JMK and J. C. Smuts, World Economic Conference, 1933

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Brand sent Keynes's letter on to Geoffrey Dawson, who accepted Keynes's proposals in a letter dated 20 November. Keynes set to work on the articles, which he finished before 6 January. They appeared between 12 and 14 January 1937.

From The Times, *12–14 January 1937*

HOW TO AVOID A SLUMP

I. THE PROBLEM OF THE STEADY LEVEL

It is clear that by painful degrees we have climbed out of the slump. It is also clear that we are well advanced on the upward slopes of prosperity—I will not say 'of the boom', for 'boom' is an opprobrious term, and what we are enjoying is desirable. But many are already preoccupied with what is to come. It is widely agreed that it is more important to avoid a descent into another slump than to stimulate (subject to an important qualification to be mentioned below) a still greater activity than we have. This means that all of us—politicians, bankers, industrialists, and economists—are faced with a scientific problem which we have never tried to solve before.

I emphasise that point. Not only have we never solved it; we have never tried to. Not once. The booms and slumps of the past have been neither courted nor contrived against. The action of central banks has been hitherto an almost automatic response to the unforeseen and undesigned impact of outside events. But this time it is different. We have entirely freed ourselves—this applies to every party and every quarter—from the philosophy of the *laissez-faire* state. We have new means at our disposal which we intend to use. Perhaps we know more. But chiefly it is a general conviction that the stability of our institutions absolutely requires a resolute attempt to apply what perhaps we know to preventing the recurrence of another steep descent. I should like to try, therefore, to reduce a complicated problem to its essential elements.

The distressed areas

It is natural to interject that it is premature to abate our efforts to increase employment so long as the figures of unemployment remain so large. In a sense this must be true. But I believe that we are approaching, or have reached, the point where there is not much advantage in applying a further general stimulus at the centre. So long as surplus resources were widely diffused between industries and localities it was no great matter at what point in the economic structure the impulse of an increased demand was applied. But the evidence grows that—for several reasons into which there is no space to enter here—the economic structure is unfortunately rigid, and that (for example) building activity in the home counties is less effective than one might have hoped in decreasing unemployment in the distressed areas. It follows that the later stages of recovery require a different technique. To remedy the condition of the distressed areas, *ad hoc* measures are necessary. The Jarrow marchers were, so to speak, theoretically correct. The Government have been wrong in their reluctance to accept the strenuous *ad hoc* measures recommended by those in close touch with the problem. Nevertheless a change of policy in the right direction seems to be imminent. We are in more need today of a rightly distributed demand than of a greater aggregate demand; and the Treasury would be entitled to economise elsewhere to compensate for the cost of special assistance to the distressed areas. If our responsibility in this direction could be thus disposed of we could concentrate with a clear mind on our central problem of how to maintain a fairly steady level of sustained prosperity.

Why is it that good times have been so intermittent? The explanation is not difficult. The public, especially when they are prosperous, do not spend the whole of their incomes on current consumption. It follows that the productive activities, from which their incomes are derived, must not be devoted to preparing for consumption in any greater proportion than that in which the corresponding incomes will be spent on consumption; since, if they are, the resulting goods cannot be sold at a profit and production will have to be curtailed. If when incomes are at a given level the public consume, let us say, nine-tenths of their incomes, the productive efforts devoted to consumption goods cannot be more than nine times the efforts devoted to investment, if the results are to be sold without loss. Thus it is an indispensable condition of a stable increase in incomes that the production of investment goods (which must be interpreted in a wide sense so as to include working capital; and also relief works and armaments if they are paid for by borrowing) should advance *pari passu* and in the right proportion. Otherwise the proportion of income spent on consumption will be less than the proportion of income earned by producing consumption goods, which means that the receipts of the producers of consumption goods will be less than their costs, so that business losses and a curtailment of output will ensue.

Difficulty of 'planning'

Now there are several reasons why the production of investment goods tends to fluctuate widely, and it is these fluctuations which cause the fluctuations, first of profits, then of general business activity, and hence of national and world prosperity. The sustained enjoyment of prosperity requires as its condition that as near as possible the right proportion of the national resources, neither too much nor too little, should be devoted to active investment (interpreted, as I have indicated, in a wide sense). The proportion will be just right if it is the same as the proportion of their incomes which the community is disposed to save when the national resources of equipment and labour are being fully employed.

There is no reason to suppose that there is 'an invisible hand', an automatic control in the economic system which ensures of itself that the amount of active investment shall be continuously

of the right proportion. Yet it is also very difficult to ensure it by our own design, by what is now called 'planning.' The best we can hope to achieve is to use those kinds of investment which it is relatively easy to plan as a make-weight, bringing them in so as to preserve as much stability of aggregate investment as we can manage at the right and appropriate level. Three years ago it was important to use public policy to increase investment. It may soon be equally important to retard certain types of investment, so as to keep our most easily available ammunition in hand for when it is more required.

The longer the recovery has lasted, the more difficult does it become to maintain the stability of new investment. Some of the investment which properly occurs during a recovery is, in the nature of things, non-recurrent; for example, the increase in working capital as output increases and the provision of additional equipment to keep pace with the improvement in consumption. Another part becomes less easy to sustain, not because saturation point has been reached, but because with each increase in our stock of wealth the profit to be expected from a further increase declines. And, thirdly, the abnormal profits obtainable, during a too rapid recovery of demand, from equipment which is temporarily in short supply is likely to lead to exaggerated expectations from certain types of new investment, the disappointment of which will bring a subsequent reaction. Experience shows that this is sure to occur if aggregate investment is allowed to rise for a time above the normal proper proportion. We can also add that the rise in stock exchange values consequent on the recovery usually leads to a certain amount of expenditure paid for, not out of current income, but out of stock exchange profits, which will cease when values cease to rise further. It is evident, therefore, what a ticklish business it is to maintain stability. We have to be preparing the way for an increase in sound investments of the second type which have not yet reached saturation point, to take the place in due course of the investment of the first type which is necessarily non-current, while at the same time avoiding a temporary overlap of investments of the first and second types liable to increase aggregate investment to an excessive figure, which by inflating profits will induce unsound investment of the third type based on mistaken expectations.

Having made these general observations, let us examine the opportunities for putting them into practice.

II. 'DEAR' MONEY: THE RIGHT TIME FOR AUSTERITY

In one respect we are better placed than ever before. On previous occasions a shortage of cash has nearly always played a significant part in turning the boom into the slump. Prices and wages are sure to rise somewhat with an increase in output. Nor is there anything wrong in that; for it is to be sharply distinguished from the so-called 'vicious spiral' which attended the post-war currency inflations. But the higher incomes resulting from increased output at a higher level of costs naturally require more cash. Formerly there was seldom a sufficient margin of cash which could be made available to finance the higher incomes. Thus the resulting shortage of cash led to a rise in the rate of interest, which, developing at a time when the maintenance of investment was already becoming difficult for other reasons, had a fatal influence on confidence and credit, and decisively established the slump.

But this time there is no risk of a cash shortage in those countries which still maintain a free economic system and are enjoying a normal recovery. The currency devaluations, the huge output of gold, and the newly-won elasticity of the foreign exchanges have combined to give us the needed freedom of action. We no longer rest under a compulsion to do what is ruinous. Unfortunately there is a widely held belief that dear money is a 'natural' consequence of recovery, and is, in such circumstances, a 'healthy' feature.

Playing with fire

Unquestionably in past experience dear money has accompanied recovery; and has also heralded a slump. If we play with dear money on the ground that it is 'healthy' or 'natural', then, I have no doubt, the inevitable slump will ensue. We must avoid it, therefore, as we would hell-fire. It is true that there is a phase in every recovery when we need to go slow with postponable investment of the recurrent type, lest, in conjunction with the non-recurrent investment which necessarily attends a recovery, it raises aggregate investment too high. But we must find other means of achieving this than a higher rate of interest. For if we allow the rate of interest to be affected, we cannot easily reverse the trend. A low enough long-term rate of interest cannot be achieved if we allow it to be believed that better terms will be obtainable from time to time by those who keep their resources liquid. The long-term rate of interest must be kept *continuously* as near as possible to what we believe to be the long-term optimum. It is not suitable to be used as a short-period weapon.

Moreover, when the recovery is reaching its peak of activity, the phase of non-recurrent investment in increased working capital and the like will be almost over; and we can be practically certain that within a few weeks or months we shall require a lower rate of interest to stimulate increased investment of the recurrent type to fill the gap. Thus it is a fatal mistake to use a high rate of interest as a means of damping down the boom. It has been the occurrence of dear money hitherto which has joined with other forces to make a slump inevitable.

If the stock exchange is unduly excited or if new issues of a doubtful type are becoming too abundant, a higher rate of interest will be useless except in so far as it affects adversely the whole structure of confidence and credit. Moreover, alternative methods are available. A hint to the banks to be cautious in allowing their names to appear on prospectuses, and to the Committee of the Stock Exchange to exercise discrimination in granting permissions to deal would be more efficacious. And if necessary a temporary increase of a substantial amount in the stamp on contract-notes (as distinguished from transfers) in respect of transactions in ordinary shares would help to check an undue speculative activity.

Nevertheless a phase of the recovery may be at hand when it will be desirable to find other methods temporarily to damp down aggregate demand, with a view to stabilising subsequent activity at as high a level as possible. There are three important methods open to our authorities, all of which deserve to be considered in the immediate future.

Boom control

Just as it was advisable for the Government to incur debt during the slump, so for the same reasons it is now advisable that they should incline to the opposite policy. Aggregate demand is increased by loan expenditure and decreased when loans are discharged out of taxation. In view of the high cost of the armaments, which we cannot postpone, it would put too much strain on our fiscal system actually to discharge debt, but the Chancellor of the Exchequer should, I suggest, meet the main part of the cost of armaments out of taxation, raising taxes and withholding all reliefs for the present as something in hand for 1938 or 1939, or whenever there are signs of recession. The boom, not the slump, is the right time for austerity at the Treasury.

Just as it was advisable for local authorities to press on with capital expenditure during the slump, so it is now advisable that they should postpone whatever new enterprises can reasonably be held back. I do not mean that they should abandon their plans of improvement. On the contrary, they should have them fully matured, available for quick release at the right moment. But the boom, not the slump, is the right time for procrastination at the Ministry of Health.

Just as it was advisable (from our own point of view) to check imports and to take measures to improve the balance of trade during the slump, so it is now advisable to shift in the opposite direction and to welcome imports even though they result in an adverse balance of trade. I should like to see a temporary rebate on tariffs wherever this could be done without throwing British resources out of employment. But, above all, it is desirable that we should view with equanimity and without anxiety the prospective worsening of our trade balance which is likely to result from higher prices for raw materials and from our armament expenditure and general trade activity, even though this may put a temporary strain on the Exchange Equalisation Fund. The recent decrease in the Bank of England's fiduciary issue indicates that we have today a plethora of gold. It is desirable, therefore, that the raw material countries should be allowed to replenish their gold and sterling resources by sending their goods to us; especially so in view of the difficulties which would remain in the way of foreign lending on the old scale even if the existing artificial obstacles were to be removed. This policy is doubly desirable. First, because it will help to relieve a temporarily inflated demand in the home market. But, secondly, because a policy of allowing these countries to increase their resources in 1937 provides the best prospect of their using these resources to buy our goods and help our export industries at a later date when an increased demand in our home market is just what we shall be wanting.

These, I urge, are the methods which will best serve to protect us from the excesses of the boom and, at the same time, put us in good trim to ward off the cumulative dangers of the slump when the reaction comes, as come it surely will. But we also need more positive measures to maintain a decent level of continuous prosperity. In a third article we will conclude with suggestions to this end.

III. OPPORTUNITIES OF POLICY

While we shall be prudent to take such steps as I have indicated to prevent the present recovery from developing into a precarious boom, I admit that I do not see much sign of this, except, perhaps, in certain special directions. For the moment we have the rearmament expenditure superimposed on the building activity and on the large non-recurrent investment in working capital and in renewals which are characteristic of a recovery as such; and this is a situation which suggests caution.

But, on the other hand, our export industries remain, on the whole, inactive; the peak of the non-recurrent investment in increased working capital (which in the last two or three years has been much larger per annum than the cost of rearmament now is) may be behind us; sooner or later the building activity will relax; and the cost of rearmament is neither permanent nor large enough while it lasts to sustain prosperity by itself (in 1936 at least seven or eight times as much was spent on new building as on rearmament). Thus our main preoccupation should be concerned not so much with avoiding the perils of a somewhat hypothetical boom as with advance precautions against that sagging away of activity which, if it is allowed to cumulate after the usual fashion, will once again develop into a slump. Too much alarm about a hypothetical boom will be just the way to make a slump inevitable. There is nothing wrong with the very moderate prosperity we now enjoy. Our object must be to stabilise it and to distribute it more widely, not to diminish it.

Positive precautions

Thus we need constructive preparations against the future. Recent experience has shown us how long it takes to prepare for useful investment; and what careful handling is necessary to develop a psychological state in the investment market which will accept a reduction in the long-term rate of interest. Moreover,

it will be much easier to check a recession if we intervene at its earliest stages. For, if it is allowed to develop, cumulative forces of decline will be set in motion which it may prove almost impossible to check until they have run their course. If we are to be successful we must intervene with moderate measures of expansion before the decline has become visible to the general public. One factor only shall we have in our favour—namely, the improvement in our export trade with the raw material countries which I now anticipate with confidence at a date not far distant. In other directions we shall be hard put to it, in my opinion, to develop useful activities on an adequate scale. The menace of the next slump, and what that would mean to our institutions and traditions, if it comes, should be at our elbow, urging us to new policies and boldness of mind.

Perhaps it is absurd to expect Englishmen to think things out beforehand. But if it is not, there are various thoughts to think. So far I have stressed the importance of investment. But the maintenance of prosperity and of a stable economic life only depends on increased investment if we take as unalterable the existing distribution of purchasing power and the willingness of those who enjoy purchasing power to use it for consumption. The wealthier we get and the smaller, therefore, the profit to be gained from adding to our capital goods, the more it is incumbent on us to see that those who would benefit from increasing their consumption—which is, after all, the sole ultimate object of economic effort—have the power and the opportunity to do so. Up to a point individual saving can allow an advantageous way of postponing consumption. But beyond that point it is for the community as a whole both an absurdity and a disaster. The natural evolution should be towards a decent level of consumption for every one; and, when that is high enough, towards the occupation of our energies in the non-economic interests of our lives. Thus we need to be slowly reconstructing our social system with these ends in view. This is a large matter, not to be embarked upon here. But, in particular and in detail, the relief of taxation, when the time comes for that, will do most for the general welfare if it is so directed as to increase the purchasing power of those who have most need to consume more.

Planning investment

The capital requirements of home industry and manufacture cannot possibly absorb more than a fraction of what this country, with its present social structure and distribution of wealth, chooses to save in years of general prosperity; while the amount of our net foreign investment is limited by our exports and our trade balance. Building and transport and public utilities, which can use large amounts of capital, lie half way between private and public control. They need, therefore, the combined stimulus of public policy and a low rate of interest. But a wise public policy to promote investment needs, as I have said, long preparation. Now is the time to appoint a board of public investment to prepare sound schemes against the time that they are needed. If we wait until the crisis is upon us we shall, of course, be too late. We ought to set up immediately an authority whose business it is not to launch anything at present, but to make sure that detailed plans are prepared. The railway companies, the port and river authorities, the water, gas, and electricity undertakings, the building contractors, the local authorities, above all, perhaps, the London County Council and the other great Corporations with congested population, should be asked to investigate what projects could be usefully undertaken if capital were available at certain rates of interest—$3\frac{1}{2}$ per cent, 3 per cent, $2\frac{1}{2}$ per cent, 2 per cent. The question of the general advisability of the schemes and their order of preference should be examined next. What is required at once are acts of constructive imagination by our administrators, engineers, and architects, to be followed by financial criticism, sifting, and more detailed designing; so that some large and useful projects, at least, can be launched at a few months' notice.

There can be no justification for a rate of interest which impedes an adequate flow of new projects at a time when the national resources for production are not fully employed. The rate of interest must be reduced to the figure that the new projects can afford. In special cases subsidies may be justified; but in general it is the long-term rate of interest which should come down to the figure which the marginal project can earn. We have the power to achieve this. The Bank of England and the Treasury had a great success at the time of the conversion of the War Loan. But it is possible that they still underrate the extent of their powers. With the existing control over the exchanges which has revolutionised the technical position, and with the vast resources at the disposal of the authorities through the Bank of England, the Exchange Equalisation Fund, and other funds under the control of the Treasury, it lies within their power, by the exercise of the moderation, the gradualness, and the discreet handling of the market of which they have shown themselves to be masters, to make the long-term rate of interest what they choose within reason. If we know what rate of interest is required to make profitable a flow of new projects at the proper pace, we have the power to make that rate prevail in the market. A low rate of interest can only be harmful and liable to cause an inflation if it is so low as to stimulate a flow of new projects more than enough to absorb our available resources.

Is there the slightest chance of a constructive or a forethoughtful policy in contemporary England? Is it conceivable that the Government should do anything in time? Why shouldn't they?

In a leading article, 'The Boom and the Budget', *The Economist* of 23 January used the appearance of Keynes's articles as a basis for discussing monetary policy. In the article it argued not only against credit contraction but also against further expansion, and suggested that the Treasury in such