**The Monetary Education of John Hicks**

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“I sometimes feel, looking back, that it ought to have been my duty, after writing ‘Simplifying’ [(1935)], to have abandoned all other interests, and to have devoted myself entirely to pushing forward along the road on which I had taken first steps. As it was, nearly thirty years had passed before I got back to it [in ‘Liquidity’ (1962)].” (Hicks, 1982, 9)

There is no doubt that post-war American Keynesian orthodoxy—in particular what in previous work (Mehrling 1997) I have called the “monetary Walrasianism” of Patinkin (1956), Modigliani (1944), and Tobin (1969)—took significant inspiration from Hicks’ early paper “A Suggestion for Simplifying the Theory of Money” (1935), as also from his famous formalization of Keynes’ General Theory in “Mr Keynes and the ‘Classics’” (1937). But the course of Hicks’ own work traced a rather different path. Ultimately he looked back on his formalization of Keynes as an inadequate characterization of what Keynes had been trying to say (Hicks 1980). And, as we shall see, ultimately he built his own alternative edifice on the 1935 “Simplifying” foundations, in his final book A Market Theory of Money (1989). In the context of Hicks’ own life, this last work arguably represents the culmination of his intellectual project, but it has been hard for modern economists to understand it, since they approach that work from their own context (see, for example, Hahn 1991 and Laidler 2004). It is this problem of interpretation that we seek to remedy in what follows.

We are not the first to make such an attempt. Surveying the chronology of Hicks’ thinking about money, his biographer tells a story of two quite separate attempts by the theorist to develop monetary theory appropriate for the very different circumstances of pre and post WWII, attempts so different as to seem the work of two different men, the early J.R. Hicks and the late John Hicks (Hamouda 1993; see also Pasinetti and Mariutti 2008). In this reading, Hicks “rejected his early portfolio approach” (Hamouda 1993, 180; see also Hamouda 2008, 211) and developed instead a liquidity theory of money which, among other differences, took time seriously. More specifically, the portfolio theory of Hicks (1935), on which Baumol (1952) and Tobin (1958) had built, was replaced by the liquidity theory of “The Two Triads” (Hicks 1967, Ch. 1-3), subsequently elaborated in “The Foundations of Monetary Theory” (1982, Ch. 19) and A Market Theory of Money (1989).

But in fact Hicks never did reject his early portfolio approach, quite the contrary. Says Hicks himself in an essay written for a 1982 collection of his monetary essays: “I have, to this day, a much higher opinion of ‘Simplifying’ than of any other of these early papers; I would still stand by what I said in it, so far as it goes.” What Hicks rejected was not what he himself said, but rather what others subsequently made of what he said. He continues: “So in the end I had to go back to ‘Simplifying’, and to insist that its message was a Declaration of Independence, not only from the ‘free market’ school from which I was expressly liberating myself, but also from what came to pass as Keynesian economics” (1982, 8-9). (See also 1989, pp. 64-65.) In Hicks’ mind there is continuity, not disjuncture, between his early and late work. Let us attempt to discover what he has in mind.

As a matter of intellectual biography, it seems more correct to say that Hicks left “Simplifying” aside for thirty years mainly because he thought that Keynes and his followers (perhaps specifically Dennis Robertson, who Hicks considered a mentor[[1]](#footnote-1)) had adequately picked up the baton and were running with it. Instead, he turned his attention to other matters, such as Value and Capital (1939) and the subsequent “pioneering contributions to general equilibrium theory and welfare theory” for which he would be awarded the Nobel Prize (in 1972).

After thirty years, however, and Robertson’s death in 1963, it had become apparent to Hicks that the Keynesians were running in substantially the wrong direction. And so he went back, picked up the baton himself, and began running in the direction he originally had in mind.[[2]](#footnote-2) Like Keynes, he was committed to developing a monetary theory of the rate of interest; unlike Keynes he insisted that such a theory was about the short term rate of interest, not the long term rate. But after thirty years Hicks was no longer a young man, indeed since 1952 he had been serving as the Drummond Professor of Political Economy at Oxford University, with all the duties of that office. It is perhaps significant that in 1965 he chose to take early retirement (at age 61), and so was able to devote the time and energy required to make the new start that he felt was needed.

Even so, it took him a long time to find his footing. Looking back in 1975, Hicks remarked: “What does matter is that the Keynes theory [in The General Theory] and the Value and Capital theory were weak in corresponding ways. They both lacked, at one end, a satisfactory theory of markets; and at the other end, they lacked a satisfactory theory of growth” (Hicks 1982, 291). As of 1975, the majority of Hicks’ published work had been on the theory of growth: “the Harrod type, the Joan Robinson type, the Kaldor type, the von Neumann type, the Solow type—one after another. I felt that I had to learn them, and the best way to learn them is to write out one’s own version.” On the theory of markets, however, he was still making a start.

The main reason for his slow progress on the theory of markets can be found in the fact that there was no similar list of contemporary authors for Hicks to learn by writing out his own version, so he could not employ his normal habit of work. Instead, he turned to economic history and the history of economic thought. In this regard, Hicks draws our attention to a “key paper”, his 1967 essay “Monetary Theory and History—an attempt at perspective”, a paper that he suggests many readers “will find the best place at which to begin” (p. vii). I suggest that this is where Hicks himself began, placing himself now firmly within the Banking (or Credit) School of Thornton and Mill, and in opposition to the Currency School of Ricardo. Keynes’ rejection of the “classics”, Hicks suggests, was in fact rejection of the Ricardian tradition, and embrace of the alternative (but also classical) tradition of Thornton and Mill. Thornton was himself a banker and so able to abstract theory from his own experience, but Mill was not and so had to build his analytical understanding from the accounts of others, especially Tooke and Fullarton. Hicks apparently determined to follow Mill’s lead, starting from the historical and institutional account provided by his former LSE colleague Richard Sayers (1936).[[3]](#footnote-3)

The central theme of Hicks’ “key paper” is the historical emergence of a credit economy, already clearly apparent in the time of Ricardo, and the attempts by contemporaries to make sense of it. They all saw, as we see today, the inherent instability of such a system. “It rests upon confidence and trust; when trust is absent it can just shrivel up. It is unstable in the other direction too; when there is too much ‘confidence’ or optimism it can explode in bursts of speculation. Thus in order for a credit system to work smoothly, it needs an institutional framework which shall restrain it on the one hand, and shall support it on the other” (1967, 158). In this respect, the great attraction of the Ricardian school was its message that instability is easily cured simply by controlling the quantity of money. The Thornton-Mill school, by contrast, frightened people by its contrary message that a credit system must be actively managed, and that such management is difficult. “It must be managed by a Central Bank, whose operations must be determined by judgement, and cannot be reduced to procedure by a mechanical rule” (1967, 164). Because of its greater attractiveness, the Ricardian school became official doctrine; because of its greater realism, the Thornton-Mill school informed actual central banking practice. That is where matters stood in the time before Keynes, and indeed where matters still stood in the time after Keynes, when monetarism emerged as the modern version of the Ricardian school.

From this perspective, the central problem for contemporary monetary theory, as Hicks came to see it, was that what had come to pass as Keynesian economics was also in effect much more Ricardo than Thornton-Mill, and some of the blame for that lay at the feet of Keynes himself. “Keynes, for us, is too monetarist. What we need, as a simplified version of the monetary system, which will stress the things which for us are important, is something which will pay less attention than Keynes did to the Quantity of Money” (1982, 264). That is what Hicks thought needed doing in 1982, and it is also what he thought he was actually doing in 1935 in “Simplifying.” There he presents his own theory as an elaboration of one particular idea in Keynes’ Treatise on Money (1930), but going beyond what Keynes had said in that book, “more Keynesian than Keynes” (1935/1967, 64).

Just so, the inherent instability of the credit system, and hence the need for active management, is quite clearly a theme of “Simplifying”, as also the importance of various frictions in keeping the system from being even more unstable than it is (de Cecco 2008), and this by itself constitutes a kind of declaration of independence from the free market school. But what is most striking about the 1935 paper is Hicks’ conception of agents, and the problem they face. “We ought to regard every individual in the community as being, on a small scale, a bank. Monetary theory becomes a sort of generalization of banking theory” (1935/1967, 74). When he says “bank”, and “banking theory”, we should understand him as having in mind what Keynes said in the Treatise in a passage Hicks later quoted explicitly. Bankers have, said Keynes,

three categories [of assets] to choose from: (1) bills of exchange and call loans to the money market, (2) investments, and (3) advances to customers. As a rule, advances to customers are more profitable than investments, and investments are more profitable than bills and call loans; but that order is not invariable. On the other hand, bills and call loans are more liquid than investments, i.e. more certainly realizable at short notice without loss, and investments are more liquid than advances. (Keynes 1930, as quoted in Hicks 1989, 61).

Hicks’ idea in 1935 was to extend this banking theory framework to every individual. That means thinking of each individual as a balance sheet, with both assets and liabilities, adjusting their money holding at a moment in time by spending and selling, lending and borrowing, repaying and redeeming debts, in light of their expectations about a future that is not just risky but also uncertain. In other words, Hicks is thinking of individuals as embedded in a credit economy.[[4]](#footnote-4) A central problem that confronts such individuals, to varying degrees, is their inability to adjust their balance sheets continuously over time in response to changing circumstances and changing expectations, because of “the cost of transferring assets from one form to another” (1935/1967, 67). Money is special because there is no such cost--it is already means of payment--and that is the fundamental reason people hold it.

This is where Hicks starts in 1935, and this is also where he starts again when he returns thirty years later, now generalizing the “liquidity spectrum” to include real assets as well as financial assets, and now distinguishing three general balance sheet categories: Running Assets, Reserve Assets, and Investment Assets (1967, Ch. 3). Further, and this is new, we see the beginning of his appreciation for the importance of “middlemen”. “It is implied in the existence of financial markets that there exist financial middlemen (just as the existence of middlemen is a necessary condition for the working of any organized market)….Surely it is in the operation of those who deal professionally upon financial markets that we have the clearest and most obvious appearance of Liquidity Preference” (1967, 47-48). In 1967, everyone is still a bank, but the liquidity preference behavior of actual banks is especially sensitive and as such crucial for understanding how the actions of the monetary authority are transmitted to the larger economy.

Subsequently, in his Theory of Economic History (1969, Ch. 3), Hicks put middlemen even more at the very center of the picture, as the origin of the distinct social arrangement he called the Mercantile Economy. Looking back in 1975, he reflected: “I am very convinced that for the purpose at hand [namely, the construction of a theory of markets], the specialized merchant is the key figure…The role of the merchant in the development of market organization is crucial” (1982, 297). Even so, he continued for a long time conceptualizing merchants mainly as a source of precautionary demand for money, which is to say as leverage points and “listening points” (1982, 273) for central bank policy. It is not until his final book that Hicks finally conceptualized merchants more fundamentally as speculative dealers, and hence market makers, in both real and financial assets (1989, Ch. 2, Ch. 8).[[5]](#footnote-5) What dealers do is to absorb fluctuations in demand and supply using their own balance sheets, by allowing inventories to rise and fall, setting the prices they quote so as to make a competitive profit above the interest rate cost of funding those inventories. “They introduce, in doing so, a little solidity” (1989, 71). Hicks does not say so explicitly, but it is easy enough to recognize dealer profits as the “cost of transferring assets from one form to another”. Thus, what was an unexplained friction in 1935 became the centerpiece of his theory of markets in 1989.

In giving dealers a central importance, in effect Hicks ultimately rehabilitates Hawtrey--“It was Hawtrey’s doctrine that the principal way in which interest affects trade activity is through its effects on speculative markets in commodities” (1989, 112)—in a more general form appropriate for the modern credit economy, with its enlarged role for speculative markets in financial assets.[[6]](#footnote-6) Indeed, the interest rate itself is formed by the operations of “a special class of dealer who will discount bills for cash” (1989, 51). In Hicks’ final formulation, the theory of markets is essentially about the operations of the dealer system, and the money rate of interest is the observable outcome of such operations in the money market.

All of this is essential background for understanding what Hicks was trying to do with his more formal modeling of the portfolio allocation decision (1962, Appendix; 1967, Ch. 6; 1982 Ch. 19, Part II; 1989, Appendix), which is to say that part of his work that most nearly resembles the Keynesian economics from which he wished to assert his independence. He is concerned in that work to establish two “theorems”. The first concerns the change in money demand as risk aversion changes. The second concerns the change in money demand as wealth changes. For Hicks, the whole reason to be interested in these matters is their bearing on the instability of a credit economy, a concern that goes back to his conjectures in “Simplifying” (1935), as he states explicitly (1982, 256, footnote 20). In a boom, arguably people on average become less risk averse, which causes them to demand less money, which drives down the rate of interest, so further fueling the boom. Also in a boom, people on average become more wealthy, which causes them to demand less money, which drives down the rate of interest, so further fueling the boom.[[7]](#footnote-7) In Hicks’ mature thinking, the second theorem is the more fundamental, presumably because it does not rely on shifting psychology as a free variable, but either way the important point is that a credit economy is inherently unstable.

Having come so far in rehabilitating “Simplifying” (1935) from the many hands that have tried to claim it for the Ricardian Currency School rather than the Thornton-Mill Banking School, it would be remiss of me to close without reconsideration of the paper that Hicks did in fact repudiate, namely “Mr Keynes and the ‘Classics’” (1937). We are now in a position to read that paper through Hicks’ own eyes, rather that the eyes of the “econometrists” for whom he wrote it and the Keynesian economists who subsequently claimed it for their own. Later generations latched onto the sticky wage assumption, but Hicks himself quite clearly insists on the centrality of the monetary theory--“It is the liquidity preference doctrine which is vital” (1937/1967, 133)—and on that point he never wavered. “The crucial point, as I now feel quite clear, on which the individuality of the Keynes theory depends, is the implication that there are conditions in which the price-mechanism will not ‘work’—more specifically, that there are conditions in which the interest-mechanism will not work” (1957/1967, 143).

It is true, as Hicks himself would recount, that in 1937 he was reading Keynes’ General Theory through the lens of his own work that would soon appear as Value and Capital (1939), and it is that reading that he would eventually repudiate. But it is also true that he was reading through the lens of “Simplifying” which is to say through the lens of his own interpretation of Keynes’ Treatise, and this he never did repudiate. Quite the contrary, his main criticism of Keynes is that the General Theory insufficiently incorporates the insights of the Treatise. “I have been greatly helped by what Keynes said on liquidity in his Treatise; but in his later and more famous book he seems to have fallen into the trap just described. And how many of his monetarist followers—in this respect they were his followers!—he led into it” (1989, 63).

What Hicks learned from the Treatise, and built into his own theory, was the central importance of liquidity preference as a rational response in a credit economy to the inescapable fact of uncertainty, a response that shows up not only narrowly in the demand for money but also much more generally in the management of balance sheet allocation as between Running, Reserve, and Investment Assets, real assets as well as financial assets. Every individual faces this fundamental management problem and, in the center of the credit system, the central bank faces its own problem of managing the system as a whole. One might say that it is a problem of “stabilizing an unstable economy”.[[8]](#footnote-8) For that purpose central bank tools are barely adequate, and anyway always chasing developments in the credit economy that eliminate frictions and so create new sources of instability. Most challenging, central banks are inherently better equipped to quash a boom than to ignite a recovery.

The Keynesian revolution, as Hicks understood it, was in the first place about broadening the set of tools available for managing the system as a whole, specifically to include fiscal policy the better to ignite recovery in the context of sustained Depression (1967, 170). But the shift in focus from monetary to fiscal policy also implied a shift from behind-the-scenes operation by central bankers to front-of-stage operation by elected national governments. Presciently, Hicks anticipated that this shift would have far-reaching consequences for the operation of the global credit economy, where “there is the same problem of the instability of credit. There is the same need that international credit should be managed, in order to be secure. … Can we find rules that are acceptable to national pride, and to national self-interest, and which yet give scope for some minimum of management—just enough to give the international credit structure the security it so sorely needs? It will be a narrow passage, but one must hope that there will be a way through” (1967, 172-173). Thus Hicks in 1967 during the last days of Bretton Woods; thus ourselves fifty years later.

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1. In his obituary notice for Robertson, Hicks takes pains to draw attention to Robertson’s “years of partnership with Keynes” (1964, 309), up to and including Keynes’ Treatise (1930), as background for understanding their subsequent rift and then reconciliation at Bretton Woods. In the end, it was not Keynes himself but rather the rigidity of those who adopted his system as a new orthodoxy that most distressed Robertson, and Hicks as well (Hicks 1964, 314). Like Robertson, Hicks always preferred to build on the Treatise rather than the General Theory, and he specifically acknowledged Robertson’s influence in this regard, stating that Robertson “converted me to my present insistence on the primacy of the Means of Payment” (1967, x). Here perhaps is the main reason that Hicks’ brief sojourn at Cambridge was not a success (see Marcuzzo et al, 2008 and 2012). [↑](#footnote-ref-1)
2. As he says himself: “’The Two Triads’ is a revision and (perhaps one might venture to say) completion of Keynes’s theory of money” (1967, vi); and “This book…is mainly to be concerned with a refurbishing of monetary theory (largely Keynes’s monetary theory)” (1989, 2). [↑](#footnote-ref-2)
3. Just so, Hicks (1967, x): “I have never been able to master the detail of monetary institutions; it has been an encouragement to me that Professor Sayers, who does understand them, has usually found that in the general way I have to talk about them, I am talking some sort of sense.” [↑](#footnote-ref-3)
4. In 1935, Copeland’s Flow of Funds accounting was not yet available (Copeland 1952), but we can see the young Hicks groping toward something like that, not only in “Simplifying” but also in his subsequent textbook The Social Framework (1942). On this point, see Klamer (1989). [↑](#footnote-ref-4)
5. There is a puzzle here, since Hicks had taken great interest in Keynes’ analytical account of normal backwardation in organized commodity forward markets (Keynes 1930 II, 143) and had adapted Keynes’ argument in his own account of the term premium (Hicks 1939, 146-7). Both phenomena are presumed to arise from systematic imbalance in fundamental demand and supply in forward markets which speculators are willing to absorb for profit. But these speculators are not yet understood as a kind of middleman or dealer. See Fantacci et al (2010, 2014). [↑](#footnote-ref-5)
6. The Hawtrey that Hicks cites is the Hawtrey of his textbook, Currency and Credit (1919) and A Century of Bank Rate (1938), not The Art of Central Banking (1932), notwithstanding Hawtrey’s emphasis in the latter book on “the inherent instability of credit” (1932, 166). It is an interesting question to what extent Hicks’ single-minded focus on Keynes prevented him from adequately appreciating the contribution of Hawtrey, until the very end. [↑](#footnote-ref-6)
7. For the latter, Hicks is explicitly thinking about businesses which experience ongoing cash calls, and financial firms that have existing financial obligations as well as assets. [↑](#footnote-ref-7)
8. The reference is to Hyman Minsky’s magnum opus (Minsky 1986). I do not suggest that either man knew or was influenced by the other. I do suggest a certain commonality of intellectual project with regard to monetary theory, on opposite sides of the Atlantic, and in very different voice. Hicks’ acknowledgement of Axel Leijonhufvud “who started me off on this undertaking, convincing me that what I said on earlier occasions was not enough” (1989, 3) can be read as evidence that this commonality of project was recognized by at least one other American monetary economist. [↑](#footnote-ref-8)