DISCUSSION PAPERS

Neo-Liberalism is Dead, Long Live Neo-Classical Economics

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Neo-liberalism is dead. So says Dani Rodrik, the young rising star of the economics profession, in his keynote speech at a conference of progressive academics and activists. Titled "Alternatives to Neo-Liberalism," the conference was held in Washington D.C. last 23–24 May 2002.

Rodrik cites the unsustainability of economic growth in the 1990s, "a disappointing decade," as the most damning failure of neo-liberalism. Rodrik states as example that only three countries in Latin America—the darling of the Washington Consensus—grew faster in the 1990s than their historical average growth rates from the 1950–80 period. These are Argentina, Chile, and Uruguay. However, Argentina is now in deep crisis arising from rigidly implementing neo-liberal policies. And Chile, though one of the countries with a high degree of economic freedom, adopted the unorthodox policy of capital control.

It is not just the lack of growth that has undermined neo-liberalism's sway. Sustained growth did not materialize in many developing countries, especially in emerging market economies and transition economies, because of the frequency of devastating financial crises. Worse, whatever growth took place came hand in hand with widening income gaps.

The countries that have performed well in an all-round way—i.e., characterized by growth and equity and insulation from painful financial crisis—are those that deviated from the neo-liberal path and adopted a combination of conventional and non-conventional policies. Solid economic performers such as China, India and Vietnam, to quote Rodrik, "marched to the beat of their own drums."

The East Asian miracle—the rise of newly industrializing counties or NICs—was likewise a product of a heterodox strategy (e.g., decisive state interventions within a market-friendly framework). But the crisis that hit some of these countries in 1997 partly but significantly resulted from following the neo-liberal prescription of capital account liberalization.

Neo-liberalism is dead in that it has lost the battle to win the hearts and minds of the people of the world. Neo-liberalism is a main target of the assorted if not disparate movements against economic globalization—along with its chief promoters, namely the International Monetary Fund (IMF), the World Bank (WB), and the World Trade Organization (WTO). A number of leaders of developing countries have also expressed their disappointment with the rules governing neo-liberalism, as seen in the collapse of the WTO talks in Seattle.

The death of neo-liberalism should be understood in a metaphorical sense. Neo-liberalism is well and alive in the multilateral institutions and in other places. But neo-liberalism's intellectual scaffolding has collapsed and its ideological hegemony has vanished.

Eminent Dissidents

Surely, Rodrik is not the first to proclaim the death of neo-liberalism. And in the economics profession, Rodrik, is by no means a voice in the wilderness. He joins other eminent economists, led by Nobel Laureates Joseph Stiglitz and Amartya Sen, who have rigorously criticized economic orthodoxy. Other prominent economists who can be grouped in this camp, as it were, are Paul Krugman and Jeffrey Sachs.

Parenthetically, Sachs was the brains of the radical liberalization reforms undertaken by the former Soviet Union that had disastrous economic and social consequences. Sachs has now positioned himself with the United Nations Development Programme (UNDP), using it as a platform to do battle with the IMF and WB. He has also moved out of Harvard, joining Stiglitz in Columbia. The conjecture is that the two (Stiglitz had the option to join Harvard when he left Stanford) would not relish working under Lawrence Summers, the current Harvard president, former chief economist of the WB, and a nemesis of topnotch economists attacking the IMF. Curiously, the brilliant and prolific Rodrik teaches at Harvard's Kennedy School of Government, which for economics theorists, cannot quite compare to the Economics Department. Rodrik joined Harvard before Summers assumed the presidency.

Nevertheless, different people, including economists, have different understandings of neo-liberalism. In the Philippines, surprisingly, many mainstream economists are not familiar with the term "neo-liberal." "*Ano iyon*?" ("What is that?") is a typical remark.

Arthur MacEwan in *Neo-Liberalism or Democracy* (1999) writes that neo-liberalism is a reincarnation of 19th century classical economic liberalism. Thatcherite and Reaganite economics is the extreme form of neo-liberalism. In MacEwan's book, the Washington Consensus (which is discussed below) summarizes the neo-liberal agenda.

University of Malaya's Jomo K.S., one of the few distinguished political economists in Southeast Asia, states that neo-liberalism encompasses both the neo-classical model and the Austrian school of thought. (This was elicited from him in an informal dinner talk organized by Action for Economic Reforms in mid-April 2002.) This follows the statement of University of Cambridge's Ha-Joon Chang that neo-liberalism is the by-product of the unholy alliance between neo-classical economics and the Austrian school—the former having the formal analysis and the latter providing the political passion.

The neo-classical model, to paraphrase Stiglitz, formally articulates Adam Smith's invisible hand and contends that markets ensure economic efficiency. The Austrian School champions laissez-faire. Its distinction lies in its abhorrence of government intervention in the market, which it regards as destructive (in neo-classical economics, market failure justifies government intervention), in its pursuit of the normative and the subjective, and in its assignment of a special role to entrepreneurship in economic development.

For Rodrik and Stiglitz, neo-liberalism is narrower in scope; it is synonymous with the Washington Consensus. Neo-liberalism, then, is not conflated with neo-classical economics. To be sure, neo-liberalism draws heavily from neo-classical economics, but it does not and cannot represent the different streams of thinking that fall under the neo-classical rubric. Aware of the overlap and the distinction, Joseph Lim of the University of the Philippines (UP) has coined the term "neo-classical neo-liberals."

Rodrik goes even further by saying that neo-classical economics is not the enemy, and in fact it should be marshaled in fighting the neo-liberalism that is embodied in the Washington Consensus.

Washington Consensus Recipe

For the unaware, the Washington Consensus is a prescriptive set of liberalization, privatization and deregulation measures that the Washington-based institutions (IMF, WB, US Treasury, and Federal Reserve Board) has been imposing on developing countries, beginning in the late 1980s. As summed up by John Williamson, the main ingredients of the Washington consensus are:

- fiscal discipline (low budget deficits if not balanced budgets)
- redirection of public spending towards public goods with high social and economic returns like primary education, primary health care, and infrastructure
- comprehensive tax reform (such as lower marginal rates, broadening of the tax base, and enhancement of tax collection efficiency)
- interest rate liberalization in conjunction with financial sector liberalization
- competitive exchange rate
- capital account liberalization to attract foreign direct investments

- privatization
- deregulation (expanding economic freedom by removing barriers to entry and exit)
- securing property rights

These make up one reform too many—they are difficult to implement in one single blow or in a short period of adjustment. Rodrik has argued that such blueprint is useless, for what really sparks growth and development is a narrow set of policy reforms that is country-specific and encourages domestic institutional innovations.

The Washington Consensus has become a one-size-fits-all approach. As originally formulated by Williamson, the Washington Consensus specifically pertains to the "lowest common denominator" of policy reforms applied by the IMF and WB to Latin American countries. But over time, the Washington Consensus has become a mantra of sound economics. What is good for Latin America is good for Asia, Eastern Europe and all other places. This is what the entrepreneur (or speculator, depending on one's bias) George Soros calls "market fundamentalism." This is what Williamson recognizes as "neo-liberalism."

Of recent vintage is the so-called "augmented Washington Consensus," which includes the sequencing of reforms, the promotion of transparency and accountability, the strengthening of regulatory institutions, and the fight against corruption. The "augmented Washington Consensus" is a delayed reaction to the criticisms as well as an acknowledgement of the weaknesses and shortcomings of the original Consensus.

Nevertheless, the augmented agenda can only complicate matters. To return to Rodrik's criticism, a blueprint with too many prescriptions is impractical for a developing country. All these policy prescriptions are common features in the mature economies. If we stretch the logic, we can surmise that were such reforms put in place in a developing country, it would instantly qualify as a highly developed country in the OECD (Organization for Economic Cooperation and Development) league. Yet, we all know that the transformation of a developing country into a rich industrial one takes more than a generation.

Neo-Classical Economics: An Ally

Arguably, some of the powerful weapons against the Washington Consensus are found in the neo-classical economic armory. In the words of Ha-Joon Chang, neo-classical economics has an "interventionist streak." That is why Rodrik has reminded the progressive scholars and activists to treat neo-classical economics as an ally in exposing and isolating the Washington Consensus. Here, we offer several examples to illustrate this point.

One example is that of capital account liberalization. One can invoke the market failure argument—specifically, the imperfect information in the financial sector as well as the problem of coordination—to slow down or control capital flows. We also recall the Mundell-Fleming model, which postulates that simultaneously having monetary policy independence, a fixed exchange rate, and full capital mobility is impossible (the model is thus called the impossible trinity). A regime of a fixed exchange rate coupled with monetary policy independence will thus eschew full capital mobility.

Another example deals with commercial policy in the context of trade liberalization. It makes economic sense for a firm to receive assistance from government in the form of loans or export subsidies when capital markets are immature. A firm entering an industry has to borrow funds, for it may initially have to operate at a loss to gain experience before earnings materialize in the longer run. The case of achieving economies of scale—that is, having a big domestic market to lower marginal costs—is also a standard and valid argument for transparent government assistance.

The last example is in relation to the state's role in the market. Raul Fabella, Dean of the University of the Philippines (UP) School of Economics, states that a "limited state agenda" in the Smithian tradition can be flexibly stretched, by invoking positive externalities, to accommodate government intervention directed at achieving egalitarian outcomes.

More to the point, Rodrik emphasizes the universal principles embedded in neo-classical theory. These include property rights and the rule of law, private incentives aligned with social costs and benefits, and sound financial and macroeconomic management.

But the real challenge lies in how to flesh out these core principles in specific country settings. China, for instance, has a weak legal regime on property rights; yet, its informal governance institutions and arrangements are sufficient to sustain high levels of investments and growth. In this regard, the volume edited by J. Edgardo Campos, *The Boom and Bust of East Asia: Corruption* (2001), illuminates. The articles explain why despite weak or bad governance in East Asia, the countries in the region, except for the Philippines, attracted huge investments and registered high growth rates over a long period.

To conclude, heterodox policies and approaches are most welcome, and they can be harmonized with conventional wisdom. As Rodrik puts it, "let a thousand growth models bloom." At the same time, old-fashioned neo-classical thinking should not be totally rejected. Some aspects of it can be used to defeat the most pernicious features of neo-liberalism. It is precisely their excellent grasp of neo-classical economics that enables the likes of Rodrik and Stiglitz to credibly and convincingly demolish neo-liberalism.