

**The Mont Pelerin Society:
A MANDATE RENEWED**

By

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Ladies and Gentlemen,

Welcome to this special meeting of the MPS. In this address I would like to explain why it has been called at such short notice and how I hope it provides a renewal of the mandate our founders set for the society.¹

After being anointed with the Presidency of this august body in Tokyo (in early September), my wife and I went on to a lecture tour in China. We were in Shanghai on a tour of the magnificent Suzhou industrial estate outside Shanghai, with MPS member Steven Cheung. On the afternoon of the 15th September Steve received a call on his Blackberry that Lehman Brothers had gone into bankruptcy. Steve opined that this marked the end of American capitalism. I thought this somewhat hyperbolic. But, on getting back to London at the end of September, as I was tending my roses, my neighbor, a Thatcherite heart surgeon, said over the hedge that, given the recent events in the capital markets, did I still stand by the views I had expressed in my last book on "Reviving the Invisible Hand".² I replied that even a severe trade cycle downturn would not undermine the well tested classical liberal principles I had espoused. Though, Gordon Brown might be in trouble having repeatedly congratulated himself for having abolished boom and bust.

Two subsequent events shattered this complacency. I had been following a political betting site called Betfair on which some youngsters at the Tokyo MPS meeting were placing bets on a McCain victory. They had also told me that the odds against a Republican win had considerably shortened since the nomination of Sarah Palin to the Republican ticket. Looking at this site at the end of September was a shock. It was clear

¹ I do not provide any answers here to the questions I raise in this address, which are meant to be Socratic. But during the last decade I have been writing a monthly op-ed column on diverse topics for the Indian financial newspaper *The Business Standard*. Over the last 2 years I have written periodically about the spiraling financial crisis with growing incredulity. My indefatigable research assistant Shogo Hamasaki has put together the relevant columns into a short compact document called "The Great Crash of 2008", which should be on your 'sticks'. It provides my views on the origins, responses and consequences of the crisis.

² D. Lal: *Reviving the Invisible Hand: the case for classical liberalism in the twenty-first century*, Princeton, 2006.

{Fig. here }

that the Lehman bankruptcy had been a major turning point, From then on Obama's lead over McCain widened by leaps and bounds. The Lehman catastrophe doomed the Republicans, and the hopes of a classical liberal resolution of the spiraling crisis.

The second was an op-ed article in the *Washington Post* (on October 30) by the former Chairman of President Reagan's Council of Economic Advisors, the distinguished fiscal conservative Martin Feldstein. He argued for a fiscal stimulus "because the current recession is much deeper than and different from previous downturns. Even with successful countercyclical policy, this recession is likely to last longer and be more damaging than any since the depression of the 1930s."³

This marked a turning point in the acceptance since the 1970's of the classical liberal viewpoint: of eschewing the Keynesian interventions commonly accepted in the two postwar decades to deal with the business cycle.⁴ A landmark of this acceptance was the statement by the British Labor Prime Minister James Callaghan's to his party conference in 1976, that:

"We used to think that you could just spend your way out of a recession and increase employment by cutting taxes and boosting Government spending. I tell you, in all candour, that that option no longer exists, and that insofar as it ever did exist, it only worked by injecting a bigger dose of inflation into the economy followed by higher levels of unemployment as the next step. This is the history of the past 20 years."⁵

It was this seeming intellectual 'victory' of classical liberal ideas which led some distinguished members to argue for the winding up of the society (in 1975 and again in 1991). Current events show this would have been premature. But, the current crisis requires us to assess whether our views and the policy conclusions we had derived from them were misguided. For all ideas need to be continually re-examined to test their continuing relevance and validity. And ideas are the lifeblood of the Mont Pelerin Society. For as the historian of the Society Max Hartwell reminds us: "it was to change ideas that the Society was founded, not to intervene directly in politics to change policies," and that "it was Hayek's idea that the Society should be a scholarly society- an academy and not a *congregatio de propaganda fide*".⁶ It was in this spirit that in early October I approached my fellow members of the Executive Committee about a special meeting to discuss the global financial crisis. Their response was gratifyingly warm and supportive. Ed Feulner, our long standing Treasurer and past President, took upon himself the onerous task of organizing the meeting at such short notice, and without his

³ M. Feldstein: "The Case for Fiscal Stimulus" reprinted by Project Syndicate, January 2009, available at www.aei.org.

⁴ Lal: *Reviving the Invisible Hand: The Case for Classical Liberalism in the Twenty-First Century*, Princeton, 2006, ps. 105-6.

⁵ Quoted in M. Friedman: Nobel lecture: "Inflation and Unemployment", *Journal of Political Economy*, Vol.85, n0.3, pp.451-72.

⁶ R. M. Hartwell: *A History of the Mont Pelerin Society*, Liberty Fund, 1995, ps. 192 and 219.

labors and those of his associates at Heritage, this meeting could not have been organized so efficiently. I wish to thank them on all our behalf.

The program was drawn up with a number of questions in mind.

1. The first and most crucial is how have things come to such a pass, with a severe global crisis developing during the watch of supposedly classical liberals in charge of US economic policy?
2. Second, were the theoretical presumptions of the classical liberal policy consensus sound, and still valid?
3. Third, what are the likely international repercussions of the crisis and responses to it for the wholly benign process of globalization?
4. Fourth, are the Obama administration's policies well judged, or are they likely to lead to another period of stagflation and dysfunctional expansion of Big Government?

We need to answer these questions, not least, because we are replaying the debates of the 1930's. On one side were Hayek and his circle at the London School of Economics led by Lionel Robbins. Basing themselves on Hayek's refurbishment of the Austrian theory of the trade cycle, they argued that the slump, which was the inevitable consequence of the 'maladjustments in the structure of production of the previous boom, should be allowed to run its course. Time was needed for labor and capital to be reallocated to correct these maladjustments, and not government deficit spending and monetary expansion. Having opposed Keynes in an official committee on both his plans for fiscal expansion and protection as cures for the British slump, Robbins later recanted on the former though not on the latter issue.⁷ As the late member of this society Gottfried Haberler (a close friend and member of Hayek's Austrian circle) noted in his astute appraisal of Hayek's business cycle theory:

"Keynes, Robbins, and many others were correct: if a cyclical decline has been allowed to degenerate into a severe slump with mass unemployment, falling prices, and deflationary expectations, government deficit spending to inject money directly into the income stream is necessary. Moreover, Hayek himself has changed his mind on this point".⁸

So the question arises, are we at present in these dire straits, particularly as the Fed chairman Ben Bernanke has kept the promise he made at our past President Milton Friedman's 90th birthday party of having learnt the lessons of Friedman and Schwartz's great book on the Great Depression. Bernanke has opened the monetary sluice gates, so inflation not deflation seems to be in the offing. Do we need a further fiscal stimulus because the Fed will nevertheless not be able to avoid deflation? If so why?

In this debate it is essential to keep a historical and international perspective. For, booms and slumps and their accompanying financial crises are endemic to the process of

⁷ Lord Robbins: *Autobiography of an Economist*, Macmillan, 1971, p. 152-6.

⁸ G. Haberler: "Reflections on Hayek's Business Cycle Theory", *The Cato Journal*, vol. 6, no.2, Fall 1986, p. 422.

'creative destruction', which promotes the dynamic efficiency of the capitalist market economy. Moreover the global monetary system is very different today than it was in the 1930s. That is why the first session of this meeting seeks to put the current crisis in historical and international context. How does this crisis differ, if at all, from other financial crises in history? My own practical experience of a global financial crisis was at the World Bank in the 1980's during the Third World debt crisis. Then, as now, many saw the origins of the crisis in global imbalances which had raised the world propensity to save, leading to imprudent lending by Western banks to the *ninja* of the day -the fiscally challenged inward looking economies of Latin America and Africa. Why did that crisis born of the global imbalances of the time not lead to the systemic crisis predicted by self-seeking bankers, whereas today it has?

In the 1990s there were another set of financial crises accompanying the liberalization of capital markets in emerging markets. What are the lessons these emerging market financial crises tell us about the ways of dealing with the current crisis? Why, despite the removal of the 'golden fetters', which are claimed to have worsened and propagated the 1930's crisis internationally, has the current crisis become internationalized? Is there a case, as some argue, for regulating international capital flows?

The next session discusses the alternative theoretical perspectives which seek to explain the current crisis as well as the remedies. Here a personal note is in order. When I got my first academic job as a lecturer at Christ Church, Oxford, my senior colleague was Sir Roy Harrod- Keynes' first biographer and keeper of his flame. On having to provide a reading list for my tutorials on "economic fluctuations and growth" I asked him what I should ask my pupils to read. I expected him to say Keynes, and his own work on trade cycles and growth. But after some reflection he said: Wicksell. So before I prescribed this to my pupils I immersed myself in *Interest and Prices* and *Lectures on Political Economy*. Since then I have been pleasantly surprised that most of the macro economic perspectives on offer really hark back to Wicksell.⁹ Keynes' *Treatise on Money* is Wicksellian, as is Hayek's refurbished Austrian theory, where the trade cycle is explained in effect by divergences between the Wicksellian natural and market interest rates, as is the latest supposedly grand modern macroeconomic theoretical consensus embodied in Michael Woodford's *Interest and Prices*¹⁰. Friedman (and Edmund Phelps') 'natural rate of employment' is (as Friedman noted in his Nobel lecture) an analogue of Wicksell's natural rate of interest. Whilst the famous Taylor Rule, seeks to provide the stabilization rules for the monetary authority by making the market interest rate stay as close to an unobservable and changing natural rate as possible. This leads on to the question: which of the various theoretical perspectives flowing from Wicksell should we follow?

⁹ My graduate supervisor at Oxford, Sir John Hicks, noted in the preface of the collection of his writings on *Money, Interest and Wages*, Blackwell, 1982, that "in order to get a [monetary] theory which would be wide enough to be appropriate, not only to the old problems, but also to new ones...I have had to go back to Wicksell". p. xiii

¹⁰ M. Woodford: *Interest and Prices: Foundations of a theory of money*, Princeton, 2003.

In this context it should be emphasized that though Keynesians see financing infrastructure spending by fiscal deficits as the centre piece of countercyclical policy, the master himself eschewed this, stating in 1942:

"Organized public works, at home and abroad, may be the right cure for a chronic tendency to a deficiency of effective demand. But they are not capable of sufficiently rapid organization (and above all cannot be reversed or undone at a later date) to be the most serviceable instrument for the prevention of the trade cycle"¹¹
Keynes was not a Keynesian.¹²

At the beginning of the 2nd World War Keynes along with Hayek argued that any inflationary consequences of financing the war should be contained by a general tax rise to generate forced savings to be returned after the war. Their advice was not taken and the suppressed inflation that ensued was contained by inefficient dirigiste price controls and rationing which remained long after the war ended.¹³ Similarly, today, to repair the fall in aggregate demand from the banking crisis, why not first, make the Bush tax cuts permanent, providing a boost to household's permanent income and thence consumption. Accompanied by a massive temporary across the board tax cut which raises the after tax income of households and businesses? It is argued that most of this extra income will be saved not spent. But if the crisis is caused by attempts to reduce unsustainable debt, the 'savings' generated by the temporary tax cut will allow the necessary deleveraging without this adjustment occurring solely through a downward spiral in income and increased bankruptcies. To the extent this extra savings allows households to pay off their mortgages and credit card debts, it will also mean that these assets of the banking system are not further impaired. Instead, the Obama stimulus plan seems to be a dog's breakfast, with insufficient tax cuts, infrastructure spending which (as Keynes emphasized) is not a sensible counter cyclical weapon, and a further expansion in entitlements, after massive increases during the Bush administration. Is this package likely to stop the crisis evolving into a serious slump, even a depression? Or will it be followed by stagflation as the public debt fuelled expansion of entitlements leads to a collapse of the bond market and thereafter to inflation? Will the inexorable rise in government spending move the US closer to the social democratic paradise of Sweden? If so, it is particularly timely that the society is meeting later this year to look at this Promised Land at first hand.

¹¹ J.M. Keynes: *Collected Works*, Vol. XXVII, Macmillan, 1980, p.122

¹² The deplorable tendency of contemporary economics graduate students not to read the works of the 'greats', relying only on the formal translations of some of their ideas is attested to by the latest Nobel laureate and New York Times columnist, Paul Krugman who admits in his paper for the centennial volume in honor of Bertil Ohlin his embarrassment that "he had never actually read Ohlin's *Interregional and International Trade* ..[as] modern economists trained to think in terms of crisp formal models...rely on translators- on transitional figures like Paul Samuelson, who extracted models from the literary efforts of their predecessors". On reading Ohlin, he makes "the startling discovery: the extent to which Ohlin in the original anticipates a view of trade that the 'new trade' theorists had to rediscover some fifty years later"! Krugman: "Was it all in Ohlin?", in R. Findlay, L. Jonung, Mats Lundahl (eds): *Bertil Ohlin- A centennial celebration (1899-1999)*, MIT Press, 2002, ps. 389, 390.;

¹³ F. A. Hayek: *Hayek on Hayek*, Chicago, 1994. p. 20

I would like to highlight a second issue to be discussed in the session on theoretical perspectives. It is generally agreed that the current crisis is above all a banking crisis. How can the toxic assets which are turning the banks into zombies be removed to restore their health? Is some form of nationalization inevitable? There is also a more generic question. Did the move (with bipartisan and academic support) to universal banks with the abolition of the Glass-Steagall Act, allow the Federally insured deposit base of the commercial banks - the utility part of the banking system- to be used as collateral to take highly leveraged bets by the investment banks- the gambling (and innovative) part of the banking sector? If so should there be some form of new regulation separating the commercial from investment banks? Friedman, it should be remembered, in his post-war monetary and fiscal framework for economic stability, argued in favor of narrow banking.¹⁴ This issue is important, as it is central to both explaining the current crisis and determining the best means to regulate the deposit taking and creating part of the banking system from moral hazard, given that removing deposit insurance is politically impossible. It is also an issue which I suspect divides many classical liberals.

The following session deals with the all important question of the origins and outcomes of the crisis in its US epicenter. As we would all like to know what our recently departed former President makes of this crisis, we are fortunate that, despite her frailty, Anna Schwartz, who is undoubtedly in telepathic communication with her long time collaborator, will be here to tell us whether he would still endorse the good chit he gave to Allan Greenspan for his famous put after the bursting of the dotcom bubble.¹⁵ We then have various panelists who were in the thick of things to tell us what went wrong when 'our side'- as it were- was in charge.

My greatest fear is that this crisis- and the responses to it- will stall or reverse the wholly benign process of globalization, which dates from the China's opening by Deng Tsiao Ping in 1978, and the reversal of India's Permit Raj in 1991. This has lifted more people from abject poverty than has ever been seen in human history. I have spent most of my academic life trying to persuade the Third World to reverse the dirigiste inward looking policies it adopted, in large part because of the collapse of the first liberal international economic order in the Great Depression. But there are many in the West arguing for it to depart from the classical liberal principles it has espoused. Typical is a recent essay by Keynes' distinguished biographer, Robert Skidelsky, who took the Conservative whip in the House of Lords till the mid 1990s and had been a junior Treasury minister in the last Tory government. Echoing Keynes' 1932 conversion to protectionism in his article "Let goods be homespun," he argues that "rich countries could probably abandon the globalist project without much damage to their material standards and with a possible gain to quality of life"¹⁶ Is he right?

¹⁴ M. Friedman: "A Monetary and Fiscal Framework for Economic Stability", *American Economic Review*, vol. XXXVIII, June 1948, reprinted in his *Essays in Positive Economics*, Chicago.

¹⁵ M. Friedman: "A Natural Experiment in Monetary Policy Covering Three Episodes of Growth and Decline in the Economy and the Stock Market", *Journal of Economic Perspectives*, Vol. 19, No.4, Fall 2005, pp. 145-150.

¹⁶ R. Skidelsky; "Where Do We Go from Here?", *Prospect*, no.154, January 2009, p.40.

In the early 1980's I wrote a small book preaching the virtues of classical liberalism in redressing the ancient poverty of the Third World.¹⁷ For a variety of reasons, these developing countries have begun to heed that message. I did not imagine that it would be necessary to preach a similar message to those who have until recently rhetorically espoused classical liberalism.¹⁸ It is notable that unlike the bowdlerized Keynes in the back pockets of Western politicians, the Chinese premier Wen Jiabao in an interview with the *Financial Times* at Davos said his bedtime reading was Adam Smith's *The Moral Sentiments*!¹⁹

However, despite all the loose talk of 'decoupling', America still remains at the center of the world economy, so that when it sneezes the rest of the world catches a cold. So, the last two sessions are devoted to the impact and responses of emerging markets and the other smaller countries caught in the backwash of this global crisis, as well as to an assessment of the likely future course of the US economy.

With this special meeting returning to the issues of economic stability which had exercised many of the early meetings, the current crisis also points to many other issues which are part of the society's mandate but which have recently been neglected. I want to end by outlining some of these.

When I was working at the World Bank in the midst of the Third World debt crisis of the 1980's and conducting a wide ranging comparative study with Hla Myint, based on the economic histories of developing countries since the 1950s, for a book on *The Political Economy of Poverty, Equity and Growth*, I observed a pattern of economic repression, followed by crisis leading to economic reform. The repression was often pursued with the aim of 'nation building'. It sought to expand the span of government control by integrating various fissiparous groups to create 'order'. This led to the growth of politically determined income streams for favoured clients of the State underwritten by various forms of economic coercion of other economic agents. This, repression in turn bred tax evasion, avoidance and the progressive erosion of the State's fiscal base. Attempts to plug this hole by foreign borrowing or the inflation tax, in turn led to a fiscal cum debt cum inflation cum balance of payments crisis and the UnMarxian 'withering away of the state'. It was to restore the fiscal base that economic liberalization was undertaken. This was also the pattern that one of the founding MPS members, the great Swedish economic historian Eli Heckscher also documented for the post Renaissance absolutist monarchies of Europe in his great book on *Mercantilism*. Are we beginning to see the same process starting in the contemporary United States?

The process of globalization requires some means of maintaining international order.²⁰ If the current global crisis leads to the current world hegemony to turn inwards, as some siren voices are suggesting, how will international order be maintained? Particularly, as it

¹⁷ D. Lal: *The Poverty of 'Development Economics'*, IEA, 1983, Harvard, 1985; revised 2nd edtn. IEA, 1997, 2002; MIT, 2000.

¹⁸ As in Lal: *Reviving the Invisible Hand*, op.cit.

¹⁹ See "Transcript: Wen Jiabao", FT.com /world, Feb.2, 2009.

²⁰ D. Lal: *In Praise of Empires*, Palgrave Macmillan, 2004; N. Ferguson: *Empire*, Penguin

is threatened by another totalitarian creed, militant Islam. Will the current 'War on Terror' sap the resolve of the American imperium to maintain global order? If not, will one or the other of the emerging Asian 'superpowers' be able to provide global order? Or will the Kantian, and Wilsonian dream of a spontaneous order of a comity of democracies emerge to keep the Peace? These are all questions which, despite being part of the aims of society, it has ignored in recent years. I hope these will be discussed at future meetings.

Another set of questions arises from the disgrace of the 'quants' in the current crisis. The epistemological basis of their form of statistical snake oil was a central concern of Hayek's and I hope will be of ours.

As will questions about the moral basis of capitalism. The shameless greed shown by many bankers- who have smashed the institutions they were charged to nurture on the rocks- is leading to a popular backlash against capitalism. This takes us back to questions raised by the great thinkers of the Scottish Enlightenment, who saw a common morality as providing the cement of society. A morality primarily dependent on a society's traditions and forms of socialization, based on using the moral emotions of shame and guilt, and not reliant on either God or Reason for their acceptance. How can the Victorian virtues embodied in the notion of the English gentleman which are today to be found more often amongst the burghers of Bombay and Shanghai than the denizens of Wall Street "The City" and Hollywood be inculcated? These are virtues which denoted a distinction of character rather than class, and consisted of 'integrity, honesty, generosity, courage, graciousness, politeness, consideration of others.'²¹ They constituted the 'sympathy' which Adam Smith considered the highest virtue which allowed healthy ambition to be combined with an empathetic conscience to promote social stability and order.²²

Further issues are: what is the way to challenge the political correctness which is leading to the abuse of reason in the humanities and many social sciences in our citadels of higher learning and which increasingly provides the intellectual lens through which most politicians view numerous public policy issues? Last but not least, how can the growth of the Nanny State's undermining of Mill's principle of liberty be countered? These are some of the many questions raised by the current crisis which fall within the mandate of the society as seen by its founders. It provides us an opportunity to renew this mandate by critically examining these new, as well as the resurrected threats to liberty in our future meetings.

²¹ G. Himmelfarb: *The Demoralization of Society*, Knopf, 1994, p. 46. The term was used to denote a distinction of character rather than class. "As James I is reputed to have said 'I can make a lord'...when his [old nurse], begged him to make her son a gentleman, 'but only God Almighty can make a gentleman'" (Himmelfarb, p.45)

²² Adam Smith: *The Theory of Moral Sentiments*, Liberty Fund, (1759) 1982. p.152

FIG 1

