6. The political economy of monetarism

It is always a double-edged compliment to characterize an idea as fashionable. The description tends to suggest impermanence and fragility, as if the idea in question could be shrugged off as a topical irrelevance. In the case of monetarism in the 1970s and 1980s, this danger was particularly acute. Many of its detractors found that the sharpest critical approach was to admit that it had gained widespread support, but to imply that such support fluctuated with the ebb and flow of opinion, and made no real difference to economic knowledge.[1] This sort of attack was unfair. Certain propositions branded as 'monetarist' were not, in fact, distinctive of any school of thought, but formed part of the core of received economic theory. Moreover, many distinctively monetarist themes, far from being an evanescent response to the inflationary excess of the 1970s, had been recognized in one form or another for decades or even centuries.

The Keynesians in Britain were hostile – or at least apathetic – towards the teaching of monetary economics in British universities and the application of monetary theory in policy-making. But the allegation that monetarism was a fashion and nothing else was strange, since the monetary tradition in British economics was at one time full of vitality. Indeed, in the first half of the twentieth century Cambridge was the acknowledged centre of monetary theory, not just in Britain but in the world, with original contributions from Marshall, Pigou, Robertson and, above all, Keynes. In the 1950s and 1960s this legacy was neglected. The leading economists at Cambridge, who called themselves 'Keynesians' and enjoyed the esteem conferred by Keynes's name, scoffed at small and diminishing bands of diehards in provincial universities who obstinately insisted on the importance of money.[2] They also isolated Dennis Robertson, who had worked closely with Keynes in the 1920s (although quarrelling with him in the mid-1930s) and had become Cambridge's foremost monetary theorist. (According to the author of Robertson's intellectual biography, Keynes' influence at Cambridge 'lived on through his disciples, and the battles Robertson fought with them in the Faculty over teaching arrangements and new appointments continued to shadow his declining years'.[3]) Arguably, the strength of opposition to monetarism, and the lack of intellectual preparedness in the policy-making establishment when it was confronted by the double-digit inflation which followed the Barber boom of 1972/73 and the Lawson boom of the late 1980s, was due to the Cambridge Keynesians' pooh-poohing of the quantity theory of money in the 1950s and 1960s. Would it then be right to blame Keynes himself for Britain's economic difficulties in the 1970s?

I

The reply to this question reveals much about the development of economic thought in Britain. One point must be made straight away. The titles of Keynes's four main books on economics – *Indian Currency and Finance* (published in 1913), *A Tract on Monetary Reform* (1923), *A Treatise on Money* (1930) and *The General Theory of Employment, Interest and Money* (1936) – suggest that Keynes was obsessed by money and finance.[4] Further, there is no doubt that he always considered the influence of money on fluctuations in output and employment to be fundamental. He thought that the weakness of economics in his day was its inability to reconcile the determination of individual prices by supply and demand with the determination of the aggregate price level by the quantity of money. His aim in *The General Theory* was

> to escape from this double life and to bring the theory of prices as a whole back to close contact with the theory of value. The division of economics between the theory of value and distribution on the one hand and the theory of money on the other hand is, I think, a false division. The right dichotomy is, I suggest, between the theory of the individual industry or firm and the distribution between different uses of a *given* quantity of resources on the one hand, and the theory of output and employment *as a whole* on the other hand. So long as we limit ourselves to the study of the individual industry or firm on the assumption that the aggregate quantity of employed resources is constant . . . it is true that we are not concerned with the significant characteristics of money. But as soon as we pass to the problem of what determines output and employment as a whole, we require the complete theory of a monetary economy.[5]

Keynes devoted over 30 years of study to analysing the interaction of the real and financial sides of a capitalist economy. It is true that at the outset he considered money to be a benign or at worst harmless contrivance for facilitating transactions, whereas at the end he had convinced himself that it could be the jinx of the free enterprise system. But, whether the existence of money was beneficial or pernicious, he had no doubt that money mattered. That an influential set of academics was able so easily and successfully to promote a 'Keynesianism' in which decisions to spend were severed from the quantity of money and interest rates was an extraordinary intellectual fabrication. How did money-less 'Keynesianism' emerge? What were its main elements and can they be related, even distantly, to *The General Theory*?

It has to be conceded that the Keynesian approach of the 1970s – as adopted, for example, by the Treasury and the National Institute – was not altogether divorced from Keynes's thinking. The principal Keynesian theoretical construct is the income-expenditure model of aggregate demand determination. Reduced to its essentials this model says that demand depends on how much economic agents decide to spend and that certain categories of spending (such as exports and government expenditure) are 'exogenous'. That is, they do not depend on the current level of national income, but instead regulate its future value by the multiplier process. The Treasury econometric model, which by the mid-1970s already had scores of equations, was nothing more than an elaboration of this simple insight.

The income-expenditure model is advanced in *The General Theory*, constituting the subject matter of books II to IV. These take up 160 of the 385 pages and are the work's analytical heart. The model is expressed in wage-units which may be equated with the wage payment to the average worker. This device could be represented as purely technical. It has the great convenience that, if demand is measured in so many wage-units, an increase in demand leads to an identical increase in the number of wage-units and, as long as wages are constant, to an identical increase in the number of men in work. The wage-unit assumption therefore facilitates the determination of demand, output and employment. (In the 1930s it enabled Keynes to proceed quickly from the level of aggregate demand to the level of employment, an undoubted merit when mass unemployment was the major economic problem.) But expository convenience is obtained at significant cost in theoretical completeness, because the result is that – within books II to IV – *The General Theory* has no method of determining the wage-unit.

For this reason book V of *The General Theory* is concerned with 'Money-Wages and Prices'. Now a key issue becomes the determination of the wage unit itself. Not surprisingly, the hypothesized effects of changes in the quantity of money are very different in this book from what they are in books II to IV. In books II to IV an increase in the money supply lowers the rate of interest, stimulates activity and does not change the price level; in book V, by contrast, a rise in the money supply boosts effective demand and 'the increase in effective demand will, generally speaking, spend itself partly in increasing the quantity of employment and partly in raising the level of prices'.[6] In the extreme case of full employment monetary expansion leads only to inflation. Clearly, the income-expenditure model is outlined in books II to IV *before* the discussion of wages and prices because it is valid only if the wage-unit is constant. Keynes was fully aware of the ramifications, and the peculiarities, of the wage-unit assumption when he organized the argument of *The General Theory*.

But the Keynesians of the immediate post-war decades overlooked these qualifications. Their income-expenditure models – both in the textbooks and in large-scale forecasting models – were (and still are, in the early twenty-first century) constructed in real terms, as if a change in wages could not occur while income and expenditure were being determined. Within the model context the absence of a clear economic mechanism for determining price and wage level changes was defensible. It is a common property of Keynesian forecasting models that an *x* per cent rise in wages is sooner or later accompanied by an *x* per cent rise in prices, implying that the real purchasing power of earnings and, hence, consumption and national income are unaffected. But the habit of forecasting the macroeconomic aggregates in real terms had very serious consequences. It persuaded the economists concerned to believe that real variables and the level of inflation were determined by two separate processes, and it allowed them to banish money from their models. As Keynes recognized, his theory was not able to disentangle the effects of a money supply increase on real output and the price level (except, of course, in long-run equilibrium when quantity-theory conclusions hold). The Keynesians came to believe not only that national income depended on decisions to spend, but also that decisions to spend had no systematic connection with the main items in the economy's balance sheet (the level of the nominal and real money supply, the market value of stocks and shares, house prices and other real estate values). If money and asset prices had major effects on expenditure, the empirical validity of the income-expenditure model would be undermined and the whole conceptual edifice of Keynesianism – as the term was understood in Britain's policy-formation establishment – would dissolve.[7]

As this account demonstrates, the story of the degeneration of Keynes's pure theory to the Keynesian 'orthodoxy' of the 1970s was quite complicated. But it could be argued that one theme of this story was the reinstatement of an invalid dichotomy. The dichotomy was invalid because it separated two aspects of the economy which, in the real world, are intertwined. One aspect was the determination of national income in real terms by the level of demand; and the other was the determination of the rate of inflation by supposing that collective bargaining drives up wage costs (that is, Keynes's wage-unit) and, in the same proportion, the price level. Here lay the intellectual origin of the Keynesian assertion that effective demand had no bearing on the increase in prices and the theoretical background to the advocacy of incomes policies. If spending changes output and not prices, demand management is a useless instrument for controlling inflation. Reliance ought instead to be placed on direct political and administrative action. That such action might distort the structure of relative prices was a minor drawback to the typical Keynesian economist because his income-expenditure model was aggregative and did not bother itself with the supply-and-demand problems of individual business people.

The dichotomy under discussion here was an associate of 'a technique of thinking' in which the signalling function of relative price movements was regarded as unimportant. Of course the signalling function of relative price movements is basic to microeconomics. The 'apparatus of mind' of some British Keynesians in the 1970s was therefore a kind of anti-economics. The advocacy of 'planning', the suppression of microeconomics and the neglect of monetary economics were interrelated. It was consistent that the Department of Applied Economics in Cambridge – where this type of anti-economics was developed most fully – should in the late 1970s propose an 'alternative economic programme' including import controls. Perhaps more than any other single factor it was this anti-economics which was responsible for the succession of misguided policies, both microeconomic and macroeconomic, pursued by the British government in the 1960s and 1970s.[8] (Fortunately, import controls were never implemented, but they were the subject of extensive, unnecessary and largely misguided discussion about them during the various crises of the 1970s. Economists disagree about many things, but there is a strong professional consensus that import controls reduce welfare and are a mistake.)

Moreover, the dichotomy that was central to the Keynesian anti-economics resembled the classical dichotomy rebutted by Keynes. The classical dichotomy said that the output of the individual industry depended on supply-and-demand and the aggregate price level on the quantity of money. Keynes insisted that via the rate of interest, money affected relative prices, output and the aggregate price level, and that money, banking and asset markets had profound effects on demand and employment. The Keynesian dichotomy of the 1960s and 1970s was, in some respects, even more unrealistic than the classical because – in its extreme forms – it dispensed with money altogether. Keynes, who thought that 'as soon as we pass to the problem of what determines output and employment as a whole we require the complete theory of a monetary economy', would surely have repudiated it. The income-expenditure models of the Treasury and the National Institute were sometimes characterized as a 'vulgar', 'hydraulic' or 'bastardised' version of what 'Keynes really said'.[9] But that was too flattering. They simplified to the point of misrepresentation and would be better described as fakes.

The resistance to monetarism in Britain cannot be attributed to the fact that Keynes was an Englishman, rather than an American or European, and that he therefore had a disproportionate intellectual influence in Britain. It was not his fault that, from his death and particularly from the early 1960s, the prestige of monetary economics at Cambridge collapsed. Indeed, monetarism could be interpreted not as an assault on Keynes's work, but as an attempt to rescue it from his successors. Friedman compared Keynes's disillusionment with the stability of capitalist financial markets in the 1930s with similar views held by Henry Simons, a professor of economics at the University of Chicago. He also described Keynes's monetary theory as 'sophisticated and modern'.[10] By contrast, one would not have guessed from the sort of statements which emanated from the National Institute or the Department of Applied Economics at Cambridge in the 1970s that Keynes had a monetary theory or, indeed, that such an entity as monetary theory, whether derived from Marshall, Keynes or Friedman, was worth discussing at all. The lack of sturdy intellectual defences against monetary abuse on the scale of the 1972–74 period, when the annual rate of money supply growth exceeded 20 per cent, and the 1985–88 period, when it approached 20 per cent, is not to be explained by Keynes and the special position he holds in the pantheon of British economists.

II

Part of the explanation for the shrillness of the debates between Keynesians and monetarists was that much more than textbook economics was at stake. As its critics understood, monetarism was not – and is not – politically neutral. It was an ally of a certain disposition towards political problems. This disposition was basically liberal, but, since the need to respect existing institutions was also emphasized, it had conservative implications. It was not tendentious to associate it with such thinkers as Hayek and Oakeshott, although Hayek in his later years disowned technical monetarism. The purpose of this and the next section is to identify some of the links between monetarism, liberalism and conservatism.

Money is usually termed 'the medium of exchange', but this does not go far enough. The phrase, 'the instrument of choice', brings into stronger relief its significance for a liberal philosophy. Of course, choice exists in a barter economy, but the possibilities for transacting are more circumscribed. Because money is universally accepted, its introduction into an economy reduces the size of the stock of goods that merchants need to engage in trade. It thereby lowers marketing costs and extends the area in which consumers are able to select the combination of products most suited to their preferences. This extension of choice is an essential preliminary to widespread specialization. If it is expensive to trade, the market may be too small to allow an individual to concentrate on one form of production. But, with exchange facilitated by a universally accepted instrument of choice, the division of labour can begin. The ensuing gains from economies of scale and experience were first described by Adam Smith in *The Wealth of Nations*, and they have formed part of the folklore of the free market economy ever since. The division of labour can, of course, be taken a long way in a socialist, centrally planned economy, but traditionally it has been a process associated with market freedom and decentralized decision-taking. The advances in productivity associated with the division of labour are an effective illustration of how self-interested individuals, not working at the behest of a single co-ordinating unit under government control, can achieve a harmonious and socially optimal result. It is one component, and perhaps the most persuasive component, of the argument for permitting the 'invisible hand' to allocate resources without interference from the state.

Hayek reinforced this argument by pointing out the dependence of a complicated economy on the fragmentation of knowledge, on the fact that each member of society can have only a small fraction of the knowledge possessed by all and that each is therefore ignorant of most of the facts on which the working of society rests.[11] Here, too, the role of money is crucial. It is a common standard of value, a numeraire in which the value of all goods may be expressed. Its presence excuses traders from having to inform themselves of the price of a good in terms of other goods (such as the exchange ratio of wheat into coffee, of cars into furniture, and so on), since it is instead adequate to know the price of a good in terms only of the money numeraire (how many pounds have to be paid for a particular weight of wheat, of different makes of car, and so on). Since the amount of information required for successful marketing and trading is reduced by this device, energies are released for other tasks and economic efficiency is improved. The advantage conferred by money in this respect is weaker if its quantity and, consequently, its exchange relationship to goods in general (that is, the overall price level) change too much in a short space of time. The monetarist distrust of sharp fluctuations in the money supply finds here its most basic rationale.

The connection between money and freedom therefore pivots on Adam Smith's theory of the division of labour and Hayek's concept of the division of knowledge. One of the characteristics of economists who believe in these ideas is that they respect the relative price structure which arises from free production and exchange. They consider that – except in certain special circumstances which need to be carefully (and sceptically) specified – unfettered market forces set prices which achieve the right equilibrium between consumer wants and scarce resources. Not surprisingly, monetarists recommend a high degree of wage and price flexibility since restrictions on price movements impede the attainment of this equilibrium. Such restrictions sometimes stem from monopoly power, but governments and regulatory bodies are often to blame.

In the UK in the 1960s and 1970s pay and price controls designed to curb inflation were the most prominent form of government interference. Although they were commonly formulated as if they were to be impartial in effect (for example, the same percentage pay increase was allowed to the whole labour force), they always discriminated in practice. It is almost part of the definition of a dynamic economy that the relative price structure should come under pressure from different rates of productivity growth in different industries, varying income elasticities of demand and so on. To proclaim the same proportional pay increase for every worker or price increase for every good was to freeze the relative price structure and weaken its allocative power. That might have been an acceptable price to pay if prices and incomes policies did in the end deliver lower inflation, but experience showed that they did not.

The monetarists' condemnation of incomes policies stemmed partly from their philosophical attitude towards market freedom and partly from the failure of such policies when attempted in practice. Of course, if it could be shown that monetary mismanagement was the cause of inflation, that lent weight to the proposition that monetary responsibility was a sufficient policy response. Direct controls, with the infringement of freedom they entailed, were unnecessary. This conclusion could not be reached by the more extreme Keynesians since money formed no part of their system. Their world view was such that only changes in wages could account for changes in the aggregate price level and only political measures to check the collective greed of the unions could prevent prices from rising.[12]

The divide between monetary and non-monetary approaches to British inflation in the 1960s and 1970s was related to another fundamental split in economic theory, between those theories which say the distribution of income is determined by productivity and those which say it is determined by comparative bargaining power. The productivity theories belong to the neoclassical strand in economics and the power theories to the Marxian.[13] In the post-war decades the thought-habits associated with the wage-unit assumption placed the Keynesians on the Marxian side. (Schumpeter did indeed once refer to the more left-wing representatives of the cause as 'Marxo-Keynesians'.)[14] Nevertheless, much of the reasoning in *The General Theory* itself is conducted in terms of standard price theory and book V makes explicit references to a marginal-productivity basis for wages. Because the wage-unit assumption implied that wages were not governed by the workings of their income-expenditure model, but were given by forces outside the model, it was open to the Keynesians to attribute pay movements, and the balance between wages and profits, to political factors. The frequent references to union militancy in Keynesian writings were a logical consequence. In the more embroidered versions phrases such as 'class conflict' and 'revolutionary struggle' even made an appearance. On this reckoning, inflation was a manifestation of 'social crisis', a sign that the system was under threat from tension between selfish workers and profiteering capitalists.

Since the problem was seen as political, so was the supposed solution. Hence, there was a need for the government to involve itself in peace-making between the different groups, by laying down pay and profit limits to be binding on all of them. Keynes's wage-unit assumption therefore culminated in centralized pay negotiations between, on the one hand, the 'peak organizations' of labour and capital, and, on the other, the government and the leading politicians of the day. Moreover, in the opinion of some Keynesians, these negotiations ought not only to help in overcoming inflation, but ought also to contribute to the attainment of 'social justice'. According to Opie, writing in 1974, 'certainly all Keynesians in the early days and most Keynesians later on were radical in some sense or other, and few would have shrunk from the egalitarian implications' of increased government activism in the economy.[15] By permitting larger pay increases to the low-paid than the well-off an incomes policy could reduce inequality. The Keynesians considered this a desirable end, partly because equality was good in itself, but also partly because they felt that the prevailing distribution of income, being determined by power, had no worthwhile economic function.

Monetarist-inclined economists took the opposite view. Their sympathies were with the neoclassical school of pricing and distribution. Because they believed that the relative price structure reflected market forces, they saw wages – which were also prices, the prices of labour – as being determined by supply and demand. A worker is paid for what he produces; if he is paid less than his product, employers are induced to compete for his labour services until his wage rises and their surplus is removed; if he is paid more, he is either made redundant or obliged to suffer a wage cut. There is a definite, if rough-and-ready, justice in this equating of pay with marginal productivity because it matches reward to effort and skill. Centralized pay controls disturb this equivalence and, aside from the potentially harmful side effects in the misallocation of labour, they tend to lead to industrial unrest. The monetarist suspicion of income policies was validated, therefore, not merely by the tenet that inflation was caused by excessive monetary expansion, but also by acceptance of the structure of relative wages, salaries and other rewards determined by market forces. (The typical monetarist view was that – if the market-determined pattern of income distribution offended against some distributive principle or other – it should be remedied by the tax system, not by interference in relative prices and wages. In qualification, this preference for tax-based redistribution is widespread among professional economists and should not be associated too closely with monetarism.)

To summarize, the monetarists' criticism of income policies was part of a broader defence of economic freedom. Economic freedom was seen as beneficial because of the gains arising from the Smithian division of labour and Hayek's division of knowledge. A trustworthy instrument of choice, in the form of a monetary unit which maintained a constant value (or, at any rate, a degree of stability) through time, was thought necessary for the smooth operation of the free market economy which the monetarists favoured.

III

By its intrinsic nature, money is private, not public, property. Since the state is able to manufacture money at zero (or minimal) cost, it has no need to hold large money balances. For most of the twentieth century central governments in the industrial world financed their expenditure partly by a continuous overdraft from the banking system. The government's money holdings are negligible in most countries, but the banks lend it large sums for ongoing commitments by taking up issues of Treasury bills and other short-dated paper. (Again, local authorities and public corporations can never face bankruptcy, because the government will bail them out, however extreme their financial incompetence. One consequence of their immunity from risk is that they do not need to have sizeable balances in the banks.) British money supply statistics confirm these observations. At the end of 1976 – when the debates between Keynesianism and monetarism were livening up – the M3 measure of money totalled £45.1 billion, while deposits held by the public sector were about £0.9 billion. Public expenditure was over 45 per cent of national output, but money held by public sector bodies was a mere fiftieth of money held by the private sector. (The situation was much the same at the end of 2005. Sterling deposits held by the public sector at UK 'monetary financial institutions' – that is, banks and building societies – were £28.7 billion, whereas such deposits held by the private sector amounted to £1324.7 billion)[16] Evidently, no private sector agent can operate with the same financial freedom as the government. Every individual and company outside the public sector must own some cash or bank deposits, or risk the possibility of going bankrupt because of an inability to service debt. There are far-reaching – although often overlooked – implications for stabilization policy. Monetary control is not a complete macroeconomic agenda. Guidelines for fiscal policy, and government spending in particular, also need to be spelt out.[17]

The political message of Keynes's macroeconomic theory was that, because of the instability of the speculative demand for money, monetary policy was an unsound tool for regulating demand and that greater reliance should be placed on fiscal policy. So it might on occasions be necessary to combat recessions by raising public expenditure. Keynes had not noticed that money was relevant only as a determinant of private sector fluctuations. By contrast, as explained above, the public sector can borrow from the rest of the economy almost at will and cannot be constrained by a lack of liquidity. One of the major flaws latent in his advocacy of fiscal activism was therefore hidden from Keynes.

This flaw came gradually to be exposed in the 1960s and 1970s. The Keynesian predilection for using public expenditure as a demand regulator aided those politicians and bureaucrats who wanted, for ideological reasons, to see remorseless expansion of the public sector.[18] It would not have mattered if, after recessions were accompanied by spending increases, booms saw equivalent spending cuts. But that was not the way the cycles worked out. Instead, recessions induced public spending increases and booms prompted restrictive monetary policy. The private sector was disadvantaged in either situation. When demand was weak, the government's inclination to stimulate public expenditure was not associated with comparable pressures to raise private expenditure; and, when demand was strong, the resort to higher interest rates was detrimental to the private sector alone.

The tendency of this asymmetry to expand the size of the state, which was implicit in Keynesianism, was reinforced by the characteristics of government employment. Because such employment is only rarely justified by marketed output, the government cannot dismiss employees on the grounds that demand has dropped and sales revenue is insufficient. The state is quite unlike a private sector company subject to commercial disciplines which can offer a practically convincing (and morally reasonable) defence for declaring workers redundant if it does not have enough money to pay their wages. Private sector redundancies, the ultimate cause of which is often a cyclical downturn due to monetary restraint, can be attributed to the lack of demand for a particular product. They have a clear – if disagreeable – rationale, even to those who go without jobs. Since public sector output is financed by general taxation, the same argument cannot be made. It is more difficult to make redundancies in the public sector than in the private sector.[19]

There is a further, related point. Keynes's attack on the effectiveness of monetary policy did not stop with his call for the activation of fiscal policy. The point was that fiscal policy could have the necessary impact only if the public sector were sufficiently large. The logical corollary was, to use Keynes's own phrase, 'a somewhat comprehensive socialization of investment'. An apparently technical and non-ideological judgement about the efficacy of monetary policy became the background to an openly socialist proposal. There was much to be said against Keynes's argument even on its own premises. For example, difficulties in predicting the consequences of monetary policy might be thought a reason for paying more attention to it, not less. Further, precisely because government employment was (and remains) more inflexible than private sector employment, variations in public expenditure were not (and still are not) an adaptable and easily deployed macroeconomic policy instrument.

But there was a more sweeping objection to the Keynesians' proposed harnessing of the state's fiscal powers for the short-term management of demand and output. The monetarists were critical of fiscal activism largely because they doubted that the relevant authorities – the government, the finance ministry and the central bank – had the wisdom, foresight and political detachment required for the role. According to one characteristic monetarist argument, the changeability of the lag between changes in the money supply and money national income did not validate the greater use of fiscal policy. Instead it justified abandoning the discretionary approach to economic policy altogether and the adoption of an automatic money supply rule. The crowding-out argument buttressed the monetarist position, because it implied that – once a money supply target was in place – an activist fiscal policy was futile and pointless. (See Essay 8, for a statement of the crowding-out argument made in an article in *The Times* in October 1975.) Aside from the crowding-out thesis, mainstream Keynesians had produced conflicting estimates of the size of the so-called 'multiplier' by which national income rises in response to an increase in government spending. Economists' uncertainties about the demand implications of public spending – about whether a £1 billion increase in public expenditure added £2 billion, £1 billion or nothing to effective demand in the economy – was symptomatic of wider difficulties with fiscal activism. These difficulties established a case for scepticism about Keynes's call for an overhaul of property relationships as radical as that implied by the phrase 'comprehensive socialization of investment'. Donald Moggridge, the editor of Keynes's writings for the Royal Economic Society, once mentioned 'Keynes' tendency towards rather wild asides'.[20] Surely the recommendation of a socialization of investment, on the spurious grounds that it was needed to make fiscal activism effective, was one such 'wild aside'.

The strength of the correlation between monetarist sympathies and a liberal or conservative approach to political problems in the debates of the 1970s and 1980s was not an accident. Money is one of the principal kinds of private property and variations in its quantity have most effect on the private sector. The 'Friedman money supply rule' was intended first and foremost as the answer to inflation, but – if adopted – it would also have gone some way to protect the private sector from the politicians. It is sometimes said that there is no intellectual connection between, on the one hand, monetarist macroeconomics and, on the other, an aversion towards excessive public expenditure and interventionist industrial policy. But support for sound money and free markets form part of a coherent and integrated political outlook. A socialist government could have a programme of constant money supply growth and a balanced budget, while maintaining a high ratio of public expenditure to national income and embarking on schemes for subsidizing or penalizing private industrial ventures. But a high ratio of public expenditure to national income reduces the scope for individually motivated choices and thus makes the management of the money supply less important. In addition, the more obvious is the state's determination 'to accelerate industrial change', and the more politicians and government officials arbitrate on the allocation of scarce inputs, the less important is the financial system's role of enforcing market-related priorities according to profitability. The monetarist advocacy of stable money sits easily with the defence of private property. Meanwhile, in Oakeshott's words, private property is the institution which 'allows the widest distribution and discourages most effectively great and dangerous concentrations of power' and, hence, is 'most friendly to freedom'.[21]

In an article in the November 1976 issue of *Encounter* Friedman tried to make more precise the warnings about how over-expansion of state spending might undermine political freedom. He advanced the notion of a 'tipping point', a particular ratio of public expenditure to national income at which political liberty is in peril and totalitarianism is imminent. For a fairly unsophisticated country, such as Chile, the tipping point might be 40 per cent; for a richer country, like Britain, it might be higher at 60 per cent.[22] These remarks received heavy criticism, notably from such leading economic commentators as Samuel Brittan on the *Financial Times*, as glib and unscientific. (At the time Brittan was usually sympathetic to monetarist ideas.) But Friedman's *Encounter* article, even if it could not substantiate the specific figure in contention, was based on some clear and indisputable features of political democracy. The vital contrast, in his view, was between political and economic markets. The political mechanism had 'the fundamental defect' that

> it is a system of highly weighted voting under which the special interests have great incentive to promote their own interests at the expense of the general public. The benefits are concentrated; the costs are diffused; and you have therefore a bias in the political market place which leads to ever greater expansion in the scope of government and ultimately to control over the individual.

The economic market was 'very different'.

> In the economic market – the market in which individuals buy and sell from one another – each person gets what he pays for. There is a dollar-for-dollar relationship. Therefore, you have an incentive proportionate to the cost to examine what you are getting. If you are paying out of your own pocket for something and not out of somebody else's pocket, then you have a very strong incentive to see whether you are getting your money's worth.[23]

Although in his *Encounter* article Friedman did not join this essentially political argument to his well-known economic prescriptions, it would not have been difficult to do so. Today, as in the 1970s, the machinery of the political market is oiled by votes. More generally, competing interest groups are able to extract resources from the state (which has a monopoly of coercion, and the powers to tax and to print money) if they can assemble voting coalitions. Whether the distribution of resources to particular groups then has any relation to economic merit or social justice is rather arbitrary. By contrast, in the economic market people receive income according to the value of what they produce, and can express their preferences for different products when they purchase goods and services. Production and consumption therefore respect individual choice and personal freedom; and the outcomes have an obvious logic, even if market forces are sometimes harsh and capricious. The lubricant of the economic market is money, and the advantages of the economic market are most obvious when the monetary system is in good working order. It is the hallmark of societies undergoing a hyperinflationary experience that pressures on the government to act as the guardian of particular sectional interests are particularly strong. In such circumstances some citizens may prefer the political market because the lack of a stable monetary unit reduces the efficiency of the economic market. Only when the value of money is steady and reliable over a period of years can the economic market develop to its full extent.[24]

IV

The last two sections showed that sound money furthers the widening of choice found in a free economy and lends support to the institution of private property. Both these themes connected monetarism with liberalism and conservatism in the 1970s and 1980s, and helped to account for the typical political attitudes of monetarist economists. This final section will suggest that an important theme in monetarist economics was scepticism about the rationalist and managerial style of politics which was dominant in the late twentieth century. Misgivings about this type of politics were expressed by Popper and Hayek and, more particularly, by Oakeshott in his *Rationalism in Politics*.

Keynesianism of the kind practised by Britain's policy-making establishment had several rationalist characteristics. It was highly ambitious in that it asked the state to pursue four goals – full employment, price stability, economic growth and balance-of-payments equilibrium – and to have a precise conception of what these goals were or should be. Once defined and (probably) quantified, these goals were to be sought by means of 'demand management'. Notice how the word 'management' had crept in, rather as if the state were a business and politicians were its board of directors. The concept of demand management presumed not only that policy-makers had a good grasp of the applicable economic theory, but also that the empirical relationships highlighted by theory were stable and reliable. Implicit throughout was the notion that the more scientific was the approach, the deeper would be policy-makers' understanding and the better would be their decisions. The electronic gadgetry of the Treasury model, with its pretence of giving exact answers to difficult questions, indicated the cast of mind involved. Also fundamental was the Keynesian assumption that all the requisite knowledge and wisdom could be concentrated in a few minds in Whitehall (or perhaps in Westminster and Whitehall, or in other versions in Westminster, Whitehall and a handful of colleges at Cambridge University). Ultimately the economy's fate – and that of dozens of industries and businesses across the land – was to be determined at a sort of central committee meeting where the crucial decisions were to be taken. (Hence, all the attention paid to meetings of the National Economic Development Council or 'confrontations' between the Chancellor of the Exchequer and the TUC [Trades Union Congress] or CBI [Confederation of British Industry].) The committee's decisions would have, if some Keynesian accounts were taken to their logical conclusion, a purely technical character, rather as though the problem of steering the economy were like that of steering a ship on an agreed course. Ideally, debate and uncertainty were to be banished, rather as if – in Keynes's own words – economics could be reduced to a kind of dentistry.

Monetarism was in conflict with the rationalist tendency in two main ways. First, it denied that enough was known for policies to be framed with the exactitude needed. Friedman's original case for the monetary rule was negative and sceptical. It was not based on an extravagant boast that he knew more about the economy than the Keynesians, but instead rested on the perhaps less vulnerable foundations of partial ignorance. Friedman argued that – precisely because so little was understood – it was sensible not to expect too much from monetary policy. A similar admission of incomplete knowledge came with his theory of the natural rate of unemployment. In the 1967 presidential address to the American Economic Association he said quite candidly that, although he thought the natural rate was an empirically valid concept, he could not measure it. This may be branded as obscurantist or applauded as prudent intellectual modesty, but either way it was not rationalist or managerial in its implications.

Secondly, monetarists distrusted the political authorities to whom Keynes felt the task of demand management should be granted. To Keynes, and arguably to most of the British upper and middle classes of his time, it was safe to believe that governments acted as servants of the community as a whole and that their members were basically honest and conscientious. This was plausible in the early twentieth century because Britain had been ruled by a political elite of unusually high quality for at least 150 years. The Benthamite and melioristic mood of Keynes and his establishment colleagues reflected this long tradition of honesty, fairness and decency in public life: it duped them into thinking that altruism among politicians was the rule rather than the exception. Henry Simons, and other social and economic observers in the inter-war USA, did not have the same respect for the political process. The American Constitution has many strengths, but the rough-and-tumble of democratic vote-catching in large American cities from the late nineteenth century was not edifying. Chicago School economists have tended to take a cynical view of politicians' motives, as Friedman's antithesis between the economic and political markets demonstrates. The monetarists of the 1970s were influenced by the new theory of public choice which was then emerging.[25] They were alert to the possibility that politicians, far from watching over the interests of the community as a whole, might put their own interest first. Taken to the logical extremes, public choice theorists argued that politics was to be analysed, not as the maximization of social utility, but as the maximization of politicians' utility. It followed that the government's powers in the economic sphere should be restricted. The monetary rule was seen as an effective barrier to political discretion. When consistently applied, it excluded 'management' of the exchange rate, 'management' of fiscal policy and 'management' of individual prices and incomes. The implied critique of Keynesianism was far-reaching. Monetarism and Keynesianism were motivated by quite different interpretations of democratic politics.

In the first three post-war decades Britain's experience of democracy became much more like the USA's, with the two main parties competing for votes by electoral promises in such areas as full employment and price stability. The boom of the early 1970s was a particularly blatant attempt to court political popularity by over-stimulating the economy. Precedents were to be found in the 1950s when the Conservatives held a general election in 1955 shortly after a Budget which cut income taxes and again in 1959 when Mr Macmillan's slogan of 'you never had it so good' was declared in the midst of an unusually vigorous cyclical upswing. Keynesianism – with its hope that governments would publicly commit themselves to full employment – encouraged a version of democracy in which political parties competed with each other to have the best management team. But managerialism refuted itself. By becoming embroiled in party politics, demand management lost its innocence and ceased to be a purely technical item on a committee's agenda. Moreover, as economic policy became increasingly contentious and political in nature in the 1960s and 1970s, macroeconomic outcomes got worse rather than better.

The progress of monetarism in public debate in the 1970s may be seen, therefore, as partly a reflection of the disillusionment with politicians which marked the decade. This disillusionment may in turn be attributed to a realization that rationalism in economic policy had not solved problems, but increased them, and had not made disagreement about policy less heated, but intensified it. But managerial economics and political democracy were, and are, confederates. Managerialism gives politicians plenty to say at elections and plenty to do in between them. An alternative set of ideas (such as monetarism) which envisages a smaller state and less adventurous economic policy may always be difficult to reconcile with the competitive, adversary style of contemporary democratic politics.

NOTES

1. One example will suffice. 'Monetarism, like Christianity, makes a comeback from time to time. When things get bad, even sceptics start paying lip service, just in case there is something in the doctrine which might conceivably save them from eternal damnation.' C. Johnson, in a review of G. Pepper's *Money, Credit and Inflation*, *The Business Economist*, vol. 22, no. 1, winter 1990, pp. 64–5.
2. Economists at provincial ('red-brick') universities and financial journalists were the main contributors to a pamphlet critical of the Radcliffe Report, *Not Unanimous*, which was published by the Institute of Economic Affairs in January 1960. Only one of the seven contributors (R.F. Henderson) was from Cambridge University. Henderson opened his chapter with a recognition of indebtedness to Dennis Robertson, but to no other Cambridge economists.
3. G. Fletcher, *Understanding Dennis Robertson* (Cheltenham, UK and Northampton, MA USA: Edward Elgar Publishing, 2000), p. 404.

4. The inclusion of *Indian Currency and Finance* in the list may seem surprising. But – arguably – this was the beginning of an interest in the place of gold in an international currency regime which continued until the Bretton Woods negotiations (and his House of Lords speeches on them) in the mid-1940s.
5. J.M. Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1936), p. 293.
6. Keynes, *General Theory*, p. 296.
7. Money plays a crucial role in asset price determination, while sharp changes in asset prices affect expenditure. For more on these themes, see Essay 9 on pp. 181–205 and Essay 14 on pp. 281–315.
8. The phrases in quotation marks are taken from Keynes's famous introduction to the Cambridge Economic Handbooks, which he edited until 1936.
9. Mrs Joan Robinson – a left-wing economics don at Cambridge – used the phrase 'bastardised Keynesianism' to characterize the textbook income-expenditure model.
10. M. Friedman, *The Optimum Quantity of Money* (London: Macmillan, 1969), p. 84.
11. F. Hayek, *Law, Legislation and Liberty*, vol. 1 (London: Routledge and Kegan Paul, 1973), p. 14.
12. Shonfield's remark in his *British Economic Policy Since the War* (quoted in note 1 to the Introduction to this volume) – that 'the success or failure of the trade unions in controlling their members will determine the level of prices – and nothing else' – illustrated this sort of thinking.
13. Professor Maurice Dobb has made the distinction between the two types of theory particularly well in a number of books, notably in *Political Economy and Capitalism* (London: Routledge and Kegan Paul, 1970).
14. E.S. Johnson and H.G. Johnson, *The Shadow of Keynes* (Oxford: Basil Blackwell, 1978), p. 137. See also M. Skousen (ed.), *Dissent on Keynes* (New York: Praeger, 1992), p. 196.
15. See R. Opie, 'The political consequences of Lord Keynes', pp. 75–90, in D.E. Moggridge (ed.), *Keynes: Aspects of the Man and his Work* (London: Macmillan, 1974). The quotation is from p. 79.
16. *Financial Statistics* (London: Her Majesty's Stationery Office), September 1977, p. 51 and p. 74; *Financial Statistics* (London: The Stationery Office), July 2006, p. 58 and p. 78.
17. This was the point of the title of Keith Joseph's 1976 Stockton Lecture, 'Monetarism is not enough'. The title did *not* mean that monetarism was inadequate; it meant that control of the money supply had to be accompanied by restraint over public expenditure. To quote from the speech itself, 'Monetary contraction in a mixed economy strangles the private sector unless the state sector contracts with it and reduces its take in the national income'. M. Halcrow, *Keith Joseph: A Single Mind* (London: Macmillan, 1989), p. 113.
18. If this remark seems outlandish, see note 9 to Essay 12 in this collection, where George Orwell is quoted as saying – in 1945 – that communists keen 'to advance Russian interests at all costs . . . abound in England today'.
19. The case for money supply targets was advocated in the public debate at about the same time as the thesis that 'Britain had too few producers', because public sector employment (financed by taxes) seemed – almost continuously – to be rising faster than private sector employment (financed by sales revenue). The thesis was presented by R. Bacon and W. Eltis in an article in the *Sunday Times* in 1974, and in a book, *Britain's Economic Problem: Too Few Producers* (London: Macmillan, 1976). Between 1961 and 1979 public sector employment climbed at an annual compound rate of 1.3 per cent from 5.86 million to 7.45 million, while private sector employment contracted from 18.60 million to 17.94 million (The source for the data is *Economic Trends: Annual Supplement* [London: HMSO, 1988], p. 209.) During the 1979–97 Conservative government these trends were reversed, partly because of the privatization of nationalized industries.
20. See D. Moggridge, 'Keynes: the economist', pp. 53–74, in D.E. Moggridge (ed.), *Keynes: Aspects of the Man and his Work* (London: Macmillan, 1974). The reference to 'wild asides' is on p. 74.

21. M. Oakeshott, *Rationalism in Politics* (London: Methuen, 1962), p. 45. The remark appears in a review of Henry Simons's *Economic Policy for a Free Society*.
22. M. Friedman, 'The fragility of freedom', *Encounter*, November 1976, pp. 8–14.
23. It should be noted that the ideas put forward by Friedman in this article owed much to work on the theory of public choice done at the University of Western Virginia. See note 25 below.
24. The point may seem remote from the realities of Britain in the 1970s when inflation was running at 'only' 10 per cent a year. However, even this rate of price increases meant that the value of money over a five or ten year time span was highly uncertain and prohibitive of long-term contracts. The issue of long-term fixed-interest debentures and loan stocks on London financial markets practically ceased in these years. The general message is that – as inflation accelerates – the time horizon of the typical economic transector shortens until finally it is no more than a few hours or minutes. See an amusing footnote on p. 41 of J.M. Keynes, *A Tract on Monetary Reform*, in vol. IV of D.E. Moggridge and E. Johnson (eds), *The Collected Writings of John Maynard Keynes* (London: Macmillan, 1971).
25. The theory of public choice – which argues that public servants may put their own private interests ahead of the 'public interest' – was developed, mostly in the 1970s, by James Buchanan and Gordon Tullock. Its 'headquarters' are usually located as the Center for the Study of Public Choice at the Virginia Polytechnic Institute and State University. The public choice perspective was largely adopted by Chicago economists.