Keynes on exchange rate systems:

Why is Europe in such a mess?

Tuesday, 22 October 2013

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1. Inspiration from Keynes's writings
2. Gold Standard substituted by international liquidity: Bancor, and international clearing union and a semi-adjustment mechanism
3. After 1973 two patterns emerged:

   a. More flexible exchange rates at the global scale (with exceptions) – semi-adjustment

   b. Rigid exchange rates – increased instability
4. Keynes's view vindicated

Gold standard vs. international currency union

Young Keynes,-1920s: Struggling with internal (price/wage level) and external monetary balance (Gold) and one or two instrument (monetary policy and exchange rate):

1.Tract on Monetary reform (1922)

2. ‘Economic Consequences of Mr. Churchill’, 1924

3. The End of the Gold Standard (1931) – we thought!

Mature Keynes,1930s-: Struggling with internal and external real imbalances – three instruments

4. International currency Union, 1940-42

The *General Theory* deviates on 3 accounts from his previous macroeconomics:

1. The impact of uncertainty on the dynamics of the macroeconomic system
2. Macroeconomic analysis relates to the ‘economy as a whole’. Talking about exchange rates and balance of payments it means the ‘international economic system as a whole’.
3. Finally, a realistic analysis of the ‘economy as a whole’ shall not be confined by a general equilibrium framework. Especially not, if the equilibrium is interpreted as equivalent to market clearing.

THE CLEARING BANK

The ostensible aim of the International Clearing Union was to secure creditor adjustment without renouncing debtor discipline. All residual

ICB's total overdraft facilities came, therefore, to half the value of pre-war international trade—\$26bn.[10] Each national currency would have a fixed, but adjustable relation to a unit of the ICB's bank money, itself expressed in terms of a unit of gold. Bank money, though, would be the ultimate reserve asset of the system.

Keynes sought to bring a simultaneous pressure on both creditor and debtor countries to 'clear' their accounts. Creditor countries would be allowed or required to revalue their currencies, unblock any foreign-owned investments, and be charged rising rates of interest (up to 10 per cent) on credits running above a quarter of their quota. Any credit balances exceeding quotas at the end of a year would be confiscated and transferred to a Reserve Fund. Debtor countries would be allowed or required to depreciate their currencies, to sell the ICB any free gold, and prohibit capital exports. They would also be charged interest (at lower rates) on excessive debits. A persistently profligate member could be expelled from the

ICB, Skidelsky, 2005, p. 18

Bretton Woods, 1944

International Clearing Union was by the BW agreement changed into: 1. IMF (conditional short term balance of payments loans – stabilization fund) and 2. World Bank (longer term loans for Structural adjustments)

American plan allowed for some quasi-automatic creditor accommodation, but retained the classical doctrine that it was, basically, up to deficit countries to 'put their houses in order', and access to the Fund's discretionary credit facilities would be conditional on their readiness to do this. This

The Bretton Woods system undermined

0. Working quite well in the 1950s

- But, US loosing strength in the 1960s
- No automatic current account clearing or adjustment
- Delayed exchange rate adjustments
- Increasing financial market speculation caused by international capital movements makes the system too rigid
- Dissolved 15. august 1971

Even UK joined the EMS in 1990, but

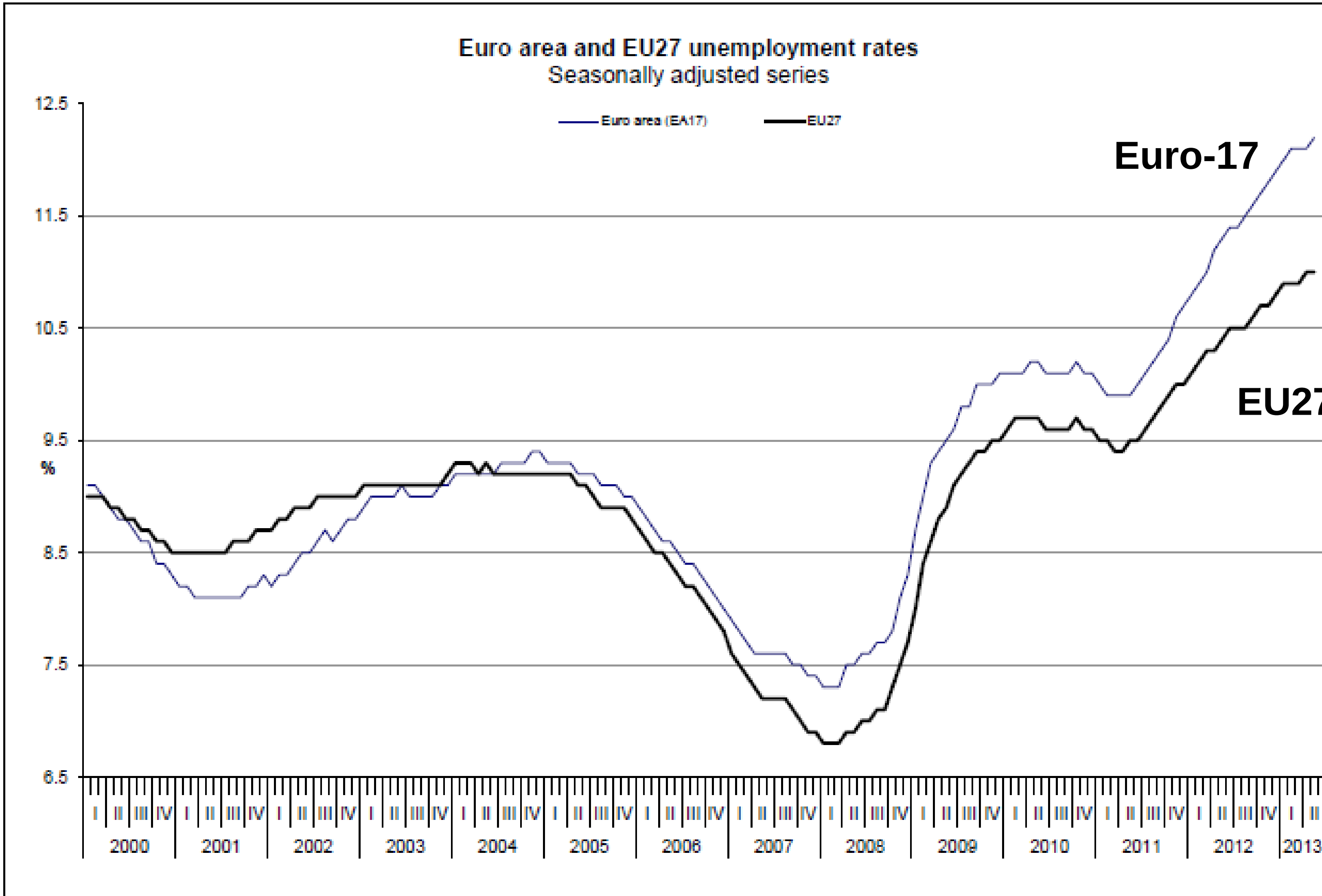
- shortly after in 1992 the weaknesses of the system was demonstrated.
- The removal of nearly any international capital control had made the amount of international liquidity without limit. UK, Italy, Sweden and Norway were speculated out the EMS within few months.
- The powers of the global financial system had been underestimated. Fixed exchange rates within a narrow band of fluctuation (+/- 2 ¼ percent) seemed to have ceased being workable without a strong economy and a credible political commitment.

- Only a common currency, a Monetary Union, could protect smaller national money from these speculative attacks – if capital control is ruled out!
- On the other hand, a Monetary Union can only work – that we know from the era of the Gold Standard – if the cost level in the traded goods industries in the participating countries is developing in parallel.
- If cost levels deviate substantially, the needed internal devaluations may have devastating social consequences.
- This is exactly where we stand right now look at the numbers.

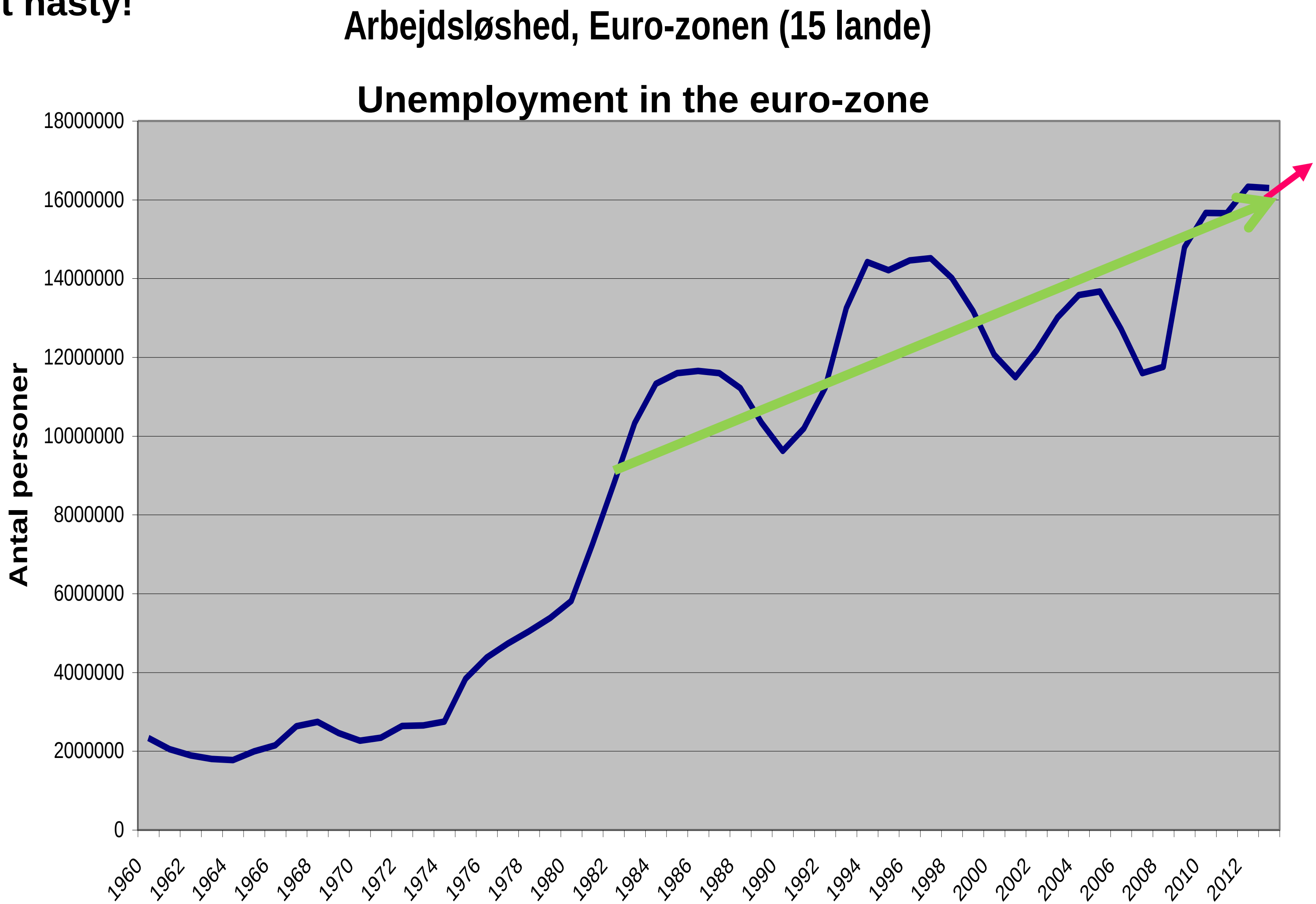
May 2013

Euro area unemployment rate at 12.2%

EU27 at 11.0%

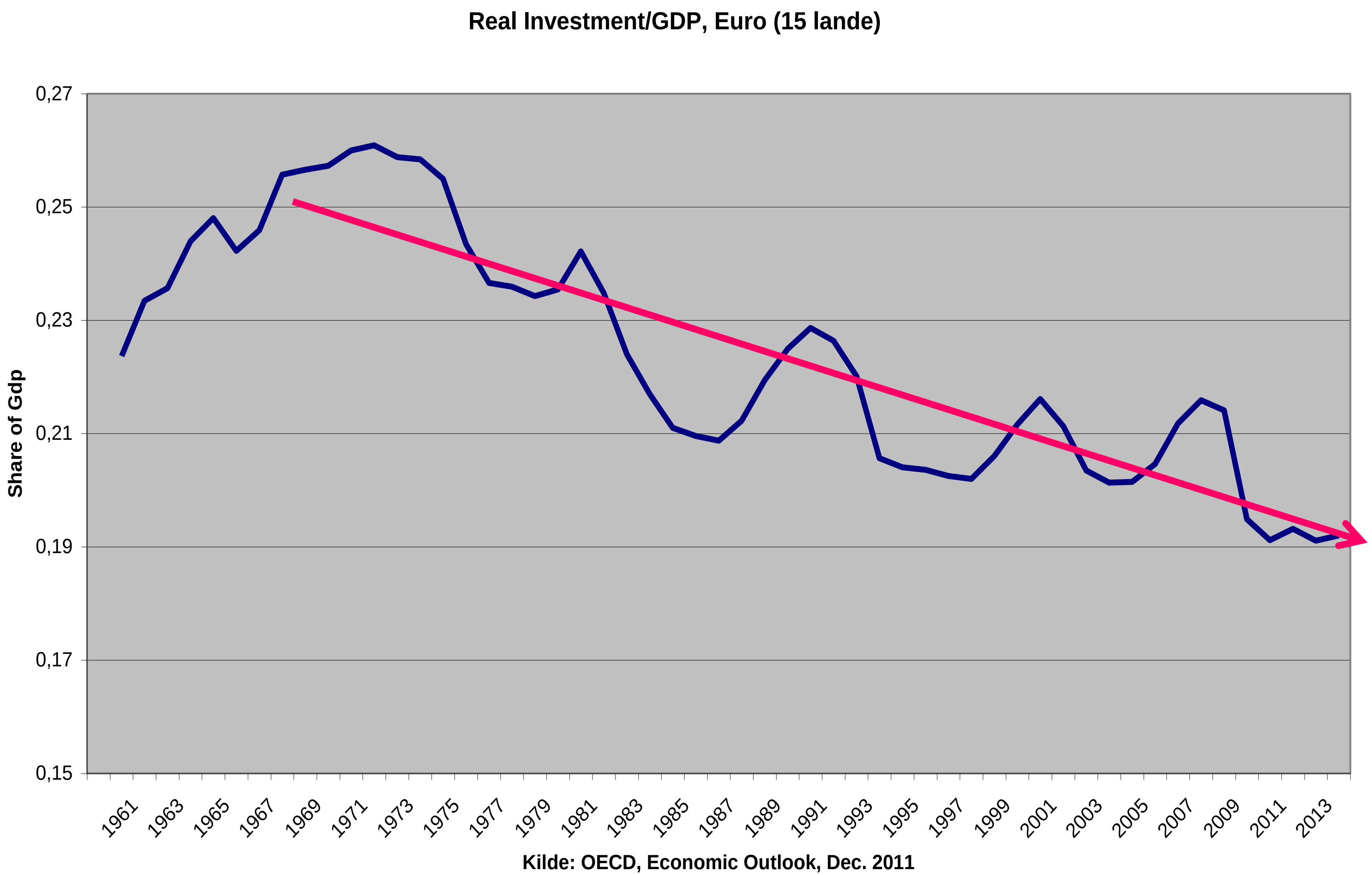


Nothing really new, but nasty!

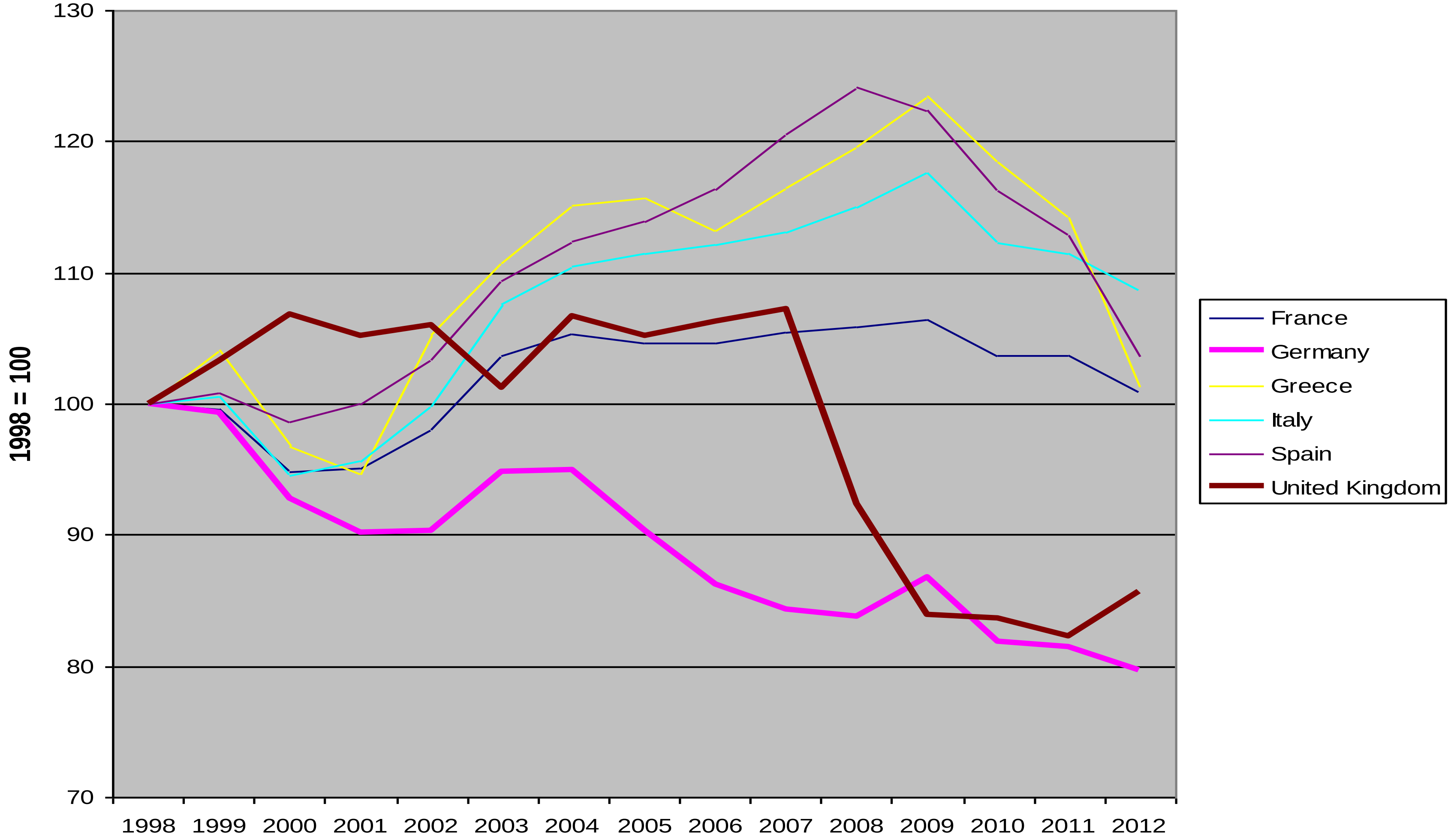


Kilde: OECD, Economic Outlook, dec. 2011

One (very) simple explanation: Falling rate of real investments

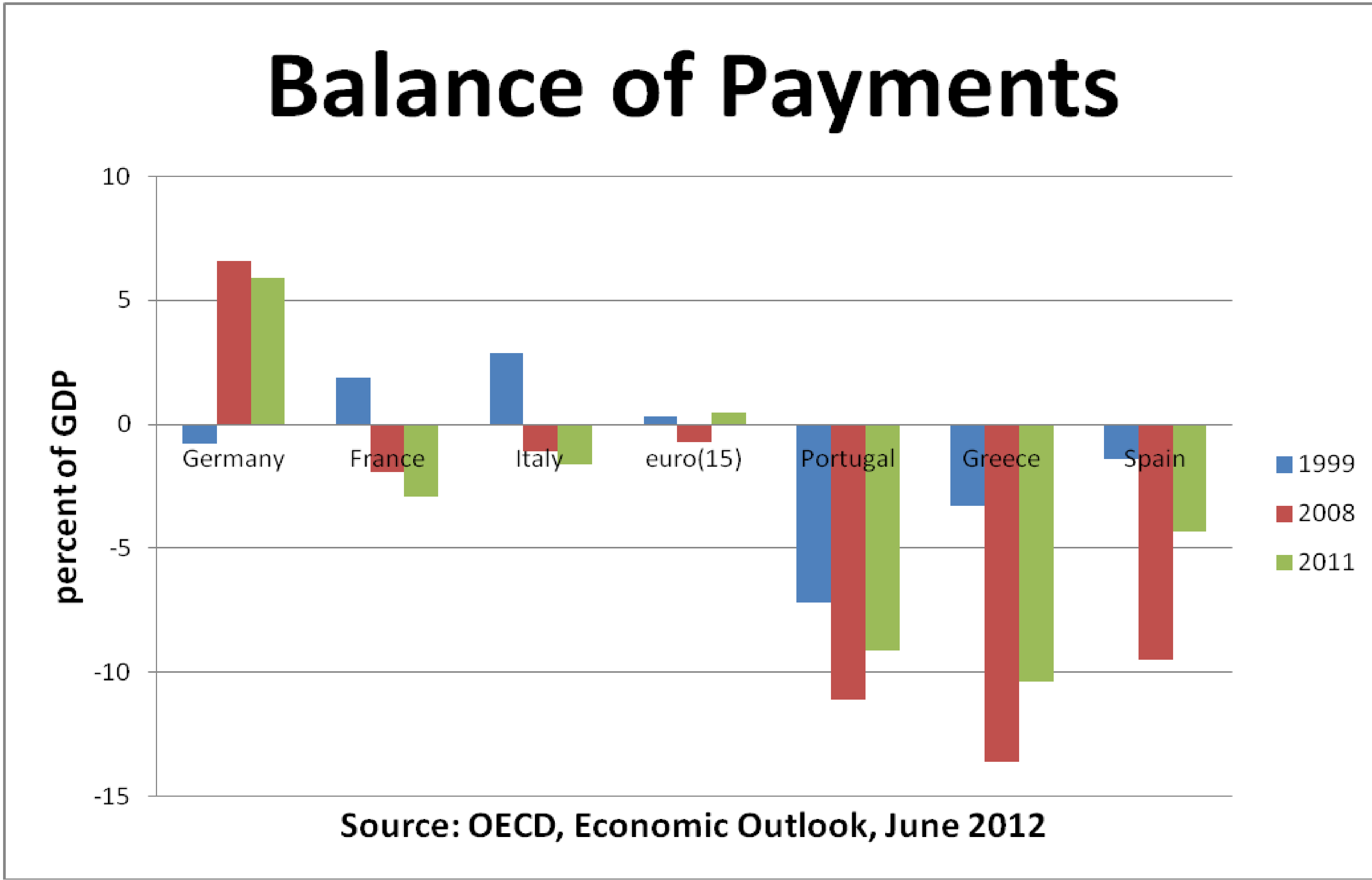


Relative Unit Labour Cost/ international competitiveness

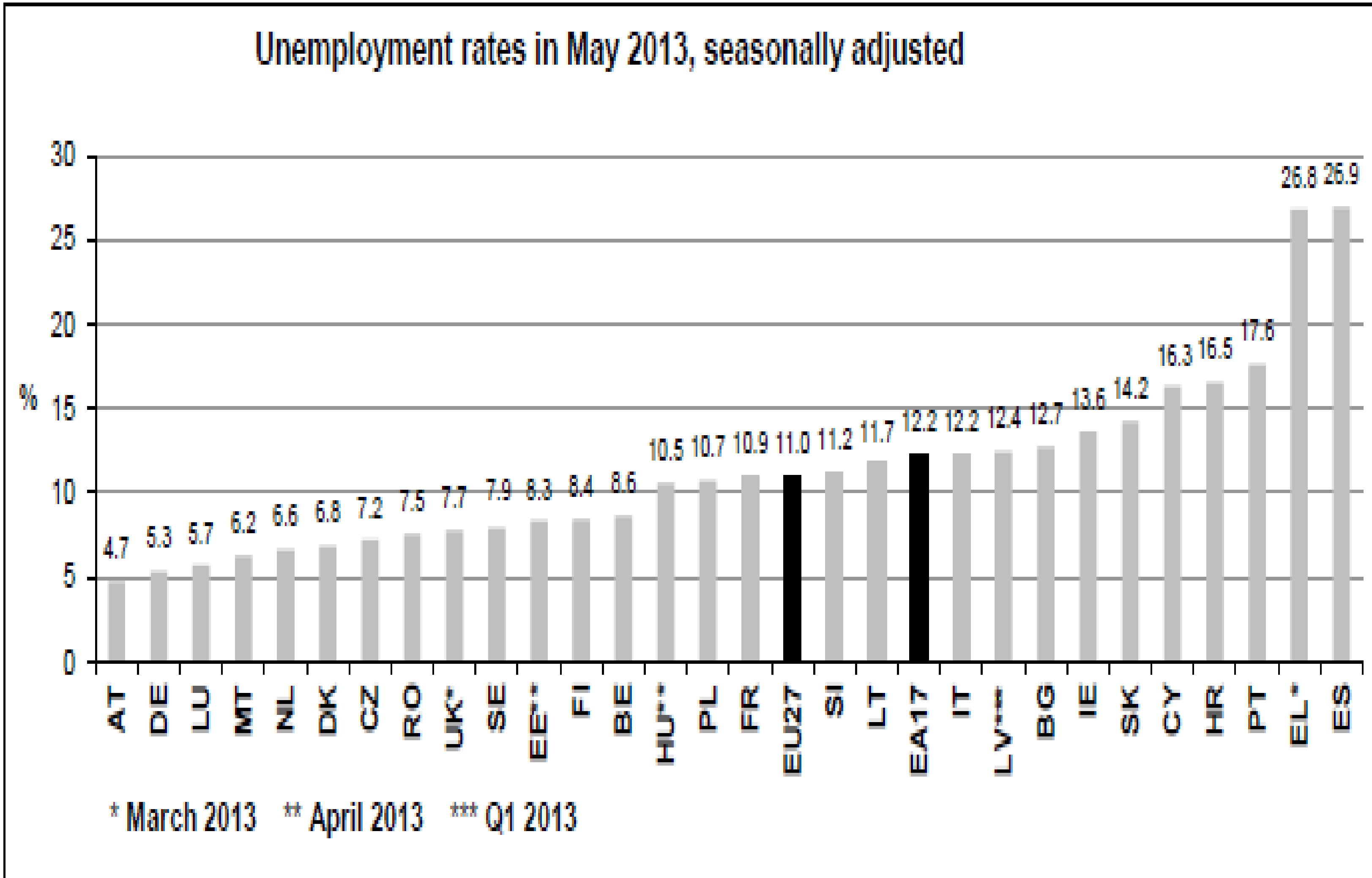


Source: OECD, Economic Outlook, 2013

Export from one euro-country is (mainly) import in another



Unemployment very unevenly distributed



Only 2 strategies forward: it is said; but there are 3 in between

1. ‘Save the euro’ at any expense, otherwise
2. ‘Chaos’, so it was said back in september 1931

Middle road with inspiration from Keynes:

1. China – fix rate + capital control
2. Japan, Sweden, Switzerland - ‘dirty floating’
3. European exchange rate mechanism,

   +/- 15 per cent have worked quite well

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