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# The revolution that never was

Will Hutton

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# About the Book

Will Hutton argues that Keynesian revolution has yet to take place. Economists, he finds, have not yet come to terms with the heart of Keynes' argument: that there are limits to what prices can do in a market economy. But referring closely to Keynes' writings, Hutton demonstrates that Keynes was concerned to show how the financial sector of the economy originated and how it reinforced the incapacities of the market economy. Post-war Keynesianism, Will Hutton concludes, has overstressed the role of fiscal polity in programmes of Keynesian economic management: it is but one element in a larger polity of financial and momentary leverage aimed at leaning against these market incapacities. By insisting that government intervention is a prerequisite to the proper functioning of the market, Keynesianism in effect becomes a political philosophy challenging the entire panoply of economic and political liberalism. As such it may require important changes in the structure of government if it is to be implemented successfully.

To Jane and Sarah

# The revolution that never was

## An assessment of Keynesian economics

Will Hutton

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# Introduction and preface

Keynesian economics is on the defensive. Its public reputation is low: it has come to be synonymous with large budget deficits, unsuccessful attempts to contain inflation with income policies, and failing economic growth. Among economists its reputation is rather higher, but no longer are the basic precepts argued with any conviction. Here, too, there is the same sense that the theory, and the economic management it spawned, have been tried, and found wanting. The intellectual initiative has passed to those prepared to argue the merits and robustness of a more ancient tradition in economics; that of economic liberalism, and the capacity of the free-market model of the economy to resolve many, if not all, contemporary economic problems. Scepticism about the potential of the market and the limits of the price mechanism has ceded pride of place to an ardent belief in their power. In today's world, it seems, public action is 'out'; private action is 'in'.

The extent of the ascendancy of this new mood is revealed not only in the tenor of economic debate and the direction of policy, but also in the lack of effective opposition. Across the gamut of economic issues, 'classical' economic prognoses are advanced, with the old Keynesian retorts either mute or unconvincing. For example, unemployment is explained in terms of excessive real wages; inflation as an oversupply of money; low growth as the consequence of dynamising market forces being stifled. Even as recently as ten years ago Keynesians would have replied with references to aggregate demand, involuntary

unemployment, and business expectations: today their argument seems tired and unpersuasive.

As in theory, so in policy. Exchange rates and interest rates have been left to find their ‘market level’; attempts at their management are undertaken reluctantly, as an unwarranted obstruction of market processes, and therefore contrary to the new orthodoxy. In general the Government’s responsibility is to limit its role and its claims: in the financial markets where it must borrow and intervene less, and in the product and factor markets where it must regulate and own less. The injunction is clear: because a market system has been shown to be the ‘best’ system, economic problems are only problems in so far as they are departures from a free-market model. The Government’s task is to move the economy back to such a model.

Yet while the reorientation of policy, and the ideas behind it, are evident, there is a growing sense of unease. Rejuvenation of the economy remains as elusive as ever, and although there have been some benefits, the overall results are disappointing. Moreover the theory, confronted by today’s economic realities, increasingly seems to fly in the face of common sense. The volatility of exchange rates and interest rates, for example, seems to belie the assertion that markets must always be ‘right’. Similarly, pouring savings abroad at the same time as there is underinvestment at home, seems to suggest that either the price mechanism is perverse or that the long-term correction needed to change the relationship may be *too long term* for the current generation of unemployed. Again, public-sector investment projects are constrained because public debt is supposed to be inflationary, whereas private debt is not. Practical responses and public action are forbidden by a philosophy which seems to stand the world on its head.

For some, of course, this is only evidence that the policies have not been carried out with enough vigour and that

substantial obstacles still stand in the way of the free and flexible operation of markets, without which satisfactory results cannot be expected. The ‘vision’ of the economy remains sound. The non-partisans, however, are becoming more and more dubious. They are suspicious of planning and economic blueprints, as these frequently involve an extension of centralised power and a loss of individual freedom, but they are also concerned about trends in the economy. If it *is* true that Keynesian economics no longer has anything to offer, and if the claims and policies of the free-market theorists *are* at the very least contestable, then what next?

This book was begun as an attempt to find some kind of answer to this conundrum, and it was with some surprise that the author discovered that the direction in which his own enquiries were leading largely paralleled those of J. M. Keynes – even if they were a great deal less exact and considerably more clumsy. But this was not the Keynesian theory described in the textbooks and used in popular debate, the reflex Keynesianism whose familiar nostrums have now correctly passed from fashion. Rather it was a theory that sought to revolutionise the terms in which economics was discussed and markets understood. Fifty years since its inception, the Keynesian critique presents just as much a challenge to established economic thinking since, in the act of translation and interpretation, the old economic orthodoxies have gradually reasserted themselves. In fact the integration of Keynesian economics back into the mainstream of economics has meant that the ‘Keynesian revolution’ has lost almost all its meaning. We are left with the slogans and empty theoretical categories; but the insights that filled them have been lost in the process of integration. The Keynesian economics that we are told has nothing to offer us today has little to do with the economics of Keynes.

The principal theme, then, of this book is that much of contemporary economic analysis, cast as it still is in the classical tradition of generalising the properties of single markets to that of *the market economy as a system*, is fundamentally flawed. There is considerable difficulty in moving from the classical construct of an exchange economy based around barter to one using money; and there is no less difficulty in moving from an economy where an initial stock of goods is assumed to be endowed, to one where goods are produced. In particular, there are the problems of expectations and time; problems that are introduced into the market economy by the existence of money and production. It is from this starting point, we shall argue, that Keynes constructed his theory, leading in turn to predictions concerning the limits to the power of the price mechanism, the quantity-adjusting tendencies of the market, the centrality of the financial markets and the portfolio preferences of financial institutions, and the inability of the market to co-ordinate the plans of savers and investors at a full employment equilibrium. These are the insights at the heart of the Keynesian critique: but without their comprehension Keynesianism is a 'Chesire Cat' theory, grinning at our problems without any prospect of helping in their resolution.

Writing this book, then, has been something of a personal rediscovery of a 'lost' theory. Although there has been a temptation to rewrite a number of passages as the manuscript has been revised, they have been left largely as they were first written, containing as they do all the surprise and freshness at communicating a view of economics that at the time was wholly new and unexpected. I hope the reader will agree with this judgement.

Chapter 1 sets out the main contours of the book, and tries to show the congruence between the key axioms of mainstream economics and classical liberalism. As Keynes's underlying philosophy is closer to the European 'social

contract' tradition than that of English individualism, it is scarcely surprising that he should present such a challenge to economics and the British economic establishment. Chapters 2 and 3 are an account of the problems that bedevil both classical economics and its contemporary exposition by having to insist that individual exchange can only arrive at an equilibrium. Chapter 4 examines the theoretical difficulties in providing a theory of price and quantity determination that delivers a notional equilibrium in a market economy where goods are produced over time. Chapters 5 and 6 set out the main elements in Keynesian thought – how time, money, and expectations upset any market process towards an equilibrium – while Chapter 7 focuses on the financial markets and institutions and the key part ascribed to them in the Keynesian story. Chapter 8 sketches some outlines of policy, in particular the leverage that must be exerted over financial institutions, and the role of fiscal policy in both compensating for quantity adjustments and managing expectations; and discusses the structure of British Government in the Keynesian context of its obligation to play a more active role in economic management.

The book has a number of objectives. It is chiefly a critique of orthodox economics and an attempt to retrieve and restate Keynesian economics; but it may also be of interest to those engaged in formulating an intellectual basis for if not consensus, at least some continuum of views around which economics can recoalesce. I hope it will be useful not only to economics students but to all those concerned at the current stalemate in economic discussion.

In a project of this type an author has any number of individuals to whom he owes thanks. I owe a particular debt of gratitude to the two Longman readers who in their different ways allowed me greatly to improve on the final manuscript – also to Jonathan Storey, Nic Morris, Paul

Ormerod, David Llewellyn, Tim Congdon, Meghnad Desai, and Roger Bootle, who all offered helpful and useful comment on earlier drafts. Erna Stuart-Bullock typed the first manuscript from beginning to end; Victoria Blunden and Clare Walker worked on later drafts and Anne Mills completed it. Sally Conover proof-read the manuscript and assembled her first index with remarkable skill. David Frost's cottage, and David Frost played no less a role. My thanks to them all. In addition, throughout the entire time of writing I am working for BBC Radio and Television Current Affairs Programmes and I must thank all my editors for their support: Vincent Duggleby, Alasdair Osborne, Richard Tait, David Lloyd, and lastly to David Dickinson – who saw to it that the book was completed. Also thanks to the Wilson Center in Washington where this edition was finally despatched to the printers and a US edition begun.

But my final and most heartfelt thanks are to my wife, Jane. Without her understanding, tolerance, and sympathy I doubt the book would ever have been finished. It is, however, now done: and I remind the reader of the usual caution with more than customary fervour. Any mistakes that follow are mine, and mine alone.

November 1985

Chapter 1

# The liberal tradition and the lost revolution


## Summary

THREE MUTUALLY REINFORCING principles underpinned the philosophy of political economy; liberty, natural law and balance. These same principles are incorporated in contemporary economics, and the first section of this chapter, ‘The liberal heritage’, is an exposition of the outlines of classical political economy and an account of its origins. It will help illustrate both the congruency of ideas and the very particular philosophy they represent; namely, the capacity of individual interest to produce the public good. The second section ‘Liberalism and economic theory’, identifies five core concepts shared by the liberal tradition and by classical economics: rational economic man, exchange, equilibrium, diminishing returns, and competition. The renaissance of interest in the classical economic tradition, described in the third section, has seen a much bolder approach in the use of these concepts, not only to sharpen the conclusions of economic theory but also to redirect economic policy. There are, however, significant weaknesses in this body of theory and they are highlighted by a fresh appraisal of the Keynesian critique of the classical

tradition, discussed in the fourth section. There are three key areas of dispute: the difficulty of using barter exchange as a model to describe a money exchange economy; the role of money, expectations, and the rate of interest; and the determination of prices. Taken together, the Keynesian argument is that the motion of the market economy is *not* towards the equilibrium that economics supposes, nor that the 'best' outcome inevitably results from free exchange between 'optimising economic agents'. A more promising perspective in which to analyse the market economy is to accept that it is quantity-adjusting (rather than adjusting to price) and is in a permanent process of uncertain experimentation; and that the key to its performance is the portfolio preferences of the financial system. In the fifth section the implications for policy are discussed. If the market does not spontaneously produce the right results then intervention by the state is imperative; in particular using the financial system as a major lever of economic management. However, this will require a different tradition in which to locate the state's responsibilities, perhaps even – given the weaknesses of the British government process – reformed state institutions.

## The liberal heritage

In the 75 years between the publication in 1776 of Adam Smith's *Wealth of Nations* and the celebration of that wealth at the Great Exhibition, there developed in Britain a very particular system of ideas about economic and political organization that has come to be known as the 'liberal tradition'. Although it had grown out of Britain's unique history in the seventeenth and eighteenth centuries and had reached maturity during the special circumstances of the Industrial Revolution, its authors claimed for it the status of a universal truth. The objective was nothing less than to reveal the invisible and immutable laws that governed the

harmonious organisation of human society, and in so doing to assert that the liberty of the individual was the absolute prerequisite for a just and prosperous political and economic order. The ‘Science of Political Economy’, the intellectual edifice fashioned by Smith, Ricardo, Mill, Bentham, *et al.*, was the demonstration that in liberty lay the key to individual and societal well-being.

The doctrine satisfied the needs of mid-Victorian England perfectly; for not only did it identify the laws that underlay an effectively functioning economy, it also suggested that those laws had reached their apogee in the England of 1850. The perspective was Newtonian, as befitted an age insistent that there existed laws governing human conduct paralleling the laws governing the behaviour of the physical world. In the same way that the laws of the universe produced the harmony of the Spheres, so the laws that governed human society would produce a harmonious society, as long as their operation was not obstructed. It was by respecting these laws that human societies were able to raise themselves up the ladder of progress, so that the higher a country had progressed, the more its institutions must comply with these hidden laws.

Balance, in this scheme of things, was seen as the stable state to which all natural forces tended: harmony in society, as harmony in Nature, required that elemental forces be balanced. The organising order in the physical world, gravity, rose from the mutual interaction of opposing forces: so order in the human world was provided by natural laws dependent on the interaction of opposing forces for their operation. The dynamic element in human society was clearly the action of the individual; so by according him his liberty the forces that would produce balance were set free. The task of economic and political institutions was to provide the forum in which individual actions, given their liberty, would be balanced.

In the political realm the object was to build a ‘Balanced Constitution’ which organised political activity into institutions that ‘checked’ and ‘balanced’ each other, so that one institution of government did not abuse another. The British parliamentary system, arising from the seventeenth-century compromise between King and Parliament, executive and legislature, seemed to meet this criterion admirably. The House of Commons, the legislature, consisted of a chamber of gentlemen elected by other gentlemen who freely deliberated on the laws that would or would not represent the public interest; while the Executive, in the person of the Queen and her ministers, could only survive as a government and enact legislation if it could muster a majority among these same gentlemen for the measures they proposed. If not, the Queen must appoint new ministers. A judiciary, appointed by the Queen, was independent of both Houses of Parliament, and interpreted the law free from political control: the rule of law thus stood as the guarantor of liberty. The Government was constrained to govern fairly and well, so that not only was the country protected from arbitrary and despotic rule, but the framework of law so established permitted the free pursuit of manufacture, trade, and commerce – and as political economy showed, this freedom was a vital prerequisite for their flourishing. The Constitution which conferred such benefits was clearly much to be commended, but then so were the principles by which the economy was organised.

Here again the object was to permit the expression of those forces whose interaction could be expected to produce a harmonious whole. Men spontaneously wish their self-betterment, and will deploy every means at their disposal in the attempt to achieve their aim. It is these elemental forces in the human world that represent the mainspring of economic activity, and their unification in a beneficent whole requires that each individual be permitted

his economic liberty, that is, the freedom to sell his services and his goods to the highest bidder, and the freedom in turn to buy from the cheapest seller. If the two forces – those who buy and those who sell – freely meet, then the portfolio of goods that each individual trader has after exchange can only be exactly what each trader wants: otherwise he would have continued trading until he reached that happy position. The single-minded pursuit of self-interest must bring a market economy to a point of balance: not only this, but it will assure prosperity.

This latter benefit is produced via the capacity of an exchange economy to encourage more and more specialisation. The famous Adam Smith dictum that ‘it is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their own regard to their own interest’ (Skinner 1970; BK 1: 119) not only aimed to underline the importance of self-interest, but to dramatise the impact of specialisation: in this world every man was a merchant bringing the wares in whose production he specialised to market, be he ‘butcher, brewer or baker’. Through buying at the cheapest price and selling at the dearest, the market would certainly arrive at a point of balance; but it also permitted each man to specialise, for he could exchange those goods he did not need for those he did – and specialisation lifted the productive power of the economy.

Specialisation, however, implied the organisation of production; and organising production requires capital. The great advantage of free exchange, argued Smith, was that by permitting each ‘merchant’ to make the highest profit he could, capital could be accumulated at the fastest rate: and as capital accumulated so there was more specialisation. Not only was the economy likely to achieve balance, it tended to progress and enrich itself, the only possible obstacle being obstruction to prices and profits as they worked their beneficent magic.

Economic and political organisation were thus linked. The State, according to this theory, had a responsibility *not* to intervene in the market process: in fact it must uphold and protect the market in its every facet. The free movement of prices and the free making of profits; private property and the rule of law; the unimpeded process of capital accumulation and specialisation; the ability to buy and sell goods in whatever market the price was highest or lowest: all these rights the State must strictly enforce however savage their consequences apparently might be. For although mid-Victorian England had its warts, the system's protagonists argued that no comparable society on earth had ever managed to harness Nature on such a scale. Its network of railways, its factories, and its trade were the envy of the world, and together with the economic and political freedoms enjoyed under the Constitution, seemed part of an indivisible process of advance and progression. Obeying the liberal injunctions was clearly the explanation of Britain's greatness. As the great apostle of free trade, Richard Cobden wrote (Weiner 1981: 28):

> Not a bale of merchandise leaves our shores, but it bears the seeds of intelligence and fruitful thought to the members of some less enlightened community; not a merchant visits our seats of manufacturing industry, but he returns to his own country the missionary of freedom, peace and good government – while our steam boats, that now visit every port of Europe, and our miraculous railroads, that are the talk of all nations, are the advertisements and vouchers for the value of our enlightened institutions.

In this world liberalism was not merely a policy or a system of ideas: it had attained the status of a faith, a faith that had the advantage of being grounded in the scientific reality of a potential natural order in human affairs.

Adam Smith – the founding father of the liberal tradition in economics – provides no better example of the way. the idea of a 'natural order' and the role of liberty intruded into the very essence of this nascent theory of the world. His *Wealth*

*of Nations* was conceived as the second book in a series of three; the preceding volume, the *Theory of Moral Sentiments* (1759), was an exposition of the spontaneous, natural growth of civilisation, and the third and last, which Smith never lived to write, was to 'provide an account of the general laws of government'. The theme that united all three books was that there existed *natural laws* underlying the progress and governance of society, and that these laws were capable of being unveiled through observation and rational reflection. Moreover, these natural laws revolved around the degree to which human societies enjoyed liberty, for it was liberty that above all else permitted man to achieve harmony with himself and society.

It is difficult to grasp, some two hundred years later, the extraordinary grip the concept of liberty and its juxtaposition with natural order had upon the late eighteenth-century mind. It is said that in 1768 there was not a single door or shutter on any house along the roads between London and Winchester and London and Oxford that did not have 'No. 45' daubed on it,[1] '45' being the edition of the *North Briton*, the paper founded and edited by John Wilkes, which prompted George III to have Wilkes arrested for treason under a General Warrant. London's streets echoed to the cry 'Wilkes and liberty'. 'Weavers' wrote Walpole, 'took possession of Piccadilly . . . and would suffer nobody to pass without blue cockades' and distributed papers inscribed 'No 45, Wilkes & Liberty' (Kronenberger 1974: 94). The year that *Wealth of Nations* was published Richard Price's book *On Civil Liberty* sold 60,000 copies (Plumb 1979). Liberty had become a battle-cry; a summons to arms against a king attempting to reassert control over the Houses of Parliament and their hard-won right to be the locus of the nation's political authority; and a rallying point for the London merchants and Northern manufacturers who were finding the system of tariffs and imposts on foreign trade increasingly irksome. It

united the mob, the merchant and manufacturing classes, and the Opposition into a formidable force; and one before which George III finally gave up his pretensions. The idea of liberty was in the air, and nothing could be more fitting than for Smith to argue that liberty in exchange provoked a natural order in the economy.

The task Smith set himself was not merely an intellectual exercise; it was a political and moral statement. In arguing that the invisible hand of the market is the secret of the 'wealth of nations' only as long as men are at *liberty* to buy at the cheapest and sell at the dearest price, Smith was providing further ammunition for the 'cause'. The public interest did not arrive from the actions of kings or self-interested legislatures, but as the unintended consequence of free and individual actions. Like the rest of his generation, Smith was infected by the enthusiasm for unfettered liberty.

The origins of classical economics thus lie in the spirited political and philosophical arguments of the 1760s and 1770s. In itself this proves absolutely nothing: many of the best ideas have a long pedigree, and the association of an idea with a particular time, place, or intellectual movement is no reason to devalue it. On the other hand, economics likes to regard itself as built on a series of *a priori* intuitive truths; and it is as well to recall that these 'truths' originated in the passionate conviction of eighteenth-century Englishmen that the most prized attribute of any society is the liberty it affords it members. They were not concerned to incorporate notions of equity, fraternity, the nature of the social contract or any of the other philosophical ideas of their age into their theory of the world. Their intention was to show how every aspect of the public interest followed in the train of the pursuit of liberty.

The founding fathers of classical liberalism were unashamedly ideological (Semmel 1970); and like all ideologies the importance of the theory is not so much the exactitude of its prognoses but the political work it has to

do. Interpreting the processes at work in the economy and polity along classic liberal lines, therefore, holds great dangers because the suggestion that economic and political phenomena must always be explained as the outcome of individual interests and decisions can, under closer scrutiny, translate into a series of tautologous statements.

What is balance? It is the order that individuals will bring about if given the liberty to express their interests. Why is society not harmonious? Because the spontaneous action of individuals is frustrated by obstacles. How can order be regained? By removing the obstacles to the creation of balance and harmony. We are locked in a circular argument of assertion in which any obstruction to the expression of personal or individual interest is the cause of the system's difficulties, so lack of harmony in the real world proves nothing about the ultimate validity of the liberal order, only that it is obstructed in its working.

By locating the individual and liberty as the focus of the system, the classical theorist is forced into denying that the whole is more than the sum of its parts, and must insist that the public good is the sum of balanced private interests. It is profoundly unsatisfactory, however well it served the political and philosophical ambitions of its authors two hundred years ago; but this is the underlying philosophy of contemporary economics.

## Liberalism and economic theory

How is the market to be understood? Economics within the classical tradition, as is already clear, makes a number of claims. An economy based on free exchange produces an economic order spontaneously. Moreover, the order so created must be the best for society as a whole because each individual has been allowed to come to his best judgement of how to meet his needs. And any interference

with this process by an outside agency is likely to be counterproductive.

Herein lies the importance of the liberal tradition and the central roles played in it of the idea of liberty, of a natural order, of the drive to self-betterment and profit, of individual and free exchange as spontaneous economic combustion, and of the State as the guarantor and protector of the whole system. This tradition provides the question; and it provides the answer. The free market is the mechanism which allows these preconditions for a natural economic order to flourish – it is therefore the state of affairs most to be desired.

Now, economists like to think of their subject as the social science that has made the most substantive progress towards rigorously comprehending and interpreting its chosen area of enquiry. The textbooks and journals abound with algebraic and geometric expositions of economic phenomena; a scientific approach that the other social sciences can nowhere match. Yet the framework in which much of this analysis takes place is that of liberal/classical economics. It is not stretching a point to argue that the discourse of economics, its fundamental language and world-view, is that of the liberal tradition. There is equilibrium in the economy; it is achieved through the interaction of supply and demand; the price mechanism sends messages to producers and consumers about what to produce and what to buy, messages that they obey because they wish to maximise their advantage; and progress in the economy arises from constant experimentation and innovation under the spur of competition. These tenets run so deep that they are simply taken as read.

Part of the reason for this of course, is the intuitive logic of each proposition – confirmed by our own behaviour. We do respond to price signals in the way economic theory suggests, and in general we want more income and more profit if it can possibly be attained. Change does happen, and typically firms are anxious to install new machines and

introduce new techniques because they will lower costs, improve profits, and so steal a march on their competitors. Equally, we can observe what happens in markets in general when prices rise or fall; if their is a shortage of oil, for example, the price rises and the quantity demanded falls – just as economic theory suggests.

Another contributory reason is the compelling liberal proof of the market's efficiency in achieving the optimum outcome in terms of the participants' welfare. The starting point is to define an optimal condition as one in which any individual can only make himself better off by making somebody else worse off; a Pareto optimum. The beauty of a system of voluntary exchange when it is at equilibrium is that it describes such an outcome.

For any individual economic agent to improve on his position must imply another agent willingly doing business with him. But 'equilibrium' is defined as a situation of 'rest', in which voluntary exchange has ceased. It therefore follows that 'equilibrium' in a system of voluntary exchange will only be reached when all economic agents, given their preferences and constraints, believe that their position can no longer be improved upon through exchange. In other words, 'equilibrium' is itself the Pareto optimum.

The apparent intuitive nature of the assumptions, the elegance with which an optimal outcome can be proved, and the ease with which the characteristics of the market square with liberal values – liberty, freedom, the objection to centralised power – combine to make the envelopment of economic theory by liberal/classical economics near total. Not only this, we can actually observe prices leading to behaviour changes in markets along the lines that the theory suggests; and the fact that our economic institutions, created as they were in a liberal era, are embued with the same liberal values completes the cocoon. Values, theory, scientific objectivity, and experience mesh into a suffocating web; the truths of economics are liberal truths.

That identity of view between the discourse of economics, the liberal tradition, and classical economics is underlined by a closer examination of the basic postulates of the conventional theory. There are at least five congruent ideas.

*1. The idea of rational economic man*. Already the idea that man desires his self-betterment and that this impulse is a prime mover of the exchange economy has been observed as a central theme in classical economics. It is for this reason that voluntary exchange will lead to the most desirable outcome as traders jockey for advantage by exchanging goods they want least for goods they want more; if they did not wish to better their initial position there would be no motivation for trade. If we are to build a theory, however, we need a more rigorous construct than simply the desire for material self-improvement, and such a vehicle is provided by the concept of 'rational economic man'.

This creature's desire for self-betterment has been translated into the requirement that whatever end he (or she) has in sight, he will want to choose the optimal means of achieving that end. Rational economic man is an optimising agent who, as long as he can rank preferences systematically, can be relied upon to respond to stimuli in the manner predicted by market theorists.

There are two important claims that can be made for this definition. The first is that by Robbins (see Ch. 3), which is that it does away with the notion that economists insist that man is just a profit-maximising beast and nothing else. Man can have any end at all; all that economists require is that he chooses the optimal means of achieving it. The second is by Hayek (1948: Ch. 1), which is that the point of devolving decision-taking to individuals in a market-place is that they are the best judge of their circumstances, interests, and preferences. Economists in the market tradition do not want the objects of their enquiry to be profit-maximising; they

want them to be sensible enough to make decisions in their own best interests.

However, while it is apparent that rational economic man is a much more sophisticated construct than the man who inhabits the world of the *Wealth of Nations*, the stimuli to which he is required to respond are remarkably similar. Robbins wants them to be 'relative valuations', whereas Hayek openly advocates the market as the place where economic man will take his devolved decisions. Rational economic man is required to be rational in a market; and that will mean attempting to maximise his gain. It is only if he does so that the system has the potential to arrive at equilibrium.

*2. The idea of voluntary exchange.* The capacity to exchange an initial endowment of goods for a portfolio of goods that better reflects an individual's preferences is perhaps the most important attribute of an economic system if it is to conform to liberal precepts. It was exchange that Adam Smith saw as the key to the *Wealth of Nations*; it is exchange that permits a Pareto optimum to be achieved. Price and quantity determination in competitive markets results from traders exchanging goods and services; exchange is the trial-and-error process by which they attempt to improve their position, and it is exchange that allows the market to find a point of balance between their varying intentions and actions.

*3. The idea of equilibrium.* Although equilibrium in economic theory is presented as a strictly neutral concept, it is in fact redolent of liberal values. General equilibrium is Adam Smith's 'natural order' in contemporary guise. For Smith there could be no other result than a spontaneous natural order if the invisible hand of the market was allowed to work properly through complete freedom of exchange. In the same way, a general equilibrium will ineluctably emerge

from the process of interlocking market relationships. There is even the same sense that the market as a system is incontestably the best means of organising an economy, and that this arises ‘naturally’, for there can be no equilibrium without the process that brought it about; in other words, an equilibrium presupposes a world of individuals freely exchanging goods and having a common interest in finding a point of balance (Sen 1983). Indeed, the fact of equilibrium validates the market; equilibrium can only arise from the circumstances of individuals exchanging goods and services. If it were created by any other mechanisms, it could not be an equilibrium because exchange is the only process by which a point of balance is achieved. Equilibrium can only happen in a world of interacting and opposing forces. But if this is true, so is the converse: that if there are opposing forces voluntarily exchanging goods and services, then equilibrium must arise. The natural state, therefore, of a market economy is an equilibrium: prices and quantities are either in equilibrium, or in the process of finding another equilibrium. By this token, economic theory is able to protect itself from attack; disequilibrium is a departure from the norm, is to be expected, and in no way invalidates the central claim of economic theory, that free markets are the key to economic efficiency and progress.

*4. The idea of diminishing returns*. It is intuitively obvious that the more we have of any given commodity, so marginal additions to our total stock will yield less and less return. Equally, the more that is provided of any given commodity, all things being equal, the progressively more costly each marginal increment will become. Diminishing returns need not detain us at this point (see Ch. 4) but it is important to note that the existence of diminishing returns guarantees that the exchange economy will arrive at an equilibrium by ensuring that the plans of demand and supply will converge.

Those who acquire a commodity require successively lower prices to persuade them to add to their stock: those who furnish the same commodity require increasingly higher prices to compensate them for the successive increases in cost. The interaction of the two elements is therefore certain to achieve a point of balance.

*5. The idea of competition*. Interaction between traders trying to improve their position is not just a means for the system to arrive at an equilibrium; it also dynamises the economy. Competition plays two functions. In the first place, it is the mechanism by which the economy finds its natural balance. Adam Smith looked to competition between traders to drive prices to their 'natural level'; in other words, there existed a natural profit that if exceeded would encourage capital to be attracted to that particular branch of manufacture. Contemporary theory uses competition in the same way: the perfectly competitive market is one with 'normal' profits, nobody can influence the price, and consumers' requirements are being perfectly satisfied by perfectly efficient producers. For such a condition to exist, there must be no barrier to the attraction of new firms into the industry so that profits can be bid competitively down to their normal level. Competition is the precondition of the 'best' prices and profits, that is, those that produce an economically efficient system, and markets should be judged by the degree to which they come near to this goal.

In the second place, competition causes capital to be accumulated at the fastest rate, and for Smith it was capital, through its ability to foster specialisation, that was the key to the wealth-creation process. So competition is now visualised as imparting a dynamic to the economy by acting as a spur to innovation and experimentation: if prices are given, then the profit-maximising firm must make sure its costs are as low as possible.

Competition for profits is thus pivotal, for it is this that makes the price mechanism work and persuades firms to be as technically and economically efficient as possible; and for Adam Smith, profit enriches not just the firm, but the system as a whole.

These key ideas define the scope of economic enquiry and allow it to project the benefits from an economy run along free-market lines: the most satisfactory matching of consumers' preferences with the ability of the economy to meet those preferences that could be conceived; the most efficient organisation of the resources of the economy into the chosen branches of production and distribution; and the tendency of the economy to find a point of equilibrium between expenditure and output while at the same time progressing and expanding at the pace and in exactly the directions that the members of the economy desire.

## The renaissance of the classical tradition

Let us now jump from the world of theory to the world of practical problems. The economic performance of the UK is disappointing. There appears to be a chronic tendency to inflation and low growth. Inflation has persistently run at levels higher than that in comparable industrialised countries, and growth, on the same basis, has been persistently lower. Although it is true there has recently been a sharp reduction in inflation, it has been won at a heavy cost: high unemployment and an unprecedented loss of output, even larger than that of the 1930s. The prospect appears to be of a prolonged period in which economic activity is never likely to provide employment for anything like the full working population. What has economic theory to offer by way of explanation and possible solutions?

Presented with a problem of this type we should not be surprised, given the discourse of economic debate, that the