**From Against the Tide by Douglas A. Irwin**

"JOHN MAYNARD KEYNES ranks among the most influential economists of the twentieth century, if not all time. His writings, particularly The General Theory of Employment, Interest and Money (1936), reoriented the discipline of economics toward thinking in macroeconomic terms: aggregate income and output, the price level, and total employment. In the debate over how to deal with a persistently high unemployment rate in the late 1920s and early 1930s, Keynes argued that free trade should be abandoned in favor of protection in light of Britain's particular circumstances. These circumstances included three key elements: downwardly inflexible wages, a government commitment to maintain a fixed exchange rate, and a large pool of unemployed labor. Under these conditions, Keynes proposed, and with his stature (like Mill and infant industries) legitimized, using tariffs to help expand output and increase employment. Despite the specific conditions under which his advocacy of tariffs had been made, Keynes's views had a profound impact on economic theory and policy and were perceived as weakening the case for free trade for decades.

Keynes began his career as a staunch proponent of free trade. As an under-graduate he served as secretary of the Cambridge University Free Trade Association and argued for free trade in several debates. In 1923, already established as a leading economist, he endorsed free trade in no uncertain terms:

We must hold to Free Trade, in its widest interpretation, as an inflexible dogma, to which no exception is admitted, wherever the decision rests with us. We must hold to this even where we receive no reciprocity of treatment and even in those rare cases where by infringing it we could in fact obtain a direct economic advantage. We should hold to Free Trade as a principle of international morals, and not merely as a doctrine of economic advantage.

Keynes also employed strong language to attack the frequent claim that tariffs could alleviate unemployment: "If there is one thing that protection can not do, it is to cure unemployment. . . . There are some arguments for protection, based upon its securing possible but improbable advantages, to which there is no simple answer. But the claim to cure unemployment involves the protectionist fallacy in its grossest and crudest form. . . . The proposal to cure the present unemployment by a tariff on manufactured goods . . . is a gigantic fraud."

By 1928, however, Keynes had softened his position by suggesting that "the free trade case must be based in the future, not on abstract principles of laissez-faire, which few now accept, but on the actual expediency and advantages of such a policy." This retreat to a more pragmatic free trade stance gave way to a decisive breach in 1930 based on new circumstances which prompted changes to his theoretical framework. With the backdrop of unrelentingly high rates of British unemployment in the 1920s, Keynes came to argue that import tariffs could help to boost aggregate output and employment. The younger Keynes would have agreed that tariffs could increase employment in protected sectors, but at the offsetting loss of employment in other (probably export) industries. Keynes now held that tariffs could expand total employment when all labor was not fully utilized.

Hints of Keynes's modified views appeared in a section of A Treatise on Money (1930) that analyzed Britain's return to the gold standard in 1925 at the pre-World War I parity. Keynes had been sharply critical of the decision to fix the pound sterling at its prewar price vis-a-vis gold, arguing that wartime inflation had diminished the value of sterling. According to Keynes, returning sterling to its prewar peg resulted in an overvaluation of sterling relative to other currencies. This tended to increase Britain's investments abroad (as the sterling price of foreign assets fell) while shrinking its balance of trade surplus (as domestic wages and prices rose relative to those abroad, harming the competitive position of British exporters and import-competing producers). If an equivalence between foreign lending and the foreign balance, to use his terminology, was not maintained, an outflow of gold would be required to finance the gap in the balance of payments (the excess of foreign lending over the foreign balance). Because the British government's gold reserves were finite, the outflow of gold ultimately had to be stopped either by reducing foreign investment or by increasing the export surplus.

A devaluation of sterling against gold would correct the underlying exchange rate misalignment, restore equilibrium to the balance of payments, and end the gold outflow, but Keynes took as given the government's commitment to keeping sterling on the gold standard at the current rate. Instead, the Bank of England had to implement a deflationary monetary policy, with interest rates set higher than they otherwise would be, to restrain foreign investment and reduce import demand and thereby stop the gold outflow. But this tight monetary stance also tended to depress domestic output and employment. In a world free of economic frictions, the loss of output and employment would prove temporary. The Hume price-specie-flow mechanism provided the classical means by which the full-employment level of output and the balance of payments equilibrium would be restored. Deflationary pressures brought about by the gold outflow would reduce the nominal sterling value of domestic wages and other production costs. As the price of British goods fell, exports (and output and employment) would increase until the balance of trade improved enough to restore external balance and eliminate the gold outflow.

Unfortunately, Keynes believed, modern conditions prevented the smooth operation of this adjustment mechanism. As he wrote in the Treatise: "I believe that the resistances to a severe income deflation . . . have always been very great. But in the modern world of organized trade unions and a proletarian electorate they are overwhelmingly strong. The attempt by the entrepreneurs to bring this expedient into operation culminated in the general strike of 1926. But political and social considerations stood in the way of allowing the advantages won by the defeat of the strike to be pushed home." Because trade unions and the electorate would fight a reduction in nominal wages, a deflationary monetary policy would reduce prices but not wage costs, leading to business losses and unemployment. Indeed, Keynes had charged in 1925 that such a monetary policy constituted a "deliberate intensification of unemployment." Eventually, of course, severe unemployment could overcome the resistance to a reduction in wages, but he argued in the Treatise (1930) that "social and political forces stand in the way" of tolerating such a situation and alternative policies were required to address Britain's predicament. Keynes's preferred escape from the dilemma was to subsidize home investment, which would reduce the incentive for foreign investment (and thus the need to have a large export surplus to maintain balance of payments equilibrium) as well as expand the domestic economy. But he admitted "coming round to the view that there is also room for applying usefully some method of establishing differential prices for home and foreign goods."

In private evidence given in 1930 before the Macmillan Committee on Finance and Industry, set up to offer economic advice to the British government at the onset of the Great Depression, Keynes elaborated on proposed solutions to the deepening economic crisis. The fundamental problem was worsening unemployment, caused in his view by the overvalued exchange rate which required the Bank of England to maintain a deflationary monetary policy. In his February testimony, Keynes considered seven possible remedies to restore business profitability so that output and employment could expand once again. First, Britain could change the price at which sterling was pegged to gold (devaluing sterling and revaluing gold) and thereby pursue a more expansionary monetary policy. For political reasons, he commented, "there is no likelihood of such a remedy being adopted in present circumstances." Second, there could be a general agreement to reduce money wages, facilitating the operation of the classical adjustment mechanism. Keynes believed that this was "in some respects the ideal remedy," but was probably impractical if not "chimerical" under the circumstances. Third, industry could be subsidized in order to restore business profitability without entailing any cut in money wages, but this encountered practical (mainly fiscal) difficulties and its adoption was "very unlikely." Fourth, industry could enhance its productivity (rationalize production), producing more output at the same wage costs, but this uncertain method operated too slowly and could actually exacerbate unemployment in the short run. Keynes noted that these four remedies were "all variations of the same tune"; they were designed to bring into balance the money costs of production at home and abroad, thereby increasing Britain's export surplus and restoring balance of payments equilibrium, and thus allowing the Bank of England to reduce interest rates and expediting an economic recovery.

Keynes also pointed to three other remedies of a different class. Fifth, as suggested in the Treatise, import tariffs could be imposed in an effort to increase domestic output and employment while improving the trade balance. Protection would reduce real wages and increase prices, he stated, something that was desirable under the circumstances. Sixth, domestic investment could be indirectly subsidized to increase domestic output and reduce foreign lending. Keynes called this "my own favourite remedy," which could be accomplished by a tax on foreign bonds, by changes in the banking system to increase domestic lending, or even by direct capital expenditures by the government. Seventh, major central banks could act jointly to pursue a more inflationary monetary policy, thereby expanding their economies and relieving unemployment without violating balance of payments constraints or requiring exchange rate adjustments. This was deemed problematic because of ignorance at the Bank of France and the narrowly domestic orientation of the Federal Reserve System.

As most remedies could be ruled out as impractical for whatever reason, the choice essentially came down to either import tariffs or home investment incentives. When asked whether abandoning free trade was worth the potential ameliorative effects of protection, Keynes replied, "I have not reached a clear-cut opinion as to where the balance of advantage lies," indicating that his preferred remedy was still a policy of increasing home investment. Keynes saw the merits of tariffs as an alleviation rather than a solution to the slump, but was reluctant to endorse them. "I am frightfully afraid of protection as a long-term policy," he testified, "but we cannot afford always to take long views . . . the question, in my opinion, is how far I am prepared to risk long-period disadvantages in order to get some help to the immediate position." He also added, "It is extremely difficult for anyone of free trade origin, so to speak, at this juncture to speak in a way that he himself believes to be quite truthful and candid without laying himself open to misrepresentation and to being supposed to advocate very much more than he really does."

By July 1930, as the economic situation worsened and no government action was forthcoming, the benefits of a general tariff became much more apparent to him. In response to questions from the prime minister, Keynes indicated that he had "become reluctantly convinced that some protectionist measures should be introduced." While additional employment could be had either by increasing exports or decreasing imports, the latter was easier to arrange through policy action and had the advantage of generating fiscal revenue and improving the terms of trade. Throughout his private and public advocacy of a tariff, however, Keynes made clear that his conviction arose from "a question of a choice between alternatives, none of which are attractive in themselves."

Having gravitated toward protection, Keynes began to press his views more strongly. In a memorandum prepared in September for the Committee of Economists of the Economic Advisory Council, Keynes elaborated on the benefits of a tariff, which he now described as "simply enormous." These benefits included solving the basic problem of the misalignment of money costs and the exchange rate: a tariff would raise domestic prices and reduce real wages toward their equilibrium value, while avoiding a disruptive fall in nominal wages. A tariff would also restore business confidence and create a favorable climate for new investment, he stated, but would not (unless poorly designed) trigger demands by trade unions for higher pay or have adverse employment effects.

In another paper prepared for committee discussion, Keynes proposed a uniform 10 percent tariff on imports and an equal bounty for exports. As an alternative to reducing money wages, he argued, such a plan would effectively restore the conditions which would exist under free trade if money costs of production were reduced 10 percent. It would also be economically equivalent to a 10 percent devaluation, except the value of sterling obligations would be left unchanged in terms of gold. Despite disputes and dissention among several of its members, the Committee of Economists issued a report in October which set out these options and reached a majority support for protection, as long as it was tied to industry efforts at rationalization. Keynes's proposal for a system of matching export bounties was rejected because it might provoke foreign countries to implement off-setting antidumping measures. The report also called for the tariff scheme to be removed either when unemployment had been sufficiently reduced or when prices had been restored to their 1925-28 level.

Up to this point, Keynes's views had been expressed only in the privacy of quasi-governmental committees and advisory groups. In March 1931, he unveiled his position to the public in a newspaper article which, according to the editor of his Collected Writings, "as the recantation of an avowed free trader, it caused a sensation.” Keynes saw three feasible policy options to increase employment and rejuvenate business activity: devaluation, nominal wage reductions, and import tariffs. Despite opposing the return to the gold standard in 1925, he rejected devaluation on grounds that it would undermine already weak confidence in the London financial markets. Indeed, Keynes now thought that "our exchange position should be relentlessly defended today, in order, above all, that we may resume the vacant financial leadership of the world." Wage reductions "would certainly lead to social injustice and violent resistance. . . . For these reasons a policy of contraction sufficiently drastic to do any real good may be quite impractical." Instead, Keynes proposed "import duties of 15 per cent on all manufactured and semi-manufactured goods without exception, and of 5 percent on all foodstuffs and certain raw materials, whilst other raw materials would be exempt." "In so far as it leads to the substitution of home-produced goods for goods previously imported," he stated flatly, "it will increase the employment of this country."

In another newspaper article in September 1931, Keynes repeated the three basic policy options: devaluation, wage reductions, and import tariffs. In the intervening months, he warmed to the idea of a devaluation-"I personally now believe [it] to be the right remedy"-but ruled it out because "the decision to maintain the gold standard at all costs has been taken" by political authorities and devaluation "is not yet the policy of any organized party in the state." Hopes for wage cuts adequate to restore equilibrium "would involve so drastic a reduction of wages and such appallingly difficult, probably insoluble, problems, both of social justice and practical method, that it would be crazy not to try first the effects of the alternative, and much milder, measure of restricting imports.” So Keynes once again fell back upon the tariff, not as the best method but simply a method of promoting economic recovery.

In various statements and writings, Keynes argued that the unequivocal case for free trade was undermined by the failure of wage flexibility to operate effectively as an equilibrating mechanism. "Free trade, combined with great mobility of wage rates, is a tenable intellectual position," he readily acknowledged, but "it presents a problem of justice so long as many types of money [wages] income are protected by contract and cannot be made mobile.” Keynes rejected the standard view that tariffs just shuffled labor from employment in one industry to another without affecting aggregate employment. "When a free trader argues that a tariff cannot increase employment but can only divert employment from one industry to another, he is tacitly assuming that a man who loses his employment in one direction will lower the wage rate which he is willing to accept until he finds employment in another direction . . . in present circumstances [this] is sheer nonsense." The trouble with free trade, Keynes suggested, was the assumption "that if you throw men out of work in one direction you re-employ them in another. As soon as that link in the chain is broken the whole of the free trade argument breaks down."

Keynes's heretical views on the tariff sparked opposition and debate within government policy circles and then in the public realm with the appearance of his newspaper articles. Lionel Robbins, also a member of the Economic Advisory Council, sharply disputed Keynes's tariff recommendations and refused to sign the final report. A tariff would not alleviate the depression in economic activity, he maintained, but would have adverse international consequences by inciting foreign protectionists and provoking retaliation. Robbins (1971, 155-56) argued (he later recalled) for a principled adherence to free trade, because "once the taboo of abstention from the obstruction of imports had been broken, there was small hope that the process would stop there." According to Robbins, Keynes "showed extraordinary naivete" in believing that import duties could be easily removed once they had served their purpose.

Other prominent economists responded to Keynes's proposals with deep skepticism if not outright hostility. Under the guidance of William Beveridge, several prominent economists then at the London School of Economics, including Robbins, T. E. Gregory, Arnold Plant, J. R. Hicks, and others, collaborated on the book Tariffs: The Case Examined, a restatement of standard arguments against tariffs. The economists were particularly insistent that protection was not a remedy for unemployment, noting that other countries with high tariff barriers were suffering from even higher rates of unemployment than Britain. They refused to concede that classical trade theory was inoperative under conditions of unemployment: it is never optimal to maximize employment of labor, land, or capital, they argued, and free trade remained the best policy, whatever the degree of resource utilization. If imports of manufactures were blocked to stimulate domestic output and employment, either exports must decrease equivalently or foreign investment must increase. It was a "pure gamble," the Beveridge (1931, 58) report stated, to assume that investment would increase and thereby avoid employment losses in export industries. However, the economists did concede that higher total employment could be brought about in the unlikely situation that a tariff shifted imports toward goods not produced at home, thereby keeping the import bill constant and not diminishing foreign demand for British exports.

Responding to his critics, Keynes acknowledged Robbins's point that reversing the tariff policy could prove difficult, but argued that the risk was overstated and "it is a risk which circumstances demand that we should take." As he once put it, by using tariffs "you may also have got into bad habits and ten years hence you might be a trifle worse off than if you had been able to grin and bear it," but you also may "have avoided a social catastrophe." In a letter to Beveridge, Keynes noted his agreement with much in the Tariffs: The Case Examined collection, but he dismissed chapter 6 on tariffs and unemployment as addressing a serious issue in an amateurish way. Keynes strongly rejected the claim by Beveridge and other free traders that a reduction of imports would not generate a net stimulus because of an offsetting reduction in exports. Keynes vigorously denied that there was any simple and direct relationship between the volume of imports and exports. Stating that Beveridge's "defense of free trade is, I submit, the result of pure intellectual error, due to a complete misunderstanding of the theory of equilibrium in international trade," Keynes posed the following question: "Does he believe that it makes no difference to the amount of employment in this country if I decide to buy a British car instead of an American car?

Keynes did not have an extended opportunity to respond to critics because the tariff debate was soon cut short and rendered moot by events. He had endorsed tariffs under the assumption that an alternative option, devaluation, had been ruled out. As it happened, just days after his September 1931 newspaper article repeating his call for tariffs, the British government abandoned its commitment to the gold standard and sterling depreciated sharply on foreign exchange markets. In a letter to the Times shortly thereafter, Keynes promptly dropped his call for a tariff and proposed moving on to discuss other policies that would stimulate economic recovery: "Until recently I was urging on Liberals and others the importance of accepting a general tariff as a means of mitigating the effects of the obvious disequilibrium between money costs at home and abroad. . . [now] proposals for high protection have ceased to be urgent." He spoke as one who rejoiced "at the breaking of our gold fetters" since it now freed monetary policy to pursue domestic economic objectives, such as stimulating the economy through lower interest rates, rather than the exchange rate objective.

The year 1931 was a tumultuous one of intellectual crossfire over the tariff issue. The tariff debate subsided after Britain abandoned the gold standard in September and passed a general tariff in February 1932. But as Keynes was (and is) such a commanding figure in economics, even his obiter dicta regarding free trade and protection are of interest as they became part of the intellectual milieu of the period. In an address in 1932, Keynes stated that "the free trader starts with an enormous presumption in his favour" because of the demonstrable gains from trade. But "the free trade argument against the use of a tariff for drawing workers into an industry for which they are relatively ill-suited fundamentally assumes that, in the absence of a tariff, they will be employed in some other more suitable industry, and does not allow for the contingency that they may not be employed at all." A worldwide system of tariffs would, of course, increase unemployment worldwide, but a country employing its tariffs alone might be able to shift some of the burden of its unemployment onto others. The Keynes of this period also often trivialized the gains from the international division of labor and implied that the costs of protection were negligible.

Revealing a deep-seated conservative streak, Keynes wrote favorably of inward-looking policies that, though economically costly, were worth the price of avoiding external entanglements. He endorsed protection to a new industry (motor cars), an old industry (iron and steel), and agriculture, all out of a sense of England's heritage and an image of what the country should be. As he put it: "Neither free trade nor protection can present a theoretical case which entitled it to claim superiority in practice. Protection is a dangerous and expensive method of redressing a want of balance and security in a nation's economic life. But there are times when we cannot safely trust ourselves to the blindness of economic forces; and when no alternative weapons as efficacious as tariffs lie ready to hand." In a famous 1933 article entitled "National Self-Sufficiency," Keynes continued on this theme, writing of his sympathy "with those who would minimise, rather than with those who would maximize, economic entanglements between nations. Ideas, knowledge, art, hospitality, travel-these are things which should of their nature be international. But let goods be homespun whenever it is reasonable and conveniently possible; and, above all, let finance be primarily national.”

The political debate over Britain's tariff policy abated with events, but the economic debate continued. In attacking the economic basis and the desirability of free trade under conditions of unemployment, Keynes had presented a real challenge to free trade and a wide gulf separated his views from those of traditional free traders. But in his major works on economic theory, as opposed to his policy advocacy in newspapers and elsewhere, Keynes was cautious about the generality of his case for tariffs for purposes of promoting employment. In his General Theory, for example, is famous for its rehabilitation of mercantilist doctrine. Although approving of the mercantilists' attention to the balance of trade, Keynes argued not in favor of systematic restrictions on trade, but against the theoretical foundations of laissez-faire, particularly "the notion that the rate of interest and the volume of investment are self-adjusting at the optimum level" Indeed, he wrote that "there are strong presumptions of a general character against trade restrictions unless they can be justified on special grounds. The advantages of the international division of labour are real and substantial, even though the classical school greatly overstressed them." Trade restrictions, he added, are "a treacherous instrument even for the attainment of its ostensible object since private interest, administrative incompetence and the intrinsic difficulty of the task may divert it into producing results directly opposite to those intended."

While a favorable balance of trade helped promote domestic employment, this benefit came only at the expense of other countries: just as not every country can improve its terms of trade against one another, not all countries could improve their trade balance against one another. Keynes concluded that domestic policies were best suited for ensuring full employment and efforts to contrive a more favorable trade balance should be avoided.

If nations can learn to provide themselves with full employment by their domestic policy, ... there would no longer be a pressing motive why one country need force its wares on another or repulse the offerings of its neighbour. . . . International trade would cease to be what it is, namely, a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle, but a willing and unimpeded exchange of goods and services in conditions of mutual advantage.”