



Britain and Europe Now: What can we learn from John Maynard Keynes?

David Vines

College of Europe

Bruges

2 February 201



1 The Brexit Shock

- * The vote for Brexit has brought to an end Britain's growth model, one which the country has exploited ever since World War II and – in particular - ever since the UK's referendum decision to stay in the EU in 1975.
- * Britain now faces just as big a choice as the one which Keynes faced in 1942.
- * I want to describe why Keynes faced that choice then and why the choice which we face now is just as difficult.
- * This choice has large implications for the rest of Europe, which is why I am discussing it with you now.
 - * Britain then was a world leading power. Britain's task – and Europe's task - is now is much more complex.
 - * Keynes can help us



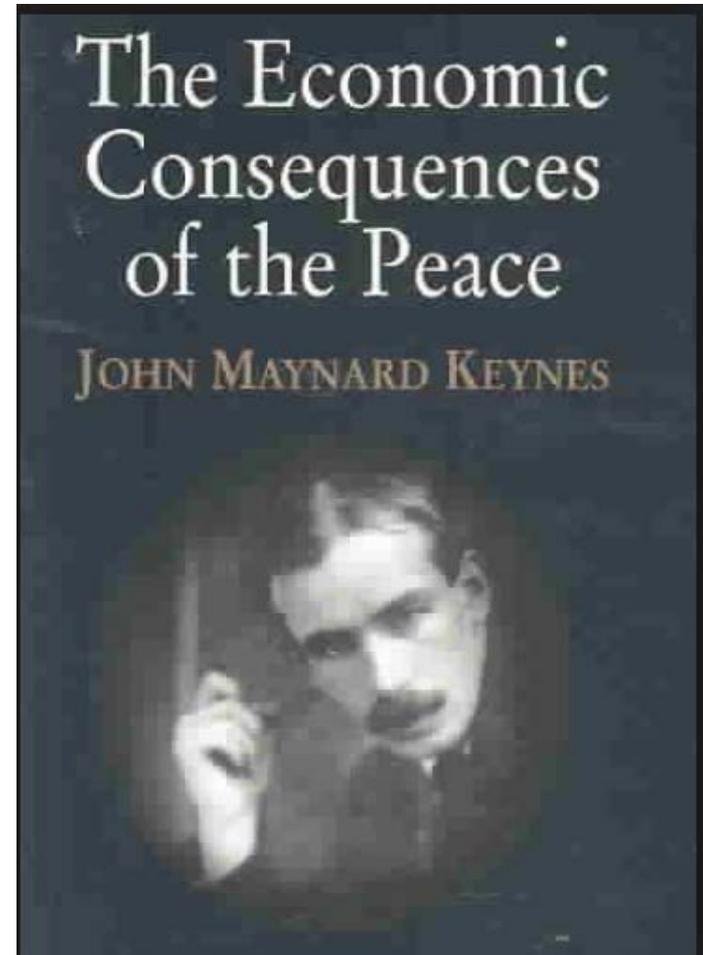
2 Why Keynes Matters I : A need to manage the *global* economy

Keynes wrote *The Economic Consequences of the Peace* when he was only 35. It immediately propelled him to global fame.

The book is known for his vitriolic attack on the Versailles peace settlement. But is important for another reason.

In this book Keynes spelled out his view of how the world economy had worked before World War 1 .

And he staked out his life's work: to find a way of restoring global capitalism back to its well-working condition before he died.



The globalized world of the late C19

Keynes wrote:

“The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend.”

This is very like the London of 2016



In a remarkable few pages of analysis Keynes explains how this world worked before World War I

- He presents what we would now call a growth model.
 - Rapid labour-saving technical progress and rapid labour force growth
 - A high savings rate
 - Ideas foreshadow the Ramsey model (1928), the Solow model and even the Lewis Model (1954) (about rural urban migration)
 - Crucially: there are no problems of demand shortage: all of the savings are always invested
 - So there are none of the issues which characterise his later *General Theory*
 - This is not a model of economic policymaking.
 - And it is certainly not concerned to thinking about one country at a time – in the way in which most teaching about economics normally proceeds
- Instead it is a combination of historical observation and economic analysis aimed at understanding, and managing, the global growth process in this earlier age of globalisation.



Crucially this was an international system

– Within Europe

“On the prosperity and enterprise of Germany, the prosperity of the rest of the Continent mainly depended. The increasing pace of Germany gave her neighbours an outlet for their products, in exchange for which the enterprise of the German merchant supplied them with their chief requirements at a low price. ... Germany not only furnished these countries with trade, but, in the case of some of them, supplied a great part of the capital needed for their own development.”

- And beyond Europe: it was a global system

- “[t]he accumulative habits of Europe before the war were the necessary condition [for this growth]: ...[o]f the surplus capital goods accumulated by Europe a substantial part was exported abroad, where its investment made possible the development of the new resources of food materials and transport, and enabled the Old World to stake out a claim on in the natural wealth and virgin potentialities of the New”



* *The Economic Consequences of the Peace* identifies one way – a debt burden caused by reparations – which might make this global system break down.

- But beyond this one problem *The Economic Consequences of the Peace* sets a much broader stage on which all of Keynes' later work is laid out.

- It is not just a combination of historical observation and economic analysis aimed at understanding the global growth process in age of globalisation.

- The life-project project is also one of understanding how to *manage* this global system



- *The Economic Consequences of the Peace* identifies one way – a debt burden caused by reparations – which might make this global system break down.

- But beyond this one problem *The Economic Consequences of the Peace* sets a much broader stage on which all of Keynes' later work is laid out – how to make global system work properly again

- Joseph Schumpeter writes – in his obituary for Keynes (*American Economic Review*, 1945)

“In those pages of the *Economic Consequences of the Peace* we find nothing of the theoretical apparatus of the General Theory. But we find the whole of the vision of things social and economic of which that apparatus is the technical complement. The General Theory [writes Schumpeter] is the final result of a long struggle to make that vision of our age analytically operative.”

- I am going to argue something much bigger to you in this talk. What Keynes made “analytically operative” was:
 - a vision of the international institutions needed to manage a globalised world and
 - A way to think about liberalisation, with has crucial implications for Europe's “Four Freedoms”



3 Interlude: The General Theory as a “way-station”*



It is possible to see Keynes hard at work in the late 1920s after Britain had returned to the Gold Standard in 1925 at too high a rate.

But what one sees is someone who has not yet provided the analytical tools with which to understand the onset of the Great Depression which arrived in the early 1930s

In the 1930s Keynes first to write his *General Theory*.....

* On the way to somewhere else – namely the management of the *world* economy



Keynes at work in the 1930s.....



The *General Theory* describes how the process of growth analysed in the *Economic Consequences* can be impeded by what we would now call negative demand shocks

- The analytic model presented in the *General Theory* enables one to understand the extent of the unemployment which might emerge
- There are a number of features of that model which Robert Skidelsky discussed with you in his lecture late last year. I suggest that you see my book with Peter Temin called *Keynes: Useful Economics for the World Economy* for a simple presentation of this set of ideas
- That model shows that in the presence of a liquidity trap – rather like today's zero bound – monetary policy may be powerless to fix the problems
- Keynes shows how - when this happens, fiscal intervention can produce a better outcome.
 - Keynes had not faced this problem head on in 1919, but he now did so
 - And he worked out an “analytically operative” way of thinking about what to do – what we would now call both a formal economic model and a study of the political economy of how the implications of that model might be implemented as policy .



4 Why Keynes Matters II: The Road to Bretton Woods (1940 – 44)

Vol. 6 No. 11. **PICTURE POST** March 16, 1940



UNOFFICIAL ECONOMIC ADVISER TO GREAT BRITAIN : John Maynard Keynes in His Study in Bloomsbury. It was he who foresaw the evil results of Versailles while that treaty was still under construction—and secured an important job to make them known. To-day, at the age of 56, he has produced a plan for financing the war without disastrous economic consequences.

gettyimages
Tim Giczel

MR. KEYNES HAS A PLAN

To carry on a war successfully we must spend over £1,000 millions a year. How are we to pay? How are we to avoid inflation? In this article Kingsley Martin, Editor of "The New Statesman and Nation," writes of the man who has given an answer to those questions, describes the answer which he gives.

WHEN "The Economic Consequences of the Peace," by John Maynard Keynes, was published in 1919 it caused a prodigious sensation. Here was an important member of the British delegation at Versailles, who had received his post in order to tell the truth about the Treaty. The sensation was due at least in part to the book's literary quality as to its expert substance. Those who knew nothing of economics could appreciate, if only from quotations in the press, Mr. Keynes's brilliant picture of M. Clemenceau, Mr. Lloyd George and President Wilson at Versailles. It successfully put over the point that the American President had kept his Puritanical conscience clear by insisting on verbal consistency with the Fourteen Points, while allowing cunning men to find ways of getting round them. It convinced us all that, whatever the other merits or evils of the Treaty, its real vice was its failure to treat Europe as an economic whole and to reconstruct it for the benefit of the common people. It was a treaty of strategy and national greediness—with the League of Nations thrown in so make it look pretty.

- Keynes turned to the problems which would occur as Britain neared full employment and started preparing for the war. Of particular concern ... was the need to create room for re-armament without running into inflationary or balance of payments pressures
- February 1940, *How to Pay for the War* published
- In June he is invited to become Economic Adviser to the Chancellor of the Exchequer

- Keynes used the model of the *General Theory* for the discussion in *How to Pay for the War* (Keynes, 1940).
- Keynes was specifically concerned with the method by which the necessary reduction in aggregate demand was to be achieved.
- In particular, he did not want the war to lead to inflation – or to pent up inflationary pressure which had emerged after world War I
- So he did not want the war to be fought with tight money, to the benefit of the rentier class.
- Thus was born Keynes' plan for war-time fiscal restraint.
 - This marvellous piece of applied economics - a phenomenally successful op-ed book - explained Keynes' plan for compulsory savings, along the lines of what we now know as the 'Singapore model'.
 - His actual plan was adopted only to a small degree – we got rationing instead – but that is not the point!



- But there was also a need for
 - External Balance – *i.e.* a satisfactory balance of trade – as well as the need for
 - Internal Balance – *i.e.* a level of aggregate demand consistent with full employment

Keynes had only analysed the former in the *General Theory* and in *How to Pay for the War*

- Here a brief historical sketch of about Imperial Preference is important
 - Imperial Free Trade the Ottawa agreement of 1932
 - The Imperial Preference Union



- The need for war-time external balance in Britain imposed two requirements, which differed according to their time-frame: the short run and the long run
- An analytic trick: given the achievement of internal balance (as described above), external problems can be analysed simply by inspecting the balance between exports and what imports would be if there was full employment.



(a) The Short-run: “Lend Lease”

- In the *short run* there was a financing need: the level of imports (both military and non-military) required for survival needed somehow to be paid for, and yet the conversion of a large proportion of Britain's export trades to the production of armaments made this impossible.
 - As a result the country became dangerously dependent on the US for its short-run survival, a problem exacerbated by Britain's commitment in the summer of 1940 to 'total war, whatever price'.
 - This led to Churchill's letter to Roosevelt of 8 December 1940 "one of the most important that I ever wrote" and to Roosevelt's generous response in the form of Lend-Lease. This was announced on 17 December 1940 in the homely image of lending a neighbour a hose to put out a fire'.
 - As a result of Lend-Lease, Britain was able to fight the war without the kind of daily threat of financial crisis which had characterised the First World War.



(b) The Long Run: Article VII of Lend Lease



In the *long run* external balance imposed the need for solvency, and required consideration of the intertemporal issues which have been raised to a central position in modern open-economy macroeconomics.

Keynes' intertemporal strategy here was to save enough external and financial strength for Britain to preserve its freedom of manoeuvre to regain - in time - a satisfactory external account.



Here Keynes ran up against a sting in the tail of Roosevelt's fire hose: Article VII of Lend-Lease, the 'Consideration'

“The terms and conditions upon which the United Kingdom receives defense aid from the United States of America and the benefits to be received by the United States of America in return therefor, as finally determined, shall be such as not to burden commerce between the two countries but to promote mutually advantageous economic relations between them and the betterment of worldwide economic relations; they shall provide against discrimination in the United States of America or the United Kingdom against the importation of any product originating in the other country; and they shall provide for the formulation of measures for the achievement of these ends”.

- When Keynes read this, he asked Dean Acheson (Under-Secretary of State) whether the article referred to Imperial Preference and to the sterling payments system. Acheson said that it did, upon which Keynes

“burst into a speech such as only he could make. The British could not ‘make such a commitment in good faith’; ‘it would require an imperial conference’: ‘it settled upon the future an iron-clad formula from the 19th century’; ‘it contemplated the hopeless task of returning to the gold standard’ and so on”. (Acheson, *Present at the Creation*, 1969, pp 19 - 30)



- When Keynes read this, he asked Dean Acheson (Under-Secretary of State) whether the article referred to Imperial Preference and to the sterling payments system. Acheson said that it did, upon which Keynes

“burst into a speech such as only he could make. The British could not ‘make such a commitment in good faith’; ‘it would require an imperial conference’: ‘it settled upon the future an iron-clad formula from the 19th century’; ‘it contemplated the hopeless task of returning to the gold standard’ and so on”. (Acheson, *Present at the Creation*, 1969, pp 19 - 30)



One can regard this discussion between Keynes and Acheson as revealing a profound difference of view .

- To the British the Imperial preference and the Imperial Payments system involved the management of what could be viewed as the British economic system.
- By contrast
 - non-discrimination was a part of the American heritage: protection of the home market, for the benefits of home producers, regarded as an expression of nationalism, but preference as an expression of modern imperialism
 - Roosevelt himself was passionately determined to dismember the British Empire, as was Cordell Hull, the Secretary of State. It became a war aim of the US State Department that Imperial Preference should be dismantled.
 - But, catastrophically, it also became a war aim of the US Treasury that Britain would be denied the use of an Imperial Payments System (or indeed of any serious balance of payments restrictions) which the competition for its imperial markets might make necessary.
 - The penultimate chapter of Part One the Third Volume of Skidelsky's biography of Keynes concludes (on p. 133) with a succinct statement of this contradiction.



How might the UK deal with these American demands?

- Keynes came to see that, since the war against Germany was inescapable, there was no way to escape from the sting contained in Lend Lease.
- Nevertheless he saw, at first dimly and then in the end with great clarity, that perhaps there was a way out of the impossible contradiction into which the US was pushing his country. This escape route required him to remake the whole world.
 - Suppose that free trade (including the absence of general balance of trade restrictions against the US and the unwinding of more specific imperial preference) were to be imposed on Britain along with open international finance.
 - Then the position of the UK could only be maintained as a good one if the trade were freer, and international finance were managed, on a global basis.
- Could a multilateral world of global free trade and open international finance really be made to work, to replace the imperial system(s) of the late nineteenth century which had been so important to Britain and which had been strengthened in the 1930s.



Keynes' response

Keynes began with the money problem, producing in late summer of 1941 the first draft of his proposal for a Clearing Union.

As Lionel Robins said: “it would be difficult to exaggerate the electrifying effect throughout the whole relevant apparatus of government of the production of this document ... nothing so imaginative and ambitious than ever before been discussed as a possibility of responsible government policy. It became as it were a banner of hope; an inspiration to the daily grind of wartime duties.”

Keynes was asked why he began where he did, with the macro. Here is his reply:

“There was a logical reason for dealing with the monetary [ie macroeconomic] proposals first . It is extraordinarily difficult to frame any proposals about tariffs if countries are free to alter the value of their currencies without agreement and at short notice . Tariffs and currency depreciation are in many cases alternatives. Without currency arrangements you have no ground on which to discuss tariffs..... It is very difficult when you have monetary chaos have older of any kind in other directions It is perhaps an accident that the monetary proposals got started first.... but I am not sure that it was not a fortunate accident”



...Key negotiating issues

1. Whether the Fund would operate according to banking principles or by subscription
 - would it be sufficiently large to meet the liquidity needs of countries with external adjustment difficulties?
 - or would it provide excessive liquidity without appropriate constraint?
- 2 How would eternal adjustment take place? Keynes' response was initially illiberal (tariffs) but he was persuaded by Meade and others that it should be the exchange rate .

Would countries be free to change their exchange rates as needed?
Or would there need to be centralized surveillance to prevent beggar-thy neighbour devaluations

What adjustment pressure could be exerted on surplus countries?

How the system should operate was written down by Meade (1952) and Swan (1955).

This system - in principle – answered the questions which Keynes has=d been unable to deal with in the late 1920s when Briatin returned to the Gold standard at the wrong exchange rate.

This was an extraordinary achievement.



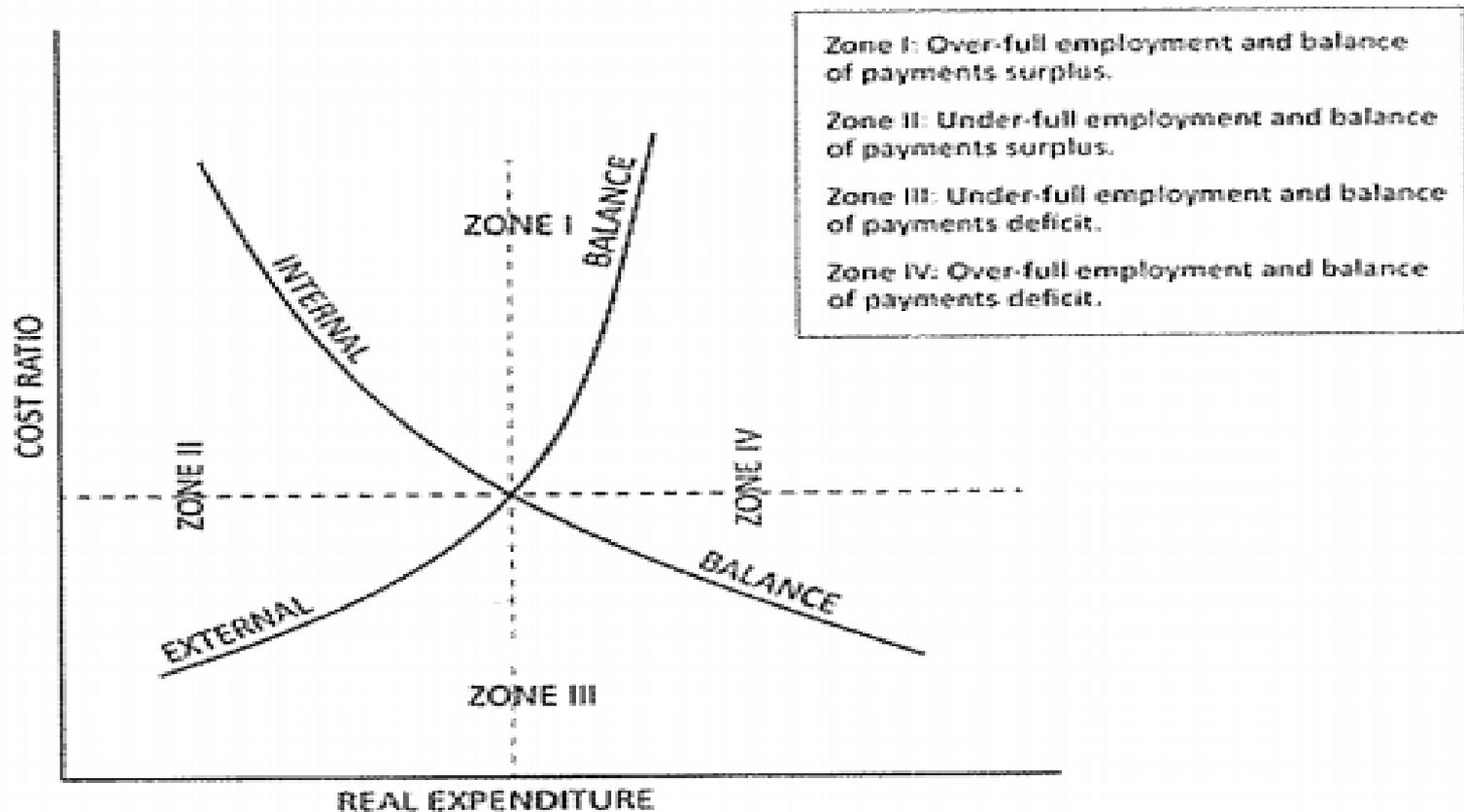
As I said earlier, the need to think about for External Balance – *i.e.* a satisfactory balance of trade – as well as the need for Internal Balance – *i.e.* a level of aggregate demand consistent with full employment created a 2 x 2 problem in economic policymaking

- Keynes thus needed thus to do more than what he had done in *How to Pay for the War*. The Bretton Woods agreements achieved this
 - See James Meade *The Balance of Payments*
 - Trevor Swan: *Longer Run Problems of the Balance of Payments*
 - Temin and Vines *Keynes: Useful Economics for the World Economy*



The “Swan diagram” (1955, published 1963); nowadays see any textbook

This solves for the Cost Ratio (R/W) and the level of Real Expenditure which will give rise to both internal and external balance



Many remaining disagreements were papered over (sometimes with legalistic text!) and the IMF was established at Bretton Woods. Negotiations were then able to turn to the trade questions raised in Article VII, which led eventually, to the ITO proposals, to the GATT



5 Why Keynes Matters Now III: trade, Migration and the Four Freedoms

- How should the UK respond when confronted with demands for an international order which are inconsistent with its perceived objectives?
 - In 1940 it was the US demand to dismember the British Empire.
 - In 2016 it has been the full implementation of the four freedoms within the EU.
- How should the EU respond to Britain's response?
- What will the Nash equilibrium look like
- What kind of leadership is required to make the competitive equilibrium better than the Nash equilibrium?



- Reprise:
 - The James Meade anecdote
 - The ITO/GATT/WTO – multilateralism and regionalism
- The Changing British Model
 - Churchill’s vision of a United Europe
 - The 1975 Referendum
 - Late 1970s - Europe “runs out of steam” : Thatcher and the Single Market



- One Crucial Divide

- A Single Market in Goods and Services, versus
- The Four Freedoms

“This approach is all wrong. While it is undoubtedly regrettable that the UK is leaving, the truth is that free trade with the EU does not have to be accompanied by free movement of people. As pure trade theory shows, the economic effects and welfare gains resulting from free trade are substituted, not enhanced, by those of free movement of labour.”

(Hans Werner Sinn, *The Guardian*, 1 February 2017)

- A Second Crucial Divide

- Majoritarianism versus “team formation”

- A Fundamental Question

- What kind of EU is consistent with the nation state? – cf Keynes’ problem with the US: what kind of Empire is consistent with the nation state?





6 Conclusion

