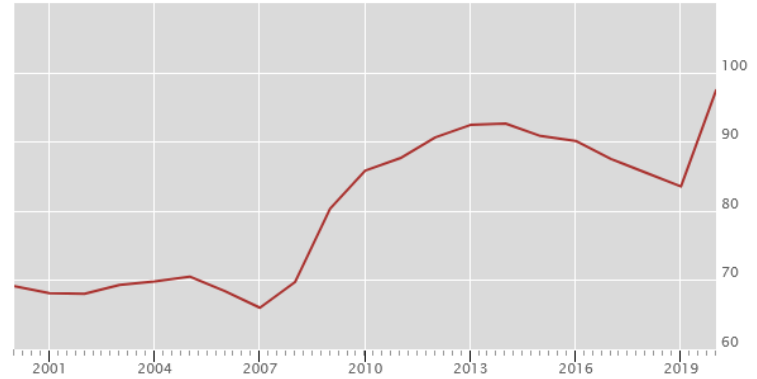
And the Covid crisis?

## Total credit to government sector at nominal value (core debt), as a percentage of GDP: Source BIS

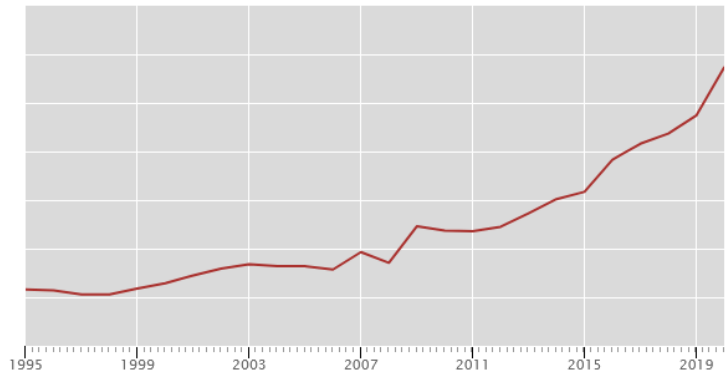
### USA



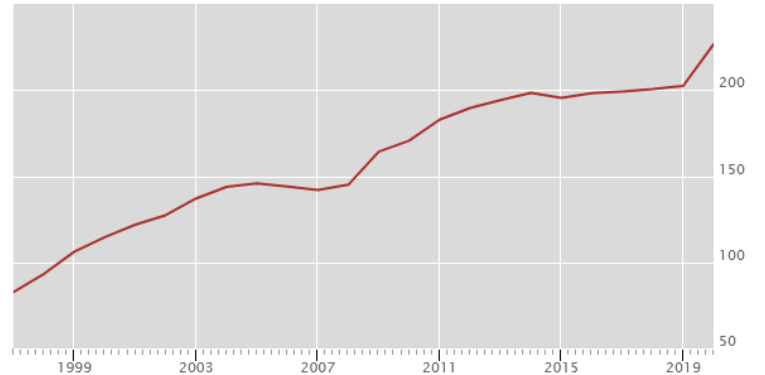
### Eurozone



### China

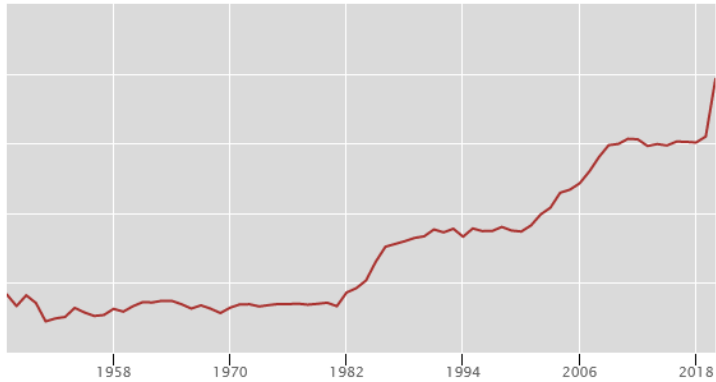


### Japa

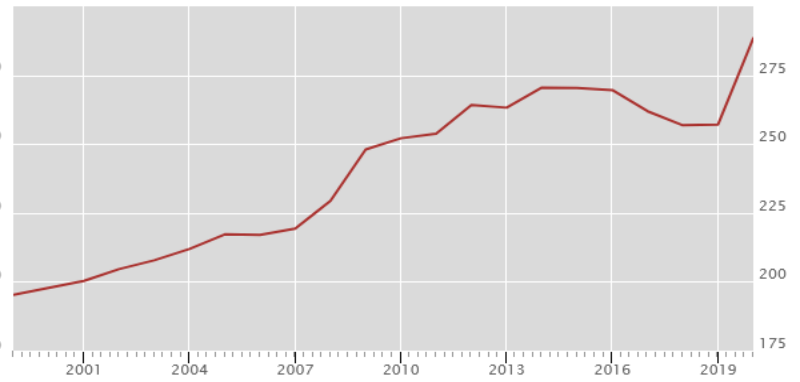


# Total credit to the non-financial sector (core debt), as a percentage of GDP: Source BIS

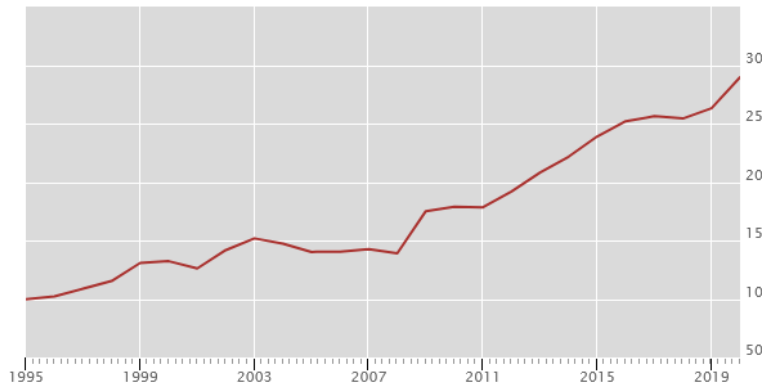
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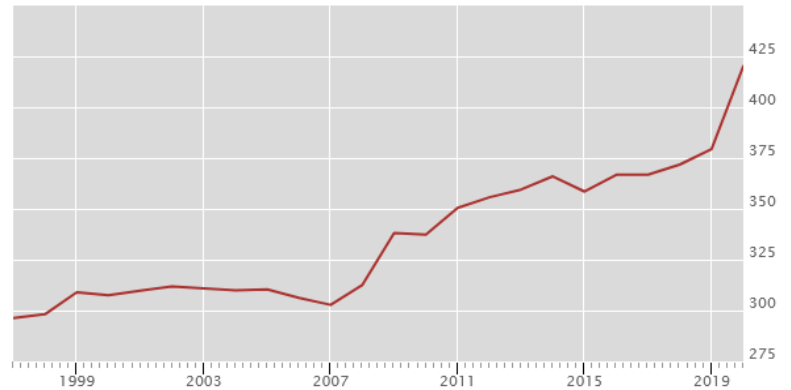
## Eurozone



## China



## Japan



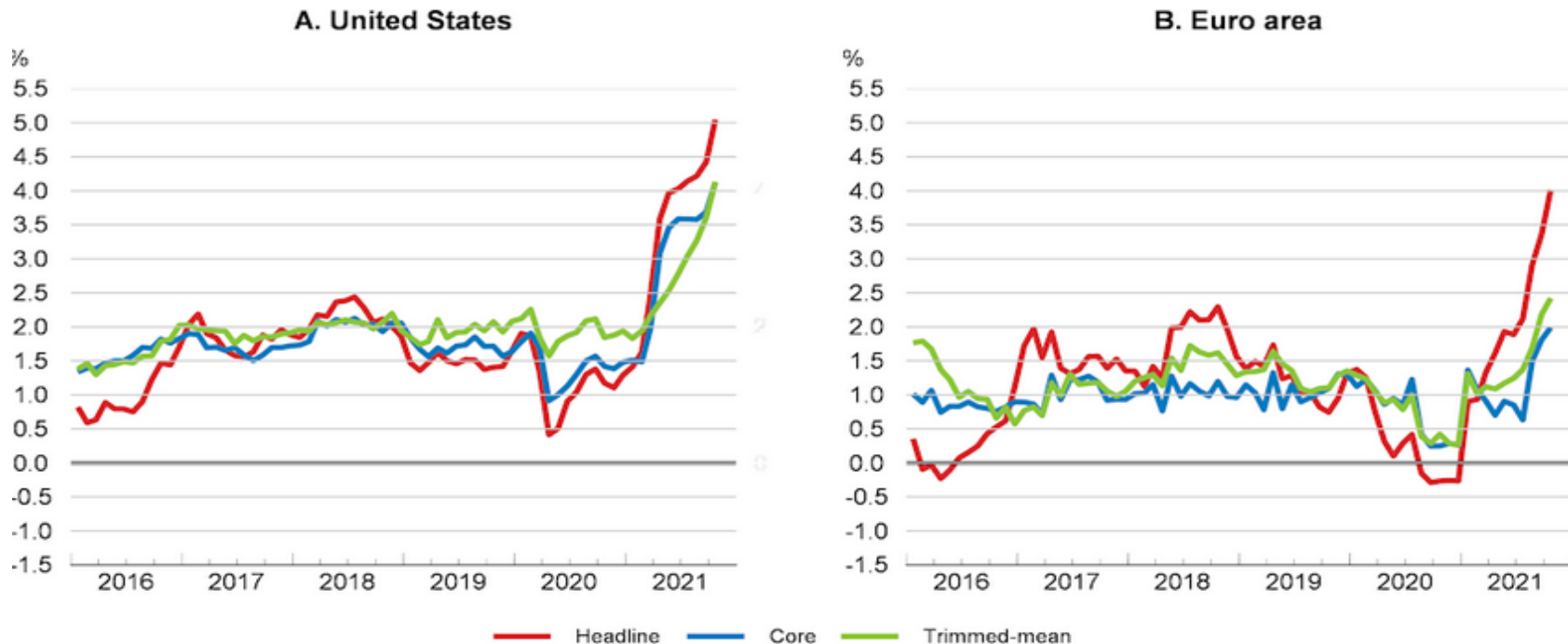
Biden's "Christmas Tree": Jan 2021  
(Interview with Paul Krugman, Feb 2021)

- A Christmas Tree of wide-ranging spending is the only thing that can be got through Congress (the Senate)
- Minimum wage > better to go for a simpler \$15 per hour (even if not appropriate everywhere)
- Low interest rates have changed the logic of debt (Olivier Blanchard, 2019, as real interest payments are less than growth)

Interview with Paul Krugman, Feb 2021 continued

- Crowding out: difference between debt and deficits.
- Some evidence that deficits put pressure on interest rates in the 1980s
- Today – significant global savings > lower interest rates
- NAIRU – “maddeningly-hard” to pin down
- Over-emphasis on the evils of the 1970s
- Should governments be entrepreneurial? –  
Can we accept government waste?

# But now inflation is rising... rapidly?

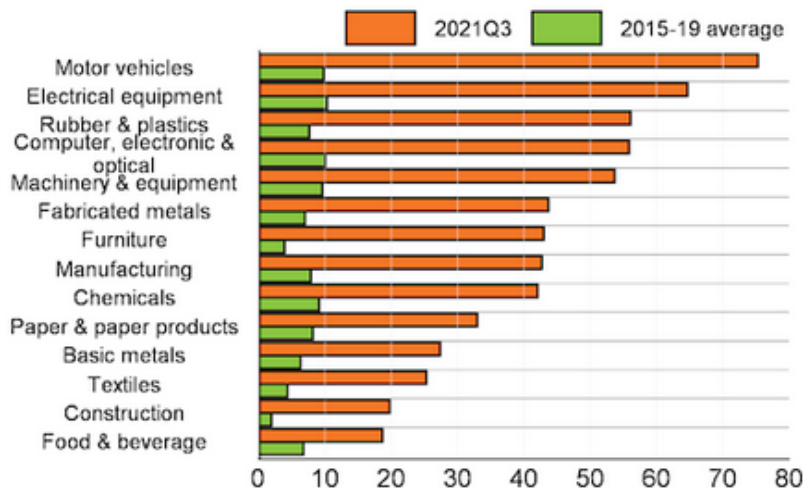


Headline = normal consumer price index; Core = excludes energy and food-related products; Trimmed-mean inflation trims 10% in terms of weights at the top and bottom of the distribution of the year-on-year growth of prices. Ibid OECD.

# Bottlenecks: supply chain problems and labour market shifts

## The “Great Resignation”?

**B. Euro area firms with production constraints from material and equipment shortages**  
%, s.a.



**A. Job openings in US small businesses with few or no qualified applicants**  
% of firms



Source: ibid OECD.



# Takeouts

- Great Inflation/Stagflation led to major change in policy paradigm – and in economics
- Adjustment was painful – and in some cases violent
- With time, the new paradigm has had damaging consequences (inequality, and massive externalities)
- The GFC and Covid-19 have led to massive government intervention
- The legitimacy of neo-liberalism has collapsed
- But no clear alternative has emerged.