As if Keynes had never lived:

the second UK (and world) crisis of financial globalization

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Prime

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1. Introduction: Keynes, monetary theory and macroeconomic policy

> Now there is no part of our economic system which works so badly as our monetary and credit arrangements; none where the results of bad working are so disastrous socially; and none where it is easier to propose a scientific solution.
>
> Keynes, speech to the Liberal Party, December 1923, *CW* XIX, Vol. I, pp. 158–9[2]
>
> [I]t means also that the task of monetary theory is a much wider one than is commonly assumed; that its task is nothing less than to cover a second time the whole field which is treated by pure theory under the assumption of Barter,
>
> Hayek, cited by Keynes in his review of *Prices and Production, Nov.* 1931, *CW* XIII, p. 254

The aim of monetary theory is to devise an economics for systems based on money understood properly as a social technology rather than on 'real exchange'. The theory should lead to practical proposals for the best way to deploy money to foster prosperity and stability. Keynes's agenda for monetary reform evolved from an interplay between practical instinct in the face of real world events and the development a theoretical analysis of increasing sophistication and worth. These events were dictated by a mixture of folly, error and a continuous and changing interplay between vested interest and various political forces as well as two of the most terrible wars in history.

His legacy was a monetary theory of economics and the practical means to the optimal operation of the monetary system of what he once called the 'world between nations'. From 'top down', these involved: his international clearing union for the financing of international trade (which gave pre-eminent position to no single country), capital controls on the movement of wealth, supporting an international development bank, a changed approach to government debt management and central bank policy towards the banking system, new arrangements for the financing of public expenditure, introducing a macroeconomic dimension to the annual budget process, based on the national accounts framework that accorded with his theoretical analysis and that in great part he had devised.

The guiding principle for most of these processes was ensuring a plentiful supply of money at permanently low rates of interest. Fundamentally, according to the *General Theory of Employment, Interest and Money*, cheap money supported high and stable fixed capital investment demand on the part of the private sector and therefore means high output and employment. The same systems supported a significantly enhanced role for the state. In his 1933 essay, 'National Self-Sufficiency', Keynes argued that economic activity should be based primarily on internal /domestic demand, with external demand/trade complementary but in second place. Today the same essay offers an approach to economics and economic activity that might be compatible with the needs of the environment.

[2] All Keynes references are to the relevant volume of the *Collected Writings*, cites as *CW* [volume], [pages].

Keynes saw his contribution to economics originating with his Cambridge mentor, Alfred Marshall, who had developed a rudimentary analysis of credit and contributed to debates on international finance (notably the bimetallic debate at the end of the nineteenth century). Keynes's own economic work began with official debates around the Indian exchange and financial system and then the financial management of the First World War.

He was concerned throughout with both public and private activity, but towards the end of his life became worried by others' excessive emphasis on the state. In his 1944 speech to the House of Lords on the Bretton Woods Agreement, he emphasised that the proposals were "an attempt to use what we have learnt from modern experience and modern analysis, not to defeat, but to implement the wisdom of Adam Smith' (18 December 1945, *CW* XXIV, p. 621). His system did not set 'market' against 'state', but cut across this common characterisation of right and left. Instead his proposals amounted to the repositioning of finance under public rather than private authority, and an inherent rebalancing of (class) interests away from finance and towards industry and labour. More generally – and fundamentally – class interest and hence conflict is a reality.

His impact on events had begun in 1931, when Britain came off the gold standard. For the remaining 15 years of his life, his influence on the world was immense.

The *structure* of the paper follows the prescription of the conference organisers. A theoretical framework to explain outcomes is set out in section 3, though inevitably in very condensed form. The key post-war policy steps and outcomes are outlined in section 4; policy over the last 30 years is addressed in section 5. Charts of key economic variables are included in the annex.

Ahead of this the events from 1931 that Keynes directly influenced are briefly sketched as integral to understanding post-war developments. Throughout the paper the emphasis is on monetary policy. As I argue in my *Keynes Betrayed*, Keynes was primarily concerned with the prevention of crisis through monetary reform; the use of fiscal policy in the event of crisis was a secondary consideration. Likewise, some international context is unavoidable, given monetary policies are inherently global in institutional terms and practical effect.

In section 6, the current situation is addressed through the contrasting fortunes of finance in the wake of the globalization of the last 40 years and the globalization of the inter-war period. The final section argues that the approach of the mainstream economics profession has meant that society is in a far worse position to confront the present crisis than it was in the wake of the great depression.

My fundamental point is that the Keynes that survived into the literature and so into 'conventional wisdom' is wholly different from the reality of his life's work. As a result the authorities greatly misunderstand the nature of the ongoing crisis and are oblivious to the possibilities for its resolution. Tragically the economics profession is actively resisting any review of Keynes's work. For as long as they continue to do so, they will have no adequate answer to the newly emerging and disturbing (but unsurprising) political forces that they so abhor.

2. Revolution: the domestication of finance, 1931-1945

Britain left gold on 21 September 1931 and a repositioning of finance to public from private authority began. Already in the Report of the 1929-1931 Macmillan Inquiry (drafted by Keynes), there had been a statement of intent.[3]

> [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 & Industry, Cmd 3897, June 1931, p. 5, para 9

Keynes was well positioned given this official work and his earlier outspoken opposition to the restoration of gold: he was immediately asked by a senior HM Treasury official (Leith-Ross) to advise on new arrangements. The announcement in the April 1932 Budget of the 'Exchange Equalisation Account' institutionalised the currency management proposals that he first set out in *A Tract on Monetary Reform* (1923). Under this arrangement the sterling exchange rate was managed by central bank intervention in the foreign exchange markets rather than by manipulation of the discount rate (henceforth 'Bank rate').

With monetary policy freed from external constraint, Bank rate was quickly cut to 2 per cent where it remained unchanged until 1951. In June 1932 the conversion operation reduced interest on the 1917 War loan to 3 ½ per cent from 5 per cent, and marked the start of direct action on the long-term rate.[4] It was supported by an embargo on overseas loans – i.e. capital control.

From 1934 fiscal policy was also on a material expansionary setting. Government consumption and investment expenditures expanded by 4 per cent in 1934 and 10 per cent in 1935, ahead of rearmament beginning in earnest in 1936.

Over the next years the global gold standard collapsed. Much of the British Empire had followed Britain's lead. The most decisive moment came when Roosevelt took the US off gold and rejected the World Economic Conference's attempt at restoration, often wrongly and misleadingly portrayed as an ignorant or regressive action. The final episode comes with Leon Blum's Front Populaire taking France off gold, adopting currency management and nationalising the Banque de France – bastion of hereditary privilege and power. The UK and US provided exchange support to France under the 'tripartite agreement' of 1936, which was quickly extended to other countries. In the meantime Roosevelt had wrested control of the Federal Reserve from financial interest, implemented banking reforms of a radical character, was pursuing cheap money even more vigorously than in the UK, and was implementing an unprecedentedly large-scale fiscal stimulus through the 'New Deal'.

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[3] The Macmillan Inquiry on Finance and Industry was set up by the 1929 Labour government under pressure from the Trade Unions. It included representation from across society: academia, trade unions, industry, charities, banking and government.

[4] http://hansard.millbanksystems.com/commons/1932/jun/30/me-chamberlains-statement

While the 1930s are portrayed as a dark age of nationalism and protectionism, the developments in international finance were radical and progressive and permitted the world economy to begin decisively to recover from the great depression. Hjalmar Horace Greeley Schacht – head of the Reichsbank in the 1920s and then economic policy supremo in Nazi Germany – refused to engage. Germany *was* on a regressive course, fiscal expansion notwithstanding.

Permitted by Churchill a near free reign in the Treasury, Keynes dictated the financial conduct of the UK's Second World War. At the April/May 1945 National Debt Enquiry (NDE) he set out proposals for post-war debt management and monetary policies. These were based on the processes that had operated successfully to hold the long-term rate 3 per cent throughout the War, not least the 'tap issue' and 'Treasury deposit receipts' (discussed below). The formal report of the NDE was written by the most senior official in the Treasury.

In his 1940 *How to Pay for the War (CW IX*, 367-439*)*, Keynes had proposed a deferred tax scheme to contain inflationary pressures as war spending increased. This led to the official preparation of National Accounts and brought the macroeconomic dimension to the annual HM Treasury budget process that continues today. He devised his clearing union (urged on by Roosevelt) as a means to financing international trade, underpinned by a new (notional) international money of account ('bancor'). This scheme for a global financial architecture that gave preferential position to no country was published as a UK government White Paper. For an all-too-brief moment, Keynes was the dominant force in UK economic policymaking.

3. Theoretical framework

When Keynes wrote his *General Theory* he was (unsurprisingly given the timing, though perhaps unconsciously) preoccupied with refuting the totalitarian response to the great depression. Every practical work of economics must inevitably be so constrained, and reflects (usually unspoken) strategic decisions about how best to present arguments in a specific political and economic context. His target was academic economics thinking and professional economists. Explaining the surprising decision to devote little space to the cause of the great depression, he was concerned to show that the market approach to economic activity was not inherently flawed but had been failed by economic thinking. Given correct thinking and revised policy and institutional arrangements, high unemployment and severe instability should not be the norm. The macroeconomic system was not inherently flawed.

The specific failure of thinking was to ignore the monetary nature of economic activity. His *Treatise of Money* (1930) has been his first full attempt at such a theory and included a formal and highly regarded (still) analysis of the nature of credit and money; this followed his earlier practical efforts – *Indian Currency and Finance* (1913) and *A Tract on Monetary Reform* (1923). The *General Theory* then reflected a fundamental insight that the key action in a monetary economy was around the rate of interest. In *The Listener* magazine of 21 November 1934, just over a year before the publication of the *General Theory*, he wrote:

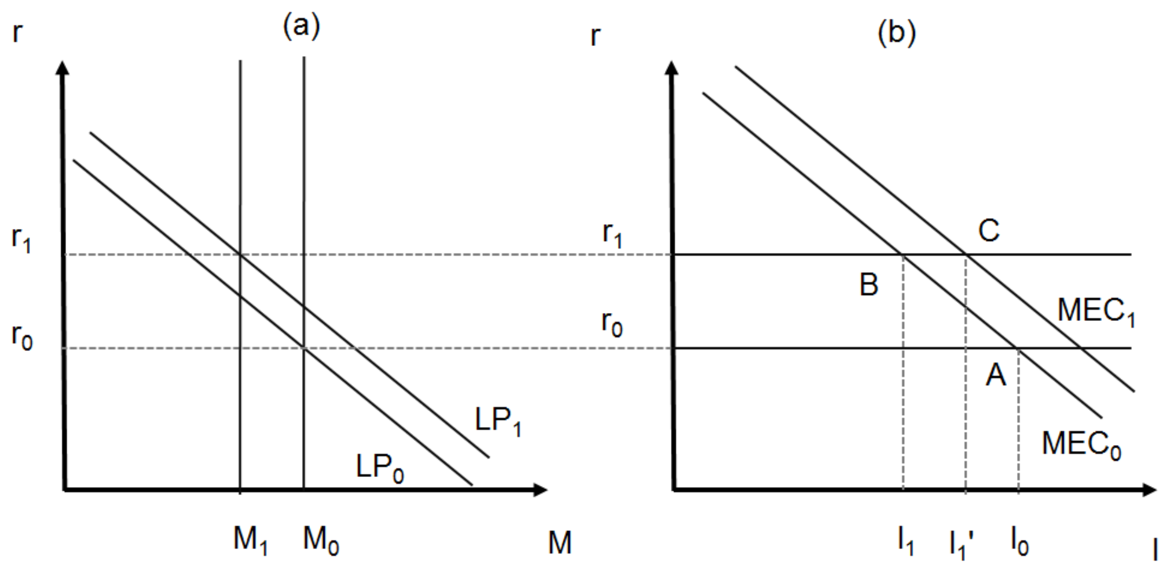
> There is, I am convinced, a fatal flaw in that part of the orthodox reasoning which deals with the theory of what determines the level of effective demand and the volume of aggregate employment; the flaw being largely due to the failure of the classical doctrine to develop a satisfactory theory of the rate of interest. (*CW* XIII, p. 489)

Keynes deconstructed the classical doctrine, and instead based the *General Theory* on three 'psychological propensities':

- liquidity preference;
- marginal efficiency of capital; and
- marginal propensity to consume.

Diagrammatically the single system of the conventional theory is split into separate but related theories of interest and investment, akin to two models of supply and demand.

Diagram 1: Keynes's theory of interest and investment



According to the *General Theory* the rate of interest was not a real but a monetary phenomenon, arising from a theory of money as a store of value. The relevant considerations were the state of liquidity preference and the supply of liquid instruments in which *wealth* (a stock not a flow) could be held. The long-term rate of interest was set according to the schedule of liquidity preference (LP) and the supply of money.[5]

[5] The latter needs very careful analysis, bearing in mind especially the distinction between money as a means of exchange and money as a store of value. As Chick (1983) has emphasised, store of value considerations come into effect after, and are generally analytically distinct from, means of exchange – and hence credit-creation – considerations. The emphasis In the *General Theory* was on former, with the latter taken for granted (see the Preface, *CW* VII, p. xxii). Those (even some post-Keynesians) that argue the *General Theory* neglects credit have done incalculable harm to the restoration of his ideas.

The liquidity preference schedule was based on investors' expectations of the rate of interest into the future, which Keynes understood as being subject to uncertainty rather than risk (Chick, 1983, Chapter 10, gives a full account). His theory explained how policymakers could manipulate expectations – and hence shift the schedule of liquidity preference – using debt-management policy to set rates of interest across the spectrum.

This is not the place for a full discussion, but the basic principle is very straightforward. If the government chooses to set the quantity of various debt instruments, the public sets the price. The conventional preference is for all public borrowing to be on long-term instruments, which Keynes referred to as the 'funding complex'. But the government can set the price if it allows the public to set quantity. From 1941, under the 'tap issue' process, the government offered debt instruments according to the maturities that the public preferred to hold (Tily, 2010, chapter 7, contains a fuller discussion). The procedure also meant accommodating the public's preference for short-term instruments (or the 'floating debt'), i.e. Treasury bills, the relevant supply of money in this application of the theory of liquidity preference. The Treasury also devised Treasury deposit receipts (TDRs) as an extension to the floating debt: these offered a marginally higher rate of interest at a longer maturity (six months), but were not discountable at the central bank and so broke the potentially inflationary link between private credit creation and the floating debt.

The potential control of the long-term rate of interest on government borrowing, and hence of the wider condition of interest (given normal margins for risk), was the essential monetary conclusion of the General Theory. The theory was vindicated by its success in practice.

Under Keynes's theory of investment, the amount of investment carried out by firms then depends on the marginal efficiency of capital (MEC) schedule and the rate of interest that the same firms face in capital markets. The MEC schedule reflects entrepreneurs' expectation of the rates of return on undertaking capital expenditure.6 At the start of any period, firms assess the likely returns on various amounts of capital expenditure and will implement investment according to the interaction between this assessment (their MEC schedule) and the rate of interest. As with market expectations of the future rate of interest, the yield on investment is uncertain:

> The considerations upon which expectations of prospective yields are based are partly existing facts which we can assume to be known more or less for certain, and partly future events which can only be forecasted with more or less confidence. (*CW* VII, p. 147)

The aggregate MEC schedule is hence dependent on the state of expectation about the future and shifts following changes in that state. 'Animal spirits' then reflected Keynes's further insight that firms' estimates of the yields of investment will periodically be subject to either excessive optimism or excessive pessimism.

[6] "More precisely, I define the marginal efficiency of capital as being equal to that rate of discount which would make the present value of the series of annuities given by the returns expected from the capital-asset during its life just equal to its supply price" (*CW* VII, p. 135).

The theory leads to a unique outcome: the MEC is a demand schedule for investment that is set against a (notional) endogenous supply of funds at 'the' rate of interest (Diagram 1, b).[7] In both the *General Theory* as well as the mainstream theory, a lower rate of interest (normally) means a higher level of investment.

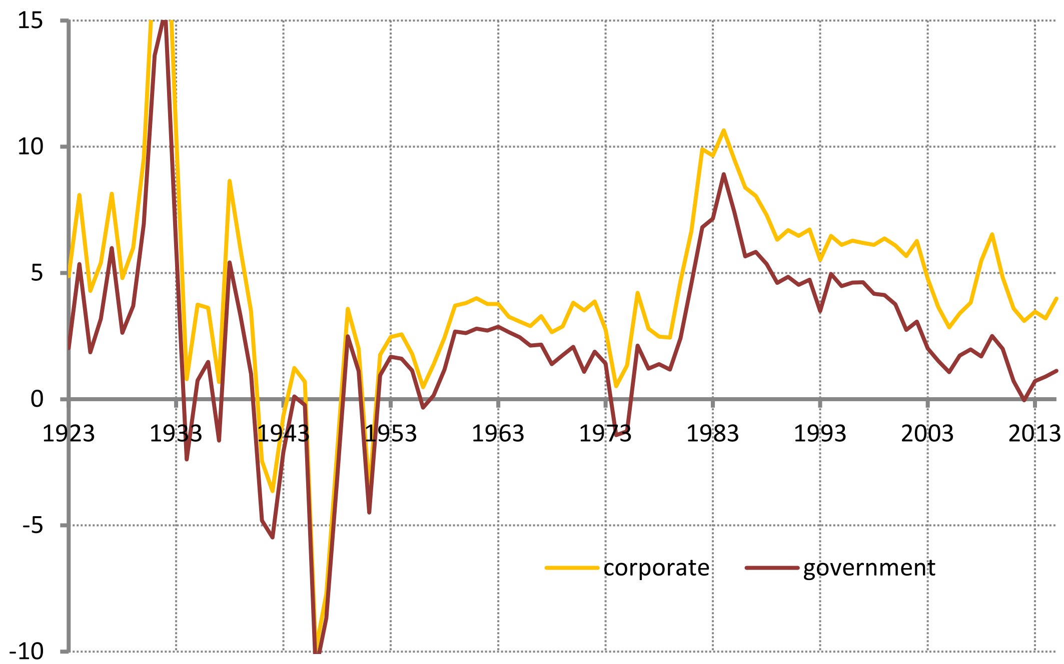
As is well known, aggregate demand then depends on the marginal propensity to consume (mpc). The follows through the multiplier relation, with variables obviously defined:

$$\Delta Y = \quad 1 / (1 – c) \Delta I$$

While the conditions of supply might affect outcomes, normally output and employment follow from demand.

The long-term rate of interest is therefore critical to economic outcomes through private investment (government does not feature in this central part of his theory). Chart 1 shows an assessment of the underlying condition of (real) interest for corporates and government throughout the past century.[8] These are US figures, but the corporate rate is likely to underpin the rate of interest for the private sector throughout the world.

Chart 2: US real interest rates



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[7] In effect there is an exogenous supply of money as a store of value and a notional endogenous supply of money as a means of exchange. Note that while the latter situation is the norm, it does not hold under all conditions, as present events indicate.

[8] Interest rate data are not readily available for many countries: the US is the exception, with long-run figures available from the Federal Reserve website, which are supplemented with Sidney Homer's *A History of Interest Rates*. Government figures are based on Treasury 10 -year bonds and corporate on BAA corporate bonds. The GDP deflator is used for price adjustment, with Bureau of Economic Analysis figures supplemented with historical information from Friedman's monetary history.

My central contention is that for the quarter of a century after the war the prosperity of the global economy (the 'golden age') was underpinned by cheap money. On diagram 1, conditions corresponded to point A. Under financial globalization, dear money was restored and the global economy shifted first to B, a brutal slump, and then to C, unsustainable excess. The excess began to unravel from 1998, but the most seismic events came after the financial crisis of 2007.

4. Compromise: post-war 'bastard golden age'[9]

The post-war Labour government set out with monetary and debt management policy faithful to Keynes's approach: initially Chancellor Hugh Dalton pursued the recommendations of the NDE. The 1946 nationalisation of the Bank of England reflected the formal repositioning of finance under public authority – as 'servant not master' in Labour's language.

However the pace of reduction of the long-term rate of interest was forced, and both TDRs and the tap issue process were discontinued. As a result, Labour lost the full control of the long rate that had been achieved in the Second World War. The Governor (Cobbold) used inflationary pressures resulting from the Korean War to agitate for a renewal of Bank rate policy, and refused to use quantitative controls on bank credit. Faithful to Keynes's doctrine, Labour used fiscal rather than monetary policy to restrain demand and paid the ultimate price of electoral defeat at the October 1951 General Election.

Under the Conservatives, conventional monetary policy through Bank rate was restored. This followed the US leading the way with the Treasury–Federal Reserve Accord of March 1951. The Keynes position was reversed: through to 1974 fiscal policy was repeatedly used to counter contractionary pressures from monetary policy. The monetary conservatism was continued under the next Labour government, notably with Harold Wilson's refusal to devalue.

Exchange rate crises were a constant theme, and followed an international arrangement at odds with Keynes's ideas. His clearing union scheme was rejected; rather than a system that favoured no single country, under the Bretton Woods Agreement, and shortly afterwards through the conditions for Marshall Aid, the US were able to call the shots.

The assessment must be negative on the basis of Keynes's explicit practical intentions and initiatives. Nonetheless policy operated so that aggregate demand was unprecedentedly vigorous. The average UK unemployment rate between 1947 and 1975 was just over 2 per cent. On the basis of the *General Theory*, this was above all a result of the cheap money that prevailed. This was likely a global factor, facilitated by capital control (the saving grace of the

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[9] Richard Kahn's phrase: 'The possibility of a Bastard Golden Age turns on the absence of any progressive tendency towards the easing of the state of finance, and, more particularly, towards a lowering of rates of interest and of yields on ordinary shares' (Kahn, 1972, p. 201).

international architecture). A higher level of government spending was obviously also important, facilitated in part by the strength of private activity (government debt fell by an average of 7 per cent of GDP each year)[10]. The Table below extracted from the Office for National Statistics shows the average annual growth of capital expenditure (GFCF) was more outstanding figure than government expenditure (GGFCE), not least relative to later experience.

Table 3: GDP expenditure components, 2013 prices, average annual per cent growth

	household	investment	government	exports	imports	GDP
1950-59	2.2	8.9	1.3	2.2	3.1	2.8
1960-69	2.2	4.9	2.2	4.5	3.7	2.8
1970-79	2.4	1.7	2.3	4.7	4.0	2.3
1980-89	3.6	4.4	0.6	3.2	5.5	2.9
1990-99	2.6	0.5	1.3	4.9	5.1	2.0
2000-09	1.8	-0.4	2.5	2.2	2.3	1.4
2010-15	1.4	3.7	1.0	3.2	3.9	2.0
average	2.5	3.5	1.8	3.9	4.3	2.5

Source: ONS and author calculations

Apart from macroeconomic considerations, the golden age saw also great social and creative advance. It is to undermine wholly Keynes's legacy by attributing these gains to fortunate supply-side conditions, and all too common.

5. Rupture: liberalisation and inflation

The inflationary crises of the 1970s were a result of increasingly more extreme departures from Keynes's doctrine. As above, Keynes's monetary policies were rapidly and completely dismantled. Expansionary fiscal policy was used as a counter-weight to increasingly contractionary monetary policy.

Moreover, gradually (and led by the US), policy was oriented towards growth and away from full employment. The approach was most obviously formalised in November 1961, when, almost immediately after its creation, the OECD announced a *fifty per cent growth target* for the 1960s as a whole. Almost in exact parallel the UK Conservative Government set up the National Economic Development Council (NEDC). By February 1963 the NEDC had approved a four per cent annual growth target, arithmetically virtually identical to 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

[10] Chick, Pettifor and Tily (2010), Table 3I.4.

September 1961, two months before the growth target was announced. Keynes's theoretical scheme has no place for the notion of growth as a (relatively stable) derivative of a continuous function; nor is it obvious in the light of experience that such a notion is a meaningful or valid way to interpret changes in the size of economies over time.

In theoretical terms, the arithmetic of decomposing 'growth' into productivity and changes in labour input, and the associated link to wages, became the fundamental vocabulary of economic policy. This decomposition is regarded as a 'truism' to which policymakers still yield today.

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; chasing growth was about supply and led to reckless expansion. Prosperity and (near) 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.

From the late 1960s, UK policymakers began to liberalise domestic banking. In particular in 1971 the Bank of England introduced the 'competition and credit control' regime, later denigrated as 'all competition and no control'. Lastly the conservative government under Edward Heath implemented extremely expansionary policies that led to the 'Barber boom' (named after Heath's Chancellor).

Along with Keynes, British Trade Unions have carried the blame for the inevitable inflationary consequences of these reckless expansionary actions. Maybe their approach was not ideal, but the extreme conditions were not of their making and their actions were symptom not cause. Nonetheless, regardless of reality, full financial globalization began.

6. Dislocation: financial globalisation

Again, my reading of the *General Theory* suggests that the most important feature of the past four decades has been a sustained increase in the long-term rate of interest. From 1979 Keynes's monetary policies were effectively operated in reverse. Capital controls were removed; Bank rate was increased with unprecedented aggression, and debt management policy restored the 'funding complex' through the 'overfunding' of long-term government debt (i.e. overall issuing more debt than was needed to support fiscal policy) and correspondingly reducing greatly the issue of Treasury bills.

Higher interest meant lower investment, lower employment and higher unemployment (Diagram 1: position B). Initially, as with the 'Volker shock' in the US, the impact on unemployment was brutal. But the consequences of dear money went way beyond this initial (and sustained) increase. On Diagram 1 (b), the effect of a dear rate of interest can be partly compensated by a rightwards shift in the MEC – so that optimism about investment yields (temporarily) triumphs over a monetary environment at odds with private activity.

For Keynes this variant was deeply dangerous and ultimately unsustainable – the intuition is very straightforward. There is a confusion that dear money restrains lending – the real problem is that it doesn't. Dear money reduces the probability of repayment: as it is far easier to earn a low rather than a high rate of interest. Dear money will restrain investment for some firms. But others will become excessively optimistic about the prospects for future income. They will be disappointed, borrowing at too high rates for projects that will not yield the expected incomes. But they will not immediately go bust; first they will engage in distress borrowing. Such actions are obviously destined to fail. 'Debt inflation' – with aggregate liabilities increasingly out of line with incomes – reflects the outcome of these processes on a systemic basis. Unsustainable by definition, the situation must end in severe collapse.

Keynes's theory was centred on corporate investment, reflecting his understanding of the great depression. I regard corporate fragilities as the original cause of the processes that led to financial collapse in 2007, even though it is usually downplayed. This process of excess investment unfolded especially over the 1990s. The corporate expansion known as 'dot.com' or 'new economy', was accompanied by rapid debt and asset inflations. These excesses were ignored as financial markets and commentators (inevitably) endorsed the economic gains as permanent.

The process came to an end almost exactly coincidently with the turn of the millennium. This can be seen in capital investment data, but it is seen even more clearly in financial market data. For example the UK FTSE100 has never materially exceeded the 7000 peak it reached in December 1999.

After the collapse of dot.com, there were further purely speculative phases over the 2000s: residential and commercial property inflations, consumer credit and a vast expansion of complex (ish) financial instruments (not least those linked to default on corporate lending). Each of these were fostered and supported by continued extensions to the liberalisation of finance. All had in common borrowing on the basis of future expectations that could not be met. And it all ended in the financial crisis which strictly began in August 2007, and of which the housing expansion and Lehman Bros collapse were symptoms not cause.

Chart 4: Corporate liabilities, % GDP[11]

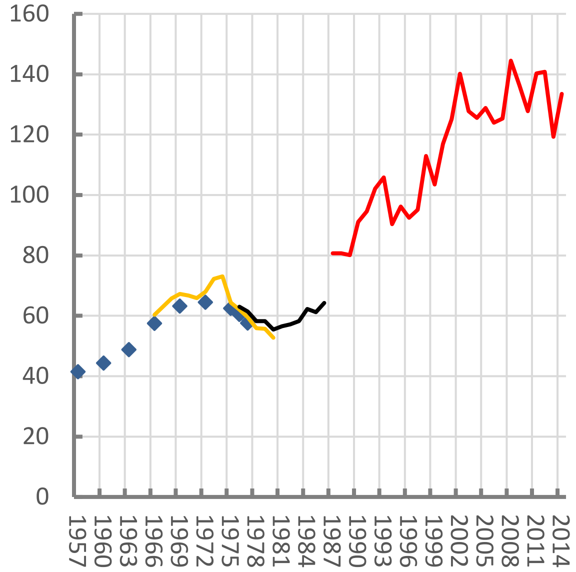
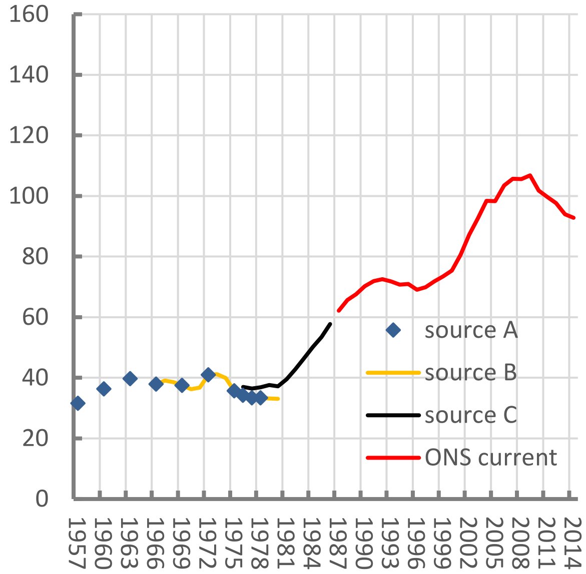


Chart 5: Household liabilities, % GDP



These phases can be seen in indebtedness figures: firms' debt rising through to start of 00s (chart 4), and a little deleveraging; then households taking up the reins (chart 5). And finally, when the global economy collapsed, government and central banks were required to take up the slack. We arrive basically in the present.

7. Defiance: finance and the crises of financial globalization

Keynes's theory also exposed the nature of fault lines between competing economic interests. In contrast to Marx, on the basis of the *General Theory*, Labour and Industry had common interests that were opposed by those of finance.

The 1920s were much more than the failure of a technically flawed financial architecture. The Versailles conference had ensured financial interests were dominant in the construction of the post-war economic arrangements. The central initiatives are wholly familiar today:

- reconstitution or setting up of central banks as independent of political authority, but with private/international financial interests heavily represented in governing structures;
- a restoration of the gold standard system and free movement of international capital;
- aiming of monetary and debt management policy at dear money; and
- tight restraints on government expenditure.

Just like the 1980s, dear money led to extreme instability and imbalance. While Britain endured a decade of stagnation, in Germany (and other central powers) and the United

[11] The different sources correspond to different vintages of ONS data restored by Thomas and Nolan (2016).

States, unparalleled excess gave way to catastrophic collapse. The Great Depression was the first international crisis of financial globalisation.

Keynes's diagnosis was swift in coming:

> I am writing these concluding lines in the midst of the world-wide slump of 1930 … Thus I am lured on to the rash course of giving an opinion on contemporary events which are too near to be visible distinctly; namely, my view of the root causes of what has happened, which is as follows. The most striking change in the investment factors of the post-war world compared with the pre-war world is to be found in the high level of the market-rate of interest. (*CW* VI, p 377)

As discussed in section 2, the authorities, first in Britain and then in the United States, were swift to use this diagnosis as the foundation of an alternative system. Finance was brought to heel. In the US, the Pecora Commission brought leading figures from the financial sector to account in the full gaze of the public. Few could have been in any doubt that the interests of finance were at odds with those of society as a whole.

But this set back was only temporary. After the war, finance slowly but surely re-asserted itself. When it came, the second financial globalization conformed in great part to the first. Obviously the gold standard was dead and buried, but the system has been the same in practical effect. In particular, interest rates have reverted to the same level as the 1920s (uncannily so – Chart 2). It is unsurprising that undoing policies put in place as a result of the great depression and reverting to the arrangement that preceded the great depression has led to a crisis that has no precedent since the great depression. Events have gone full circle to the point when Keynes was about to take over, but no further. This time, Britain has not 'left the gold standard'.

The most striking and dispiriting feature of this, the current and ongoing phase, has been the resilience of financial authority and the timidity of political initiative.

In the 1930s there was a genuinely open debate, drawing on a wide range of opinion that was exemplified in Britain by the Macmillan Committee. And there was genuine action – in the UK by a predominantly conservative administration.

My sense is that this time, chastened by the experience of the 1930s, finance got its retaliation in first. Finance dictated its own rescue through the large-scale deployment of government and central bank resources. With crisis arrested – at least in the banking system –austerity policies were demanded. These policies have restrained and stymied political initiative ever since. There has been severe social damage, and in the UK the rhetoric around cuts (not least the fallacious household budget analogy) has greatly confused the democratic process.[12] In some countries the scale of austerity is still beyond belief.

[12] On 15 July 2016 the *Financial Times* reported Rupert Harrison – George Osborne's key economic adviser in the coalition parliament – admitting: "the rhetoric of the cuts was always worse than the reality in order to gain public support".

The extent of fiscal restraint has, however, meant an ongoing requirement for monetary ease. There is a casual disregard – even denial – among policymakers about the extent to which the global system is now reliant on the creation of central bank reserves on a scale surely never before known in history.

To my mind it is highly unlikely that this status quo can endure indefinitely. Underlying fragilities have not gone away. Most obviously aggregate indebtedness remains as elevated as ever. In February 2015 McKinsey observed:

> **Seven years after** the bursting of a global credit bubble resulted in the worst financial crisis since the Great Depression, debt continues to grow. In fact, rather than reducing indebtedness, or deleveraging, all major economies today have higher levels of borrowing relative to GDP than they did in 2007.[13]

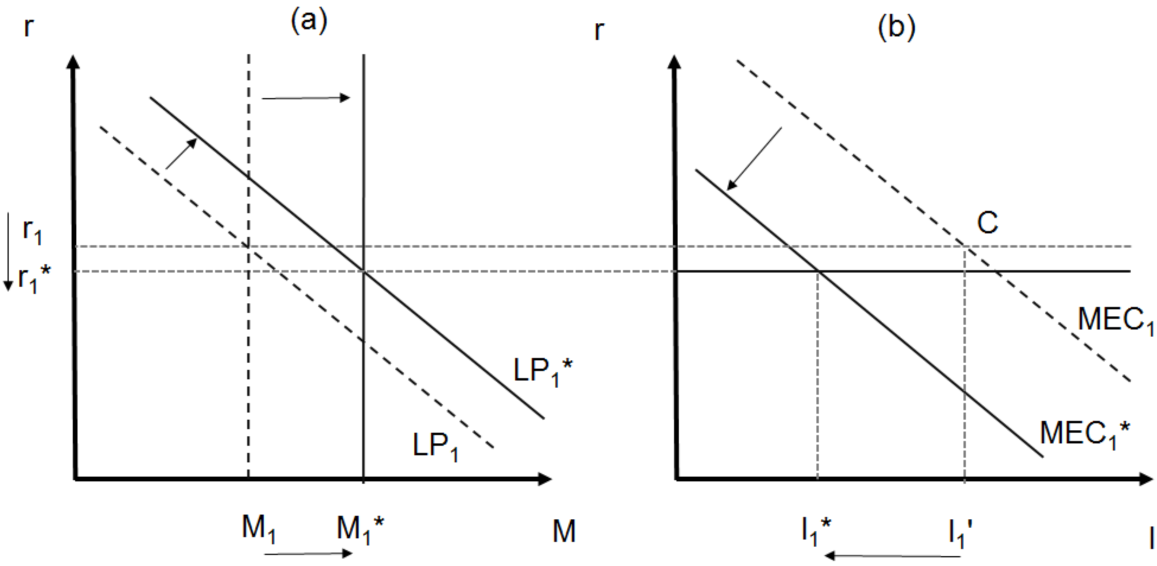
In parallel quantitative easing has ensured that asset prices remain severely inflated, perhaps protecting vulnerable balance sheets across the corporate sector. But these actions have not prevented output stagnating and a continuous price disinflation, with many countries flirting with outright deflation (at zero per cent in 2015, calendar year CPI inflation in the UK was last lower in 1933). And deflation is a reality in certain industries, e.g. steel and oil.

Some policymakers may be slowly backtracking from the most harmful initiatives. But there has been no recognition of the scale of the failure of post-2010 policy. Most obviously, as was obvious on a Keynes view, cutting spending growth has hit the economy harder than policymakers expected and so the public debt ratio has not been reduced.

The current situation may be extremely bleak, but Keynes still offers a means to its resolution. Diagram 6 shows the position in terms of the earlier theoretical framework, starting from point C – the excessive expansion.

[13] http://www.mckinsey.com/insights/economic_studies/debt_and_not_much_deleveraging

Diagram 6: The post-crash environment



A significant increase in liquidity preference (probably since the collapse of the Black-Scholes advised Long-Term Capital Management in 1998) has been counteracted by repeated increases in the supply of money, most recently from central banks. But any reduction to the rate of interest has been more than offset by a collapse in the MEC, so that private investment has stagnated. Jobs growth has been supported only by an unprecedented decline in real wages. Policymakers await a supply-side revival that repeatedly never comes.

On my reading this ongoing failure is once more at root a failure of economic thinking, though with financial interests looming very large. The solution is to move forward as in the 1930s. There is no a priori reason that position A on Diagram 1 is any more implausible today than it was then and through the post-war age. If correct, this is a conclusion of the most immense implication for society and the economy.

8. Concluding remarks

At the end of the third chapter of the *General Theory*, Keynes wrote:

> The completeness of the Ricardian victory is something of a curiosity and a mystery. It must have been due to a complex of suitabilities in the doctrine to the environment into which it was projected. That it reached conclusions quite different from what the ordinary uninstructed person would expect, added, I suppose, to its intellectual prestige. That its teaching, translated into practice, was austere and often unpalatable, lent it virtue. That it was adapted to carry a vast and consistent logical superstructure, gave it beauty. That it could explain much social injustice and apparent cruelty as an inevitable incident in the scheme of progress, and the attempt to change such things as likely on the whole to do more harm than good, commended it to authority. That it afforded a measure of justification to the free activities of the

individual capitalist, attracted to it the support of the dominant social force behind authority.

> But although the doctrine itself has remained unquestioned by orthodox economists up to a late date, its signal failure for purposes of scientific prediction has greatly impaired, in the course of time, the prestige of its practitioners. For professional economists, after Malthus, were apparently unmoved by the lack of correspondence between the results of their theory and the facts of observation; – a discrepancy which the ordinary man has not failed to observe, with the result of his growing unwillingness to accord to economists that measure of respect which he gives to other groups of scientists whose theoretical results are confirmed by observation when they are applied to the facts.
>
> The celebrated *optimism* of traditional economic theory, which has led to economists being looked upon as Candides, who, having left this world for the cultivation of their gardens, teach that all is for the best in the best of all possible worlds provided we will let well alone, is also to be traced, I think, to their having neglected to take account of the drag on prosperity which can be exercised by an insufficiency of effective demand. For there would obviously be a natural tendency towards the optimum employment of resources in a Society which was functioning after the manner of the classical postulates. It may well be that the classical theory represents the way in which we should like our Economy to behave. But to assume that it actually does so is to assume our difficulties away.
>
> Keynes, 1936, Chapter 3, Section III.

Nothing has changed. The economics profession has offered only a prescription of restraint for a diagnosis of 'living beyond means'. 'Macroprudential' regulation aims at monetary restraint (though sits uneasily with the scale of QE), and fiscal consolidation ensures fiscal restraint. Even those who dissent, do so only around the timing and extent of fiscal restraint. Steadily lower interest rates on government debt are regarded as a consequence of the progressively more dismal performance of the world economy, and an indicator of continued stagnation into the future (rather than reflecting overlapping considerations of risk, liquidity preference and money supply). Everything is understood on a supply view, largely outside the reach of macroeconomic policy. Most creativity is devoted to devising future threats (robotics, aging population) rather than resolving existing problems.

But there are small fractures. The IMF (2016) has published a bold critique of free capital flows and the small state. Elsewhere there is growing support for action on infrastructure spending, and there is even talk of industrial strategy. Policymakers are unanimous in deploring extreme inequalities of income and wealth, having only a few years ago insisted their necessity for growth. But insofar as there is any coherent logic, the critique is only of the market failure type.

Keynes was motivated by the failure of theory exposed by the great depression to devise an alternative theory that was fit for purpose and led to specific policy conclusions and actions.

These were wholly the reverse of the mainstream approach. The economy had not been living beyond its means, only beyond the means of a dysfunctional financial system. A monetary economy could be made to operate in a genuinely optimal manner, rather than the phoney optimal manner of the Candides.

Finally, Keynes saw his theory as the barricade to the totalitarian response to the same events. This meant the most profound reordering of competing economic interests, which had begun before the war. The scale of these reforms to finance and the changed role of the state in Roosevelt's US, Blum's France and the UK/British Empire were unprecedented. But the world – led by the United States – emerged from the Second World War unwilling to go as far as Keynes had envisaged. The 'bastard golden age' was a compromise. Ultimately 'Keynesian' economics was servant to this compromise. Thomas Balogh (Oxford academic and adviser to the Harold Wilson) is one of the few who have spoken relatively frankly on this:

> Now, no doubt, Keynes and his most intimate colleagues began by creating an open-ended system very different from the mechanical excellence of the old determinate 'science'. But its development and application would have implied an historical and sociological approach to the unique sequences of economic development. This the profession was fiercely unwilling to undertake.
>
> Instead a new theoretical edifice was erected which could be reconnected to the neo-classical theory of harmony and just shares in the distribution of income ...
>
> The 'Keynesian' Revolution gained acceptance because ultimately it was, after its formalisation, deeply conservative in character. (Balogh, 1976, pp. 83–4)

Even in spite of the best efforts of more than one generation of post-Keynesian economists, Keynes's 'open-ended system' is lost to society. All that remains are various sets of simultaneous equations that owe nothing to the *General Theory* and offer only the trivial idea that governments might spend when the private sector does not.[14] Really, the extent of the distortion of Keynes's life's work is beyond belief.

In spite of another catastrophic failure of theory revealed by the 2007-8 financial crisis, the economics profession resists meaningful reform. There is a refusal (including in the economics department of Cambridge University) to consider whether there has been a failure to understand what Keynes really said, let alone that it might be important.

In the meantime intensifying economic hardship has meant malign political forces have growing momentum. In the 1930s, Keynes's barricades were successfully erected in the US and UK and across much of the world outside Europe. This time there are no barricades, anywhere. Truly, it is as if Keynes never lived.

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[14] But even this is incorrectly described as 'deficit spending', and debates around financial mechanisms are seriously confused.

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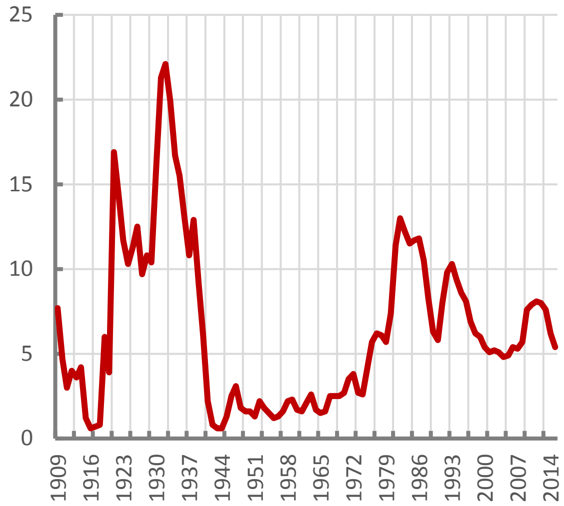
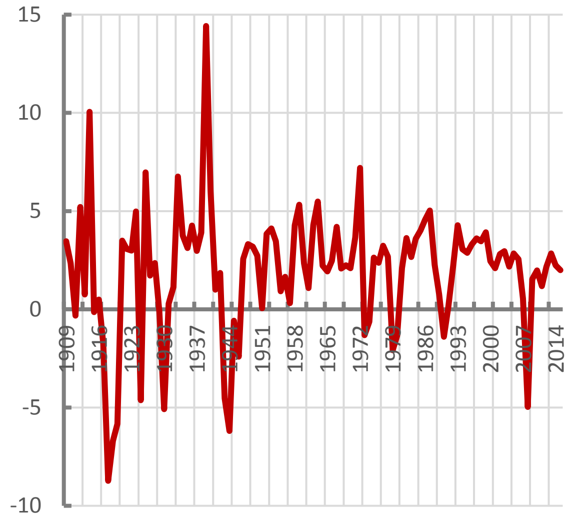
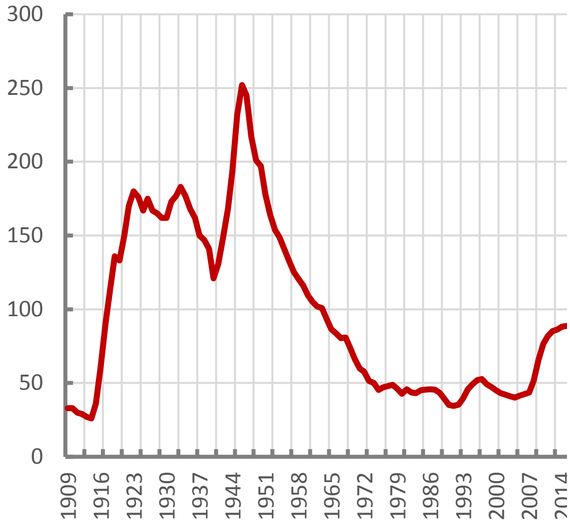
A. Unemployment rate, per cent



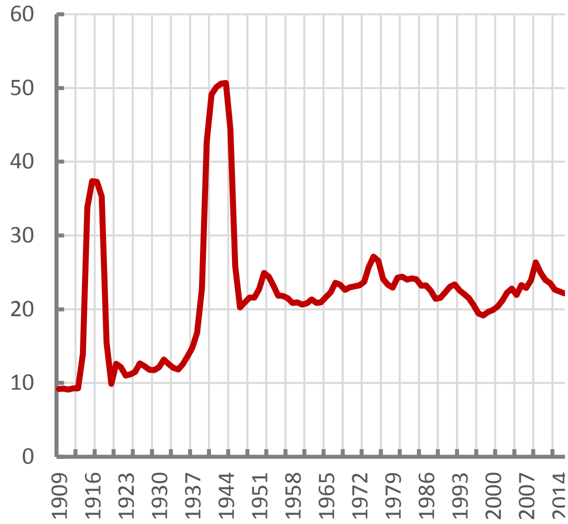
B. Real GDP growth per cent



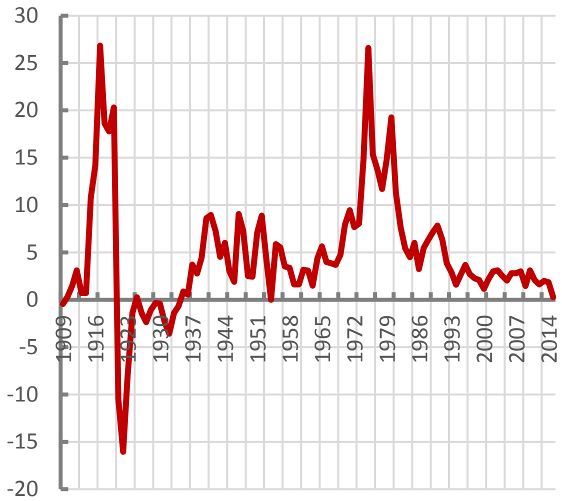
C. Public debt, % GDP



D. Government spending, % GDP



E. GDP deflator growth, per cent



F. Interest rate on government bonds

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