Creative Consolidation or Punctuated Equilibrium?

The Orthodox Paradigm in the UK Economy

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‘Without an understanding of the economic process, and without a passionate, even irrational commitment to democratic ideals, an agenda for change, in response to a perceived need for change, can become the instruments of demagogues who play on fears and frustrations and offer panaceas and empty slogans’ (Minsky, 2008: 10).

Introduction

Within the three major perspectives on economic policy-making it has been said that ‘despite their different lineages, all institutional arrangements are ultimately concerned with two sides of the same problem: how order is maintained and how change is possible’ (Blyth, 1997: 244). These perspectives attempt to provide a guide as to how individuals interact with their institutional environment and thus explain which dynamics guide economic policy decision-making. Rational institutionalism focuses on the micro-level dynamics of the institutional environment, specifically on the individual, whose actions as agents are said to be motivated by material self-interest and utility-maximisation and thus economic policy is influenced by interested individuals and groups. Historical institutionalism focuses on macro-level dynamics, these dynamics being alternatively: (i) the historical nature of institutional arrangements across jurisdictions and (ii) the national pathways across economies that have lead to diverse national institutional arrangements, with economic policy thus being a product of these twin dynamics (Katzenelson & Weingast, 2005: 1 – 3). The final perspective is that of economic constructivism which focuses on a mixture of micro and macro dynamics. Micro dynamics of economic constructivism relate to how individuals’ behaviour and interests are governed by ideas, not institutions or interests whilst macro dynamics focuses of the role of ideas as being the pre-requisite for policy innovation which leads to the institutional reformation of the state (Blyth, 1997: 246). The aim of this paper is to probe this literature to see how well these three perspectives help us to understand economic policy-making in the United Kingdom (UK). The paper will begin by providing an overview of the three different perspectives, emphasising the use by the three of a punctuated equilibrium model, used to provide the dynamic upon which innovation in economic policy can occur. The second half

1 Whilst the paper will proceed in this manner, it is worth being aware of the problems associated with attempting to smooth out differences between different perspectives to assign easily identifiable labels. On this see (Gofas & Hay, 2010a: pp. 14 – 17).
of the paper will apply this framework of punctuated equilibrium to the study of UK monetary policy in the Inter-War period, focussing on this period by virtue of the sheer number shocks and level of uncertainty\(^2\) that befell the UK economy in such a short space of time. The paper will conclude that the punctuated equilibrium model fails to tell us an accurate story regarding economic policy-making in the UK. Rather than policy innovation and thus paradigm-succession in times of uncertainty, the direction of UK economic policy is best encapsulated by the term creative consolidation, describing the process whereby uncertainty is followed by a period of consolidation as policy coalesces around an observable orthodox paradigm.

**The Tale of Two Institutionalisms**

The foundation of rational institutionalism lays in the marginal revolution of political economy in the 19\(^{\text{th}}\) century\(^3\), associated with works by Jevons (1871), Walras (1874/1954) and Menger (1871/1950)\(^4\) with the theory that would develop from it forming the basis of what would become neoclassical economics\(^5\). Neoclassical theories are based on Newtonian concepts of universal gravitations which contributed to the idea of an ordered and rational universe. Natural phenomena in this concept are reducible to the movements of atoms, they themselves regulated by laws intrinsic to the state of nature. The world is therefore perceived as being self-regulatory, with human relationships governed by mechanical laws. By 1879 this new form of theory had become known as economics, rather than political economy, signalling the very different form of analysis this new theory adopted, in which economic laws were said to assume the absolute and objective characteristics of natural laws and economics was likened to the natural sciences. For this to be accomplished social relations had to removed from the field of economics and a scientific form of enquiry developed with maths being deemed as the most effective communicator of this rational universe (Scrupanti & Zamagni, 2005: 63 – 65, 166 – 167). This use of mathematics now claimed to be ‘inseparable’ from and ‘interwoven’\(^6\) (Weintraub, 1985: 171) in economic discourse. Furthermore, it is claimed that it was this development that has enabled neoclassical economics to establish itself as the mainstream and orthodox approach to economics taught in all major universities around the globe. Dominance illustrated by the suggestion that ‘the status of non-neoclassical economists in the economics departments in English-speaking universities is similar to that of flat-earthers in geography departments’ (Weintraub, 2002).

One of the foremost examples of the use of mathematics in the marginal revolution was the use of simultaneous equations by Walras (1874) to express his general equilibrium theory, claimed to be ‘the outstanding landmark on the road that economics travels towards the status of a rigorous or exact science’ (Schumpeter, 1994: 827). The theory sought to show that a price level exists upon which supply and demand can marry in a way promoting overall equilibrium in competitive markets\(^7\). The contemporary articulation of general equilibrium\(^8\) was provided by Arrow and Debreu (1954) who argued that markets not only had equilibrium

\(^2\) Exogenous = First World War, wall street crash, collapse of the gold standard, great depression, onset of the Second World War.
Endogenous = Two decades of economic instability, decline and unheard of levels of unemployment.

\(^3\) On the importance of Jevons, Walras & Menger to the marginal revolution (Schumpeter, 1994: 825-839).

\(^4\) To which, among others, we could also add English economist Alfred Marshall (1920) & US economist John Bates Clark (1889).

\(^5\) The term neoclassical was actually coined by institutional economist Thorstein Veblen (1900: 246).

\(^6\) For this argument in more detail (Weintraub, 1985: Part 3, Chapter 11).

\(^7\) For more on the development of the general equilibrium theory (Schumpeter, 1994: 963 – 971, 998 – 1002).

\(^8\) For historical analysis of the contemporary development of general equilibrium theory (Weintraub, 1985: Part 2, Chapter 6).
but were also Pareto efficient (Pareto, 1972; Cirillo, 1978: 13 – 25; Tarascio, 1967: Chapter 6), their work becoming known as the first welfare theorem. Uniting the new approach of economics however was the adoption of a utilitarian approach to the understanding of human behaviour, which is reducible to individual rationality and utility-maximisation. Furthermore these are laws of behaviour which are considered to be universally valid to all individuals regardless of circumstance, forming the basis upon which calculations of Walras, Arrow & Debreu’s general equilibrium were founded (Screnpanti & Zamagni, 2005: 166 – 167). Thus modern neoclassical economics holds three basic assumptions regarding the behaviour of individuals: (i) that people have rational preferences, (ii) Individual maximise utility and firms maximise profits and (iii) people act independently on the basis of full knowledge and information, cumulatively claimed to form three ‘fundamental assumptions [that] are not open to discussion’ (Weintraub, 2002). It was upon these foundations that early literature in the rational institutionalism field focussed, stressing how institutional arrangements and economic policy were a product of the pursuit of rational self-interest (North & Thomas, 1973; Williamson, 1985).

Historical institutionalism has its roots in classical political economy and Marxism. Despite classical economists like Smith and Hume commonly considered as being the forefathers of the latter development of neoclassical theory (Smith, 1776/1925: Book 1, Chapter 79 & Book 4, Chapter 2; McGee, 1989; Scenpanti & Zamagni, 2005: 63 – 64) both should actually be considered as providing the foundations of the institutional approach to the economics (Scenpanti & Zamagni, 2005:77 - 82). Both authors based their philosophy of human behaviour on different precepts to neoclassical theory, illustrating that individual behaviour can also be motivated by feelings of passion, sympathy and desire (Smith, 1759/1872; Hume, 1739/1986; Dow, 2009). Furthermore Smith argued that the economic relationships, such as that existing between master and labourer as expressed in the payment of wages, were governed not by natural laws and individual rationality, but by the existence of an uneven power relationship in favour of the master (Smith, 1776/1925: Book 1, Chapter 8). Marx meanwhile by seeing capitalism not as a series of markets, but rather as a historical system based on the legacy of class struggle, can also lay claim to having formed a foundation of analysis that would influence the direction of historical institutionalism (Marx, 1848/1930: 25 – 30). From within the historical institutionalism approach there have arisen many critiques of neoclassical theories, charting the many incidences of manias and panics, rather than equilibrium, which have characterised the historical evolution of domestic and global markets (Kindleberger, 1978; Galbraith, 2009; Stiglitz, 2003; 2010 Soros, 1998; 2008). As Haring and Douglas (2012; 7 – 8) note, given the demanding conditions of perfect rationality and information, the conditions needed to achieve equilibrium are not justified by economic reality.

The basis of these institutional criticisms of neoclassical theory was provided by Minsky (2008). For Minsky the domestic institutional environment was most important in determining economic decision-making. This was because Minsky believed that economic systems were not based on a set of natural laws. Rather the economy is a social organisation created either through legislation or the evolutionary process of invention and innovation. Thus Minsky argued that ‘policy can change both the details and the overall character of the economy, and the shaping of economic policy involves both a definition of goals and an awareness that actual economic processes depend on economic and social institutions’ (Minsky, 2008: 7). Therefore ‘any successful program of change must be rooted in an understanding of how economic processes function within the existing institutions’ (Minsky,

9 Articulates the concept of the invisible hand without referring to the term directly.
Minsky argued that economic theory was not ordained by nature but was ‘the product of creative imagination; its concepts and constructs are the result of human thought’ (Minsky, 2008: 3). For this very reason, Minsky argued that economic theory was not ordained by nature but was ‘the product of creative imagination; its concepts and constructs are the result of human thought’ (Minsky, 2008: 3). For Minsky, that neoclassical theory relied on mathematical models, which ignored processes of human thought, human interaction and issues such as time or uncertainty, mitigated neoclassical claims to be a value-free scientific body of theory. This form of critique has been advanced in the contemporary era. It has been argued that poor economic performance in the US has led to an age of diminished expectations, mirrored by developments in the global economy which has led to the return of depression economics (Krugman, 1994; 2003; 2008; 2012). It has been suggested that poor US economic performance, for instance, has been driven by faulty neoclassical economic theory, itself supported and enhanced by a permissive US institutional environment which has allowed economic policy to prioritise the needs of a particular version of finance capitalism as the means with which to secure economic prosperity (Krugman, 2003: Introduction & Part Three). Furthermore, in the contemporary economic crisis it is these same elites that are now hindering the adoption of policies that could arrest the global economic decline through the promotion of the self-defeating policies of austerity (Krugman, 2012).

Historical Institutionalism is thus focussed on how the institutional framework governs individuals’ behaviour (Gourevitch, 1986). Institutions are claimed to provide a logic of appropriateness, as well as logic of consequences, for how individuals conduct themselves (March & Olsen, 1989). This approach originally came to the fore with the work of Thorstein Veblen (1889/1953; 1900; 1904/1910), deeply critical of the neoclassical school he believed that ongoing economic processes within domestic economies were cumulative and path-dependent, the results of particular historical developments (Screpanti & Zamagni, 2005: 301 – 303). Whilst the emergence of new institutional economics, defined the institutional approach as viewing the economy as a complex structure containing complicated sets of interrelationships arguing further that whilst the welfare of human beings may depend on the flow of goods and services, the cost of exchange in this process is mediated by national domestic institutions (Coase, 1998)11. Historical Institutionalism thus focuses on the national pathways of institutional development (Gershenkron, 1962; Katzenstein, 1985; Collier & Collier; 1991, Skocpol, 1992, Spruyt, 1994, Ertman, 1997; Huber & Stephens, 2001) and how these have lead to the emergence of differing varieties of capitalisms across economies (Johnson, 1982; Albert, 1993; Schmidt, 2002; Part Two, Beeson, 2006; Story, 2006). These varieties of capitalisms themselves depending on the development and strength of various groups in labour, finance, industry, the political realm (Katzenstein, 1978) and society (Mann, 1986; 1986a). The evidence of these divergent domestic institutional arrangements being the very different ways states often respond to the same crises (Evans et al, 1985: 351 – 352).

Rational and historical institutionalisms were not without criticisms however (Blyth, 1997; 2003: 696-697; Gofas & Hay, 2010a: 13 – 40; Seabrooke, 2010: 79 – 83). Among

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10 For similar arguments on weak institutional environments being captured by elites see (Kalecki, 1943; Haring & Douglas, 2012: Chapter One). For the argument that weak global institutional environment is hindering successful economic development by the developing world (Stiglitz, 2002; 2006). For the argument that strong domestic institutional environments are needed to promote economic development in the developing world see (Evans, 1995; Rodrik, 2007; 2011). 11 This definition is remarkably similar to the one provided by the ‘old institutional economics school (Commons, 1934; 1934a).
those criticisms, being the most important in relation to this paper was the static conception of economic policy that they brought to the table. How did economic decision-making, being primarily the result of static variables like rational self-interest or historical institutional legacy correlate with the visible world of innovation in economic policy? In response to these criticisms both institutionalisms began to incorporate other aspects into the dominant narratives of their frameworks. Thus historical institutionalism began to speak of the subordinate role of ideas in relation to institutional environments (Gourevitch, 1986, Hall, 1989; 1993) and rational institutionalism began to address the role institutions and ideas may play in shaping individuals self-interest (North, 1990; Goldstein & Keohane, 1993; Weingast, 1995; Wade, 1996; Knight & North, 1997; North, 2005; Greif, 2006).

**Economic Constructivism and Punctuated Equilibrium**

The main dynamic introduced to the institutional literature in an attempt to account for economic policy innovation was the model of punctuated equilibrium. As Seabrooke (2010: 79 – 85) has shown, the punctuated equilibrium model is common to all three approaches, seen as providing the dynamic necessary for economic policies to undergo a period of innovation. In the following paragraphs the punctuated equilibrium model will be examined by recourse to the final approach within the institutional literature, that of economic constructivism.

Like historical intuitionalism, economic constructivism arose from the influence of another two great economists, in this instance those being John Maynard Keynes and Friedrich Hayek. Famously Keynes argued that ‘the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slave of some defunct economist’ (Keynes, 1936/2008: 239). Furthermore Keynes explicitly argued that when compared to the role of ideas, factors such as vested interests were greatly exaggerated. Whilst ideas may take a while to gain influence, for Keynes, it was nevertheless ideas ‘not vested interests which are dangerous for good and evil’ (Keynes, 1936/2008: 239). Similarly Hayek would argue that ideas were the key determinant in understanding individuals’ behaviour and economic policy. As he argued ‘if in the long run we are the makers of our own fate, in the short run are the captives of the ideas we have created’ (Hayek, 1944/2001: 2). Unlike Keynes however, Hayek argued from the neoclassical perspective on the role of market equilibrium and efficiency and as such, adopted neoclassical theories methodological individualism. Hayek thus argued that the single key idea that should determine economic and public policy was that of individual freedom, because government intervention leads to the imposition of tyranny (Hayek, 1944/2001; 1960/2006). Economic constructivism thus arose from these convictions to place the role of ideas at the very centre of our understanding.

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12 For this criticism in relation to rational institutionalism see (Rodrik, 2013).

For this criticism in relation to historical institutionalism see (Thelen, 2003: 208 – 211).

13 An interesting aspect of this literature is the rise of accounts which see the dynamics of economic decision-making not being driven by the rational interest of individuals, but of trans-national corporations (Klein, 2000; Hertz, 2001).

14 For the use of the punctuated equilibrium model in rational institutionalism literature see (Goldstein & Keohane, 1993: 17; Levi, 1997: 23 – 28) – claims exogenous shock leads to a reinterpretation of interests by individuals.

For historical institutionalism see (Hall, 1993; Gourevitch, 1986: 9) - claims exogenous shock challenges existing institutional arrangements spurring conflict.

For economic constructivism see (Parsons, 2003: 8 – 9, McNamara, 1998: 7, 57 – 61, Klein: 2008) - claims exogenous shock allows elites to restructure individuals’ incentives through the use of economic ideas.
of individual behaviour and economic policy (Woods, 1996; Berman, 1998; Blyth, 2002; Schmidt, 2002; Campbell, 2004; Beland, 2006; Jabko, 2007; Pemberton, 2009; Rodrik, 2013) and provides us with a prime opportunity to investigate the model of punctuated equilibrium.

The implications of the punctuated equilibrium model are two-fold: (i) that both markets and policies have equilibrium positions characterised by stable and certain conditions and (ii) only significant innovation in policy can occur after exogenous shocks that punctures equilibrium. One example of the use of a punctuated equilibrium model was by Mark Blyth (2002: 18, 35 – 37). In its simplest economic constructivist format punctuated equilibrium is explained as thus: existing institutional and ideational equilibrium is disrupted by exogenous shock, leading to a period of economic and policy uncertainty, during which elites, or norm entrepreneurs (Finnemore & Sikkink, 1998; Blyth, 2003: 698), articulate new ideas upon which a new policy equilibrium should be based. The winners of this battle of ideas are then able to stabilise policy and create a new institutional and ideational equilibrium, which forms the basis of political interaction until the next exogenous shock. It is this sequence of events, correlating periods of uncertainty with paradigm-succession that this paper will question.

Leonard Seabrooke (2007; 2010) provides an interesting counterpoint within the ideational literature on punctuated equilibrium. Whilst not disagreeing with the notion, he does argue that policy innovation can also be brought about by endogenous factors relating to a two-way mechanism between policy elites and the everyday practices of non-elites. This is driven by the need to garner legitimacy behind proposed ideas, policies and institutional reform that will form the basis of the next institutional structure. To illustrate his point, Seabrooke argues that it was in fact a legitimacy gap between elites and non-elites in the 1920s and 1930s which paved the way for institutional experimentation and the fertilisation of the eventual Keynesian revolution15. This perspective has been applied to contemporary policy developments within the UK economy, first to suggest that a sense of moral panic by the middle classes provided the Brown government with the legitimacy needed to recapitalise the banks (Watson, 2009) and second, that middle class guilt regarding excessive consumer indebtedness provides the legitimacy needed for the Coalition government to implement the policies of austerity (Stanley, 2013).

In terms of this paper however it is the suggestion that innovation can actually arise from endogenous sources, not merely exogenous shocks, that is important, a concept that has been articulated across a broad range of literature (Marx, 1848/1930: Part One, 30 – 42; Schumpeter, 1943: Chapter 7 & 8; Polanyi, 2001; Minsky, 2008). One interesting account of endogenous shock comes from Reinhart and Rogoff (2009) who use a quantitative econometric approach familiar to the neoclassical school to chart the history of financial crises. The authors argue that financial crises are characterised by excessive debt accumulation by both governments and private sector. The authors argue that the key determinant in the accumulation of debt is an affliction of the mind called the ‘this time is different syndrome’. A term used by the authors to encapsulate a process whereby fading memories during economic booms forget the lessons of previous collapses itself fostering a belief that the economic fundamentals of the contemporary boom is different than others that have preceded it and prosperity will this time be maintained indefinitely. Thus debt is accumulated and the seeds of the next crisis are sown. Furthermore the authors suggest this

15 Whilst Seabrooke has some interesting passages charting economic dissent in the inter-war period, he is wrong to attribute intervention in the economy in this period as something new, driven by a legitimacy gap between elites and non-elites. UK micro-economic policy, then as now, is best characterised as a policy of selected interventionism. Indeed this policy is so pervasive in UK economic history it should be considered as forming part of the UK orthodoxy.
process is innate to human economic behaviour arguing that whilst ‘countries, institutions and financial instruments may change across time,... human nature does not’ (Reinhart & Rogoff, 2009: xxviii) and that ‘no countries, irrespective of its global importance, appears immune to’ the syndrome (Reinhart & Rogoff, 2009: 287). However, by laying the blame of financial crises at the door of human decision-making the authors have implicitly accepted a central core position principally that actors do not operate according to the dictums of neoclassical theory. If the authors are correct, individuals do not act upon complete information but rather blind optimism and as such fail to act rationally and are thus rendered as imperfect entities. In this case the concept of equilibrium, which relies upon humans being perfect entities and assumptions regarding certain types of economic behaviour, cannot occur and rather than uncertainty being exogenous, as equilibrium theory assumes, because of human fallibility, it is in fact endogenous and characterises all types of economic relationships.

Thus by assuming that shocks are exogenous, and periods of innovation are limited to those moments, historical institutionalism and economic constructivism are themselves operating on the terrain of neoclassical theory and its rational individualist methodological assumptions16. As neoclassical theories of complete information have progressively been illustrated as illusory (Greenwald & Stiglitz, 1986), the suggestion that individuals pursue genuine self-interest must be dismissed and a new concept put in its place, that individuals in fact pursue perceptions of self-interest. This is because without complete information they can never truly know what their genuine interests are. As such the ‘inexorable link between context and conduct opened up by the assumption that behaviour is a logical correlate of contextualised rationality is shattered’ (Gofas & Hay, 2010a: 24 – 25) and the argument that uncertainty is endogenous replace our understanding of uncertainty being a product of exogenous shocks. However if this is the case, then the argument surrounding the relationship between punctuated equilibrium and policy innovation becomes tenuous. If ideas need the incubation of uncertainty to become influential, why should the power of ideas be relegated only to certain periods? In many ways this argument can be illustrated by using the conclusions of Keynes’ General Theory (1936/2008). The major element of Keynes’ theory was his rejection of the central tenets of neoclassical theories, specifically the idea that general equilibrium, in which all resources are used efficiently, is a norm case. Keynes rather, argued that markets are characterised by uncertainty leading them to operate at sub-equilibrium positions, characterised by high unemployment, and that equilibrium, rather than being the norm, was in fact a special case scenario. Like Keynes we should reject neoclassical assertions of equilibrium and rather, when judging economic policy-making, accept that uncertainty provides us with the norm environment.

Finally it has been argued that the current economic policies of austerity and deficit reduction implemented by the Coalition Government are paradigm (or equilibrium) reinforcing rather than paradigm-threatening, something for which the existing literature, with its concern to link exogenous shocks to periods of policy innovation, does not adequately prepare us for, it being argued that ‘whether a crisis proves paradigm-challenging or paradigm-reinforcing depends on how it is perceived – specifically whether it is seen to signal an exhaustion of the paradigm or (as here) to emerge from a violation of its core precepts’ (Hay, 2013: 23 – 24). The rest of this paper will illustrate the historical precedence for just such a phenomenon and that rather than this being a one off event in reaction to the latest economic crisis, the UK regularly implements policies that reinforce an identifiable

16 For a similar argument see (Gofas & Hay, 2010a: 25).
paradigm of orthodoxy rather than embark on innovation leading to paradigm-succession. This process is termed creative consolidation.

**Case Study – Monetary Policy in the Interwar Period**

Any discussion of monetary policy in the interwar period must begin with an examination of the gold standard. The classical era of the gold standard is commonly considered to have existed from the 1870s until 1914, when it was suspended due to the outbreak of World War. The UK and some of its colonial territories had been operating a gold standard in the decades preceding 1870; however this year is commonly used as marking the beginning of the classical period because it was in this year that Germany took steps to join. This decision, along with the economic and political dominance of the UK and thus the attraction of securing access to the City of London, gave sufficient impetus to other countries to join the standard and by 1900 all countries except China and some Central American states were members. The objective of the gold standard was to create a stable international payment system within the global economy by fixing the major currencies to gold, with weaker currencies attached to those in turn. The money supply of each country was thus linked to gold, as the amount of money in circulation was limited to a multiple of central banks’ gold reserves as a means to facilitate compliance with a requirement of the gold standard to convert money into gold on demand. Finally, differences in international balance of payments accounts were settled in gold (World Gold Council, 2013; 2013a).

The gold standard was said to create a stable international monetary system because of its properties of autonomous adjustment. This process of adjustment was based upon the economic principles of David Hume’s price-specie flow mechanism. According to Hume, running consistent surpluses failed to produce any permanent benefits because it activates the process of autonomous adjustment. The inflow of gold to cover the trade surplus would cause internal prices to rise as the money supply rose, whilst the opposite flow would mean countries posting a balance of payments deficit would suffer from a gold outflow, lowering prices as the money supply contracted. This would automatically make the surplus countries less competitive in international trade and the deficit countries more so, thus correcting the imbalance in balance of payments and returning the global economy to its stable and equilibrium position (Screpanti & Zamagni, 2005: 63; World Gold Council, 2013). But this theory itself was based upon another of Hume’s theories, his dynamic version of the quantity theory of money. Hume’s theory states that increases in the supply of money, whilst generating short-term production and employment, were of a temporary nature. This was because increased money in circulation, transmitted from sector to sector, also worked simultaneously to raise prices thus creating inflation (Screpanti & Zamagni, 2005: 63). As this paper will show, this quantity theory of money provides the basis for the policy paradigm of orthodoxy. As Chancellor of the Exchequer, Winston Churchill would state in 1925 the reasons for returning to the gold standard was because ‘everyone knows... that the gold standard renders inflations impossible and that its introduction deprives the exporting power of a country of the hectic stimulus of a collapsed exchange’ (Churchill, 1925). Churchill was thus explicitly stating that the twin reasons for returning to the gold standard in 1925 was because it reintroduced a mechanism in monetary policy that provided the means of eradicating inflation and thus meeting the ends of macroeconomic orthodoxy: price stability.

In many ways referring to wars as exogenous shocks feels particularly vulgar, a denigration of the sacrifices across generation paid in blood on land, sea and air. However wars are used as examples of exogenous shocks that can puncture established equilibriums and it is certain to say that, in meeting the needs of the First World War, the UK economy
underwent some vast changes between 1914–1918, in both the micro and macroeconomic realms, from the environment which had existed in 1913 (Morgan, 1952: 98, Peacock & Wiseman, 1961: 36, Sayers, 1967: 48 - 49; Tomlinson, 1990: 50 – 52, 62). However at the end of the war, rather than seeing these innovations prove a challenge to the existing paradigm of orthodoxy, very quickly a process of consolidation and paradigm-reinforcement occurred, in which the stated objectives of policy was engineer price stability via the re-imposition of the gold standard (Cunliffe Committee, 1918). The question remains therefore, why did the exogenous shock of the First World War not lead to a new equilibrium in policy-making as we should expect?

Two interlocking processes appear to be at play in the reintroduction of the Gold Standard. Firstly, because the desirability of a return to gold was considered to be the accepted wisdom of “responsible authority” these being experts on committees and members of political parties (Churchill, 1925). Certainly when it comes to the political parties there was a weakness in opposition to a return to the standard that covered much of the political spectrum and major interest groups. Thus the operation of the Cunliffe Committee, which committed the UK to a return to the gold standard, saw no major dissenting opinions. Furthermore later debate over the timing of returning to gold and the deflationary conditions that would accompany such a policy were all conducted within the framework in which the return to gold was a given (Tomlinson, 1990: 44). Indeed Conservative (1922/2000; 1923/2000a; 1924/2000b; 1925/2000c), Liberal (1918/2000; 1922/2000a; 1923/2000b; 1924/2000c; 1925/2000d) and Labour (1918/2000; 1922/2000a; 1923/2000b; 1924/2000c; 1929/2000d) party manifestos across the five elections between 1918 – 1929 failed to mention the gold standard once, indicative of the state of economic opinion found above. Churchill himself prioritised the wisdom he gained from the experts that sat on various committees over wisdom from other sources. As he himself stated on announcing the return of the UK to gold in 1925 “surely the experts, to whom this achievement belongs, must be very high authorities on the subject. Surely they are the people who ought to know most about it. Surely their opinion counts more than the clever arguments of academic theorists or the interested attitude of party politicians” (Churchill, 1925a). If this was the case then it is worth asking who the experts on committees that advocated the UK returning to orthodox policy were?

The answer to this question is quite helpfully provided by the Cunliffe Committee themselves stating that ‘the committee, reflecting the consensus opinion of British financial and commercial sectors, unanimously recommend a return to the gold standard, the reduction of government debt and borrowing, and the accumulation of sufficient reserves to underpin the system’ (Cunliffe Committee, 1918: 109). As Sidney Pollard (1970) notes the return to the gold standard cannot properly be understood until it is realised that the monetary authorities were dominated by a narrow section of the City of London, the section predominately concerned with international finance. Both the Cunliffe and Bradbury Committees, which helped set the return to orthodoxy, were dominated by interests of financial services. This cross-pollination continued into the central economic policy-making institutions of the UK. In 1924-1925, the final full year before the return to gold, of 26 members of the Bank of England Court, including the Governor, at least 15 were connected with the international financial aspects of City of London activity. Even with this narrow representation of wisdom, why would this direct economic policy back towards orthodoxy over the implementation of new policies and objectives? This can again be explained by a further two interrelated processes: (i) the weak institutional environment already alluded to that allowed policy to be dominated by the concerns of the international position of the City of London and (ii) the ideational aspect that drove UK policy orthodoxy, namely that the
macroeconomic objectives of price stability achieved by establishing a quantity theory of money as the basis of macroeconomic policy was the only route available to secure economic growth and prosperity. Both of which are best explained by examining the final process at play in the reintroduction of the gold standard, that being the economic prestige associated with returning to gold at the pre-war parity of $4.86.

By 1924 both the US and Germany had returned to the gold standard. For the UK, that two of its direct competitors seemed to be enjoying the benefits of monetary stability, whilst Sterling continued to fluctuate uncertainly without an anchor, threatened the status of the City of London as a global financial centre. Both the City, Bank of England and Treasury stepped up their campaign to get the UK to return to gold citing the threat to the City and UK commerce not doing so provided (Calvin, 2000: 49 – 50; O’Brien & Williams, 2007: 110). That these arguments were influential is evident again from the words of Churchill who would declare in his House of Commons speech announcing the return to gold of the UK economy that “if we were to repudiate the gold standard, and introduce legislation for the purpose of prolonging the embargo, an immense injury would be done to the whole structure of British finance” (Churchill, 1925a). Furthermore it was decided to return to gold at the pre-war parity of $4.86. For Pollard (1970: 2 - 3) the return to gold at $4.86 had little reference to economic realities of the time either in trade or international finance instead, the return at the pre-war parity being an irrational attempt to recapture the power and glory of the pre-war London gold standard and the prestige and status that such a position had ceded to the City, Bank and Treasury.17

The return to gold at $4.86 however was not just a consequence of the permissive institutional environment in which a particular version of finance capitalism was allowed to dominate. As Ben Bernanke (2007: 59) has stated, it was thought that a return to gold standard on anything other than the pre-war parity would mean losing the faith of a class of bondholders whose prosperity counted upon price stability. Thus, if the institutional environment was one aspect of the perpetuation of orthodoxy over policy innovation in the inter-war period, the second relies upon the ideational aspect of orthodoxy, which sees the only route to economic prosperity as the inculcation of a quantity theory of money into economic policy thus providing the means to achieve the orthodox macroeconomic objective of price stability.

After the horrors of the First World War it was believed in UK policy-making circles that ‘nothing can contribute more to a speedy recovery from the effects of the war, and to the rehabilitation of the foreign exchanges, than the re-establishment of the currency upon a sound basis’ (Cunliffe Committee, 1918: 109) and that it was ‘of the upmost importance that we should return as quickly as possible, to the normal procedure which existed before the war’ (Conservative Party, 2000: 23). Thus from the ideational perspective of orthodoxy, the return to gold at $4.86 appears more readily comprehensible, reinstituting as it did the normal procedure which had existed before the disruption of the First World War, itself thought to be the necessary condition with which to bring back prosperity via a revival of international trade (Churchill, 1925). This illustrates another aspect of orthodoxy, the economic conditions considered necessary to generate prosperity. Ideational orthodox see prosperity arising

17 The decision to return to gold at the pre-war parity of $4.86 was not unanimous however. Keynes (1925/1970) argued that $4.86 overvalued Sterling by 10% and would do an immense injury to British industry. Furthermore Keynes argued that Churchill had been misled by his experts and the siren calls of conventional finance. The Macmillan report would later confirm Keynes’ hypothesis declaring that ‘the sacrifices which a return to gold at the old parity involved have not been compensated by the advantages of international price stability which were anticipated’ (Committee on Finance and Industry, 1931: 106).
primarily from economic conditions outside of the UK economy, principally a stable and open global trade and financial environment, which economic conditions inside the UK economy should be structured to take advantage of. This is rather than a vice versa situation, where creating a supportive and nurturing internal economic environment for UK business takes precedence over the international environment in which they operate. This orthodox position flowed from the belief that employment and living standard were dependent on imports, this necessitating a vibrant export sector, in itself dictating policies of free-trade, a domestic environment which kept costs low and open global capital markets so overseas investment from the City of London could generate orders for UK business (Middleton, 1996: 217). Thus the principle macroeconomic objective of the orthodoxy, to secure prosperity and employment, need only be price stability which would create stable domestic economic conditions to take advantage of international conditions through securing foreign confidence and access to foreign markets. In this situation ‘not only did the restoration of the gold standard close many avenues to policy-makers, but also the adoption of the view meant that the authorities saw no need for any policies other than sound finance needed to achieve that aim’ (Howson, 1975: 141).

Within a few short years of the return to gold the UK economy was subjected to further series of shocks in the Wall Street crash, the great depression and in September 1931 the collapse of the gold standard (Snowden, 1931). The rest of this paper will examine the UK reaction to these series of shocks by way of the work of Eichengreen and Temin (1992; 2000; 2010). Similarly to the UK, the authors argue that policy decisions globally around 1930 were made according to the view that the primary prerequisite for prosperity was the maintenance of the gold standard. The gold standard dictated stable policy reactions to external events and policy-makers when looking for alternatives did so only from a range of option permissible with membership of the gold standard. Possible policy innovation from outside the regime were not taken seriously and considered as aberrations, the result of which was the implementation of contractionary economic policies at the very time when expansionary ones where needed, themselves contributing directly to the economic crises which was then unfolding. For the authors this was why abandoning the gold standard became the essential pre-condition for economic recovery as the shock of the collapse of the standard opened up a policy vacuum in which new policy options could be considered for implementation. As they state ‘it was not so much devaluation in and of itself that mattered... but the expansionary policies whose unilateral adoption was facilitated by the abandonment of the gold standard’ (Eichengreen, 1992: 393 -394). As such the collapse of the gold standard opened up the avenues for policy innovations like that found in Sweden (Calvin, 2000: 142) where fiscal budgets began to be balanced over economic cycles rather than annually, and in the US with major schemes of public works under the New Deal programmes (Bernstein, 1987: 184). As we shall see however UK policy, rather than innovate like the Swedes and Americans, in response to shock once again retreated to within its orthodox paradigm of policy.

As the UK left gold in September 1931 the Treasury assumed responsibility for the conduct of monetary policy. Over the winter of 1931-1932 monetary policies of cheap money were introduced, both as a means to manage Sterling and as a counter-cyclical policy to combat the economic slump, as interest-rates were lowered from 6 per cent to 2 per cent. Despite the reduction of interest-rates as a means to stimulate investment, this policy cannot be considered as a radical departure from what came before. (Howson, 1975: 142). First, central banks had commonly manipulated interest-rates during the operation of the gold standard even in its classical period (Middleton, 1996: 218; World Gold Council, 2013a).
Second the justification for cheap money presented by Treasury Official Ralph Hawtrey was practically indistinguishable from the theoretical justifications made on behalf of orthodoxy in the 1920s. Hawtrey applied a dynamic quantity theory of money to argue that it was the supply of money which determined prices and productivity and thrift which determined income and employment. For Hawtrey the trade cycle was a monetary phenomenon to be treated by monetary policies, providing a more reliable boost to recovery. Alternative policy innovations like increased public expenditure and public works were dismissed because of the inflationary pressures they would induce, thus threatening overall price stability (Hawtrey, 1933; Peden, 1984: 168). Thus during the interwar period the fiscal orthodoxy of balanced budgets and national debt reduction formed an integral part of achieving the orthodox objective of price stability (Hawtrey, 1933). In fact the fiscal orthodoxy of balanced budgets and debt reduction has existed since before the interwar period, forming part of the orthodoxy during the classical gold standard period, and indeed has its genesis much earlier in the 18th century. Observation of public expenditure as a percentage of GNP notes that in 1790 the ratio stood at 12 per cent, which despite fluctuations, it still stood at in 1913 (Buchanan et al, 1978: 31 - 45; Peacock & Wiseman, 1961: 35).

Further illustrations of the orthodox nature of cheap money policies come from their operation after implementation. As Peden (1984: 178) notes in practice the Treasury found it difficult to manage newly floating Sterling as they wished as it faced speculative pressure from international finance. This situation lead to the primary purpose of the interest-rate being, not to stimulate investment, but to influence the international capital position so as to strengthen and protect gold reserves and thus achieve the orthodox objective of price stability (Middleton, 1996: 218). A situation illustrated by the excessive intervention by UK monetary authorities in foreign exchange markets during the period (Dimsdale, 1981: 322). Furthermore the creation of the Sterling Area after the collapse of the gold standard served to reinforce fiscal conservatism. The willingness of members to hold Sterling believed to be predicated upon confidence felt in London, this confidence founded upon the applying the orthodox means of a quantity theory of money and fiscal rectitude to achieve the orthodox macroeconomic objective of price stability (Tomlinson, 1990: 103). As Peden (1984: 179) notes therefore, possible repercussions of foreign financial opinion, in ways that might negatively impact upon the exchange-rate, reinforced the belief in UK policy-makers of the need to achieve the orthodox macroeconomic objective of price stability. As such the orthodox paradigm continued to constrain the possibility of policy innovation as it had done throughout the interwar period by consolidating policy around its core policies and ideational perspective.

Conclusion

The main emphasis of this paper has been to illustrate that the model of punctuated equilibrium, when applied to the UK economy, does not provide an accurate picture of economic policy-making in the UK. According to the model, exogenous shocks disturb established policy paradigms by introducing periods of uncertainty. This uncertainty creates a vacuum from which a new paradigm, established around new interests, new ideas and the creation of a new institutional environment, is created. This paper has questioned this model from two different approaches. Firstly, by questioning whether we should accept the neoclassical premise of the punctuated equilibrium model, principally that uncertainty is the new orthodoxy. 18 Ralph Hawtrey is an interesting figure. His reputation as an economist far outweighed his administrative position in the Treasury, where he never rose above the position of Administrative Secretary (Gaukroger, 2008).
product of exogenous occurrences outside of markets. As explored earlier, accepting this position allows us to fall into the trap of the neoclassical theorists highlighted by Minsky, that in relying on models to explain human behaviour we ignore important issues such as the suggestion that uncertainty, rather than being exogenous, is in fact endogenous to all economic behaviour.

This argument however is far from saying the entire institutionalism literature is incorrect. It is just to claim that the use of a punctuated equilibrium model is misguided, at least in the case of attempting to understand policy innovation in the UK. As the quote at the beginning of the introduction argued, institutional literature is focussed upon explaining how order is maintained and how change occurs. In terms of attempting to prioritise which approach provides a superior explanation of the influences on economic decision-making, it is wise to follow the advice provided by scholars (Gofas & Hay, 2010; Katznelson & Weingast, 2005) and avoid ontological duality, accepting that economic decision-making is driven by a complex combination of factors (Walsh, 2000). This correlates with work on the economic policy-making process which suggests that rather than viewing the process through the orderly lens of formulation, implementation and evaluation, we should in fact, see the messy and unpredictable world of multiple centres and sources of authority and influence on the policy environment which actually exists (Cairney, 2012: 1 – 2).

The second approach was to apply the punctuated equilibrium model to the case study of UK monetary policy in the interwar period. As the literature indicates it is quite possible that the orthodox paradigm documented during the interwar period would not have been over-turned, and policy innovation would not have subsequently emerged, had it not been for the exogenous shock of the Second World War, which created the uncertainty within which a Keynesian inspired paradigm could appear (Moggridge, 1976: 12; Pemberton, 2009: 49). In this vein it has been noted that, economic policy in 1939, was still far from accepting the position it had reached by 1944, when the objective of macro-economic policy became the management of demand and employment (Winch, 1969: 218; Peden, 1988; Middleton, 1985: Chapter 6 & Conclusion). Viewing the Second World War as an exogenous shock however, leading to the implementation of a new policy paradigm misses the broader picture of UK economic history. The innovation in economic policy that occurred during and after the Second World War should not be viewed purely as a product of that singular exogenous shock, but rather, as the end product of three decades of unprecedented uncertainty. A period that encapsulates the First World War, the Bolshevik revolution, the Wall Street Crash, the collapse of the gold standard, the great depression, the collapse of global trade, a general strike, economic decline, hunger marches, unprecedented levels of unemployment, the rise of fascism and the Second World War. The real story of UK economic policy in the interwar period is not the slow evolution of the ideas and policies of Keynes, a process that was eventually cemented by the Second World War, but rather the remarkable resilience of the orthodox paradigm maintained by the process of creative consolidation.

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19 I am however explicitly saying that methodological individualism of rational institutionalism is incorrect. If people cannot gain access to complete information they cannot act rationally. If they cannot act rationally then can never know behave in accordance with genuine conception of self-interest, but rather can only act upon a perception of their self-interest. This is not to deny that individuals may act upon a perception of their self-interest, but this in itself is a radically different proposition from the one put forward in neoclassical theory. Accepting that people may only act upon a perception is to accept that people are indeed fallible and may not act in ways such as to maximise their own utility.
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