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**J. M. Keynes' s Foreign Exchange Rate Theory? : A Reading of 1946' s
Posthumous Paper**

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Abstract

1946's paper of Keynes was published posthumously. The paper analyzed American balance of payment after World War II and showed some expectation of the economy's future. Though it is a very practical analysis, we can deduce Keynes's insight into foreign exchange rate of his last days. Keynes wrote about foreign exchange rate 1923's book first. From that time, he continually kept the critical position to purchasing power parity (PPP). Keynes separated internal and external equilibria in 1930's book and regarded balance of payment rather than PPP as the determining factor of foreign exchange rate. Because he published 1936's book and showed the possibility of plural levels of production, his belief that foreign exchange rate must be determined with the other economic variables endogenously was supposedly established. Keynesian spirit about foreign exchange rate gives us a critical point of view to the revival of PPP in contemporary macroeconomic theories.

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1. Introduction

A paper named 'the Balance of Payment of the United States' was published in 1846 just after J. M. Keynes's death. Keynes wrote about foreign exchange rate in 1923's book first. From then, Keynes continually kept a critical position to the theory of purchasing power parity (PPP). Keynes thought that PPP was appropriate in the long run while economic power balance was more important in determining foreign exchange rate of the short run. Keynes also distinguished internal and external equilibria¹. And he insisted we should give internal balance, which means full employment, a priority over external trade balance.

Even in theoretical level, Keynes came to emphasize balance of payment as the determining factor of foreign exchange rate rather than PPP. Keynes wrote that not the change of price levels of both countries but balance of payment would give more effect on exchange rate in 1930's book. By the publication of *General Theory* in 1936, Keynes's theoretical perspective was limited in one country's economy. He, however, kept his concern on the relation between balance of payment and foreign exchange rate.

Keynes's posthumous paper is, of course, treating American balance of payment. It is written as an analysis of contemporary affairs of Keynes's days. Nevertheless we should pay attention to the fact that it also refers to the background of foreign exchange rate and it was written after 1936's book. We will make a reading of the paper as telling something like Keynes's theory of foreign exchange rate here.

2. *General Theory* and 1946's paper

Keynes pointed two agendas about American economy. One is the capacity of Britain exports to the United States. The other is the capacity of the United States to absorb goods and services from the rest of the world. Keynes expected IMF could clear the transaction among countries of all over the world. If it is achieved, bilateral arrangement will not be necessary between the United Kingdom and the United States. And Keynes told that he would concentrate into America's current account. His purpose is not a definite prediction but a gradual understanding of the situation.

Keynes said that when we saw the figures of pre-war era, we could notice it had not been so favorable. Keynes divided the period into three stage. The average current accounts are

¹ In this meaning, we can say that Keynes's approach at this stage of thinking is similar to the theory of fundamental equilibrium exchange rate (FEER).

\$356 million, \$98 million and \$231 million. Anyway these figures are less favorable than those of the United Kingdom in the same period. In those days, the United Kingdom invested in foreign countries.

During the great depression, American imports was depressed comparing with exports. And Keynes wrote we had to understand the US's creditor position to the rest of the world. This position is based on the country's large reserve of gold. The United States built the huge gold holdings during World War II. The US's administration blocked the country's asset throughout the war. After the war the statistics become available for us. At the same time, the US Treasury published the census of foreign-owned assets in the United States.

The sterling prices of goods became doubled than the pre-war period. This ratio is much higher than dollar prices. The difference of price level made the US's exports to become much larger. When exports increased, then productions in America must increase. And the increase of productions required imports of raw materials. Keynes explained this relation by using the terms "the great increased activity of the American industrial machines and its increased consumption of imported raw materials²". Here Keynes's theory of determination of production level which he proposed in 1936's book.

The theory of purchasing power parity (PPP) insists that foreign exchange rate is determined by purchasing power of currencies as domestic price levels are given. The given price levels mean that both supply amount and demand amount are given. It is supposed that PPP originally premises full-employment price level³. Keynes, however, introduced the theory of determination of production level. This made possible him to think the situation in which production level could change when foreign exchange rate changed. Because of this, foreign exchange rate and production level come to have interactions. Keynes attained new standpoint of criticizing PPP.

3. The US's balance of payment through World War II

American government made actions to decrease its prolonged unemployment during the 1930s. After World War II, economies of the rest of the world recovered and their imports from the United States increased. The increase of the US's exports, however, was supported by Lend-Lease. Behind this situation, there was a fact that prices of agricultural produce and raw materials was much higher than their world prices. In addition to that, the wage level of

² Keynes [1946], 178.

³ This is the reason why PPP revived in contemporary macroeconomics like new open economy macroeconomics.

the United States is two and a half times higher than Britain's. Therefore, loans to foreign countries and subsidies to exports from America were necessary for American exports.

Keynes separated visible and invisible exports. The United States had already enjoyed an adverse balance of invisible trade even in the pre-war era. Keynes, however, expected a favorable change for America in the post-war era concerning with shipping because America kept much larger holdings of ship tonnage. On the other hand, he said that American analysts forecast a continual deficit in travel because of increase of American tourists.

After this, Keynes emphasized the importance of current receipts of interest and dividend from other countries. He picked up a month's bank letter as a sample. He knew that the analysis was very difficult because these receipts and payments were closely connected with governmental loans and its free gifts to other countries. The countries which drew money from IMF had to pay interest and the countries which invested money in IMF could receive dividend. Keynes also referred to United Nations Relief and Rehabilitation Administration (UNRRA) many times. In addition to interest payments, amortization of capital has to be also taken into account. In American case, the total account of invisible balance including interest and dividend was supposed to be negative than favorable. Keynes told that American commercial policy could improve the balance.

Keynes mentioned the situation of American balance from 1924 to 1930. Exports of goods showed enough surplus but the deficit of shipping and traveling reached a half of the surplus.

4. Keynes's view on economic future of the United States

Keynes wrote that three elements were important in expecting American future of balance of payment. The United States had liquid assets in the shape of ear-marked gold, bank balances and market securities. Keynes said that these assets were available to cover the balance of payment favorable to the United States. Secondly America also had contributions to UNRRA and credits for Lend-Lease settlements. Thirdly, other USSR, Canada and South Africa came to output more gold than before. So the rest of the world other than the US was getting more power of payments in those days.

Keynes, after this, made a prediction. In post-war era, other countries than the United States would demand more and more dollar. This could cause "the chances of the dollar becoming dangerously scarce⁴". Then "America will lose gold⁵". And Keynes progress his

⁴ op. cit., 185.

⁵ Ibid.

prediction further into the long run. He said we had to have doubts about the old belief that invisible hand would lead us to equilibrium. The United States, Keynes told, was “becoming a high-living, high-cost country beyond any previous experience⁶”. Keynes wrote⁷;

Unless their internal, as well as their external, economic life is to become paralysed by the Midas touch, they will discover ways of life which, compared with the ways of the less fortunate regions of the world, must tend towards, and not away from, external equilibrium.

We can see that Keynes foresaw America’s future as an ordinal country. Keynes did not believe that import tariffs and export subsidies, which he called “the classical medicine⁸”, would work by themselves. Keynes, nevertheless, did not necessarily know the fittest alternative. He wrote⁹;

It is for this reason that, speaking in the House of Lords, I claimed that “Here is 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.”

Though Keynes referred to Bretton Woods system here, he also, “No one can be certain of anything in this age of flux and change.¹⁰” Keynes defined our age as “when our command over the production of material satisfactions is the greatest ever¹¹” and “when more than before we should be able to afford these satisfactions¹²”. On the contrary, the “scope for individual decision and choice¹³” is “diminishing¹⁴”. We can see “an underlying contradiction in every department of our economy¹⁵”. “No plan will work for certain in such an epoch.¹⁶”

⁶ Ibid.

⁷ Ibid.

⁸ Ibid. 186.

⁹ Ibid.

¹⁰ Ibid.

¹¹ Ibid.

¹² Ibid.

¹³ Ibid.

¹⁴ Ibid.

¹⁵ Ibid,

¹⁶ Ibid.

Therefore we have to progress in a try-and-error way. Keynes wrote down hopeful words finally¹⁷;

Meanwhile for us the best policy is to act on the optimistic hypothesis until it has been proved wrong. We shall do well not to fear the future too much. Preserving all due caution in our own activities, the job for us is to get through the next five years in conditions which are favourable and not unfavourable to the restoration of our full productive efficiency and strength of purpose, of our prestige with others and of our confidence in ourselves.

5. Conclusion

PPP says that foreign exchange rate is determined so as to equalize purchasing powers of two countries. In other words, it considers only the price levels in the two currencies. We think Keynes's discomfort was directed to this point mainly. He thought various factors which constructed balance of payment would wholly affect foreign exchange rate.

It is especially true after Keynes published *General Theory*, where he told a country's production level was not fixed. After 1946's paper, Keynesian economists built many kinds of Keynesian open economy macroeconomic models, where foreign exchange rate is determined endogenously. This makes a big difference to PPP, which determines foreign exchange rate separately apart from the other variables of the economy.

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¹⁷ Ibid. 186-187.