Treasury orthodoxy and sound money delusions

Bartholomew Steer

Bankruptcy, Bubbles and Bailouts:
The inside story of the Treasury since 1976
Aeron Davis
Manchester: Manchester University Press, 2022, £16.99 (p/b)

War and Gold:
a five hundred year history of Empires, Adventures and Debt
Kwasi Kwarteng
London: Bloomsbury, 2015 £9.99 (p/b)

The Capital Order:
How Economists invented Austerity and paved the way to Fascism
Clara E. Mattei
Chicago: University of Chicago Press, 2022, $30 (h/b)

The context for this review has been the collapse of governance in the UK. Any country which has three Prime Ministers within a short time, the second involving the seeming tearing up of the financial rule book (and the peremptory sacking of the Permanent Secretary to the Treasury) needs to answer some serious questions. Not least, how did this come about?

After reading the Davis book published in October (and Kwarteng's *War and Gold* for a wider perspective), we have the outlines to some answers. While reading a lot of books covering the period (which are very well detailed in his book), Davis has interviewed many of the leading actors who have managed the UK economy. Although this process has winkled out some candid admissions and revealed doubts not expressed at the time, in the end the story told seems to be that of a mistaken grasp of history (crucially centring on whether sound money policies[1] were the basis of the successful economy that existed since the nineteenth century), a short term focus for economic

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[1] These were first laid out by Robert Peel and William Gladstone as support for free trade, *laissez-faire* economics, low taxes, small states and balanced budgets. It also encompassed support for the gold standard and a stable currency.

decision taking (obsessed with balancing the cash book[2] rather than steering the national economy) and complacency.

The author's final concluding and speculative remedy, of encouraging more decentralisation of Treasury powers, I fear, is not going to do it. That the book was obviously finished before the collapse of the Truss government only underlines the diagnosis of the problem: the weight of Treasury orthodoxy and conventional economic thinking has been a national economic burden for some time. The Keynesian 'interlude' of 1945-76 was more than readily shrugged off and Truss's attempt to go for growth and to defy those who would limit public spending was not so much shrugged off as summarily dismissed.

How Keynesianism was abandoned in 1976 by Dennis Healey and Jim Callaghan (under pressure from the IMF), and the complicity of the Labour Party, unable or unwilling to counter the monetarist mumbo–jumbo, is described in Davis' first chapter. Those who have read accounts of this period will have further grist to the mill but sadly no greater insights. Again the author recounts many of the stories told to him rather than critically engaging with the issues raised. The lesson learnt by Treasury insiders was that the period around 1976 was such a humiliation for them, they have sought to ensure it never happens again by exerting a vice-like grip on public spending.

Chapter 2, 'Creative destruction and the road to nowhere', explains how the Treasury was weaponised by the Thatcher government from 1979 onwards to control government spending and to set in motion the 'long journey towards state withdrawal, not only from direct forms of government intervention and management, but from national economic management altogether'. (p. 238) Chapter 3, 'The City's Trojan horse enters the Treasury', describes how Thatcher encouraged the City and financial markets to take over ownership and financing of UK corporations. Chapter 4, 'Pseudo-Keynesianism; debt and the magic money tree', looks at 'how the Treasury found alternatives to stimulate economic activity that avoided government intervention and Treasury expenditure'. Chapter 5, 'Visions of Empire and globalisation', shows how the UK encouraged international investors and big foreign multinationals to come in and invest in new industries and markets in the UK. Chapter 6, 'The great Financial Crash and the great paradigm shift: a technocrats tale', describes how the fantasy of the 'great moderation' and the great financial crash of 2008/9 was followed by the great elite consolidation and the greater failure to achieve a paradigm shift. 'No political, economic or

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2 Day-to-day spending receipts: see, for example, <https://www.investopedia.com/terms/c/cash-book.asp>.

intellectual paradigm shift emerged. And, arguably, the UK economy has been floundering ever since.' (p. 150)

Davis holds responsible the genteel technocrats in the Treasury and elsewhere who backed off from major confrontation with the power nexus of the political and banking elites. And he also holds them responsible for giving public cover to that same nexus:

> They were central to a shifting crisis narrative that went from government of banking mismanagement to technical explanations of economic failures. 'Once the crisis was reframed as a technical debacle, more limited technical responses became the answer . . .' (p. 151)

Chapter 7 describes how the show was kept on the road by a reversion to sound money maxims and spin. These included Austerity policies directed by 'Treasury orthodoxies and Thatcherite small statism, which have hobbled recovery and hit the poorest hardest', in the view of the author. While wealthy asset holders were supported, inequality and imbalances in the economy have been exacerbated. Then came Brexit, Johnsonian 'cakeism'[3] and failure to manage Covid. All that the author sees as he finishes is further bloody establishment conflict lying ahead.

The scope of the book and the topics covered are thus the heart of economic and political management of the UK over the last forty years and more. It focuses on the Treasury but it also reports the stories that politicians and officials have been telling each other to justify their policies. The book is a mere 264 pages and though it has ample footnotes, references and telling first-hand quotes from those close to the action, it left this reader wanting more.

I sought out Kwasi Kwarteng for the other side of the story. This sets the context as the failures of democratic socialism in the post-war period leading to 1979 and the Thatcher government. He quotes her memoirs, *The Downing Street Years,* referring to this period as demonstrating 'no theory of governance was ever given a fairer test or a more prolonged experiment in a democratic country than democratic socialism received in Britain. Yet it was a miserable failure in every respect . . .' This verdict seems biased, given that the Labour Party only headed the government for 12 of the 34 year period, including the six years after the war when national wealth had plummeted by 25% during the war and the Empire was being dismantled; and perverse, given that when compared to subsequent years, the post-war period up to 1979 saw relatively high growth. It would be more accurate to describe that period as being heavily influenced by Keynesianism, not socialism. Quotes in the Davis book from Terry

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[3] <https://www.spectator.co.uk/article/cakeism-is-boris-johnson-s-true-legacy/>

Burns, ex permanent secretary of the Treasury, convey the disarray of the seventies and the rationale for the break that took place:

> The fact is the whole post-war consensus had fallen apart. We had inflation at 25%, a huge balance of payments deficit, substantial government deficits and the IMF were here. The previous consensus of demand management through fiscal policy, incomes policy, devaluation when you've got the opportunity, as a way of boosting exports, had collapsed in a heap really by 1975/76 . . . Because that standard Keynesian model could not explain what happened between 1971 and 1975. (p. 28)

He added:

> It all became very serious when in 1976 we effectively went bankrupt. We didn't default, but we couldn't borrow from anybody. We couldn't borrow internally. We couldn't borrow externally. The government credit was somewhere close to zero . . . it was a loss of confidence in UK economic management . . . talking to our various allies around the world, none of them were willing to lend us money unless we went to the IMF, which was code for saying 'unless economic policy is changed'.

That's not how others saw it. These included Sir Douglas Wass, Treasury permanent secretary at the time (and model for Sir Humphrey in *Yes Minister*) who argued for devaluation and more modest cuts in expenditure. And it omits the evidence that the IMF episode was at least partially political: the Americans reigning in a 'socialist' government.[4] But the other views were routed by Thatcher. In retrospect the monetarist solution provided a pseudo–scientific justification and rationale for old style Treasury orthodoxy.

It would not be unfair to re-examine the Thatcherite epoch of 1979-2022 (New Labour having endorsed its outlines) as a long running and failed experiment, but with as yet no persuasive alternative having emerged.

What Kwarteng does is expand on why that may be the case. He sees the Treasury ethos as rooted in the old motifs of 'sound money' referred to earlier, which in turn emanated from a time before the Treasury even existed and the economics profession was still emerging. Sound money came from the pens and words of Robert Peel and William Gladstone, political pillars of the nineteenth century with roots in the booming cotton mills of Lancashire and the ports of Liverpool and Manchester. It was a time when the industrial revolution was in full swing (with the slave trade for much of the period). The empire was expanding and UK factories were serving a great empire with new

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[4] See, for example, <https://billmitchell.org/blog/?p=33825>.

industrial goods. It is preposterous to attribute the success of the industrial revolution to 'sound money'. It is much more plausible to explain the relatively stable nature of the UK's national finances by the existence of a booming economy rooted in the industrial revolution and the avoidance of European wars.

In fact, from the nineteenth century onwards, there have been claims that 'sound money' policies have hobbled the growth of the UK economy, compared to the United States, Germany, France and Japan, and more lately China. Those countries resisted *laissez-faire* and sought to protect home industries and markets, and governments increasingly intervened in favour of its own companies and areas of comparative advantage. Only in the UK has there been such a fetish for free trade, culminating in the debates around Brexit and the enthusiasm of some of the Brexiteers for opening European markets to unregulated and dubious products from the world market – often centring on debates on the merits of chlorinated chicken, hormone injected beef and pesticide enriched genetically modified products from the agrochemical industry.[5]

In economics and statistics those claiming the benefits of sound money in producing a sound economy up to two hundred years or more ago, are mistaking correlation for causation. In fact I would argue that the causal relationship is the other way round. The existence of a buoyant and successful industrial and trading sector provides for a successful financial services and insurance sector. Only since the Thatcherite/neoliberal indifference to de-industrialization, the focus on the service economy, especially financial services, and the absence of efforts to keep up in health and public services, has the economy faltered – culminating in the financial crash of 2008 and the Austerity decade from 2010 onwards.

What emerges from both books therefore is a failure to properly engage with what is known as Keynesianism. It seems to be taken as read that it inevitably led to inflation, and that all would be well if the Keynesian 'interlude' was curtailed and normal service based on 'sound money' was restored as soon as possible. In fact Kwarteng covers the main reason for the surge in inflation: the US economic policies under Lyndon Johnson, which simultaneously sought to put a man on the moon, fight a cold war with the Soviet Union, a hot war in Vietnam and to stem social unrest and a potential race war by introducing some basic elements of a welfare state for the sick and elderly (Medicare and Medicaid) and for the poor, homeless and

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[5] See <https://tinyurl.com/mtt4654k> or <https://etheses.whiterose.ac.uk/29959/1/Final%20thesis%20with%20minor%20corrections%2025-11-2021.pdf>

unemployed. The surge in spending that ensued sucked in imports, created a balance of payments deficit which weakened the international value of the dollar. Because the US dollar was still formally tied to gold, foreign creditors of the US were able to convert their slowly devaluing dollars into gold at $35 per oz. as per the Bretton Woods agreement.

When the US was forced to abandon conversion of dollars to gold in 1971, oil producers in the Middle East coupled their distaste for the US support for Israel with a demand for higher prices for their oil. As events since the war in Ukraine began have shown, increases in energy costs feed through into rising prices – what economists call cost-push inflationary pressure.[6] This has nothing to do with Keynesianism *per se*, nor does it justify the claims of monetarists to have the tools to rectify the situation.

Thus Davis finds plenty of people, in the Treasury and elsewhere, both in the past and now, who disdain monetarism as never true in the first place and certainly not true in the years following deregulation of financial services, when the banks went on a credit creation binge. Even neo-liberals now distance themselves from the strictures of monetarism, seeing it as representing just one strand of the Chicago school of thinking associated with Milton Friedman rather than a theory of everything. An article from the Mises Institute[7] helpfully discusses the different strands in right-wing thinking, identifying the libertarian stand of thinking, associated with Hayek, Ayn Rand, and Lizz Truss (by way of Thatcher) and the separate and more neo-classical orientation of the macroeconomic modelling associated with the Chicago school of economists under Friedman.

The libertarians led by Hayek were never taken seriously in their time in the first half of the twentieth century – Keynes referring to Hayek's work as a frightful muddle.[8] Interestingly, from the article on the Mises Institute[9] we learn that Hayek supported the idea of capital levies to fund the Second World War and Keynes was recorded as being very concerned with inflationary pressures during the war. The thrust of Keynes' work in fact remained a rejection of *laissez-faire* economics and the recognition of the need for government intervention. As for Ayn Rand, the fact that the hero of her novel

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[6] And Prime Minister Edward Heath chose the wrong time to adopt Competition and Credit Control legislation which allowed the British banks to go on a credit creation boom. This is discussed on p. 76 of 'Well, how did we get here?' at <https://www.lobster-magazine.co.uk/article/issue/60/well-how-did-we-get-here/>.

[7] <https://mises.org/library/why-mirowski-wrong-about-neoliberalism-and-austrian-school#>

[8] <https://academic.oup.com/cje/article/45/1/1/5918810>

[9] See footnote 7.

The Fountainhead blows up his building rather than submit to planning controls says it all. That Ayn Rand was the hero of Sajid Javid, the Chancellor of the Exchequer before Rishi Sunak,[10] perhaps explains the readiness of some from this school of thought to contemplate blowing up the UK economy in the belief that good will emerge from the ashes. Rightly Javid has now declared he intends to retire from front line politics.

The neo-liberal monetarists in the meantime have had other problems: for all their faith in numbers and the science, their models never worked and their predictions proved false. They now restrict themselves to rather more modest claims, akin to promoting the ideas of sound money as though they were true. It was they who turned on Truss when she seemed to be working in breach of its maxims in a libertarian push for growth.

These issues in my view could have been covered by Davis in more depth: the real reasons for inflation in the seventies; the real record of the Keynesian era of Treasury management and why in the end sound money defeated it; the counter factual claims for free trade and *laissez-faire*; the resort to pseudo Keynesianism to manage the economy rather than monetarism, culminating in Trussonomics, the repudiation of sound money and the backlash against it.

Fortunately in seeking answers to these questions my attention was directed to Clara E. Mattei's book *The Capital Order: How economists invented Austerity and paved the way to Fascism*. The book 'traces modern austerity to its origins in interwar Britain and Italy, revealing how the threat of working class power after World War 1 animated a set of top-down policies that elevated owners, smothered workers, and imposed a rigid economic hierarchy across their societies'.

We all know that Keynes was outspoken in the post WW1 period, opposing *laissez–faire* economic policies and the imposition of onerous war reparations on Germany. But I was unaware of the extent to which WW1 had exposed the *laissez-faire* economic orthodoxy gripping the establishment running the country.

Mattei goes back to the source documents and strips bare the real reasons why there was a crisis of government in the early 1920s: the failures of *laissez-faire* had been revealed during the First World War and the war was only won belatedly by the recourse to state-led nationalisation of shipping (private shippers having sold their ships to overseas owners to avoid being sunk by U Boats), the railways, and the war effort generally. Populations knew this and demands for peacetime government action hung in the air.

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10 <https://www.spectator.co.uk/article/why-do-tories-love-ayn-rand/>

For a fuller account, *The Triumph of Nationalisation* by Leo Chiozza Money[11] (available in facsimile) is illuminating reading. A Russian revolution had taken place and in Italy at least workers were occupying the factories. In the UK demands were put for post-war reconstruction. Thus capitalism itself was under threat and answers had to be found. The answer was thrashed out at the world's first International Financial Conference of 1920, in Brussels. This was when indirect taxation was invented ('*pour forcer les masses populaires a faire des economies, il faut recourir a la taxation indirecte*').[12] It set the rules for imposing fiscal austerity and the notion that 'Nations, like individuals, must earn their living and pay their way'. Budget deficits were to be cut, budgets balanced and the maxims of good housekeeping restored. This meant explicitly the reduction of welfare and social expenditure and the removal of price controls. The Brussels Conference was followed by the Genoa Conference of 1922 which identified the taming of inflation, and the restoration of currency stability and sound money as requiring the need for monetary austerity – essentially imposing increased interest rates to reduce borrowing. Expensive credit was good for savers but slowed down economies and increased the price of exported goods (by sustaining the value of currencies at higher levels).

It should be noted that although these were international conferences it was the UK that was firmly in the driving seat with Mattei showing it was the ideas and leadership of the UK's Ralph G. Hawtrey, Sir Basil Blackett and Sir Otto Niemeyer (the latter Treasury officials) that very much set the agenda, drafted the key documents and carried the day. In Mattei's telling this was when the policy of Austerity was invented 'through identifying a series of direct measures (reductions in pay and jobs) and indirect measures (restrictive monetary and fiscal policies that depressed economic activity and raised unemployment)'. It had the planned impact, then and now, of shifting resources from the working majority to the saver/investor minority. 'Austerity . . . enforced a public acceptance of repressive conditions in economic production. This acceptance was further entrenched by experts whose economic theories depicted capitalism as the only and best possible world'. (p. 7)

Recognising the unpopularity of such measures, these conferences asserted the need for independent technocratic bodies, in particular central banks, to be freed from political pressures – in order to guarantee that they

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11 <https://tinyurl.com/3dkdwccy> or <https://www.amazon.co.uk/Triumph-Nationalization-George-Chiozza-Money/dp/129890904X>

12 To force the popular masses to make savings, it is necessary to resort to indirect taxation. Quoted by Mattei on p. 147.

'should be conducted solely on the lines of prudent finance'.[13] Thus in the UK 'the Geddes axe'[14] resulted in the cut in average weekly earnings of 29% by 1923. In Italy the King invited Mussolini to create a government in 1922 to force through austerity.

The UK and European elites, including Keynes himself at the time, were clear that capitalist orthodoxy and the tenets of sound money were essential to the future of capitalism itself. It was only when the results of these policies created mass unemployment, suffering and a slump in economic activity that Keynes and others started to tease out alternative policies. They faced uphill struggles, not least from the senior figures in the Treasury and Bank of England, who stuck rigidly by their rulebook. It was only with WW2, the need to mobilise national resources again to ensure the war was won, and the perceived threat of communism sweeping across Europe, that a turn to public spending, nationalisation and government intervention was once again tried. This led to the golden years of Keynesian intervention all the way to 1979 and its repudiation. Paradoxically policy making went full circle and once more fiscal and monetary austerity, as the 'obvious' answer to economic troubles, were adopted again following the crash of 2008.

The trouble is, just as austerity failed in the interwar years, so it has failed since 1980 and 2010 to restore either national fortunes in the UK or elsewhere in the west. What it has done is ensure capitalism as a system has survived and restored the fortunes of capitalists themselves, but at the expense of everyone else.

Could there be an alternative? Proponents of Modern Monetary Theory[15] have shown that theoretically monetary austerity is both unnecessary and counterproductive. Chinese economic success emphasises that state intervention and state capitalism can achieve much. Other European countries, notably France and the Scandinavian countries, have shown that capitalism isn't synonymous with low taxation and low public spending. A mixed economy is not such a difficult concept and has existed in many countries since early experiments with municipal socialism and syndicalism more than a hundred years ago. The record of industries de-nationalised by Thatcher – gas, water, railways, electricity generation, dentistry, social care and the car industry – shows that old issues can re-emerge under new guises. Questions of the need for public ownership, control, planning, regulation and

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13 Mattei p. 151

14 <https://www.oxfordreference.com/display/10.1093/oi/authority.20110803095845742>

15 For example see <https://www.amazon.co.uk/Deficit-Myth-Modern-Monetary-Economy/dp/1529352525>.

stewardship remain and are even more relevant today in cleaning seas, dealing with health threats and in countering/living with global warming.

While Davis gives a plausible account of the post 1976 period of Treasury management of the UK economy, and Kwarteng offers a readable conventional account of sound money theory and practice, it is Mattei who gets closer to where the action was at key moments of the country's economic history, its motivation, and gives better clues to future events.

In her remarkable book Mattei exposes the political nature of economics. The priority in all major decision making in the immediate post WW1 years in Britain and Italy was to defeat working-class aspirations and to restore the effective role of the bourgeois classes to the management and direction of the economy. Keynes wholly supported this and saw no real alternative to the saver/investor as the motor of the UK economy. It was only much later when the results of the austerity policies of this era became obvious and socialist alternatives loomed that he adjusted his thinking. But it falls to the Treasury and the Bank of England to manage the economy and Mattei shows that there is not only continuity in time with policies being used now and in the early 1920s but consistency alarmingly between the UK and Italy in the Mussolini era and Italy in its recent EU era in the way economic policy is guided: by economic experts freed from democratic influence but empowered to inflict austerity to maintain the capitalist economic system.

For those who find difficulty in accepting these uncompromising messages and the drawing of historical parallels from a hundred years ago, the good news is that Mattei is working on a sequel: a book project which critically reassesses the Golden Age of Capitalism (1945-1975) and its Keynesianism through the lens of austerity capitalism.

Stand by for a bracing read.