Keynes on Global Economic Integration

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Abstract

Keynes’s vision of how to reorganize the world’s financial system after World War II was rooted in his longstanding effort to understand both the strengths and weaknesses of the pre-1914 era of globalization under the gold standard. (JEL B31)

The Lost Paradise of Pre-1914 Internationalization

“What an extraordinary episode in the economic progress of man that age was which came to an end in August 1914!” exclaimed Maynard Keynes [1919, pp. 10–12] in a famous passage.

The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend. He could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality, could dispatch his servant to the neighboring office of a bank for such supply of the precious metals as might seem convenient, and could then proceed abroad to foreign quarters, without knowledge of their religion, language, or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference. . . . The projects and politics of militarism and imperialism, of racial and cultural rivalries, of monopolies, restrictions, and exclusions, which were to play the serpent to this paradise, were little more than the amusements of his daily newspaper, and appeared to exercise almost no influence at all on the ordinary course of social and economic life, the internationalization of which was nearly complete in practice. [Keynes, 1919, pp. 10–12].

Kevin O’Rourke and Jeffrey Williamson [1999] trace the history of the growing global, and especially trans-Atlantic, mobility of goods, capital, and labor from the Napoleonic Wars to the First World War, while Harold James [2001] recounts the downfall of this
wave of globalization between the two world wars. Keynes became an economist, and published his first book, in that world, and the memory of that Belle Époque shaped his thinking in times of world war and reconstruction, hyperinflation, and depression.

Although The General Theory [Keynes, 1936] deals with a closed economy, much of Keynes’s career was devoted to open-economy macroeconomics, to understanding the exceptional episode of la Belle Époque, and to devising institutions to regain its international cooperation and liberalized trade while protecting the autonomy of domestic macroeconomic stabilization. Indian Currency and Finance [Keynes, 1913] explored the working of the gold-exchange standard and the need for a reserve bank to manage India’s participation in it; The Economic Consequences of the Peace [Keynes, 1919] argued that the transfer problem made the reparations clauses of the Versailles Peace Treaty unworkable; A Tract on Monetary Reform [Keynes, 1923] exposed the social costs of hyperinflation, discussed inflation as a tax on holding money and government bonds, and analyzed covered interest arbitrage in the forward market for foreign exchange in the resulting world of floating exchange rates [Dimand, 1988]; and The Economic Consequences of Mr. Churchill [Keynes, 1925] opposed Britain’s return to the gold standard at an overvalued parity that required prolonged unemployment to push sticky wages down by a 10th. These well-known polemics, and some less well-remembered episodes, shaped the mind of the future British negotiator at Bretton Woods, faced with the reconstruction of a replacement for the bygone pre-1914 global economy.

Doubts About Unfettered Foreign Lending and Borrowing

In the first of those lesser-known episodes, Keynes early discerned problems with the prewar flow of overseas lending. In August 1924, in an address to the Liberal Summer School published in The Nation and Athenaeum, Keynes [1924] raised the specter of sovereign risk and questioned, in a manner that would have been thought unorthodox before the war and caused some commotion even then, whether there was any national advantage from foreign lending:

No investments have ever been made so foolish and so disastrous as the loans of France to Russia, and on a lesser scale, to the Balkans, Austria, Mexico, and Brazil, between 1900 and 1914. They represented a great proportion of the national savings of the country, and nearly all has been lost. Indeed, it is probable that loans to foreign governments have turned out badly on balance—especially at the low rates of interest current before the war. The investor has no remedy—none whatever—against default. There is, on the part of most foreign countries, a strong tendency to default on the occasion of wars and revolutions and whenever the expectation of further loans no longer exceeds in amount the interest payable on the old ones.... Thus it is doubtful whether in the past loans to foreign governments and public utility undertakings have been really advantageous. Yet in the future the motives tending towards repudiation, partial or complete, may become much stronger..... In short, the nineteenth century, as in so many other respects, came to look on an arrangement as normal which was really most abnormal. To lend vast sums abroad for long periods of time without any possibility of legal redress if things go wrong, is a crazy construction; especially in return for a trifling extra interest. [Keynes, 1981, pp. 277–78].