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CONTENTS

2

KEYNESIANISM, NEOCLASSICISM, AND THE STATE

Geoff Bertram

A sea-change struck New Zealand macroeconomic policy in 1984. The defeat of the Muldoon Government, and the appointment of Roger Douglas to be the new Minister of Finance, ushered in an era of sweeping deregulation and faith in market forces to solve the problems of the New Zealand economy. The detailed changes introduced under Rogernomics have been widely documented and discussed elsewhere (Bollard and Buckle, 1987; Bollard and Savage, 1990; Collins, 1987; Douglas and Callen, 1987; Easton, 1989a; Walker, 1989), and it is not the aim of this chapter to provide such a discussion. The intention is rather to relate the macroeconomic debates of the past decade in New Zealand to the longer-term evolution of economics as a body of thinking and prescription about the role of the State in the management of a capitalist market economy.

Some Aspects of the History of Economic Thought

Modern economics as a distinctive subject emerged about the time of the British Industrial Revolution (the second half of the eighteenth century), from the clash of two competing philosophical currents. One of these currents, originating with the Ancient Greek writers Aristotle and Plato, argued that the pursuit of the good life was possible only within structured communities, which consciously pursued the collective well-being of their citizens. The role of the State in such communities was essentially positive, as an embodiment of the general public interest, with a duty to advance the common good. The problem for political philosophy was to ensure that State power was wielded properly by virtuous individuals. The aim of economic and other social analysis was to guide the rulers towards those actions of the State that best served collective welfare.

The second intellectual current was the moral philosophy of the Enlightenment, a form of radical individualism which viewed the State in all its forms as the natural enemy of liberty, and sought to restrict its power wherever possible both by constitutional restrictions and by lobbying for deregulation. The slogan '*laissez faire, laissez passer*', originally coined by

the French Physiocratic school of the 1750s, provided the rallying cry for several generations of British economists following in the footsteps of two moral philosophers of the Scottish Enlightenment, David Hume and Adam Smith.

By the eighteenth century the community-oriented approach to government and economic policy had developed into the body of doctrines commonly described as mercantilism. In mercantilist thinking the relevant community was the nation, and the task of government was to maximize the power and wealth of the nation—both by mobilizing all available productive resources domestically and by protecting strategic economic activities from foreign competition. The mercantilist pursuit of full employment and export-led growth in a hostile international environment led to a regime of regulations, subsidies, and legal monopolies (epitomized by the East India Company). Whether the hothouse development of early capitalism in the emerging nation States of northern Europe would have occurred more rapidly under free trade than it did under mercantilism is a question of more than mere historical interest, but not one to which a clear answer can be given. (Comparison of the post-war economic performance of mercantilist Singapore versus free-trade Hong Kong at least demonstrates that neither policy regime is necessarily fatal to capitalist growth! See *The Economist* 22 August 1992, p. 18, and for a wider-ranging discussion of this issue in the East Asian context, Wade, 1990.)

Adam Smith's frontal assault on mercantilism in Book IV of his *Wealth of Nations* (1776) suggested that it was in the nature of State institutions to become the tools of vested interests against the common good, and that the best solution was to limit the powers of the State to essential public functions such as defence and justice. In making this case, Smith laid down most of the standard themes of the modern Public Choice school of economics (Brennan and Buchanan, 1985; Buchanan et al., 1980; Ekelund and Tollison, 1981). But Smith's individualism was never as extreme as that of the modern New Right. He retained the Greek notion that individuals could exist only within society, he insisted on the pursuit of broadly defined social justice (not simply law and order), and he identified a wide range of particular cases where government intervention would be desirable to promote the development of an 'improved and civilized society' even under a market economy—including public works, public education, limited measures of trade protection in cases of market failure, and the raising of revenue by proportional income taxes (Oser and Brue, 1988, pp. 63–72).

Greek communitarianism and Enlightenment individualism do not mix easily. In the modern mixed economy or Welfare State they form an unstable compound, which lacks secure roots in either philosophical tradition, and is perennially threatened by the tension between them. The ideological splits which have divided economists in the two centuries since Smith are due directly to the subject's origins as a branch of moral philosophy, with room for radical differences of opinion on the priority to be given to the interests of the individual as against those of the community, and hence on the appropriate role of the State in a capitalist economy. It is not surprising that individualists, with their deep-rooted distrust of government in general, have always been drawn to economic theories and models which propose that free markets deliver the best results; while those who see the State as an instrument of the common good have been sympathetic to economic models which assign a positive role to managed markets.

But this affinity between economic models and ideological beliefs should not be overstated. The neoclassical or marginalist economics which emerged in the 1870s provided powerful analytical tools for investigating the working of the price mechanism, and thus played a key role in defending market capitalism against the challenge posed by Marxism and other socialist traditions; but those same tools could be used also to buttress the case for interfering with the free play of the market (see S. Clarke, 1982, chapter 6). In the hands of Alfred Marshall and A. C. Pigou between 1890 and 1920, the utilitarian ideas that underlay neoclassical economics were turned into a powerful case for redistributing income from rich to poor as a means of raising aggregate welfare; while in the hands of Piero Sraffa, Joan Robinson and Edward Chamberlin in the 1920s and 1930s the neoclassical theory of the firm turned out to provide a powerful critique of monopoly and a case for regulation and even nationalization of certain types of economic activity. Not all neoclassical economics, in other words, is hostile to government intervention in the economy. Quite the contrary; the search for market failures, and the design of policies to deal with them, have always been major parts of the mainstream neoclassical research programme.

The importance of this is evident when one of the great turning points in twentieth-century macroeconomics is considered, the so-called 'Keynesian Revolution' triggered by the publication in 1936 of Keynes's major book, *The General Theory of Employment, Interest and Money.* Within a decade of the appearance of this book a 'synthesis' of neoclassical and Keynesian economics had become the dominant position of the mainstream economics profession, and in the 1950s and 1960s this synthesis was as dominant in economic policy-making as it was in the textbooks. The new consensus formed so easily and so rapidly because of a widespread acceptance that Keynes had been successful both in identifying areas of market failure in capitalist monetary economies, and in prescribing policies that could remedy these failures without overturning the market system itself. Keynesian economic management, as understood in the 1950s and 1960s, involved the deliberate manipulation of fiscal and monetary policy to keep output and employment at high levels, together with a general presumption (derived from Keynes's pre-1936 writings) in favour of low interest rates, and of exchange rates which were consistent with balance-of-payments equilibrium at full employment.

Smithin (1990, p. 9) acutely identifies the factors which determine acceptance and rejection of macroeconomic theories by the mainstream of economists:

> The relative lack of success of econometric testing in discriminating between alternative theories . . . does not mean that there is no relationship between economic theory and the facts. What seems to have been decisive in practice, both in the 1980s and in earlier episodes, is whether or not the theory corresponds with some very crude large-scale empirical generalizations . . . which are widely accepted. The case in which a theory cannot explain some widely accepted empirical generalization corresponds to L. Laudan's notion of an 'empirical problem'. . . . An obvious example of an empirical problem for an economic theory was the impact of the mass unemployment of the 1930s on the status of the macroeconomics of the classical school.

For a generation after the Great Depression, neoclassical macroeconomics was considered discredited almost entirely on the basis of its failure to predict, and then its failure to offer remedies for, the Depression's clearly visible impact on output and employment across most of the then developed world. Keynesian economics, during the same period, enjoyed high prestige mainly because of its claim to have provided an explanation for the Great Depression in terms of a failure of effective demand—that is, in terms which rejected the classical proposition known as Say's Law.

According to Say's Law as generally understood, the economy's output and employment were determined entirely by supply conditions (that is, by the utilization of all productive resources in the most profitable activities). Demand for this output would automatically be forthcoming so long as prices were free to adjust. In contrast, the consensus Keynesianism of the post-war era held that the economy's price level was not free to adjust without restriction because of the institutional realities of modern capitalism, so that an essential condition for Say's Law to work was missing, leaving the way open for State intervention to correct for the market failure of 'sticky' prices and wages. The Great Depression was attributed to a fall in aggregate effective demand followed by a downward spiral (the multiplier effect) to an equilibrium state of low output and high unemployment. Recovery from the Depression was attributed to fresh injections of effective demand from government, private investment, and (in trade-dependent economies such as that of New Zealand) rising export sales.

By crediting government with the ability to influence aggregate output and employment—directly by means of changes in expenditure and taxation, and indirectly via exchange rates and interest rates—the Keynesian synthesis gave governments the responsibility for maintaining prosperity and full employment in western economies, together with a blueprint for short-term macroeconomic management. The attractions of this package remained compelling so long as the post-war prosperity and low unemployment continued. But the allegiance of economists and policy-makers to the new synthesis was as fragile as their pre-1930 adherence to neoclassical economic ideas, and disintegrated with equal speed once a gap seemed to open up between 'crude empirical generalizations' and Keynesian economics as understood by the mass of its adherents and practitioners.

This fragility of the Keynesian ascendancy, in the face of the stagflation and oil shocks of the 1970s, is an important clue to the recent revival of neoclassical doctrines which had been regarded as extinct for half a century. Macroeconomic theories are tested, in practice, by means of policy experiments carried out on real-world societies. Whichever school of thought is currently dominant finds its propositions embodied directly into government policies, and thus into attempts to change the state of the world. Politics being what it is, this translation of theory into practice generally overlooks the qualifications and small print of the theory. Macroeconomic models stand or fall, in the public domain, on the robustness of their broad generalizations, and on the perceived success or failure of government policies based on them.

Equally, the public prestige of any body of economic doctrines is heavily influenced by the number of major vested interests that it can attract as allies and adherents. In the wake of the Great Depression and the two World Wars, large sections of both the business community and organized labour in the developed capitalist world saw advantages in the Keynesian model of a managed mixed economy with a strong State sector. By the 1970s important defections from this coalition were evident, especially financiers and large industrial firms eager to take their chance in a less regulated market environment. Thatcher and Reagan were both able to build electoral success on their rejection of the Keynesian model, and were able to rationalize that rejection in terms of the new classical theories.

But intellectual ascendancy achieved by this essentially political route needs always to be distinguished from the ascendancy of a scientifically superior theory over its competitors, as in the traditional fable of scientific progress. In strictly scientific terms, the choice between Keynesian and neoclassical paradigms remains as open now as it was fifty (and indeed 150) years ago, and a renewed Keynesian political ascendancy remains a strong

probability as disillusionment mounts with the policies derived from new classical advice, and as a new generation of economists see the opportunity to build their careers on the rehabilitation of old doctrines.

Of course neither Keynesian nor neoclassical economics is as monolithic or coherent a body of thought as simple stories such as the above might suggest. In terms of the theoretical and scientific process within economics, vigorous debates have always occurred within both traditions and there is a continual contest to define the 'true' or essential message of each. Continual reinterpretations of 'what Keynes really meant' were coming from diverse points of view even during the high era of Keynesianism (Clower, 1965; Hicks, 1974; Leijonhufvud, 1968; Malinvaud, 1977; Robinson, 1973; Shackle, 1974). Similarly, the intellectual coherence of the New Right can easily be over-estimated. There are major differences among the various strands of monetarist and new classical economics, and contests among them have at times been heated (see, for example, Roberts (1984) on the struggle among monetarists, supply-siders, and new classicals for influence in the Reagan administration).

Four Macroeconomic Litmus Tests

In terms of macroeconomic inquiry within economics over the past two centuries, four central issues lie at the core of the debates. These are:

- the strength, speed and nature of the self-adjusting properties of a market economy;
- whether inflation is caused solely by monetary expansion, and hence whether it can be sustainably cured by monetary discipline;
- whether unemployment is the result of aggregate demand failure or is attributable to labour-market rigidities;
- whether exchange rates should be fixed by governments, or determined by market forces.

Generally speaking one can identify two ideal-type positions which can be labelled, not altogether unfairly, neoclassical and Keynesian, while recognizing that all sorts of permutations and combinations occur in the literature.

The neoclassical position stresses the self-adjusting properties of the market and tends to a particular view of macroeconomic adjustment, according to which the quantity of output is determined on the supply side, and the price level on the demand side. Bohm-Bawerk, a leading neoclassical economist of the Austrian School, summarized this view as follows in 1902:

> [The claim] that a curtailment of consumption for immediate enjoyment must involve also a curtailment of production, is erroneous. The truth is that a

curtailment of consumption involves, not a curtailment of production generally, but only, through the action of the law of supply and demand, a curtailment in certain branches. . . . There will not, however, be a smaller production of goods generally, because the lessened output of goods ready for immediate consumption may and will be offset by an increased production of 'intermediate' or capital goods. . . . Through saving not a single particle of the demand for goods is extinguished outright . . . as J. B. Say showed in a masterly way more than one hundred years ago (cited in Oser and Brue, 1988, p. 247).

The Keynesian view, in contrast, stresses the relative slowness of market adjustment, the social stress and dislocation that may accompany adjustment, and argues that disturbances on the demand side of the macroeconomy have an impact on output as well as on the price level. In espousing this view in 1936 Keynes was following the lead of his teacher at Cambridge, Alfred Marshall. Marshall in 1890 had attacked the neoclassical pioneers Jevons, Walras and Menger for their microeconomic models of markets with fixed supply rationed by variable price, and had proposed that market adjustment takes place by individual firms varying their output quantities until supply and demand were equalized – a theory drawn in turn from Adam Smith's *Wealth of Nations* (Marshall, 1936, pp. 342–50 and 817–21.) Transferring this critique of the neoclassicals from microeconomics to macroeconomics took over forty years, and was finally triggered only by the massive fall in Britain's aggregate output during the Great Depression—a fall too great, it seemed, to be credibly accounted for by changes on the supply side of the economy. (New classical economists are now, incidentally, endeavouring to reinterpret the Great Depression in terms of supply-side changes).

In the interim, from the 1880s to the end of the 1920s, the image of the macroeconomy held by neoclassical economists was that of the general equilibrium model of Walras, in which a given stock of commodities was traded at relative prices which ensure that all markets cleared simultaneously. According to Walras 'equilibrium is the normal state, in the sense that it is the state towards which things spontaneously tend under a regime of free competition in exchange and competition' (cited by G. Whitwell, 1986, p. 27). Breaking free from the pervasive influence of this model was an important part of the 'long struggle of escape . . . from habitual modes of thought and expression' which Keynes himself had to undergo in writing his *General Theory* (Keynes, 1973, p. xxiii). He considered that 'the system is not self-adjusting', and, indeed, 'seems capable of remaining in a chronic condition of subnormal acitivity [characterized by high unemployment] for a considerable period without any marked tendency towards either complete recovery or towards complete collapse' (cited by

G. Whitwell, 1986, p. 39) The 'principle of effective demand' which Keynes then developed opened up the theoretical prospect that demand-management policies could directly influence national output and thus real income, with or without some accompanying impact on the economy's price level. It also, of course, involved rejection of Say's Law of markets, at least in the short run.

On the question of inflation, the neoclassical tendency is to adopt some version of the old-established quantity theory of money which argues that the price level is determined by the size of the money supply, and inflation by its rate of growth. Inflation is therefore to be fought with monetary policy. Keynesian economics (though not so much Keynes himself) became identified with an eclectic theory of inflation which suggested that inflation could arise from cost pressures (that is, from the supply side rather than just the demand side of the economy) and might therefore be met by policies of cost containment such as incomes policies and exchange-rate policy. Because of the Keynesian view that reductions in aggregate demand could reduce output and employment, monetary disinflation always seemed to Keynesians to carry the risk of inducing a recession. The ideal-type neoclassical perspective with its emphasis on a constant, 'natural' level of output and employment, suggested that, on the contrary, monetary disinflation could be achieved without loss of output.

On unemployment, neoclassical economists focused on the supply side of the labour market—the willingness of workers to work at a market-clearing wage—and explained unemployment as a condition entered into voluntarily by workers holding out for wages above what the market would bear. Unemployment was therefore to be fought by exposing individual workers to more competitive pressures, and by freeing-up labour-market institutions to enable workers to search for jobs, and assess market conditions, more rapidly. Keynesians, in contrast, attributed mass unemployment to a lack of demand for labour, denied that wage reductions in a free market would eliminate unemployment, and treated aggregate employment as a direct function of total output, so that policies which reduced output would reduce employment at the same time.

On exchange rates, the neoclassical position is less clearcut. In the nineteenth century the gold standard system rested upon the notion of a market-determined exchange rate tightly constrained by the obligation to exchange national currencies for gold on demand. Modern neoclassicals tend to favour floating exchange rates in the hope that they will permit each country to pursue its own monetary policy (and thus be able to reduce its own inflation regardless of what other countries are doing). Keynes, on the other hand, was associated with the design of the Bretton Woods system of fixed exchange rates and the accompanying notion that fiscal, monetary and incomes policies should be so conducted as to keep each country's balance of payments healthy at the fixed rate. Since the demise of Bretton Woods in the early 1970s, it is probably fair to say that the Keynesian position has been sceptical of the virtues of floating rates, and inclined to favour some management of exchange rates.

The 1970s New Classical Revival

By 1970, the generation of economists with personal experience of the Great Depression was being replaced by a younger generation with experience only of the post-war prosperity; and the empirical generalizations against which macroeconomic theories tend to be judged had changed away from the 1930s problem of unemployment towards the 1970s issue of inflation. This was an area in which neoclassical macroeconomics had always claimed a special advantage in the form of the so-called quantity theory of money—the belief that (in Milton Friedman's words) 'inflation is always and everywhere a monetary phenomenon' which can be cured by monetary policy (Friedman and Friedman, 1980, p. 254). In the USA, where the main debate took place, the crucial factor in the switch of allegiance from Keynesian to neoclassical economics was the apparent failure of one of the 'crude large-scale generalizations' which had underpinned the Keynesian ascendancy. This was the Phillips curve which predicted that inflation would rise as the economy moved towards full employment, and fall as unemployment increased (see Chapter 4). By the early 1970s unemployment and inflation were rising together, to the consternation of governments throughout the OECD. Friedman offered a theory which explained the disappearance of the Phillips curve by suggesting that, over time, people simply adjusted to live with any level of inflation that prevailed, so that unemployment could not be held down permanently below its so called natural level simply by expansionary demand management. The only durable solution to inflation, Friedman argued, was to restrict the growth of the money supply.

The neoclassical macroeconomic revival came in two clearly recognizable stages, often described as 'Monetarism I' and 'Monetarism II' (cf. D. Smith, 1987). Monetarism I was associated particularly with Friedman, and placed heavy emphasis on (a) the importance of stable monetary policy to control inflation and (b) the alleged evils of government macroeconomic management. Friedman challenged the usual Keynesian explanation for the Great Depression by attributing it to a failure of government policy, rather than a failure of effective demand under free market conditions. In his story, the Great Depression had been the result of an inappropriate tightening of monetary policy by the US Federal Reserve system, and the lesson to be drawn was that giving government agencies the power to manipulate monetary and fiscal policy was a recipe for making the economy perform worse, not better, than it would have done under a free market. This line of argument did not claim that the free market did a perfect job of always maintaining full employment and stable prices; it simply said that active government intervention would make matters worse rather than better, so that there was no practical way of avoiding the ups and downs of the capitalist business cycle. Government, then, should limit itself strictly to keeping the money supply growing at a steady non-inflationary rate, and should not try to use fiscal or monetary policy to 'fine-tune' the economy. This Friedman critique of economic fine-tuning became very influential in New Zealand thinking at the end of the 1970s and contributed strongly to the ascendant Treasury and Reserve Bank ideas of 1984.

Monetarism II, the new classical macroeconomics of Lucas, Sargent, Wallace and their associates, moved quickly in to exploit the breach opened by Friedman in the mainstream Keynesian position. Whereas Friedman had attempted to build a theory that could at least explain the Great Depression, the new classical models initially preferred to ignore it altogether and to return instead to the pre-Keynesian idea of a market economy which naturally tended always to operate at full employment so long as prices were free to move. Whereas Friedman had emphasized the importance of monetary forces in driving the business cycle, the new classicals thought in terms of a world in which money was 'neutral' in the sense that changes in the quantity of money could change prices but not quantities (that is, money was linked to inflation, but had nothing to do with output or unemployment). When new classical economists were eventually obliged to provide some explanation for the Great Depression, their natural inclination was to seek an explanation in terms of changes in the 'natural' or 'full employment' level of output for the economy, caused for example by changes in technology or in workers' wage demands, and to deny that government policy could have much effect, either for good or ill, except insofar as it might generate price inflation.

Both versions of the neoclassical revival offered policy-makers a standard answer to the pressing issue of what should be done to control inflation, which in the early 1970s had suddenly become a major issue. That answer was to rely on tight monetary policy to do the job.

To Keynesians who argued that tight monetary policy could cure inflation only at the expense of a prolonged and deep recession, various strands of new classical theory offered a three-pronged response which was persuasive to many governments. First, following Friedman's lead, some theorists argued that unemployment and recession were only temporary costs to be borne on the way to a long-term cure for inflation, since output and employment would in the long run move back automatically to their 'natural' levels, with inflation tamed. Second, they argued that these transitional costs of disinflation could be reduced by freeing-up the main markets in the economy—especially the labour market, where worker resistance to wage cuts was identified as the real culprit so far as unemployment was concerned. Third, the more strong-minded new classicals suggested to politicians that the tendency of the economy to maintain its natural output level was so powerful, and the neutrality of money so complete, that inflation could be defeated by tight monetary policy without significant transitional costs—an approach to macroeconomics that harks back to the work of David Ricardo in his debates with Thomas Malthus (a classical precursor of Keynesianism) in the period 1810–1820.

The new classical package was simple, clearcut, and very attractive to beleaguered politicians. It placed the blame for inflation squarely on loose monetary policy, which meant that the hard work and endless negotiations required to operate an incomes policy (one of the standard Keynesian prescriptions to curb inflation) could be done away with and replaced by a simple instruction to the central bank to control monetary growth. This in turn meant that the need for government to maintain close contact with organized labour was reduced; instead, labour could be dealt with at arm's length by means of impersonal, albeit brutal, 'market forces'. Furthermore, the new classical approach placed the blame for unemployment squarely on workers (for pricing themselves out of jobs) rather than on insufficient aggregate demand (the Keynesian view, which had made unemployment seem the responsibility of government). Finally, the new classical approach suggested that government intervention on the demand side was powerless to correct any failings of the market system other than inflation.

In a nutshell, the new classical policy package gave politicians the chance to abdicate, with a clear conscience, many of the responsibilities which the State had assumed in the preceding decades.

A wider New Right agenda was promoted internationally in the late 1970s, on the back of the rising prestige of monetarist macroeconomics. The new conservatism held out the prospect of a new age of growth and prosperity if only the accumulated mass of regulations and controls were stripped away—including the Welfare State systems which were giving governments serious budgetary headaches by the 1970s. Governments were advised to step back from the attempt to secure the great aims of the post-war era: full employment, growth, and collective responsibility for social welfare. Under the new policy prescription, governments' responsibilities were to be pruned back to a minimalist conservative prescription of securing price stability by means of monetary policy, and balancing a reduced government budget. Politicians in many countries seized eagerly upon the alibi thus offered for their failure to meet the economic expectations of their electorates.

A key step in the argument was the monetarist/new classical prognosis that an anti-inflation programme would cause unemployment to rise only temporarily, and only to the extent that workers were so misguided as to hold to unrealistic wage expectations. OECD governments adopting monetarist proposals at the end of the 1970s were given no reason to believe that they were thereby embarking on a decade of mass unemployment; and as the reality unfolded, they were assured that a frontal assault on organized labour should suffice to remove the obstacles to re-establishing full employment. It has been the long persistence of mass unemployment in Europe since 1980 that has, as in the 1930s, done most to discredit the neoclassical prescriptions. In the USA, as many commentators have pointed out, Reagan's willingness to run very large budget deficits resulted in the mid-1980s in an economic recovery led by fiscal policy, in accordance with the fiscal policy theorems of the mainstream Keynesian economics of the 1960s. The long-term consequences of this deficit-financed upturn are yet to be revealed.

The Turning of the New Zealand Tide: 1975–1985

The 1984 election marked a dramatic switch in policy regime, from Muldoon's interventionism and corporatism to Roger Douglas's anti-statist and anti-corporatist crusade. With the election of the fourth Labour Government, the floodgates were opened to the ascendancy in Wellington policy-making of a new generation of officials and lobbyists committed to various aspects of the New Right programme, but largely free of party-political loyalties and unconcerned with the manifesto commitments and political principles which had won Labour the election. The policy revolution of 1984 was, however, quite predictable in terms of the policy debates which had been under way within the New Zealand economics profession over the preceding decade, as well as the old-established tendency for New Zealand governments to follow the lead of the UK. Some aspects of those debates are discussed in this section.

Two of the first major blows against the old New Zealand policy consensus were struck by the New Zealand Planning Council (then headed by Sir Frank Holmes) in a pair of reports which were strongly (if obliquely) critical of the policy stance of the Muldoon Government in the second half of the 1970s. The first report, *The Welfare State? Social Policy in the 1980's* (New Zealand Planning Council, 1979), introduced the idea of public sector overload to New Zealand, and thereby laid the groundwork for what became in the 1980s a sustained campaign to reduce the ratio of total government expenditure to GDP. The second report, *The Stabilisation Role of Fiscal Policy* (Deane and Smith, 1980) strongly made the case against the use of fiscal policy to fine-tune the New Zealand economy and to counteract cyclical booms and slumps.

The case against activist fiscal policy put forward by Deane and Smith rested mainly upon the record of fiscal management during the difficult years of the 1970s. They pointed out that in a small open economy, economic cycles were driven mainly by external events, and the New Zealand data suggested that 'for much of the past two decades government expenditure has tended to be pro-cyclical in the sense that it has generally moved in sympathy with changes in economic activity as a whole' (1980, p. 7). Thus the government budget had generally moved with the cycle, not against it as a simple Keynesian prescription for fine-tuning might have prescribed. To explain this they appealed to the various lags involved in formulating and implementing fiscal adjustments, to which of course had to be added the lags in the economy's response to fiscal changes (p. 3).

Where fiscal changes had been made with counter-cyclical intentions, Deane and Smith suggested that the effects had done more harm than good. The attempt by the third Labour Government to sustain economic activity in the face of the 1973 oil shock, they argued, had delayed necessary adjustment to new economic realities (pp. 4–6), while the abrupt post-election clamp-down by Muldoon in 1976 had thrown the economy into an unnecessarily sharp recession. Fiscal policy in the 1970s, they concluded,

> helped induce considerable uncertainty about the likely path of economic activity; at least initially seriously delayed adjustment to the overseas deficit; probably encouraged rather than dampened inflation; and perhaps diverted attention from the pursuit of a more gradual, phased adjustment to New Zealand's external difficulties based on a well-balanced package of measures designed to achieve a reasonably clearly defined set of objectives over the medium term (p. 17).

Their solution was to abandon the use of fiscal policy to pursue short-run adjustment, and move to

> a medium term view of New Zealand's problems, over say three to five years, accept the facts of life as dictated by the external constraint, and design an integrated array of policies designed to move us gradually but steadily towards the set of objectives which we wish to achieve (p. 17).

Multiplier analysis using the Reserve Bank's model of the New Zealand

economy was cited as suggesting that the full multiplier effects of a fiscal expansion took about three years to materialize, so that the lag in responding to such a stimulus would be likely to 'span . . . more than one cyclical period' (p. 9). Furthermore, the model runs seemed to show that a fiscal expansion financed by tax increases would be expansionary only in its initial effects, and contractionary in the longer run. More seriously, the multiplier analysis emphasized that the (damaging) multiplier effect on the balance of payments from increased government spending was stronger than the (beneficial) effect on GNP.

The Deane–Smith study quickly became conventional wisdom among New Zealand policy commentators and directly contributed to the Muldoon Government's loss of credibility among key market participants, especially in the financial sector. Along with their case against fiscal fine-tuning and their focus on long-run structural adjustment went several companion themes which equally became staples of the Reserve Bank position of the early 1980s: the desirability of adopting in New Zealand the then-fashionable monetarist notion of steady growth rates of monetary aggregates as the key objective of monetary policy; the need for fiscal policy to be harmonized with the dictates of 'effective monetary policy'; the desirability of fully funding any government budget deficits by borrowing from the domestic private sector; and the need for Government to break wage indexation by a move to 'resisting wage increases based purely on an overgeneralised relativity concept and negotiat[ing] with its employees on a discretionary basis' (pp. 14–18).

Over the following three years the Reserve Bank produced an impressive series of research papers which circulated widely among the professional economists and were very influential in forming a mainstream consensus in favour of particular ideas about macroeconomic policy. The Bank was at this time the pre-eminent macroeconomic research agency in New Zealand, with a large computer model of the New Zealand economy and a team of mainly young economists led by Deane (then Deputy Governor of the Bank). Deane's ideas, based on his reading of the overseas literature combined with the Bank's empirical work on the New Zealand economy of the 1970s, carried considerable professional authority. In 1981 Deane reinforced his earlier attack on fiscal policy in New Zealand since 1973, repeating the empirical claim that policy had made the economy more unstable, not less, and clearly signalling the directions for future reforms to the macro policy framework:

> Given the reluctance of Governments in various periods to use interest rate policy actively to promote appropriate financing of fiscal deficits, the swings in the money supply have sometimes been severe. An adherence to a pegged

exchange rate has at times added to these difficulties, as has also the ready access of the Government and other quasi-Government agencies (including importantly the marketing organizations) to central bank finance (1981, p. 8).

Deane's three key prescriptions for change followed from this diagnosis. Effective macro policy, he claimed, required the ability to operate a monetary policy that was independent of both fiscal policy and the balance-of-payments deficit. This implied three things:

1 The Government would have to be prepared to finance fully its deficit before borrowing by non-bank domestic borrowing, i. e. the Government should not be able to borrow from the Reserve Bank;
2 The Reserve Bank should not lend to private sector customers, such as in the form of virtually open ended overdraft facilities for primary product marketing authorities; and
3 There should also be a market-determined exchange rate to ensure equilibrium between external receipts and payments (p. 13).

These boiled down to deregulated market interest rates, 'full funding' of fiscal deficits by borrowing from the private sector at commercial rates, and a flexible exchange rate which adjusted so as to prevent the balance of payments having any direct effect on monetary conditions. Adoption of these measures, Deane suggested, would amount to a shift from a Keynesian (short-run) to a monetarist (long-run) policy stance (p. 14) and he devoted long sections of the paper to discussion of Keynesian, Friedman-monetarist and new classical views (pp. 9–11 and 14–16).

The Reserve Bank's explicit comparison of the competing paradigms in overseas macroeconomics was carried through to their modelling work. The new 'Core' version of the RBNZ model produced at the beginning of the 1980s had alternative 'operating modes', described as Keynesian and new classical, which Bank staff used to compare the predicted effects of policies through the eyes of the two schools. The Keynesian model had output determined by aggregate demand, and prices set as a markup on costs. The new classical model had output determined at a supply-determined long-run level, and prices determined by import prices and changes in the New Zealand money supply (see Deane and White, 1982, p. 25). The feature of the new classical model which especially distinguished it was its prediction that the economy would automatically adjust back to its long-run equilibrium following a disruptive shock. Part of this self-righting tendency was the ability of the model economy to move its balance of payments back towards equilibrium over a period of three to five years, especially if a flexible exchange rate was assumed (pp. 25, 42–3).

The suggestion that the balance of payments (the most basic constraint on the performance of the New Zealand economy) might perform better under market adjustment than under active policy management recurs in the writing of Deane during this period. In Deane and White (1982) he argued the advantages of the so-called 'monetary approach to the balance of payments', suggesting that 'New Zealand has at times not only attempted to moderate the self-correcting nature of overseas deficits, but has on some occasions taken action directly contrary to the automatic adjustment mechanism' (p. 17). Strongly anti-inflationary monetary and fiscal policies, combined with exchange rate flexibility and respect for the self-adjusting properties of the economy, emerged as the preferred policy package, although Deane was careful to note difficulties and qualifications that would be obvious to professional economists (though possibly not to politicians suddenly enamoured of the pro-market message).

During 1983 opposing positions in the professional debate over economic adjustment became more clearly defined in the course of several more or less informal meetings in Wellington. The first of these was a full-day seminar organized in April by Victoria University, at which papers from members of the Economics Departments of Auckland and Victoria Universities were juxtaposed against critical commentaries from staff of Treasury and the Reserve Bank. The published proceedings of this meeting (Buckle, 1983) reveal academic economists of broadly new-Keynesian or structuralist persuasion set against Government officials with a generally monetarist or new classical approach. Buckle and Pope (two of the Victoria economists) argued that any programme to curb inflation in New Zealand had to start from two structural features of the economy: the foreign exchange constraint and the indexation of local wages and prices, which meant that New Zealand's inflation rate was simply imported from its trading partners. Moving towards exchange rate flexibility without addressing the structural issues, they claimed, was a recipe simply for accelerating domestic inflation as a by-product of devaluation—a process which they claimed had been occurring under the crawling-peg exchange rate system since 1979, and which would doom to failure any attempt to solve the balance of payments problems merely by a more flexible nominal exchange rate (Buckle, 1983, p. 47). Deane, in response, argued strongly from the monetary approach that devaluation was a substitute for tight monetary policy and had the same effect of lowering nominal expenditure, and thus strengthening the balance of payments (p. 63).

Two other Victoria economists, Wells and Bertram, advanced the argument that unemployment and output were constrained by aggregate demand rather than by too high a real wage, and that wage reductions would not succeed in raising employment unless they were accompanied by demand expansion. (The most credible argument for lower wages seemed to them to be the increase in export demand that might follow from increased competitiveness.) The commentary, by a Treasury official, emphasized the importance of real wage reductions in securing economic recovery, and foreshadowed institutional changes to the labour market to reduce or eliminate 'real wage resistance' (which meant, needless to say, resistance to wage cuts) (p. 132). Other academic papers came from Brosnan who argued for the feasibility of tripartite wage agreements as a basis for incomes policy, and criticized the Muldoon Government for failing to deal in good faith with worker and employer representatives and from Professor Bryan Philpott who argued for a full employment package of macroeconomic measures including a prices and incomes policy and exchange rate devaluation.

A second round of Wellington debates focused directly on the question of whether the central problem for the New Zealand economy was a shortage of foreign exchange or a low savings rate. Here the Victoria University economists (arguing for a lower real exchange rate, incomes policy, and structural changes to promote exports and import substitutes) were pitted against another academic grouping headed by Charles Perrings of Auckland University, in a series of discussions and exchanges of papers under the aegis of the Parliamentary Labour Party. An important underlying policy issue in these debates was the priority to be assigned to measures aimed to raise the rate of private savings—in particular, high interest rates and reduced personal income tax rates.

This essentially technical academic debate over constraint regimes shaded over into the third set of meetings—that of an informal think tank established by Roger Douglas in the middle of 1983, which met fairly regularly until late in that year before being disbanded. Known to participants as the 'Talavera Group' (because meetings were held at Suzanne Snively's home in Talavera Terrace) this forum brought together Victoria academics, two Treasury economists seconded to the Opposition and closely involved in the early design of what later became known as Rogernomics, and half a dozen economists working in policy-related roles in Wellington. The divide within the Labour Party between structuralist/corporatist 'wets' and new classical 'dries' was reproduced within this group, and no consensus position emerged from the debates, leading Douglas to withdraw. He was to comment later that 'as a large group we were not capable of reaching the same conclusions. What I did learn along the way was that a lot of academics have no flair for decision making. They qualified every statement and were not prepared to commit themselves to anything' (Douglas and Callen, 1987, p. 30). Several of the main elements in Douglas's November 1983 paper for the Labour Party Policy Council (ibid. pp. 30–5) were canvassed in advance with this group.

By the time of the defeat of the Muldoon Government in July 1984, a strong body of thinking had consolidated within Treasury and the Reserve Bank in favour of economic deregulation, exchange-rate flexibility, and a move to a monetary policy modelled on the Thatcher Government's medium-term financial strategy of the early 1980s. While much of the groundwork had been laid in the Reserve Bank's research effort of the preceding decade and a half, the emerging new policy élite also drew intellectual ammunition from the overseas writings of the new classical school which at that time was at the peak of its influence. Muldoon's insistence during 1983–84 on interest rate ceilings, the wage and price freeze, the 'think big' investment programme and maintenance of an obviously overvalued exchange rate put him directly at loggerheads with the thinking of key officials in these two government departments and had led to a virtual policy stalemate within Government well before the snap election was called in mid-1984. The fall of Muldoon provided a decisive opportunity for the new, pro-market, anti-Keynesian generation of officials to dislodge the remaining defenders of the older tradition of New Zealand policy-making, at the same time as the allies of Roger Douglas defeated the 'corporatist' wing within the Labour Party (see Oliver, 1987, 1989).

The ascendant new policy synthesis was set out publicly in the 1984 briefings presented to the incoming Labour Government by Treasury and the Reserve Bank (see Chapter 3). Under the heading 'Resistance to Adjustment', Treasury argued that government itself had been the major obstacle to adjusting the economy to the new realities of the world economy following the oil shocks. Government had unduly increased its spending on industry support:

> Incomes were maintained throughout the community at levels which were not appropriate given the large drop in our terms of trade. . . . We have protected subsectors of the economy at the expense of general welfare. To adjust faster we would have needed a steadier monetary policy, smaller government deficits and a freer exchange rate policy. These are fundamental, but they must be supplemented by action to overcome the sclerosis that has built up through the regulation of many markets of the economy. . . . ' (Treasury, 1984, p. 107).

Treasury called for more consistency and transparency in the design of macro policy, more use of market mechanisms, and abandonment of direct controls. A key paragraph rejected the view that inflation originated on the supply side of the economy (from wages and import costs) and pointed to 'the fundamental (monetary) source of inflationary pressure' (p. 115). Removal of interest rate controls was advocated because 'besides the disruption they bring to the vital functions of financial markets, they work directly against the primary intention of monetary policy which is price stability through the management of the money supply' (p. 115). The government deficit was described as 'excessive', and it was asserted that re-establishing monetary control would require 'a substantial programme of debt sales' (p. 115). Turning to exchange rate policy, Treasury urged a need for more flexibility and 'suggested that the Government should plan for a floating rate regime' (p. 116) with appropriate fiscal and monetary policy. In the labour market, Treasury prescribed lower real wages and increased flexibility (p. 118); in social policy, tighter targeting and less direct government provision of services (p. 119); and in the public sector, reform of State-owned enterprises along private-sector lines (p. 120).

The new policy regime was not universally acclaimed by New Zealand economists. Quite the contrary; there were sharp public disagreements during the first few months of the fourth Labour Government's term, culminating in a head-on clash at the Wellington meeting of the New Zealand Association of Economists in February 1985. The Treasury's major 1984 position paper was categorized as 'monetarist' in a critique by seven Victoria University economists which was debated at that meeting (see Nicholl, 1985; Treasury, 1985; Zanetti et al., 1984; Zanetti, 1985).

Monetarist doctrine, the Victoria group suggested, was recognizable by three distinguishing characteristics (Zanetti, 1985, p. 123). First, monetarists regarded unemployment as a microeconomic problem, not a macroeconomic one, so that aggregate demand management was rejected as a means of reducing unemployment, and policy was focused on pushing through real wage cuts and labour market restructuring. This left inflation as the central problem for macroeconomic policy. Second, monetarists favoured a floating exchange rate, in the name of monetary independence. Third, monetary policy was identified with the attempt to control the stock of money, rather than to control the level of interest rates. All three of these propositions matched the line taken in the concrete proposals of Treasury and the Reserve Bank in their briefing papers (and equally were consistent with the policy stance actually adopted by Roger Douglas as Minister of Finance).

On this basis the Victoria economists categorized official thinking as monetarist and raised in response many of the standard theoretical and practical arguments against monetarism of this sort. The attempt to halt inflation simply by controlling the quantity of money, they stated, ignored the complex real-world causes of inflation and carried the risk of inducing a severe economic recession with high interest rates (Zanetti et al., 1984, pp. 17–18). The monetary approach to the balance of payments (which blames balance of payments deficits on loose monetary policy) provided no theoretical case for floating the exchange rate, and overseas experience during the 1970s showed

that floating had not solved balance of payments problems (pp. 18–20). A floating exchange rate under New Zealand conditions would be likely to become a source of inflation if the rate depreciated (p. 21) yet if tight monetary policy had to be used to hold the exchange rate up, this would eliminate the original hope of running an independent monetary policy (p. 19).

Treasury's macroeconomics was strongly attacked as naïvely neoclassical in its assumptions, treating all unemployment as voluntary and all inflation and balance of payments difficulties as monetary issues caused simply by excessive fiscal deficits. Tackling complex structural problems by a simplistic drive to reduce the fiscal deficit, the critics argued, implied an austerity programme that might well fail to deliver the goods. In addition, the 'sequencing' of changes through time had been completely ignored by Treasury, and institutions which had evolved as vital functioning parts of the New Zealand economy (especially in the labour market) were being treated simply as obstacles to be cleared away in the pursuit of a free market goal (pp. 21–5). Overall, the critics concluded, Treasury had fallen into the trap of treating the real world as though it matched exactly the pure theoretical neoclassical model, and had therefore failed to warn the incoming government of the real-world consequences of the policies being recommended. The Reserve Bank, it was noted, because of its substantial research record and experience of real-world financial markets, had been far less extreme than Treasury in its advocacy although 'one can see a monetarist trying to get out' (p. 28).

At the heart of the Victoria critique of the Treasury package was the belief that the pursuit of economic adjustment along monetarist/new classical lines would bring heavy costs in terms of unemployment, lost output, and reduced public services, without delivering the promised revival of economic growth or a sustained solution to the deficits on the government budget and balance of payments. A number of the technical issues raised received support from a later Reserve Bank-based retrospective assessment of policy between 1984 and 1990 (Margaritis et al., 1991).

The 1984–85 'opening-of-the-books' debate was followed up by three further Victoria-based academic attacks on key planks of Rogernomics. In the lead-up to the float of the exchange rate in March 1985 Buckle and Pope drew attention to the risk that tight monetary policy aimed to stop inflation would drive a floating exchange rate above its appropriate level, severely squeezing the profitability of traded-goods producers, and they proposed the need for some 'anchor' to keep the exchange rate within acceptable limits (Buckle and Pope, 1985). In 1986 Professor Bryan Philpott presented to the Association of Economists a paper based on the Victoria University computer models of the New Zealand economy, predicting slow growth and high unemployment as the likely consequences of government policies then being pursued by Roger Douglas (Philpott, 1986). Although strongly attacked at the time by apologists for Rogernomics, these predictions turned out essentially correct (Philpott, 1990a). In 1990 Philpott repeated the exercise, projecting high unemployment and slow growth for 1995 if the monetarist policy line was continued (Philpott, 1990b). In the event a significant policy switch at the end of 1991 brought to a close the period of rigorous Rogernomics, and signalled acceptance by Government of several of the key criticisms previously offered by Philpott and others (cf. Philpott, 1992). Meanwhile, on the monetary front, over several years staff of the Money and Finance Group at Victoria argued that the Reserve Bank's attempt to control the quantity of money via control over the primary liquidity of the financial system was misconceived (Sheppard and Whitwell, 1990; J. Whitwell, 1987, 1989).

It would, thus, not be fair to suggest that the economics profession as a whole were agreed on the desirability of New Zealand adopting the monetarist/new classical policy package. It was, however, the case that the economic debate on these matters in New Zealand never achieved the public prominence that it did in the USA and UK. This in part was a reflection of the structure of the State in New Zealand and the role of the universities in the wider society.

The public forums in which alternatives to the New Right line might have been discussed and developed were few, and becoming fewer. The 1984 Economic Summit conference, which articulated a broadly corporatist and moderately interventionist line (Dalziel, 1986, 1989) was convened for only a single session, and its conclusions were unceremoniously ignored. The attempt by a parliamentary select committee, chaired by Jim Anderton and including the deposed Sir Robert Muldoon among its members, to hold a public inquest into the 1984 devaluation crisis was quickly stopped by the Government. The New Zealand Planning Council, in the 1970s the vehicle for the early introduction of some key New Right ideas to New Zealand debates, became in the 1980s the home for ongoing sectoral modelling of the growth prospects for the New Zealand economy but was progressively sidelined and finally (in 1991) abolished. Government departments such as Trade and Industry and the Ministry of Works, which had provided powerful vested-interest backing for the advocacy of industrial promotion and major investment planning, were also abolished, and public sector reform broke up many nuclei of potentially contrary policy advice among civil servants. At Victoria University, the Economics Department was broken up into five small quasi-autonomous 'groups', government funding was withdrawn from Professor Philpott's Project on Economic Planning, and in 1985 the death of Mervyn Pope removed a key contributor to the quest for a genuinely New Zealand-based economics.

All of these developments, however, were merely symptoms of a deeper reality. New Zealand's small size and limited research establishment have always resulted in a tendency to import key economic ideas from elsewhere, and to concede substantial authority to the international climate of opinion. Local debates are generally conducted in terms of pragmatic policy-making and attempts to make empirical estimates of economic relationships. The critics of the New Right, like the New Right themselves, drew much of their theoretical ammunition from the overseas literature, and the resulting debate had a rather second-hand quality which gave an edge to the well-funded lobbying organizations supportive of the New Right programme, who were able to bring a long series of 'overseas experts' to New Zealand to legitimate their case in the eyes of politicians and the public.

Throughout the New Zealand debates of the mid-1980s, there was a general tendency for policy proponents to avoid clear theoretical identification. The 1984 criticism of Treasury and the Reserve Bank for having adopted 'monetarist' positions drew the standard response that the officials concerned considered themselves to be acting on the basis of an 'eclectic' position rather than any single theory (see Nicholl, 1985, pp. 119 and 121; Treasury, 1985, p. 96) and that it was unreasonable and unhelpful to pigeonhole the Treasury position on the basis of abstract categories. Proponents of the radically new policy package introduced after 1984 took shelter not behind theoretical identities but behind the down-to-earth claim (with immediate appeal to many New Zealanders) that they were getting on with the job of tackling urgent economic problems that had been allowed to fester for too long. Highly controversial claims about the supposed lessons to be drawn from 'economics' were thus dressed up for public consumption as commonsense propositions.

The Changing Character of the New Zealand State

A key part of the intellectual ammunition of the New Right has been provided by the criticism of 'rent-seeking élites' contained in the work of the Public Choice school of economists. State activism is suspect, in the eyes of these writers, on the grounds that its only credible motive is to benefit a privileged few at the expense of the many. The power of this rent-seeking model of the State varies from place to place and from time to time, depending on the performance (and public perception) of particular governments. The New Zealand State during the 1970s and 1980s exhibited behaviour which corresponded in several important ways to the Public Choice model. In particular this was true of the increasingly obvious role of powerful, self-interested bureaucratic élites which were selectively responsive to the lobbying demands of particular constituencies, and shaped policy accordingly, often with little regard to the ostensible checks and balances of democratic politics.

The 'think big' programme of the early 1980s thus reflected the powerful position within the State apparatus of development-orientated agencies such as the Ministry of Works and Development, the Ministry of Energy, and the Ministry of Trade and Industry, allied with big-corporate lobbyists from the private energy sector. In what amounted to an internal coup d'état within the State structure, this alliance was overturned in 1983–84 by a new dominant élite, centred in Treasury and the Reserve Bank, and with strong allies in the financial community. The loss of democratic control over bureaucratic empires such as these has been a serious problem for the New Zealand political process.

These experiences gave credibility to the Public Choice attack on the motivation of government—the claim that governments in practice are incapable of advancing the wider interests of society, because the idealist concepts of the 'statesman' and the 'public servant' are utopian fantasies, and real-world government is simply a matter of the capture of rents by vested interest groups. Theoretically, it is important to note that New Right economics has thrown up also a second line of criticism of activist macroeconomic management. This is the claim that even if government itself is perfect, demand-management policies cannot change the level of output and employment—either because governments cannot respond quickly enough to new situations (the Friedman view which underlay the Deane–Smith attack on Muldoon's fiscal fine-tuning) or because government policy is inherently ineffective in changing the real economy (the later new classical position, which has however not stood up well to empirical testing—see Bryant, 1991).

Both critiques have to be met before a sound case can be established for active macroeconomic policy. Obviously, even if sound and appropriate policies can be designed in principle to enable government to influence the course of the real economy, such policies would be unlikely to deliver the goods in the hands of a State dominated by rent-seeking élites, as generations of policy advisers in Africa and Latin America can testify. By the same token, a democratic State which embodies some clearly defined public interest would be powerless in practice to control macroeconomic forces if the new classical analysis of policy ineffectiveness holds true. Blinder (1987, p. 400) constructs a simple table to identify the circumstances in which alternative policy models are likely to prove most suitable. Figure 2. 1 below is an adapted version:

Figure 2.1

	Character of the actually-existing State:	
	A: Incompetent, dishonest, prisoner of rent-seeking élites	B. Competent, honest, embodiment of public interest
Market 'failure': Prevalent	Intervention likely to do harm rather than good	Social-democratic interventionist policy regime is appropriate
Rare or absent	Neo-conservative free markets with legal restraints on government may be appropriate	Successful intervention is feasible but seldom required: light-handed government works

The irony of the history of the past half-century is that the international economy of the 1950s and 1960s was expanding at a rate which greatly reduced the prevalence of generally perceived market failure in developed economies, and governments were able to operate in a relatively light-handed way on macroeconomic policy (compared to the sort of interventions that a competent, representative government might undertake in the face of major crises). The onset of more difficult economic times in the 1970s and 1980s seems to have been accompanied by (and is likely to have contributed to) a decline in the competence and honesty of governments, at the level of 'crude large-scale empirical generalization'. The period when effective intervention by representative, social democratic-minded government might have been most fruitful in countries such as New Zealand was also the period when the State moved across the spectrum towards increased domination by narrow vested interests, and hence towards decreased competence to undertake successfully the measures which a whole-hearted Keynesianism might have devised. Simultaneously the growing conviction among key officials involved in economic management that the new classical models were correct, and that policy interventions would be ineffective, contributed to a decline in the competence of the State to undertake such interventions.

The actual effects of any policy package, thus, depend upon the quality and attitudes of the policy agency as much as on the concrete measures contained in the package itself. An enduring legacy of the New Right's work in the past two decades is likely to be a general acceptance that macroeconomic theorizing cannot be complete unless it is harnessed to a satisfactory theory of the State.