THE GENERAL THEORY AND POLICIES FOR GLOBAL PROSPERITY

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a) Introduction

Keynes constructs the General Theory model to consider the condition of capitalism and to address the big policy issues of the day. In peacetime conditions the *leitmotiv* of Keynes' proposals is the call for an expansionary rather than a contractionist cure for economic ills. This paper demonstrates this contention with reference to the policies Keynes proposes to promote global prosperity. The paper indicates Keynes' theoretical justification for his opposition to international wage cuts as a contractionist cure for global depression. Once wage cutting is set aside it is easy to appreciate the wisdom of Keynes' proposals for globally coordinated expansionary policies to cure a worldwide downturn.

Keynes is also concerned to promote long term global prosperity. Certainly this involves nations independently implementing expansionary fiscal and monetary policies to achieve domestic levels of full employment. A key threat to these domestic policies is the potential emergence of trade imbalances. The paper outlines Keynes' rejection of a contractionist cure for trade imbalances – which results in lower global economic activity and higher worldwide unemployment. It goes on to outline his plan for a new commercial and trading system which provides an expansionary cure for trade imbalances. With such an expansionary cure Keynes is confident that long term global prosperity can be achieved. Keynes' plan is certainly worthy of consideration by world leaders' intent on creating a new "Bretton Woods" system for the 21st century.

Before outlining Keynes' policy proposals for global prosperity it is essential to appreciate his theoretical justification. It is the General Theory model – an

audacious new workable classification which Harrod rightfully claims to be an intellectual achievement consistent with that of Smith and Ricardo.

b) The General Theory Model

Keynes departs from the classical school by constructing an innovative new theory - the General Theory model (Keynes, 1973a, 1973b, 1973c, 1973d, 2007; Sheehan, 2009). What marks Keynes' approach from that of the classics is the very different causal flow of analysis; Keynes' choice of independent and dependent variables is quite distinct from that of the classical school. In other words Keynes' *ordering* of economic variables diverges from the economic order chosen by the classics: consequently the two approaches generate disparate analytical conclusions, and different policy recommendations.

Keynes assumes that some variables in the economic system are given in the short-period. These given variables are the existing skill and quantity of available labour; the existing quality and quantity of available equipment; the existing techniques of production; the degree of competition in different sectors of the economy; the tastes and habits of consumers; the disutility of different intensities of labour; the systems of supervision and organisation within firms; and the influence of the social structure on the distribution of income. These are the underlying *ceteris paribus* assumptions of the model.[1]

Keynes' discards the main pillars of the classical macroeconomic theory. In its place he proposes a distinctive set of *ultimate independent variables* that are the main moving forces of his analysis. They are the:

- propensity to consume;
- psychological expectations of future yields on capital assets;

- state of liquidity preference;
- money supply;
- aggregate supply relationship.
- money wage rate (or more precisely the wage unit);

These moving forces determine the levels of expected aggregate consumption and expected total investment spending both expressed in real –wage unit - terms. The propensity to consume determines expected consumption expenditure in wage units. The marginal propensity to consume governs the values of both the investment and employment multipliers. The nominal value of expected investment spending is determined by the inter-action of the marginal efficiency of capital and the rate of interest.[2] The expectation of yields on capital assets largely determines the marginal efficiency of capital; whilst the state of liquidity preferences and the money supply determine the money rate of interest. The real value of expected aggregate investment spending is calculated by deflating the nominal value by the wage unit.

Expected prospective yields and liquidity preferences are heavily influenced by the *state of long term expectation*. Although the General Theory model focuses on the short period, it provides a link to the distant future by examining *short-period* changes in the state of long term expectations.[3] To explain the formation of long term expectations Keynes applies the construct of a conventional method of calculation, which decision makers apply in an uncertain environment. Given uncertain knowledge of the future, short-period changes in the state of long term expectations are a continual threat.

The aggregated sum of real expected consumption and investment spending determines the aggregate demand price measured in wage units - the actually

expected proceeds from the sale of output associated with a volume of employment. The stable aggregate supply relationship determines the value of the real aggregate supply price - the expected proceeds which just induce entrepreneurs to offer a volume of employment. Aggregate effective demand measured in wage units is defined when the real aggregate demand price and real aggregate supply price are equalised.

In Keynes' model *aggregate effective demand is the central overarching concept which impacts on all the dependent variables*. The primary dependent variables of the model are the volume of employment and the level of real aggregate income. Other dependent variables include the real volume of aggregate saving (having rejected Say's law), the general price level and the real wage rate. [4]

Fluctuations in aggregate effective demand measured in wage units cause the level of employment to be unstable. However due to the presence of certain psychological propensities it is possible that a capitalist economy can be become stuck in an equilibrium position. One possibility is an equilibrium position with involuntary unemployment due to deficient effective demand.[5]

What is true for one economy is true for the global economic system.

c) Promoting Global Recovery through International Wage Cuts?

The global economy may experience a serious depression with heavy global unemployment and a falling price-level due to deficient international levels of effective demand. Faced with large scale global unemployment the classical solution of general money wage cuts – the contractionist cure - can be applied internationally, but with what effect?

Keynes explicitly rejects the classical *analysis* of how a change in international levels of money wages influences the volume of global employment. In the classical model a general wage cut (that is either a money or real wage reduction for they came to much the same thing) stimulates employment until the diminishing marginal revenue product of the last worker just equals the lower money wage, or to where the diminishing physical product of the last worker just equals the lower real wage rate.

In the General Theory model, by contrast, a general cut in money wages in a national economy *only influences the volume of employment in as far as it changes the level of aggregate effective demand measured in wage units.* Keynes outlines the key issue precisely.

> "[W]hilst no one would wish to deny the proposition that a reduction in money wages *accompanied by the same aggregate effective demand as before* will be associated with an increase in employment, the precise question at issue is whether the reduction in money wages will or will not be accompanied by the same aggregate effective demand as before measured in money, or, at any rate, the an aggregate effective demand which is not reduced in full proportion to the reduction in money wages (i.e. somewhat greater measured in wage units)."
>
> [Keynes, 2007, pp. 259-260; Keynes' emphasis]

Put another way a change in the general level of money wages only influences aggregate employment if it changes the propensity to consume, the marginal efficiency and the rate of interest, the state of confidence, the overall burden of debt, and the balance and terms of trade.[6]

What about the global impact of wage cutting? Keynes offers little hope for stimulating employment in terms of the overall impact on the propensity to consume, the marginal efficiency of capital and the rate of interest, and the state of confidence. However he readily admits that *a competitive wage cut by one nation* can have a beneficial impact on its domestic effective demand by improving the balance of trade. But this nation merely gains at the expense of others – a form of beggar thy neighbour policy. There is however the possibility that other countries can neutralise the efforts of a wage cutting nation to gain competitiveness. They do this by raising tariffs on the exports of that nation. In this circumstance there is no benefit of wage cutting for a specific nation in terms of the balance of trade, although its terms of trade may be changed.[7]

If however wage cuts become generalised across the global economy Keynes claims that they cancel each other out; the balance and terms of trade then remain unchanged between countries. In addition, when wage cuts are internationalised this triggers a worldwide downward trend in wages and prices and massively increased debt burdens (and bankruptcy) across the global economy. This results in a significant reduction in global effective demand and a fall in employment levels worldwide.

This is why Keynes is an eloquent opponent of the *contractionist cure* of international wage cutting for a 1930's style worldwide depression. By contrast Keynes argues for an *expansionary cure* to a global downturn (Keynes, 1972a,

1972b, Liberal Industrial Inquiry, 1977; Keynes and Henderson, 1972; Tily, 2007; Sheehan, 2009). Hence Keynes proposes globally coordinated expansionary fiscal and monetary policies to stimulate worldwide levels of effective demand. The fiscal expansion should take the form of a state-led capital development programme conducted simultaneously by leading nations. Monetary policy should also be coordinated to accommodate the worldwide fiscal expansion, whilst keeping interest rates low (i.e. cheap money) in order to promote private investment spending. The resulting expansion in global effective demand causes international output and employment to recover, and generates a semi-inflation of the global price-level. This semi-inflation is an important part of the expansionary cure as it lowers the real value of debt across the globe.

d) Promoting Global Prosperity over the Long Run

Keynes is keenly aware that the long run prosperity of a nation cannot be achieved independently of what is happening in the global economy. The inter-relations in terms of trade and foreign direct investment mean that nations tend to march together – forward or backward. Nations had marched forward together during the fifty years prior to World War 1, but they had collectively marched backward during the inter-war years, and especially during the Great Depression. In the latter period trade, in volume and value terms, collapsed and foreign direct investment dried up almost completely. Put another way the spread of globalised capitalism, and prosperity, which accelerated up until 1914 went into retreat.

In the post-war world Keynes is keen to get the global economy marching forward once again – predominately because this is essential to the long term

maintenance of global full employment. Keynes argues that a necessary complement to a stable programme of public investment and cheap money is a global commercial system that promotes exports and the reliable payment for exports. Moreover this commercial system should encourage nations to re-cycle export revenues by buying more imports thereby keeping the global level of effective demand rising (Keynes, 1980a, 1980b, 1980c, 1980d and 1980e; Sheehan, 2009).

The main obstacle to this expansionary ideal is the existence of trading imbalances. That is some nations, usually the larger and more powerful ones, will run trade surpluses and other nations, usually the smaller and weaker ones, endure trade deficits. In the aftermath of World War 1 with its huge economic dislocation, these imbalances were massive. A powerful US economy enjoyed large trade surpluses, whilst others, including the UK, found their balance of payments position immeasurably weakened. Clearly there must be some process of adjustment to cure trading imbalances. Keynes outlines two possible adjustment processes.

The first is the *contractionist cure*, where the deficit country pursues a dear money policy and deflation in order to balance off trade at a lower level of economic activity, and higher unemployment. The deficit nations take the lead in the adjustment process; however the surplus countries are not immune from the process. For the latter discover that their positive trade balances diminish as weaker nations deflate and economic activity around the globe slows down. Surplus countries therefore also experience higher unemployment, especially in the export sectors. With the contractionary cure the correction of trade imbalances cause all nations to march together *backwards*, although the pain of

adjustment in terms of unemployment and social unrest will be most acute for the weaker deficit nations.

This is effectively the way the Gold Standard system worked in the interwar period. Nations sought trade surpluses, and those who succeeded hoarded them – through extra gold holdings - refusing to re-cycle them by buying more imports. This meant the burden of adjustment fell on the weaker smaller deficit countries, who suffered a disproportionate amount of unemployment and social unrest. And without capital controls, speculative capital movements – hot money – was attracted to the currencies of surplus nations and away from the currencies of those in deficit, thereby amplifying the imbalances and making the pain of adjustment even greater.[8]

But Keynes argues the Gold Standard had not always worked in this way. In the fifty years prior to World War 1 trade imbalances had been successfully managed predominantly because the UK had re-cycled its trade surpluses through direct foreign investment – capital exports – to the rest of the world. These capital exports stimulated economic expansion and new employment in other nations, who in turn became better customers for the exports of the UK and other nations. Each national currency was fixed in value in terms of sterling, which in turn had a fixed value with an ounce of gold.[9] During this period therefore the Gold Standard had provided an expansionary cure for trade imbalances.

Keynes wishes to replicate the *expansionist cure* for trading imbalances to encourage long term prosperity in the post World War 2 world, but without a return to the discredited Gold Standard system. Consequently Keynes designs an entirely new global trading and payments system.

The starting point for the new system begins by drawing an analogy with the principles of banking in a closed economy. For centuries during the middle-ages economic development had been stymied by the hoarding of metallic currency – gold, silver and copper. Banks develop practices to overcome hoarding through the creation of bank money. A depositor with a credit balance only requires a small proportion of these balances to conduct every-day business. The banks re-cycle the unused balances by lending them out to others who have a demand for money which exceeds their resources. The loans or overdrafts count as deposits for the borrowers, and the volume of bank money is expanded. No harm is done to the person with the credit balance, whilst benefits flow to the borrower and of course the bank (in terms of profits). For the banking system its liabilities and assets balance as the volume of lending expands. The additional loans and overdrafts (assets) are matched by new deposits (liabilities). From the perspective of the overall economy the hoarding of money is eliminated and the elastic volume of bank money expands or contracts with economic activity. Keynes' genius is to appreciate that the principles of banking for a closed nation can be applied to the global economy. Keynes believes that just as bank money in a closed system can overcome the restrictions of creditors hoarding money, so international bank money can overcome the contractionist tendency of nations with trade surpluses hoarding gold. Of course the creation of international bank money requires the creation of an international bank, which Keynes calls the International Clearing Union (ICU).[10] Keynes proposes that the ICU can accept deposits from countries with trade surpluses and grant overdrafts to nations with trade deficits using an international bank money which he calls *bancor*.[11] Just like bank money in a national system bancor must be in

elastic supply responding to changes in the level of world trade and foreign direct investment and the size of trading imbalances. The fact that a nation is running a trade deficit – being in debit on its account with the ICU – is not a matter for concern. The debit account is treated as an overdraft giving the trade deficit country some leeway to resolve the imbalance by efforts to stimulate exports e.g. restructuring industries to make them more competitive. For the ICU of course these debit accounts are matched by credit accounts held by countries with trade surpluses – so its liabilities and assets always balance.

To make this international bank money effective, however, requires that the ICU has unchallengeable control over the supply of bancor. Keynes therefore argues that the ICU must only conduct business – open accounts - with the central banks of member states, and *that each central bank must monopolise foreign exchange dealing on behalf of its own citizens*. This means that the central banks of member states of the ICU will have ICU accounts that reflect the trading position of each state. A nation with a trade surplus will have a central bank with a credit account with the ICU that reflects this surplus; the central bank of a country with a trade deficit will have a debit account with the ICU which reflects this position.[12]

Keynes is hopeful that active policies to promote full employment around the world, and the consequent growth of world trade and direct foreign investment, will cause trade imbalances to disappear. But he is wise enough to acknowledge that this might not happen. A nation with a persistent and growing trade deficit might abuse the opportunity to run up an overdraft with the ICU. So just as an ordinary bank will not allow a customer to run up an unlimited overdraft, if the trade deficit of a nation increases beyond some trigger point Keynes proposes

that the ICU require it to take action to reduce the bancor debit account.[13] Keynes suggests the ICU have the power to insist a debtor nation devalue its currency – by up to 5 per cent - or restrict capital exports or even deposit some gold reserves with the ICU to reduce its bancor debit.[14]

This is however where the analogy with the practice of an ordinary bank ceases. For Keynes' argues the ICU must also require a nation with a persistent and growing trade surplus to take remedial action to reduce its bancor credit account. This is perhaps the most imaginative element of Keynes' plan. It means that the adjustment process in his managed fixed exchange rate system is *symmetrical* – both debtor and creditor must adjust. It is the vital element that ensures the contractionist cure to imbalances is avoided as nations with expanding trade surpluses are not allowed to hoard ever greater credit balances on account with the ICU.

Once a trade surplus exceeds a trigger point Keynes argues the ICU should be able to require a creditor nation to enact remedial action to reduce the surplus.[15] This might involve the ICU insisting on the upward revaluation of the currency in terms of bancor, or a more expansionary domestic monetary policy to increase effective demand, or higher money wages, or reduced national tariff levels or even greater foreign direct investment by the nation in less developed regions of the globe. All of these remedial actions reduce the trade surplus by stimulating global economic activity. Moreover as the trade surplus is lowered so the trade deficits of other nations shrink whilst economic activity rises all around – an expansionary cure to trade imbalances.

The Keynes plan for promoting external balance is a necessary complement for nation states that seek to achieve full employment domestically. It seeks to

reinforce the expansionary trend over the long run through a system of multi-lateral clearing that promotes exports and the payments for exports, whilst encouraging trade surpluses to be re-cycled into higher import spending. Under his plan all nations once again march together forwards, just as they did in the fifty years prior to World War 1. In the process Keynes hopes for more global prosperity over the long run based upon the freeing up of trade and the lowering of trade barriers, especially tariffs.[16]

There is however one area where Keynes remains a fierce opponent of economic freedom. This relates to the so-called "freedom" to act as a currency speculator on the foreign exchanges. Keynes blames the demise of the Gold Standard in the 1930's in part on the actions of unregulated and uncontrolled currency speculators. Consequently he is not prepared to permit speculator "freedom" to threaten his plans for a new global trading and payments system. Indeed he claims the unfettered freedom of speculators to move currencies around the globe is really just a "license to promote indiscipline, disorder and bad-neigbourliness" (Keynes, 1980c, p131).

The Keynes plan is designed to discourage speculative activity. The plan requires that each central bank is able to monopolise currency transactions on behalf of its citizens. The central bank can then provide open licenses for those involved in international trade or foreign direct investment to access foreign currency, whilst speculators will not be granted licenses. The global system will run in the interests of those who engage in trade and invest abroad in order to encourage higher employment. The usual habitat of the currency speculator by contrast will be undermined and such activity will die off – causing the euthanasia of the currency speculator.

Of course Keynes' plan for a new commercial and trade system was never implemented. As Skiddelsky (2000) notes it was unacceptable to U.S. interests and instead the Bretton Woods fixed exchange rate system, based around the dollar and an International Monetary Fund (IMF), was established in 1944. Crucially the IMF was not the international bank that Keynes hoped for, nor did it have the credit creation powers which Keynes thought so vital to the long term achievement of global full employment. It is ironical that this U.S. led commercial and trading system collapsed in the latter years of the Golden Age of economic growth due to the build up of excessive trade imbalances.

However in contemporary circumstances of a world economy beset by global instability the many advantages of Keynes' plan for an expansionary cure for trade imbalances is more attractive. It might form part of a wider package to restore durable prosperity. It certainly provides a viable framework around which to build a new "Bretton Woods" system for the 21st century. That is if global leaders are wise enough to recognise the opportunities Keynes' plan provides.

e) Overview

Keynes in essence departs from the classical school by asking different theoretical questions, applying a distinctive economic order on a complex reality, and addressing new policy issues. The *leitmotiv* of Keynes' peacetime policy recommendations is a preference for expansionary cures for both worldwide depression and global trade imbalances. This preference for expansionary cures precedes the *General Theory*. Armed with the General theory model Keynes is

able to thoroughly justify his policy proposals. These proposals continue to have relevance to modern policy debates

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ENDNOTES

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[1] Keynes states that assuming these elements are given does not mean they are unchanging but that they are changing so slowly as not to materially affect the conclusions of the model.

[2] The propensity to save does influence the marginal efficiency of capital, but in ways quite distinctive from those supposed by the classics (Sheehan, 2009).

[3] The fact that Keynes' model focuses on the short-period does not explain the differences with its classical predecessor. For it is possible to relax each of the given elements in the General Theory model to consider the longer term consequences of such changes. This is what Joan Robinson sought to do in the aftermath of the publication of the *General Theory*. Robinson's generalisation of the General Theory model is a much underrated contribution to economics (Robinson, 1979).

[4] It is important to emphasise Keynes' claim that (having rejected the aggregated labour market) both aggregate employment and the real wage rate are *dependent variables* in the General Theory model. Aggregate income and aggregate saving measured in *nominal terms* are also dependent variables.

[5] Another possibility is an inflationary equilibrium where the growth of nominal effective demand is excessive causing an inflationary spurt.

[6] There is a further aspect of Keynes' analysis of flexible money wages requiring clarification. Keynes considers *two* ways in which the general money-wage level can adjust to the emergence of unemployment. First, a generalised money wage cut which is immediate and significant, after which

wages are expected to move on an upward trend. This can be referred to a *wage adjustment speed A* and applies when governments can impose changes by administrative decree (e.g. in a fascist state). Second, a gradual diminishing of the general level of money wages in response to a gradual increase in unemployment that sets in motion expectations that wages will sag down even further in the future - in what follows referred to as *wage adjustment speed B*. This adjustment process is more Marshallian in character and most likely to occur in open democratic societies, where wage bargaining between entrepreneurs and workers is free and decentralised.

[7] Keynes notes that the extent of the gain from competitive wage cutting by one nation is conditioned by the degree of openness in the economy. The greater the openness to trade the larger the potential for improving the net export position by cutting money wages, and vice versa. Keynes claims this might be a reason why the efficacy of wage cutting is better thought of in the inter-war period in the relatively open UK economy than in the relatively closed American economy.

[8] It is little surprise that the Gold Standard began to break up in this period. In its place a number of dubious "solutions" to the problem of maintaining external balance were tried by different nations – allowing exchanges rates to float freely, competitive exchange rate depreciations, the imposition of tariffs and other barriers to trade etc. Keynes claims these "solutions" did not resolve global imbalances, and when they reduced the imbalance of one nation this imbalance simply passed on to neighbouring states.

[9] This fixed exchange regime encouraged multilateral clearing in which national currencies were convertible and each could be used for trading around the globe.

[10] Keynes first addresses the need for the supernational management of the global commercial system in the *Treatise*. There he proposes the creation of a Supernational Bank to manage a Gold Standard system with the purpose of stabilising the international price-level – or what he calls the international standard (Keynes. 1971).

[11] In the *Treatise* Keynes calls the international money Supernational Bank Money (SBM's).

[12] Keynes proposes that to make this international bank money widely acceptable a unit of bancor should have a fixed value in terms of an ounce of gold. In turn each member state of the ICU must have its currency fixed in value in terms of bancor. This use of gold camouflages the fact that Keynes proposes to create a managed fixed exchange rate system that dethrones gold from its previously privileged position.

[13] The trigger point for a debtor nation is 25 per cent of a quota; the quota is 50% of the combined level of exports and imports of a member state over a three year period. The ICU actions become more onerous on a member state if the deficit exceeds 50 per cent of the quota (Keynes, 1980c).

[14] The ultimate sanction on a non-compliant member state that refuses to follow the instructions of the ICU is that it can be expelled from the ICU meaning it loses its overdraft facility to finance its trade deficit (Keynes, 1980c).

[15] The trigger for ICU action in regard to creditor nations begins if the trade surplus exceeds 50 per cent of the quota of the member state (Keynes,

1980c). The reason why the trigger is greater for a trade surplus than a trade deficit nation is as Keynes notes because "we are a little afraid of [the former]" (Keynes, 1980d)

[16] In this sense Keynes returns to his free trade instincts which he had abandoned when proposing the revenue tariff in the special circumstances of the Great Depression (Keynes, 1972c).