Journal of Economic Literature
Vol. XXI (March 1983), pp. 59–65

On Keynes and Capital Flight*

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IN THE CONCLUSION of his ambitious reassessment of Keynes' *General Theory* in the March 1981 issue of this journal, Allan Meltzer points out what he believes to be a "puzzling aspect" of Keynes' analysis (p. 62). Keynes expressed his hope in the *General Theory* and elsewhere that the pure interest rate could be driven to zero within one generation, approximately. To bring about the "euthanasia of the rentier," Keynes proposed that the stock of capital be increased through "state management of investment" or "state control of investment" (Meltzer, 1981, p. 61) to the point where it was no longer scarce; at that point, the interest rate would be zero and there would be no return to property ownership per se.[1] What puzzles Meltzer is that "Keynes never explains why, in a world of capital mobility, he expects a single country to drive the rate of interest to zero and increase investment. Keynes does not say anything about capital flight during the one generation that passed before the interest rate reached zero" (1981, pp. 62–63).

Indeed, the solution to this puzzle cannot be found in the *General Theory*. But in other of his writings, Keynes demonstrated that he was well aware that Britain's integration in a free-trade international economic system posed an insurmountable obstacle to his program to achieve not only the "euthanasia of the rentier" but also domestic full employment. Moreover, in the 1930s and 1940s Keynes made numerous proposals to resolve this contradiction, proposals designed to change the international economic environment so that it would foster, not impede, the maintenance of full employment in Britain.

In a wide-ranging essay written in the depth of the Great Depression, and published simultaneously in Britain and in the *Yale Review* in the United States (1933), Keynes analyzed the combined domestic and international requirements for the creation of an efficient and humane economic system to replace the laissez-faire, free-trade capitalism which, he argued, had been largely responsible for the political and economic chaos of the previous twenty years. Distilled to its essentials, his program had two major aspects: first, the state would undertake primary responsibility for guiding and planning the domestic economy; second, economic intercourse with the rest of the world would be politically controlled as well as reduced in size and scope. As for capital flight, the free movement of capital across Britain's borders would be eliminated.

In this essay, entitled "National Self-Sufficiency," Keynes argued that the two major threats facing the contemporary world—depression and the possibility of world war—were in part derivatives of existing capitalist institutions. He pulled no punches in his indictment: "The decadent international but individualistic capitalism, in the hands of which we found ourselves after the war, is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous—and it doesn't deliver the goods. In short, we dislike it and are beginning to despise it. But when we wonder what to put in its place, we are perplexed" (1933, pp. 760–61). The pursuit of peace and prosperity required the creation of additional or alter-

* I am grateful to Diane Flaherty and Walter Salant for helpful comments and suggestions. See p. 47, above for publication information.

[1] See Chapter 16 of the *General Theory* for a discussion of the relation between the scarcity of capital and the rate of profit.

native economic institutions. Keynes proposed that Britain begin an evolutionary, trial and error, process of creating a more planned and controlled economic system at home, simultaneously instituting a system of controls over the international movement of goods and especially money. In his opinion, the domestic program could not be successful without such controls.

In "National Self-Sufficiency" Keynes turned first to the question of peace. Free trade was a reasonable system for conducting international commerce in the nineteenth century, he believed, when real capital flows accompanied the movement of financial capital and countries had stark differences in their relative degree of industrialization. But, he continued, "it does not now seem obvious that a great concentration of national effort on the capture of foreign trade, that the penetration of a country's economic structure by the resources and the influence of foreign capitalists, and that a close dependence of our own economic life on the fluctuating economic policies of foreign countries are safeguards and assurances of international peace. It is easier, in the light of experience and hindsight, to argue quite the contrary" (1933, p. 757). Therefore, he argued, "a greater measure of national self-sufficiency and economic isolation among countries than existed in 1914 may tend to serve the cause of peace rather than otherwise" . . . "[L]et goods be homespun wherever it is reasonably and conveniently possible, and, above all, let finance be primarily national" (1933, p. 758). In Keynes' view, the loss in economic efficiency caused by a diminution of the degree of international specialization would be far smaller under then-current conditions than it would have been in the nineteenth century, and it would be far outweighed by the increased potential for peace and prosperity that greater national self-sufficiency would make possible.[2]

With respect to the issue of full employment and domestic prosperity, Keynes believed that the state would have to take responsibility for basic economic decisions concerning the level of investment and saving, the allocation of investment among competing uses (broadly defined), and the general distribution of income. State control of the investment process through public works, public or semi-public corporations, investment planning boards, credit allocation schemes, and so forth—not monetary and fiscal policy as conventionally defined—was the cornerstone of Keynes' domestic economic policy proposals.

In "The End of Laissez-Faire" he had written: "I believe that some co-ordinated act of intelligent judgement is required as to the scale on which it is desireable that the community as a whole should save, the scale on which these savings should go abroad in the form of foreign investments, and whether the present organisation of the investment market distributes savings along the most nationally productive channels" ([1926] 1963, p. 318). In the *General Theory* he proposed "a somewhat comprehensive socialisation of investment . . ." ([1936] 1964, p. 378) and spoke of the state "taking an ever greater responsibility for directly organising investment . . ." ([1936] 1964, p. 164). Keynes' emphasis on the use of state control of investment to stabilize the economy at full employment continued undiminished in the 1940s. In 1943, he wrote that "if the bulk of investment is under public or semi-public control and we go in for a stable long-term programme, serious fluctuations are enormously less likely to occur" (1980c, p. 326). That same year, he argued that if "something like two-thirds or three-quarters of total investment will be under public or semi-public auspices, the amount of capital expenditures contemplated by the authorities will be the essential balancing factor . . . . It has nothing whatever to do with deficit financing" (1980c, p. 352).

Keynes left no precise definition of what he meant by the socialization of investment or state control of the investment process, al-

[2] Although Keynes couched his argument in terms of national self-sufficiency, his goal was not autarky, but *control* of the international sector and its subjugation to domestic economic objectives. The particular political and economic conditions prevailing in 1933 explain his emphasis on self-sufficiency. As the world-wide depression increased in severity, protectionism grew apace; many countries were moving toward greater economic isolationism. Moreover, the rise of facism in Europe had reached a point where the possibility of wide-spread armed conflict could not be ruled out. Increased self-sufficiency seemed prudent.

though in several essays he stressed the key role to be played by "semi-autonomous," "semi-independent" or "semi-socialised" public corporations run by technical experts; corporations which were to be insulated to some degree from the direct control of elected officials.[3] For example, in "The End of Laissez-Faire" he argued that "progress lies in the growth and the recognition of semi-autonomous bodies within the State—bodies whose criterion of action within their own field is solely the public good as they understand it, . . . bodies which in the ordinary course of affairs are mainly autonomous within their prescribed limitations, but are subject in the last resort to the sovereignty of the democracy expressed through Parliament" ([1926] 1963, pp. 313–14). However, his scattered hints about the institutions of investment planning do not constitute a detailed blueprint for the new Keynesian economic system.

Keynes thought of the movement toward a centrally coordinated economy as an experimental process. In "National Self-Sufficiency" he said that "the new economic modes, towards which we are blundering, are, in the essence of their nature, experiments. We have no clear idea laid up in our minds beforehand of exactly what we want. We shall discover it as we move along . . ." (1933, p. 768).

He was perfectly clear about one thing, however; this experiment could not succeed while Britain remained fully integrated in the international economy. He specifically referred to the problem of capital flight as one example of the dangers posed by an open economy. "Indeed, the transformation of society, which I preferably envisage, may require a reduction in the rate of interest towards vanishing point within the next thirty years. But under a system by which the rate of interest finds a uniform level, after allowing for risk and the like, throughout the world under the operation of normal financial forces, this is most unlikely to occur" (1933, p. 762). Earlier in the essay he argued that: "Advisable domestic policies might often be easier to compass, if the phenomenon known as 'the flight of capital' could be ruled out" (1933, p. 757). His proposal for national self-sufficiency was specifically designed to eliminate the threat of capital flight and insulate the domestic experiment in economic planning from disruptions originating in the international sector.

Thus, Keynes argued, "we all need to be as free as possible of interference from economic changes elsewhere, in order to make our own favorite experiments towards the ideal social republic of the future; and . . . a deliberate movement towards greater national self-sufficiency and economic isolation will make our task easier, in so far as it can be accomplished without excessive economic cost" (1933, p. 763). Regarded from this point of view, he said, "the policy of an increased national self-sufficiency is to be considered, not as an ideal in itself, but as directed to the creation of an environment in which other ideals can be safely and conveniently pursued" (1933, p. 762). The pursuit of these ideals of freedom from war and depression involved, for Keynes in the 1930s, the beginning of an evolutionary process of social transformation, "a transition towards greater national self-sufficiency and a planned domestic economy" (1933, p. 767).[4]

It is true, of course, that in the early 1940s Keynes became an advocate of a more integrated world economy. He was, after all, Britain's most influential representative to the negotiations with the United States which ultimately led to the creation of the International Monetary Fund. However, the historical record, especially as augmented by recently published volumes of Keynes' *Collected Writings,* shows that the objectives he sought in these negotiations were identical to those aimed at in his program for national self-sufficiency in the previous decade; what changed

[3] See, for example, "The End of Laissez-Faire" [1926] and "Am I a Liberal?" [1925] in Keynes (1963, especially pages 313–16 and 331). By 1945, presumably as the result of his wartime experience, Keynes appears to have changed his mind on the need for "semi-autonomy." At that time, he recommended that the Treasury Department, under the Chancellor of the Exchequer, be granted the requisite authority to manage investment planning (1980c, pp. 405–13).

[4] In the section of the article where this quotation appears, Keynes warns the reader of the potential cost of conducting this social experiment with undue "haste." He clearly desired an evolutionary process of economic transformation, not a political revolution.

with historical circumstance were the means by which he sought to achieve them.

The role Keynes played in the evolution of the post-war international economic order is complex, controversial and not widely understood; however, those aspects of the story which are most germane to the points at issue here can be clearly, if briefly, stated. To simplify matters I will focus on Keynes' writings through 1943; correctly identifying his post-1943 attitude on some of these questions involves a problem of interpretation that I will address below.

There can be no doubt that the international financial system that Keynes proposed and defended in the early 1940s had as a major objective the facilitation of high rates of growth and low rates of unemployment in its constituent countries. Under the previously prevailing system, serious payments imbalances created deflationary pressures on deficit countries. The ensuing contractions that developed in these countries could then spread to surplus countries through the erosion of their export markets. In the extreme instance, this chain of events had the power to generate a world-wide slump.

Keynes' International Clearing Union proposal attempted to reverse the logic of this process; it focused its corrective pressures on surplus rather than deficit countries. Penalties of increasing severity were to be imposed on countries whose foreign exchange position became swollen from accumulated balance of payments surpluses. These penalties were intended to motivate surplus countries to accelerate the rate of expansion of their domestic economies, a development which would help stimulate the imports of the surplus countries and the exports of the deficit countries. Moreover, ample credit would be made available to deficit countries. Thus, payments imbalances were to be corrected through expansion in the surplus countries, not contraction in the deficit countries. As a result, Britain would not find its full-employment policy disrupted by the direct or indirect effect of trade deficits. "The plan," Keynes wrote in 1942, "aims at the substitution of an expansionist, in place of a contractionist pressure on world trade" (1980a, p. 112). He stressed the fact that under its provisions the corrective measures required of a country in substantial payments deficit "do *not* include a deflationary policy . . . having the effect of causing unemployment; for this would amount to restoring . . . the evils of the old automatic gold standard" (1980a, p. 143, italics in original).

Keynes' determination to eliminate the problems caused by capital flight was, if anything, even stronger than before. Initially, he assumed that each central bank would monopolize its country's supply of foreign exchange in order to control international capital movements. "I share the view," he wrote in 1941, "that central control of capital movements, both inward and outward, should be a permanent feature of the post-war system" (1980a, p. 52). When it became clear that the U.S. did not share his view on this issue, he insisted that strict capital controls be permitted in the new international monetary order in those countries which chose to adopt them. Keynes argued here, as he had in the 1930s, that the free flow of capital among countries would make successful domestic planning for full employment in any country impossible.

Keynes' long-time associate, Roy Harrod, was an ardent opponent of capital controls. In a letter to Harrod in 1942, Keynes stated his position as forthrightly as one could desire:[5]

> I disagree most strongly with your view that the control of capital movements may very possibly be unnecessary. . . .
>
> . . . I see no reason to feel confidence that the more stable conditions [of the post-war era] will remove the more dangerous movements [of capital]. These are likely to be caused by political issues. Surely in the post-war years there is hardly a country in which we ought not to expect keen political discussions affecting the position of the wealthier classes and the treatment of private property. If so, there will be a number of people constantly taking fright because they think the degree of leftism in one country looks for the time being likely to be greater than somewhere else.
>
> [Moreover,] you overlook the most fundamental long-run theoretical reason. Freedom of capital movements is an essential part of the old *laissez-faire* system and assumes that it is right and desirable to have an equalisation of interest rates in all parts of the world. . . . In

[5] For additional statements by Keynes in the 1940's on the necessity of capital controls, see Keynes (1980a, pp. 129–30, 212–13, and 275–76; 1980b, pp. 16–17; and 1980c, p. 429).

my view the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is a corollary to this [1980a, pp. 148–49].

With respect to international commercial as opposed to monetary arrangements, Keynes continued to oppose a return to a regime of free or unrestricted international trade. He envisioned an economic order in which both national governments and international institutions would play a major role in determining the nature and extent of trade. In 1943 he argued:

> I am, I am afraid, a hopeless skeptic about this return to nineteenth century *laissez-faire*. . . .
> I believe that the future lies with—
> (i) State trading for commodities;
> (ii) International cartels for necessary manufactures; and
> (iii) Quantitative import restrictions for non-essential manufactures [Quoted in Harrod, 1951, pp. 567–68].[6]

Keynes even proposed extending his vision of domestic planning for full employment to the international economic system as a whole. He believed it would be possible to construct a set of international institutions capable of controlling, or at least influencing, the rate of economic growth in the world economy as well as in its constituent parts. The following quote is taken from a 1942 version of his Clearing Union proposal:

> If an International Economic Board is established, this Board and the Clearing Union might be expected to work in close collaboration to their mutual great advantage. If an International Investment or Development Corporation is also set up together with a scheme of Commodity Controls for the control of stocks of the staple raw materials, we might come to possess in these four institutions a powerful means of combating the evils of the trade cycle, by exercising contractionist or expansionist influence on the system as a whole or on particular sections [1980a, p. 133].

Keynes' proposal for an International Clearing Union and the American proposal for an international Stabilization Fund were in serious conflict on a number of important issues. Major areas of disagreement between the British and American positions included, among others: the initial resources to be made available (the Union called for up to $40 billion, while the Fund might have as little as $5 billion); the elasticity of resources (the Union's supply of credit would automatically expand to meet the demand for it, while the amount of resources available to the Fund was fixed); the question of whether the international institution could set conditions on member nations' access to their quotas (Keynes demanded unconditional access or 'passivity'—he did not want the Union to have the power to interfere with its members' domestic policies and was especially concerned that the U.S. might take advantage of 'conditionality' to control the activities of other countries—while the U.S. refused to accept the principle of unconditional access); the status of quantitative import controls (Keynes strongly supported import controls as permanent instruments of planning, while the Americans opposed their use beyond the transition period leading to peacetime normalcy).

Negotiations between the two sides were held from late 1942 through 1944. Although the Bretton Woods Agreements which evolved in 1944 did permit the use of capital controls, most of the key Clearing Union provisions were either watered-down, eliminated, or replaced by conflicting provisions taken from the Stabilization Fund proposal. For example, the automatic elasticity of credit embodied in the banking principle of the Clearing Union, which Keynes had insisted was an "essential condition" for British acceptance of any agreement, was replaced by the fixed-resource provision of the Fund, (1980a, p. 317). How then are we to explain Keynes' apparently enthusiastic efforts to promote the Bretton Woods Agreements to the British public and to Parliament in 1944 and 1945?[7]

[6] In a letter to Michal Kalecki written in 1944, Keynes stressed the importance of permanent import controls. In an attempt to clarify an apparent misunderstanding, he stated: "If, as is alleged, I said that the International Monetary Plan 'would ensure the conditions necessary to maintain full employment at home . . . without further direct control of foreign trade,' I must have been out of my mind" (1980c, pp. 382–32).

[7] It goes almost without saying that the IMF as it actually evolved in the years following Keynes' death

Harrod, in his well-known biography of Keynes, suggested that Keynes was eventually won over to the U.S. position by the logic of the arguments marshalled against his earlier views and by the surprisingly cooperative attitude of the American negotiators: in other words, he simply changed his mind. Others have argued—more convincingly in my opinion—that the U.S. took advantage of its growing economic power and Britain's increasingly precarious economic condition to dictate the final terms of the Bretton Woods Agreements. Keynes thus found himself confronted with the following dilemma: he either had to accept an international economic order that would make it virtually impossible to achieve the economic and social objectives he sought for Britain, or watch Britain enter the post-war period without sufficient U.S. economic assistance to restore even a semblance of prosperity to the economy and without any institutional protection against a return to the international economic anarchy of the 1920s and 1930s.

The second option seemed so catastrophic to Keynes as the war dragged on that he felt compelled to accept the first as the lesser of two evils. In 1944, Keynes appraised the contrary policy of the Bank of England in the following words:

> The Bank is not facing any of the realities. They do not allow for the fact that our post-war domestic policies are impossible without further American assistance. They do not allow for the fact that the Americans are strong enough to offer inducements to many or most of our friends to walk out on us, if we ostentatiously set out to start up an independent shop. . . . I feel great anxiety that, unless . . . we move with no uncertain steps along the other path [that is, to accept the American plan and thus gain American financial assistance], the Bank will continue to lead us, in new disguises, along much the same path as that which ended in 1931 [1980a, p. 412].

was *not* the kind of international monetary institution he had in mind in the 1940s. Indeed, in many ways the IMF performed the disciplinary functions of the gold standard, rather than the expansionary functions for which the Clearing Union had been designed: drawings on the Fund totalled only $1.2 billion during the first nine years of its operation, while the growing use of "conditionality" and "letters of intent" created precisely those deflationary pressures on member nations that Keynes had been so determined to eliminate.

Harrod painted an even starker picture.[8] "[T]he condition of Britain was indeed parlous, with her staggering load of foreign debt and her present inability to pay her way from day to day" (1951, p. 600). Should massive U.S. aid not be forthcoming:

> rations would have to be drastically cut; the factories would stand idle. . . . Would there also be labour troubles and even civil strife? . . . There might be violence of a kind unknown in the fair island for many generations. . . . Was this to be a turning point of history? Would the Britain of Shakespeare and Newton lapse into being a secondary Power, a slum of squalid living and brutish ways? [1951, p. 600].

Assuming that Keynes also viewed the alternative in this light, it is not surprising that he ultimately yielded to American pressure.

A full examination of the evidence bearing on the hypothesis that Keynes did not change his mind on the basic issues would need separate and extended treatment. I believe that the evidence supports this view. But Keynes felt compelled to solicit support for the Bretton Woods Agreements from his countrymen; as a result, he made numerous public statements which suggest that he eventually came to accept the American position on its merits. Lord Kahn describes the situation as follows:

> An attempt to make an appreciation of the development of Keynes' attitude presents the difficulty that while Keynes was obviously fighting a rearguard action, constantly being forced to yield ground to the Americans, he was claiming from time to time that his concessions on points to which he had attached importance were not after all of serious consequence. He was terrified of failing to secure agreement with the Americans, and, at the same time, he had to maintain the *morale* of the U.K. Delegation, of officials and Ministers in London, of the Bank of England—and of himself [1976 p. 14].

Lord Balogh makes the same point:

> The Americans had the whip hand. Britain was bankrupt, its export markets had been lost

[8] Indeed, Harrod makes what appears to be a compelling case for the lesser-of-two-evils thesis only to conclude his analysis by supporting the alternative view that Keynes was persuaded by the logic of the American position (Harrod, 1951, Chapters 13 and 14).

> . . . its reserves were not only low but far [lower] than pledges to its creditors. The country was war-weary and exhausted and it could not take further sacrifice. We had to agree to whatever [the Americans wanted] to enforce.
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> . . . Keynes at first resisted strongly. This is evident from the published material and his proposal for a 'Clearing Union.' He was pushed and he retreated. Once he had accepted these very onerous . . . terms he began to defend himself by defending the settlement. . . . [H]e talked to the British public about the American conditions as something very noble [1976, p. 74].[9]

While reasonable people may disagree on the appropriate interpretation of Keynes' post-1943 views on international questions, a solid case can be made for the proposition that his espousal of national self-sufficiency in the 1930s and his proposals for a new international economic order made throughout the 1940s were consistent in their objectives. Each was designed in a different historical setting to remove the impediments inherent in traditional international economic arrangements to the attainment of valued domestic economic and social objectives. Each was intended by Keynes to enable the British to successfully undertake their domestic experiment in economic planning.

[9] Kahn (1976, pp. 23–31) describes a revealing incident that occurred on Keynes' trip home from the first meeting of the IMF and of the World Bank in Savannah, Georgia in March, 1946, an incident which exposed Keynes' underlying lack of confidence in these institutions.

Apparently, Keynes was both disheartened by and angry about what he saw as the manipulation of these institutions by the Americans for their own partisan purposes. In a letter to Kahn, he wrote: "The Americans have no idea how to make these institutions into operating concerns, and in almost every direction their ideas are bad. Yet they plainly intend to force their own conception through regardless of the rest of us. . . . The Americans . . . think they have the right to call the tune on practically every point" (Keynes, 1980b, p. 217). By the end of the Conference, Keynes was so disillusioned with the status of the Fund and the Bank that he decided to advise the British government to withdraw from the IMF, in spite of the dire consequences which would result from such action.

George Bolton, adviser to the British delegation at Bretton Woods and at Savannah, and first U.K. director of the IMF, described Keynes' attitude at Savannah as follows: "His indignation had been inspired by the revelation that the U.S. Treasury intended to control the Fund and use it to further American policy . . ." (Bolton, 1972, p. 1387). On the trip home on the Queen Mary, according to Bolton:

> [Keynes] spent the voyage in writing an article for publication condemning American policy with extraordinary ferocity and passionately recommending HM government to refuse to ratify the Fund and Bank Agreement [Bolton must mean 'withdraw from the Fund and Bank'; the Agreements had been ratified the previous December]; such action would automatically have frustrated the US and Canadian Loan Agreements. . . . [With] Britain in her exhausted and bankrupt condition . . . , the government had to have the money and also access to the Fund resources. . . . In addition, the publication in 1946 of such an explosive document as Keynes wrote would have had momentous political results; so Ernest Rowe-Dutton [another delegate] and I spent most of the voyage trying to dissuade Keynes from pursuing these proposals. Eventually he agreed to destroy the paper . . . [1972, p. 1387].

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