<u>Remarks on 'Fiscal policy and the substitution between National and Foreign Savings' and on the *General Theory* and international economics</u>

Geoff Tily, May 2013

Greta deal of sympathy with the conclusion, the spirit and approach of the paper. But I wonder if parts of the approach overcomplicate.

Overall though the subject is tremendously important, and rightly seeks to address perceived shortcomings in the PK account.

These shortcomings were to some extent shortcomings in Keynes's own account, though only from the perspective of written theory, not practice.

I should stress that international *theory* – PK and otherwise – is far from my area of expertise, in spite of a preoccupation with Keynes's international approach. So I hope these comments are taken in the spirit of debate, rather than judgements on either the problem at hand or Keynes's approach more generally.

I'll focus on the two specific aspects of the paper:

- contesting Krugman's twin deficit argument
- and in doing so, some discussion of finance-investment-saving-funding (FISF) and its extension to the international dimension

Worth stating up front the Krugman against the PM (Phillip/Marco) view, and an alternative Keynes view:

Krugman **Def ↑⇒ Sn↓ ⇒ r↑ ⇒ Ɛ ↑ ⇒ CAD ↑**

PM **Def ↑…'possibility of ' Ɛ ↑ ⇒ NX ↓ ⇒ Sn↓ CAD↑ ⇒ Sf↑**

Keynes? **[Def ↑or G ↑] ⇒ Y↑⇒ Sn↑**
⇒ NX ↓⇒ CAD↑ ⇒ Sf↑⇒Ɛ↑

[crying out, appears in n.12]

So the killer distinction between a Keynes and the Krugman approach – as all PKs know – is that in Keynes the increased saving comes from increased income. Because Krugman will not permit / recognise this process, he relies on an increase in Sf, a little less bad than crowding out perhaps. This process must overlay any trade relations. And we get the twin deficits.

So the Keynes version begins with ∆Y↑. I should add that I have reservations about any deficits, let alone twin ones.

Just that ∆Y↑ would lead to an increase in saving, it leads to a increase in taxation revenue and reduced transfer expenditures. A rise in G therefore does not necessarily correspond to a rise in the public deficit.

FISF is a tremendously valuable clarification of the domestic processes underpinning the central proposition that is the saving-investment identity. I am not sure to whom this proposition should be attributed, nor am I sure that they are common to all PK, and I think it might be worth dwelling on this.

For me the proposition is vital to the scheme of the GT, as well as to the transition from the *Treatise* to the GT. Kahn emphasised this critical role as early as 1934.

The point of FISF is then that it clarifies and elaborates the proposition as a monetary relation, effected by bank credit. [I find the specific distinction between the producer and purchaser of the investment very helpful, and wonder whether it would help PM.] Plainly Keynes and his contemporaries understood this, but the understanding was lost in IS-LM, where S=I is an equilibrium condition, not an identity or fact. Now I am not sure who rectified this state of affairs, but it was not Studart (as on p. 3); as a footnote to this reference recognises, Davidson detailed the FISF process in 1986, and Chick was on the case in *Macroeconomics after Keynes* in 1983.

The identity is fundamentally incompatible with IS-LM, and I find it depressing that Harcourt in his recently issued [and rather scurrilous] 2011 lecture is still maintaining that "IS-LM us a useful pedagogical start to the teaching of Keynes, provided you stress the limitations".

In the international context the point of extending FISF (or the saving-investment identity) should be to show there is no necessary relation between the external position and $\mathcal{E}$.

I would take this as analogous to the saving-investment identity being independent of r. As Keynes put it in his 1933 lectures: "Saving and investment balance at any rate of interest, therefore any analogy with demand and supply analysis doesn't work" (Rymes, 121-2).

The current account is identical to the capital account, independently of $\mathcal{E}$.

This is simple national accounting or balance of payments arithmetic: any increase in the current account deficit must be matched by a surplus on the capital account. [adjusting for changes in reserves]

So the net flow of goods across a border is matched by a net flow of financial instruments in the opposite direction, and corresponding flows of income. Most obviously, the US financed their ballooning deficit in the 2000s by issuing government debt to the Chinese.

Equally, the Chinese recycled their $ surplus on the goods and services account into US government debt on the capital account.

Given these flows match, with consequent offsetting demands for foreign exchange, they tell me nothing about the exchange rate.

That said, even in spite of this identity, is there any reason the current account might widen and/or exchange rate might change following an 'expansion in the public deficit'?

In my view, this analysis should concentrate on flows of spending not of saving, as more in the spirit of Keynes. Really, saving has no causal role whatsoever in GT.

For me the multiplier analysis begins with $\Delta r\downarrow$ and $\Delta I\uparrow$ or $\Delta G\uparrow$, with leakages through saving and imports, via the mpc and mpi.

I am interested in PM view of an export multiplier, and can see how it follows with exports as an alternative primary expenditure.

I am not sure to whom originally we owe these extensions of the multiplier theory into the international domain. In a 1938 paper Colin Clark note: "In our analysis of the Australian statistics, Mr Crawford and I adopted the definition of putting changes in the value of exports on exactly the same footing as changes in the level of investment" (p. 438).

But it is not clear to me whether we need this overseas multiplier/FISF process to enable the balance of payments arithmetic, and to generate S_f. Perhaps there is a distinction between current and capital imports, with the process required in the case of capital goods imports, when the producer of the investment is overseas?

Going back to Krugman, an expansion in domestic demand may certainly lead to an increase in imports and hence deterioration in net exports.

(The export side is plainly less straightforward; I suppose there is reason to believe an expansion might be common to several countries; but even confined to one country, any expansion of exports means an increase in national income/output and potentially imports.)

For me the question is not whether $\mathcal{E}$ would change NX – and hence PM are unduly preoccupied with this causality – but whether NX would change $\mathcal{E}$. And so what if it did?

We have already established there is no shortage of saving, but a fuller answer demands a return to theoretical and practical matters in Keynes.

On the theoretical view, it is not clear whether Keynes addressed adequately the theory of the exchange rate.

According to his obituary essay on Alfred Marshall, Keynes was sympathetic to a PPP theory of exchange. He set out Marshall's "most important" and "characteristic" contributions to monetary economics; the fourth was:

> (4) The enunciation of the 'Purchasing Power Parity' Theory as determining the rate of exchange between countries with mutually inconvertible currencies. (CW X, p. **)

We might be served best by thinking of the parities not as an 'equilibrium' of *price* – as in the so-called law of one price. But instead, as an equilibrium of quantity. So the PPP exchange preserves the purchasing power of income from one country to another. As a result the underlying equilibrium follows from real GDP, and the idea provides an explanation for why countries' exchange rates should appreciate as they become relatively richer.

But no doubt too, Keynes would have recognised a role for speculation and expectations in the determination of exchange rates in a 'short-run'.

Is this right or any use? I really don't know.

But his practical view is unambiguous. It is rarely right to consider Keynes's theory without the practical context.

The backdrop to his life's work was rejection of the gold standard, and, with its demise, the instigation of first his proposed system of managed currencies, and second aiming at his clearing union, watered down as the Bretton Woods Agreement. His proposals for the managed currency were based explicitly on an empirical assessment of PPPs, and volume XXI records his list of 62 commodities that "could form the basis of discussion" (p. 27).

I believe Austin Robinson's judgements, made 25 years apart, to be spot on.

Keynes wanted an international regime that permitted nations autonomy to implement the expansionary policies that would to increases in national income. Through r↓ and perhaps also G ↑.

To protect r, he put in place capital control. See here.

The purpose of his CU was to protect ε. The system would permit an elastic supply of international money and would automatically recycle any balance of payments imbalances, though with limitations on both deficit and surplus countries.

Plainly his view was that international considerations should not inhibit expansionary policy, but he saw that an ideal system would require institutional change.

Events once more proved him correct. From the 1930s, capital control and a managed exchange permitted the expansionary policy that led to recovery. A rise in the rate of interest was not a *consequence* of expansion (as for Krugman); a fall in the rate of interest was a *cause* of expansion. While a greater extent of central control and other special arrangements – not least lend-lease – supported the ultimate test that was World War Two, any idea that expansionary policy should lead to a rise in r or fall in $\mathcal{E}$ was decisively refuted. The 3 per cent war was fought with sterling seemingly fixed between $4.03 and 4.035.

PM are very right to address these issues as unfinished and deserving work, and to contest Krugman's view. But for me it is fundamental that the broader context is kept in mind when we explore the international dimension to the General Theory.

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