

Neoliberalism, Neoclassicism, and Economic Welfare
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Economists of every variety generally agree that the object of policy is the creation of conditions conducive to social provisioning or democratic problem solving. Over the past 25 years, the international financial economy has been witness to a variety of Neoliberal reforms thought to be consistent with this goal. Some argue, however, that in practice the opposite has been achieved. Instead of growth, stability, and the narrowing of income gaps, we have seen stagnation, volatility, and increased inequality. The object of this paper is to examine the theory that justified these policies, describe an alternative approach that argues they were ill-advised, and take a brief look at a small group of Latin American countries in the aftermath of the Mexican Crisis. It will be shown that not only does the alternative view raise serious doubts about the efficacy of Neoliberalism, but that those countries that refused to follow suit were better protected against contagion after the December Mistake.

The paper is organized as follows. The first section describes the Neoclassical theories that led to the implementation Neoliberalism and shows how the latter follows logically from the former. Next, the Institutional perspective, which takes issue with the wholesale implementation of free-market reforms, is explained. A short look at the differential impact of the Mexican financial crisis on select Latin American countries follows. Finally, conclusions are offered.

Neoclassical Economics and the Justification of Neoliberalism

Keynes argued in 1936 that theory determines policy (Keynes 1964: 383). If ideas drove the policies associated with Neoliberalism, then a useful starting point would be in outlining the

responsible theory. That was, of course, Neoclassicism, and not only does it appear that pressure was exerted by various Neoclassically-dominated international organizations, but there is evidence that the pedigree of economic policymakers in each country played a direct role. In a detailed study, Jeffrey Chwieroth traced the educational backgrounds of various developing-world advisors and ministers from 1977 through 1999 and showed that, controlling for other factors, earning a PhD from a Neoclassically-oriented program was a significant factor in leading a nation to implement Neoliberal reforms: the “results are highly suggestive that Neoliberal economists—who have yet to receive systematic attention in the literature—were critical in shaping capital account policy decisions in emerging markets” (Chwieroth 2007: 450). This begs the question of what these young men and women were learning in their classrooms, particularly with respect to exchange rates and capital flows.

Starting with the former, there is no single, universally accepted model of currency-price determination within Neoclassicism. However, each generally reduces to the proposition that market-determined exchange rates are a function of trade flows. If that is true, then the currencies of nations with current-account deficits must be in relatively low demand, meaning that they will depreciate; meanwhile, those of nations with surpluses are in high demand and will appreciate. Payments imbalances are thus automatically corrected and exchange rates fluctuate no more violently than the generally sluggish trade flows driving them. Portfolio capital flows (to be discussed below) may add some short-term volatility in currency markets, but this is no more than white noise and, at any rate, speculation by rational agents merely nudges prices on their way to market-clearing levels faster than would have otherwise occurred. In the long run and in the absence of government intervention, exchange rates adjust slowly and smoothly and

follow a time-path that encourages balanced trade.

The Neoclassical view of the financial flows is similarly optimistic. It is assumed that market participants are rational, self-interested agents who are able to (at least on average and with the discipline imposed by the market) correctly discount the future value of all assets. This means that stock and bond prices set by free enterprise reflect the best possible forecast of the true future earning potential of the issuers. Prices set in this manner are expected to allocate resources to the most successful and therefore economically optimal and efficient activities. As a consequence of this process, countries with liberalized capital markets will find that profitable firms will naturally prosper, thereby enhancing growth and income; other, less efficient, firms whither and die for lack of access to financial capital.

Such a worldview is clearly consistent with the Neoliberalist agenda of free market reforms. If Neoclassicism correctly describes the economy then they are quite right that we should rein in government power as much as possible and allow rational, utility maximizing agents to freely choose among available options and thereby increase world welfare; and little wonder we have witnessed a widespread dismantling of regulatory structures in nations where Neoclassical economists held positions of power.

Institutional Forces and International Finance

Just because a theory is popular, however, does not mean that it is correct.¹

Institutionalist scholars, among others, have taken issue with Neoclassical economics, beginning its analytical foundation in methodological individualism. Knowing that someone is a rational, utility maximizer—i.e., that she is a reasoning being who tries to do what makes her most

happy—is not particularly enlightening. What makes her happy? What means are at her disposal and what obstacles exist? These are socially determined and are reflected in formal and informal norms, mores, sanctions, and worldviews in the society in question. A realistic analysis of economic behavior therefore requires that we first discover the rules of the game set by institutions.² The focal point of such an analysis is the social unit rather than the individual.

A detailed study of the institution of international finance lies well beyond the scope of the current paper. However, even limiting our attention to those factors affecting the length of time agents tend to hold assets is more than sufficient to show the flaws in the Neoclassical approach. Note first that when agents are induced to buy and hold for the long run, there exists a strong incentive to undertake detailed and in-depth research into the asset issuer, its competitors, and relevant market conditions. This makes the outcomes predicted by the Neoclassical school—optimal allocation of resources to the most efficient firms—much more likely, if not guaranteed. Market participants are well educated regarding the factors most likely to determine future firm performance and financial flows are directed accordingly.

By contrast, however, study of the subculture of international investors reveals that it is far more likely to encourage short termism than buy-and-hold strategies:

international portfolio investors are enthusiastic participants in capitalist high finance. They thoroughly enjoy the process of buying and selling, and their membership in the fraternity of world capitalist financiers is a major part of their self-image. They wear as a badge of pride the volatility of the market in which they participate (and inadvertently create), and both the personalities attracted to the industry and the pressure to earn profit (the more the better) or attract

customers creates a tendency to take risks (further adding to the volatility of the market). (Harvey 2006: 161)

This is a function of agents' "socialization in the capitalist system . . . and subsequent molding within the subculture of portfolio investors," not any instinctive or genetic drives (Harvey 2006: 153). Status in their tribe is a function of earning quick profits. This is maintained by self-selection of those who enter the industry and is reinforced through training and interactions with colleagues and superiors. Customers, too, have come to expect rates of profit that can only be achieved via risky portfolio choices and the blind pursuit of bandwagons. In this subculture, one does not buy a round of beers to celebrate a stable, five-percent per annum return earned over a three-year period. Their self image is that of a warrior taking great risks and reaping rich rewards (Harvey 1993: 693).

If no effort is made to check or redirect these tendencies, then this would cause agents to spend more time forecasting next week's market psychology than next year's corporate profits. This not only severs the link between well-researched evaluations of the profitability of issuing agents and the price of their assets, but it introduces myriad ephemeral factors into investors' forecasts, thus creating Keynes' beauty contest. This negatively affects the allocative role that financial markets should play and it increases price volatility. In fact, evidence suggests that the transformation is so complete that in the real world, agents are less concerned with the accuracy of breaking news than in being the first to hear it (Oberlechner and Hocking 2004: 418). In this manner, rumors carry every bit as much weight as fact and these often become indistinguishable from one another as they are passed from one member of the financial community to the next (Oberlechner and Hocking 2004: 415 and 421).

This is obviously a very different picture of the international financial economy than that painted by the Neoclassical school. Physical investment, to which asset prices should ultimately be tied, requires a long-term time horizon if it is to be properly done. But, institutional forces encourage the pursuit of short-term capital gain. Asset prices are not a function of careful analyses of industry fundamentals and this represents a serious obstacle to social provisioning in that it both interferes with the allocative function of the financial market and it creates volatile asset and currency prices. In addition, portfolio investment markets now follow their own internal logic and dominate international trade flows rather than acting to accommodate them. This not only creates a much more unstable currency market, it also means that current account imbalances lose their self-correcting tendencies since, once substantial capital flows are added in, a trade deficit or surplus no longer necessarily represents a disequilibrium in the foreign exchange market. Furthermore, an economy so structured tends to create a large financial sector as the higher volume of trades leads to more jobs for brokers and dealers. The nation's best and brightest are drawn to exploitative pursuits rather than industrial ones and the consequent lack of attention to democratic problem solving is likely to generate highly uneven distributions of income.

One thing a policymaker would not want to do under these circumstances is encourage existing worldviews by offering them an intellectual justification for their actions and creating a legal structure that enables their dysfunctional behavior. But this is precisely what is accomplished by Neoclassical economics and Neoliberal policies. Rather than quick turnaround being deterred and punished by regulations, taxes, and fees, it is promoted. Market participants are encouraged to believe that pursuit of their self interest is increasing world welfare and

governments are advised to rush to embrace these principles.

Mexican Crisis and Contagion

If the Institutionalist critique is correct, then we should find that nations who fully embraced Neoliberal principles found themselves with more volatile and crisis-prone financial systems than those who did not. The particular route by which these ills manifest themselves may vary considerably from country to country. What they would have in common, however, is a general shift towards ceremonial rather than instrumental valuing, thereby frustrating the process of social provisioning. Clearly, no such statistic is available, but income distributions can serve as a proxy.³ These will be less even where economic activity is oriented toward invidious distinction, status seeking, and predation; they will be more even in economies where the norm is goal-oriented experimentation directed toward democratic problem solving. As a data set of income distributions (in the form of the Theil statistic, which rises as inequality increases) is available from the **University of Texas Inequality Project**, this was the primary means by which countries' performances were compared.⁴

Testing also requires finding a classification scheme for developing country policy stances. Graciela Kaminsky and Sergio Schmukler do this for 28 nations for the period 1973-2005 (2007). In particular, they track policy changes in the capital account, domestic financial sector, and stock market, marking each as fully liberalized, partially liberalized, or repressed.⁵ They then assigned an overall grade to each financial system as follows:

- Fully Liberalized: at least two sectors fully liberalized and one partially liberalized;
- Partially Liberalized: two or more sectors at least partially liberalized;

- Repressed: fewer than two sectors at least partially liberalized.

As their work is Neoclassical, using their scheme should bias any results against the Institutional argument.

On the surface of it, one would imagine that a simple comparison of income distributions and other economic indicators under fully liberalized, partially liberalized, and repressed conditions would suggest which tends to generate more favorable outcomes. However, one quickly runs into a causality issue since capital controls are often put in place during periods of crisis and then removed once markets are again calm. Hence, this would give the impression that liberalization is associated with stability while “repression” causes volatility. For that reason, it was decided to instead compare what occurred in various countries in the aftermath of a shock. Data considerations made the Mexican financial crisis of 1994 a reasonable choice.

To test the hypothesis that nations embracing Neoliberal principles are less able to weather shocks than those who do not, annual rates of change of the Theil statistic were calculated for the seven Latin American countries for which data were available. Positive numbers indicate a deterioration in the distribution of income, while negative ones suggests an improvement. As the Mexican financial crisis did not strike until December of 1994, that year is used as the base. It was assumed that the primary impact of the crisis would be felt over the course of the following two years. Table One shows the results.

The data are sorted according to the last column (average annual increase in the Theil from 1994 to 1996) such that the country at the top is the one that experienced the largest deterioration in income distribution while the one at the bottom had the biggest improvement. The trend is very clear: the distribution of income in every nation with full liberalization for the

TABLE ONE: Income distributions in the aftermath of the Mexican Financial Crisis.

	Financial Liberalization Stance	Avg Annual Increase in Theil 1994 to 1996
Mexico	Full Liberalization	19.0%
Chile	Full Liberalization	5.6%
Argentina	Full Liberalization	3.9%
Peru	Full Liberalization	-0.5%
Colombia	Partial Liberalization	-2.6%
Venezuela	Repressed	-6.0%
Brazil*	Repressed/Full Lib	-8.0%

*Data for Brazil only 1994 to 1995; Brazil financially repressed in 1994, full liberalization starts in March 1995.

Financial Liberalization Stance data from Kaminsky and Schmukler; Theil data from the University of Texas Inequality Project.

entire period deteriorated with the exception of Peru, which experienced a modest improvement. Meanwhile, all three of those with only partial liberalization or repression actually experienced a decline in income inequality. On average, the four fully liberalized countries were witness to a 7% annual increase in the Theil from 1994-96. It was, of course, the worst in Mexico, where real wages fell by 26% and inflation accelerated from 6.9% in 1994 to 54.5% in 1995 and 27.7% in 1996 (Peters 1998: 359).⁶ Table One also show that Chile, generally thought to have avoided the worst of the contagion effects, fared poorly (research by Mathur, Gleason, Dibooglu, and Singh 2002, however, agrees with the findings in this paper). In Argentina, where unemployment jumped from 12% to 16.6% and share prices collapsed, the income distribution deteriorated by 3.9%. The exception to the rule is Peru, where there was not only a slight improvement in income distributions, but an increase in nominal share prices and real GDP and a fall in unemployment (International Financial Statistics). Their unique experience may be as a result of the populist government that was in place when the crisis hit (Roberts 1995).

Those repressed or partially liberalized as of December 1994 saw an average decline in inequality of a little over 5%.⁷ Beginning with Colombia, though they experienced a fall in share prices and an increase in unemployment, real GDP continued to rise. In addition to their only partially liberalized stance, they benefitted no doubt from “stable and successful policies almost continuously” and “comparative political stability” (Galbraith and Cantu 1999: 5). The more “repressed” Venezuela performed even better, with a decline in inequality of 6%.

Unemployment jumped, but neither GDP nor nominal share prices suffered (International Financial Statistics). Last, Brazil (for which 1996 Theil data were unavailable) showed the largest improvement. Unemployment increased, but so did GDP (International Financial

Statistics).

Conclusions

While a much more detailed study would be necessary to clearly establish the determinants of the changes in the Theil shown (if such a feat is even possible given the quality and quantity of data), these results are consistent with Institutionalist argument that Neoliberal reforms in financial markets lead to stagnation, volatility, and increased inequality rather than growth, stability, and the narrowing of income gaps. Social provisioning, as measured by the Theil, suffered most in countries where markets were fully liberalized. It improved in repressed and only partially liberalized economies. If the above does not represent a decisive indictment of Neoliberalism, it is certainly reason for pause. Not only is the case for it theoretically suspect, but it lacks empirical support.

ENDNOTES

1. Thomas Kuhn argued, for example, “that choice between paradigms . . . has less to do with the scientific merits of theories are more to do with extraneous sociological or political factors influencing the researchers” (Mair and Miller 1991: 9).
2. When I was in the late Walter Neale’s class in 1983, he gave us the example of walking into a room full of people playing cards at a table. What allows you to better explain/predict their card play: the rules of the game or their motivations for playing? Surely we would like to have both; but, not only are we unlikely to be able to discern the latter, even if we could it still would not tell us why the lady with the two aces and three sevens was permitted by the others to put *their* money into *her* pockets!
3. This approach was employed in Elliott and Harvey 2000, Harvey and Klopfenstein 2001, and Harvey 2004.
4. The **University of Texas Inequality Project** makes available data, a series of excellent papers (most featuring James K. Galbraith as a co-author), and tutorials and other guides on their web site: <http://utip.gov.utexas.edu/>.
5. Note that this does not mean that foreign exchange markets are being ignored. As argued above, capital flows dominate currency and thus circumstances in the former have a decisive impact on the latter (Harvey 2009).
6. A number of authors have further argued that the shock itself was a result of Neoliberal policies (see, for example, Cruz, Amann, and Walters 2006, Cypher 1996, and Lopez-Gallardo, Moreno-Brid, and Anyul 2006).
7. For this calculation, Brazil was given half the weight of Columbia and Venezuela since 1996. Theil data for Brazil was not available.

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