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Introduction: economics and history

This is a book about both history and economics. As a history book, it describes, in chronological order, the main monetary 'events' of the twentieth century, concentrating on the five major economies – the United States, the United Kingdom, Germany, France and Japan. The century is divided into eight periods of ten to fifteen years, and a chapter is devoted to each of them. Each chapter begins with a section that describes the behaviour of the major economies in respect of inflation, output growth, unemployment and interest rates.

A very broad overview of the century is provided by figures 1–4 at the end of this introduction (pp. 21–2).

> At the beginning of the century inflation was low everywhere. In both world wars, and immediately after them, it was high, sometimes very high indeed. Between the wars it was sometimes negative. In the latter half of the century it was persistent, but not explosive. Towards the end of the century it was again generally low.
>
> Growth rates varied greatly from year to year in the first half of the century. In the interwar period, output fell continuously for four years in America. There were recessions in the latter half of the century as well, but they were not so long, or so deep.
>
> The peak rate of unemployment in the 1930s was much higher in America (and in Germany) than it was in Britain. Full employment was maintained in Europe for a generation after the Second World War. In the last two decades of the century, however, the rate was persistently higher in Europe than in the USA.
>
> Interest rates remained low throughout the first half of the century, showing far less variation than there was in rates of inflation.

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In the second half, on the other hand, they rose almost continuously for about thirty years, reaching double figures, before turning sharply down again.

These will be some of the story lines running right through this book. Whilst the meaning of the statistics does change from one period to another, it is often helpful to see the events of each decade, or regime, in the context of the longer-term trends.

The history of monetary regimes cannot properly be considered except in a broader political context. In each of the chapters, a second section will describe the evolution of economic policy in general, and of monetary policy in particular. The story is not quite the same in every country, but the broad trends are similar. There were relatively 'liberal' or 'free-market' regimes at the beginning and again at the end of the century, with relatively 'interventionist' or 'planned' regimes in between.

One cannot discuss the domestic policy regimes of nation states without considering how their external relations were conducted. The third section of each chapter is devoted, therefore, to international monetary systems. The first chapter describes the gold standard as it operated at the start of the century; the final chapter focuses on the formation of the European Monetary Union. In the intervening chapters some account is given of the turmoil between the world wars, of the Bretton Woods system from the 1940s to the 1960s, and of the subsequent experience with more or less freely floating exchange rates.

This is also a book about economics. It is about the interrelation between economic behaviour and the character of the monetary regime. There is, it will be argued, no general theory of macroeconomics which is independent of politics, social institutions and beliefs. One cannot, therefore, choose between alternative monetary regimes on the basis of 'the economic arguments' alone. A fourth section of each chapter will illustrate this interrelationship for each period and each policy regime. The remainder of this introduction will develop some related themes. It will look at the connections between economics and history from a number of different angles.

To Utopia and back

At the beginning of the twentieth century the freedom of action of central banks was constrained by the commitment to convert their currencies freely into gold. At the end of the century they were again inhibited by the need

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to maintain confidence in international capital markets. But in the middle decades of the century monetary regimes were of a quite different character. Monetary policy was one element in a scientifically designed strategy intended to maximise the economic well-being of an independent nation state. We have been to Utopia and back again.

In his introduction to the history of the world economy over these hundred years, Robert Skidelsky (1998) distinguishes four phases: 'liberal market (1900–13), autarkic (1914–50), managed market (1950–73) and neo-liberal (since 1973)'. In his conclusions he refers to the 'remarketization of economic life' in the closing years of the century as 'a modest movement back towards the world with which the century opened'. From a British perspective the phases are particularly easy to recognise, especially the sharp contrast between the role played by the state in the economy before and after the Second World War, and again before and after the change of government in 1979. But broadly the same grand narrative can be used to shape the history of America or western Europe, and indeed of the world as a whole. The sequence of monetary regimes, both national and international, relates to an accompanying succession of institutional and social developments.

The grand narrative tells how the nation state took increasing responsibility for the stability and prosperity of the national economy for a period of about sixty years, and then progressively abandoned that responsibility over the next forty years or so. The story can be told as a tragedy. Two generations of political leaders, public servants and applied economists overcame dark forces of ignorance and self-interest. They created, in the mixed economies of the mid-century, a system of economic management which gave the world a period of unprecedented prosperity. Then, perhaps because of some flaw in social organisation, or in human nature itself, their work was destroyed. The next two generations were unable, or unwilling, to sustain the system which gave us the 'golden age', and it fell apart.

Another way of telling the story is to condemn the attempt to manage economies as a dangerous attack on individual liberty. It was an attempt to copy the deceptive early achievements of economic planning and control in the totalitarian systems of Russia and Germany. The attempt to build the 'Great Utopia', as Hayek (1944) described it, was simply 'the Road to Serfdom'. It might be inspired by high ideals to begin with, but sooner or later 'the worst get on top'. The high road of human progress did not, on this view, lead through the regimes which were constructed in the middle years of the century. All that was just a diversion which led nowhere. It was necessary to retrace our steps.

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It is not the purpose of this study to offer support to either side in this clash of ideals and historical interpretations, but it is important to recognise the strong feelings which lie just below the surface of much academic debate. Economics may seem to be a detached and scientific discipline, but it seldom is or has been. The history of economic thought can be seen as itself part of the same grand narrative. It justified successive changes of monetary, and indeed economic and political, regime. It supported – often tacitly – the values, and indeed the material interests, of some groups in society against others. The Keynesian revolution from the 1930s to the 1960s, and the counter-revolution which followed, were both expressions of changing political philosophies as well as shifts in the accepted explanatory paradigm. New evidence certainly played a part in changing the beliefs of economists, but what happened in economics cannot be fully understood in isolation from the political environment of the times.

It might seem therefore that economic history cannot be written without taking sides in the great controversies of political economy. One cannot avoid the need for a theoretical framework when describing economic behaviour and the consequences of monetary regimes. A mere catalogue of events would be superficial, and probably not in fact free from bias. Does one not therefore need at the outset to declare oneself a conservative or a radical? The contention of this study is that one can, and should, avoid making such a choice. Many different theories of behaviour may all be valid, each in the interpretation of a different regime. For example, classical economics may be appropriate to describe behaviour under a liberal regime, whilst what was called 'modern' economics may be right for a managed economy. Perhaps neither would qualify as a truly 'general' theory.

Macroeconomics and history

Clearly, there is a methodological question here of some importance, concerning the relationship of history and theory in economics. It was very familiar to students of the subject a hundred years ago and is not finally settled even now. There is an extensive discussion by J.N. Keynes (1891) (the father of the better known son). The historical school, especially in Germany, maintained that each country and each historical period had its own laws of economic behaviour, depending on its methods of production, its social structure and its institutions. The interesting questions to study concerned economic development and institutional change. The analytical school, on the other hand, in particular the British neoclassicals, sought to

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build economic theory on axioms of individual rationality which were supposed to be of general application. So-called 'economic man' is a model of human nature itself, not just of members of our own culture and society. It has been, in the main, the analytical approach which has prevailed. So far as what we now call 'microeconomics' is concerned, this may well be for the best, and this was what interested economists most at the start of the century, but it is a different matter when the focus is on what we now call 'macroeconomics'.

J.N. Keynes did recognise that social beliefs and interactions can influence economic behaviour, despite his general support for the axiomatic approach. Two examples that he gives are particularly relevant to this study, because they refer to two phenomena of particular concern for the design of monetary regimes, that is inflation and financial crises. The passage is worth quoting at length:

> Even in the case of a purely monetary question, such as the circumstances determining the amount of depreciation of an inconvertible currency, an important consideration may be the extent to which a people's distrust is aroused, and this in its turn may depend partly on their political sympathies, and on their knowledge and intelligence, or on the extent to which their power of moral restraint prevents them giving way to unreasoning panic. This last point is still more clearly important in connection with the phenomena that constitute a financial crisis. The theory, for example, of the recurrence of such crises at regular intervals, so far as it does not involve the operation of physical causes (as in Jevons' sun-spot theory), may require to be modified according to the stage of a nation's intellectual and moral development. (pp. 134–5)

The crucial question that faced macroeconomists in the twentieth century was the stability of the market system. Could the economy safely be left to stabilise itself? Or did the monetary authorities need to intervene, occasionally or all the time? Theory could point to mechanisms which should preserve or restore equilibrium. But how generally applicable was that theory? The evidence of the turbulent interwar years was that the system was fragile, or sluggish, or unreliable. How relevant was the experience of that period to others? If we are to gain a deeper understanding we must look at institutional change, at the framework of law and at the common beliefs which underlie the choices of individuals. This historical approach to macroeconomics may not result in many straightforward testable predictions, but it is nevertheless indispensable.

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If we think of individual behaviour as rational and calculating, then it is clear enough that the nature of the monetary regime will affect behaviour. This is the favoured approach of present-day monetary theory, taking the theory of choice under uncertainty as its starting point. It follows that influencing rational expectations is the essence of monetary policy. A credible commitment to a fixed exchange rate, for example, will encourage stabilising capital flows. There will be little need for actual market intervention by government or central bank, because currency traders and speculators will anticipate such action. Similarly, a credible commitment to a money-supply target will discourage wage increases that are potentially inflationary. A credible commitment by government to maintain full employment may also encourage firms to initiate investment projects even in a time of recession. In all these cases rational individual behaviour will tend to preserve and validate the regime.

Commentators often use the more elusive concept of market 'confidence'. This is not just another word for expectations. It is a state of mind as well as a view of the future. It may be particularly significant when views of the future are most difficult to form rationally. Under great uncertainty people have to put their trust in something, even when they do not have the information on which an estimate of probabilities might be based. Confidence is not just an individual conviction; it is a shared belief, reinforced much of the time by social contact.

The ability to think rationally was seen by J.N. Keynes as a mark of moral development, the ability to keep one's head. But, if so, there has been little development since his time. Markets can still behave like herds of cattle or flocks of birds. Economists are reluctant to introduce crowd behaviour into their theories of economic behaviour, but clearly it is crucial to the understanding of events such as bank failures or stock market booms. It may also be important to the explanation of business cycles, and to the success or failure of monetary regimes. We shall keep an open mind.

A liberal regime is more likely to be viable if people believe that it is so, if people read neoclassical economists and trust central banks to observe the rules of the game. Equally a managed regime is viable, and indeed necessary, if people have been taught to rely on government intervention to keep the economy on course. It might seem, then, that whichever monetary theory is generally believed becomes, in that context, correct. This is too simple and too sweeping a conclusion. The relationship between the behaviour of the economy and the choice of monetary regime is more complex than that. It involves institutions as well as beliefs.

Clearly the behaviour of an economy must reflect its social organisation. For example, the equilibrium level of unemployment may depend on

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social security provision; the equilibrium real interest rate may depend on the normal age of retirement; the amplitude of cyclical fluctuations may depend on the degree of industrial concentration, unionisation and tariff protection. The role of the state in economic life generally is part of the institutional setting of the monetary regime. It interacts with the institutions of the private sector, for example when protection favours cartelisation, or incomes policies enhance the influence of trades unions.

Monetary regimes

We need a definition of a monetary regime, so as to distinguish it from the day-by-day policy measures taken by the monetary authorities, and also from the role of government more generally in relation to the economy. A monetary regime is defined both by law and by custom. The law will say what is legal tender and may regulate its creation and convertibility into other currencies or precious metals. The law may constrain the balance- sheet position of the central bank and some financial institutions in the private sector. There may also be international agreements and treaties which limit the independence of each national central bank.

But the definition of a regime is not only a matter of law and it may not all be set out unambiguously in black and white. The central bank will have some discretion within the law and the way that it uses its freedom of manoeuvre is also part of the definition of a regime. It may, for example, set monetary targets or exchange rate zones. It will have customary methods of operation, for example setting its discount rate at monthly intervals or varying the required reserve ratios of commercial banks. The nature of the monetary regime will interact with the behaviour of the economy and its institutional structure both as cause and as effect.

A particular monetary regime may be set up because it is thought to be appropriate to a particular institutional setting. The story of the twentieth-century regimes could be told that way. A liberal regime had been established in the nineteenth century because legislators understood this to be appropriate to the competitive economy of the time. Later on, however, a managed regime had to be introduced instead because markets became less flexible. Later still, the neo-liberal regime at the end of the century may be seen as a necessary response to the globalisation of finance.

It is also possible to tell the story with causation running in the other

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direction. Perhaps regimes determine institutions. There are some situations where we can quite clearly observe this happening. The growth of off-shore banking is, of course, a response to national regulation. The index-linking of contracts is a response to persistent inflation accommodated by a relaxed monetary regime. Perhaps we should see cartelisation and unionisation as being, amongst other things, the consequences of a regime which permits fluctuations in the levels of prices and nominal wages.

It is, then, interesting to consider whether adaptation of this kind tends to preserve an existing regime or to undermine it. To simplify greatly, a liberal or classical monetary regime would seem to work best when markets are competitive and prices are flexible; a managed regime would seem to require the cooperation of organised labour and big business. To what extent will the existence of either kind of regime maintain the conditions necessary for its own survival? Alternatively, does the existence of one kind of regime encourage the development of institutions and behaviour more appropriate to the other?

These are some of the questions which will be addressed in this study. There is, in the century, a great variety of experience on which to draw. There are periods of falling prices, stable prices, persistent and slow price increases and explosive hyperinflations. There are periods of steady growth in output, with or without full employment, sharp recessions and deep depression. There are banking crises and stock market crashes, commodity price booms and administered price hikes. There are examples of fixed exchange rate systems and of free floating, as well as various experiments with intermediate regimes. There are, of course, two world wars, and many lesser conflicts. As a result, economists today have no difficulty in writing a natural history of the monetary economy. We have developed plenty of what might be called expert knowledge; we can recognise certain patterns and recurrent combinations of events. Whether this has resulted in any deeper comprehension is another question. The system we observe may evolve more rapidly than we can learn to understand it.

A regime can be described in various ways. For the purpose of this study we identify four characteristics which will be of central concern. The first is the degree to which the behaviour of the monetary authorities is bound by preset rules. The second (which is related, but not the same) is the extent of reliance on market mechanisms. The third is the degree of national autonomy. The fourth identifies the main instruments of policy, especially the role of administered interest rates. We shall discuss each of these briefly in turn, adopting the timeless analytical approach of economic theory, before embarking on our account of history.

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Rules versus discretion

Essentially there are two models of economic policy, whether it is conducted by governments or central banks. Either the 'authorities' act as referee or they are players in the game. In the first case the purpose of government is to uphold the rule of law. Those who exercise delegated authority must themselves be governed by rules. In the second case the duty of government is to enhance the well-being of the nation, assuming such powers as this task requires. Provided that public servants act in a disinterested way, they should be allowed full discretion to monitor events and act accordingly. The right balance between rules and discretion is a matter of perennial debate in political theory, as well as the central issue in the choice of a monetary regime in our own times.

As long ago as the days of the Roman republic it was recognised that dictatorial powers may be needed in times of war or other national emergency. This was certainly the case during the world wars of the twentieth century and I shall argue that the power given to governments to control the economy in wartime had a profound effect on the development of peacetime regimes as well. But, what constitutes a national emergency? This question has to be answered again and again in relation to economic policy. Postwar reconstruction may require that special powers are given to government, but what about more chronic economic backwardness or loss of international competitiveness? A long and deep economic depression may be sufficient reason for special measures to combat unemployment, but should governments seek to iron out the normal fluctuations of the business cycle? Different political philosophies will draw the line in different places.

In monetary theory the case for rules against discretion has been argued rigorously in recent decades. The first argument favours simplicity and predictability. Governments themselves are uncertain about the behaviour of the economy, and averse to risk, so they should not intervene too vigorously, trying to be too clever; they could make the instability worse. Moreover, they will confuse agents in the private sector who might otherwise behave in a stabilising way – sudden and unexpected changes in the rate of interest, for example, will bankrupt otherwise sound businesses. It was arguments of this kind which led Milton Friedman in the 1950s to advocate a regime in which the growth of the money supply was slow and constant year after year. A case for a fixed exchange rate regime could be constructed on similar lines.

The second, and more powerful, argument is about what is called 'time inconsistency'. This is not just a technical issue in the design of monetary

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regimes, but a problem which besets social control of almost any kind. The policy action which seems best 'before the event' will not seem best 'at the time'. The authority which controls behaviour by threats and promises will not in general wish to carry them out. The criminal law may threaten capital punishment, for example, but popular opinion may nevertheless plead for a reprieve. Economists have rediscovered and formalised this fundamental dilemma in the context of monetary policy.

A central bank which has its hands bound may be better at maintaining price stability than one which is able to react to events. In this respect controlling the economy is not like controlling a physical or mechanical system. The behaviour of the economy depends on expectations, which are formed intelligently. The market can sometimes foresee that the authorities will not really be prepared to raise interest rates to the level required to hit their declared target for the money supply or the exchange rate. Their commitment to a monetary rule may only be credible if their discretion is entirely taken away.

There is also a third and very well-known argument against executive discretion of any kind: power corrupts. Economists too easily assume that governments, or for that matter central banks, are altruistic servants of the public good. An older, more cynical, tradition has been revived in the contemporary theory of public choice. This assumes that politicians and public officials are inspired by the same motives as traders in a market – they seek their own advantage.

Governments in a democracy seek re-election. If they have discretion in the management of monetary policy they will seek to win favour by cutting interest rates as the date of the election approaches. Central bankers are not subject to this temptation if they have security of tenure, but some would say that they show a rather different bias. Their constituency is the financial community – the City of London or its equivalent. They may keep interest rates and exchange rates too high for the good of manufacturing industry or the economy as a whole. If governments and central bankers cannot be bound hand and foot, then they should at least be made accountable and made to work within clear guidelines and a policy framework.

Laissez faire and monetary policy

The general proposition that governments should not intervene in the operation of a market economy has long born the name of 'laissez faire'. The classical case rests, not only on the three arguments for rules already de-

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