

An engraving of the Palace of Versailles, showing the grand facade and the formal gardens with fountains and paths. The scene is filled with people in 17th-century attire.

On Prosperity, Growth and Finance

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Prime

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By Geoff Tily

Taken from his lecture at the Capital Divided? Conference at City Perc in November 2014, Tily argues that Keynes's goal was high employment founded on a high level of domestic activity. "Growth" was a later and rival preoccupation that must be understood as inherent only to the case for the globalised system that was opposed to both his policies and his goals.

0. Introduction

I sympathise, therefore, with those who would minimise, rather than with those who would maximise, economic entanglement among nations. Ideas, knowledge, art, hospitality, travel – these are the things which should of their nature be international. But whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national.

From the essay, *National Self-Sufficiency*, by John Maynard Keynes.¹

Ask a follower of Keynes to discuss ‘growth, sustainability and the place of the city’, and there is a good chance that the answer will be motivated with his 1933 essay: *National Self-sufficiency* (*Collected Works XXI*, p. 236). This essay was no passing fancy; it was a statement of core belief, made after he had devised his *General Theory*. For mainstream economists it is a statement that does not compute, given there is no mention of the state.

I want to name Keynes’s concept of ‘letting finance be primarily national’ as the ‘domestication’ of finance. This would be achieved, as it was after 1931, with international capital mobility controlled and the financial system based on the domestic banking / credit system. The word domestication has the advantage of being the antithesis to uncontrolled and unsafe *wildness*. Impartial language would oppose domestication and globalisation. For me the choice – and it is a choice – between these two economic courses – domestication or globalisation - is, and always has been the essential substance of democracy.

National Self-Sufficiency also suggests that ‘goods should be home spun’. The purpose of the domestication of finance was to permit the domestication of economic activity, so that it is founded on internally motivated demand and production, rather than production aimed at external trade.

As in the rest of Keynes’s work, his essay does not mention growth. He was concerned above all with raising the *level* of activity and employment. I want to argue here that ‘growth’ is a post-war preoccupation, and must be understood as inherent to the rival case for a *globalised* system.

I stress that this is not just about abstract historical ideas. These conflicting ideas are fundamental to understanding our world, to the trajectory of prosperity over the past century to the present. I don’t think we can understand what we need to do *now* if we don’t understand what has happened in the past.

¹ *The Yale Review*, June 1933: <https://www.mtholyoke.edu/acad/intrel/interwar/keynes.htm>

² *Econometrica*, 1933, 1 (4): 337-57

³ 1999, *The City of London*, Volume III, *Illusions of Gold, 1914-1945*, p. 368.

My discussion today follows this trajectory. I start after World War One, and at Versailles, when a first effort imposing financial globalisation began. Catastrophic in practice, the Great Depression then heralded the beginning of an era when finance and economic activity were domesticated.

Up to a point, this system survived the Second World War and served as backdrop to “the golden age” of economics from 1945 to around 1970. But the domestic system was under attack really the moment the war ended. In Britain, *growth* was the means by which policies that had achieved full employment for the first time in history were undermined. Growth and domestic liberalisation led in turn to inflation. Inflation led to globalisation and globalisation led to where we are now.

It may be ludicrous to try and cover so much ground in a short talk, but I want to tempt you to take a proper look at this interpretation of the economics of Keynes and of events in its light for yourselves.

1. The first globalization of finance, 1918-31

Much has been written about the restoration of the gold standard in the UK, but this was only the local manifestation of a wider imposition of financial globalisation on the post First World War world. The agenda emerged from Versailles. Reparations were only part of the story. I offer as suggestive this review of Keynes’s *Economic Consequences of the Peace*, done anonymously, in verse, and published in *Punch* magazine (14 January 1920).

There was a superior young person named Keynes ...
Still we feel, as he zealously damns the Allies
For grudging the Germans the means to arise,
That possibly some of the Ultimate Things
May even be hidden from fellows of King’s.

The post-war globalisation of finance began with the central powers – [Germany](#), [Austria](#), [Hungary](#), the [Ottoman Empire](#) and [Bulgaria](#). The process was choreographed by major investment banks (Barings, Morgans, Rothschilds, Schröders, Warburgs) and central banks, with political authority mainly from the US government and the newly-founded League of Nations.

The gold standard was restored in the 1920s and capital markets were opened. To aid the transition, large-scale international loans at high rates of interest were made and managed by these investment banks. Central banks were reconstituted or instigated so that they were independent of political authority but with private, international financial interests heavily represented in their governing structures. And of course the financiers demanded tight restraints on government expenditure. This was inevitable when the payments of reparations and war debts were about to begin.

Gold was restored first in Austria, then Hungary and then Germany, all ahead of Britain. This first effort at globalisation unravelled with a rapidity that was astonishing. The imposed conditions led to wildly excessive expansions, exacerbated by surges in international capital flows. The whole thing then reversed as debt deflations, captured (partially) by Irving Fisher in his 'Debt-Deflation Theory of Great Depressions'.² From a global perspective, the greatest excesses and collapses came first in Germany and then in the United States.

As in any liberalized financial regime, the gold standard permitted and fostered excess. It then exacerbated decline. In spite of severe unemployment crises, interest rates were raised to combat the collapses in currency exchanges which were an inevitable consequence of economic collapse. All this was played out in a cycle of economic brutality never known before, although Greece and other 'periphery countries' today bear some resemblance to conditions at that time. And of course, public spending was not permitted.

2. Domestication of finance

While the UK experience was not so extreme, the deflationary policies ahead of and during gold standard membership meant unemployment was permanently high through the 1920s and 1930s. When the global banking system collapsed in 1931, interest rate increases and cuts in public expenditure were demanded to support the sterling exchange. These and the associated economic dislocation led to the demise of the minority Labour Government, and the advent of the National Government in 1932.

Keynes had been consistent and resolute in his rejection of the gold standard. The prominence of this opposition as well his undamaged relationship with much of the British policymaking establishment, meant that he was well positioned to capitalise on its failure. The domestication of finance began. Nor was Keynes a lone voice. The report of the British Parliamentary Macmillan Committee, set up by the Labour Party in 1929, was a statement of intent on the part of a significant body of economic expertise and cut across the whole of society:

[In] the case of our financial, as in the case of our political and social institutions we may well have reached the stage when an era of conscious and deliberate management must succeed the era of undirected natural evolution.

Report of the Committee on Finance and Industry, Cmd 3897, June 1931, p. 5, para 9.

² *Econometrica*, 1933, 1 (4): 337-57

Keynes's long-standing proposals for currency management were effected as the Exchange Equalisation Account in April 1932. Under this scheme, the sterling exchange was managed by central bank intervention in the market rather than through the Bank rate, which was then freed to support domestic needs. Within only a few months the Bank rate had been reduced to 2 per cent, where it would remain until 1951, redundant as a lever of policy.

In June 1932, the Government took direct action on the long-term rate, announcing the conversion of the War Loan from 5 to 3½ per cent, and an embargo on overseas loans. "The economic and monetary environment in which the City functioned had changed fundamentally", writes the city historian David Kynaston.³

From London, the change rippled through the whole of the empire.

Elsewhere, Keynes's ally was democracy. The most important manifestation of which was the election in the United States of Franklin D. Roosevelt. He had finance full square in his sights. "The practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men" declared the new President in his inaugural address. Roosevelt pursued Keynes's prescription with vigour and speed, not least by bringing under public control the Federal Reserve system, terminating US adherence to the gold standard, and by launching his New Deal.

The election of Leon Blum's popular front government in France in 1936, was followed by the nationalisation of the *Banque de France* and the negotiation of the Tripartite Agreement on exchange cooperation between France, Britain and the United States. The domestication of finance had become truly global in scale, supported, it must be emphasised, by a major political shift towards the left.

3. Domestication of economic activity

International trade would cease to be what it is, namely, a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle, but a willing and unimpeded exchange of goods and services in conditions of mutual advantage.

General Theory, pp. 382-3

³ 1999, *The City of London*, Volume III, *Illusions of Gold, 1914-1945*, p. 368.

The purpose of domesticating finance was to permit countries control of their economic destinies. For me, the *General Theory* was about motivating prosperity and employment through internal, domestic forces, rather than relying on the vagaries of international trade in a globalized environment.

In my book (*Keynes Betrayed*, 2010) I was preoccupied with the central importance of a low long-term rate of interest to the strength of domestic demand, as well as to the stability of aggregate outcomes. For Keynes a lower rate of interest implied higher investment and higher income via the multiplier. This is hardly difficult to understand. In monetary terms, any expansion was supported by domestic credit rather than international finance.

The same financial conditions would permit the expansion of government spending to whatever extent deemed necessary or desirable. Trade and competitiveness were no longer the be all and end all of activity, but would be complementary to domestic activity.

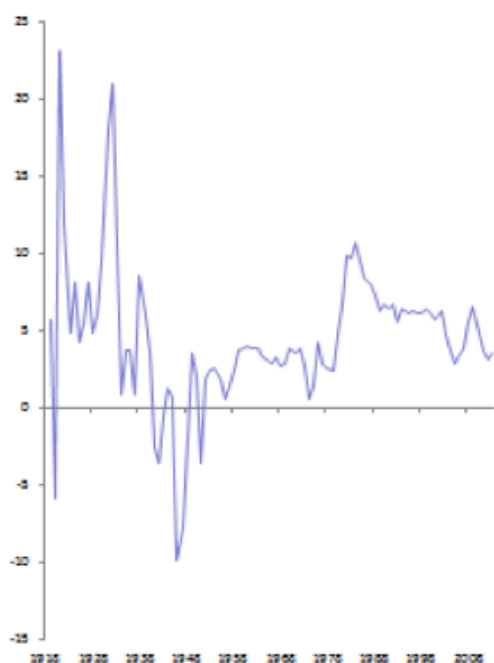
Keynes's judgements were vindicated in practice. A decisive recovery from the Great Depression was underway when the Second World War intervened. But the same analysis informed the profoundly effective economic management of the war. His doctrine was then central to much of the economic policy of the post-war Labour government. Labour was then categorical about the repositioning of finance, demanding that it should be "intelligent servant not stupid master". Labour's leaders took on board Keynes's message about cheap money as a permanent policy.

I should stress this was not anti-credit or anti-bank, or even anti-private bank. It just involved public rather than private sector authority and management - as the Macmillan Committee had envisaged.

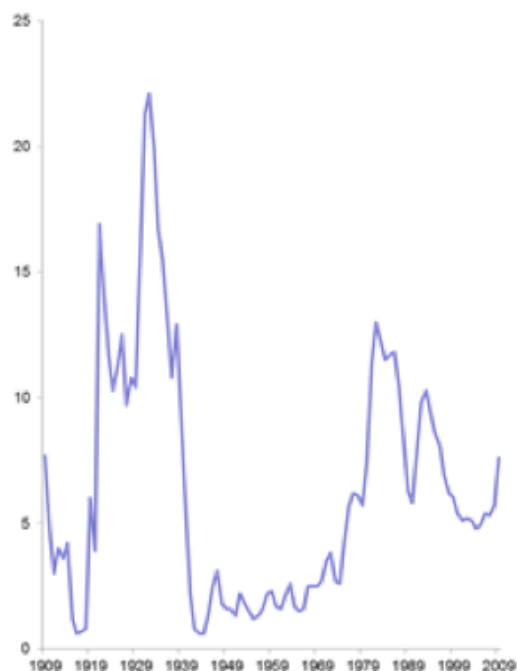
In the first post-war years, policy was aimed at the *level* of activity, at full employment and at avoiding inflation. While the specific conditions that Keynes had sought to establish were very quickly undermined, this aim was maintained through much of the 1950s, even with Labour out of office.

I offer as evidence the right hand chart of the UK unemployment rate, which was held between one and two per cent for much of this period. On the left are US real interest rates. Here we see the way cheap money had become embedded on a global basis for the whole of "the golden age".

Real long-term rate of interest, per cent



UK unemployment rate, per cent



4. Growth and supply forced onto the domestic agenda

The concept of ‘growth’ served as the basis on which post-war outcomes of the golden age were undermined. This was achieved at the level of day-to-day economic and political debate.

I have written a separate essay about the emergence of growth as *the* benchmark of economic performance.⁴ We must remember that ahead of the Second World War the concept of growth scarcely existed. In particular there was no sense of a systematic, and to some extent uniform, rate of change of the level at which an economy operated.

In Britain, the (far broader) National Accounts were devised to assist policies aimed at recovery from the Great Depression and to assist the conduct of war. For these

⁴ ‘The National Accounts, GDP and the “Growthmen”’, a review essay of Diane Coyle (2013) *GDP: a brief but affectionate history*, <http://www.primeconomics.org/book-reviews/the-national-accounts-gdp-and-the-growthmen>

purposes only nominal/cash figures were required. Even up to the 1953 version, the System of National Accounts was concerned only with nominal figures.

It appears that the post-war Organisation for European Economic Cooperation (OEEC) was important in this shift towards growth. At home, British economists joined in, and began to castigate the authorities for what they claimed was the less-than-dynamic performance of the UK economy.

The relevant empirical evidence was assembled by F. T. Blackaby, and is shown on table 3 below. I should stress that these figures must have been rudimentary, of limited legitimacy and without any guarantee of integrity.

Table 3: ‘Growth rates: real national product per man-year’

	1922- 1938	1938-1961	1950-1961	1950-1955	1955-1961
<i>average annual compound per cent rates of change</i>					
Western	*	2.3	4.7	6	3.5
Germany					
France	1.8	2.6	3.8	4.3	3.5
Italy	1.7	2.3	4.7	5.4	4.1
Netherland	0.8	1.7	3.6	4.4	2.6
s					
United	1.1	2.2	2	2.8	1.4
States					
United	1.5	1	1.7	1.8	1.6
Kingdom					

Source: ‘The recent performance of the British economy’, *Advancement of Science*, March 1963, pp. 489-98

Yet they enabled comparison between the poor old UK GDP-per-head growth rate in the last column, with that of other countries. The fullest account of the alleged British failure was Samuel Brittain’s, who had at that time was inventing the idea of an ‘economics commentator’ on the *Financial Times*. Brittain was proud to identify himself as a ‘growthman’, and his manifesto was published in 1964 under the deceptive title *The Treasury under the Tories, 1951-1964*

The unemployment achievements of the UK that had initially surpassed those on the continent were seemingly incidental as far as the critics were concerned (Table 4). Moreover this surely was important at a technical level: faster growth merely reflected the deployment of those previously idle resources over a period where the UK was close to capacity. The real failure was that of the US, whose lead ultimately everyone would follow.

Table 4: Unemployment rates, per cent

	1951	1961	Change
Austria	5.7	2.7	-3
Belgium	9.8	4.2	-5.6
Canada	2	7.1	5.1
Denmark	9.7	3.9	-5.8
W. Germany	9	0.8	-8.2
Ireland	7.3	5.7	-1.6
Italy	8.8	3.5	-5.3
Japan	1.1	1	-0.1
Netherlands	2.3	0.9	-1.4
UK	1.3	1.5	0.2
USA	3.3	6.7	3.4

Source: United Nations, *Statistical Yearbook*

The OEEC became the OECD on 30 September 1961. On 17 November, 1961 the OECD agreed a *fifty per cent growth target* for the whole of the 1960s. Almost in exact parallel the Conservative Government instigated the National Economic Development Council (NEDC). By February 1963 the NEDC had approved a four per cent growth target, arithmetically basically identical that that of the OECD.

In parallel came a growing emphasis on supply-side policies, and hence a practical commitment to increased deregulation of economic activity. This is exemplified by the Council of the OECD adopting their ‘Code for Liberalisation of Capital Movements’ on 12 September 1961, two months before the growth target was set.

The aim of fixing *the level* of employment and output to sustainable levels had been abandoned. Instead the world had officially been set a systematic and improbable target: to chase growth. Nobody seems to have paused to consider whether growth derived as the rate of change of a continuous function was a meaningful or valid way to interpret changes in the size of economies over time.

In theoretical terms, the arithmetical decomposition of ‘growth’ into productivity, the size of the labour market, and the associated link to wages became the fundamental vocabulary of economic policy. This decomposition is regarded as a ‘truism’ to which we still yield.

The policies have been described as ‘Keynesian plus’, but this is a gross misrepresentation or distortion. They reflected *the undoing*, not the intensification of Keynes’s approach. Keynes was about demand and restraint; this was about supply and reckless expansion. Prosperity and full employment had been attained without

aiming at growth; since then, relentless growth has never attained full employment, and has instead done profound damage not only to social but also to environmental relations.

For Britain it was also the highest politics, and the very substance of the initial debate on the membership of the EU.

From a financial perspective, the EU was from its inception almost by definition outwardly rather than inwardly looking. Individual countries immediately turned away from autonomy of economic and political action and domestication, and moved to a collective approach. From a monetary point of view this external / collective orientation has been present throughout from the original European Payments Union, through monetary union, to the operation of the European Central Bank (ECB) and the seeming emerging goal of banking union.

Hugh Gaitskell was a politician of great integrity with an unparalleled understanding of the post-war economics, having played a significant role in the development of the Labour agenda and becoming Chancellor towards the end of their period of office. At the time of the founding of the EU he was leader of the Labour opposition and was deeply suspicious of the new institution. In his biographer's words, "ever since his time at the Treasury he had loathed their [EU nations'] banker-dominated regimes".⁵ Gaitskell met Jean Monnet in 1962, and was decidedly underwhelmed. In his famous '1000 years of history' speech, echoing arguments already made by the Trades Union Congress, he demanded to know how the Common Market was compatible with the "overriding recognition of the importance of maintaining full employment". His intervention was decisive in setting the British Labour party initially against Europe.

5. The 1970s inflation

With Gaitskell's death, the leadership fell into the hands of Harold Wilson, who was only too eager to pursue the supply agenda.

By the 1970s a mess of contradictory and wrongheaded approaches had built up over the preceding decades. Aspects are characterised as 'stop-go' according to a balance of payments cycle, overlaid by the political business cycle. In the 1960s today's approach was in reverse: with Wilson's refusal to devalue sterling, monetary policy was contractionary, but was countered with seriously expansionary fiscal policies. In parallel were various efforts at incomes policies to restrict wage growth according to the new supply / productivity doctrine.

⁵ Phillip Williams, 1979, *Hugh Gaitskell*, p. 715.

Financial deregulation also proceeded apace, most important, the freeing up of credit-creation. This followed a rudimentary form of monetarism, according to which the banking system operated more efficiently if credit was deregulated, with control exercised through manipulation of interest rates, rather than restricted with direct controls such as lending ceilings. (Again this policy partly followed the influence of supranational organisations, with in the late 1960s the IMF imposing a ‘domestic credit expansion’ regime, which linked credit to the balance of payments.) Then finally came the introduction in 1971 of the mis-named ‘Competition and Credit Control’, derided afterwards as “all credit and no control.”

Irrespective of the distance that policy had travelled from Keynes’s prescriptions, throughout this period events and outcomes were attributed to his initiative. See for example, Robert Lekachman’s 1968 book *The Age of Keynes*, and Nixon’s declaration (coined apparently by Milton Friedman) that “we are all Keynesians now”. When the inflation inevitably came, Keynes was blamed, and then thrown out. Within the terms of the trite, simplistic and erroneous history of the post-war age, Keynes’s state had failed and it was now time for Friedman’s market. The reality of course was that deregulation and the market had already failed. But this was not about reason; it was about ideology.

We arrive finally at the present.

6. The second globalisation of finance

Thatcher and Reagan were the figureheads for this revolution, even though politicians of both right and left since the 1950s had taken many steps in this direction. Substantial increases in discount rates and the removal of capital controls provided the backdrop for abrupt and sustained increases which took long-term interest rates back to the level of the 1920s (Chart 1).

Ironically productivity is the one measure that (and only arguably) shows any improvement over outcomes during the golden age. For the UK and US, the era has been one of vastly increased unemployment; public finances have been under virtually permanent pressure and the current account nearly always in deficit. The system of pensions failed, as did housing. In the policy space we have lurched from one target to another. Growth. Money supply. Exchange rates. Inflation. And more recently: a brief flirtation with unemployment.

Brief periods of stability and prosperity in individual countries or groups of countries have repeatedly been hailed as vindication of the globalised approach. But without fail, they have failed. And of course finally in 2008, after almost 30 years of globalisation, the world collapsed into the greatest depression since the Great Depression.

‘Growth’ evaporated. GDP per head fell. As we know, for many individuals, not least in the US, incomes per head have been static for decades. The social gains of the golden age have been reversed, with inequality reverting to levels last seen in the 1920s. There is no point in productivity if nothing else improves.

The winners; well we all know who they are.

7. Conclusion

To wrap up, these are the words of Harold Macmillan, Conservative Prime Minister, reflecting on his government of 1957 - 1963:⁶

When I left office [1964], we had a balanced budget; we had a favourable balance of trade; we had unemployment running about 600,000 to 700,000, about 2 to 3 per cent; inflation, perhaps 2½ per cent not more; we had a pound based on gold; we had the sterling area intact; we were bankers to half the world; we were really in quite a good position. Some genial commentator coined the phrase which had a certain popularity ‘you never had it so good’.

There’s no mention here of growth. Really MacMillan was standing on the shoulders of giants, and his government had set the rot in motion. But from where we stand now, we had certainly never had it so good. Born in 1965, I’ve had more bad than good policy of anyone in this audience. In the 1960s the ‘growthmen’ took over; finance was first deregulated and then globalised. We forgot about demand. Indeed – unbelievably – today, we continue to seek a supply-side explanation for our present and deep malaise.

‘Growth’ was always a red herring. It was a device used to make the case against the domestication of finance, and ultimately against demand. Demand-orientated policies aimed at employment were rejected because they were not delivering enough growth. Yet in fact we never again performed as well as we had done during the golden age – on any measure, even growth. On the contrary: we started to perform badly, not least in failing to curb inflation and with current account almost permanently in deficit. Inflation was not a failure associated with demand, or of government expenditure in its own right. Instead inflation was caused by aiming at growth. Inflation was not a failure of Keynes’s policies. Even if we permit the ‘growthmen’ the benefit of the doubt and allow them legitimate rather than ideological motivation, subsequent experience merely further affirmed the rightness of Keynes’s demand approach.

⁶ <https://www.youtube.com/watch?v=Kl1vn8IF9h8>;
http://news.bbc.co.uk/onthisday/hi/dates/stories/july/20/newsid_3728000/3728225.stm

And sustainability? In part, it is inherent to the taming of finance and the domestication of economic activity. Domestication permits full employment. It gives us the possibility of aiming part of that employment at social and environmental ends. It permits us the economy we want, and the economy we need.

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