

## COMMENT ON LLACH'S PAPER

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Reflections on the conceptual foundations of economic thinking and political actions may have a cathartic function and be a source of intellectual renewal. Precisely because such reflections do not form part of daily work, they may exercise considerable leverage: what is involved are the foundations of economic and political efforts. Llach and Crespo have presented an interesting paper, which is concerned on the one hand with the conceptions of human beings implicit in economic theory, and on the other with the supposed and much-cited new orthodoxy in international economic and development policy, in the shape of the 'Washington Consensus'. These two subjects of the analysis appear disparate at first sight, but the authors emphasize that there is a close link between them.

### I.

In the first section, an undue simplification of the human being and his reduction to the *homo oeconomicus* are deplored. As a result, major aspects of human existence which also have a bearing on economic actions are disregarded. It is claimed that the picture which economics paints of its scientific subject, the human being, is distorted and incomplete. The necessity of a limitation and simplification of the scientific subject as a prerequisite for its analysis (a 'discipline-determined definition of economics') is not acknowledged. Instead, the authors argue in favour of a 'field-determined definition', which declares everything that is directly or indirectly of significance for economics to be relevant to economic science. The fact that the subject thereby threatens to get quite out of hand (anthropology, sociology, psychology, cultural sciences, biology, technology, history, geography etc. etc. would have to be included) is accepted. At the same time, the consequent impossibility of arriving at a formal system of statements the logical

consistency of which is objectively verifiable, and which meets Popper's falsification criterion, is likewise accepted.

In the history of science there have been numerous approaches to a more 'holistic' way of looking at things. A parallel to the notions of the authors is provided, for instance, by the programme of the 'German Historical School', of which they may not have known. But since it played a major role for a particularly long period, and not only in Germany, it may be outlined briefly here. The object of the Historical School was to comprehend economic trends, in their historical uniqueness, as comprehensively as possible and from all points of view, but without primarily looking for the development of general laws or rules. It came about as a counter-movement to English classicism and dominated economic science in Germany from the 1840s until well into the twentieth century. The rise and decline of the German Historical School reflects not only the justification of the criticism voiced by Llach and Crespo, but also its weakness.

The architects of the German Historical School – just like Llach and Crespo – assumed that economic life is not conducted in isolation from political and social life, but rather in close conjunction with the web of culture as a whole. The lines of development do not run identically in accordance with universal rules, but assume diverse shapes in different societies and nations. Those architects rebelled against the one-sided and rationalistic doctrine of the classicists and formulated the 'historical method' of political economy. The chief thinker of the older Historical School, Wilhelm Roscher, developed this method in his programmatic book, Roscher (1843), as follows:<sup>1</sup>

1. Political economy is a science that can produce results only in close conjunction with other social sciences. Particularly important in this context are the history of law, of politics and of culture;
2. A people is more than just a mass of individuals, and research into its economy therefore cannot be based on the mere observation of current economic structures;
3. Given the great mass of phenomena, the difficulty of identifying the essential underlying laws involved makes it necessary to compare all peoples with one another economically. The study of ancient peoples is particularly instructive in this context, since their destiny is already fulfilled.

<sup>1</sup> Cf. e.g. Haney (1949), p. 539 f.

4. The Historical School was very reluctant generally to praise or to blame economic institutions, because only very few of them were exclusively good or exclusively bad for all peoples at all times.

The younger Historical School was dominated by Gustav von Schmoller. Finally, Arthur Spiethof, Werner Sombart and Max Weber were the leading representatives of the third wave at the beginning of the twentieth century.

Llach and Crespo's criticism of *homo oeconomicus* coincides in major respects with the stance of the Historical School. In his *Grundlagen*, Roscher certainly recognizes self-interest as one of two psychological motives for economic action. For him, it is 'a powerful principle of creation, preservation and renewal'.<sup>2</sup> But in classic economic theory he sees no sign of the community-related, ultimately spiritual, dimension of human existence.

But then there are the demands of God's voice in us, of our conscience: whether we call them, with a merely philosophical retracing of the outlines, 'ideas of equity, justice, benevolence, perfection and inner freedom' or with their realization in everyday life 'the yearning for the kingdom of God'. No matter how much the divine image has been obfuscated among most human beings, the yearning for it has not disappeared completely among any of them. This fact keeps self-interest under control; indeed, it is transformed into an earthly comprehensible means to an eternally ideal end.<sup>3</sup>

The seemingly contradictory tendencies of self-interest and conscience act together, according to Roscher, in mutual limitation, generating *community spirit* in human social life:

It is on this community spirit that, in steps, family life, parish life, national life and the life of mankind (which last should coincide with the life of the Church) is based. It is only through this spirit that God's life on earth is realized...; only through it that self-interest is truly certain and lastingly expedient.<sup>4</sup>

Schmoller, too, thinks that human beings have been misunderstood, with respect to their underlying relationship to the community, by the individualistic approach of classical English economics. He believes that the

<sup>2</sup> Roscher (1897), p. 26, Roscher's chief book *Grundlagen* first appeared in 1854. Here and below, quotations are from the 22nd edition, edited by Robert Pöhlmann.

<sup>3</sup> Roscher (1897), p. 26f.

<sup>4</sup> Roscher (1897), p. 27.

wish to earn money, as an abstract principle, is insufficient. Nor does it suffice to adduce, as Roscher does, community spirit as another abstract principle: what is required, rather, is a psychological and historical analysis of the motives for human actions in general.<sup>5</sup> The classical theory, he asserts, is based on an incomplete analysis of human beings.<sup>6</sup>

This brief glance back at the Historical School can at the same time shed some light on another assertion in the paper by Llach and Crespo. In 1883 there flared a disagreement between the Austrian Karl Menger and Gustav von Schmoller, conducted vigorously by both parties, on the epistemology appropriate to economics – known as the ‘dispute on methods’.<sup>7</sup> Menger claimed that only the concept of a law, as in physics, could form the basis of a theoretical science. To evolve an exact theory, economics must study only one particular side of social phenomena, the economic side. It must proceed in an abstract manner, isolating and deducing, namely from the principle of individualism and the maximization of benefits. General and immutable laws of human action could be derived from that. Menger thus adopted the position which Llach und Crespo designate as ‘discipline-determined’. Schmoller, by contrast, drew attention to inductive research into historical reality and, in the field of economics, denied the existence of abstract, immutable laws, like those in the natural sciences. He claimed that it was the task of the economist to collect data and to derive there-from, by means of induction, systematic descriptions which remained within the framework of general history – hence his standpoint was ‘field-determined’.

Today we know that the main error of the two opponents lay in the exclusivity with which each advocated ‘his’ method. In the end, Schmoller actually acknowledged this, but the disagreement had a practical economic policy dimension at the time which is likewise reflected in the paper on which I am commenting. During the nineteenth century, Germany’s rapid development from a traditional agricultural society to an industrial nation led to radical changes in underlying structures and thus to what was known as the new ‘social issue’. Schmoller and many of his supporters believed that this development would have to be accompanied by active intervention by the state and by social reforms if revolutionary upheavals were to be pre-

<sup>5</sup> Schmoller (1900), p. 33.

<sup>6</sup> Schmoller (1900), p. 92.

<sup>7</sup> The occasion was Menger’s book *Untersuchungen über die Methode der Sozialwissenschaften und der Politischen Ökonomie insbesondere* and Schmoller’s review.

vented.<sup>8</sup> In contrast, the Austrian school, headed by Menger, continued to advocate classical laissez-faire liberalism.

Max Weber, rated by Joseph Schumpeter (1954) to be 'one of the most powerful personalities that ever entered the scene of academic science' likewise resorted to the method of the Historical School. His best-known work *Die protestantische Ethik und der Geist des Kapitalismus* (Protestant ethics and the spirit of capitalism), may in fact be regarded as exemplifying the methodological approach of the Historical School. But something else is also manifest: although Weber was a professor of economics from 1894 onwards (initially in Freiburg and subsequently in Heidelberg), in the relevant literature he is rarely described as an economist. As a rule, he is counted among the founding fathers of sociology. In the mass of the anthropological and historical references to be followed, he gradually lost sight of the original focus of his efforts – economics.

But nothing more was heard of the Historical School, even in Germany, in most of the time after World-War II and today it sometimes seems as though this combination of holistic approach and social policy commitment had never existed in economics. That is also true of the German-speaking area itself: the names of Roscher and Schmoller are normally unknown to younger economists today. No doubt this is not solely due to stronger Anglo-Saxon influences in Germany since the War. One must admit that the eye-witness Othmar Spann is right, at least in part, when he ascribes the decline of the Historical School to the fact they chose to be incapable of structured theoretical work:

the younger Historical School lost itself increasingly in economic history and economic description ... This went so far that the last generation of our economists positively lost sight of the theoretical tradition.<sup>9</sup>

This historical experience – especially in Germany – of the views put forward in the paper by Llach and Crespo now brings me to a number of critical questions. Is the *homo oeconomicus* really a conception of a human being implicit in economic science? Does economics have a conception of a human being at all? And is that its duty?

<sup>8</sup> On this point see Nau (2000). Because of their stance on social policy, Schmoller and his supporters were on occasion mocked as *Kathedersozialisten* (socialist professors). Schmoller also played a major role in the establishment of the *Verein für Sozialpolitik* (Social Policy Association), a name that is still in use today by the Association of German-Speaking Economists.

<sup>9</sup> Spann (1949), p. 164f.

At several places in the first section of their paper, Llach and Crespo draw attention to the fact that the conception of a human being presented by economists themselves (unlike that in economics) is indeed often 'human' and 'holistic', and that economists can obviously live with this contradiction. Does this not suggest that the *homo oeconomicus* is not a conception of a human being at all, but only an intellectual fiction designed to produce falsifiable hypotheses?

Economists are apparently guided by the methodological principle of the theologian William of Ockham (1285-1349): *Pluralitas non est ponenda sine necessitas*. They endeavour to make no more assumptions than are required to understand the subject of research. The *homo oeconomicus* is particularly simple. His actions can therefore be described and forecast precisely. It is then up to reality to falsify such a forecast or not. It has proved to be very fruitful to approach an economic phenomenon, as a *first* step, with an attempt to explain it in terms of being the outcome of interactions between rational and self-interest-oriented individuals. This is quite often possible, especially for instance in financial theory, in the development of valuation models from arbitrage calculations. Where it cannot be done, other facets of reality have to be included as well. Here, too, financial theory provides good examples. Many economically significant developments on financial markets cannot be explained without the assumption of limited rationality, such as those mentioned in the outstanding monographs by Shiller (2000) on 'Irrational Exuberance' and Shleifer (2000) on 'Inefficient Markets'. Incidentally, the award of the Nobel Prize to Daniel Kahnemann demonstrates once again that the Jury evidently does not underrate the significance of such a departure from perfect rationality. Moreover, the representative individual is increasingly being called into question as an intellectual starting point: in many recent papers, including ones on macro-economic issues, the heterogeneity of the players is taken very seriously.

It is true that many economists may sometimes appear ponderous and unimaginative when they have to give up assumptions that have not proved their worth. But that should not be blamed on the approach itself. It imposes discipline and counters the risk of 'anything going'. For much research, the *homo oeconomicus* can definitely provide a starting point for needful further analyses.

## II.

In the second section of their paper, Llach and Crespo consider orthodox and heterodox economic-policy concepts. Here, they follow in Schmoller's footsteps, for whom economic policy was a self-evident focus of economic analyses. Besides a number of remarks about the failure of certain 'heterodox' approaches, at the heart of this second section the so-called Washington Consensus is criticized as the embodiment of 'orthodox' thinking – the authors speak of 'neo-classical' thinking.

The Washington Consensus is described in the paper as too simplistic, too one-dimensional. The authors identify two categories of sins. On the one hand, the list of propositions<sup>10</sup> compiled by Williamson in 1989 omits a number of economic targets that the authors consider particularly important. They designate these as 'sins of omission'. Besides these, they also perceive some 'sins of commission'. Some of the propositions, they say, are simply counterproductive. In the authors' view, the Consensus leaves no scope for taking account of the particular circumstances in time and space. Wherever the demands of the Consensus were realized precisely, that resulted in failures. Successes were scored only when they were realized in a manner in line with the prevailing circumstances.

In my former official capacity, I had every opportunity of observing, especially in the 1990s, the shaping of opinions in the IMF and other international bodies. Without wishing to go overmuch into detail here, the shaping of opinions both among the staff of the IMF and in the political bodies involved was more sophisticated, more complex and more contradictory than is reflected in Williamson's list quoted in the paper. Moreover, it was notably dynamic, and changed in the course of time and experience. The crucial factor was and still is today what the countries affected made of it. The conditions set by the IMF were and are mostly the outcome of negotiations.

An example of this is *exchange-rate policy*. Item 5 on the agenda 'a competitive exchange rate' did not reflect the diverse range of opinions underlying it as early as 1989, as Williamson (2003) frankly admitted.

The fact is that in sections of the IMF staff, but also among many Anglo-Saxon economists, a 'doctrine of two alternatives' had emerged at that time: either freely floating exchange rates or a regime of completely fixed rates (ideally in the context of a Currency Board) were regarded as suitable for

<sup>10</sup> Concerning this list and its history, cf. Williamson (2003).

preventing currency crises. However, this standpoint was not shared by all in the IMF bodies, and not by me personally either. After all, between these two poles quite a number of in-between solutions are possible, which may have their merits in specific situations. Exchange-rate policy only has to be consistent with domestic policy, that is what counts. In the real world there are, of course, not infrequently differences between the 'official' monetary regimes and the 'de facto' standards that constitute the framework for actual monetary management.<sup>11</sup> Notably over-rigidly fixed exchange rates may have serious drawbacks if the country concerned is unable to cope durably with the ensuing consequences for its own policies. After all, such exchange rates tie the internal and external monetary policy of the weaker country to those of the stronger land for good or ill. That may well result in serious conflicts with that country's domestic targets. The crises in south-east Asia during the 1990s were mostly a consequence of such untenable exchange-rate rigidities. And Argentina, too, clung for too long to the fixed link to the Dollar (mainly of its own volition) even though it could not maintain it in its domestic policies.

On closer inspection, the call for freedom of *capital movements* likewise turns out to be ambivalent. The orthodox doctrine rejects controls on capital movements as a source of inefficiencies and the reason for the cementing of obsolete structures. In essence, that is no doubt correct but the state of development of the economy also plays a role. Incidentally, a call for the abolition of *all* controls on capital movements does not feature on Williamson's list; but as a matter of fact the international financial organizations pursued that target too unconditionally at times, which was repeatedly criticized in the IMF bodies at the time. After all, nascent financial systems are often not yet resistant enough to be incorporated in the global financial system without any protection. To begin with, they need a sufficient degree of maturity. Things may be particularly critical if liberalized financial markets come up against a fixed-exchange-rate policy. If, for instance, expectations of a devaluation then arise, players on the financial markets are faced with a 'one-way bet'. Gigantic sums may be set in motion in no time at all, dooming to failure any attempt to maintain the parities. And that is particularly dangerous for countries that do not already have in place a sufficiently sophisticated domestic financial system.

<sup>11</sup> Cf. on this point von Hagen and Zhou (2004). While the former are usually designated as fixed or floating exchange rate regimes, the latter on closer inspection are mostly variants of managed floating.



Much the same is true of the hypothesis of the *liberalization* of foreign trade. It certainly makes good sense if both sides really open their borders to the movement of goods. But whether a complete opening actually makes sense for developing countries when developed countries retain their restrictions in their agricultural and industrial policies is quite a different question.

And even the slogan *fiscal discipline* is not always as unproblematic as it sounds. An often requisite rigorous reduction of excessive government spending generally has a really positive economic effect only if it is part of a consistent fiscal-policy strategy that is durably credible. Short-term *ad hoc* austerity measures *alone* usually fail to generate any new confidence among investors in the midst of a profound adjustment recession, and will hardly create any new economic dynamism. Austerity measures must take due account of both the initial conditions and the overall conditions. In this case, too, the erstwhile crises in Asia have taught important lessons in several respects: some decisions that made sense, and were correct, in the Latin-American environment merely exacerbated the situation in some countries of south-east Asia.

### III.

This is not the right place to discuss, and evaluate in detail, the economic policy performance of the IMF as a whole. In my judgement, most of it has been good so far, though some of it has also been problematic. Alongside some justified criticism, one ought not to overlook the favourable overall development of the global economy and the catching-up process of many developing countries. And the much-cited Washington Consensus should not be made a distorted picture. The increased recourse to supply-side policies has in my opinion done a great deal to ensure that, in retrospect, the 1990s – despite of some serious crises – as a whole might well prove to be one of the positive decades in economic-history, also with respect to distribution policy.<sup>12</sup>

Yet the last part of Llach and Crespo's criticism is undoubtedly valid, and may be levelled at any policy that is 'pushed through' blindly and unimaginatively without regard to the ruling spatial, temporal and cultural

<sup>12</sup> Cf. on this point the Richard T. Ely Lecture given by Stanley Fischer (2003). This overall positive assessment doesn't overlook some serious critical points also mentioned by Joseph Stiglitz in his book 'Globalisation and its Discontents'.

preconditions. Salvation is not to be expected of soulless bureaucracy. Successful political action consists in the intelligent adjustment of timeless truths to the prevailing circumstances. That presupposes among all those responsible both the consideration of economic realities and relationships and a high level of intellectual flexibility.

If one goes through Williamson's list for the so-called Washington Consensus again, almost every point appears good and correct – in general. But each individual point easily becomes bad if it is to be pushed through everywhere alike, mechanically and without regard to the prevailing starting conditions. As I indicated above, that was a basic point in the work of the German Historical School. Perhaps their discoveries and methodological insights should not have been forgotten quite so thoroughly, neither among professional economists nor in practical economic policy. To that extent I am glad to concur in Llach and Crespo's findings.

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