

TRANSFERS, NON-TRADED GOODS, AND UNEMPLOYMENT: AN ANALYSIS OF THE KEYNES – OHLIN DEBATE

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CESIFO WORKING PAPER NO. 1588
CATEGORY 7: TRADE POLICY
NOVEMBER 2005

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Abstract

In the famous debate between Keynes and Ohlin on the transfer problem, the interaction between non-traded goods and unemployment complicates the analysis considerably. We analyze these issues using four different models to conclude that Keynes's concern regarding the large burden imposed on Germany was justified. Simultaneously, we show that Ohlin's presumption that a transfer does not affect the donor's terms-of-trade either favourably or unfavourably was also justified. Moreover, Ohlin was also right in asserting that a transfer tends to lower the price of non-traded goods for the donor and raise them for the recipient.

JEL Code: B0, F0, O1.

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We would like to thank seminar participants at the University of Groningen, Radboud University Nijmegen, and Erasmus University Rotterdam, two anonymous referees for useful comments and suggestions. Any errors are, of course, our own.

1. Introduction

The economics of international transfers has repeatedly given rise to interesting debates to increase our understanding of the issues involved. The most famous of these was the discussion between John Maynard Keynes and Bertil Ohlin in 1929 regarding Germany's capacity to pay reparations after the First World War and the terms-of-trade effect, see Keynes (1929a-c) and Ohlin (1929a,b).¹ Ever since he wrote the *Economic Consequences of the Peace* in 1919, Germany's ability to pay reparations was on Keynes's mind.² The occasion for the famous 1929 debate was a new committee of experts under the American Owen Young. The committee had to reorganize Germany's reparation payments of the Dawes plan of 1924, scheduling payments of increasing magnitude. In this 1929-debate, Keynes represented a classical, partial equilibrium view and argued that a transfer would cause a terms-of-trade deterioration for the donor. Ohlin, however, pointed at the importance of income effects on demand as a result of the transfer to conclude that there was no presumption for the terms-of-trade to move either in favor of, or against, the donor.

The focus of the literature soon moved to the welfare effects of a transfer. After Leontief (1936) pointed out, by means of an example, the possibility of transfer paradoxes (in which the donor gains and/or the recipient loses from the transfer) the main point of reference has been Samuelson's (1947) assertion that Leontief's example requires instable markets. More specifically, in a perfectly competitive, Walrasian stable, two-country world with two traded goods the donor's welfare falls and the recipient's welfare rises, see also Kemp (1964) and Mundell (1960). We refer to this result (which was hiding in a footnote) as "Samuelson's Theorem."³

Samuelson's Theorem does not hold if productive resources are transferred instead of purchasing power, if distortions are present in the system, if aid is tied, or if there are more than two countries. Transfer paradoxes are thus quite possible in more general

¹ Two other debates were the bullionist controversy, regarding the convertibility of gold and payments by Great Britain to its allies around 1800, involving e.g. Henry Thornton, David Ricardo and John Wheatley, and the debate in 1980-1983 concerning the importance of third parties, involving e.g. Graciela Chichilnisky, Jagdish Bhagwati and T.N. Srinivasan.

² Keynes (1919) calculated that Germany could not possibly pay what the European Allies demanded. He thought that Germany could pay a total of £1500m, in thirty annual instalments of £50m. See Skidelsky (1992) for details on the evolution of Keynes's thinking between 1919 and debate of 1929.

³ See Samuelson (1947, p. 29) and Brakman and Van Marrewijk (1998).

settings, see e.g. Jones (1967, 1985), Ohyama (1974), Gale (1974), Chichilnisky (1980), Bhagwati, Brecher and Hatta (1983), Kemp and Kojima (1985), Schweinberger (1990), Kemp (1995), and Kemp and Shimomura (2003).

In their debate Keynes and Ohlin both acknowledged that non-traded goods exist and that their presence complicates the analysis considerably. Even more so, if unemployment or price rigidities are present. Without either party changing its point of view, Keynes and Ohlin focused on the terms-of-trade effect of a transfer in the presence of non-traded goods, as did the subsequent literature on the transfer problem analyzing non-traded goods, see e.g. McDougall (1965), Samuelson (1971), Chipman (1974), and Jones (1975). Yano and Nugent (1999) analyse the small-country case in which prices of international goods are given. In this case transfer paradoxes can arise if tariffs are introduced as an additional distortion. They show that in practice transfer paradoxes are unlikely in these special cases.

This paper presents and investigates the non-traded goods and unemployment confusion by analyzing international transfers in a simple, but general, two-country dual framework. We focus attention on the welfare effects of a transfer, on the terms-of-trade effect, and on the price of traded goods relative to non-traded goods, a point emphasized by Ohlin. Section 2 gives a brief overview of the historical discussion on transfers between Keynes and Ohlin. We summarize their positions at the end of section 2 in four statements. Section 3 briefly provides the analytic framework of four separate models: (i) the standard model, (ii) the non-traded goods model, (iii) the unemployment model, and (iv) the complete model. Section 4 derives and discusses the analytic consequences of a unilateral transfer in these four models in the light of the four assertions made by Keynes and Ohlin identified in section 2. Section 5, finally, summarizes the results and concludes.

2. Historical overview

Discussions on transfers often give rise to confusion and misunderstandings. This also holds for the discussion on the effects of transfers in the presence of non-traded goods, particularly in conjunction with unemployment. The first example of this particular confusion is the famous discussion on transfers between Keynes and Ohlin in the *Economic Journal* in 1929 in which Keynes analyzed the problem of German

war reparation payments as a classical economist. In essence this means that the current account surplus is the transfer. If this surplus is absent or fails to materialize the terms-of-trade (or the exchange rate) deteriorates. If the price-elasticity of exports is smaller than one, as Keynes believed to be the case for Germany, a paying country is confronted with declining terms-of-trade. If the paying country has to pay reparations over a longer period of time, the terms-of-trade will decline from year to year. It is important to note that not only Keynes and Ohlin discussed these matters in the 1929 volume of the *Economic Journal*. Most notably Jacques Rueff (1929, p.394) added additional concerns to the debate that prelude the monetary approach to the balance of payments that was developed later.⁴ He argued, contrary to Keynes that:

“the commercial balance has shown a tendency to adjust itself to the necessities of the balance of payments, whatever they might be and whatever their origin.”

After further discussing the history of France, he concludes (p.395):

“What is remarkable in the case of France after 1870 is that a surplus appeared in the commercial balance at precisely the moment when theory would lead one to expect it. This only constitutes a presumption – but a very strong presumption – in favour of the said theory.”

However, according to Keynes this is not the only problem which faced Germany. One of the main problems is that (Keynes, 1929, p. 3):

“...when foreign borrowing (of Germany) comes to an end, it will be a question, not of reducing current consumption in Germany, but of transferring labour from capital works in Germany to the export trades....where the outcome of capital improvements ...is not in exportable form (and much of it will not be in such a form), the diversion of production out of employments into export trades...will have to be on a greater scale than is required by the payment of the Reparations alone...”.

Keynes then concludes (p.3) that one of the main problems is not

“the release to foreign consumers of goods now consumed by Germans, but the diversion of German factors of production from other employments into the export industries.”

The increase of exports is crucial in Keynes’s thinking. He considered this as “a formidable task” and even if efficiency wages are reduced this may not help to increase Germany’s exports, or might even make her worse off, in the case (p.5):

“where the output, e.g. personal services or buildings, cannot be exported anyhow.”

⁴ The introduction of money requires that time is introduced explicitly – money is only held if it can be used to buy commodities tomorrow – this however, does not affect the general conclusions of the models described in the next section (see Brakman and Van Marrewijk, 1998, section 10.3).

So, in the eyes of Keynes the existence of non-traded goods very much reduced Germany's capacity to pay. In Keynes's analysis this is a major concern, because (relative) prices in the traded goods sector must decrease in order to make the transfer possible, making such a diversion of German factors of production into the traded goods sector unlikely. Ohlin (1929, p.175), in his comment to Keynes, points out that the existence of a non-tradable sector does not alter his main point, namely that income effects can make terms-of-trade adjustments redundant in principle.

The presence of non-traded goods complicates the analysis considerably, and certainly has not made the discussion between Keynes and Ohlin more transparent. Keynes thought that their presence strengthened his case. The consequences of non-traded goods for the transfer problem are still problematic, as the latest edition of the best-selling textbook of Krugman and Obstfeld (2006) shows. They point out that the United States spend only a fraction of income on foreign goods, just like Keynes pointed this out for Germany in 1929. Obviously, this gives us no information at all on the marginal propensities to consume a particular good for Germany or the United States.⁵ Moreover, Krugman and Obstfeld (2006, p. 98) argue:

"Here the crucial point is that a country's non-traded goods compete with exports for resources. A transfer of income from the United States to the rest of the world lowers the demand for non-traded goods in the United States, releasing resources that can be used to produce U.S. exports. As a result, the supply of U.S. exports rises. .. The result is that a transfer by the United States to other countries may lower the price of U.S. exports relative to foreign, worsening U.S. terms-of-trade."

They then conclude on the basis of this reasoning that "Keynes was right in practice." However, the above quote suffers from two omissions. First, resources released from the production of non-traded goods in the U.S. could also be used for the production of goods otherwise imported. Second, and more importantly, the transfer to the rest of the world has increased the demand for U.S. exports, as stressed time and again by Ohlin. Indeed, Ohlin argues that (1929a, p. 174):

⁵ Suppose, for example, that there are two countries with an income level of 100, each spending 50 on traded good x and 50 on traded good y , while one country produces (in value terms) 60 of x and 40 of y and the other 40 of x and 60 of y . Then the observation that both countries only spend 10 percent on foreign goods says nothing about the average propensities to consume, let alone the marginal propensities to consume.

"Home market prices tend to rise in A [that is: the recipient] and fall in B [that is: the donor], relative to prices of export and import goods and prices of the goods which compete with import goods. ... It is not necessary that A's export prices should rise and B's fall. Thus, B need not offer its goods on cheaper terms-of-trade to induce A to take a greater quantity of them. Indirectly, however, it is probable that a certain shift of the terms of exchange will take place."

So, he notes that in the presence of non-traded goods price changes might happen but that these are not necessary, as Keynes believed. Ohlin (1929, p.175) concludes :

"This erroneous conclusion is reached because of the fact that the shift in buying power is ignored, except in so far as it *directly* affects demand for international goods."

To be fair to Keynes we also deal with the possibility of unemployment and rigidity.⁶ As Keynes (1929a, p. 6) stresses, and what is also forcefully put forward by Rueff who cites Keynes (1929, p. 390):

"In the case of German reparations, we are trying to fix the volume of foreign remittances and compel the balance of trade to adjust itself thereto. Those who see no difficulty in this...are applying the theory of liquids to what is, if not a solid, at least a sticky mass with strong internal resistances."

To settle the issue of the terms-of-trade effect of an international transfer and its relation to non-traded goods we first need to extend Samuelson's result on the welfare effects of a transfer to non-traded goods. Furthermore, we allow for the possibility of unemployment and rigidity. At this point it is fair to point out that Keynes was not the ignoramus as he is sometimes portrayed to be in this debate (Keynes, 1929a, p.2):

"If 1 pound is taken from you and given to me and I choose to increase my consumption of precisely the same goods as those of which you are compelled to diminish yours, there is no Transfer problem."

However, he thought that this was only a special case. Keynes was very much a practical man in this discussion and he was convinced that Germany could never pay the total of war reparations.

For Keynes this was not the first time he was worried about the possibilities of Germany to pay war reparations, as is illustrated in his *The Economic Consequences of the Peace* (1919). In the transfer debate of 1929 he was uneasy that the debate became more and more theoretical instead of practical (Keynes, 1929c, p. 404): "the

⁶ We are grateful to one of the anonymous referees for drawing our attention to Rueff (1929).

controversy...moves quite inevitably, from the particular (that is, Germany) to the general." From a practical point view he turned out to be right; Germany could never pay the huge amount it should pay and the fact that it was forced to do so helped to pave the way for Hitler. As Kershaw (1999, p. 355) notes:

"With the Brüning government under siege, ruling by emergency decree, its policies - calculated to demonstrate Germany's inability to pay reparations - sending the economy plummeting to disaster in a catastrophic downward spiral of cascading production levels and soaring levels of unemployment and social misery, more and more voters were cursing the wretched Republic [the Weimar republic]."

Our analysis below is general. The analysis simplifies, however, if we make the standard assumption in international economics of an identical demand structure.⁷ For ease of reference, we label this assumption 1.

- *Assumption 1.* Donor and recipient have an identical demand structure: $\overline{m}_u^A = \overline{m}_u^B$

Moreover, we summarize the assertions made by Keynes and Ohlin as discussed above in four statements:

- *Keynes's concern:* transfers impose a (large) burden on the donor; this holds particularly for Germany in the presence of non-traded goods and price rigidities.
- *Keynes's presumption:* a transfer deteriorates the donor's terms-of-trade, specifically in the presence of non-traded goods.
- *Ohlin's presumption I:* there is no reason for a transfer to affect the donor's terms-of-trade either favourably or unfavourably.
- *Ohlin's presumption II:* the price of non-traded relative to traded goods will rise for the recipient and fall for the donor.⁸

⁷ See, for example, p.6 in Bowen, et al. (1998).

⁸ It is interesting to note that Harry Johnson concurred with this presumption. In the final section of Johnson (1976) he notes that additional income for the recipient increases the demand for non-traded goods, which (initially) leads to price increases of non-tradables. He argues that the subsequent substitution process can be in the direction of importables or exportables, but "*since there is no reason to assume that the effect is biased one way or the other*, p.219" the introduction of non-tradables has no bearing on the discussion. In the sections below we show the importance of Ohlin's second presumption in the debate.

3. The models⁹

We analyze international transfers under four different settings of perfect competition if there are two countries (donor A and recipient B) and two traded goods (numéraire good x and good y with price p). The settings are referred to as (i) the *standard model* (no unemployment or non-traded goods), (ii) the *non-traded goods model* (with a non-traded good for both donor and recipient), (iii) the *unemployment model* (with unemployment in the donor country), and the *complete model* (with both non-traded goods and donor unemployment). We let $J = A, B$ be the country index, q^J is the price of the locally provided non-traded good, E^J is the expenditure function, R^J is the revenue function, T is the transfer from country A to country B , u^J is the welfare level, v^A is employment in country A , w^A is the real wage in country A , and m^J is the net demand for good y , i.e. $m^J = E_p^J - R_p^J$, where subscripts refer to derivatives.¹⁰

The equations below are used to construct the various models mentioned above.

- (1) $E^A(p, q^A, u^A) = R^A(p, q^A, v^A) - T$
- (2) $E_q^A(p, q^A, u^A) = R_q^A(p, q^A, v^A)$
- (3) $R_v^A(p, q^A, v^A) = w^A$
- (4) $E^B(p, q^B, u^B) = R^B(p, q^B) + T$
- (5) $E_q^B(p, q^B, u^B) = R_q^B(p, q^B)$
- (6) $m^A(p, q^A, u^A, v^A) + m^B(p, q^B, u^B) = 0$

Equation (1) is the donor's budget constraint. It indicates that total expenditure E^A , which is a function of the prices p and q^A and the attained welfare level u^A , is equal to total revenue R^A , which is a function of the prices p and q^A and the employment level v^A , after subtracting the transfer to country B (measured in terms of good x). Similarly, equation (4) is the recipient's budget constraint. As we do not analyze unemployment for the recipient, the argument v^B is suppressed. Equation (2) is the donor's market clearing condition for non-traded goods. Making use of the derivative properties of expenditure and revenue functions, domestic demand E_q^A must be equal

⁹ Detailed derivations can be found in the appendix.

¹⁰ Note, that the model assumes non-satiable wants. The case of satiable wants in the context of transfers was analyzed by Johnson (1976).

to domestic supply R_q^A . Similarly, equation (5) is the recipient's market clearing condition for non-traded goods, where the argument v^B is again suppressed. If we analyze unemployment in the donor country, we will always assume that the sticky real wage rate w^A is a binding restriction, such that actual employment v^A is endogenously (demand) determined, see equation (3). Finally, using again the derivative properties, equation (5) is the market clearing condition for traded good y . The four models mentioned above can now be summarized as follows.

- The *standard model* ignores non-traded goods and unemployment; it consists of equations (1), (4), and (6), with the endogenous variables p, u^A , and u^B .
- The *non-traded goods model* ignores unemployment; it consists of equations (1), (2), (4), (5), and (6), with the endogenous variables p, q^A, q^B, u^A , and u^B .
- The *unemployment model* ignores non-traded goods; it consists of equations (1), (3), (4), and (6), with the endogenous variables p, v^A, u^A , and u^B .
- The *complete model* incorporates non-traded goods and unemployment; it consists of equations (1)-(6), with the endogenous variables p, q^A, q^B, v^A, u^A , and u^B .

For the models incorporating non-traded goods, we will simplify the analysis by eliminating equations (2) and (5), which can be solved for the price of non-traded goods q^J for donor and recipient as a function of the price p of good y , employment v^A , and domestic welfare u^J :

$$(7) \quad q^A = q^A(p, u^A, v^A); \quad q^B = q^B(p, u^B), \quad \text{with}$$

$$q_v^A = \frac{R_{qv}^A}{(E_{qq}^A - R_{qq}^A)}; \quad q_p^J = -\frac{(E_{qp}^J - R_{qp}^J)}{(E_{qq}^J - R_{qq}^J)}, \quad q_u^J = -\frac{E_{qu}^J}{(E_{qq}^J - R_{qq}^J)}, \quad J = A, B$$

Note that if there is any substitution at all in either production or consumption of the non-traded good in country J , then equation (7) is well defined for that country (that is $E_{qq}^J - R_{qq}^J < 0$), as we henceforth assume. Also note that if the traded good y and the non-traded good are net substitutes (that is $E_{qp}^J - R_{qp}^J > 0$), then q_p^J is positive, while if the non-traded good is a normal good (that is $E_{qu}^J > 0$), then q_u^J is also positive.

4. The results

For each of the models introduced in section 3 we now briefly provide and discuss the main analytic results, identified by sub-indices *st*, *nt*, *un*, and *co* for the standard, non-traded goods, unemployment, and complete model, respectively.

4.1. The standard model

The basic economic implications of international transfers are most easily understood by restricting attention to the standard model, that is by allowing for two traded goods, two countries, perfect competition, and no imperfections. We normalize such that $E_u^J = 1$ and define Ω and Δ for notational convenience as follows:

$$(8) \quad \Omega \equiv \sum_J m_p^J < 0; \quad -1/\Delta \equiv \sum_J (m_p^J - m^J m_u^J) < 0$$

The term Ω is always non-positive as it is the derivative of the compensated net demand for good y with respect to its own price p . If there is some substitutability in either demand or supply (or both) between good y and good x , the term will be strictly negative, as we henceforth assume. The positively defined term Δ is associated with Walrasian stability, based on a dynamic adjustment process where the price falls (rises) if it is higher (lower) than the equilibrium price, see Brakman and van Marrewijk (1998, pp. 39 – 41) for details. Differentiating equations (1), (4), and (6) with respect to p, u^A, u^B and T , solving these equations, and imposing Walrasian stability gives the following the terms-of-trade and welfare effects:

$$(9) \quad \left. \frac{dp}{dT} \right|_{st} = (m_u^B - m_u^A) \Delta > 0 \Leftrightarrow m_u^B > m_u^A$$

$$(10) \quad \left. \frac{du^A}{dT} \right|_{st} = \Omega \Delta < 0; \quad \left. \frac{du^B}{dT} \right|_{st} = -\Omega \Delta > 0; \quad \left. \frac{du^A}{dT} \right|_{st} + \left. \frac{du^B}{dT} \right|_{st} = 0$$

Equation (9) indicates that the price of good y will rise, if and only if $m_u^B > m_u^A$, that is if the recipient's marginal propensity to consume good y is higher than the donor's propensity to consume this good. Obviously, there is no terms-of-trade effect if the demand structure is identical (Assumption 1). Even if there are demand differences, however, the donor may either export or import good y , so there is no presumption that the terms-of-trade will move against the donor. Equation (10) indicates that the transfer indeed imposes a burden on the donor as its welfare decreases. Similarly, the

transfer is welcomed by the recipient, whose welfare increases. Finally, as there are no imperfections in the standard model, there is no room for Pareto improvements.

Result 1. In the standard model: Keynes's concern is valid (donor burden), as is Ohlin's presumption I (neutral terms-of-trade effect)

4.2. The non-traded goods model

One of the central points in section 2 is that the discussion between Keynes and Ohlin was complicated by the presence of non-traded goods. The non-traded goods model provided in section 3 is used to analyze these issues. It is convenient to define analogous terms as in the standard model:

$$(8') \quad \bar{m}_r^J \equiv m_r^J + m_q^J q_r^J, \quad r = u, p; \quad \bar{\Omega} \equiv \sum_J \bar{m}_p^J; \\ -1/\bar{\Delta} \equiv \sum_J (\bar{m}_p^J - m^J \bar{m}_u^J) < 0$$

The inequality in the last term of equation (8') is again based on Walrasian stability. All the definitions take the non-traded goods effects into consideration. Take, for example, the term $\bar{m}_u^A = m_u^A + m_q^A q_u^A$. It consists of the sum of m_u^A and $m_q^A q_u^A$. The former is the regular marginal propensity to consume good y , while the latter is the indirect effect on this marginal propensity through the non-traded goods sector. If good y and the non-traded good are substitutes, the term m_q^A is positive. If the non-traded good is a normal good, the term q_u^A is positive, see section 3. Under those circumstances, then, the total marginal propensity to consume good y is positive if the direct effect dominates the indirect effect, see also below.

For analytic purposes, it is important to sign the term $\bar{\Omega}$. From the definition of $\bar{\Omega}$ and equation (7) it follows that

$$(11) \quad \bar{\Omega} = \sum_J \left(m_p^J - \frac{(m_q^J)^2}{(E_{qq}^J - R_{qq}^J)} \right)$$

Thus, using the definition of m^J in (11), a sufficient condition for $\bar{\Omega}$ to be negative is for each term in the summation in (11) to be negative, that is

$$(12) \quad E_{pp}^J - R_{pp}^J - \frac{(E_{pq}^J - R_{pq}^J)^2}{(E_{qq}^J - R_{qq}^J)} < 0 \quad \text{for } J = A, B$$

Since the net expenditure function $E^J - R^J$ is concave in prices both conditions in (12) are satisfied.¹¹ The term $\bar{\Omega}$ is therefore unambiguously negative. Differentiating equations (1), (2), (4), (5), and (6), with respect to p, q^A, q^B, u^A, u^B , and T , solving the equations, and imposing Walrasian stability gives:

$$(9') \quad \left. \frac{dp}{dT} \right|_{nt} = (\bar{m}_u^B - \bar{m}_u^A) \bar{\Delta} > 0 \Leftrightarrow \bar{m}_u^B > \bar{m}_u^A$$

$$(10') \quad \left. \frac{du^A}{dT} \right|_{nt} = \bar{\Omega} \bar{\Delta} < 0; \quad \left. \frac{du^B}{dT} \right|_{nt} = -\bar{\Omega} \bar{\Delta} > 0; \quad \left. \frac{du^A}{dT} \right|_{nt} + \left. \frac{du^B}{dT} \right|_{nt} = 0$$

Equation (9') indicates that the price of good y will rise, if and only if $\bar{m}_u^B > \bar{m}_u^A$, that is if the recipient's direct plus indirect marginal propensity to consume good y is higher than the donor's direct plus indirect propensity to consume this good. Again, there is no terms-of-trade effect if the demand structure is identical (Assumption 1) and even if there are demand differences, the donor may either export or import good y , so there is no presumption that the terms-of-trade will move against the donor. Equation (10') indicates that the transfer also imposes a burden on the donor in a non-traded goods setting (as its welfare decreases) and is welcomed by the recipient (as its welfare increases). Since the marginal rate of substitution is equal to the marginal rate of transformation both internationally (between traded goods) and domestically (between traded and non-traded goods), Pareto improvements are again not possible.

What about relative prices? Keynes was convinced that a major aspect of the transfer problem was to divert factors of production from the non-traded to the traded goods sector. This problem becomes more important if relative prices of traded versus non-traded goods decline. Suppose, then, that there is no terms-of-trade effect as a result of the transfer. How about the price of non-traded goods? From (7) it follows that

$$(13) \quad \left. \frac{q^J}{dT} \right|_{nt} = q_u^J \left. \frac{du^J}{dT} \right|_{nt} + q_p^J \left. \frac{dp}{dT} \right|_{nt}$$

¹¹ The matrix of second-order price derivatives is negative semi-definite, such that

$(E_{pp}^J - R_{pp}^J)(E_{qq}^J - R_{qq}^J) - (E_{pq}^J - R_{pq}^J)^2 > 0$. This, in conjunction with $(E_{qq}^J - R_{qq}^J) < 0$, gives (12).

Thus, if $dp/dT|_{nt} = 0$ we can conclude for the recipient that the sign of $dq^B/dT|_{nt}$ is the same as the sign of q_u^B (since $du^B/dT|_{nt}$ is positive, see equation (10')), which in turn is the same as the sign of E_{qu}^B , see (7). Therefore, the recipient's price of non-traded goods rises if, and only if, the marginal propensity to consume non-traded goods is positive. Similar reasoning with a reverse effect holds for the donor of the transfer, which therefore experiences a fall in the price of non-traded goods. Even if the price p of traded good y changes, it is obvious from equation (13) that the above conclusions on the changes in the price of non-traded relative to traded goods for donor and recipient still holds if we construct a price index of traded goods in which the weight given to good y equals q_p^J (this weight is positive if non-traded goods and good y are net substitutes).¹² To summarize the above discussion:

Result 2. In the non-traded goods model: Keynes's concern is valid (donor burden), as is Ohlin's presumption I (neutral terms-of-trade effect) and Ohlin's presumption II (the price of non-traded goods rises for the recipient and falls for the donor)

4.3 The unemployment model

As discussed in section 2, Keynes's concern regarding Germany's ability to pay for the imposed international transfers was partially based on a potential exacerbation of Germany's high unemployment rate at the time of the debate. In effect, the transfer may shift resources into or out of the unproductive 'unemployment' sector, see Bhaduri and Skarstein (1996). Before turning to the interaction between non-traded goods and unemployment, we first analyze the model of sticky-wage unemployment outlined in section 3 in the absence of non-traded goods, see also Berthélemy (1988) and Beladi (1990). It is convenient to define:

$$\begin{aligned}
 (8'') \quad \varepsilon^A &\equiv (\partial w^A / \partial p)(p / w^A) = R_{pv}^A (p / R_v^A); \\
 \eta^A &\equiv -(\partial w^A / \partial v)(v / w^A) = -R_{vv}^A (v / R_v^A) > 0; \\
 -1/\tilde{\Delta} &\equiv -1/\Delta + (\varepsilon^A w^A v / \eta^A p^2)(pm_u^A - \varepsilon^A) < 0
 \end{aligned}$$

¹² See also McDougall (1965), who uses a Divisia price index for traded goods.

The terms ε^A and η^A are two elasticities, where ε^A is the donor's Stolper-Samuelson factor price elasticity for good y . In a standard Heckscher-Ohlin model, ε^A will be larger than 1 if good y uses factor v (labor in this case) intensively and negative if good x uses factor v intensively. Alternatively, ε^A will be positive but smaller than 1 in a Ricardo-Viner model, see Dixit and Norman (1980). The positively defined elasticity η^A indicates how quickly the real wage rate falls if employment rises. The last inequality is again based on Walrasian stability. Differentiating equations (1), (3), (4), and (6), with respect to p, v^A, u^A, u^B , and T , solving the equations, and imposing Walrasian stability gives:

$$(9'') \quad \left. \frac{dp}{dT} \right|_{un} = (m_u^B - m_u^A) \tilde{\Delta} > 0 \quad \Leftrightarrow \quad m_u^B > m_u^A$$

$$(10'') \quad \left. \frac{du^A}{dT} \right|_{un} = -1 - m^A \left. \frac{dp}{dT} \right|_{un} + w^A \left. \frac{dv^A}{dT} \right|_{un} ; \quad \left. \frac{du^B}{dT} \right|_{un} = 1 - m^B \left. \frac{dp}{dT} \right|_{un}$$

$$\left. \frac{du^A}{dT} \right|_{un} + \left. \frac{du^B}{dT} \right|_{un} = w^A \left. \frac{dv^A}{dT} \right|_{un} = w^A \left(\frac{\varepsilon^A v^A}{\eta^A p} \right) \left. \frac{dp}{dT} \right|_{un}$$

The first thing to note from equation (9'') is that the price of good y rises, if and only if $m_u^B > m_u^A$, that is if the recipient's marginal propensity to consume good y is higher than the donor's propensity to consume this good, just like in the standard model. Our conclusions regarding the terms-of-trade effect are therefore not affected by incorporating unemployment in the model. The welfare effects, however, are less clear cut. Since unemployment represents a distortion in the model, neither the donor's nor the recipient's welfare effect can be signed in general. For that reason, equation (10'') is written to identify the main welfare effects. The recipient is confronted with a positive direct welfare effect from receipt of the transfer (the term 1 in equation (10'')) and a terms-of-trade effect (the term $-m^B(dp/dT|_{un})$ in equation (10'')), which is positive if the price of the recipient's export good rises. The donor is confronted with a similar terms-of-trade effect and a negative direct transfer effect. In addition, the donor faces an employment effect (the term $w^A(dv^A/dT|_{un})$ in equation (10'')), which is positive if total employment rises. If the latter is the case, the transfer causes a positive total welfare effect. In theory, this employment effect can be so large

that a Pareto improvement is possible (welfare increase for both donor and recipient). The employment effect, however, may also work in the opposite direction, by reducing total welfare and making the donor even worse off, which was one of Keynes's concerns (in which case there could be a welfare decrease for both donor and recipient). Note, however, that under identical demand conditions (assumption 1) none of this is relevant. In that case, both the terms-of-trade effect and the employment effect are zero. This leads to:

Result 3. In the unemployment model: Keynes's concern is valid (donor burden), as is Ohlin's presumption I (neutral terms-of-trade effect).

4.4. The complete model

The effect of international transfers in the presence of non-traded goods and unemployment can be analyzed in the complete model. The analysis in the preceding sections is useful for understanding the main effects of the complete model, particularly under assumption 1. As we did when moving from the standard to the non-traded goods model (from section 4.1 to section 4.2), we define analogous terms incorporating the direct and indirect (non-traded goods) effects when moving from the unemployment model to the complete model (from section 4.3 to this section), see equation (8[#]). In this case, however, there is an additional complication, arising from the interaction between non-traded goods and unemployment. This can be most easily understood by looking at equation (3): $R_v^A(p, q^A, v^A) = w^A$.

- In the absence of non-traded goods, this reduces to $R_v^A(p, v^A) = w^A$, implying that any changes in employment are caused exclusively by changes in the terms-of-trade. Under assumption 1, there are no changes in the terms-of-trade, and hence no employment effects (see section 4.3).
- If there are non-traded goods, however, changes in employment can be caused either by changes in the terms-of-trade p or by changes in the price of non-traded goods q . Now recall from the non-traded goods section 4.2 that even if there is no change in the terms-of-trade (assumption 1), there still is a change in the price of

non-traded goods. In the complete model, then, this change in the price of non-traded goods will affect employment, and hence indirectly the terms-of-trade.¹³

$$(8^\#) \quad \bar{m}_v^A = (m_v^A + m_q^A q_v^A); \quad \bar{R}_{vr}^A \equiv (R_{vr}^A + R_{vq}^A q_r^A), \quad r = p, u, v$$

$$-1/\hat{\Delta} \equiv (1 + w^A \bar{R}_{vu}^A / \bar{R}_{vv}^A)(-1/\bar{\Delta}) + (m^A \bar{R}_{vu}^A - \bar{R}_{vp}^A)(w^A \bar{m}_u^A + \bar{m}_v^A) / \bar{R}_{vv}^A < 0$$

The inequality denotes Walrasian stability.¹⁴ Differentiating equations (1)-(7) with respect to $p, q^A, q^B, v^A, u^A, u^B$, and T , and solving the equations gives:

$$(9^\#) \quad \left. \frac{dp}{dT} \right|_{co} = \left[(\bar{m}_u^B - \bar{m}_u^A) + (\bar{R}_{vu}^A / \bar{R}_{vv}^A)(w^A \bar{m}_u^A + \bar{m}_v^A) \right] \hat{\Delta}$$

$$(10^\#) \quad \left. \frac{du^A}{dT} \right|_{co} = -1 - m^A \left. \frac{dp}{dT} \right|_{co} + w^A \left. \frac{dv^A}{dT} \right|_{co}; \quad \left. \frac{du^B}{dT} \right|_{co} = 1 - m^B \left. \frac{dp}{dT} \right|_{co}$$

$$\left. \frac{du^A}{dT} \right|_{co} + \left. \frac{du^B}{dT} \right|_{co} = w^A \left. \frac{dv^A}{dT} \right|_{co} = w^A \left[(\bar{m}_u^B - \bar{m}_u^A) - (\bar{R}_{vu}^A / \bar{\Delta}) \right] (\hat{\Delta} / \bar{R}_{vv}^A)$$

It is evident from equation (9[#]) that even with an identical demand structure (assumption 1) there will be a change in the terms-of-trade caused by the indirect effect of the change in the price of non-traded goods, as outlined above. In general, as in the case of the unemployment model, no definite conclusions regarding the welfare effects can be drawn. As a result of the interaction between non-traded goods and unemployment, this even holds under an identical demand structure.¹⁵ We can, however, draw conclusions on the employment effects under assumption 1, and hence on the total welfare effect. From the last equation in (10[#]) it is clear that the employment effect depends crucially on the sign of $\bar{R}_{vu}^A / \bar{R}_{vv}^A$ since $\bar{\Delta}$ and $\hat{\Delta}$ are positive. Assuming that the direct effect dominates the indirect effect, we know that $\bar{R}_{vv}^A < 0$. From the definition, it follows that $\bar{R}_{vu}^A \equiv (R_{vu}^A + R_{vq}^A q_u^A) = R_{vq}^A q_u^A$. If non-traded goods are normal goods $q_u^A > 0$. Finally, we know that depending on the labour

¹³ This result is exactly what Ohlin (1929a, p. 174) had in mind "...It is not necessary that A's export prices should rise and B's fall. Thus, B need not offer its goods on cheaper terms-of-trade to induce A to take a greater quantity of them. Indirectly, however, it is probable that a certain shift of the terms of exchange will take place."

¹⁴ Note that we could define elasticities analogous to those of section 4.3 on the basis of \bar{R}_{vr}^A .

¹⁵ We do not think it is very likely that the indirect effect is large enough to cause a welfare paradox (donor enrichment or recipient impoverishment), but we are unable to rule this out analytically.

intensity of non-traded goods R_{vq}^A can be positive or negative (see the discussion with respect to equation 8’). In a Ricardo-Viner model, which reflects Keynes’s world of rigidities better than the neo-classical world, $R_{vq}^A > 0$, and hence $\bar{R}_{vu}^A > 0$. Under assumption 1, therefore, the employment effect is positive. The transfer tends to alleviate the distortion imposed on the donor economy, and thereby mitigates the negative welfare effect imposed on the donor, weakening Keynes’s concern.

Result 4. In the complete model: Keynes’s concern is weakened (donor burden) and Ohlin’s presumption I (neutral terms-of-trade effect) is valid.

5. Summary and conclusions

Keynes’s concern regarding the economic burden imposed on Germany after World War I with respect to the reparations payments can be based on four effects:

- A. The direct burden of the transfer, indicating that Germany had to give up real resources that could have been used for its own consumption and reconstruction.
- B. The indirect burden of a transfer through a deteriorating terms-of-trade.
- C. The indirect burden of a transfer through rising unemployment.
- D. The indirect burden of a transfer through a change in the price of non-traded goods, which may exacerbate the unemployment problem.

We analyze these concerns using four different settings incorporating non-traded goods and unemployment, as summarized in Table 1. On the basis of assumption 1, we now briefly relate these results to the Keynes – Ohlin debate (as reviewed in section 2). See the main text, however, for details of the analysis. From a practical point of view, Keynes’s concern regarding the burden imposed on Germany certainly seems to be valid. The donor is worse off and the recipient is better off in the standard model, the non-traded goods model, and the unemployment model. Since the interaction between non-traded goods and unemployment in the complete model in general leads to a reduction of unemployment, thus mitigating this distortion, Keynes’s concern is weakened in the complete model.

Table 1 Summary of results for the four models

1.a Summary of effects under assumption 1

	type of model			
	standard	non-traded	unemployment	complete
donor terms-of-trade	0	0	0	?
donor welfare	-	-	-	?
recipient welfare	+	+	+	?
donor price non-traded goods	n.a.	- [*]	n.a.	?
recipient price non-traded goods	n.a.	+ [*]	n.a.	?
donor employment	n.a.	n.a.	0	+ ^{**}

1.b Summary of results under regular supply and demand conditions

Keynes's concern	valid	valid	valid	weakened
Keynes's presumption	not valid	not valid	not valid	not valid
Ohlin's presumption I	valid	valid	valid	valid
Ohlin's presumption II	n.a.	valid	n.a.	unclear

n.a. = not applicable;

* if non-traded goods are normal ($q_u^J > 0$); ** if non-traded goods are normal and $\bar{R}_{vq}^A > 0$

In the presence of non-traded goods, Ohlin's presumption II, that the price of non-traded relative to traded goods will rise for the recipient and fall for the donor, is also valid. It is readily understood from the fact that, other things equal, the transfer increases demand for non-traded goods for the recipient and reduces demand for the donor. Although this force is also operative in the complete model, no clear conclusions can be drawn in this setting because both the terms-of-trade and the employment level will change, and both these changes will also affect the price of non-traded goods relative to traded goods.

Ohlin's presumption I, that there is no reason for a transfer to affect the donor's terms-of-trade either favourably or unfavourably is valid under all circumstances. This implies, simultaneously, that Keynes's presumption that a transfer worsens the donor's terms-of-trade is not valid. In most cases, a terms-of-trade change is not necessary at all in response to an international transfer because the recipient's increase

in demand is offset by the donor's decrease in demand. Only in the complete model is a change in the terms-of-trade necessary; this follows from the fact that, in the absence of any other changes, the reduction in the donor's demand for non-traded goods causes a price change for non-traded goods, starting off a series of indirect price effects through the production and demand structure.

Finally, it is clear from the top part of Table 1 that the most important economic effects of an international transfer cannot be unambiguously signed in the complete model, incorporating both non-traded goods and unemployment. This makes the largely unresolved Keynes – Ohlin discussion understandable. Our analysis discusses not only the most important economic consequences in a framework of non-traded goods and a framework of unemployment, but also how the interaction between these two phenomena complicate the analysis in the complete model. In short, it shows the value of analytic model building in guiding the discussion and our understanding.

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Appendix: Transfers, non-traded goods, and unemployment

This appendix briefly derives the main results for the four models. The equation numbers refer to the equivalent numbers in the paper.

1. Standard model

$$(1) \quad E^A(p, u^A) = R^A(p) - T$$

$$(4) \quad E^B(p, u^B) = R^B(p) + T$$

$$(6) \quad m^A(p, u^A) + m^B(p, u^B) = 0$$

Normalize $E_u^J = 1$ and define $\Omega \equiv \sum_J m_p^J < 0$ and $-1/\Delta \equiv \Omega - m^A m_u^A - m^B m_u^B < 0$.

Differentiate with respect to p, u^A, u^B and T and solve:

$$\begin{bmatrix} m^A & 1 & 0 \\ m^B & 0 & 1 \\ \Omega & m_u^A & m_u^B \end{bmatrix} \begin{bmatrix} dp \\ du^A \\ du^B \end{bmatrix} = \begin{bmatrix} -1 \\ 1 \\ 0 \end{bmatrix} dT$$

$$\frac{dp}{dT} = (m_u^B - m_u^A) \Delta > 0 \quad \Leftrightarrow \quad m_u^B > m_u^A$$

$$\frac{du^A}{dT} = \Omega \Delta < 0; \quad \frac{du^B}{dT} = -\Omega \Delta > 0; \quad \frac{du^A}{dT} + \frac{du^B}{dT} = 0$$

2. Non-traded goods model

$$(1) \quad E^A(p, q^A, u^A) = R^A(p, q^A) - T$$

$$(2) \quad E_q^A(p, q^A, u^A) = R_q^A(p, q^A)$$

$$(4) \quad E^B(p, q^B, u^B) = R^B(p, q^B) + T$$

$$(5) \quad E_q^B(p, q^B, u^B) = R_q^B(p, q^B)$$

$$(6) \quad m^A(p, q^A, u^A) + m^B(p, q^B, u^B) = 0$$

Solve (2) and (5) for the price of non-traded goods and substitute in (1), (4), and (6):

$$(1) \quad E^A(p, q^A(p, u^A), u^A) = R^A(p, q^A(p, u^A)) - T$$

$$(4) \quad E^B(p, q^B(p, u^B), u^B) = R^B(p, q^B(p, u^B)) + T$$

$$(6) \quad m^A(p, q^A(p, u^A), u^A) + m^B(p, q^B(p, u^A), u^B) = 0$$

Define $q_p^J \equiv -(E_{qp}^J - R_{qp}^J)/(E_{qq}^J - R_{qq}^J)$; $q_u^J \equiv -E_{qu}^J/(E_{qq}^J - R_{qq}^J)$; $\bar{m}_u^J \equiv m_u^J + m_q^J q_u^J$;
 $\bar{\Omega} = \sum_J \left(m_p^J - (m_q^J)^2 / (E_{qq}^J - R_{qq}^J) \right) < 0$; and $-1/\bar{\Delta} \equiv \bar{\Omega} - m^A \bar{m}_u^A - m^B \bar{m}_u^B < 0$.

Differentiate with respect to p, u^A, u^B and T and solve:

$$\begin{bmatrix} m^A & 1 & 0 \\ m^B & 0 & 1 \\ \bar{\Omega} & \bar{m}_u^A & \bar{m}_u^B \end{bmatrix} \begin{bmatrix} dp \\ du^A \\ du^B \end{bmatrix} = \begin{bmatrix} -1 \\ 1 \\ 0 \end{bmatrix} dT$$

$$\frac{dp}{dT} = (\bar{m}_u^B - \bar{m}_u^A) \bar{\Delta} > 0 \quad \Leftrightarrow \quad \bar{m}_u^B > \bar{m}_u^A$$

$$\frac{du^A}{dT} = \bar{\Omega} \bar{\Delta} < 0; \quad \frac{du^B}{dT} = -\bar{\Omega} \bar{\Delta} > 0; \quad \frac{du^A}{dT} + \frac{du^B}{dT} = 0$$

3. Unemployment model

$$(1) \quad E^A(p, u^A) = R^A(p, v^A) - T$$

$$(3) \quad R_v^A(p, v^A) = w^A$$

$$(4) \quad E^B(p, u^B) = R^B(p) + T$$

$$(6) \quad m^A(p, u^A, v^A) + m^B(p, u^B) = 0$$

Let $\varepsilon^A \equiv (\partial w^A / \partial p)(p / w^A) = R_{pv}^A(p / R_v^A)$; $\eta^A \equiv -(\partial w^A / \partial v)(v / w^A) = -R_{vv}^A(v / R_v^A)$;

and $-1/\tilde{\Delta} \equiv -1/\Delta + (\varepsilon^A w^A v / \eta^A p^2)(pm_u^A - \varepsilon^A) < 0$. (note: $m_v^A = -R_{pv}^A$)

Differentiate with respect to p, u^A, u^B, v^A and T and solve:

$$\begin{bmatrix} m^A & 1 & 0 & -w^A \\ m^B & 0 & 1 & 0 \\ \Omega & m_u^A & m_u^B & m_v^A \\ R_{vp}^A & 0 & 0 & R_{vv}^A \end{bmatrix} \begin{bmatrix} dp \\ du^A \\ du^B \\ dv^A \end{bmatrix} = \begin{bmatrix} -1 \\ 1 \\ 0 \\ 0 \end{bmatrix} dT$$

$$\frac{dp}{dT} = (m_u^B - m_u^A) \tilde{\Delta} > 0 \quad \Leftrightarrow \quad m_u^B > m_u^A$$

$$\frac{du^A}{dT} = -1 - m^A \frac{dp}{dT} + w^A \frac{dv^A}{dT}; \quad \frac{du^B}{dT} = 1 - m^B \frac{dp}{dT}$$

$$\frac{du^A}{dT} + \frac{du^B}{dT} = w^A \frac{dv^A}{dT} = \frac{\varepsilon^A w^A v^A}{\eta^A p} \frac{dp}{dT}$$

4. Complete model

$$(1) \quad E^A(p, q^A, u^A) = R^A(p, q^A, v^A) - T$$

$$(2) \quad E_q^A(p, q^A, u^A) = R_q^A(p, q^A, v^A)$$

$$(3) \quad R_v^A(p, q^A, v^A) = w^A$$

$$(4) \quad E^B(p, q^B, u^B) = R^B(p, q^B) + T$$

$$(5) \quad E_q^B(p, q^B, u^B) = R_q^B(p, q^B)$$

$$(6) \quad m^A(p, q^A, u^A, v^A) + m^B(p, q^B, u^B) = 0$$

Solve (2) and (5) for the price of non-traded goods; substitute in (1), (3), (4), and (6):

$$(1) \quad E^A(p, q^A(p, u^A, v^A), u^A) = R^A(p, q^A(p, u^A, v^A)) - T$$

$$(3) \quad R_v^A(p, q^A(p, u^A, v^A), v^A) = w^A$$

$$(4) \quad E^B(p, q^B(p, u^B), u^B) = R^B(p, q^B(p, u^B)) + T$$

$$(6) \quad m^A(p, q^A(p, u^A), u^A) + m^B(p, q^B(p, u^A), u^B) = 0$$

$$q_v^A \equiv R_{qv}^A / (E_{qq}^A - R_{qq}^A); \quad \bar{m}_v^A = (m_v^A + m_q^A q_v^A); \quad \bar{R}_{pv}^A \equiv (R_{pv}^A + R_{vq}^A q_v^A); \quad \bar{R}_{vv}^A \equiv (R_{vv}^A + R_{vq}^A q_v^A);$$

$$\bar{R}_{vu}^A \equiv R_{vu}^A q_u^A; \quad -1/\hat{\Delta} \equiv (1 + w^A \bar{R}_{vu}^A / \bar{R}_{vv}^A)(-1/\bar{\Delta}) + (m^A \bar{R}_{vu}^A - \bar{R}_{vp}^A)(w^A \bar{m}_u^A + \bar{m}_v^A) / \bar{R}_{vv}^A < 0.$$

Differentiate with respect to p, u^A, u^B, v^A and T and solve:

$$\begin{bmatrix} m^A & 1 & 0 & -w^A \\ m^B & 0 & 1 & 0 \\ \bar{\Omega} & \bar{m}_u^A & \bar{m}_u^B & \bar{m}_v^A \\ \bar{R}_{vp}^A & \bar{R}_{vu}^A & 0 & \bar{R}_{vv}^A \end{bmatrix} \begin{bmatrix} dp \\ du^A \\ du^B \\ dv^A \end{bmatrix} = \begin{bmatrix} -1 \\ 1 \\ 0 \\ 0 \end{bmatrix} dT$$

$$dp/dT = [(\bar{m}_u^B - \bar{m}_u^A) + (\bar{R}_{vu}^A / \bar{R}_{vv}^A)(w^A \bar{m}_u^A + \bar{m}_v^A)] \hat{\Delta}$$

$$\frac{du^A}{dT} = -1 - m^A \frac{dp}{dT} + w^A \frac{dv^A}{dT}; \quad \frac{du^B}{dT} = 1 - m^B \frac{dp}{dT}$$

$$\frac{du^A}{dT} + \frac{du^B}{dT} = w^A \frac{dv^A}{dT}$$

$$\frac{dv^A}{dT} = [(\bar{m}_u^B - \bar{m}_u^A) - (\bar{R}_{vu}^A / \bar{\Delta})](\hat{\Delta} / \bar{R}_{vv}^A)$$

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