Course 3: The Neoliberal Paradigm

Stagflation of the 1970s (in the old industrialised countries) > profound search for new policies > the new “Western economics”

- The struggle to control inflation and the monetarist critique of Keynesianism
- Changes in fiscal policy – the tax revolt
- *L’exception française*
- The “Jackson Hole” Consensus
- Less government and regulation
- “Class war” and the weakening of labour
- Deepening and generalised “commodification”

The struggle to control inflation

(Why) Is inflation a bad thing?

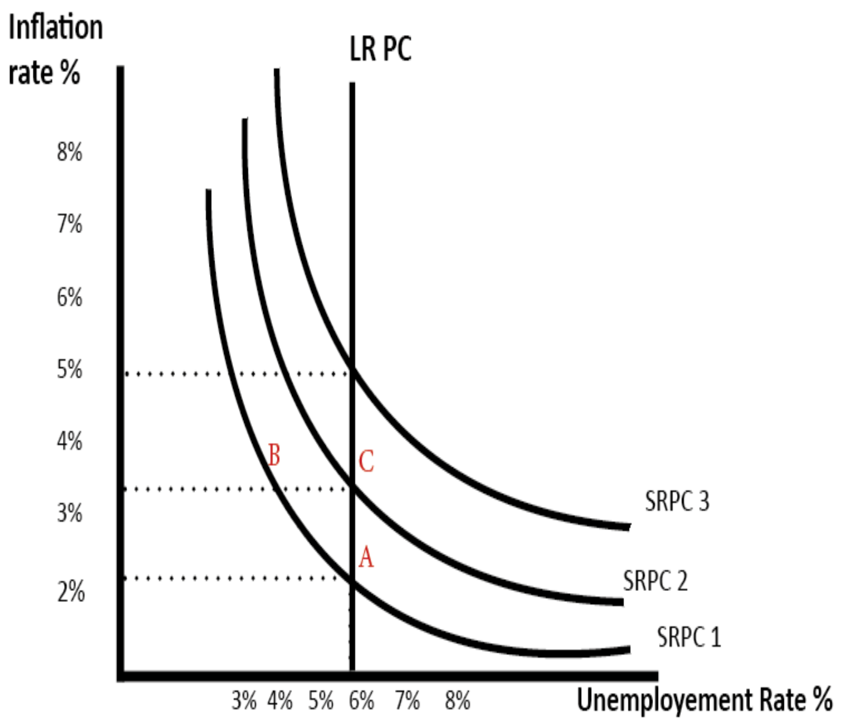
Iranian rials in 2011.

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 - time checking prices
- Distorts investments – into commodities and other economic activities/assets which are not necessarily productive
- Hard to control once it accelerates (even leaving aside hyperinflation)

Monetary causes 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

- European countries 1980s > DM peg

“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.“

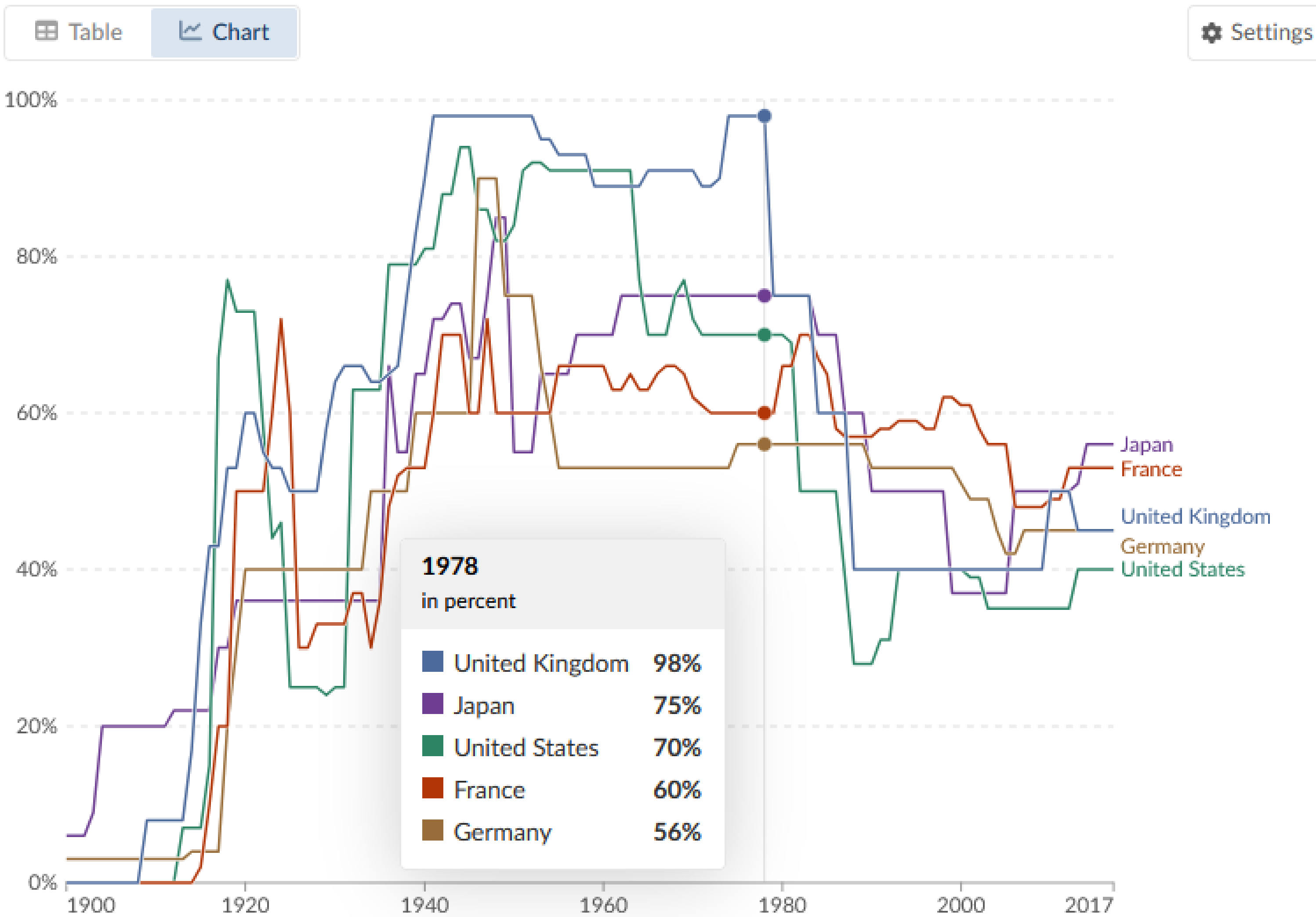
Alan Budd: “When we set off with various Barber-like experiments [fiscal expansion 1972] in the early and mid-70s, I did not think the effect would be inflation. The monetarists said it would be. They were right. I was wrong. Obviously, it was good Popperian stuff… And of course politicians like simplicity…

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

Top marginal income tax rate, 1900 to 2017

Top marginal tax rate of the income tax (i.e. the maximum rate of taxation applied to the highest part of income)

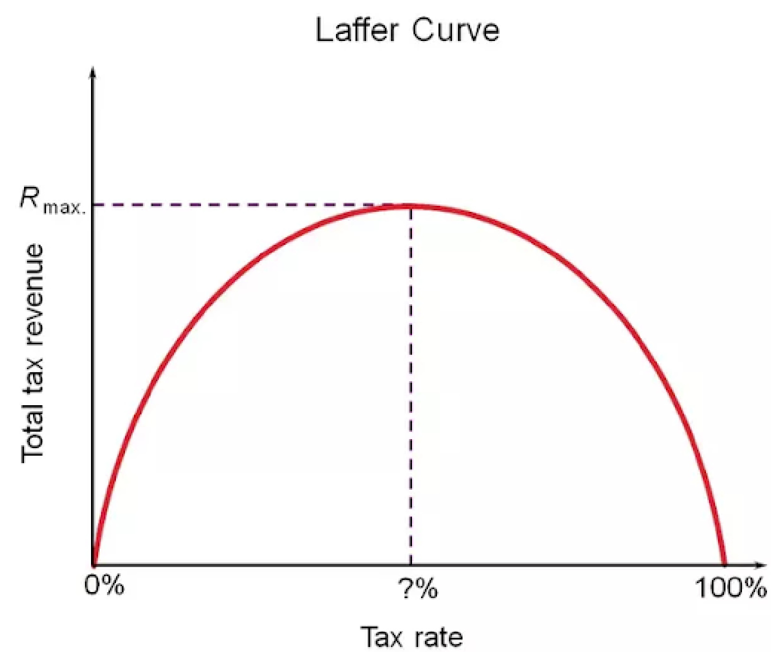


The Tax Revolt > Supply-Side Economics

California (1978)
Proposition 13

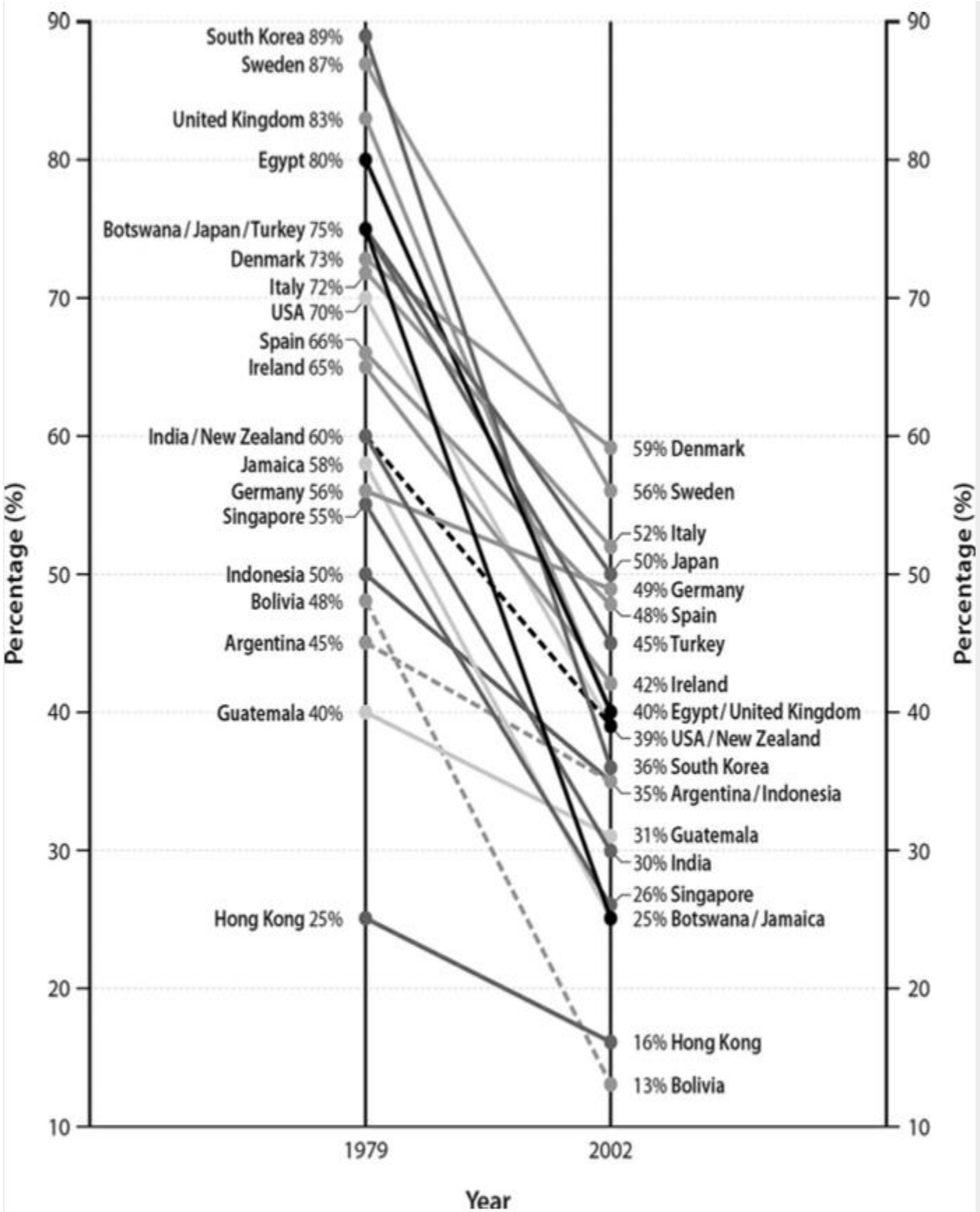
Thatcher elected May 1979: top tax rate cut from 83% to 60% (higher VAT)

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



Cuts in top tax rates: a truly global phenomenon

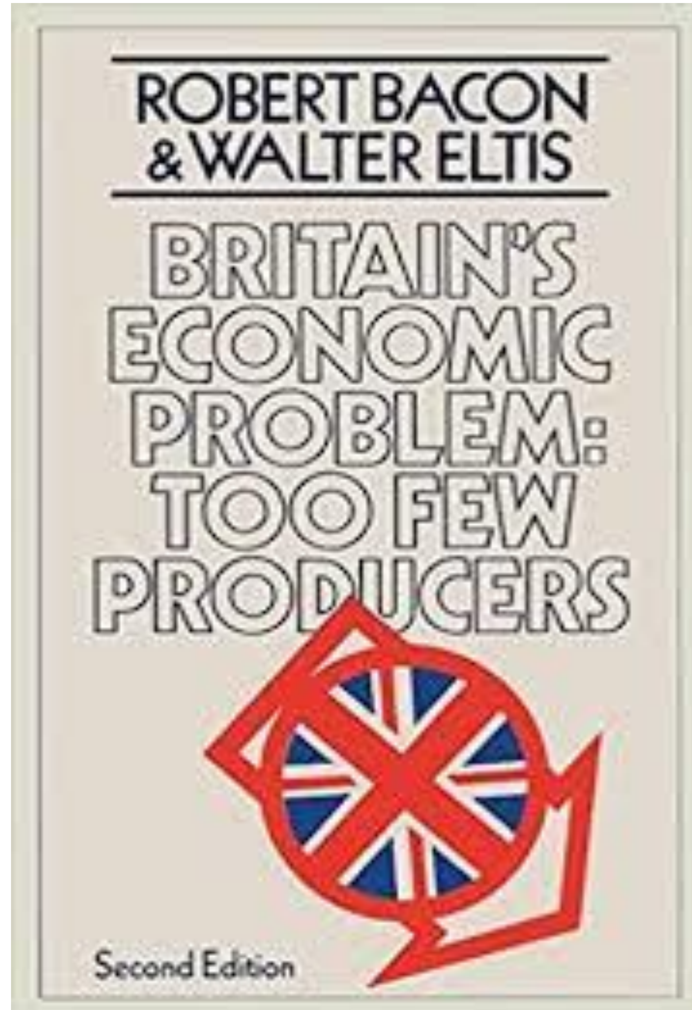
Minouche Shafik, *What We Owe Each Other: A New Social Contract*, London, Vintage, 2021.

“Crowding out”

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

(In the UK)

Large public sectors also “crowd out” private sector employment.



Prices and incomes policies

Back in the 1970s

US (early 1970s, under Nixon)

UK The Social Contract – mid-1970s

Canada: Anti-Inflation Act 1975

Australia: experiments in late 1970s > Prices & Incomes Accord 1983

France & Italy: negotiations with employer/employee bodies

Germany: Konzertierte Aktion in late 1960s and in 1970s

Energy cap policies in Europe after Covid and war in Ukraine

- UK energy price cap (began in 2019) used extensively in 2022 through to 2024.
- France and EU – similar policies to limit energy prices rises
- **(February 2024 – France lets electricity prices rise by 8.6%)**

Nigel Lawson: Mais lecture, June 1984

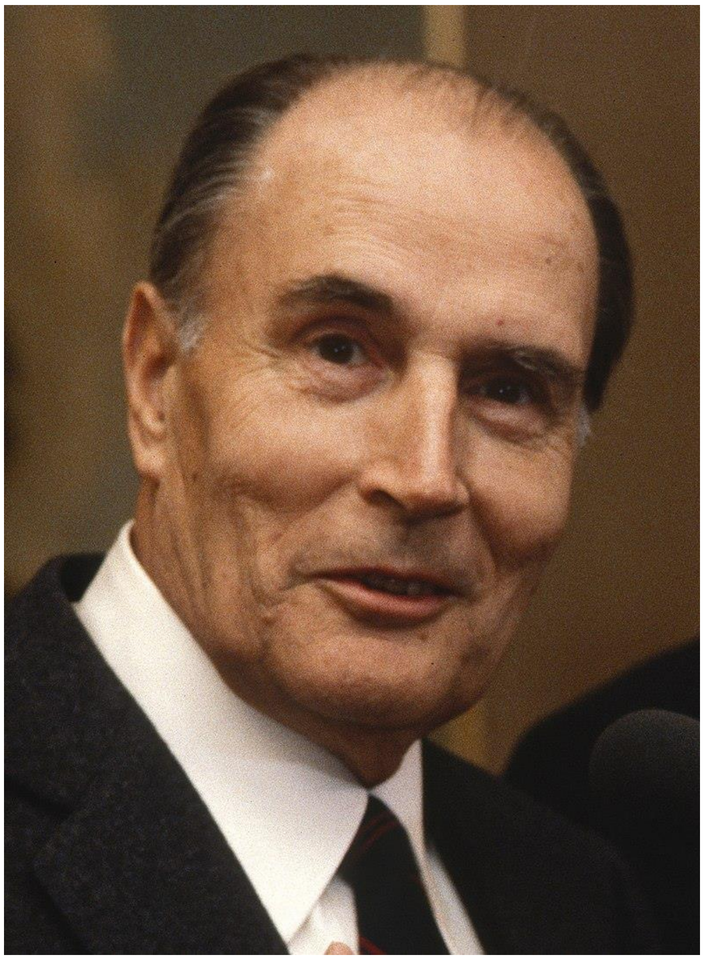
The Roles of Macro and Micro Policy

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.

L’exception française

Mitterrand's Socialist Experiment (1981-1983)



- Keynesian stimulus
- Many nationalizations – including banks
- 10% rise of min. wage
- 5th 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


EN UN MOIS

FRANC : −2,5%

MARK : +5,5%

APRES
LE RAJUSTEMENT
MONETAIRE
DE BRUXELLES

Et maintenant :
la note !

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

La désinflation competitive

Social unrest

Mitterrand pursues European integration:

Single European Act 1986 (market liberalization)

Maastricht Treaty 1992 (enshrines monetary orthodoxy)

Remembering Verdun (1984)

La politique du « franc fort »

Ou la politque Frankfurt?

EEC countries pursued deflation by anchoring currencies on the DM

The "Jackson Hole Consensus" and the Taylor Rule

The Jackson Hole Consensus: 1990s onwards

- Monetary policy > inflation targeting (New Zealand 1990 – NZ laboratory of neoliberlism)
- 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

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

i_t target short-term nominal interest rate
π_t rate of inflation (GDP deflator)
π_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."

Simplified Taylor Rule (Investopedia)

$$r = p + 0.5(p - 2) + 0.5y + 2$$

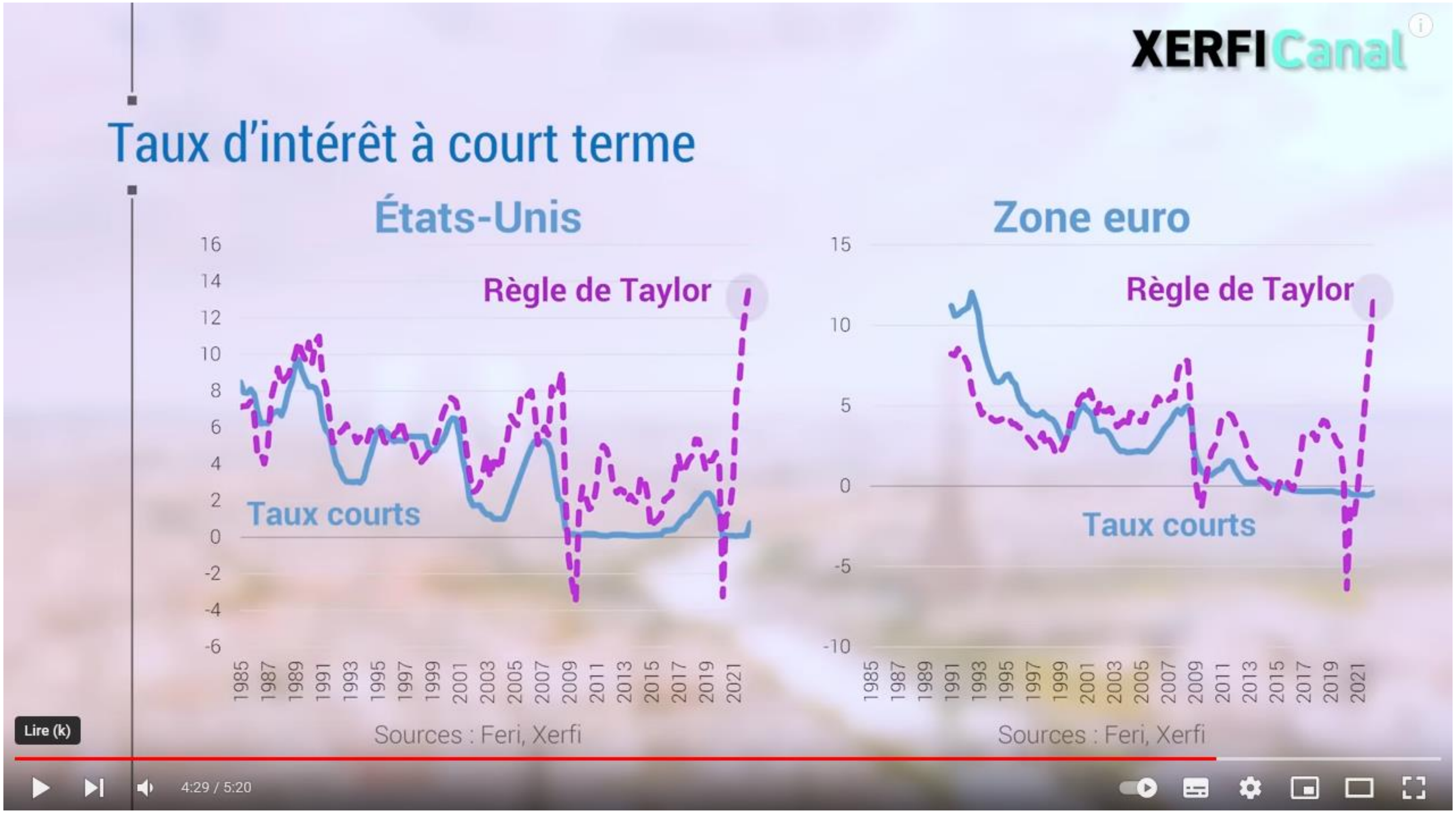
r = nominal fed funds rate

p = rate of inflation

y = percent deviation between current real GDP and long-term linear trend in GDP (the Fed has sometimes used the “unemployment gap”)

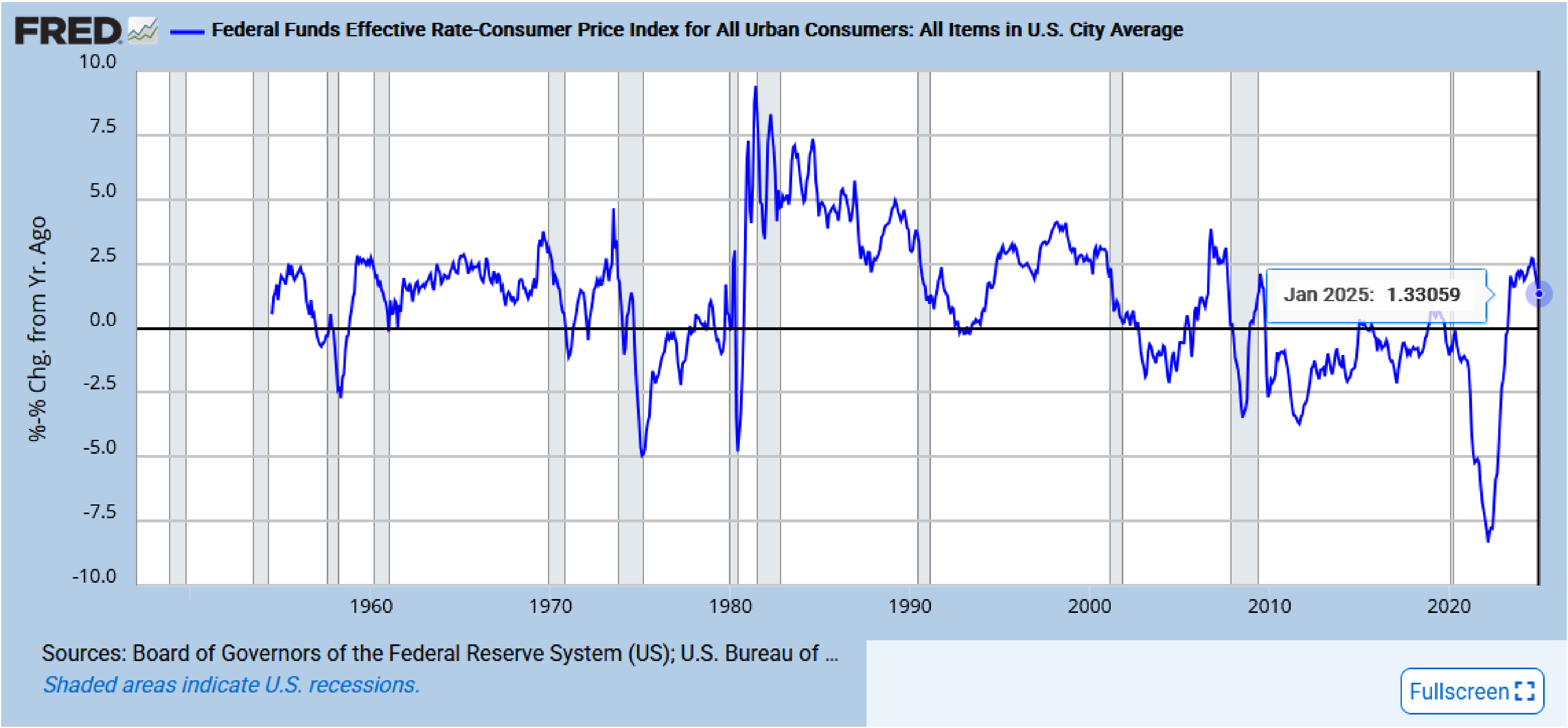
The equation assumes the equilibrium federal funds rate of 2% above inflation, represented by the sum of *p* (inflation rate) and the "2" on the far right.

Olivier Passet, "Les économistes n'y comprennent plus rien", *Xerfi Canal*, 12 septembre 2022



Federal Funds Effective Rate – Consumer Price Index

Source: https://fred.stlouisfed.org/graph/?g=6TK



Negative real interest rates since the global financial crisis make typical historical saving by households (i.e. putting money in a savings account) impossible.

Less government and deregulation

Hayek: **The Use of Knowledge in Society** (1945)

There is too much knowledge in production for a central planner to collect.

Prices provide sufficient knowledge for producers to organise their production.

A restatement of Smith's "invisible hand"

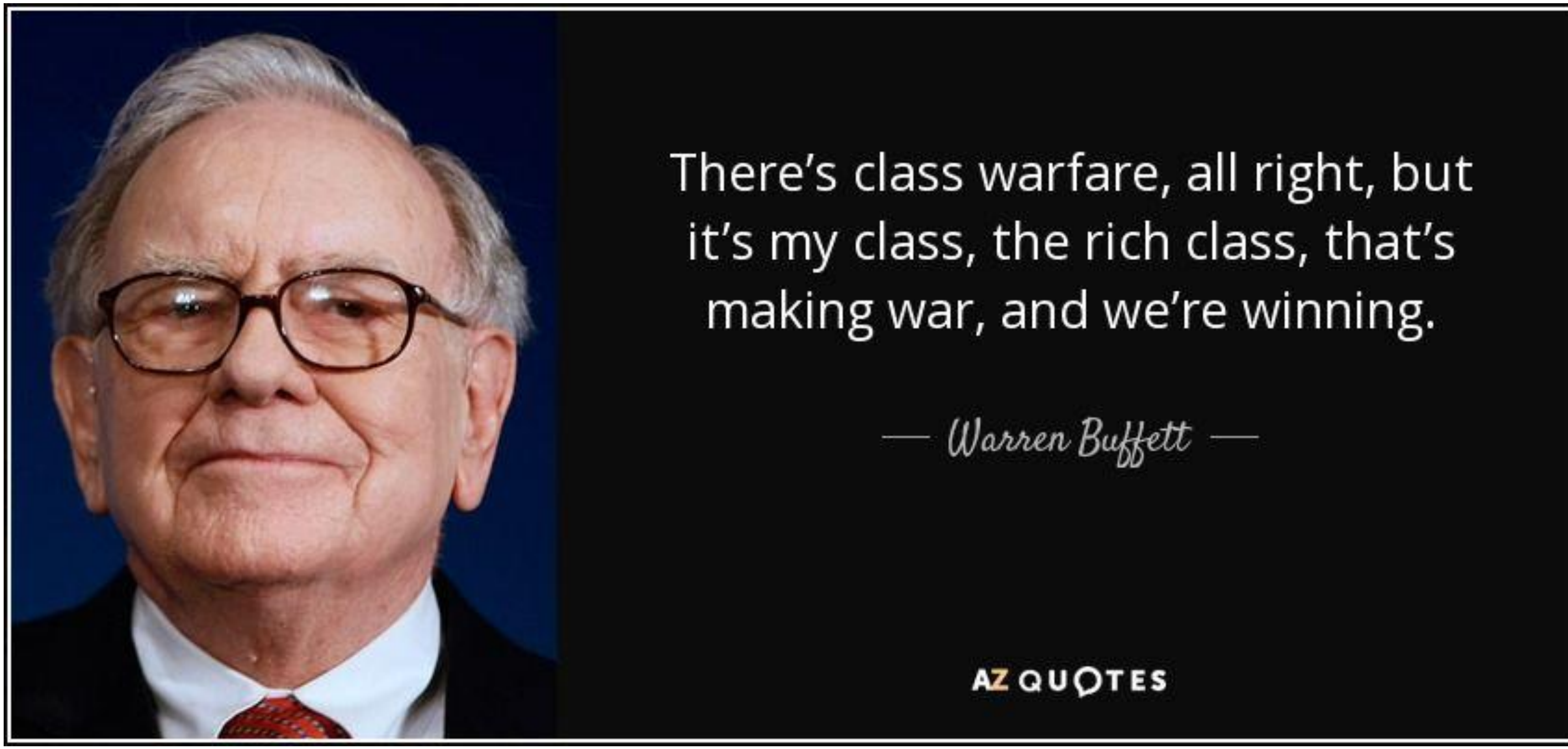
Friedman recounting "I, pencil"

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)
- Privatization of network industries (natural monopolies) – government regulators

Weakening Labour

Class War


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

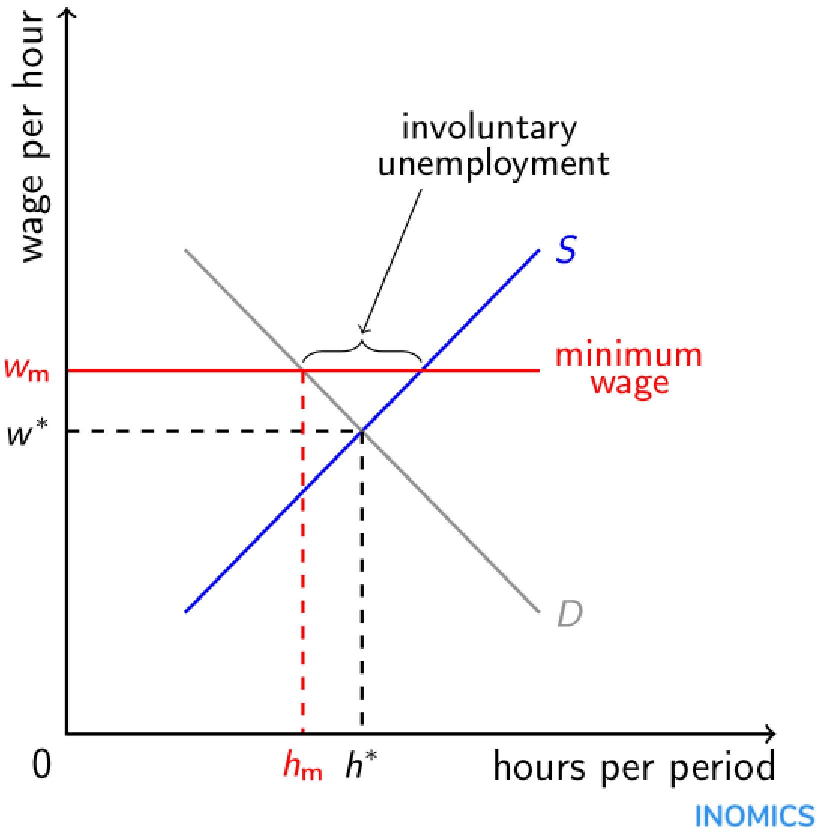
The weakening of labour

- **In Chile (1973 onwards),** the Pinochet dictatorship also weakened labour as part of its free-market policies (*The Shock Doctrine*, Klein)

- **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.

Freeing the market and commodifying labour



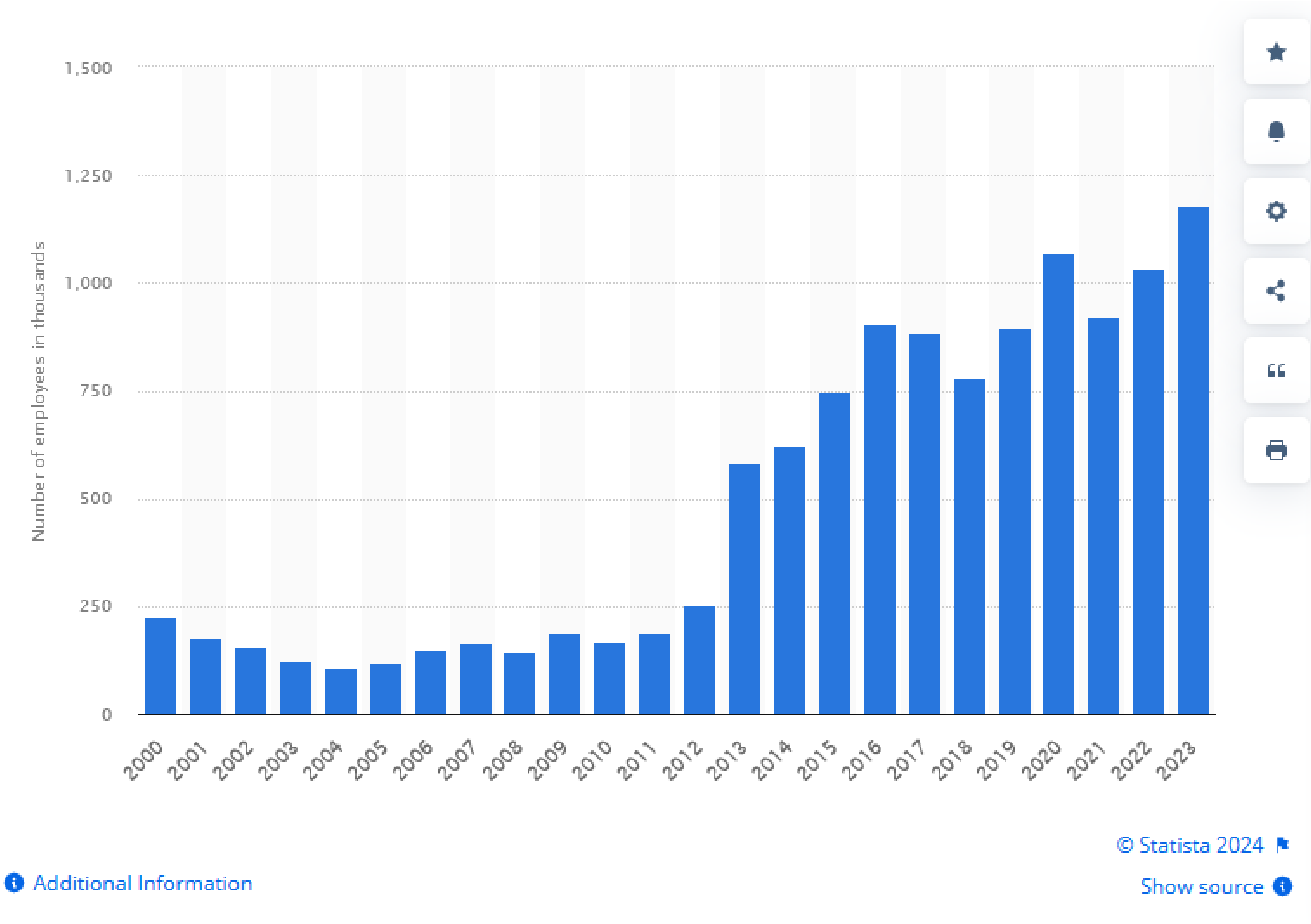
US federal minimum wage $7.25 (2024)

UK "zero hours contracts"

Much less regulation elsewhere

No unemployment because salaried labour is limited

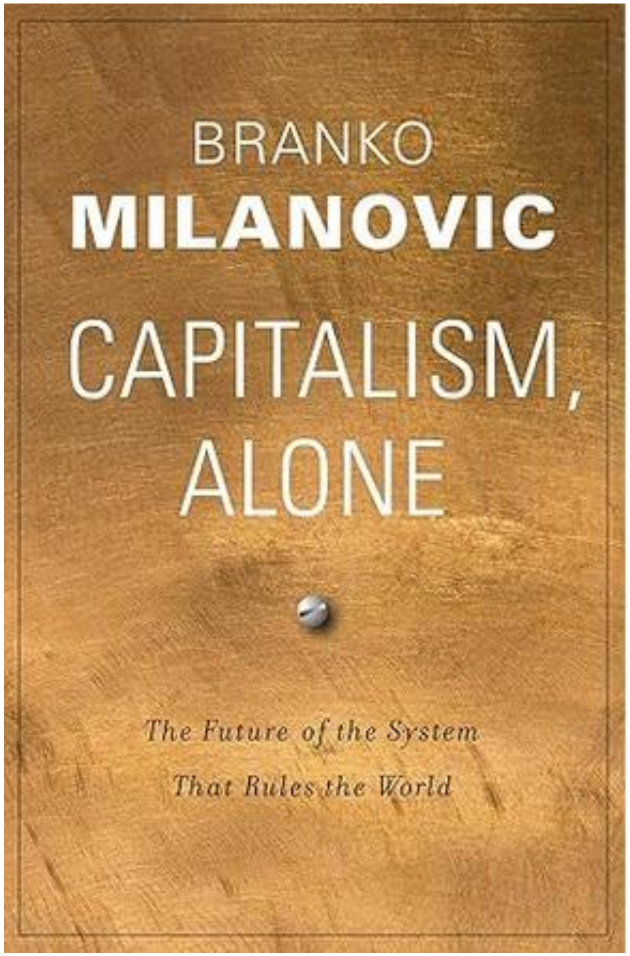
UK: Number of employees on a zero-hours contract from 2000 to 2023 (Statista 2024)



Deepening commodification

"All that is solid melts into air, all that is holy is profaned…"

Capitalism Alone, Branko Milanovic

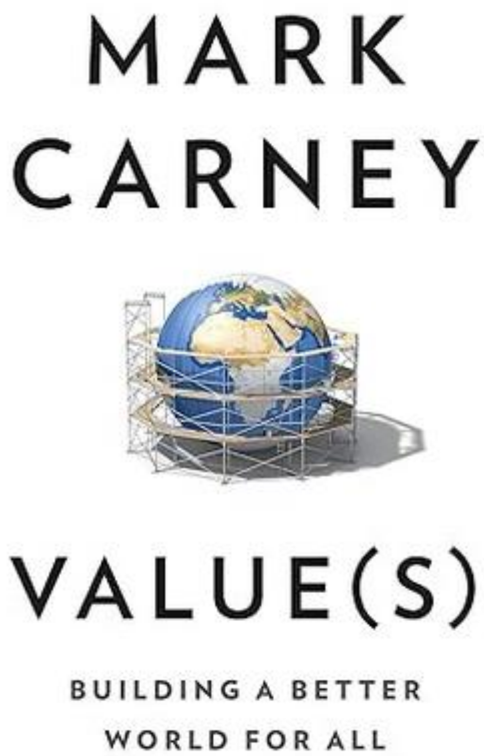


Money-making not only is respectable but is the most important objective in people's lives…

Commodification of the private sphere is the apogee of hypercommercialized capitalism

["Homes" are assets to be monetized – via Air BnB]

The market society



"A cynic is man who knows the price of everything, and the value of nothing"

Oscar Wilde

"something which is not priced is neither valued nor valuable"

"we have moved from a market economy to a market society, and this is now undermining our basic social contract of relative equality of outcomes, equality of opportunity and fairness across generations"

Marx & Engels, *The Manifesto*, 1848 (Part 1)

The bourgeoisie cannot exist without constantly revolutionising the instruments of production…

All fixed, fast-frozen relations, with their train of ancient and venerable prejudices and opinions, are swept away, ... All that is solid melts into air.

The need of a constantly expanding market for its products chases the bourgeoisie over the entire surface of the globe.

The bourgeoisie … has left remaining no other nexus between man and man than naked self-interest, than callous “cash payment.

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