

**The Keynesian Revolution:
Has It Reached China?**

by
Ingrid Rima*

Seminar Paper No. 5

October 2001

Abstract

The experiences of the United States during the inter-war period provide insight into the historical circumstances that became catalysts in the emergence of demand management policies in the Western World. For a newly developing economy like China's, which is trying to move in the direction of free markets, the experiences of the West provide her policy makers with an invaluable lesson in Keynesian demand management alternatives. China's bid to achieve a positive impetus to employment and growth through a policy of export led demand management, facilitated by membership in the WTO, is analogous to the choices made by the U.S., the UK, and France in the 1930s to sever their economies from the gold standard.

The Keynesian Revolution: Has It Reached China?

Ingrid Rima

Temple University

The Keynesian revolution was ushered in by J. M. Keynes's last great work *The General Theory of Employment Money and Interest*, which was published in 1936. The book launched the most momentous intellectual as well as political and sociological movement of the first half of the twentieth century. *The General Theory* was not only Keynes's most important book, but it was also the most influential book ever written in economics—more influential even than Karl Marx's *Capital*, written in 1853, or Adam Smith's *Wealth of Nations*, written in 1776. Its influence extends to the present day, in which it is shaping the economic policies of economies like China and the Eastern bloc countries of Europe, all of which are moving in the direction of privatization to pursue what economists call “aggregate demand management policies.”

To understand what is at issue here, it is necessary to take at least a brief look at the economic history of Europe and the U.S. during the inter-war period—that is the period between World War I, coming to an end in 1918, and World War II—into which the U.S. entered in 1941. While this period was, on the surface at least, an era of relative political calm, it was a period of considerable *economic* upheaval—the calm before the storm—so to speak. From an economic perspective it became the catalyst for the great lessons of the Keynesian revolution. This revolution was closely linked both to the Great Depression and the reasons for the

rejection of the international gold standard. Now while these events seem to have little relationship to the present, especially not to China, this is far from the case, because as China becomes more capitalistic it will enjoy the benefits of capitalism, but also encounter its problems. The greatest of these is no doubt its sensitivity to the business cycles, especially those dreaded phases of recession and *depression*.

The Great Depression began with the return to peace in Europe after WWI, and by the mid-1920s it caused the Western World serious unemployment and deflation; i.e., falling prices. It spread to the U.S., showing itself first in the great stock market crash of 1929, but soon afterward in massive factory failures and rates of unemployment so high that by official estimates 1 in 4 workers became jobless. Keynes's work was precipitated by the inability of governments in England and the U. S. to restore satisfactory levels of employment and stop the decline in prices. Falling prices, while they might seem welcome from a consumer perspective, are very destructive because they wipe out business profits and lead to worker layoffs. Clearly, without a job a worker is without a wage payment so that he is lacking the means to take advantage of falling commodity prices. This compromises *future* business profits and business confidence that further investment will be profitable.

Keynes's primary diagnosis of what ailed the economies of Europe and the United States was that the capitalistic system was inherently *unstable*, and that the primary reason for this instability was the inherent unpredictability of the outcome

of business decisions. Keynes compared the behavior of the investors whose decisions drive the business sector to the decisions of gamblers in a casino. A gambler doesn't know until after the game is over whether and how much he wins or loses, so he cannot know the outcome of his decisions in advance. Gamblers tend to be optimistic or pessimistic as a group. They act according to a "herd instinct"—"animal spirits"—Keynes called it, so that the tendency is either toward great profits or precipitous losses. These behaviors cause stock markets to be so erratic that we speak of them as *bull* and *bear* markets characterized by irrational anticipatory buying followed by equally irrational sell-offs.

The surprising and totally unexpected characteristic of the decline of the 1930s was that, unlike earlier depressions, which generated revivals within 18-24 months, this decline simply persisted. Keynes spoke in terms of the economy being "stuck" in underemployment equilibrium. Alvin Hansen, a leading Harvard economist whom some think of as the American Keynes, spoke in terms of economic *stagnation*. He envisioned an America that for the first time in its short history was experiencing a declining rate of population growth, a birth rate so low that the new generation did not numerically replace the one that was dying. Also, America was no longer the frontier economy that led to the discovery of gold in California and Alaska, and accomplished the building of the transcontinental railroad. He also did not anticipate new major technological opportunities to provide capital using investment opportunities comparable to the generation of steam and electrical

power. Hansen, of course, had no way of anticipating that within a decade World War II would launch the nuclear age; even less could he anticipate the electronic revolution that has led us into the present Information Age. Its relationship to global competition has particular relevance to the reasons why Keynes's revolution is indeed relevant for contemporary China.

Before proceeding it is necessary to reflect on yet another contributing factor to paving the way for the Keynesian revolution. The unemployment and falling price level phenomena of the 1930s were closely related to the fact that Western economies and the United States were linked together through the international gold standard. A gold standard exists when: first, nations define their currencies in terms of gold; second, use gold as a basis for paper currency that is legal tender and convertible into gold; and third, use gold to make payments on international accounts. It is this latter characteristic of the gold standard that makes it impossible for any single economy to protect and insulate its domestic economies from economic declines originating in other economies.

A particularly disturbing set of events was provoked when France decided in the late 1920s to devalue the French franc to alleviate her unemployment problem by cheapening the prices of her exports on the world market. This policy was initially quite successful, in that it accomplished what economists call "exporting a country's depression." Buyers in England and America purchased such large quantities of French commodities and found France such an inexpensive country to

visit and spend dollars and pounds that these paper debts soon required payment in gold. This is where the real problem began, for France decided unilaterally—that is, on its own—that it would no longer play according to gold standard “rules of the game.” Instead of using gold receipts as a basis for issuing additional amounts of currency, the Bank of France simply “sterilized” its gold receipts; i.e., held the gold in its vaults. Playing according to the rules of the gold standard game would have required France to issue additional amounts of currency, which would have raised her commodity prices. This in turn would have reversed her export advantage and caused gold to return to gold-losing countries like the United States and England, whose prices would then be low relative to those of France. With the ongoing low value of the French franc, England continuously lost gold, as did the U.S., which worsened unemployment in both countries and also subjected them to further falling prices. By 1931, when the pound sterling was still equal to \$4.86, the unbelievable happened. The Bank of England, unable to pay its foreign obligations, closed its doors. This signaled the beginning of the end of the international gold standard, which the U.S. also left when President Franklin Roosevelt declared the bank holiday March 4, 1934. It is precisely the interdependence among the domestic economies of the industrial economies that is inherent in the gold standard that led to Keynes’s basic economic analysis and its accompanying policy message.

Keynes's economic revolution is based on his principle of aggregate effective demand. Unlike the so-called supply-side economics that attracted attention and gained some fame during the 1980s, the principle of aggregate effective demand maintains that the economy's output and employment is dictated by its resource base and the state of its technology, which do not change in the short-run. Thus, Keynes argues that the determinant of the level of employment and income is to be found on the demand side in the level of aggregate effective demand; i.e., the sum of consumption and investment. To these two components Keynes's model adds government expenditures and net foreign investment. The latter is the difference between exports and imports and, depending whether the balance of payments reflects the positive influence of exports or the negative influence of imports, net foreign investment can take on either a positive or negative value. Thus aggregate effective demand can be expressed as $C + I + G + X - M$.

With the publication of Keynes's *General Theory* in 1936, the principle of aggregate demand has become the basis for the formulation of economic policies by all of the industrial economies of the world, as well as substantially all of the developing economies. The so-called "Japanese miracle" that quite literally catapulted Japan from the post-feudal economy of the early post-World War II years into a major industrial power in only a few decades was based on export led growth which was subsidized by government decision to promote comparative advantages that either might never have developed at all under free market

conditions, or which would have taken decades longer to accomplish. While other newly developing economies—Turkey, Egypt, India and now the newly independent states of the former Soviet Union have been less zealous in pursuing export led growth and have relied more on monetary policy, economic growth is their key policy objective. This is very much in keeping with Keynesian aggregate demand theory and the policy prescription that follows from it.

Now it is China's turn to become a leading industrial power. She is entering the twenty-first century with some unique advantages, but also some unique problems and challenges. The advantages are perhaps obvious. China is endowed with a tremendous base of natural resources; she is also endowed with the world's greatest potential stock of human capital. Her large population, which implies that she is "over-peopled", is being judiciously controlled, seemingly with popular support. But more important, China's youth are industrious and ambitious, and seem physically and psychologically able to cope with the challenges they confront. A remarkably large number of them also have the intellectual capability and drive to pursue college and university programs, with many going into technical specialties. These demographic characteristics promise to contribute to China's success in achieving industrial growth at a time when the industrial powers of the West are confronted with so many of their own economic problems that they are less willing to help Newly Developing Economies leap forward than they were in the second half of the twentieth century.

The process of privatization in China is accompanied by the systematic dismantling of state-owned enterprises. The objective is to improve the efficiency of production. But in the process, large numbers of workers have been laid off, which reflects a different kind of inefficiency—the inefficiency inherent in unemployed labor resources. Finding new employment opportunities is partly a supply side problem in the sense that without new and better human capital skills these workers will remain not only jobless, but unemployable. But more to the point, finding new employment opportunities is a demand side problem. That is it is a *Keynesian problem* of aggregate demand. It is essential to China's future growth that she increases the economy's level of aggregate demand. What is needed is to better manage the sum of Consumption + Investment.

Manipulating the consumption variable is not very promising. People develop habits of spending and saving which are unlikely to change in the short run. The Chinese life style is characterized by a high propensity to save. Working people are saving to buy that much-desired apartment or home. The new housing reform program will help make that a reality much sooner for many families. But, in the meantime their savings are a drain on aggregate demand. At the same time China has a large import surplus that further subtracts from aggregate demand. Also, the import surplus is of necessity accompanied by an outflow of capital. It is essential that China find a way to repatriate these funds. Without this repatriation the investment in new industry and infrastructure that China so desperately needs for

growth is being compromised. While some American-Chinese remit part of their savings home to their Chinese families, this is a small and uncertain amount. One policy that could attract funds into China is for the central bank to raise interest rates. This is, of course, a two edged policy, for it would also compromise bank lending and investment in China's domestic economy. Policies to attract foreign investment into China are more promising. Many regions and large cities, Guangzhou, Shanghai, and Dalian among them, are extensively engaged in trying to attract foreign capital. These efforts seem to be paying dividends, but only slowly, for there are substantial cultural problems that may well require a generation or more to bridge.

That directs attention to the most promising and potentially most effective demand management tool toward which China can look at the present time. This tool is to enhance her export potential. China is eagerly anticipating her entry into the World Trade Organization. Unfortunately, but understandably, the WTO is a difficult club to join. China has just recently substantially reduced her tariffs on several important American agricultural products. That is a very smart decision—first because it gives Chinese consumers access to new commodities at better prices, which raises their real incomes and living standards. But second—and perhaps more important—it is politically important to win the support of American legislators elected by voters in states that are dominated by agri-business. Their support is essential if China is to achieve the permanent trading partner status it

needs to acquire if it is going to pursue the Keynes-type demand management policy that is most compatible with its goals. These goals are first, to achieve world-class status as an industrial power; second, the extension of China's economic development into the provinces, which now contribute only 15 percent of the GDP. China's government clearly understands the necessity for correcting the sectoral imbalance that is part of the larger problem of raising living standards throughout China. The third goal is to strengthen the role of the market in directing resources, including workers and capital. There are many people who recommend a market driven economy on philosophical grounds; that is, it is consistent with the ideal of individualism. To economists, the recommendation for a free market may well be strictly pragmatic. The market economy is efficient because it enables businessmen to earn profit. This opportunity is the essence of capitalism.

The popular interpretation of capitalism is that the system essentially means the right to own private property. It does, of course, mean that, but it means much more. Specifically, it means the right to negotiate legal contracts to use the property; i.e., the resources owned to earn a profit. It means that there is a court system to which a businessman can turn to enforce contracts and to penalize that party who has broken the contract. It is this system of legal contracts and their enforcement that makes private enterprise the most efficient vehicle economies can have for achieving economic growth. If and when the profit motive becomes unable to sustain the growth of an economy's GDP, then—as Keynes helped us to

understand—it will again be time for social investment. That is, Keynes envisioned social investment and private investment as being *complimentary*, not competitive. This seems to be precisely the kind of policy China is trying to follow domestically. It is encouraging private enterprise in the substantially developed regions of the east and the southeast, while recognizing that the underdeveloped provinces of the West are not ready for private enterprise except on a small scale.

Keynes was also a great international statesman. Were he alive today he would champion the WTO. He would also champion international cooperation to help economies prevent the kinds of long-term import surpluses that both China and the U.S. continue to have. So Keynes's message is three fold. To provide the kind of institutional setting what will make private enterprise work. To have social investment when and where private investment cannot provide jobs for all who want employment at fair wages, and ultimately to have international economic cooperation to achieve domestic policies of stability and growth. This is a message that has reached China. This is clear from her eagerness to become part of the WTO.

References

Friedman, Milton, and Schwartz, Anna Jacobson (1963). "A Monetary History of the United States 1867-1960", Princeton University Press.

Hansen, Alvin (1941). *Fiscal Policy and Business Cycles*, New York: Norton.

Hansen, Alvin (1953). *A Guide to Keynes*, New York: McGraw-Hill.

Keynes, J. W. (1936). *The General Theory of Employment, Interest and Money*, New York: Harcourt Brace.

Minsky, Hyman (1975). *John Maynard Keynes*, New York: Columbia University Press.