Inside the stock exchange in Santiago, Chile, one of the first countries to adopt a form of neoliberal policies.

# Neoliberalism: Oversold?

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**Instead of delivering growth, some neoliberal policies have increased inequality, in turn jeopardizing durable expansion**

MILTON Friedman in 1982 hailed Chile as an "economic miracle." Nearly a decade earlier, Chile had turned to policies that have since been widely emulated across the globe. The neoliberal agenda—a label used more by critics than by the architects of the policies—rests on two main planks. The first is increased competition—achieved through deregulation and the opening up of domestic markets, including financial markets, to foreign competition. The second is a smaller role for the state, achieved through privatization and limits on the ability of governments to run fiscal deficits and accumulate debt.

There has been a strong and widespread global trend toward neoliberalism since the 1980s, according to a composite index that measures the extent to which countries introduced competition in various spheres of economic activity to foster economic growth. As shown in the left panel of Chart 1, Chile's push started a decade or so earlier than 1982, with subsequent policy changes bringing it ever closer to the United States. Other countries have also steadily implemented neoliberal policies (see Chart 1, right panel).

There is much to cheer in the neoliberal agenda. The expansion of global trade has rescued millions from abject poverty. Foreign direct investment has often been a way to transfer technology and know-how to developing economies. Privatization of state-owned enterprises has in many instances led to more efficient provision of services and lowered the fiscal burden on governments.

However, there are aspects of the neoliberal agenda that have not delivered as expected. Our assessment of the agenda is confined to the effects of two policies: removing restrictions on the movement of capital across a country's borders (so-called capital account liberalization); and fiscal consolidation, sometimes called "austerity," which is shorthand

for policies to reduce fiscal deficits and debt levels. An assessment of these *specific* policies (rather than the broad neoliberal agenda) reaches three disquieting conclusions:

- The benefits in terms of increased growth seem fairly difficult to establish when looking at a broad group of countries.
- The costs in terms of increased inequality are prominent. Such costs epitomize the trade-off between the growth and equity effects of some aspects of the neoliberal agenda.
- Increased inequality in turn hurts the level and sustainability of growth. Even if growth is the sole or main purpose of the neoliberal agenda, advocates of that agenda still need to pay attention to the distributional effects.

## Open and shut?

As Maurice Obstfeld (1998) has noted, "economic theory leaves no doubt about the potential advantages" of capital account liberalization, which is also sometimes called financial openness. It can allow the international capital market to channel world savings to their most productive uses across the globe. Developing economies with little capital can borrow to finance investment, thereby promoting their economic growth without requiring sharp increases in their own saving. But Obstfeld also pointed to the "genuine hazards" of openness to foreign financial flows and concluded that "this duality of benefits and risks is inescapable in the real world."

This indeed turns out to be the case. The link between financial openness and economic growth is complex. Some capital inflows, such as foreign direct investment—which may include a transfer of technology or human capital—do seem to boost long-term growth. But the impact of other flows—such as portfolio investment and banking and especially hot, or speculative, debt inflows—seem neither to boost growth nor allow the country to better share risks with its trading partners (Dell'Ariccia and others, 2008; Ostry, Prati, and Spilimbergo, 2009). This suggests that the growth and risk-sharing benefits of capital flows depend on which type of flow is being considered; it may also depend on the nature of supporting institutions and policies.

Although growth benefits are uncertain, costs in terms of increased economic volatility and crisis frequency seem more evident. Since 1980, there have been about 150 episodes of surges in capital inflows in more than 50 emerging market economies; as shown in the left panel of Chart 2, about 20 percent of the time, these episodes end in a financial crisis, and many of these crises are associated with large output declines (Ghosh, Ostry, and Qureshi, 2016).

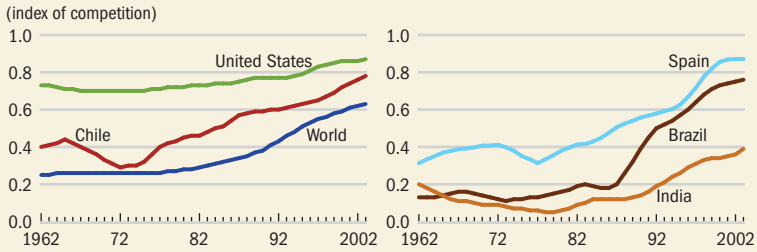
The pervasiveness of booms and busts gives credence to the claim by Harvard economist Dani Rodrik that these "are hardly a sideshow or a minor blemish in international capital flows; they are the main story." While there are many drivers, increased capital account openness consistently figures as a risk factor in these cycles. In addition to raising the odds of a crash, financial openness has distributional effects, appreciably raising inequality (see Furceri and Loungani, 2015, for a discussion of the channels through which this operates). Moreover, the effects of openness on inequality are much higher when a crash ensues (Chart 2, right panel).

The mounting evidence on the high cost-to-benefit ratio of capital account openness, particularly with respect to short-term flows, led the IMF's former First Deputy Managing Director, Stanley Fischer, now the vice chair of the U.S. Federal Reserve Board, to exclaim recently: "What useful purpose is served by short-term international capital flows?" Among policymakers today, there is increased acceptance of controls to limit short-term debt flows that are viewed as likely to lead to—or compound—a financial crisis. While not the only tool available—exchange rate and financial policies can also help—capital controls are a viable, and sometimes the only, option when the source of an unsustainable credit boom is direct borrowing from abroad (Ostry and others, 2012).

Chart 1

**Push to compete**

Since the 1980s countries have adopted policies to foster increased domestic competition through deregulation and opening their economies to foreign capital.



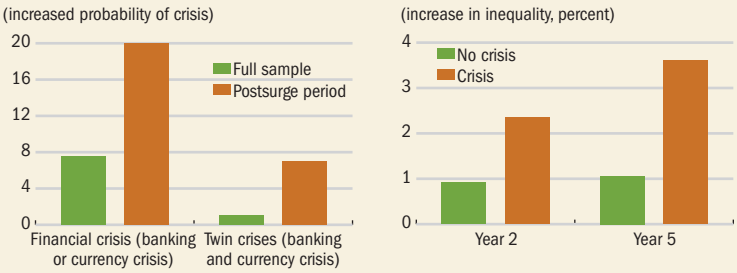

Source: Ostry, Prati, and Spilimbergo (2009).

Note: The chart shows the average values of a composite index of structural policies that countries adopted with the aim of increasing competition. The areas are openness of capital account; openness of current account; liberalization of agricultural and network industries; domestic financial liberalization; and reduction in the amount of taxes between wages and take-home pay. An index value of zero is total lack of competition and 1 is unfettered competition.

Chart 2

**Opening up to trouble**

Surges of foreign capital inflows increased the chance of a financial crisis, and such inflows worsen inequality in a crisis.




Sources: Ghosh, Ostry, and Qureshi (2016), left panel; Furceri and Loungani (2015), right panel.

Note: The left panel shows the increased probability of a crisis during a surge in capital inflows. It is based on 165 episodes of inflows in 53 emerging market economies between 1980 and 2014. The right panel compares the increase in the Gini measure of income inequality when capital account liberalization was followed by a crisis with periods when no crisis ensued. It is based on 224 episodes of capital account liberalization in 149 countries between 1970 and 2010.

## Size of the state

Curbing the size of the state is another aspect of the neoliberal agenda. Privatization of some government functions is one way to achieve this. Another is to constrain government spending through limits on the size of fiscal deficits and on the ability of governments to accumulate debt. The economic history of recent decades offers many examples of such curbs, such as the limit of 60 percent of GDP set for countries to join the euro area (one of the so-called Maastricht criteria).

Economic theory provides little guidance on the optimal public debt target. Some theories justify higher levels of debt (since taxation is distortionary) and others point to lower—or even negative—levels (since adverse shocks call for precautionary saving). In some of its fiscal policy advice, the IMF has been concerned mainly with the *pace* at which governments reduce deficits and debt levels following the buildup of debt in advanced economies induced by the global financial crisis: too slow would unnerve markets; too fast would derail recovery. But the IMF has also argued for paying down debt ratios in the medium term in a broad mix of advanced and emerging market countries, mainly as insurance against future shocks.

But is there really a defensible case for countries like Germany, the United Kingdom, or the United States to pay down the public debt? Two arguments are usually made in support of paying down the debt in countries with ample fiscal space—that is, in countries where there is little real prospect of a fiscal crisis. The first is that, although large adverse shocks such as the Great Depression of the 1930s or the global financial crisis of the past decade occur rarely, when they do, it is helpful to have used the quiet times to pay down the debt. The second argument rests on the notion that high debt is bad for growth—and, therefore, to lay a firm foundation for growth, paying down the debt is essential.

It is surely the case that many countries (such as those in southern Europe) have little choice but to engage in fiscal consolidation, because markets will not allow them to continue borrowing. But the need for consolidation in *some* countries does not mean *all* countries—at least in this case, caution about "one size fits all" seems completely warranted. Markets generally attach very low probabilities of a debt crisis to countries that have a strong record of being fiscally responsible (Mendoza and Ostry, 2007). Such a track record gives them latitude to decide not to raise taxes or cut productive spending when the debt level is high (Ostry and others, 2010; Ghosh and others, 2013). And for countries with a strong track record, the benefit of debt reduction, in terms of insurance against a future fiscal crisis, turns out to be remarkably small, even at very high levels of debt to GDP. For example, moving from a debt ratio of 120 percent of GDP to 100 percent of GDP over a few years buys the country very little in terms of reduced crisis risk (Baldacci and others, 2011).

But even if the insurance benefit is small, it may still be worth incurring if the cost is sufficiently low. It turns out, however, that the cost could be large—much larger than the benefit. The reason is that, to get to a lower debt level, taxes that distort economic behavior need to be raised temporarily or productive spending needs to be cut—or both. The costs of the tax increases or expenditure cuts required to bring down the debt may be much larger than the reduced crisis risk engendered by the lower debt (Ostry, Ghosh, and Espinoza, 2015). This is not to deny that high debt is bad for growth and welfare. It is. But the key point is that the welfare cost from the higher debt (the so-called burden of the debt) is one that has already been incurred and cannot be recovered; it is a sunk cost. Faced with a choice between living with the higher debt—allowing the debt ratio to decline organically through growth—or deliberately running budgetary surpluses to reduce the debt, governments with ample fiscal space will do better by living with the debt.

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Austerity policies not only generate substantial welfare costs due to supply-side channels, they also hurt demand—and thus worsen employment and unemployment. The notion that fiscal consolidations can be expansionary (that is, raise output and employment), in part by raising private sector confidence and investment, has been championed by, among others, Harvard economist Alberto Alesina in the academic world and by former European Central Bank President Jean-Claude Trichet in the policy arena. However, in practice, episodes of fiscal consolidation have been followed, on average, by drops rather than by expansions in output. On average, a consolidation of 1 percent of GDP increases the long-term unemployment rate by 0.6 percentage point and raises by 1.5 percent within five years the Gini measure of income inequality (Ball and others, 2013).

In sum, the benefits of some policies that are an important part of the neoliberal agenda appear to have been somewhat overplayed. In the case of financial openness, some capital flows, such as foreign direct investment, do appear to confer the benefits claimed for them. But for others, particularly short-term capital flows, the benefits to growth are difficult to reap, whereas the risks, in terms of greater volatility and increased risk of crisis, loom large.

In the case of fiscal consolidation, the short-run costs in terms of lower output and welfare and higher unemployment have been underplayed, and the desirability for countries with ample fiscal space of simply living with high debt and allowing debt ratios to decline organically through growth is underappreciated.

## An adverse loop

Moreover, since both openness and austerity are associated with increasing income inequality, this distributional effect sets up an adverse feedback loop. The increase in

inequality engendered by financial openness and austerity might itself undercut growth, the very thing that the neoliberal agenda is intent on boosting. There is now strong evidence that inequality can significantly lower both the level and the durability of growth (Ostry, Berg, and Tsangarides, 2014).

The evidence of the economic damage from inequality suggests that policymakers should be more open to redistribution than they are. Of course, apart from redistribution, policies could be designed to mitigate some of the impacts in advance—for instance, through increased spending on education and training, which expands equality of opportunity (so-called predistribution policies). And fiscal consolidation strategies—when they are needed—could be designed to minimize the adverse impact on low-income groups. But in some cases, the untoward distributional consequences will have to be remedied after they occur by using taxes and government spending to redistribute income. Fortunately, the fear that such policies will themselves necessarily hurt growth is unfounded (Ostry, 2014).

## Finding the balance

These findings suggest a need for a more nuanced view of what the neoliberal agenda is likely to be able to achieve. The IMF, which oversees the international monetary system, has been at the forefront of this reconsideration.

For example, its former chief economist, Olivier Blanchard, said in 2010 that "what is needed in many advanced economies is a credible medium-term fiscal consolidation, not a fiscal noose today." Three years later, IMF Managing Director Christine Lagarde said the institution believed that the U.S. Congress was right to raise the country's debt ceiling "because the point is not to contract the economy by slashing spending brutally now as recovery is picking up." And in 2015 the IMF advised that countries in the euro area "with fiscal space should use it to support investment."

On capital account liberalization, the IMF's view has also changed—from one that considered capital controls as almost always counterproductive to greater acceptance of controls to deal with the volatility of capital flows. The IMF also recognizes that full capital flow liberalization is not always an appropriate end-goal, and that further liberalization is more beneficial and less risky if countries have reached certain thresholds of financial and institutional development.

Chile's pioneering experience with neoliberalism received high praise from Nobel laureate Friedman, but many economists have now come around to the more nuanced view expressed by Columbia University professor Joseph Stiglitz (himself a Nobel laureate) that Chile "is an example of a success of combining markets with appropriate regulation" (2002). Stiglitz noted that in the early years of its move to neoliberalism, Chile imposed "controls on the inflows of capital, so they wouldn't be inundated," as, for example, the first Asian-crisis country, Thailand, was a decade and a half later. Chile's experience (the country now eschews capital controls), and that of other countries, suggests that no fixed agenda delivers good outcomes for all countries for all times. Policymakers, and institutions like the IMF that advise them, must be guided not by faith, but by evidence of what has worked. ■

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