Polanyi's Economics

Paul Craig Roberts and Norman Van Cott

[Editor's Note: Paul Craig Roberts, an economist who was one of Polanyi's last graduate students, was invited to present a paper on Polanyi's economic ideas at the annual meeting of the Polanyi Society in Orlando, Florida on Nov. 22, 1998. The following paper was Robert's presentation. This paper was based upon a longer paper done in 1971with Norman Van Cott and presented to the Western Economics Association; since Dr. Roberts wishes to acknowledge the collaborationof Norman Van Cott, he is listed here as a joint author. This essay appeared recently in *The Independent Review: A Journal of Political Economy* is printed with permission]

ABSTRACT: Key words: Michael Polanyi, Keynesian and monetarist economics.
In 1945, Michael Polanyi achieved, in ***Full Employment and Free Trade****, the integration of Keynesian and monetarist economics that the economics profession did not ahieve until the 1970s. In yet another field, Polanyi saw the heart of important matters long before anyone else.*

People familiar with Michael Polanyi are impressed with his intellectual powers, the range of his mind, and his ability to get to the heart of issues, often long before anyone else. This is no less true of his work in economics. In *Full Employment and Free Trade* published in 1945 by Cambridge University Press, Polanyi synthesized Keynesian economics with the monetary school of economics later associated with Milton Friedman. In this synthesis, Polanyi was at least two decades, and perhaps three, ahead of the best minds in the economics profession.

This is a remarkable achievement, especially for that time. It was generally believed then that John Maynard Keynes' *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 new theory established that full employment was not the natural state of a free economy.

Amidst 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)—items considered to be mutually incompatible—and setting out in detail a monetarist explanation of Keynes' theory. Not only did money matter, Polanyi showed that money was all that mattered.

Being untrained 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, before the monetarist critique, an integration of the two approaches that economists did not reach 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 shrinking the supply of money. This story was to come later from Milton Friedman and Anna Schwartz. In England the unemployment problem began earlier when the British government tried to re-establish the pre-World War I parity of the pound with gold and the dollar. This required a deflationary policy that deprived the economy of a sufficient supply of money to maintain full employment. When the government abandoned its attempt to return to pre-war parity, Britain started to recover. But at the time there was a jumble of voices. Some were Marxists. And there was the more reassuring voice of Keynes.

Unemployment, Keynes said, was due to an insufficiency of total or aggregate demand. As a result of inadequate demand, resources, which includes people, were left unemployed. The solution, said Keynes, was for government to increase demand by running a deficit in its budget. By spending more than it collected in tax revenues, government would add to aggregate demand.

Keynesians have a diagram, which still exists in economics texts, that shows the sum of consumer and investment demand crossing the aggregate supply schedule at a point below full employment. Government then calculates the gap in demand and fills it in with the appropriately sized budget deficit.

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

Polanyi saw this instantly. He produced movies which he showed to audiences all over the U.K. 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 was not inflationary until the Money Belt widened beyond the width necessary for full employment.

Full Employment and Free Trade used the concepts and terminology that Polanyi had developed for his films for public audiences. Using a "squirting pump" to inject money into a "Money Belt" may have struck economists as childish terminology and kept them from seeing the challenging theoretical concepts that Polanyi had developed. If Polanyi had not felt the responsibility to inform the public and, instead, had used mathematical equations to express his relationships, he might have advanced the economics profession twenty years in one swoop.

On the other hand, Polanyi might have intentionally pitched his appeal to the public on the bet that academics and intellectuals were a lost cause. Polanyi was up against more than terminology, theory and analysis. The same predisposition toward planning, which Polanyi had fought in science, was abundantly present in economics. Polanyi's solution to unemployment—money creation—required no extension of the government sphere of influence. But an increase in the size and role of government was precisely where economists were heading. Economists maintained that full employment was unthinkable 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 meant an insufficiency of money. This realization permitted full employment to be maintained without the need for national economic planning and without running up the national debt. There was no reason to incur public debt and interest payments when the purpose of the fiscal deficit was 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.

Polanyi, in other words, used Keynes' fiscal deficit to implement an expansionary monetary policy. Even today this is advanced thinking for economists, who still think of monetary and fiscal policy as distinctly different areas of policy.

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. Since it is the expansion of money that increases demand, Polanyi's policy of issuing new money to finance a deficit achieves the same result as monetarists achieve when the central bank buys bonds to expand bank reserves. In a depression climate of fear and uncertainty, Polanyi's solution is more direct as it is independent of the willingness of borrowers to borrow and lenders to lend.

The Keynesians of Polanyi's day intended to use public investments to fill the gap in aggregate demand. Polanyi objected, noting not only was this pointless when money creation was costless, but also that the consequences would be to distort the allocation of resources, violate the neutrality principle, and drive down the return from public 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. This principle requires that government expenditures be rationally determined on their merits as investments and that the nation's resources not be squandered in order to fill a gap in demand or to fight "social evils."

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

This 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 savings will fall off. Money will be redirected to consumption, and the Money Belt will widen, eliminating the need for deficits.

In 1945 many economists and policymakers believed that depression would resume with 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.

Appendix I
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 his "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 increases 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.

Appendix II
The Predilection for Planning

By 1945 when Polanyi's book was published, the issue for many economists was no longer one of 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 investments 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 of nationalizing the Bank of England and setting 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 Unemployment and the Beveridge Plan to devastating criticisms which are as analytically sound today as the day they were written. In addition, he devotes 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 tradition.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 these 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."

Bibliography

T. Balogh, "The Planning and Control of Investment," *Bulletin, Oxford University Institute of Statistics,* Vol. 7, No. 14 (Oct. 13, 1945).

William H. Beveridge, *Full Employment in a Free Society* (New York: Norton, 1945).

G. Harberler, *Prosperity and Depression* (Third edition, 1941).

M. Kalecki, "The White Paper on Employment Policy," *Bulletin, Oxford University Institute of Statistics,* Vol. 6, No. 8 (June 10, 1944).

A.C. Pigou, "The Classical Stationary State," *Economic Journal*, Vol. 53 (1943).

_______, "Economic Progress in a Stable Environment," *Economica*, Vol. 14 (1947).

Michael Polanyi, *Full Employment and Free Trade*, Cambridge University Press, 1945.

_______, "Beyond Nihilism," in *History and Hope*, ed. by K.A. Jelenski (London: Routledge & Kegan Paul, 1962).

White Paper on Employment Policy (London: His Majesty's Stationary Office Cmd. 6257 (May 1944).

Notes on Contributors

Paul Craig Roberts, an economist who was one of Polanyi's last graduate students, is Chairman and John M. Olin Fellow at the Institute for Political Economy (505 S. Fairfax Street, Alexandria, VA 22314) and Senior Research Fellow at the Hoover Institution, Stanford University. He was Assistant Secretary of the Treasury in 1981-82.

Norman Van Cott is chairman of the Department of Economics at Ball State University, Muncie, Indiana.

Phil Mullins teaches in the interdisciplinary humanities program at Missouri Western State College, St. Joseph, MO. He has been the *TAD* editor since 1991and prior to that for several years coordinated the annual meeting of the Polanyi Society. In both capacities, he worked closely with William T. Scott who he first met more than twenty years ago.

Marty Moleski, S. J. currently coordinates the annual meeting of the Polanyi Society. He teaches at Canisius College, Buffalo, NY. For approximately the last two years, he has been completing the Polanyi biography which William T. Scott worked on for many years.

Submissions for Publication

Articles, meeting notices and notes likely to be of interest to persons interested in the thought of Michael Polanyi are welcomed. Review suggestions and book reviews should be sent to Walter Gulick (see addresses listed below). Manuscripts, notices and notes should be sent to Phil Mullins. Manuscripts should be double-spaced type with notes at the end; writers are encouraged to employ simple citations within the text when possible. Use MLA or APA style. Abbreviate frequently cited book titles, particularly books by Polanyi (e.g., *Personal Knowledge* becomes *PK*). Shorter articles (10-15 pages) are preferred, although longer manuscripts (20-24 pages) will be considered.

Manuscripts normally will be sent out for blind review. Authors are expected to provide a hard copy and a disk or an electronic copy as an e-mail attachment. Be sure that electronic materials include all relevant information which may help converting files. Persons with questions or problems associated with producing an electronic copy of manuscripts should phone or write Phil Mullins (816-271-4386). Insofar as possible, *TAD* is willing to work with authors who have special problems producing electronic materials.

Phil Mullins
Missouri Western State College
St. Joseph, Missouri 64507
Fax (816) 271-5987

Walter Gulick
Montana State University, Billings
Billings, Montana 59101
Fax (406) 657-2187