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PRECURSORS

Michael Polanyi's Economics

PAUL CRAIG ROBERTS AND T. NORMAN VAN COTT

People familiar with Michael Polanyi are impressed by his intellectual powers, the range of his mind, and his ability to get to the heart of issues, often long before anyone else. These attributes also apply to his work in economics. In *Full Employment and Free Trade,* published in 1945 by Cambridge University Press, Polanyi synthesized Keynesian economics and the monetary school of economics later associated with Milton Friedman. In constructing that synthesis, Polanyi preceded the best minds in the economics profession by at least two decades, perhaps three.

That achievement was remarkable, especially for the time. It was widely believed then that John Maynard Keynes's *General Theory of Employment, Interest and Money* had established the irrelevancy of monetary economics. As Friedman later put it, monetary policy was "twice damned" and was considered a useless remedy for unemployment. Moreover, Keynesians also thought that their theory established that full employment was not the natural state of a free economy.

Amid this confusion stood Polanyi, talking in the same breath about full employment and free trade (by which he meant a free market, as opposed to a planned economy)—conditions considered to be mutually incompatible—and setting out in detail a monetarist explanation of Keynes's theory. Not only did money matter; Polanyi showed that money was all that mattered.

Lack of training as an economist allowed Polanyi to avoid pitfalls that confused economists. It also left him unaware of the magnitude of his achievement. He saw himself as a Keynesian, but in fact he achieved, in the early years of Keynesianism,

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before the monetarist critique, an integration of the two approaches that other economists did not create until the 1970s.

Needless to say, Polanyi got no credit for his achievement. He was too far ahead of his time and too far outside his bailiwick. Had he possessed an economics chair and graduate students, he might have been in contention as the most important economist of his time, eclipsing both Keynes and Friedman by his early synthesis. Economics and public policy would have been spared the long and pointless Keynesian odyssey toward big government.

Keep in mind that in 1945 economists still did not know that the Federal Reserve had caused the Great Depression by allowing the supply of money to shrink by nearly a third. That story was to be told later by Friedman and Anna J. Schwartz. In England the unemployment problem had begun earlier, when the British government tried to reestablish the pre–World War I parity of the pound with gold and the dollar. That policy required a deflation that deprived the economy of a sufficient supply of money to maintain full employment. When the government abandoned its attempt to return to the pound's prewar parity, Britain started to recover. But at the time there was a jumble of voices. Some were Marxists bent on overthrowing the capitalist order. Keynes spoke in a more reassuring voice.

Unemployment of workers and other resources, Keynes said, reflected an insufficiency of total, or aggregate, demand. As a solution, he proposed that the government turn to deficit finance. By spending more than it collected in tax revenues, it would add to aggregate demand.

Keynesians have a diagram, which still appears in economics texts, that shows the sum of consumer and investment demand crossing the aggregate supply schedule at a point below full employment. In such a situation, the government calculates the gap in demand and fills it with the appropriate budget deficit.

Keynes had his finger on a source of the trouble. Aggregate demand was insufficient. But what he, or the Keynesians, did not understand was that demand was insufficient because the supply of money was insufficient.

Polanyi understood that an insufficiency of money lay at the root of the unemployment problem. He produced movies, which he showed to audiences all over the United Kingdom. The movies showed what he called the "Money Circle" and the unemployment that resulted when the circulation of money, or the "Money Belt," was not wide enough to maintain full employment. Polanyi's diagrams had the additional advantage of showing that "squirting" money into the economy would not cause inflation until the Money Belt widened beyond the width necessary for full employment.

In *Full Employment and Free Trade,* Polanyi used the concepts and terminology he had developed for his films for public audiences. A "squirting pump" injecting money onto a "Money Belt" may have struck economists as childish terminology and kept them from appreciating the challenging theoretical concepts that Polanyi had developed. If he had not felt the responsibility to inform the public and, instead, had

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used mathematical equations to express the relationships, he might have advanced the economics profession twenty years in one swoop.

On the other hand, Polanyi might intentionally have pitched his appeal to the public on the bet that academics and intellectuals were a lost cause. He was up against more than terminology, theory, and analysis. The same predisposition toward planning that Polanyi had fought in science was abundantly present in economics. His solution for unemployment—money creation—required no extension of the government's sphere of influence. But an increase of the size and scope of government was precisely what "modern" economists sought. They maintained that full employment was impossible in an unplanned market economy. As William H. Beveridge expressed it in *Full Employment in a Free Society:*

> Full employment cannot be won and held without a great extension of the responsibilities and powers of the State exercised through organs of the central Government. No power less than that of the State can ensure adequate total outlay at all times, or can control, in the general interest, the location of industry and the use of land. To ask for full employment while objecting to these extensions of State activity is to will the end and refuse the means. (p. 36)

Polanyi realized that an insufficiency of demand reflected an insufficiency of money. That realization permitted the maintenance of full employment without the need for national economic planning and without running up the national debt. It was unnecessary to incur public debt and the obligation to make interest payments when the real purpose of the fiscal deficit was only to satisfy an excess demand for money and absorb an excess supply of goods and labor. The government should finance its deficit by issuing new money. In other words, Polanyi proposed using Keynes's fiscal deficit to implement an expansionary monetary policy. Even today this idea is advanced for economists, who still think of monetary and fiscal policies as distinct.

Polanyi's wedding of monetary and fiscal policy solved a difficulty that monetarists later pointed out in the Keynesian system. Monetarists showed that financing a deficit by borrowing does not increase aggregate demand unless the central bank "accommodates" the fiscal policy by expanding the money supply. Because it is the expansion of money that increases demand, Polanyi's policy of issuing new money to finance a deficit achieves the same result that monetarists understand the central bank to achieve when it buys bonds to expand bank reserves. In a depression climate of fear and uncertainty, Polanyi's solution works more directly, because it is independent of the willingness of borrowers to borrow and lenders to lend.

The Keynesians of Polanyi's day intended to use public-works spending to fill the gap in aggregate demand. Polanyi objected: not only was such spending pointless when money creation was costless, but the public works would distort the allocation of resources, violate the neutrality principle, and drive down the return from public

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investment far below the return in the private sector. Polanyi argued that a balance must be maintained between public and private expenditures so that the joint satisfaction derived from both would be a maximum. That principle requires that government expenditures be rationally determined on their merits as investments and that the nation's resources not be squandered to fill a gap in aggregate demand or to fight "social evils."

Because Polanyi understood the depression in terms of a shortage of money, he understood its prolonged continuation as a consequence of a continuing insufficiency of money, which frustrated the public's determination to build up its cash balances. In Keynesian terms, the excess demand for cash balances meant that saving could exceed investment for a lengthy period, thereby sustaining the "deflationary gap."

The imbalance would be corrected by issuing money to cover fiscal deficits. "There is a balance between all the needs of man," Polanyi wrote, "and when a certain measure of financial security is attained, the desire for more will be abated" (pp. 41–42). The rate of saving will fall. Money will be redirected to consumption, and the Money Belt will widen, eliminating the need for deficits.

In 1945 many economists and policy makers believed that depression would resume after the end of World War II. Polanyi, however, predicted correctly that the cash

> balances accumulated during the course of this war are likely to reduce the rate of thrift . . . considerably for a time after the return of peace, and that their possession may even cause the public to spend at a rate which may threaten inflation. In the light of such suppositions it may appear likely that the chronic excess of Savings over Investment and the consequent state of permanent depression, which have so sorely tried the highly industrialized countries in this century, could have been all avoided merely by allowing the public to accumulate cash balances. (p. 42)

No economist has ever written truer words.

Polanyi's Adaptation of the "Pigou Effect"

Gottfried Haberler in 1937 and A. C. Pigou in 1943 showed that a downward wage-price spiral had the effect of increasing real money balances. As price declines drove up the value of the existing money supply, the increase in real money balances would at some point satisfy savings desires and result in a resumption of consumption. Pigou later dismissed the "Pigou effect" or "real balance effect" as an academic exercise, because a government would not employ a downward wage-price spiral as a means of increasing the real money supply. In contrast, Polanyi recognized the real-world policy implications of the real balance effect. He dismissed the wage-price flexibility discussion as irrelevant and stated the "Pigou effect" in terms of constant prices and in-

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creases in the nominal stock of money. In Polanyi's approach, the policy issue is not obscured by adverse effects on expectations caused by price-level declines.

The Predilection for Planning

By 1945, when Polanyi's book was published, the issue for many economists was no longer full employment. Keynesian full-employment policy had become a stalking horse for a vast program of social reform. The idea that economic life should ever again be left to the market was beyond the pale for progressive thinkers—regardless of whether full employment could be maintained by careful regulation of monetary circulation. Even the conservative authors of the 1944 White Paper on employment policy were committed to the planning of public investment as a full employment policy and worried that "civilian production, when it is resumed, may concentrate on the wrong things from the point of view of national needs" (p. 7).

In his assessment of the White Paper, M. Kalecki noted that budget deficits are not the only path to full employment: "The same end can be achieved by redistribution of income from higher to lower income grades" (p. 135).

In Britain the issue was "Plan or No Plan." The "no plan" position called for planning public works to offset fluctuations in private investment. The "plan" position called for planning private investment as well, if not the entire economy. In 1945 T. Balogh could welcome the king's speech for announcing the intention to nationalize the Bank of England and set in place "machinery to provide for the effective planning of investment." Balogh noted that in order for the government to operate the economy in the national interest, finance would have to be controlled no less than materials and labor.

In *Full Employment and Free Trade,* Polanyi subjected the White Paper on Employment Policy and the Beveridge Plan to devastating criticisms, which are as analytically sound today as the day they were written. In addition, he devoted two chapters to showing that the totalitarian powers, Soviet Russia and National Socialist Germany, did not secure full employment with planning but with increases in monetary circulation.

Polanyi, however, was confronting an intellectual force much more powerful than the Keynesian income-expenditure model and unsubstantiated notions about economic planning. He realized that economic analysis alone could not influence the intellectual and emotional attitude that attributes irrationality and social injustice to societies that evolve on their own by cultivating beliefs inherent in their traditions. Instead, this attitude seeks justice in a society revolutionized from above by "pure and sensitive souls" motivated by "the charming spectacle of the public good." Polanyi would later use those words of Robespierre to good effect when, recognizing that the real challenge was an excess of moral passions, he moved on to diagnose the pathology of our time as "moral inversion."

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