BSc. IBP - Political and Economic Thought (Autumn 2019) Final Examination

BSc in International Business and Politics

Submitted 13/1-2020

Referencing system: APA 6th edition

Student ID:

Examiner: Joachim Lund

Pages: 10 (13 including front page and bibliography)

Characters: 22.624 (23.240 with in-text citations)

Question: Does economic liberalism provide the means to overcome economic crises?

Student number
Political and economic thought exam - IBP
January 2020

Introduction

The debate on which economic policies governments should implement to overcome economic crises has a long history. While the debate is broad, we are fortunately able to dig deep in archives and research what some great thinkers in history had to say on the matter. To reach answers on today's issues, we can use Nietzsche's philosophy from his book 'The use and abuse of history' from 1874, on how we should not only study history for its own sake, but rather use it to create something new in the present world (Westacott, 2018). One pattern of economic thought that has been significant is economic liberalism, and this assignment seeks to discuss if economic liberalism does provide the means to overcome economic crises. In this context, *this assignment will argue that economic liberalism does not provide the means to overcome economic crises, if it entails that a state should not intervene in its economy.* To do this, I will first introduce economic liberalism considering the thoughts of mainly Adam Smith. Subsequently, a critique of economic liberalism will be presented. Then, I will introduce a 'third way' of state intervention in an economy based on the thoughts of John Maynard Keynes. After this, a critique of this 'third way' will be presented considering the thoughts of Friedrich Hayek and Milton Friedman. Finally, a discussion of state intervention will be based on the opposing thoughts presented considering three cases of economic crisis in history.

The break with mercantilism and beginning of economic liberalism

Economic liberalism emerged from the ideas of the moral philosopher, Adam Smith (1723-1790), who was inspired by the Physiocrats, who all disagree with the economic ideas prominent from 1500 to 1775. In this time, mercantilism was the core paradigm of economic thinking and was based on ideas from thinkers such as Thomas Mun (1571-1641). The idea was that states should try to be self-reliant and not import goods from other states but rather export (Lund, 2019c). An argument was that economic crises could be avoided because states had no dependence on other states for trade and imports of certain goods. However, in 1755, the physiocrat François Quesnay (1694-1774) among others criticized mercantilist restraints on the economy. This instigated a movement towards economic liberalism and introduced the concept of a laissez faire or passive state. Quesnay, who was a doctor of medicine, compared the economy to a human body, arguing that one should not block a vein (agriculture) with taxes and tariffs, as mercantilists did for instance with the corn laws of the time (Galbraith, 1991). An interpretation of this could be that in order to avoid and overcome economic crises (and food shortage as Quesnay focused on), a liberalization of the economy was necessary.

Smith would argue that economic liberalism in terms of a free market with capitalism and no state intervention, would provide the means to overcome economic crises. During the Scottish enlightenment, Smith was inspired by the Physiocrats and various enlightenment thinkers of political liberalism such as John Locke (1632-1704). Building upon the idea of a laissez faire state, Adam Smith introduced economic liberalism which marks the beginning of classical economics and made economics a separate field of study. To Smith, the ideal state was a passive or 'shadow state' with minimum interference in the economy. However, on certain areas where the individual could not be held responsible, the state should step in, for instance in law enforcement, security and protection of private property, which would be financed by "just taxation" (Lund, 2019b). It was thereby the states responsibility to protect its citizens from harm, in order to give individuals the freedom to interact in peace without interference (A. Smith, 2013). Taxation would hinder innovation and efficiency, and disrupt the natural laws of the market, which Smith tried to define with positivism just as Sir Isaac Newton (1643-1727) did in physics also in the age of enlightenment. This notion implies that the only way to overcome economic crises, was for a market to equilibrate by itself without state intervention.

However, it later became evident that economic liberalism also had flaws.

Critique and validity of economic liberalism

The validity of economic liberalism can be contested, as it was modified by John Stuart Mill (1806-1873) and criticized by Karl Marx (1818-1883). An economic system is based on a certain view of the human, life and role of the state. However, these views are not necessarily universally accepted. Mill had a different view of the state, and argued that it should intervene in areas of business to prevent child labor and create a safety net for workers (Lund, 2019d). The utopian socialists, including Robert Owen (1771-1858), and later the scientific socialists Karl Marx and Friedrich Engels all criticized economic liberalism and the capitalism that followed, by arguing that it led to misery and exploitation of workers in industries owned by capitalists (Marx, 2010). This suggests that economic liberalism and a capitalist system would lead to exploitation of workers or child labor and instigate a situation of disharmony with economic crises as a result of a struggle between the classes.

Following Marx, Mill and Smith, it seems that there is a significant disagreement whether economic liberalism can provide the means to overcome economic crises. Smith makes a case for a free market economy with a passive state. Marx makes a case for a planned economy with a dominant state (Marx,

2010), and somewhere in between, Mill agrees with Smith that a free market is preferred, but with modifications to the laissez faire model. This suggests that there are multiple theories and views on which means are necessary to overcome economic crises. While economic liberalism can be criticized, its solutions are largely also ideological and related to certain political views and ideas that humans are rational and self-interested rather than maybe social and altruistic for instance. It is therefore premature to conclude anything at this point.

However, it might be possible after an introduction of more recent sets of ideas on how to overcome economic crises.

A new third way of state intervention in the economy

While debates on whether liberal or social economic thought consisted, the major incident of the Great Depression in the US in 1929, possibly due to market failures, led to the creation of Keynesian economics and a new way to handle economic crises (Brue & Grant, 2013). This was a new third way of thinking economics, as its main thinker, the Cambridge scholar John Maynard Keynes (1883-1946), did not think of himself as either a socialist or a liberal. An issue was that policymakers tried to solve the new Great Depression with policies based on classical economics. According to Keynes, the problem was that economic thought was dominated by classical economics such as Says Law, which argued that production was source of demand (thus focusing on the supply side of economics). Keynes focused on demand rather than supply and argued that there was a shortage of demand in the markets due to the crisis, and increasing aggregate demand was needed to prevent high unemployment rates. In short, he proposed a level of state intervention with fiscal and monetary policies in the economy to solve this.

Keynes broke with the idea that an economy on a national level should be managed like a household, in which when hit by crisis, more savings must be made. What he suggested would be tax cuts or increasing spending by the state on infrastructure projects for instance (Keynes, 1964). Spending and increasing deficits would create a multiplier- and accelerator effect on the economy, as a government spending on infrastructure projects would boost growth and lower unemployment. This expansionary fiscal policy provided the means to overcome economic crisis, when it already had occurred. At the same time, a state could also prevent economic crisis via contractionary fiscal policy, in which

increasing taxes and reducing spending would slow down economic growth in order to prevent overheating of the economy. With this, the state was suddenly responsible for the economy.

While the economic ideas of Keynes dominated government policy up until the 1970's in the west, another set of economic ideas also emerged as a result of the Great Depression of in 1929.

Neoliberalism and monetarism: A critique of the third way

The scholar from the London School of Economics, Friedrich Hayek (1899-1992), argued that economic crises could and should only be solved by free markets themselves, both for practical and moral reasons. Hayek was part of the Austrian School in economics, in which the members generally emphasizes a free market economy beyond centralized political control and are supportive of economic liberalism and capitalism (B. Smith & Grassl, 1986). Hayek argued that there was a problem with supply rather than demand during the Great Depression. The central banks were the problem, as they manipulated and interrupted organic mechanisms of the markets, when they would inject money into the economy and pave the way for excessive credit creation leading to overspending ("Keynes v Hayek: Two economic giants go head to head - BBC News," 2011). An argument was that the market was better at getting the full value out of materials and waste the least, rather than central planning by people who did not know the wishes of ordinary people. Thereby Hayek insisted, that in any case, it would not be reasonable for a state to intervene in its economy as he argues: *"The chief evil is unlimited government, and nobody is qualified to wield unlimited power."* (Galles, 2006)

With a rather (but not entirely) similar assessment, Milton Friedman (1912-2006) of the Chicago School argued that economic crises could be overcome with a form of state intervention in monetary policy, and he was also in favor of free market economic liberalism. Friedman argued that the total amount of money should grow at a constant rate, which would stabilize money supply and the economy. At the same time, he made a case for a free market and no state intervention in fiscal policy, by arguing that a state trying to reduce unemployment would make inflation rise significantly. Intervening in fiscal policy would be harmful, and the only goal of the state in an economy should be preventing high inflation levels (Lund, 2019a). Friedman's work on monetarism did not have the attention of policy makers until the 1970's, in which the theory of the Philips Curve was proved to be fragile, as both inflation and unemployment could rise at the same time, which will be discussed in the following text.

A discussion of state intervention

The Great Depression of 1929

Up until Keynes, governments would boost supply by lowering interest rates to overcome economic crises and create an incentive for people to invest or start a business. However, Keynes disagreed with this focus on supply, and instead argued that people would hold their money, which would reduce aggregate demand and make businesses have decreasing sales, shut down or fire employees. According to Keynes, this happened during the Great Depression in 1929, in which a crash in the US economy occurred. When businesses would lower wages for workers due to the economic crisis, this would decrease the budgets of workers (who were consumers also), and thereby decrease their consumption and thus hurt the economy. It was a negative spiral, that needed a correction, Keynes argued (Keynes, 1964). The market was not perfect and was unable to correct itself. On the other hand, Hayek argued that savings and private investments in firms rather than increased consumption would be the cure to the Great Depression, even though Keynesian economics could have also provided an incentive to do this. An argument could be made that a non-volatile economic cycle, which Keynesian economics was created to establish, could mean trust in the economy, and thereby make people optimistic about the future and want to invest. This not only goes for national investments, but also international, since foreigners would be more likely to invest, immigrate or establish business in the particular state because of the economic stability.

As Hayek believed that the economy was organic and that state intervention was upsetting, in similar fashion as to what Quesnay and Smith thought, Keynes instead believed that the economy was mechanical which needed a mechanic to fix it. To intuitively explain the idea that the economy is mechanical, an analogy to a car can be made, in which the car engine is the economy that needs a spark to get going. This analogy can be taken further, if we imagine that the speeder is expansionary fiscal policy, the break is contractionary fiscal policy, the economic growth/cycle is the speed of the car, the driver is the state and the car is the economy. Thus, adequate use of the speeder and brake by the driver is required to make the car drive at a stable speed and avoid a crash. At the same time, Keynes argue that the 'animal spirits' or human emotion affect the economy, thus suggesting that a crisis could affect the psychology of consumers, and make them unwilling to invest due to low levels of optimism that would exist, if no one acts to ensure a recovery of the economy. While Keynes believed that state intervention was a solution, Friedman on the contrary argued that government was exactly the problem: *"The Great Depression, like most other periods of severe unemployment, was*

produced by government mismanagement rather than by any inherent instability of the private economy." (Friedman, 1982). Regardless of the validity of Friedman's monetary argument and Hayek's philosophical argument against centralized control, Keynesianism dominated government policy in the west.

However, in the 1970's a new phenomenon challenged Keynesian economics: Stagflation (stagnation and inflation).

Stagflation in the 1970's

In the 1970's, Friedman argued that both unemployment and inflation levels could rise at the same time, thus periodically ending the domination of Keynesianism, and suggested the re-establishment of economic liberalism and his idea of monetarism. In 1958, A. W. Phillips (1914-1975) showed a relationship between unemployment and inflation in the UK between 1861 to 1957. The graphic representation of this data came to be known as the 'Phillips Curve', and it illustrated that when inflation levels would rise, unemployment would decrease, and vice versa, making them inversely proportionate (Brue & Grant, 2013). However, in the 1970's, the core idea behind the Phillips Curve was disputed. This occurred as both inflation and unemployment rose due to economic growth and oil prices rising, following a negative supply shock as a result of the oil crisis in 1973. This made production decline in the US, and it became a core critique of Keynesian economics by Friedman. Keynesian economics did not provide an answer to stagflation and could not solve the economic crisis that the phenomenon had caused. It was around this time Margaret Thatcher in the UK and Ronald Reagan in the US started promoting new ways of thinking economics in government, moving away from Keynesian ideas towards neoliberal thought. As Reagan stated in 1981: *"Government is not the solution to our problem, government is the problem"* ("Inaugural Address | The Ronald Reagan Presidential Foundation & Institute," 1981). Thus, a revised form of economic liberalism came to dominate political and economic thinking in the US and UK, maybe in hope that it would provide a better alternative to achieve prosperity and the means to overcome economic crises.

While Friedman and Hayek both reject Keynesian economics, they still have a disagreement on state intervention, even though they both are supportive of economic liberalism. Friedman was a liberal economic thinker, but he also emphasized that governments should use monetary policy, to solve economic crisis and focus on preventing high inflation levels rather than unemployment (Lund,

2019a). However, he did not recommend that governments should use fiscal policy, as Keynes did. At the same time, Friedman saw politics and economics as entangled, just as Hayek, and they agreed that individual freedom could only be preserved in a free market capitalist economy. They both agreed that socialism could not be democratic, as Hayek argued that it would lead to fascism, and as Friedman argued that it could not guarantee individual freedom. However, Hayek still might have viewed Friedman's ideas on monetary policy as somewhat Keynesian, as Hayek argued that no government was capable intellectually or morally to decide on money or an economy in any way (Hayek, 1990). We did not see Keynes live long enough to answer the question of stagflation, assuming that he had an answer of course, and thus the debate appeared to be won by Friedman and Hayek from the 1970's and onwards in the west.

However, this was only accurate until the economic crisis of 2008.

The economic crisis of 2008

The economic crisis of 2008 made governments bring back Keynesian economics, as it showed that policies influenced by economic liberalism prior to the crisis had failed to prevent it. The somewhat liberal EU policy of a maximum allowance of a 3% deficit of GDP in its member states from the late 1990's was paradoxical. The intention was to create economic stability and align fiscal policies in the EU, but it also prevented states such as Greece from increasing spending to kickstart their economy from 2008 (European Commission, 2018). In the US, even the conservative (and arguably economic liberal) President Bush supported the "TARP" bill that would bail out banks, as he faced the consequences of global recession if the banks crashed (Glass, 2013). While it would provide a short-term gain, this would in Hayek's eyes just increase long term costs as banks would have less incentive to safeguard themselves against crises, as they would have an insurance or expect that the US government would save them in the worst case. However, it could have been necessary, as society maybe was not able to bear the losses of a bank crashing and wait for the economy to stabilize. As Keynes argue: *"In the long run, we are all dead"* (Hennigan, 2015), it would be reasonable to intervene and act, even though the economy and markets in theory could stabilize in the long run if a state stuck with economic liberal policies. After Bush, President Obama also introduced stimulus packages, using fiscal policy and increasing deficits by building on the multiplier effect to stimulate the US economy and combat global recession. While monetary theory later has been broadened with the concept of quantitative easing, in which a central bank can buy bonds to stimulate an economy,

recently in 2020 a former director of the US federal reserve, Ben Bernanke, argue that monetary policy still will not be sufficient to prevent future recessions (The Economist, 2020).

In 2020, 12 years after the economic crisis in times of economic boom, it seems that there has been a move away from Keynesianism in the US once again towards economic liberalism or even mercantilism, but this may be a risky move. While the Obama administration adopted Keynesian policies and increased spending to stimulate the US economy via the multiplier effect after the crisis, President Trump has made various statements signalizing different economic policies. While he has sought to deregulate the US economy and lower corporate tax rates, it should also be said that there has been indications of mercantilism against free trade, as indicated in an address to the UN: *"The future belong to patriots"* (Bloomberg, 2019). At the same time, Trump has also introduced new tariffs on goods from the EU and China and heavily criticized that jobs have moved out of the US. One issue with a turn to mercantilism is that regulation in the economy on a national level to overcome economic crises could be wishful thinking, as more states' economies are increasingly becoming influenced by global factors as a result of globalization. International regulatory moves could be necessary to face global recessions and economic crises. This could be avoided by a complete implementation of mercantilism, but this would likely be even more costly than a global recession for the US.

In the economic crisis of 2008, in the end it was "big government" that saved the economy as Paul Krugman (1953-) argue (Krugman, 2009). While it is possible that economic liberalism can be reinvented and refined, making it able to overcome economic crises, Keynesianism and state intervention in the US economy has been the factor that has provided the means to overcome economic crises. Though it would unwise to say anything with absolute certainty, there is an indication that state intervention is necessary to overcome economic crises, and that economic liberalism in its classical understanding does not provide the means to overcome economic crises. However, one thing that can be said for certain, is that nothing can be said for certain about the world and the economy, as the circumstances in which they exist are ever-changing along the course of history. However, Keynes attempt to provide us with wisdom with his words: *"When the facts change, I change my Mind. What do you do sir?"* ("Keynes was half right about the facts | Financial Times," n.d.).

Conclusion

To sum up, this assignment argues that economic liberalism does not provide the means to overcome economic crises, if it entails that a state should not intervene in its economy. Smith argues that economic liberalism in its classical understanding provide the means to overcome economic crises. However, the validity of economic liberalism can be disputed, as it is criticized by Marx and modified by Mill. A third way of state intervention in an economy proposed by Keynes, suggests a new way of thinking economics, as he argues that economic crises can be overcome through state intervention with fiscal and monetary policies. Keynesian economics is criticized by Hayek and Friedman, as Hayek argue that a state is not intellectually and morally capable of intervening in an economy, and Friedman argue that a state should only intervene in monetary policies. To conclude, the discussion finds that, in theory, economic liberalism could provide the means to overcome economic crises, as an economy can stabilize, and markets can equilibrate in the long run. However, in practice, governments have either turned to Keynesian state intervention because they were forced to or because they willingly wanted to, which has been the solution to economic crises in a majority of cases. Thus, this assignment approaches the conclusion that economic liberalism, in practice, does not provide the means to overcome economic crises. Acts of state intervention to overcome economic crises are necessary, since we don't live long enough to wait for the economy to stabilize and markets to equilibrate.

Bibliography

Bloomberg. (2019). Trump Says the Future Belongs to Patriots - Bloomberg. Retrieved October 23, 2019, from https://www.bloomberg.com/news/videos/2019-09-24/trump-says-the-future-belongs-to-patriots-video

Brue, S. L., & Grant, R. R. (2013). *The Evolution of Economic Thought*. South-Western Cengage Learning.

European Commission. (2018). Applying the rules of the stability and growth pact. Retrieved January 9, 2020, from https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/applying-rules-stability-and-growth-pact_en

Friedman, M. (1982). Capitalism and Freedom: Fortieth Anniversary Edition - Milton Friedman, Rose D. Friedman.

Galbraith, J. K. (1991). *A History of Economics: the past and the present*. PENGUIN BOOKS.

Galles, G. (2006). Hayek blazed a trail for liberty – Orange County Register. Retrieved January 10, 2020, from The Orange County Register website: https://www.ocregister.com/2006/05/09/hayek-blazed-a-trail-for-liberty/

Glass, A. (2013). Bush signs bank bailout, Oct. 3, 2008. *Politico*. Retrieved from https://www.politico.com/story/2013/10/bush-signs-tarp-legislation-oct-3-2008-097742

Hayek, F. A. (1990). Denationalisation of Money. *The Institute of Economic Affairs*.

Hennigan, M. (2015). In the long run we are all dead - John Maynard Keynes. *Finfacts*. Retrieved from http://www.finfacts.ie/Irish_finance_news/articleDetail.php?In-the-long-run-we-are-all-dead---John-Maynard-Keynes-159

Inaugural Address | The Ronald Reagan Presidential Foundation & Institute. (1981). Retrieved January 9, 2020, from https://www.reaganfoundation.org/ronald-reagan/reagan-quotes-speeches/inaugural-address-2/

Keynes, J. M. (1964). *The General Theory of Employment, Interest and Money* (First Harv).

Keynes v Hayek: Two economic giants go head to head - BBC News. (2011). Retrieved January 9, 2020, from https://www.bbc.com/news/business-14366054

Keynes was half right about the facts | Financial Times. (n.d.). Retrieved January 9, 2020, from https://www.ft.com/content/96a620a8-3a8d-11e5-bbd1-b37bc06f590c

Krugman, P. (2009). Averting the Worst. Retrieved January 9, 2020, from The New York Times website: https://www.nytimes.com/2009/08/10/opinion/10krugman.html

Lund, J. (2019a). *PET Lecture 12, 2019, Slide 21*. IBP course Political and Economic Thought 2019.

Lund, J. (2019b). *PET Lecture 4, 2019, slide 27*. IBP course Political and Economic Thought 2019.

Lund, J. (2019c). *PET Lecture 4, 2019, slide 7*. IBP course Political and Economic Thought 2019.

Lund, J. (2019d). *PET Lecture 5, 2019, slide 28*. IBP course Political and Economic Thought 2019.

Marx, K. (2010). *Das Kapital*. Pacific Publishing Studio.

Smith, A. (2013). *Nationernes Velstand 1*. Informations Forlag.

Smith, B., & Grassl, W. (1986). *Austrian Economics: Historical and Philosophical Background*. Routledge.

The Economist. (2020). Monetary policy will not be enough to fight the next recession. *The Economist*. Retrieved from https://www.economist.com/leaders/2020/01/11/monetary-policy-will-not-be-enough-to-fight-the-next-recession

Westacott, E. (2018). Nietzsche's "The Use And Abuse Of History." Retrieved January 10, 2020, from ThoughtCo. website: https://www.thoughtco.com/nietzsches-the-use-and-abuse-of-history-2670323