

# Battle of Economic Ideas

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## Abstract

Policymakers across the world are deeply divided along ideological lines on the future course of action to navigate the world economy. In this paper, we will trace the history of economic thought from seventeenth century onwards to provide a context to the current fractious policy debates. Starting from the emergence of a rational and modern society during the Age of Enlightenment (1650s-1780s), we will cover the era of the Classical Liberals (1750s to 1880s) which witnessed the birth of modern economics through the works of Adam Smith. Post that, we will trace the Marxian and Keynesian backlash (1850s to 1970s) against the ideas of the Classical Liberals before ending with an overview of the neo-liberal era when a diluted version of Classical Liberalism was reincarnated.

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The power of ideas cannot be undermined. While the people and the events linked to them may wither, ideas can live for eternity. It is perhaps for this reason that John Maynard Keynes had written, “...*the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else...*”<sup>1</sup> In this paper, we attempt to trace the evolution of economic ideas that have shaped history and influence policy discourse even today.

The evolution of economic ideas has been complex. The fundamental problem which these ideas try to answer is- how best to organize society so as to satisfy unlimited human wants with finite resources. The solution to this ‘economic problem’ differs based on different schools of economic thought and this sets the ground for these ideas to battle for primacy. It is, of course, a gargantuan task to trace the historical development of such ideas. In doing so, we are guilty of prioritizing brevity over detail.

### Structure

This first part of this paper will trace the origin of modern philosophy during the Age of Enlightenment (1650s-1780s) which was a precursor to the emergence of the modern economic thought during the Classical Liberal era (1750s to 1880s). The second part will give an overview of the Marxian and Keynesian backlash against the classical liberal ideas which reached a crescendo in the first half of the twentieth century. The third and final part will comment on the partial re-incarnation of classical liberal ideas through the neo-liberal counter-revolution and conclude with how the contemporary economic debate is poised.

### **Part I**

#### Age of Enlightenment (1650s-1780s)

Prior to the Age of Enlightenment, the question of how to organize society was primarily answered through the doctrine of ‘Divine rights of the King to rule.’ Under this doctrine, kings and noblemen gained their political legitimacy by asserting that they derived their right to rule directly from God. James I, the King of England from 1603-1625, in a speech to the Parliament in 1610, said, “*The state of monarchy is the supremest thing upon earth; for kings are not only God's lieutenants upon earth, and sit upon God's throne, but even by God himself they are called gods.*”<sup>2</sup> Thus, the defining trait of this doctrine was that a king had divine powers to rule. Two important corollaries flow from this- there is no separation between the Church and the State and, reason is based on religion.

This changed during the Age of Enlightenment. The political legitimacy of an absolute monarch was challenged through the separation of the Church and the State, and scientific reasoning was given prominence in the discovery of truth over religion. A prominent figure in this era was Rene Descartes (1596-1650), a French philosopher and mathematician considered to be the father of modern philosophy<sup>3</sup>. In many ways, Descartes epitomized the zeitgeist of the Age of Enlightenment when he said he will research and write on philosophy “*as if no one had written on these matters before.*”<sup>4</sup> He famously remarked, “*I think, therefore I am*”<sup>5</sup> and in his magnum opus, *Discourse on Method*, wrote that knowledge is built on the foundation of rules of thought, the first being, “*never to accept anything for true which I did not clearly know to be such.*”<sup>6</sup>

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<sup>1</sup> Keynes, John Maynard, 1936, “The General Theory of Employment, Interest and Money”, Ch. 24, Concluding Notes, p. 383-384

<sup>2</sup> <http://www.h-net.org/~hst201/SpeechParl.htm>

<sup>3</sup> <http://www.iep.utm.edu/descarte/>

<sup>4</sup> Descartes, René, 1649, *Passions of the Soul*

<sup>5</sup> Descartes, René, 1637, *Discourse on Method*, Part II

<sup>6</sup> *Ibid.*

It is not difficult to see that anybody adopting Descartes' methodology would immediately call into question several "truths" of the Middle Ages<sup>7</sup>. In his pursuit for truth, Descartes considered any belief that did not "exclude all ground of doubt"<sup>8</sup> as false. Thus, thinkers like Descartes laid the foundation for an intellectual renaissance during the Enlightenment era.

Another prominent thinker during the Enlightenment era was John Locke (1632-1704) who played a significant role in changing the political discourse. Locke, an English philosopher and physician, advocated the natural rights hypothesis, under which, all individuals have a natural right to life, liberty and property as long as they do not infringe on someone else's rights. This was a radical thought which ran counter to how individual rights were perceived prior to the Enlightenment era - as being wholly subservient to the "divine" rights of kings. Locke further developed his ideas on natural rights through the doctrine of 'social contract' in which each individual enters into a contract with the State for the preservation of their rights.

The political doctrine which flows from Locke's individual rights hypothesis is that of 'government by consent', an idea he detailed in his magnum opus *Two Treatises of Government*. Maurice Cranston, in his brief biography on Locke<sup>9</sup>, wrote, "One key word in this whole book is 'consent'. The idea that the authority of a king or other ruler rested on the consent of the people he ruled was a controversial one in the seventeenth century.... Indeed, the Divine Rights of Kings was a widely accepted belief throughout Europe..... it was Locke more than any other theorist who overthrew belief in the Rights of Kings."

Though what Locke said would now appear commonplace, it must be understood that "a lot of things which we take for granted today were new and remarkable when he (Locke) first said them."<sup>10</sup> Think about how revolutionary the ideas about natural rights of individuals were when society was just progressing from its feudal vestiges. Also, his views regarding government by consent was in stark opposition to the established doctrine of the divine rights of the kings.

A prominent event during the Enlightenment era was the Glorious Revolution (1688-1689) which was a battle between the notion of the divine rights of kings to rule and the Parliament of England. The outcome of this Revolution was the abolition of absolute monarchy in England through the promulgation of the Bill of Rights in 1689. Locke's ideas played an important role in the Revolution and he is often referred to as the "philosopher of the Glorious Revolution."<sup>11</sup>

Locke's ideas on natural rights of individuals and limited government also echoed prominently in the American Declaration of Independence in July 4, 1776, when thirteen erstwhile British colonies declared their independence and jointly formed the United States of America. The founding fathers of the United States of America were strongly influenced by Locke's natural rights hypothesis as is evident in the drafting of the Declaration of Independence, which includes the following, "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness."<sup>12</sup>

Thus, the Age of Enlightenment was truly an era which took a decisive break from the past, particularly in ideas relating to political philosophy. The convulsions during this era served as a blow on the feudal institutions of the Middle Ages and a stepping stone towards the era of Classical Liberalism.

### The Golden Age of Classical Liberalism (1750s to 1880s)

In continuation of the process of emancipation of the individual from his political masters, the Classical Liberal era was a time in history when ideas of individual liberty in all spheres of life - political, civil and economic, was gaining ascendancy. The Classical Liberal era also witnessed the birth of modern economic

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<sup>7</sup> The Middle Ages refers to the period from the 5<sup>th</sup> to the 15<sup>th</sup> century

<sup>8</sup> Descartes, René, 1637, Discourse on Method, Part II

<sup>9</sup> Cranston, Maurice (1966), John Locke and Government by Consent, Political Ideas – Edited by David Thomson, p. 75

<sup>10</sup> Ibid.

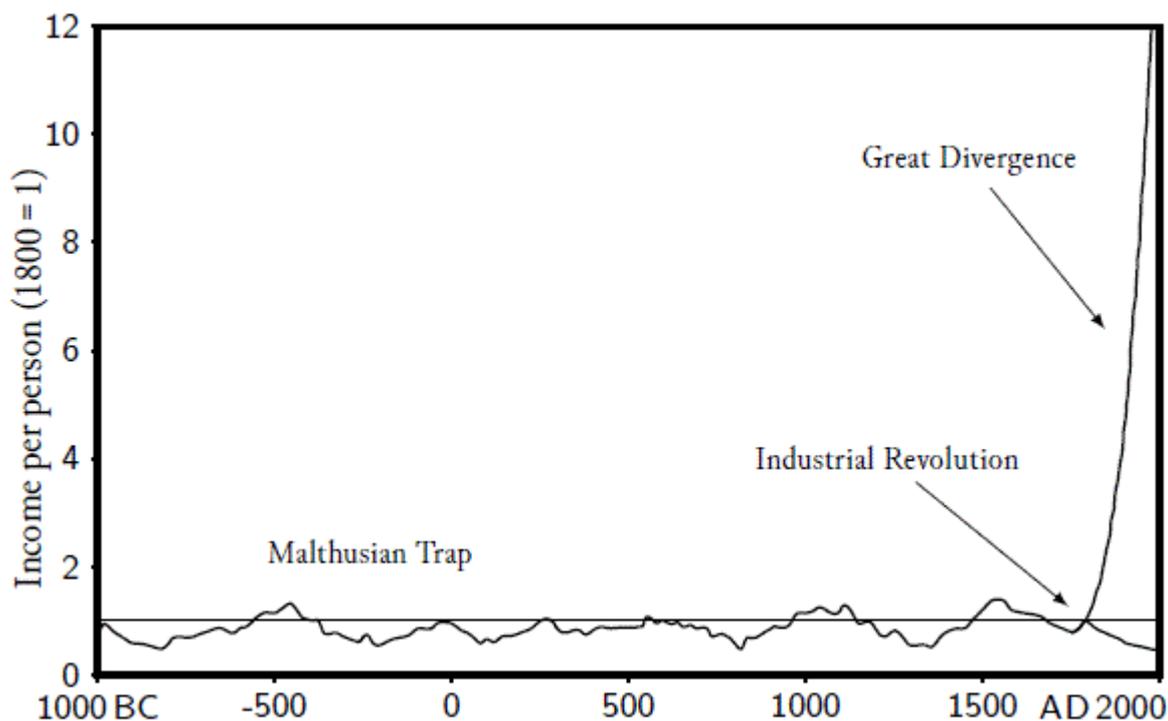
<sup>11</sup> Ibid.

<sup>12</sup> <http://www.ushistory.org/declaration/document/>

theory through the work of Adam Smith, a key figure in the Scottish Enlightenment movement of the eighteenth century. The credo of the Classical Liberal era is often summarized in Smith's famous 'invisible hand' hypothesis, as per which, actions undertaken for individual benefits also leads to unintended social benefits. This is also captured in what is perhaps the best known quote from Smith's magnum opus *An Inquiry into the Nature and Causes of the Wealth of Nations*, which was published in 1776<sup>13</sup>, "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest."<sup>14</sup>

In Smith's world, individuals endowed with their natural rights trade with other such individuals based solely on their self-interest, and such *voluntary* individual actions in a marketplace feeds into betterment of the entire society. Thus, Smith's theories provided a justification for the government not to intervene in the functioning of the market<sup>15</sup>.

It would be important to ruminate here on how far the world had come from the pre-Enlightenment era. While thinkers like Locke set in motion the unshackling of the individual from political slavery, Smith's theories provided a justification for the individual's economic freedom. Thus, the classical liberal period saw a proliferation of two key ideas - political freedom through democratic ideas, and economic freedom through free-market laissez-faire ideas. A key event which encapsulated these ideas was the Industrial Revolution (1760-1820).



Source: Hoppe, Hans-Hermann, 2013, From the Malthusian Trap to the Industrial Revolution, Mises Circle Feature

The Industrial Revolution has rightly been categorized as one of the most important event in history<sup>16</sup>. Robert Emerson Lucas Jr., who won the Nobel Memorial Prize in Economic Sciences in 1995, said, "For the first time in history, the living standards of the masses of ordinary people have begun to undergo sustained growth.... Nothing remotely like this economic behaviour has happened before."<sup>17</sup> The reason

<sup>13</sup> Co-incidentally, the same year as the American Declaration of Independence

<sup>14</sup> Smith, Adam, 1776, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Book 1, Chapter 2

<sup>15</sup> It should be noted that Smith was not opposed to all government intervention. In his writings, he has expounded several areas where he sees a role for the government.

<sup>16</sup> Nardinelli, Clark, 2008, *Industrial Revolution and the Standard of Living*, *The Concise Encyclopedia of Economics*, Library of Economics and Liberty

<sup>17</sup> Lucas, Robert E., Jr., 2002, *Lectures on Economic Growth*. Cambridge: Harvard University Press. pp. 109–10

for this “sustained growth” was that through the Industrial Revolution, mankind was able to, for the first time, break free from the ‘Malthusian trap’.

Elucidated by Thomas Robert Malthus, an English scholar, the trap refers to the gloomy conclusion one derives when the process of population growth is compared to the process of growth in the supply of cultivable land (or food supply)- while the former grows geometrically, the latter grows arithmetically. In his 1798 treatise<sup>18</sup>, Malthus wrote, “... *the human species would increase in the ratio of 1,2,4,8,16,32,64,128,256,516, etc. and subsistence as 1,2,3,4,5,6,7,8,9,10, etc. In two centuries and a quarter the population would be to the means of subsistence as 512 to 10; in three centuries as 4096 to 13, and in two thousand years the difference would be incalculable.*”

Thus, for most of history, the increase in population was hostage to the rate of increase in food supply. Though there is a tendency for the population growth to outstrip growth in food supply (due to the former’s geometric rate of increase compared to the latter’s arithmetic increase), any “excess” growth in population resulted in famines, after which, the population again realigned with the growth in subsistence. What this also means is that for most of history, per capita income remained stagnant as any increase in subsistence was accompanied by increase in population<sup>19</sup>.

As highlighted by economic historian Gregory Clark, “...*there is no sign of any improvement in material conditions for settled agrarian societies as we approach 1800. There was no gain between 1800 BC and AD 1800 -- a period of 3,600 years.*”<sup>20</sup> This changed during the Industrial Revolution when the human race escaped from the Malthusian trap. The Industrial Revolution was characterized by rapid increase in both per capita income and population made possible by the attainment of a critical mass of technological improvements and capital stock not witnessed until then. This contributed to the ‘Great Divergence’, which refers to the rapid increase in the wealth and power of Western civilisation, leaving behind the civilizations of India, China, Japan and the Ottomans.

One cannot help but feel awed by a phenomenon so divergent from what had been observed for the entire recorded history. The factors responsible for the Industrial Revolution continue to be debated. However, even if one can disagree on the weightage, it cannot be denied that the emergence of reason and political liberty during the Enlightenment era and free trade policies of the Classical Liberal era were enabling factors for the Industrial Revolution. It was as if starting from the Enlightenment era, the lid on what Keynes termed as “animal spirits” blew off and set in motion a phenomenon never witnessed before.

The world was a very different place in the latter half of the nineteenth century as compared to the seventeenth century. Political ideas changed. Feudal institutions from the Middle Ages were attacked. Modern economics was born and the Industrial Revolution saw mankind finally break the gloomy Malthusian trap. One would almost have thought the future could only see a further strengthening of the classical liberal ideas of liberty through the deepening of the political-economic structure of democratic-capitalism. However, as subsequent events would reveal, beneath the rosy story of Industrial Revolution, another revolution was fomenting. And when it erupted, it shook the edifice of classical liberalism right down to its foundation.

## **Part II**

### *The Marxian-Keynesian Backlash (1850s to 1970s)*

Not everybody was pleased with the Industrial Revolution. While the Classical Liberals saw in the Industrial Revolution the salvation for the masses through increase in per capita income, others viewed it as the enrichment of few at the cost of the poor. Others still viewed the Revolution as the degradation of society

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<sup>18</sup> Malthus, Thomas Robert, 1798, *An Essay on the Principle of Population as It Affects the Future Improvement of Society*

<sup>19</sup> Which is to say that any increase in numerator was accompanied by an increase in the denominator in the computation of per capital income

<sup>20</sup> Clark, Gregory, 2007, *A Farewell to Alms: A Brief Economic History of the World*, Princeton University Press

at the altar of material wealth. Critics drew attention to the following aspects of the Revolution- poor working conditions, child labour, rising inequality, environmental degradation and rise of materialism.

The Sadler Report<sup>21</sup> for instance, written in 1832 by Michael Sadler, a member of UK Parliament, highlighted the poor and exploitative conditions of child labour in English factories and sought to limit the hours of work for children. Historian Royston Pike commented that the Report is, “a mass of evidence, constituting a most formidable indictment of factory conditions ...It is impossible not to be staggered by the revelations of human misery and degradation - impossible not to be moved by the dreadful stories of children and young persons (and adults, too, for that matter) who were bullied and cursed and tormented, pushed around and knocked about by those placed in authority over them.”<sup>22</sup> The report drew public outrage and was a damning indictment on England’s factory system.

Another manifestation of a backlash against the Classical Liberal ideas was the rise of Romanticism (1800s-1850s), a movement which railed against the ‘evils’ of the factory system. This movement emphasized on the emotional over the rational, beauty over utility and subjectivity over specificity. Romanticism pitched itself squarely against the ‘materialistic’ ethos of the Industrial Revolution. Thinkers associated with this movement, which included artists, musicians and several literati, sought to highlight that society should strive for lofty ideals than mere accumulation of material wealth.

Even though Romanticism was on the rise, it took the revolutionary ideas of the “German scholar par excellence, slow, meticulous, and painstakingly, even morbidly, perfectionist”<sup>23</sup> Karl Marx to provide “the gravest, most penetrating examination the capitalist system has ever undergone.”<sup>24</sup> To fully comprehend Marx’s view of capitalism, we need to take a small detour to outline the *conception of history* embedded within the Marxian analysis. The Communist Manifesto, an 1848 political pamphlet by Marx and his life-long friend, collaborator and the co-founder of Marxism, Friedrich Engels, starts with the lines, “The history of all hitherto existing society is the history of class struggles.... The modern bourgeois society that has sprouted from the ruins of feudal society has not done away with class antagonisms. It has but established new classes, new conditions of oppression, new forms of struggle in place of the old ones.”<sup>25</sup> Thus, Marx and Engels viewed history as a process of constant class antagonism with the oppressors and the suppressed changing depending on the epoch. Emanating from this conception of history is the Marxian view that while the capitalistic society has progressed from a feudal society, it still retains class antagonism- only the oppressors have changed. During the feudal ages it was the aristocratic class who were the oppressors, while in a capitalistic society the *bourgeois* (owners of the means of productions) are the new oppressors and the *proletariat* (working class) the suppressed.

But what is the genesis of this class antagonism? In the Marxian view, class antagonism is a function of the super-structure adopted by society for production and its distribution. In the words of Engels, “...production, and with production the exchange of its products, is the basis of every social order; that in every society that has appeared in history the distribution of the products, and with it the division of society into classes or estates, *is determined by what is produced and how it is produced, and how the product is exchanged.* According to this conception, the ultimate causes of all social changes and political revolutions are to be sought, not in the minds of men, in their increasing insight into eternal truth and justice, but in changes in the mode of production and exchange; they are to be sought not in the philosophy but in the economics of every epoch concerned.”<sup>26</sup> (*emphasis mine*).

Thus, in the Marxist view, class antagonism in a capitalistic society cannot be ameliorated because such antagonism is embedded within the capitalistic system of production and distribution. Only if this system of production and distribution is changed (which is to say capitalism is discarded) can there be hope of establishing a classless society- the communist society.

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<sup>21</sup> Report of the Select Committee on Factory Children's Labour (Parliamentary Papers 1831-32, volume XV

<sup>22</sup> Royston Pike, E (1966). Human Documents of the Industrial Revolution in Britain. London: George Allen & Unwin

<sup>23</sup> Heilbroner, Robert L., 1999, The Worldly Philosophers, Simon & Schuster, p140

<sup>24</sup> Heilbroner, Robert L., 1999, The Worldly Philosophers, Simon & Schuster, p168

<sup>25</sup> Communist Manifesto, Chapter 1: Bourgeois and Proletarians

<sup>26</sup> Engels, Friedrich, 1878, Anti-Duhring, p. 294

It should be noted that Marx was not *against* capitalism. He viewed the emergence of capitalist mode of production as a necessary stepping stone to socialism and then to communism. Also, a fully developed capitalist structure was required to expand production for the implementation of the Marxist credo of “each according to his ability to each according to his need”<sup>27</sup>. Under the Marxian analysis, the ascendancy of capitalistic forces during the Industrial Revolution would bring class struggles to its forefront and stoke a revolution for the overthrowing of the private ownership of means of production. Socialism would be the result of such a revolution where the ownership of the means of production would be assumed by the State. However, this too would not eliminate class struggle as there would be a new class of owners, and in a subsequent revolution, the concept of ‘ownership’ itself would be eliminated with the onset of a true classless communist society.

The contribution of Marx and Engels in changing the dominant discourse in the fields of politics, sociology and economics cannot be undermined. Marx’s theories inspired leaders like Lenin, who organized the Bolshevik revolution in Russia that led to the formation of the Soviet Union. Though there were differences in the ideas of Marx and Lenin, Lenin’s successor, Joseph Stalin, coined the term “Marxism-Leninism” and officially adopted it as the State ideology of the Soviet Union.

Marx’s ideas led to the complete decimation of the Classical Liberal ideas of laissez faire in countries which embraced communism. He died in 1883 in London. Coincidentally, the same year, not very far from London, an English economist, journalist and financier was born, who would play an equally staggering role in re-defining economics away from its Classical Liberal roots. This gentleman was John Maynard Keynes.

Before we proceed, it is important to clarify that though the theories of Marx and Keynes departed from the Classical Liberal approach, the similarity ends there. Keynes was hardly a socialist or communist. In 1931, he said, “How can I accept the [Communist] doctrine, which sets up as its bible, above and beyond criticism, an obsolete textbook which I know not only to be scientifically erroneous but without interest or application to the modern world?”<sup>28</sup>

Keynes central idea was that markets are not self-correcting<sup>29</sup> and he saw a large role for the government in stabilizing market forces. He was thus an ‘activist’ economist- his ‘activist’ streak most visible when he wrote, “Economists set themselves too easy, too useless a task, if in tempestuous seasons they can only tell us, that when the storm is long past, the ocean is flat again.”<sup>30</sup> He discredited the Classical Liberal ‘balanced budget hypothesis’, as per which a government should refrain from borrowing. On the contrary, Keynes’ theories advocated that government should regulate economic activity by running budget deficits in times of depression and budget surplus at times of heightened economic activity, thereby regulating aggregate demand and freeing the economy from the vicissitudes of business cycles.

Economics does not exist in a vacuum. If it did, then economic ideas will be exactly that, only ideas. The field of politics provides the outlet for economic ideas through the promulgation of State policies, and in the case of Keynes, his ideas were most visible in the policies adopted by Franklin D. Roosevelt, the 32<sup>nd</sup> President of the United States from 1933 to his death in 1945. Roosevelt assumed Presidency when the United States was in the midst of the Great Depression of the 1930s which also happened to be the decade in which Keynes published his magnum opus *The General Theory of Employment, Interest and Money*. His analysis that, “an economy in depression could stay there. There was nothing inherent in the economic mechanism to pull it out. One could have ‘equilibrium’ with unemployment, even massive unemployment”<sup>31</sup> strongly resonated with the depression in the developed world. In line with the

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<sup>27</sup> Marx, Karl, 1875, Critique of the Gotha Program, Part I

<sup>28</sup> Heilbroner, Robert L., 1999, *The Worldly Philosophers*, Simon & Schuster, p279

<sup>29</sup> Keynes had once remarked that “The market can stay irrational longer than you can stay solvent.”  
<http://blogs.wsj.com/marketbeat/2011/02/11/keynes-he-didnt-say-half-of-what-he-said-or-did-he/>

<sup>30</sup> Keynes, John Maynard, 1923, *A Tract on Monetary Reform*, Chapter 3

<sup>31</sup> Keynes, John Maynard, 1936, *The General Theory of Employment, Interest and Money*

Keynesian prescription, Roosevelt's New Deal<sup>32</sup> substantially increased the role of the government in the economy through social security laws combined with aggressive fiscal policy. Roosevelt also sought to dispel the misgivings regarding government intervention. In a 1938 speech, he said, "Let us never forget that government is ourselves and not an alien power over us. The ultimate rulers of our democracy are not a President and senators and congressmen and government officials, but the voters of this country."<sup>33</sup>

The Keynesian world had departed substantially from the Classical Liberal world of absolute free markets. Though Keynes diluted the Classical Liberal credo of zero government intervention, he was not against capitalism. In fact, Keynes actually saved capitalism from the growing influence of socialism. Keynes' version of restricted capitalism provided a political-economic system that borrowed from socialism's top-down economic planning, while retaining the basic fabric of unbridled capitalism. He salvaged capitalism by offering the world Capitalism Version 2, exactly at a time when there was a fear that capitalism as a political-economic system would be crushed under the growing influence of fascism and socialism as manifested in the rise of authoritarian leaders like Hitler in Germany, Benito Mussolini in Italy and Stalin in the Soviet Union.

Keynes was undoubtedly the most influential economist of the twentieth century. His influence was so wide reaching that in 1971, Richard Nixon, the 37<sup>th</sup> President of the United States, said "I am now a Keynesian in economics". Ironically, as subsequent events would prove, the 1970s happened to be the decade during which Keynesian economics started to splutter. Just when it seemed Classical Liberalism has been crushed under the weight of Keynesian ideas, like a phoenix, it rose, albeit in a different avatar, to once again fight for primacy in the battle of economic ideas.

### Part III

#### Neo-liberalism: 1970s to 2007

Post the publication of Keynes' magnum opus *The General Theory of Employment, Interest and Money* in 1936, the world had taken a decisive turn towards Keynesian economics. The Great Depression in the US, which started in 1929, led to a clamour for the government to play a more active role in controlling business cycles. Keynes' ideas provided an outlet to this pent up demand by providing a framework for the government to regulate aggregate demand in an economy and temper business cycles. This trend of increasing government role in economic affairs of a country was exacerbated by the Second World War (1939-1945). War efforts necessitated central economic planning not only for the operation of the war, but also for post-war reconstruction.

So great was the turn towards central planning that Keynes' principal intellectual opponent, F.A. Hayek, published his renowned book *The Road to Serfdom* in 1944, warning that the increasing role of the government in economic affairs can lead to severe erosion of political liberty. In the book, commenting on the increasing role of the government in England's economy, Hayek wrote, "*It is one of the saddest spectacles of our time to see a great democratic movement support a policy which must lead to the destruction of democracy and which meanwhile can benefit only a minority of the masses who support it.*"<sup>34</sup> The book's lasting contribution was to highlight the reciprocal relationship between economic freedom and political freedom, and why one cannot exist without the other. Hayek warned that erosion of economic liberty also leads to erosion of political liberty and hence paves the way for a despotic government.

In 1947, alarmed at the continued rise of Keynesian ideas, Hayek invited 36 scholars (economists, historians, philosophers) to meet at Mont Pelerin, near Montreux, Switzerland, to "*discuss the state and*

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<sup>32</sup> The New Deal refers to several policy initiatives by the Roosevelt administration in the United States between 1933 and 1938.

<sup>33</sup> Roosevelt, Franklin D., 1938, Address at Marietta, Ohio. July 8, 1938

<sup>34</sup> Hayek, F.A., 1944, *The Road to Serfdom*

*the possible fate of liberalism (in its classical sense)<sup>35</sup> in thinking and practice.”* The meeting led to the establishment of the Mont Pelerin Society. Members of the Mont Pelerin Society, *“Though not necessarily sharing a common interpretation, either of causes or consequences, they see danger in the expansion of government, not least in state welfare, in the power of trade unions and business monopoly, and in the continuing threat and reality of inflation.”<sup>36</sup>*

The neo-liberal counter-revolution against Keynesian ideas can be traced back to the establishment of the Mont Pelerin Society. The members of this Society, though divergent in their many other views, shared a common concern that the increase in government power could lead to the rise of authoritarian governments. The experience of Germany, Italy and Russia, where increasing role of the government in economic policy making gradually led to the complete jettisoning of political freedom made the group wary of the government. While democracy in Germany and Italy was crushed under the fascist regime of Hitler and Mussolini, socialism under Lenin (and his successor Stalin) led to the autocratic regime of the Soviet Union.

Neo-liberalism seeks to carve out a middle-way between Keynesian and Classical Liberal ideas. Most neo-liberals see a larger role for the government in the economy than Classical Liberals, but not as large as that advocated by Keynesians. Between this spectrum, a wide variety of neo-liberals are dispersed, some very close to Classical Liberals, while others relatively closer to Keynesians.

Though the Mont Pelerin Society was successful in bringing together diverse thinkers who were broadly sympathetic to the Classical Liberal ideas of the 18<sup>th</sup> and 19<sup>th</sup> century, it was only after the 1970s that Keynesian ideas showed a retreat. The event which single-handedly propelled the neo-liberal counter-revolution against Keynesianism was the stagflation of the 1970s in the major developed nations of the world.

The term stagflation was coined by Iain Macleod, the spokesman on economic issues for UK’s Conservative Party. In 1965, he said, *“We now have the worst of both worlds—not just inflation on the one side or stagnation on the other, but both of them together. We have a sort of “stagflation” situation. And history, in modern terms, is indeed being made.”<sup>37</sup>* The reason he said history is being made is that standard Keynesian models were not consistent with the phenomenon of rising unemployment and inflation at the same time. With the onset of stagflation, the conventional inverse relationship between inflation and unemployment (characterized by what economists call the Philips Curve) under Keynesian models broke down.

The exact reason for the global stagflation of the 1970s is still debateable. The broad reasons highlighted for this phenomenon are supply-side shocks, increase in money supply and structural rigidities. Leaving aside the supply-side shock theory, it is easy to see that the other two reasons fit squarely in the neo-liberal narrative of minimal government by laying the blame for stagflation at the doorsteps of the government.

All the above three theories have support in evidence. The role of the supply-side shock was played by the 1973 oil crisis when Organization of Petroleum Exporting Countries (OPEC) curtailed oil supply. Increasing money supply was a result of central banks pursuing expansionary monetary policy in the light of anaemic

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<sup>35</sup> It is important to note that the word “liberal” has been used here not in the American sense (which is interpreted as support of expansion in government powers) but in the European or classical sense which stands for minimal government.

<sup>36</sup> <https://www.montpelerin.org/montpelerin/home.html>

<sup>37</sup> Macleod Iain, speech to the House of Commons on 17 November 1965, House of Commons’ Official Record, 17 November 1965, page 1165

growth, while the blame for structural rigidities was placed on the increasing government regulation of the economy post the Second World War.

The sluggish growth in the developed world in the 1970s, combined with high inflation, led to widespread disillusionment with government's handling of economic affairs. No longer was the government viewed as the panacea to all economic evils. The failure of government policies like increased regulation, wage and price controls, and expansionary monetary policy to overcome stagflation gave a shot in the arm to the neo-liberals to try and reincarnate the Classical Liberal ideas of minimum government.

Milton Friedman, the winner of the Nobel Prize in Economic Sciences in 1976, had an important role to play in the neo-liberal movement. Friedman, the founder of the Monetarism school of economic thought, sought to remove the discretionary power of the government in controlling money supply. Friedman said, *"Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output. ... A steady rate of monetary growth at a moderate level can provide a framework under which a country can have little inflation and much growth. It will not produce perfect stability; it will not produce heaven on earth; but it can make an important contribution to a stable economic society."*<sup>38</sup> Such monetarist views were an indictment of the Keynesian view that markets could be unstable and required active demand management. On the contrary, the monetarist view suggested that markets are inherently stable and discretionary fiscal, and more importantly, monetary policies result in business cycles. Accordingly, the cure lies in a stable and predictable money supply that is increased by a fixed percentage every year.

The monetarist view of inflation (i.e., that high inflation during the 1970s was a result of increase in money supply) was put into practise by Paul Volker, who was the Chairman of the Federal Reserve from 1979 to 1987. Volker pursued a contractionary monetary policy which ended the reign of high inflation by the end of 1980s – a problem which had plagued the US for the previous two decades.

Among political leaders, if Franklin D. Roosevelt was the Keynesian hero who challenged Classical Liberalism, Margaret Thatcher in the UK and Ronald Reagan in the US deserve the titles of neo-liberal crusaders. Thatcher had read Hayek's book, *The Road to Serfdom*, when she was an undergraduate at Oxford. Hayek's work made a lasting impression on Thatcher and as Prime Minister of UK from 1979 to 1990, she presided over a substantial roll back of the government's role in the economy through large scale privatization and cut back in social spending. Similar policies were adopted by Ronald Reagan, who was the President of the United States from 1981 to 1989. Reagan had once remarked, *"The nine most terrifying words in the English language are: I'm from the Government, and I'm here to help."*<sup>39</sup>

The neo-liberal counter revolution got a further boost from the dissolution of the Soviet Union in 1991. The collapse of the bastion of socialism discredited central government planning. The dissolution of the Soviet Union also led to the pouring out of "real" information on the erstwhile country. As was discovered later, much of the socio-economic "achievements" of the Soviet Union turned out to be fabricated cold-war propaganda.

Post the fall of the Soviet Union, the neo-liberal counter revolution transformed to the neo-liberal orthodoxy. The dominant economic policies in the 1990s, sometimes labelled as the "Washington Consensus" (due to support from both the World Bank and the IMF), was a mix of deregulation, privatization and removal of international trade barriers.

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<sup>38</sup> Friedman, Milton, 1970, *The Counter-Revolution in Monetary Theory*

<sup>39</sup> <http://www.reaganfoundation.org/reagan-quotes-detail.aspx?tx=2079>

### Current scenario: 2007 onwards

In 2003, in a Presidential Address delivered at the 115<sup>th</sup> meeting of the American Economic Association, Robert E. Lucas, Jr., (recipient of the Nobel Prize in Economic Sciences in 1995) said, *“Macroeconomics was born as a distinct field in the 1940s, as a part of the intellectual response to the Great Depression. The term then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. 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.”*<sup>40</sup>

This optimistic view was also echoed by Olivier J. Blanchard, the chief economist at the IMF. In his 2008 paper, *The State of Macro*, he concluded that the *“state of macro is good”* and that there is substantial convergence among different macroeconomic ideas. Blanchard wrote, *“For a long while after the explosion of macroeconomics in the 1970s, the field looked like a battlefield. Over time however, largely because facts do not go away, a largely shared vision both of fluctuations and of methodology has emerged.”*<sup>41</sup>

So, do we live in a world where economists have broadly a homogenous view of macroeconomics? Not really. Keynes’ ideas are far from dead and not everybody is a neo-liberal. Paul Krugman (who won the Nobel Prize in Economic Sciences in 2008), wrote in 2009, that *“Until the Great Depression, most economists clung to a vision of capitalism as a perfect or nearly perfect system. That vision wasn’t sustainable in the face of mass unemployment, but as memories of the Depression faded, economists fell back in love with the old, idealized vision of an economy in which rational individuals interact in perfect markets, this time gussied up with fancy equations.”*<sup>42</sup> Krugman is foremost amongst several economists who have advocated for a revival of Keynesian ideas. The global financial crisis has also led to the re-emergence of Marxian theories that capitalism will always be cursed with crises (what is commonly referred to as ‘crisis theories’).

The spate of crises in the twenty first century- the dot com bust, the US subprime crisis and the Euro crisis, have brought the differences in economic ideology right to the forefront. Reminiscent of Winston Churchill’s remark, *“Never let a good crisis go to waste”*, economists of all hue have been sharpening their argumentative knives and dishing out varying policy prescriptions.

Undoubtedly, the global economic turmoil has led to a sharp polarization of economic ideas and it is difficult to forecast whether a new consensus is building. Perhaps we should not be surprised. As the evolution of economic ideas over the last 300 years has shown, one thing has been elusive - unity among economists. The battle of economic ideas is far from over.

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<sup>40</sup> Lucas, Robert E Jr., 2003, Macroeconomic Priorities, Presidential Address delivered at the 115<sup>th</sup> meeting of the American Economic Association, January 4, 2003, Washington, DC

<http://pages.stern.nyu.edu/~dbackus/Taxes/Lucas%20priorities%20AER%2003.pdf>

<sup>41</sup> Blanchard, Oliver J, 2008, The State of Macro, NBER Working Paper No. 14259, <http://www.nber.org/papers/w14259>

<sup>42</sup> Krugman, Paul, 2009, How did Economists get it so wrong, The New York Times, <http://www.nytimes.com/2009/09/06/magazine/06Economic-t.html?pagewanted=all>