Edited, with a preface, by
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THE NEW OUTLINE OF MODERN KNOWLEDGE

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LONDON
VICTOR GOLLANCZ LTD
1956

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ECONOMICS, 1900–1950
by R. F. Harrod

1. Alfred Marshall and Liberal Reform, 1900–14

Economic thought in Britain at the opening of the century was subject to the tranquilizing influence of Alfred Marshall. His ascendancy was notable, although naturally not without challenge—for instance, by H. S. Foxwell in his own Cambridge and in London by Edwin Cannan, whose sturdy self-regard would suffer him to bow to no man. But F. Y. Edgeworth, sole representative of economics in Oxford, who was Marshall’s equal on the plane of severe abstract speculation, gave unstinted recognition of his leadership. In public life he was judged to be the best representative of academic thought and his views were respectfully attended to by successive Royal Commissions. There was no important challenge to his main body of doctrine. The Socialists, of course, were gathering their strength, and bent for their own reasons on the eventual overthrow of the capitalist system; but the Fabians at least were not disposed to prefer Marx to Marshall, if it was a question of analysing how wicked capitalism actually worked.

This ascendancy was partly due to personal qualities: a palpable devotion to the truth; an immense conscientiousness and sense of responsibility, leading to the polishing and repolishing of all his work and indeed to delays in publication, which in certain cases proved to be excessive; a judicial quality, a restraint and an unwillingness to intervene unless he could give the matter in question his utmost consideration; a private austerity, a certain hauteur and an instinctive sense of how, when one is a great master, one should act the role of great master.

This was the personal background; but what is more important to our purpose is to see how the specific character of his intellectual contribution qualified it for a commanding influence at the time. He was not a great path-breaker, like Ricardo or Keynes or even Jevons; he did indeed create certain tools of thought which have proved serviceable and durable, and he had a certain quality of impeccability and a strong sense of the limits and reservations to be attached to doctrines, so that when subsequent thought has shown the need for a qualification to some Marshallian tenet simply
conceived, his admirers have often been able to show that the qualification was there in his text all the time. All this was valuable. But we are not yet at the heart of the matter. It is necessary to take a backward glance.

The genius of Adam Smith and of the British economists of the early nineteenth century consisted in their ability to sort out the vastly confusing and heterogeneous phenomena of economic life, and to introduce concepts and classifications facilitating orderly thinking. Their "system" has been criticized as over-simplified, as no doubt it was; nonetheless it was a great advance from the preceding chaos. It gave prima facie arguments in favour of individualism, and, if pushed to an extreme, these might be deemed to justify complete laissez-faire. The economic principles involved were intelligible with moderate study and were in fact comprehended by quite a large class of persons engaged in some form of public life. They became part of the stock-in-trade of the well-informed. As thus popularly understood, the doctrines of "political economy" became, no doubt, too rigid; yet even so their guidance was better than none, and nineteenth-century policy and administration in England were more rational than they would have been without that guidance.

Thought does not stand still. In Britain and elsewhere there were challenges to the "classical" system. On the one hand there was the view that it failed to recognize the significance of historical development, and that it claimed universality for generalizations that at most were true of a passing phase of capitalism. It must be admitted that some of the classical writers were rather narrow in their purview, but the "historical school" may have underrated the value of abstraction owing to a deficiency of intellectual toughnes. There were other challenges. There were those who, finding a lack of precision at certain points in the classical thought, wanted to build systems anew from the beginning. Such were the Austrian school of marginalists and their counterpart in England, Jevons.

Marshall regarded such attempts at revolution with distaste. But his attitude to them was not one of intolerance; rather he sought to avert the evil consequences of rebellious fervour by comprehending what was valid in the rebel thought in his own system. He recognized the claims of history in principle. In regard to the marginalists he judged, I believe correctly, that much of their theory was already implicit in the older traditional system and for the rest constituted a welcome refinement. The doctrine of demand for goods and for factors of production based on their marginal utility was fully integrated with the older British cost of production theory of value in his famous Principles. The Austrian school continued to flourish and to thrive on controversy, and it has its progeny today. But British economists could argue that Marshall succeeded in incorporating everything that was of value in their thought without any fuss.

He laid stress on the continuity of economics and on the substantial truth at most points of the older doctrines. This attitude had a double value. Economics was (and is) a young discipline; as a science its main success so far has been conceptual and classificatory; it had not and—despite the development of statistics—still has not to its credit many laws that can be expressed quantitatively; it can do little experiment. A subject of study in this phase can all too easily become a field of fierce terminological controversies; the inexpert can mistake these conflicts for disagreements about matters of substance, and the controversialists may in their egoistic zeal themselves lose their firm grasp of the slender body of doctrine which is all that their science can vouchsafe. By such strife gains previously won may be dissipated and lost. In such a phase, skill in the choice of terms and modes of enunciating principles may require a wise sense of expediency; this does not imply any compromise with truth, for the same laws can be formulated in alternative ways. It may be wise expediency to instil and even if you can to impose—and Marshall could—what may be called a linguistic conservatism, for this will tend to curb the natural tendency of each new generation of students to mistake linguistic novelties for real contributions to the subject. And this in turn will canalize their energies into making real contributions. Marshall presented economics as a set of principles which had in the main stood the test of several generations; this might abash the tyro disposed to think it an easy matter to rewrite them. It is fair to add that in imposing this discipline Marshall was correspondingly modest about his own substantial contributions.

I have referred already to the wide diffusion in the nineteenth century of some knowledge of "political economy". This was another reason for linguistic conservatism. Facts and theories were becoming more complicated. This must put a strain on the layman. It seemed important to ensure, as far as possible, that economics should not be overlaid with technical jargon, and to dress the subject so that the politician, the administrator and the journalist should be able to retain the most essential principles within their comprehension. In this secondary aim Marshall may not have succeeded completely, but he strove hard, and he fully recognized how easily the position might slip, to the detriment of public affairs. To a large extent economic doctrine did retain its hold on the public for another generation. Marshall's more brilliant pupil Keynes did not feel these inhibitions; that there has been some loss by consequence can hardly be doubted. But whatever the proceedings of the academic world, the recent confusing changes in the real world might alone have sufficed to obfuscate the economic vision of the layman.

The synthesis achieved by Marshall must not be regarded as an
isolated British product. Systems structurally similar to his were being developed abroad at the same time by such economists as J. B. Clark in America, and Walras, Pareto, Auspitz and Lieben, and Wicksell on the Continent. The minds of these eminent economists were moving in the same direction as that of Marshall, but they did not, like him, gain widespread contemporary recognition for their systems.

The older economies had a reputation for harshness, in part unfairly so; its practical maxims inclined strongly to laissez-faire, although its foremost proponents always allowed many exceptions. Its classification was broad and deemed handy for practical use. The Marshallian system was more refined and precise; it had been given a mathematical formulation; its assumptions were more clearly specified, and this was in itself a safeguard against the over-ready application of crude maxims. It may be well to consider how the traditional maxims stood at the opening of the present century.

The high regard for the virtues of competition and free enterprise was still, outside the ranks of Socialists, undimmed. The virtues ascribed were twofold. First, competition was held to be the only available method for ensuring efficiency and progress. Secondly, it secured for the consumer the assortment of goods he required. This was in accordance with Adam Smith's famous "hidden hand"; this conception did not of course imply some providential agency, but was a flowery description of the practical forces generated in free markets, now often referred to as the "price mechanism".

The more precise mathematical formulation of the economic equilibrium, to which reference was made in the last paragraph, revealed relations which might raise doubts, expressed but not stressed by Marshall, as to the precise accuracy of those forces, when industries were subject to the laws of diminishing or increasing returns. These doubts made no immediate impact on thinking about public policy, but were to become quite important thirty years later.

Both virtues of competition, when regarded on an international scale, required, as a corollary, Free Trade. While the new century saw the beginnings of a Protectionist agitation under the auspices of Joseph Chamberlain, the leading professional economists were agreed in rejecting the arguments. The triumph of Free Trade as the official British policy, eventually supported by both political parties, had been the greatest practical achievement of the classical school. It was a notable triumph of intellect over prejudice, because Free Trade, although valid, is not an inherently popular doctrine. It was frankly based on self-interest, and, in accordance with the doctrine of Ricardo, who reduced the generalities of Adam Smith to an exact theory, its benefit to the country adopting it is independent of whether other countries adopt it or not, and of whether their wages are high or low. But it was also deemed to be a fine example to other nations, whose adoption of it would bring further advantages to themselves and others; and this was reckoned a good reason for scorning to infringe the general principle in those exceptional cases where, by self-interested calculation alone, some advantage might be obtainable. The rigid adherence to the principle of the open port by Britain during her period of greatest ascendency has not only the quality of enlightenment, but also one no less essential to leadership, the quality of dignity, and, I would even say, of majesty. It will long continue to stand to her credit in a survey of the centuries. In 1900 the economists were to remain united in its defence for a further period.

What had they to say at this time on the problem of poverty? This has usually been near the heart of economists, for some zeal in regard to it has often been their motive in devoting themselves to this arduous study; if they have achieved, especially in early days, the reputation of being hard-faced, that is because study leads to scepticism about facile solutions.

The early school was much influenced by Malthus's views on the population question, which led to what was known as the "subsistence theory of wages". Given the normal human tendency to reproduction, population will increase at an insupportable and indeed in the long run fantastic rate, unless checked by a high death-rate, i.e. by extreme poverty. All agreed that the level of subsistence could be raised progressively if only the birth-rate could be reduced below its natural level. On this Malthus himself was pessimistic, especially in his earlier phase; implying that contraception should be repugnant to a good Christian, he doubted if moral restraint alone would be sufficient to prevent breeding up to the point at which poverty was inevitable. Ricardo and J. S. Mill took more optimistic views about the possibility of restraining births. As the nineteenth century wore on less was heard about the population principle. Despite prodigious increases in the British population, the standard of living had in fact been greatly improved, and there was a disposition to relegate Malthus to limbo. This was superficial. The forward strides in industrial efficiency and, more important, the growing dependence of Britain on food supplies from overseas had staved off the working of the Malthusian principle. By themselves these could only provide passing respite, for in the end, given traditional birth-rates and the greatly fallen death-rate, Britain would be bound to become packed full with people, like a tin with sardines. Careful students have observed with surprise that there are still vestiges of Malthusian views in Marshall, and have attributed this to his usual unwillingness to break with traditional doctrine. But on the facts at his disposal he was still right to be cautious. What has revolutionized the situation has been the great fall in the
birth-rate; this trend had indeed begun earlier but could not yet be clearly recognized in 1900. Indeed as late as 1919 Keynes attempted to revive a population scare. The spectacular fall in the birth-rate has now for some time rendered Malthusian anxieties obsolete for Western Europe. But Malthusian doctrine, so prominent in J. S. Mill and not quite dead in Marshall, still has relevance for the poorer regions of the world where birth-rates remain high. However, Malthusian fears were no longer influencing thought about policy in Britain in 1900.

The pessimism, or perhaps one should rather say the caution, of the earlier school had a second string, known as the Wages Fund theory. This theory, which is formally correct, holds that the total amount that can be paid out in wages, wherever there is a time interval between the application of labour and the completion of a product for consumption, cannot exceed the rotating fund of accumulated savings. The practical conclusion was that the only true beneficiary of the working classes was the man who added to his savings and that neither legislation nor Trade Union action could add a penny to the total wages bill, any sectional improvements being necessarily accompanied by deteriorations elsewhere.

By the end of the century the hold of this doctrine had weakened somewhat. J. S. Mill late in life made a resounding, though not completely convincing, retraction of it. There was a shift of emphasis. What was really implied was that it would be safe to regard the wages fund—perhaps better called savings fund—as sufficiently elastic, if only higher wages could be justified on other grounds. The emphasis on demand and on the margin, initiated by the Austrian school and incorporated by Marshall and others, led to a theory being expressed in the form that wages are the product of labour. Thus if only productivity could be increased, wages could be increased; this favourable situation would attract the necessary extra savings, and thus the wages fund would look after itself. Perhaps in certain circumstances the causation might work the other way round: the grant of a wages increase might improve the health and stamina, and thereby the productivity, of the wage-earner and thus create a state of affairs justifying the increase ex post. Or take another case. In a free and properly organized market, the wage-earner should obtain his whole produce as wage; but it may be that the market is not properly organized, that there is an inequality of bargaining advantage and some monopolistic element on the side of the employers, and that there is by consequence in some sense an "exploitation" of labour in which the worker receives less than his product. If in those circumstances a Trade Union comes forward and insists on higher wages or a statutory Trade Board is set up empowered to fix a minimum, lo and behold, the higher wage can be paid without adverse repercussions.

Of course these ideas must be applied with due caution. If a Trade Union too militant or a Trade Board too humanitarian fixes a wage above the product, either some workers will be thrown into unemployment or an increase of prices will follow causing a deterioration in the buying power of wages generally.

Such ideas had been weaning economists away from the rigid doctrine that the wage-earning classes must wait passively for capital accumulation eventually to pour benefits into their lap, and had been making them more receptive to the view that Trade Union action and, within carefully defined limits, state intervention might benefit the poor. Public opinion was also in a mood to form an independent judgement. It is only in the present age that we have full statistics of the distribution of the national income. Even without them it may be yet possible to form a rough and ready judgement. In the early days of the Industrial Revolution, aristocrats might enjoy a luxurious standard, but most industrialists were living hard and ploughing back their profits. Common sense might guess that there was not a large cake available for redistribution, except at the expense of savings vitally needed for industrial expansion. By the end of the century there was rather a large high-living middle class, and it seemed manifestly absurd to argue that nothing was available for redistribution to mitigate the harsh lot of the poor, which was visible enough to those who looked, and repeatedly publicized in surveys and reports. We do not have to assume that an increase in humanitarianism occurred at this time, for in the earlier days some harshness had been a stern necessity. But we need not categorically deny that the great writers of the century, whether Wordsworth, Dickens or George Eliot, had a slow-working influence in diffusing a more humane social outlook in ever-widening circles. And self-help too played its part; the Trade Unions, only efficiently organized after much perseverance and many set-backs, and the Parliamentary vote helped to push open the door, from which the heaviest bolts had already been removed.

Thus the trend of economic theory and of public opinion and the circumstances together set the scene for the experiment in economic reform of the Liberal administrations of 1906 to 1914. These were designed to bring relief to the poor. Already in the nineteenth century the State had intervened in many fields—factory legislation, education—thereby infringing the strict principles of laissez-faire. But the new measures went further in securing a redistribution of income on lines that would have been deemed by an earlier generation to be "contrary to the laws of political economy". The group of measures of these Liberal administrations may be reckoned as having introduced in principle what we have since come to know as the "Welfare State"; but the amounts involved in terms of pounds, shillings and pence were still small in these early stages.
The expediency of having collective bargaining by wage-earners who, as individuals, were the weaker party, was recognized by the Trades Disputes Act (1906), which gave the Unions a much more secure status and removed them from the anxiety that their collective-bargaining activities, including the withdrawal of labour, might be deemed civil conspiracies or otherwise offend against the law; some argued that the Act went too far in raising the Unions above the law. Non-contributory Government pensions for the aged were provided in 1908. A far-reaching departure was the establishment of Trade Boards (1909) empowered to impose statutory minimum wages in what had hitherto been “sweated” trades; here the State came in to prescribe and enforce a raising of standards for the poorest classes of wage-earners. In the same year Labour Exchanges were set up to provide information and increase the mobility of labour. In 1911 the great system of National Insurance was inaugurated, partly based on German precedent; it provided for compulsory insurance with State contributions against sickness and, in part of the field, against unemployment. The Shops Act (1911) provided a compulsory half-holiday. In 1912 statutory minimum wages were enacted for the important group of coal-miners workers.

These measures were accompanied by fiscal reform, also of a redistributive tendency. An attempt was made to tax the “unearned increment” of the land. The doctrine that the land was an especially suitable object of taxation descended from the early days of classical economics; crudely set out, this doctrine contains many fallacies, and, if such an impost is to be at all equitable, it is necessary to have immense patience, namely over a period of many decades, to get any substantial returns from it; this particular attempt proved abortive. More important was the introduction of the super-tax, which made direct taxation progressive—there was a death-duty precedent. Here again the important step was the introduction of the principle; two wars caused this weapon of tax collection to be carried far beyond the scale originally intended, and perhaps beyond what is wise and equitable.

II. The First World War and its Aftermath, 1914-25

The First World War led to the introduction of a widespread system of Governmental control through the economy. The question may be raised why, if free enterprise is really the more efficient system, is it abandoned in time of war. In the first place, the operations themselves place the Government in the position of a purchaser of labour and goods on a preponderant scale, and its direct interests ramify throughout the economy. Secondly, in war, speed is more important than efficiency; there is little doubt that in both wars the systems of Government interference involved colossal waste; but that had to be accepted in the interest of that speed of adjustment which a dictate can alone ensure. After the First World War the system of controls was very rapidly liquidated, and did not have a great effect on subsequent events; but the memory of it may have been an encouragement to Socialists against the dogmatisms of traditionalists who affirmed that a widespread system of controls would be totally impracticable and break down in chaos and absurdity.

There was, however, one great aftermath of the war which had a profound influence on thought and practice, namely the currency inflation. For many years before the First War, orthodoxy in this field was securely established and not subject to serious challenge. The gold standard was accepted as the best plan; even the enthusiasms of bi-metallists had abated and died; there were indeed a number of interesting developments, particularly in the provision of “gold exchange standards” for less developed regions, and Keynes’s reflections upon the Indian system (1913) had seminal ideas, which were eventually to raise doubts about certain orthodoxies. Major inflations were regarded as distempers of an earlier age. One remembered the issue of assignats during the French Revolution, and sundry currency excesses on the American continent; but these were deemed to self-condemned and unlikely to crop up again. But now they had cropped up. The causes were set forth by economists on orthodox lines; it was generally recognized that inflation was not merely a matter of note issue, but also connected, in accordance with already received monetary theory, with excess lending—in the interests of the smooth running of the war—by the banking system. The evils of inflation were manifesting themselves strongly, and hardly needed emphasis. They were not only seen on the domestic front in the upward spiralling of prices and wages, but also in the foreign-exchange markets. Traditional doctrine laid down that loss of internal purchasing power would be measured by a corresponding depreciation of a currency in the foreign exchanges. The foreign-exchange rates, however, did not fully measure inflation, because a world-wide process had caused a deterioration in the commodity-value of gold itself; and although the United States returned to specie payments at the old gold parity for the dollar in 1919, the dollar, and consequently gold, had much less purchasing power in terms of goods than before the war.

Where various currencies had undergone different degrees of inflation, this should be measured in their various exchange quotations against one another. The Swedish economist Gustav Cassel coined a popular phrase to express this, “purchasing power parity”. The basic truth of this doctrine, and also the various modifications that have to be attached to it, was set out with a new precision. In particular it was noted that the foreign-exchange market had a
strong tendency to anticipate the future, so that the countries which had not yet mastered their own internal inflationary process tended to have their currencies undervalued in foreign-exchange markets.

To English-speaking and Scandinavian economists all this was plain enough. But there were doubts in other quarters. Economic theory, although well represented in the various Continental countries, had not bitten so deep there, and it did not appear to them so axiomatic that the falling value of their currencies at home and abroad was due to their own actions in increasing the quantity of notes or bank loans. They seemed to themselves to be caught up in some kind of ineluctable process, to be the victims of irresistible pressures; they were apt to claim that the progressive rise of prices was due to forces beyond their control, and that in accommodating the amount of currency issued to the higher needs for circulation due to these higher prices, they were doing what was absolutely inevitable. The British never admitted this, and in principle it cannot perhaps be admitted. On the other hand it may be allowed that in certain cases it would not have been quite as easy as orthodoxy suggested, given the general economic circumstances, for these nations to rescue themselves from the toils of the inflationary process. It may not always be possible to draw a precise line between what is difficult and what, for practical purposes, may be reckoned impossible.

Prominent among these cases was that of Germany. This brings us to the Reparations problem. In this there were certain deep questions involved which, despite all the talk and literature, were not fully brought out at the time. The demands and the assertions of those who wanted to make Germany pay the full cost of the war were so fantastic, and the case against them so overwhelming, that Keynes was able to win an easy victory among those of well-informed opinions. Absurd Reparation demands caused much confusion in the post-war years until they were reduced to a reasonable level in 1933; the uncertainties of that period retarded the European recovery and may well have been responsible, by their disturbing effects on the social fabric of Germany, for the Second World War.

Keynes held that the Germans could not pay the large sums asked; the implications of this proposition were not duly considered because the sums asked were so fantastic, and the words “could not” could readily be given a rough common-sense meaning. Keynes held, not merely that the Germans could not pay these fantastic sums, but that they could not even pay much more moderate sums in excess of a certain amount. It was assumed in his argument that the payments were to be made by the normal processes of a free economy, including the heavy taxation of German citizens, and not by a coercive system under which the whole of the German economy would be rigidly controlled and a portion of its people set down to work for others by central direction. His point was that the free system does not provide means for such large adjustments as those envisaged. This contention was not strictly in line with orthodox economics. It was never put to the test or even argued out because of the rapid abatement of the demands upon Germany. But it has relevance to the problem of whether it would have been possible for the world to carry through those other large adjustments that were necessitated by the Second World War without the aid of a system of fairly comprehensive controls.

For a number of countries, including Britain and the United States, the inflationary period was over by the middle of 1920 and was followed by a period of deflation. This was a less familiar problem in the orthodox economic texts, although Ricardo had some sage ideas upon its incidence after the Napoleonic Wars. It was found that the deflationary process gave rise to some very acute evils of its own—widespread unemployment, business loss and a freezing of new enterprise.

Before the values of currencies in the countries subject to deflation had been restored to their 1914 values in terms of goods, the authorities made up their minds that deflation too was an evil and that it was not desirable to carry the process any further. The resilient United States economy was already in 1922 recovering fairly well from the deflationary bout; but the British economy remained depressed, and unemployment was greater than it had ever been within living memory, or in the records. This phenomenon provoked a train of thinking in Keynes which gave rise to the most important basic changes in economic theory in the last hundred years.

From early days one branch of economic thinking had consisted in the study of the ups and downs of trade. The British school comprised important contributors to this subject: Tooke, Walter Bagehot and, above all, W. S. Jevons. Before the war there were also notable contributions by Continental writers—Tugan-Baranovsky, Spiethoff and Aftalion—and in the United States Wesley Mitchell had begun his monumental labours. Shortly before the war in England Professor Pigou (Wealth and Welfare, 1912) and Mr. Hawtrey (Good and Bad Trade, 1912) had made contributions; and attacking the problem with sharper tools and more profound and subtle thinking, Sir Dennis Robertson published his notable volume on Industrial Fluctuations (1915). The period of inflation followed by deflation re-stimulated interest in the more fundamental and permanent problem of what had come to be called the Trade Cycle. In the post-war period a good deal of stress was laid on the monetary causes of fluctuations, perhaps as a natural consequence of the big disturbances in the monetary system that had taken place. There was an old tradition among monetary theorists that an ideal money
ought to have stable purchasing power in terms of commodities. In the United States, Irving Fisher had recently made prominent proposals for a dollar that should be stable in terms of commodities. Now a whole host of very eminent writers concentrated their attention on the need for monetary stability—Fisher, R. G. Hawtrey, Cassel, R. McKenna, Keynes and Sir Dennis Robertson. The last-mentioned made some subtle but fundamental reservations, and presented these in a new form in his Banking Policy and the Price Level (1926).

England did not return to the gold standard until 1925. When she did so, she returned to the pre-war parity; she chose this rate largely for prestige reasons. Anticipation that she would do so had floated the pound up in the free markets so that the technical operation was not difficult. Keynes argued strongly that this would mean an overvaluation of sterling and have woeful consequences, but he did not get much support. He did not, however, concentrate his attention upon the undesirability of forcing the pound up to an unjustified level, but mingled his pleading with arguments against returning to the gold standard at all. He deemed that we were getting along very well in the period 1922-4 with a pound that was fairly steady, but was not absolutely stable in the foreign-exchange markets. Subscribing to the view that money should be stable in terms of commodities, he argued that the de facto arrangements at this time were working well and that we should take this opportunity for an experiment in a “managed” currency to remain detached for gold and to be held roughly stable in terms of commodities. After the return to gold in 1925 there was a good deal of retrospective support for Keynes’s opposition to a return to the old parity, but much less for his desire to be free of a fixed gold par altogether, and some complaint that if he had not mixed the two lines of thought he might have had greater success in his advocacy of a lower parity. But his advocacy of a floating pound was destined to have far-reaching effects later.

In 1914 the United States, which had been without a central bank for eighty years, established the Federal Reserve System which was a chain of twelve central banks co-ordinated by a Federal Board. After the post-war inflation and deflation, the Federal Reserve System deliberately set itself to aim at internal monetary stability.

In the management of sterling prior to 1914 the Bank of England had had perforce to concentrate its attention in its monetary management mainly on the country’s external balance of payments. In the twenties the United States had a very large gold reserve and was consequently free to concentrate attention on internal stability. This was a new departure. Its implications for the international equilibrium were not clear, but its internal objectives were entirely in line with the thinking of those economists who were urging the supreme importance of having a money that should be stable in terms of its purchasing power over commodities. The Federal Reserve experiment was thus watched with some enthusiasm, and it was hoped that we might be at the beginning of a new era in monetary affairs, in which the world should enjoy, under this American leadership, a more stable medium of exchange. For seven years all seemed to go well, but then the American slump came. Space does not allow me to examine Federal Reserve policy here; it must suffice to say that no one has been able to demonstrate that its conduct of affairs in the years 1923-9 was gravely at fault.

III. Keynes

It is well known that the American slump had a most far-reaching influence on the course of events, political as well as economic. It also had a very important effect on the course of thinking. Naturally enough it encouraged those who regarded the Trade Cycle as of central importance in economic studies. But it discouraged those who hoped to find the cause and cure of the Cycle in monetary management alone. If there had been no Federal Reserve System, the matter might have been otherwise. But the fact that this unprecedented slump occurred in a country which had in fact enjoyed the benefit of monetary management in accordance with the best ideas available, raised doubts as to the potency of this weapon and suggested that there might be more fundamental causes of oscillation than lay within the power of monetary authorities to counteract. This subject cannot be regarded as closed at the present day. In the thirties thinking took a new direction.

Some held that the great disturbances of the world slump were a delayed aftermath of those due to the First World War. Apart from the physical destruction, which was not great, there were disturbances due to the changes in the established pattern of international trade and also those specifically concerned with reparations and inter-allied war debts. Some held that these were not large enough to account for the huge dimensions of the great world slump of 1929-32. Study of the Trade Cycle revived. With the increased doubt about whether monetary mismanagement could be regarded as a prime cause, attention reverted to alternative theories, such as those advanced by the writers whom I have mentioned above, notably to theories that concerned fluctuations in the level of investment activity. While different lines of thought and different authors made their contributions to the common stock of understanding (and special stress ought to be given to Sir Dennis Robertson and to the Swedish school which had continued to flourish since the days of Wicksell), the thinking of Keynes came more and more to attract attention, both by reason of his energy and lucidity as a writer, and
because his disposition was to relate his thinking about economic depression to more general economic theories.

In some respects his first step away from orthodoxy deserves most attention, as being pregnant with large developments. We have seen that he was particularly interested in the phenomena of deflation that occurred after 1920. He continued to advocate a more expansive monetary policy in England prior to the set-back of the return to the gold standard in 1925. But although monetary policy in the three preceding years was not as expansionist as he could wish, it would be hard to stigmatize it as a strongly deflationist policy; and yet unemployment had never been so severe. It therefore seemed that something more than monetary relaxation was needed, and he accordingly advocated a vigorous policy of public works to reduce unemployment. This was certainly out of step with traditional economics. According to that doctrine, economy in outlay is always a prime recipe for trouble. Public works need not be vetoed in every case, but must be judged on their merits; they are not to be encouraged, save to the extent that they can be shown to serve a really useful purpose; if anything, the balance should be tilted against them in the interest of economy; and in all cases it would be desirable if possible for them to be financed out of ordinary revenue. Keynes took the opposite view; he wanted them financed by Government borrowing. This was very disturbing to those deeply imbued with the older system of thought. A counter view was put forward which was later christened the "Treasury view". If the Government borrowed for public works, it was argued, it would merely draw funds from the capital market and reduce the amount that industry would otherwise have spent on capital account. Thus it merely diverted funds from purposes which private enterprise deemed profitable to the more problematic field of public works where expenditure might depend on the crotchets of bureaucrats; in any case no new employment would be given. While christened the "Treasury view", this opinion was none other than the age-old doctrine of traditional economics. To some Keynes's advocacy was particularly displeasing on the ground that it seemed to pander to ignorant notions of expediency and to the fallacies of public men, who could see the employment given by the public works and were too crude in their mental processes to work out how this use of funds might automatically create unemployment in another part of the economy. It seemed quite shameful that an economist of repute should lend himself to such rubbish. At the same time Keynes recommended that Britain should devote less resources to overseas investment; this seemed rather paltry.

Keynes, however, persisted in his opinion. He was deeply concerned not only to get his policy of public works implemented, but to establish its validity in the face of orthodox disfavour. He worked on this subject for a dozen years, publishing meanwhile various new presentations of his ideas; this culminated in his famous treatise The General Theory of Employment, Interest and Money (1936). It is not necessary to trace the evolution of his ideas, although in their various phases they had certain specific influences. But in any history of economics, however brief, some space must be given to the doctrines that he propounded in his final large volume. There is every reason to believe that, but for the Second World War and his relatively early death in 1946, he would have carried them to a further stage of systematization.

Traditional economics placed great reliance on what is known as Say's Law. This was deemed to guarantee that under free enterprise there could be no general over-production. There could only be over-production of particular commodities, and the economy had means for adapting itself so as to reduce the output of those in excess supply in favour of other forms of output. There could not be too much of everything; this not only meant that there could not be more than men had need for, but also that there could not be more in aggregate than men have money to buy. Apparent all-round saturations of the market were only temporary or frictional phenomena or, if prolonged, were due to some form of monetary mismanagement, or to some very big changes, such as those following war, to which it might take time for the economic system to adapt itself. There could be no chronic and systematic tendency for the monetary demand for goods in general to be inadequate.

The reason was that people who are paid to make goods, whether in wages, profits, etc., spend their money in demanding goods. Of course they might save some of their income. These savings were available for capital outlay. Could we always be sure that the capital outlay would be sufficient to utilize these savings, so that the demand on account of consumption and the demand for capital goods together sufficed to absorb the whole product offered? The answer to this was in the affirmative. The free system contains a mechanism to achieve this precise result, namely the rate of interest. Just as the price of wheat tends to equate the demand to the supply of wheat, so the rate of interest, that is the price paid for funds on loan, always served in the end to equate the demand for money to be spent on capital account to the supply of savings available for that purpose. If there was any tendency to excessive savings, the rate of interest would fall; whether this discouraged saving or not, it would certainly encourage capital outlay, and the fall would continue until sufficient capital outlay was encouraged to absorb all the savings, and thus to make up the total demand for goods to an equal level with the supply. The implication of this is that a free economy will tend, subject to frictions and some inevitable lags in adjustment to a new situation, to the position of full employment.
Keynes denied this tendency to full employment, and he denied the operation of Say’s Law. He did not merely hold, what was obvious for all to see, that there might be intervals of grave maladjustment in which productive resources could not find the right outlet. He held that the very working of the system might in certain circumstances systematically tend to an equilibrium with massive unemployment present. To uphold this view, he was bound to deny, and did deny, that the rate of interest played the part assigned to it in Say’s Law. There were two parts to this denial. First he brought to notice forces other than the demand for and supply of savings, bearing upon the rate of interest. These arose under what he called “liquidity preference”. Among the various forms of assets which property owners may hold, swapping them with one another according to taste, we may concentrate our attention upon two, money and bonds. Bonds consist essentially of promises to pay money at a later date; thus money and bonds are both, in a sense, money. But money is available for use at any time; bonds represent money available for use later; thus money is more liquid. It is true that reputable bonds are not altogether illiquid. But as the rate of interest varies in the market, so will the price of bonds vary; if a man wants to dispose of bonds suddenly, without waiting for their date of redemption, he may have to realize at a loss. For many purposes a man may prefer to be on the safe side and hold ready money; bonds on the other hand carry interest. As money and bonds are both in a sense money, but bonds carry interest while money does not, this interest must be related to the one feature in which bonds differ from money, namely their lack of liquidity. From time to time property owners for various reasons desire now more, now less, liquidity. The total amount of liquidity available to them, which is the total amount of currency and bank-deposits in existence, is determined by the banking system. (On that point Keynes and the orthodox school were not in disagreement.) The rate of interest must be such as to equate the demand for to the supply of liquidity. If there is not enough liquidity to satisfy needs, some people will be sellers of bonds in the market. This will depress the price of bonds; that is, it will send up the rate of interest; this means that when the supply of liquidity is deficient, the rate of interest, which is precisely the premium for parting with liquidity, goes up.

Now suppose that there is a new force which according to Say’s Law should affect the rate of interest, such as an increased propensity to save; this should cause a fall in the rate of interest if full employment is to be maintained. But it is quite possible for such an event to occur and yet for there to be no change whatever in the balance between the demand and supply of liquidity; and in that case, according to Keynes, the rate of interest cannot change; Say’s Law is frustrated.

Then there is a second arm to Keynes’s attack on the traditional theory of interest. By that theory the demand for and supply of savings must somehow be brought to equality; how but by the rate of interest? Keynes urged that the rate of interest did a quite different work, namely that of bringing the demand for and supply of liquidity to equality. It cannot do both at once, since the changes in the supply/demand conditions affecting liquidity may be quite different from the changes in the supply/demand conditions affecting savings. It was therefore needful for Keynes to show how on earth the demand for and supply of savings were brought to equality, since equal they must undoubtedly be. It is usually the price of a valuable that brings the demand for and supply of it to equality. Could it be different in the case of saving? What was the price paid for saving but the rate of interest?

Keynes held that there was quite a different force—securing this particular equality. If investment demands, which constitute the demand for saving, proved deficient in relation to the propensity of people to save, there would be a decline of activity, employment, and income. Saving was brought to equality with investment demand, not by a fall of interest stimulating investment demand, not by a fall of interest encouraging saving, but by a shrinkage in the source of saving, namely a shrinkage of income itself. The volume of people’s saving is not only determined by the price they can get for doing so, but also by their wherewithal from which to save. If activity and income shrink all round, saving would shrink; and it is by this painful process that saving is brought to an equality with investment when investment opportunities are insufficient to absorb all that people would be willing to save were they fully employed. Unemployment is thus a symptom of investment opportunity being deficient in relation to the propensity of the community to save. If investment opportunities are gravely deficient, and if they remain deficient, the unemployment may be very severe and remain severe; and there is nothing in the ordinary working of the economic system which tends to remove this unemployment. It is this analysis which justified Keynes in having pronounced twelve years earlier that public works would provide a net addition to employment; they increased total investment opportunity. If you raise total investment opportunity and the propensity to save remains the same, then, by a converse argument to that just supplied, the whole level of employment and activity will rise. The public works do not divert capital from other uses, but, by raising activity and income and saving, automatically create as much additional saving as is needed to finance them.

In the foregoing argument it was assumed that traditional theory held that Say’s Law would always require full employment. It might be argued, however, that traditional theory allowed for sustained unemployment on one condition, namely if the workers,
through their trade unions or otherwise, stuck out for higher wages than corresponded to their product. The natural remedy in these circumstances was to reduce wages. Keynes did not deny the principle that wage-earners cannot continue to receive more than their product. But he held that the general level of what, in the technical language of economics, are called “real” wages was not affected by trade-union bargaining, although sectional increases could be secured. If the general level of money wages was raised to an unjustified level in terms of existing prices, prices would rise accordingly and thus the general level of “real” wages would not in the event have been increased. The moral for the unemployment situation followed. If investment opportunity is insufficient to absorb what would be saved in the full-employment situation, and thus Say’s Law fails, the total effective demand will be insufficient to give employment to all available labour. Only something that raises total effective demand can alter this situation. According to the traditional view just cited, if there is unemployment, money wages should be reduced, and this would stimulate employment. On the contrary, Keynes held that if Say’s Law failed and there was insufficient effective demand, a reduction of wages would not increase demand, and would not therefore increase employment. The effect of a reduction of money wages would be a fall of prices, and real wages on average would be left just where they were before.

To this sweeping generalization he readily admitted that there were exceptions. Of these by far the most important is concerned with foreign trade; Keynes did not live to elaborate a complete theory of foreign trade in the light of his new ideas. If a country is on the gold standard, or has a fixed rate of exchange, then a reduction of wages might create employment—he did not deny it—by making the country’s goods more competitive in world markets. As a practical proposition, however, he held that if a country had got into the unfortunate position of having wages at a higher level in terms of gold than the product of its labour justified, then, since a general all-round reduction of wages is impracticable, and a partial reduction is bound to involve great inequity, the wisest solution was to alter the foreign-exchange rate, so as to bring internal costs into line with world prices. This was the principal reason why he continued to favour flexibility in the foreign-exchange rates.

Another departure from traditional theory may be noted. We have seen that in Keynesian theory the general level of prices is somewhat flexible, responding readily to upward or downward movements in the general level of wages in such wise as to preserve the existing equilibrium of full employment or, when Say’s Law was failing, the existing equilibrium of unemployment. This is in contrast with “the quantity theory of money” by which the general level of prices is supposed to depend on the quantity of money outstanding. He held that only part of existing money was used to circulate goods, the remainder being held as a reserve asset, where it satisfied the desire of liquidity. It was the amount of money available for this latter purpose that governed the rate of interest; the amount of money available for this purpose was the total amount of money in existence less that required for active circulation.

If a rise of activity or of wage-rates promoted requirements for more money in active circulation, money would be pulled out of the reserve pool; and conversely. This flow in and out of the reserve pool would have its effect on the rate of interest and so on activity and so, indirectly, on the general level of prices; but in the Keynes system the relation between the total quantity of money and the general level of prices was much more indirect than under orthodox “quantity theory” doctrine.

Thus, in Keynes’s theory, money, although still playing a substantial role, no longer played the principal role in governing the tendency to inflation or deflation; this last was governed by agregate real demand, namely demand arising on consumer account and demand arising on investment account; and to these we should hasten to add, in the light of modern conditions and fully in conformity with Keynes’s own doctrine, demand arising on Government account.

Keynes’s views met with, and still meet with, tough academic resistance in many quarters. But in some respects they conform rather more easily to the notions of the man in the street than did the older orthodoxy; contrary to many novelties of economic doctrine, their practical acceptance has been more rapid and widespread than their academic acceptance. During the early years of the war, the British Treasury under Keynes’s influence issued a white paper setting out the main elements of the national income. This has since been greatly amplified, and widely imitated. Nations which issue national-income statistics can hardly deem themselves self-respecting in these days. These throw light on the magnitude and trends of the main categories of demand. Study of these and kindred statistics is now a foremost method used for diagnosing or prognosticating inflationary or deflationary trends. Should demand appear excessive or deficient, consideration is given to means for operating on the main sectors of demand, whether by way of stimulation or restraint. All this line of thinking would have been totally unacceptable to the pre-Keynesian school, although it is fair to add that the minds of distinguished economists, not all of whom have accepted Keynes’s complete theory—for example, Professor Pigou, Sir Dennis Robertson, the Swedish economists—were moving in a similar direction in the early twenties. According to the earlier school, it would be perfectly futile to think of stoking
up total demand by such means as public works or a budget deficit. If there was prolonged unemployment, the only logical remedy was a reduction of wages. No great attention was paid to the components of aggregate demand since, by Say's Law, this was deemed able to look after itself and to give employment to all who needed it, subject to their not asking for too much pay, and subject, of course, to friction and time-lags, which might be considerable.

In regard to the role of money, there is no such sharp divergence of principle between Keynes and the older orthodoxy, but by Keynesian doctrine the role of money is de-emphasized. Earlier thinking suggested that an increase in the quantity of money would have some direct impact on the level of prices; for Keynes it might have such an impact, but only to the extent that by reducing the rate of interest it succeeded in substantially increasing demand on investment account. According to Keynes's thought banking policy still had a role to play. But he held that in certain circumstances it could not maintain full employment unaided, but would have to be supplemented by other means of stimulating investment demand.

By the logic of Keynes's thinking, aggregate employment could be stimulated by a Government equally well by (1) increasing public expenditure without increasing taxes, or (2) reducing taxes without reducing public expenditure. He was apt to stress the former recipe. That may have been partly due to his sense that a great deal more public work in Britain was required on its own merits, and that in many respects we had fallen woefully behind. But there seems to have been another cause of this emphasis. His views had, like other novel views, to overcome the imputation of being disreputable. Advocacy of public works financed by loan seemed a shade more respectable than the advocacy of a budget deficit on current account financed by loan. It is interesting in this connexion to study the Report by the Committee for Economic Development (U.S.) on Defence Against Recession (March, 1954). This committee is directed by progressive but nonetheless highly responsible and respectable American industrialists. The doctrines implicit in its recommendations are altogether Keynesian. Public works and outright remissions of taxation are both recommended as desirable measures in the event of a recession proving serious and obdurate. But there is a decided preference for the remission of taxation, leading to an open deficit on current account. Thus the wheel has swung full circle. It may well be that Keynes, in view of the great growth of the tax burden since the Second World War, would in these new circumstances have shown the same preference himself.

A few words should be said about the wider political implications of Keynes's doctrines. They have advocates and opponents both on the Left and on the Right. Some Socialists welcome them as being a thin end of the wedge, as a useful weapon for breaking down initial prejudices against State interference, as a prelude to the transition to a full-blown Socialism, in which the State shall own the means of production, distribution and exchange, and all shall be centrally planned. On this view Keynesianism is a mere stepping-stone to something better. Other Socialists, who have grown doubtful of the virtue of universal nationalization, are Keynesians in a more genuine sense. While seeing the need for more State interference than is necessarily implied by his doctrines, they nonetheless welcome them as genuine methods of overcoming some of the outstanding evils of capitalism of the old order. But those of the political Right-wing in whose minds the fearful tragedies of the great depression have had influence, and who have had the sense that all was not well with capitalism and perfect laissez-faire, have also welcomed Keynes's doctrines as holding out the hope of preserving all that is best in an individualist economy by a means of central guidance within strictly circumscribed limits. Only those who pin their faith to complete laissez-faire—but these are now in an extreme minority—maintain strong opposition to Keynes. I should add that there is also a quite widespread hostile prejudice, especially in the United States, among those who are altogether ignorant of his authentic views.

Certain other developments in economic thought during the inter-war period must be recorded. One was the growth of the doctrines of "imperfect competition". It will be remembered that the theory of the equilibrium of prices and output was receiving a stricter mathematical formulation at the turn of the century. This formulation implied a more precise concept of competition than was intended by the authors who used that word in an earlier age. The mathematical analysis could be used to show that competition, working through the price mechanism, secured what might be regarded as an ideal arrangement; this was Adam Smith's "hidden hand" reduced to precise terms. But then certain anomalies appeared. Marshall had suggested that industries subject to increasing returns ought to be given some special stimulus or bounty. This led to a more precise analysis of the working of increasing returns, to which Professor Pigou made his contribution; this in turn led to a re-examination of the notion of competition. It transpired that in the equilibrium equations, competition had to be given a certain form, which was later christened "perfect competition". It also transpired that in a large range of economic activity, commonly dubbed competitive, including most of manufacture and distribution, competition was by no means perfect in this sense; but where competition was not perfect, the price mechanism did not always lead to an ideal result. Accordingly a substantial body of doctrine was developed, constituting generalizations about what happened where competition was short of perfect, which really comprised all
cases where an individual could not sell his output in an organized market at a price unaffected by his own contribution to it. Quite a systematic and interesting body of opinion was built up. There may have been some tendency for the aberrations from the ideal thus disclosed to add to the doubts of those who were disposed to criticize free enterprise.

Although the doctrines of imperfect competition were fairly clear, they had to make some rather drastic assumptions about how business-men behave. Some of these assumptions have since been criticized, and the subject has been further developed since the war. In this more recent work, doubts have been raised whether the distorting effects of “imperfections” of competition are as great as had previously appeared in the first flush of enthusiasm of those propounding the new doctrines.

The other important development in the inter-war period was the growth of what is called econometrics, under the influence of such distinguished pioneers as Dr. Ragnar Frisch, Dr. Tinbergen, and Dr. Kalecki. Hitherto economic doctrine had consisted of a body of laws or tendencies stated in qualitative terms only, and often in forms that were difficult, if not impossible, to verify. Indeed many so-called laws are not properly generalizations at all, but truisms or self-identical propositions, which may nonetheless throw light on the workings of the economic system. Economists had often been experts in their knowledge of statistics, but the statistics mainly served the purpose of historical or geographical description or, if brought into relation with economic laws, were used for illustrative purposes only. It was the ambition of the econometricians to change all this, to formulate economic laws in terms which could be statistically verified, and to make a vigorous onslaught on the statistical series available, in order to make them answer the question whether certain laws were true or not. New techniques were devised; Trade Cycle study appeared an especially good field for the use of econometric methods. This approach presents formidable problems, and it cannot yet be said to have led to authenticated generalizations of first-rate importance; but perhaps some negative results may be credited to it. These methods are still in their early stages, and there is little doubt that a great future lies before them.

IV. The Second World War and its Aftermath

The Second World War ushered in a new period of economic control, considerably more intensive and all-pervasive than that of the First. Once again the prime reason for resorting to a controlled system was the priority that the situation required to be given to speed as against economy and efficiency. For Britain the crucial control was that concerned with imports. The absorption of shipping for military purposes and the great lengthening in the time of each ship’s voyage and turn-round, together with the loss of shipping, a minor factor at first but becoming more important later, reduced the availability of ships far below the need for importation. Food and materials were thus in short supply; if this had been looked after by the “price mechanism”, there would have been a danger of acute inflation, towards which other forces also were working; furthermore, with the reduction in the size of the “real” national income—that is, the quantity of goods and services available for personal consumption, it was desirable that a much larger share of it should go to the poorer sections, so that their standard of living should be sustained; at a time when all were called upon to make what sacrifices they could, it was thought that the richer and middle sections should bear the main economic burden; such a redistribution could hardly have been effected quickly through the workings of a free system. Food shortages were looked after by price control and rationing; material shortages by central allocation in accordance with priority. The last-mentioned was an extremely crude system, but may be deemed to have been carried out efficiently considering the very defective nature of the system as such. Free wage bargaining was maintained in Britain, while restraint was urged and displayed; with this in view prices were kept down by subsidies which served to fill the gap between the prices that had to be paid for imports and those which it was desired to charge in the shops, and also to stimulate domestic agriculture. Vast Government expenditures naturally set up an inflationary tendency; more was covered by taxation than in the First War, but large-scale borrowing also had to be relied upon. The Keynes doctrine, that interest rates could be kept low by creating a sufficient amount of liquidity, was put into effect. Inflation, in the sense of excessive aggregate demand, was reduced by disallowing all forms of new investment other than those required for the war, while the tendency to spiral was reduced by the price controls and the wage restraints already mentioned.

After the war, the United Kingdom maintained a system of fairly intensive control. The real intention behind this will probably continue to be judged ambivalent. The Labour Party was in power for the first time; no one knew, and perhaps it did not know itself, how far it was still committed to the full Socialist doctrine of the eventual nationalization of the means of production, distribution and exchange. It inherited from war-time a very comprehensive system of state control, and it was naturally not inclined to dismantle this. The forms of control were determined by war-time needs, and were no doubt different from those which would have been adopted by a Socialist Government fresh to power and devising by the light of its inner consciousness the first steps towards a
Socialist Utopia. Many Socialists no doubt hoped that the de facto system of control would be consciously transformed into a first phase of Socialism, from which to advance further to a fully planned economy. Others may have abandoned the fuller aims and have been converted to the idea of a “mixed” economy, partly shaped by the kind of controls already in existence, and partly by the ideas of Keynes, but flavoured with a larger spice of nationalization than he would have desired. It does not follow that all non-Socialists were opposed to the maintenance of the controls. To some extent, the war-time conditions that made the controls expedient were still present. The shipping shortage was in due course relieved, but was succeeded by an acute imbalance of international payments which seemed to require drastic restrictions on imports; and these would continue to have widespread implications for the economy as a whole, setting up the need for rationing, material allocations, etc. High Government expenditure overseas and expenditure on reconstruction at home maintained effective demand at a high level, which could easily lead to vicious inflation. A disturbingly large amount of inflation occurred despite the controls. This mixture of motive makes it difficult to interpret the post-war phase of British economic policy in the light of any particular doctrine. Meanwhile there was a considerable extension of those measures which were first initiated in the 1936-14 period and are sometimes thought of as constituting a “Welfare State”. Lord Beveridge who played a notable part in the earliest days in the inception of the system and had since been associated with it in various ways, produced a comprehensive survey during the war on the need for a great extension; and his name has in consequence been justly associated with the system. While in some minds the “Welfare State” is associated with a Socialist philosophy, it could also be claimed that it was in the Liberal tradition.

In the United States the controls were quickly relaxed. This was also true of Belgium. In France they were retained for a longer period, but, partly owing to temperament and partly to the mentality engendered by occupation, when it might be patriotic to evade controls rather than the other way round, the post-war controls were far less efficient than in Britain. The Scandinavian countries and Holland maintained “mixed” economies. Western Germany was subjected to the controls involved by occupation, but after her “currency reform” took rather decided steps in the direction of a free economy. Generally, after the first post-war quinquennium, there was a marked tendency to economic Liberalism in Europe; and in this Britain joined, although more tentatively and with greater reservations, particularly after the accession of a Conservative Government in 1951.

Thus it is difficult to relate the course of events very closely to any one trend in economic philosophy and doctrine. The requirements of expediency from time to time took charge and systematic thinking was in abeyance. There was, however, much new thought on economic policy in relation to international economics. This occurred while the war was still proceeding, and was largely due to American initiative. The aftermath of the world slump had involved a considerable growth of restrictionism in international trade, and in the case of Germany this was not unconnected with power politics. The Americans hoped that victory, when achieved, might be made the occasion for a return of economic liberalism in the international field, and suggested to the British that obligations due under Lend-Lease arrangements should be written off if they joined with the Americans in giving a lead to the free world in this direction. The British entered with some enthusiasm into these discussions, but, while not averse from a greater degree of liberalism, stressed that some measures of concerted policy between the nations were needed to prevent the post-war recurrence of disasters such as the slump of 1929-32. They also had in mind that the great difficulties with which they, and other countries of Europe, would be faced after the war might present obstacles to an easy return to international liberalism. The discussions were also perplexed by the great American dislike for the system of Imperial Preference, which was of old standing, but in which the British themselves had played little part before 1932; on the British side the policy of Preference had come to be supported by sentimental as well as economic considerations.

In the discussions that took place, Keynes played a leading part, and his thoughts about the causes of depression had influence; some of the American participants were already subscribers to Keynes’s doctrines on this topic. The results of the discussions were embodied in an agreement subscribed to by a large number of nations (some, however, only represented by Governments in exile) at Bretton Woods (1944). In consequence the International Monetary Fund and the International Bank for Reconstruction and Development were established when the war was over. The former of these institutions was set up to supervise a world monetary system: the different nations agreed to maintain fixed rates of exchange which could, however, be altered from time to time should a “fundamental disequilibrium” arise. To facilitate the system, a central Fund was set up to which all the nations subscribed, which would constitute a pool of resources that could be drawn upon to tide nations over temporary difficulties. Some held that this would also play an important part in the event of an onset of world depression. In such a case, nations are liable to resort either to deflation, which by Keynes’s doctrine only tends to intensify the world slump, or to a restriction of imports, which is essentially
beggar-my-neighbour in a time of slump, or to both. The hope was that the Fund would eliminate or reduce the need for the adoption of either of these undesirable expedients. It also embodied a provision, known as the "Scarcity Currency Clause", which was designed to put some of the responsibility for redressing an imbalance in international trade on creditor countries. This was a concession by the Americans who were deemed by others to have failed in the period before the war to take measures appropriate to a creditor country for reducing international disequilibrium. The International Bank was designed to re-stimulate the flow of international investment which had sorely languished after the world slump. There were also discussions for internationally held buffer stocks, which might reduce the excessive oscillations in the prices of primary products; but these came to nothing. All these plans and measures might be deemed expressions of the philosophy that holds that central management and policy are required to preserve capitalism from its recurrent tendency to depression and to maintain an international equilibrium of payments. The British were willing, not altogether without misgiving, to take American agreement to these plans as sufficient earnest of good intention to justify them in co-operating in bold measures to reduce restrictions and discriminations in international trade; these were embodied in the proposed International Trade Organization, which was, however, never implemented, and then, in a modified form, in the General Agreement on Trade and Tariffs.

While these various institutions have come into being, it cannot be said that the general plan for combining concerted action on an international scale to secure a trade balance and full employment on the one hand with a great abatement of restrictions of trade on the other has been implemented. Post-war dislocations have proved much larger than was anticipated. Restrictions have been severe; these have included discriminatory restrictions to which the Americans from the beginning took particular exception. It had been hoped that the convertible of currencies, in accordance with the pars established with the International Monetary Fund, would be achieved within a five-year period. This has not been realized. Currencies have been "inconvertible" in a new sense. In the old days a "convertible" currency was one that was redeemable at will in gold, or in some other gold-convertible currency; "inconvertible" currencies were not so redeemable, but could always be legally sold at a discount in free markets. Inconvertibility in the new sense has involved restriction even on the right to sell at a discount. Sterling in particular, which is a currency of world-wide use, has had a complicated history, various different kinds of sterling having come into existence, entailing different privileges for their owners in regard to their rights to convert or to transfer. After the war, all the nations experienced an intense imbalance of payments vis-à-vis the U.S. dollar, and old-fashioned measures of commercial policy did not appear sufficient to restore this. This has been one important cause of the various brands of inconvertibility and of commercial restriction. The problem was temporarily eased, but not solved, by very generous aid granted by the United States to other countries. The difficulties have gradually become less formidable. It is hoped that the world may yet move towards some system not dissimilar from that envisaged at Bretton Woods, but by much slower stages than was anticipated.

In 1950 the countries of Europe, which were then enjoying the full benefits of Marshall Aid and seeking to put it to its best use, set up the European Payments Union, whose principles were in some respects not dissimilar from those of the International Monetary Fund. It was markedly dissimilar in one respect, however, in that it came into full and active operation and has served greatly to reduce the impediments to trade inside Europe. British membership had the result that the sterling area was included in the mechanism of payments set up; Europe and the sterling area together form such a wide region as to make this experiment a very notable one.

The great complications resulting from various kinds of inconvertibility and of foreign-trade restriction, as well as those pertaining to attempts to control or repress domestic inflations, require corresponding developments in the theory of international trade and of inflation. Events have moved quickly, and it cannot be said that theory has kept pace with practice. Expediency has ruled; at times it has been wise and evolved after remedies than theorists might ever have thought of; but in some respects lack of theory has been harmful; failing the guidance of general principles, policy has often been short-sighted, sometimes one might even say blind. The situation remains fluid, and policies and institutions are likely to undergo much further adaptation in the near future. It may quite well be that economic historians will never be able to give a coherent account of the true causes and effects that were operating in the international economic field in the period 1945-54.

Meanwhile the number of economists and the volume of high-class economic literature have been growing rapidly, and economists of undoubtedly distinguished intellectual ability have gained reputation. It is not clear, however, that there has been important progress in fundamental theory. We have noted that at the turn of the century "the principles of political economy" were restated with far greater precision in the formulation of equations determining a "static equilibrium". Recently these doxines have been restated with a still greater degree of refinement. There has been a desire to get away from the notion of an abstract "utility" with its doubtful philosophical implications and unamenable to precise
measurement. Immense efforts have been directed to stating basic postulates with the utmost precision and freeing them from all assumptions that cannot be warranted by the strictest logic. Econometric studies have been further advanced. In the older economics "static" and "dynamic" elements were intermixed, perhaps confusedly; in the refinement of static theory at the end of the last century, dynamic elements tended to be lost sight of. Recently attempts have been made to formulate a precise body of theory, which should constitute a system of dynamic principles. These efforts are still only in an early stage, but it is hoped that an important body of theory and doctrine will in due course emerge.

In fine, the rapidity and bewildering complexity of recent changes have tended to outpace the powers of systematic study. Nonetheless, on the theoretical side, a large amount of highly intellectual and subtle work has been done. It cannot be said that there have been new seminal ideas of a fundamental character. But the subject is in movement, and the position is therefore hopeful. In regard to the application of theory to policy and practice, the availability of national-income statistics, subject to continued improvement, has been much the most important development. For the rest, the development of a body of settled doctrines of applied economics is likely to proceed more quickly when the commotions and the tempo of change that are the aftermath of the Second World War cease to be so violent.

BOOKS SUGGESTED FOR FURTHER READING


496