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Automatists, Hawtreyans, and Keynesians

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SIR JOHN HICKS

Automatists, Hawtreyans, and Keynesians

I AM APPRECIATIVE of the honour you have done me in inviting me to give the opening address at this conference; I must however confess that I find it not a little embarassing. For though I have written a few things which have been found interesting by monetary specialists, I am very clear that I am not myself a monetary specialist. I have spread my interests in economics much too widely for that. I know enough about money to understand that monetary problems are problems of the working of institutions, yet of how monetary institutions work I have no more than very general ideas. I shall have to walk very carefully if I am not to be shown up as a fraud.

I am indeed inclined to think that my chief qualification for addressing you is that I did live through the great age of monetary theory in the thirties, not entirely as an onlooker, but matching myself, now and again, against the paladins. I can remember the first impact of the *General Theory* [8]; I can remember it very directly, for I had to write a review article on it, within three months of its publication, for the *Economic Journal* [5]. I had not been concerned (like Harrod and Meade and Kahn and Joan Robinson) in the discussions which led up to it; but I was not altogether unprepared. It did not come to me like a bolt from the blue (as I think it still does to many of those who write about it, and on issues arising from it, nowadays). I did not regard it as an isolated revelation, but in its context: as a stage, or turning point, in a debate that extended beyond its pages, and in which several others, by repulsion as well as by attraction, had been concerned.

And that is how, even now, I would prefer to regard it. I feel sure that if an independent researcher, without personal involvement, were to write the story of that intellectual revolution, he would have to go back quite a way beyond 1936. I do not mean that he would have to go back to the pre-history: to the

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quasi-Keynesian ideas which can be discovered in a number of nineteenth-century writers, such as Henry Thornton and John Stuart Mill. Nor even that he would have to go back to Wicksell. Already, by the time of the Treatise on Money [7] (1930) Wicksell's influence had come in; but even then it was not central. It could have been Wicksell who opened the debate, but in fact it was not. It was Hawtrey.

Hawtrey's *Currency and Credit* [2] was published in 1919; but I believe that one is justified in treating it as the beginning, for there are large parts of the Treatise which are a reply to it. A reply to it, on the matters where Keynes and Hawtrey differed; I shall come to these in a moment, but only after insisting that on the most basic issue they were on the same side. When the chrysalis burst, and the debate (which in these formative years was confined to England) became worldwide, the doctrine that a free market system is not automatically self-righting was a chief stone of stumbling. To judge by many of the bright new books one reads, it still is. To those who come to the "New Economics" only through the *General Theory* and the works that have followed it, the "instability of capitalism" (the *monetary* instability) is a typically Keynesian doctrine; to some of them it is *the* characteristically Keynesian doctrine; the fact remains, however, that it is not specifically Keynesian at all. It has never been better stated than in the first chapter of *Currency and Credit*, the chapter with the provocative title *Credit without Money*. Hawtrey starts straight off with a pure credit system, in which the media of exchange are simply debts (or credits); the banker is just a dealer in debts. Debts must be expressed in terms of a unit of account; but there is nothing to determine the value of the unit of account, save the carryover of memory, which makes people determine today's actions on the basis of yesterday's prices. And this, as he shows, though it prevents prices moving altogether erratically, does not prevent a continual slide in one direction or the other.

I shall not allow myself to be drawn into a discussion of the attempts to elude this key principle, which have gone on being made from that day to this. I shall merely state, rather baldly, the reason why I hold that they must be rejected. It is true that any general movement of prices involves a transference of real purchasing power from debtors to creditors, or from creditors to debtors; and there is a presumption, if one looks only at its effect on saving, that the transference will work in a stabilizing direction. But that is by no means the only force that must be taken into account. The "wealth effect" has only been thought to be a sufficient stabiliser because the "psychological" effect of the price-movement has been neglected. As soon as prices move sufficiently for people to extrapolate—to base their expectations of future prices not upon current prices but upon the way prices have been changing—a destabilizing force is set up which is bound to swamp the much weaker stabilizing power of the "wealth effect." That is the basic cause of the instability.

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Though Hawtrey begins with the pure credit system, which has this inherent instability, he proceeds to modify it by introducing a "hard money"—though only as one possible stabiliser. This, I am sure, is the right way to go about it. A free market economy does not have to have a hard money; and in fact, as time has gone on, the monetary system has approximated more and more closely to the pure credit system. The reasons for this have not been only, or even mainly, political. It is a natural development of the market economy—to substitute a cheaper means of payment for one which is more expensive; it will move in that direction if it is not stopped. And it is quite hard to stop it. Metallic money in fact, has disappeared from internal circulation, and even in international transactions it is disappearing. The creation of a "substitute hard money" by control over the quantity of some sort (or sorts) of money is continually defeated by human ingenuity in the invention of other sorts. Though (especially to begin with) they often seemed to slip back. Hawtrey and Keynes were surely right in holding that they were dealing with a system that had no automatic stabiliser: a system which needed to be stabilised by *policy*.

But by what policy? By what instruments of policy? We come now, of course, to the difference. It is a difference that has more aspects than are commonly noted. It will be useful to follow its history through, for it is quite instructive.

They started from common ground, not only on the need for policy, but in agreement that the instrument of policy was the rate of interest, or "terms of credit," to be determined, directly or indirectly, by a Central Bank. But what rate of interest? It was Hawtrey's doctrine that the terms of bank lending had a direct effect on the activity of trade and industry; traders, having more to pay for credit, would seek to reduce their stocks, being therefore less willing to buy and more willing to sell. Keynes, from the start (or at least from the time of the *Treatise*—1930) rejected this in his opinion too simple view. He substituted for it (or began by substituting for it) an alternative mechanism through the long rate of interest. A change in the terms of bank lending affected the long rate of interest, the terms on which business could raise long-term capital; only in this roundabout way would a change in the terms of bank lending affect the activity of industry.

I think we can now see, after all that has happened, and has been said, since 1930, that the trouble with both of these views (as they were presented, or at least as they were got over) was that the forces they purported to identify were not strong enough to bear the weight that was put upon them. This is what Keynes said about Hawtrey (I quote from the *Treatise*):

> The whole emphasis is placed on one particular kind of investment, namely, investment by dealers and middlemen in liquid goods—to which a degree of sensitivity to changes in Bank Rate is attributed which certainly does not exist in fact. . . . [He relies] exclusively on the increased costs of business resulting

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> from dearer money. [He] admits that these additional costs will be too small materially to affect the manufacturer, but assumes without investigation that they do materially affect the trader. . . . Yet probably the question whether he is paying 5 or 6 per cent for the accommodation he receives from his banker influences the mind of the dealer very little more than it influences the mind of the manufacturer as compared with the current and prospective rate of take-off for the goods he deals in and his expectations as to their prospective price-movements. [7, Vol. I, pp. 193–5.]

Granted, but could not very much the same be said of Keynes's own alternative mechanism? One has a feeling that in the years when he was designing the *General Theory* he was still clinging to it, for it is deeply embedded in the structure of his theory; yet one suspects that before the book left his hands it was already beginning to pass out. It has left a deep mark on the teaching of Keynesian economics, but a much less deep mark upon its practical influence. In the fight that ensued after the publication of the *General Theory*, it was quite clearly a casualty.

I suppose that in terms of influence upon the thinking of English economists (I am sorry to be so insular, even at a point where I ought not to be on my own principles, but I do not have the knowledge to go further) the turning point was the publication in 1938 of the summary of replies to the Oxford questionnaire about the influence of the rate of interest on business decisions, to which 37 business men gave dusty answers [1]. But what to my mind is an even more effective demolition of the Keynesian mechanism came from Hawtrey himself.

It had taken him some time to mount his attack on Keynes's "modus operandi of Bank Rate" but when it came it was formidable. The empirical data which Keynes had used to support his thesis were derived from a short period only—the 1920's; and Hawtrey was able to show that it was only in the first half of that decade (when, in the immediate aftermath of the War, the long rate in England was for that time unusually volatile) that an effect of monetary policy on the long rate, sufficient to give substantial support to Keynes's case, was at all readily detectable. Hawtrey took a much longer period. In *a Century of Bank Rate* [3] which, in spite of the narrowness of its subject, seems to me to be one of his best books—he ploughed through the whole of the British experience from 1844 to the date of writing; and of any effect of Bank Rate (or of any short rate) upon the long rate of interest, sufficient to carry the weight of Keynes's argument, he found little trace.

> On the whole I think that we may infer that Bank Rate and measures of credit restriction taken together rarely, if ever, affected the price of Consols by more than two or three points; whereas a variation of ⅛ per cent in the long-term rate of interest would correspond to about four points in the price of a 3 per cent stock.
>
> Now a variation of even less than ⅛ per cent in the long-term rate of interest ought, theoretically and in the long run, to have a definite effect for what it is worth on the volume of capital outlay. . . . But there is in reality no *close* adjustment of prospective yield to the rate of interest. Most of the industrial pro-

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> jects offered for exploitation at any time promise yields ever so far above the rate of interest. . . . [They will not be adopted until] promoters are satisfied that the projects they take up will yield a commensurate profit, and the rate of interest calculated on money raised will probably be no more than a very moderate deduction from this profit. [3, pp. 170–71.]

There was a lot of guesswork and what would now seem to be very amateurish econometrics in all this; but the negative argument (in each case) was found convincing. Tweedledum and Tweedledee had both fallen flat, and the way was cleared for the Age of Fiscal Policy.

Hawtrey, however, would not admit that that is the end of the story, and I am inclined to agree with him. I think that there is something that survives. I would like to try to follow it out.

A Century of Bank Rate was largely concerned with the demolition of Keynes's roundabout method; but it also contains a restatement of Hawtrey's positive view. When I reviewed the book [6] I treated the points which he made on this side as "new qualifications" which "made the theory more acceptable"; Hawtrey refused to accept this description, insisting that they had been there all the time. It is indeed the case that there are references to them in his earlier works (as he stated in the *Reply* which he made to my review [4]); but I still do not feel that he has previously given them the same emphasis. They had not got over to me, and in this I am sure that I had plenty of company; it is clear, to take the leading example, that they had not got over to Keynes himself.

They are to be found in a section entitled "Psychological Reactions" [3 p. 249 ff]. I would rather doubt that the second point which he makes in that section is properly so described: it is a reminder of the imperfection of the loan market, a denunciation of the usual economist's fallacy of supposing that lenders are willing to lend indefinite amounts at a given rate of interest, so that the decision how much to borrow is made wholly by the borrower. This is perfectly valid, and perfectly relevant; but it is hardly necessary (now) to enlarge upon it. Perhaps I may cut it out, and leave what was said on the first point in isolation.

> The pressure applied to traders by a moderate rise in the short-term rate of interest, say 1 per cent., is undeniably very slight. Yet apparently the Bank of England always counted on a rise of 1 per cent. or even ½ per cent. having a noticeable effect. . . . The explanation is . . . [that] when the use of Bank Rate to restrict credit became an established practice, traders, being aware of the intentions of the Bank, were inclined to anticipate them. When Bank Rate went up from 3 to 4 per cent., a trader would reason that this was intended to have a restrictive effect on markets, and that, if the effect was not brought about, the rate would simply go higher and higher until it was. . . . Those who took this view would restrict their purchases and demand would fall off, and so the 4 per cent. rate might be found potent enough, even though, if unsupported by traders' anticipations, a 6 or 7 per cent. rate might have been necessary. . . .
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> If the efficiency of Bank Rate depended upon these psychological reactions it would be precarious; for if people ceased to believe in it, the reactions would no

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> longer occur. But the psychological reactions are in reality no more than a reinforcement of a tendency which in any case exists. Were they absent, that would only mean that Bank Rate would have to be raised higher. [3, p.279 ff.]

As you will observe, Hawtrey in this book (and often indeed in his other works) is writing as an economic historian; he is analysing the working of a system of control which he holds to have operated at a particular place and time, a time which when he wrote must already have been, at least to some extent, in the past. This historical reference has probably limited the impact of what he wrote; but I think that it is a pity that it should have done so. For his particular system is also a standard system; it is a model of a working system of monetary control. That it is a model that can be used for the interpretation of a particular set of historical data is a source of strength. It puts it into a different class from many of our theoretical models:

But to have emphasised the historical application to such an extent, in the exposition of the theory, may well have been unfortunate; for it distracted attention from its *general* significance. Too much attention was in consequence concentrated upon the apparent implication that the principal channel by which Bank Rate exercises an effect is through its influence on the holding of stocks by traders. It is certainly true that Hawtrey was thinking (and in his historical application rightly thinking) of an economy in which the operations of traders upon rather perfect markets (including, in many cases, futures markets) occupied a key position; so that a change in the willingness of such traders to hold stocks would have effects on industry which radiated far and wide. We can recognize that it is in such an economy that the working of the Hawtrey system is at its most elegant. It is indeed an elegant type of economy; it survives for its elegance in many of our textbooks. But it is no longer a realistic description of an existing economy. Even in the thirties, at the time of the Keynes-Hawtrey controversy, it had already passed into history.

I am sure that Keynes was right in holding that he was dealing with an economy in which changes in the propensity to undertake fixed capital investment were more important, as a cause of fluctuation, than changes in the willingness to hold stocks. But it does not follow from this that a direct operation upon the decision *whether or not* to undertake fixed capital investment (the kind of effect which Keynes—at least in his first phase—thought to be capable of being exercised through the long rate of interest) is a convenient, or even a practicable, way of exercising control. Even in the case of fixed capital investment, even allowing for all the planning rigidities of which so much is made nowadays, it is possible for monetary control to be exercised over timing. Plans may interlock; the efficient execution of a development programme may require that its various sub-processes keep step with one another; yet the relation between plan time and calendar time remains to some extent elastic. And there are few expansion plans, even though they are to be mainly financed from retained profits, or from long-term capital raised upon the market, which do not depend upon the availability of bank credit *at some stage of the process.*

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The availability of bank credit, at such a stage, can still affect timing. It is his sense of the importance of timing which is expressed, in Hawtrey's model, by his emphasis on the *short-term* rate of interest. But the short-rate itself, though a symptom, is not the cutting edge; that is a matter of the availability of credit and the effect on expectations.

When I reviewed the *General Theory*, the explicit introduction of expectations was one of the things which I praised; but I have since come to feel that what Keynes gave with one hand, he took away with the other. Expectations do appear in the *General Theory*, but (in the main) they appear as *data;* as autonomous influences that come in from outside, not as elements that are moulded in the course of the process that is being analysed. Perhaps it is that famous (but I now think rather wicked) chapter on "Long-Term Expectations" which is the root of the trouble. For one can grant that there exists an irrational element in expectations (the element of which Keynes made so much) without conceding that they are so irrational as to be random—and therefore incapable of being moulded, at least to some extent, by policy.

I would maintain that in this respect Hawtrey is distinctly superior. In his analysis of the "psychological effect" of Bank Rate—it is not just a vague indication, it is analysis—he identifies an element which ought to come into any monetary theory, whether the mechanism with which it is concerned is Hawtrey's, or any other. I am indeed proposing, before I have done, to suggest that it has a much wider significance. But before I come to that, I must add a few further words on the Hawtrey mechanism.

What is essential, on Hawtrey's analysis, is that it should be possible (and should look as if it were possible) for the Central Bank to take *decisive* action. There is a world of difference (it follows from what he is saying) between action which is determinedly directed to imposing restraint, so that it gives the impression that if not effective in itself, it will be followed by further doses of the same medicine; and identically the same action which does not engender the same expectations. Identically the same action may be *indecisive*, if it appears to be no more than an adjustment to existing market conditions; or if the impression is given that it is the most that is politically possible. If conditions are such that gentle pressure can be exerted in a decisive manner, no more than gentle pressure will as a rule be required. But as soon as there is doubt about decisiveness, gentle pressure is useless; even what would otherwise be regarded as violent action may then be ineffective. From this point of view (coming back to the historical application) the nationalisation of the Bank of England was a deathblow to the Hawtrey system. It was presented as making little difference, but it did in fact make a great difference; for it made the Bank constitutionally incapable of arousing the expectations on which it had hitherto relied. If decisive action was thereafter possible, it was only possible in crisis; the gentler action which would have forestalled the crisis was prevented from having effect.

That, I believe, is indeed a part of the truth; but it is not a point that should

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be allowed to stand alone. The very noticeable tendency to a fall in the amplitude of the movements of Bank Rate between 1844 and 1875 on the one hand and 1875 to 1914 on the other can be explained, in Hawtrey's manner, as a sign that the market was "learning"; but it can also be interpreted as a consequence of the growth of the international capital market, which gave the Bank less freedom to operate an interest rate policy, the possibilities of which were closely circumscribed by international repercussions. The Bank was already ceasing to be a "Monetary Authority" in the economist's sense; it was becoming no more than a Member Bank in an international system. This is recognized, of course, both by Keynes and by Hawtrey. It is presumably one of the reasons which led Keynes to turn towards Fiscal Policy, as being a method of control over which the single national government can have a freer hand. Hawtrey, I think one can see, came to favour the other way out. It is the fixed rate of exchange which imposes the international constraint; if that is abandoned, the Bank can recover its authority. A system in which the rate of exchange is free to move, while internal stability is maintained by a relentless application of the Bank Rate mechanism, is theoretically conceivable, and as a model it is instructive. But it would seem to depend for its working upon the maintenance of confidence in some *normal* rate of exchange, from which the current rate would be supposed to diverge only more or less temporarily; and it is not easy to see how such confidence could be engendered.

If only that obstacle could be overcome, one could see the Hawtrey mechanism working—and working, it is important to notice, *both ways.* For the Hawtrey system (especially when it is amended in this manner) is less affected than the Keynesian by the famous trouble of the "floor" to the rate of interest: a trouble which is one of the legacies to "modern" Keynesian economics of Keynes's preoccupation with the long rate, which (as we have seen) must be rejected, on other grounds, as an adequate stabiliser. In Hawtrey's (amended) model, high bank rate would be accompanied by a rise in the exchange above normal, which would reinforce the effect of the high bank rate on activity, and would also be a deterrent to the inflow of capital; since such capital, although it would earn a high rate of interest in the local money, would have to anticipate the probability of a loss on the exchange. Vice versa in the opposite case. The effect of low bank rate would be intensified by the downward fluctuation of the exchange (again supposed temporary). If confidence in the *normal* level of exchange could be maintained, this could work.

But it is not for the sake of this particular recipe (in which, as will be seen, I do not share Hawtrey's confidence) that I have been bringing you to retrace the steps of this old controversy. The moral I would draw from it myself is distinctly different.

I am certainly not contending that it is either possible, or desirable, that the Old King—Bank Rate—should be put back on his throne. We are living in the reign of his successor—the Government's Budget; that must be accepted. But the new reign, like the old, may not last forever; we can already see that the

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storm clouds are gathering round it. Doubtless it has merits that the old did not have; but it has parted with some of the merits of the old. Is it quite impossible that they could, to some extent, be reincorporated?

There is a term which was invented, and then spoiled, by Pigou in his book on Public Finance [9], on which I am itching to get my hand; it is the term *announcement effect*. I do not want to use it in the way Pigou did, but in a way which seems to me to be more appropriate. I want to use the announcement effect of an act of policy to mean the change which takes place in people's minds, the change in the prospect which they think to be before them, before there is any change which expresses itself in transactions of any kind. It is the same as what Hawtrey calls "psychological effect"; but that is a bad term, for it suggests something irrational, and this is entirely rational. Expectations of the future (entirely rational expectations) are based upon the data that are available in the present. An act of policy (if it is what I have called a *decisive* action) is a significant addition to the data that are available; it should result, and should almost immediately result, in a shift in expectations. This is what *I* mean by an announcement effect.

What I learn from Hawtrey's analysis is that the "classical" Bank Rate system was strong, or could be strong, in its announcement effects. Fiscal policy, at least as so far practised, gets from this point of view much worse marks. It is not simply that it is slow, being subject to all sorts of parliamentary and administrative delays; made indecisive, merely because the gap between announcement and effective operation is liable to be so long. This is by no means its only defect. Its announcement effect is poor, for the very reason which is often claimed to be one of its merits—its selectivity; for selectivity implies complexity and an instrument which is to have a strong announcement effect should, above all, be simple. That fiscal policy is inefficient as a signal has long been recognised; it is one of the reasons for the rise of "indicative planning". But a Plan, even more than a budget, is too cumbrous to be an effective signal. It is announced that the Plan is to be revised. How? We have to wait and see.

I am nevertheless by no means inclined to argue that Bank Rate, or its equivalent, is the only possible signal that can have a fair degree of announcement efficiently. I feel sure that we should be looking about for possible alternatives.

There was a time, in England in the 1950's, when it appeared to be possible that the standard rate of income tax might be used as a Regulator; it would have been less efficient than the "classical" Bank Rate, but it is conceivable that up to a point it might have worked. Income tax, however, has a distributional function which is properly regarded as paramount. This has caused it to move away, first from a flat rate, and then from a schedule that is dominated by a single parameter—towards a schedule that is subject to continual tinkering, in which the possiblity of simple *decisive* movement gets lost. In this field, again, selectivity has been the enemy of announcement efficiency.

Corporation tax which in England dates from 1965 is imposed at a flat rate;

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it could therefore be used for the purpose that I have in mind, and there have been indications that it is intended so to use it. Yet at much the same time as the Wilson Government introduced the corporation tax, which could have this advantage, they threw away the old system of flat rate investment allowances, a means of control which was quite promising in its announcement effect; substituting for it a selective system of investment grants, so arbitrary and uncertain in its operation that the possibility of using it to get an announcement effect is almost zero. But perhaps it is possible that some day England will revert to the former system of investment allowance; the opportunity of using Corporation Tax as a regulator would then be much better.

It is hard to see that indirect taxation, however general (such as might be levied through a universal sales tax, or value added tax, or employment tax) could ever have a high degree of announcement efficiency. It is condemned by the perversity of its effect on anticipations. As soon as an upward movement of the tax rate is anticipated, there will be an incentive to try to beat the gun, and vice versa the other way. I do not mean that these devices may not have some part to play, but it is hard to see that they could be usable as a principal instrument.

The rate of interest—the short rate of interest—when properly interpreted as a symbol of credit ease or credit stringency, has a superiority over all tax methods, in that it gets the timing of its announcement effects just what they should be. If it cannot be used in the "classical" way, we should be on the lookout for new ways in which it could be used.

One, which would certainly seem to be worth exploring, would be to use it for the regulation of the investment expenditure of the Public Sector itself. In the Hawtrey model, the direct impact of Bank Rate was on the holding of stocks by dealers, taken to be a key sector of the economy. An efficient Regulator must operate directly upon some key sector; the investment expenditure of the Public Sector, in the semisocialised economies which have now become the rule, would seem to be a promising candidate. If public bodies (in the British case, local authorities, nationalised industries and other supported institutions—such as universities!) were obliged to finance their investment expenditure by loans from a government bank, that Bank could finance them at a rate of interest which was variable, and which need have no regular relation with rates of interest on international markets. It could be raised as high as desired; and if desired it could be made negative. But the existence of this freedom of movement would mean (for Hawtrey's reason) that once the signal had been learned, big swings should not be necessary. In view of the effect on expectations—not only within the Public Sector, but also outside it—moderate movements should suffice.

This, perhaps, is a dream; I do not claim to be a judge of political possibilities. But I am not afraid to draw the moral, which emerges rather clearly from the line of thought I have tried to follow out, that the issue with which we have

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been concerned is political—even constitutional—as well as economic. There is the technical economic problem of the Instrument; but it is tied up with the political problem of how to secure that it is used decisively. This is a problem which Keynesian economics, so it seems to me, has refused to face; while the automatists, who have seen it, twist their economics in order to avoid it. For myself, I would face it. I think we should say that monetary regulation is a major function of Government; but we should emphasize that if it is to be exercised decisively, it needs to be separated, in what is in fact the constitutional sense, from other functions. We need to remember the ancient doctrine of the Separation of Powers. The judicial function, in well-ordered states, is recognized to be a function of Government, but a function that is better *separated.* So it is with the monetary function. It is far too responsible a function to be handed over to a "company of merchants" (Ricardo's pejorative expression for the Bank of England). Nevertheless it is harmful for it to be confused, as Keynesianism has led it to be confused, with the regular financing of the executive government. It belongs to the province of the executive government to further the maintenance of high employment and steady growth, within the framework of an economy that is monetarily well-regulated. But it is a disaster that these things have got so mixed together.

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