The Gap in

By

"In case the reader finds it hard
to manage our lives for us c

> ### Substantial Gaps
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> THINGS, you might say, are moving in the required direction. So they are — but the Chancellor has to decide whether the pace should not be quickened.
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> It is an unenviable decision — and it isn't made any easier by the notorious unreliability of economic statistics.
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> Time and time again in post-war years the Treasury has been hopelessly wrong in its crystal-gazing.
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> Strenuous efforts have been made to improve the system, but there are still substantial gaps. Official statistics are subject to constant adjustments — and no chancellor if he has sense places too much reliance on them.
>
> —William Davis in the *Evening Standard*, July 13

MOST of the writings on economics over the past twenty years have been devoted to the subject of managing the economy, but the trouble with making any sort of survey of these writings is that the position is—to put it mildly—confused.

In the December 1964 issue of the *Economic Journal*, for example, there is a review of a book by J. C. R. Dow called *The Management of the British Economy* 1945-1960. The author is quoted as saying: ". . . budgetary and monetary policy failed to be stabilising and must, on the contrary, be regarded as having been positively destabilising." Shorn of its jargon, this is saying that those who were attempting to manage the economy achieved precisely the opposite of what they set out to do.

The reviewer of the book is generally hostile, but he says that "most members of the Economic Section (of the Treasury) will now find themselves agreeing very closely with Mr. Dow's interpretation of events."

There are, broadly, two ways in which governments have attempted to manage the economy: one has been by varying government expenditure, as suggested by Keynes. One cannot do better here than refer to the Plowden Report on Public Expenditure, of 1961.

"The emphasis here is on stability of expenditure policy. In the past, however, successive Governments have sought to vary public expenditure as a means of maintaining the short-term stability of the national economy. It must be accepted that some changes in plans for Government expenditure policy are inevitable. The Government is required by public opinion to seek to manage the national economy with only small variations in the level of employment. It is natural, therefore, to explore the possibilities of using variations in public expenditure to help in this task. Experience shows, however, that Government current expenditure cannot be varied effectively for this purpose. Attempts, at moments of inflationary pressure, to impose short-term "economies" (or to make increases at moments when "reflation" is called for) are rarely successful and sometimes damaging, and we think that these attempts should be avoided.

"There has been a tendency in the past to over-estimate the possibilities of useful short-term action in public investment, and to under-estimate the indirect losses caused by sudden changes. Experience shows that at least six to nine months (and often more) must elapse before short-term changes in either direction take full effect. In the two-year period from high to low, which seems to characterise post-war fluctuations in the economy, the effect of the action taken may well appear at the very moment when the economy is already on the turn. The remedy may, therefore, be worse than the disease."

This method having been tried and having been shown to have failed, the remaining method is to influence private spending by manipulating the monetary system.

In this field the academic economists have no cause to complain that the politicians have ignored their advice. Indeed, it is a most remarkable fact that as soon as a new idea appears, however theoretical, the Treasury and the Bank of England act upon it immediately. This seems to have been true whichever government was in power. In fact, the theories of monetary control which were put forward by the professors in the mid 1950s were so rapidly accepted that they became known as the New Orthodox Theory.

What they were saying was that the economy could be controlled by regulating the issue of Treasury Bills and that it really did not matter very much how much cash was in circulation. Everyone accepted it. So it was that when the Radcliffe Committee on the Working of the Monetary System came to present its report in 1959, it said that "the supply of Treasury Bills and not the supply of cash has come to be the effective regulatory base of the domestic banking system."

For a Chancellor of the Exchequer this was a very useful piece of magic. It meant that he could have more money printed without worrying too much about inflation—because he could always get the experts to keep the monetary system under control.

It is not often that a piece of economic theory can be put directly to the test in the same way as a theory in, say, chemistry. But here is an occasion in which it has been. For the results of this method of managing the economy are on record and they tell a story as clearly as any laboratory notebook. The results show that the New Orthodox Theory did not work at all!

conomic Thinking

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An analysis of the past ten year's figures appears in the *Economic Journal* for December 1964. The author concludes that control of Treasury Bills is ineffective and that it is the supply of cash which is important. This is, of course, the exact opposite of the conclusions of the Radcliffe Committee. The author also finds that policies which the New Orthodoxy would expect to be contractionary turn out in fact to be expansionary.

In case the reader finds it hard to believe that learned gentlemen who are so willing to manage our lives for us can be so neatly, completely and utterly wrong, I would refer to an article in *The Economist* of June 19, aptly titled "Whatever happened to Credit Control?":

". . . Ten years ago *The Economist,* among others, went to great pains to expound a new and modern theory of credit control to its readers, and not least to the Bank of England. The Bank accepted the theory, but shrank from its full implications. It now turns out that the theory was based on assumptions that events have shown to be invalid . . . The new monetary orthodoxy, it would seem, had been found unworkable almost before it had been fully enshrined in the text-books."

One could not ask them to eat their words more thoroughly than that!

Inflation has been taken by this journal to be simply the issue of unbacked cash, and the intricate questions of credit creation have been ignored on the grounds that their effects are merely consequent upon the volume of cash. Here is one point on which other schools of thought would have considered this approach naive or irrelevant. It would appear, however, that this simple-minded approach was after all the right one.

Where does this leave the modern economists? Perhaps it would be going too far to say that they have failed to find any effective way of putting Keynes's theory into effect. But certainly they must be conscious of a very big gap in their economic theory.

In many ways this is a time of great opportunity in economics. The long period of complacency that followed the general acceptance of Keynes's philosophy is at last over. It will not be said that Keynes was wrong—in the sense of making an error of logic. He was logically right about how his model worked—and his model was intended to be a simplification of reality. In the acid test of practical usefulness, however, it has been shown to be lacking.

The economists in the universities are undoubtedly able, painstaking and conscientious. The same, however, could be said of those who attempted to dissuade Gallileo from his belief that the earth revolves around the sun. If the premises on which these gentlemen had founded their arguments had been correct, one could not have faulted them on their logic.

Before Gallileo's theory could be accepted, the prevailing approach to the problem had to change. What is it about the current approach to economics that should be changed? One is a change in the philosophical approach.

The present philosophical weakness lies, I believe, in an attachment to the notion of the economic model. The thinking behind the use of models runs something like this. Supposing that it was required to analyse the working of a factory. It would not be practicable to do so by examining the behaviour of every man and every machine in the factory—any more than a botanist examines the behaviour of every individual molecule that makes up a plant. All that would be necessary, or indeed practicable, would be to examine the effects of varying the inputs—labour, capital and materials—upon the outputs, the finished products.

When one does this one is looking, not at the factory, but at a mental model of the factory. However, if the model is well enough constructed it will behave overall in the same way as the factory itself. The advantage of this approach is that the model is easier to think about than the factory. In fact, it is often not difficult to write down a set of mathematical expressions that describe the working of the model. Then all one has to do is to feed whatever information one wishes into these equations and they will tell one what the outcome would be.

This model method is a very powerful way of examining a factory. It is also a powerful way of examining the operation of a market in which articles are bought and sold. But is not the national economy after all just an aggregate of factories and markets? So why not set up a model representing the whole national economy? We can then perform experiments on the model and use the results to guide our actions in managing the national economy.

For people trained in mathematics this is a very fascinating idea. The fact that the mathematics may be difficult

The Anti-Planners

SAM (alias the computer growth model of the economy devised by the Department of Economic Affairs at Cambridge) is not helping the discussion along enormously, either. In its latest report this week, it assumed that from 1960 to 1970 the British aircraft industry would probably grow, on two possible assumptions about the economy, by about 50 per cent; and that among the industries likely to grow more in the sixties than during the fifties would be coal.

Magnifique; mais ce n'est pas le planning . . .

The Economist, July 17, 1965.

only adds to its appeal as an intellectual challenge. With the development of the electronic computer, moreover, the tedium of performing vast quantities of routine calculations has been removed.

This process has already been carried almost to its logical conclusion. A group working at Cambridge has already published a computer programme representing the British economy.

This is all very marvellous—but there are several snags. One of them was pointed out by G. K. Chesterton as long ago as 1904. His book *The Napoleon ofNotting Hill* opens with the following paragraph:

"The human race, to which so many of my readers belong, has been playing at children's games from the beginning, and will probably do it to the end, which is a nuisance for the few people who grow up. And one of the games to which it is most attached is called 'Keep tomorrow dark', which is also named 'Cheat the prophet.'

The players listen very carefully and respectfully to all that the clever men have to say about what is to happen in the next generation.

The players then wait until all the clever men are dead, and bury them nicely.

They then go and do something else.

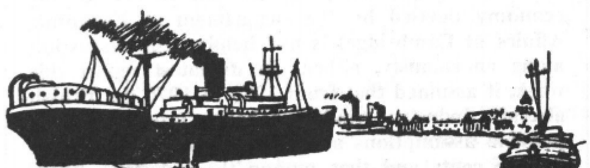
That is all.

For a race of simple tastes, however, it is great fun."

This is just how the New Orthodox monetary theorists were caught out. They observed that the majority of bills held by the banks were Treasury Bills, with comparatively few commercial bills. Accordingly their model was constructed on this basis. In the event the banks reduced their holdings of Treasury Bills and increased their holdings of commercial bills. They did so not out of an impish sense of humour (this is not the way of bankers) but because the policies of the New Orthodox methods made it attractive to do so.

This illustrates one of the great temptations of the model method. That is to choose the basic assumptions in such a way as to make a definite conclusion possible without a lot of ifs and buts—and then to forget that they were only assumptions and not statements of immutable fact.

When the users of models are more cautious, their results tend to be less simple. An illustration is provided by a pair of mathematical papers by Professors Kemp and



Samuelson in the *Economic Journal* of December 1962 on Gains from International Trade. Using a very cautious set of assumptions they proved with great mathematical vigour that the world as a whole would be better off under Free Trade than under any possible system of Protection. They also arrived at a whole series of heavily qualified conclusions regarding the circumstances under

which protection could benefit certain individuals, groups or even countries—at the expense of the rest.

Now this highly logical piece of work can be used to show that the economic case for free trade is not impregnable. The next stage would be to accuse anyone who says that he is for free trade, without adding a lot of qualifications and reservations, of being ignorant or bigoted.

What Professors Kemp and Samuelson do not see is the absurdity of tackling what is essentially an ethical question by purely mathematical methods. One could make an analytical attack on the proposition that "crime does not pay." A rigid analytical demonstration would no doubt show that the world as a whole would be better off without crime than with it, but that certain individuals, groups or countries could conceivably benefit from crime. This would have absolutely no influence upon the ordinary man's attitude to crime—he knew this all along in his own muddled way.

There may be general agreement on the ethical basis for certain human actions, but there is any amount of scope for logical error in its application. To illustrate let me refer to Henry George's analysis of the rights of property.

His ethical starting point is: "Every man has a right to himself." This is, of course, unprovable, but it is a proposition that hardly anyone would deny. It is not the starting point that causes the difficulty, and yet its logical conclusion—that private property in land as opposed to private property in the products of man is wrong—gets comparatively small support.

To examine economic policy without an ethical starting point is like exploring a wilderness without a compass. The compass of ethics is necessary, but it is not enough. Unless the exploration is logical and systematic we shall still be lost.

The essential appeal of land-value taxation and free trade is an ethical, not a purely technical, appeal, although the technicalities can be fully met.

We have today a whole host of devices that divert wealth and activity towards certain sections of the community. Subsidies, special loans, government contracts, licensing systems, purchase tax etc. all have a similar effect. The practical question is not whether there could be circumstances in which protection can benefit certain groups, but whether the actual protective measures now proposed or in force are justified.