

The trap of liquidity: analysis and countermeasures following J. M. Keynes

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*Copia nulla famem relevat, sitis arida guttur
urit, et invisio meritis torquetur ab auro.*

Ovidius

Liquidity is the modern name for money. Originally, it refers to an essential feature of money, rather than to money itself. Money is liquid, as long as it flows from hand to hand, in exchange for goods and services. It is the circulation of money that allows the division of labour and the distribution of its products. Therefore, it is vital that money be liquid, as all substances by which it has been, over the centuries, metaphorically described: like water, blood, and muck¹.

From the very beginning of his enquiry into the nature and functioning of money, Keynes supposes it to be liquid: «Money is only important for what it will procure» (CWK 4: 1). Money is intended to be spent, to circulate, to flow. Money is *just* a means of exchange. Keynes's monetary theory follows a long and authoritative tradition, according to which it is indispensable for money to be dispensable (Amato 2015).

What is peculiar to Keynes is the observation that this feature of money tends to be denied: «It is not easy, it seems, for men to apprehend that their money is a mere intermediary, without significance in itself, which flows from one hand to another, is received and is dispensed, and disappears when its work is done from the sum of a nation's wealth» (CWK 4: 124). Keynes points thus straight from the outset to the question that would become the main object of his analysis: when and why is money kept rather than spent? what are the economic consequences of this misapprehension by which money ceases to be *liquid* because it is conceived, and withheld, as *liquidity* itself?

In economics, liquidity indicates «the interchangeability of assets and money»². There are two sides to the coin: speaking of an asset, liquidity consists in its prompt convertibility into money; whereas speaking of money, liquidity refers to its use as an asset, i.e. as a store of value rather than as a means of exchange. Economic theory retained from Keynes the conception of money in terms of liquidity—neglecting that Keynes himself regarded it as a misconception (Amato and Fantacci 2012: 19-20). The tendency to hold assets in the form of money (or the liquidity preference) is, indeed a crucial factor in Keynes's analysis of economic disequilibria. For him, it was the task of economic theory to explain it; but it was the task of monetary reform to contrast it.

The 'liquidity trap' is a situation in which monetary policy fails to affect, and particularly to reduce, the rate of interest, because all expansionary efforts are offset by an increase in the hoarding of money. Although Keynes never used the expression 'liquidity trap', he not only elaborated the concept of liquidity preference, as constituting the demand for money and the main link between the quantity of money and the rate of interest (and hence between monetary and real variables), but he also detected several cases in which the link was severed, and monetary policy was made ineffective by variations of the liquidity preference (Wray 2006).

¹ See Hume (1752: 54), Hobbes (1651: 131), and Bacon (1625: 67) respectively.

² *Oxford English Dictionary*, s.v.

Starting from the late 20s, Keynes commented extensively on economic depression and the policies required to overcome it, through articles, interviews, public lectures, correspondence with statesmen, and hearings of advisory bodies (such as the Macmillan Committee and the Economic Advisory Council). A reason for growing concern was the loss of effectiveness of conventional monetary policy. Keynes analysed various factors that could thwart the efforts of the central bank in pursuing the goals of full employment and growth: among these, the failure of a monetary expansion to reduce market rates of interest on long-term loans.

The object of the present paper is to recollect what Keynes wrote before the *General Theory* concerning what is now called the liquidity trap. It leaves his theoretical essays in the background, to concentrate on his journalistic, political, and financial writings. Paragraph I addresses the causes that, according to Keynes, stand in the way of monetary authorities attempting to reduce the rate of interest, with a special focus on the causes connected with an increase in liquidity holdings. The remedies proposed by Keynes are then considered, distinguishing monetary arrangements within the existing regime (II), and more radical reform proposals (III).

I. Causes

It was observing the conditions of depression, which in Britain had begun already in the early 20s, that Keynes developed the analysis that would eventually lead him to the notion of liquidity preference. When, at the beginning of 1930, he was appointed to the Economic Advisory Council, set up by the British government to investigate the causes of the slump and devise possible remedies, Keynes repeatedly pointed to the high level of the long-term rate of interest as the main factor of world-wide depression;³ and he suggested a reduction of the rate of interest as the most necessary measure to revive new enterprise (Harrod 1951: 469).⁴

The causes that he indicated for the high level of interest are apparently consistent with a straightforward explanation in terms of market forces. If the rate of interest is regarded as a market price, the main determinants will be, of course, (1) supply of loans and (3) demand for loans, with an important role played by (2) intermediation costs and (4) expectations. However, as we shall see, all these factors are related to an indeterminate increase of the liquidity preference, induced, in turn, by the particular form of monetary institutions throughout the interwar period.

(1) One factor that kept rates of interest on long-term loans from falling was the reluctance of those who had money to lend it out at lower rates. Keynes mentioned three circumstances that could be held responsible for depressing the supply of loans.

The first had to do with inertia. Lenders were accustomed to receiving high returns on their investments. During the war, governments had been willing to sustain high debt costs in the prospect of overcoming the enemy. After the war, enterprises had found it convenient to pay high interests on loans for a rapid reconstruction of their working

³ See the letter to the Governor of the Bank of England, Montagu Norman, 22 May 1930 (CWK 20: 353); and the answers to the Prime Minister, Ramsay Macdonald, 21 July 1930, *Economic Advisory Council: The State of Trade* (CWK 20: 372). As pointed out by Tily (2006: 659), the failure of new investment to meet current saving due to high interest rates is also a fundamental proposition of the *Treatise* (CWK 6: 337). In the letter to Montagu Norman, Keynes boldly stated his confidence in its validity: «I am ready to have my head chopped off it if is false» (CWK 20, 351).

⁴ 'A Note on the Long-Term Rate of Interest in Relation to the Conversion Scheme', *The Economic Journal*, September 1932 (CWK 21: 114).

capital. As the opportunities for profitable investments diminished, so did the number of borrowers, whilst lenders maintained high expectations on the remuneration of their capital.⁵

Another restraint on lending was more specific to certain countries. The return to gold, after post-war inflation and depreciation, put great pressure on governments and central banks to maintain their currency at the designated parity. Particularly France and the United States accumulated enormous amounts of gold, without reinvesting them on international markets.⁶

This resulted in an increase in long-term rates of interest throughout the world.⁷ Indeed, even countries less anxious to hoard idle balances had to tighten monetary policy to contrast capital flights. In turn, the commitment of central banks to defend the exchange rate strengthened investors' expectations of high interest rates in the long run, and reduced their willingness to accept low rates on long-term debts.

(2) Even when discount rates were eventually reduced, market rates remained comparatively high. The difference corresponded to the costs of intermediation. The official rate was only one component of interest charged by banks to their customers. If they were to avoid losses, banks had to add a mark-up, covering expenses and protection against risk.⁸

In May 1930, the central banks of Europe and the United States reduced the bank rate, following a co-ordination meeting at the Bank for International Settlement in Brussels. Bank rates throughout leading financial centres were set between 2½ and 3 percent. As Keynes observed, operative rates for loans couldn't be expected to fall accordingly. In France, the Bank rate did not govern but a small proportion of transactions; in England, the Big Five seldom followed Bank rate downwards below 5 percent.⁹ The spread between official rates and market rates reflected the operative expenses of the banks (and, perhaps, collusive practices in defence of their margins).¹⁰

Bringing together lenders and borrowers implied another cost: risk. This was a further reason why, according to Keynes, a low Bank rate policy might not manage to bring down the rate of interest and foster new investment. A low Bank rate meant a low rate of interest on riskless enterprise. But new enterprise always involved some risk, and the risk was even higher in a period of depression. As a consequence, for the risk of parting with their funds, lenders would ask a higher remuneration than what borrowers expected to earn.¹¹

(3) At market prices, demand meets supply. Market rates of interest above the official rate were a clear sign that exacting lenders found willing borrowers, even at rates exceeding the return reasonably expected on productive investments. Keynes pointed to the presence

⁵ *Economic Advisory Council* (CWK 20: 372).

⁶ "A Gold Conference", *The New Statesman and Nation*, 12 September 1931 (CWK 20: 600); *Economic Advisory Council* (CWK 20: 373).

⁷ Letter to Montagu Norman, 22 May 1930 (CWK 20: 353).

⁸ "Is it Possible for Governments and Central Banks to Do Anything on Purpose to Remedy Unemployment?", *Harris Foundation Institute Round Tables* (CWK 20: 535).

⁹ "The Industrial Crisis", *The Nation and Athenaeum*, 10 May 1930 (CWK 20: 345).

¹⁰ See also *General Theory* (CWK 7: 208).

¹¹ *The World's Economic Crisis and the Way of Escape*, Halley-Stewart Trust lecture, London, 1932 (CWK 21: 60). The *General Theory* introduces the further qualification of moral risk, the risk of a default caused by dishonesty of the borrowers. As long as the lenders have no certainty concerning the honesty of the borrowers, they will be induced to set the rate of interest at a higher level, that will discourage borrowers who do not intend to be dishonest (CWK 7: 208).

of ‘artificial borrowers’, who for various reasons stood ready to accommodate the expectations of the lenders, crowding out funding for new enterprise. The failure of saving to transfuse entirely into new *real* investment represented for Keynes «the most fundamental explanation of the world slump».¹² Four groups of artificial borrowers were responsible for distracting funds from productive purposes and bidding up the interest rate.

The first group was a legacy of the War, and even more of the ‘Carthaginian Peace’. As the United States claimed full repayment of war loans from Britain, and Britain of its loans to the Allies, and France of reparations from Germany, the European loan market was literally choked by creditors. Debtor nations were forced to borrow money at any cost, just to meet impending obligations, without any benefit (or relation) to their capacity of production. Keynes called these ‘distress borrowers’.¹³

Governments were also, together with central banks, the most conspicuous members of the second class: the ‘banking borrowers’, in Keynes’s phrase, needed money to build up reserves and restore convertibility. The gold exchange standard, established at the Genoa Conference in 1922, was intended to loosen deflationary pressures caused by limited stocks of gold, by allowing countries to hold reserves in foreign exchange, essentially dollars. However, since the United States had a favourable balance towards Europe, countries wishing to increase their exchange reserves were forced to borrow dollars, which they would hold in demand deposits in the US. «In two or three years, estimated Keynes in 1930, some £500.000.000 was thus borrowed on long term and re-deposited on short term».¹⁴ This practice had the obvious effect of raising long-term rates of interest relatively to short-term rates.

The third class of artificial borrowers was particularly important in the late 20s, when banks, brokers and even ordinary individuals, especially in the United States, borrowed money to re-invest it on the stock market. These were the ‘speculative borrowers’, who drained enormous amounts of liquidity to purchase, again, not capital goods but equities, in the hope of reselling them at a higher price. «Since the gold standard ensures a high degree of mobility of international lending, this meant dear money everywhere».¹⁵

When prices eventually precipitated, not only on the stock market, a fourth category of artificial borrowers appeared. The fall in commodity prices and in industrial output resulted in unexpected losses that enterprises and governments were forced to make good by recurring to loans, at any cost. If they wanted to meet past obligations, these *new distress borrowers* had no alternative than to enter into further obligations on even harder terms, without any relation to prospective returns on new investment.¹⁶

(4) Hence the last, and perhaps most structural, factor of depression: expectations. The productive process necessarily involves a time lag between the moment when

¹² “The Future of the Rate of Interest: Prospects of the Bond Market”, *The Index*, September 1930 (CWK 20: 395-6). *The Economist*, commenting on Keynes’s article, questioned the alleged fall in investment by citing figures for new issues on the London and New York stock markets. In his reply, Keynes specified what he meant by ‘real investment’: «I cannot accept the figure of new capital issues which you quote as having any direct bearing on the question. For by ‘investment’ I meant, as perhaps I should have explained more clearly, ‘physical investment’, that is to say the net increment of capital goods» (CWK 20: 400). See also *Treatise* (CWK 6: 87-8).

¹³ *Economic Advisory Council* (CWK 20: 372); “The Future of the Rate of Interest”, (CWK 20: 394-5).

¹⁴ “The Future of the Rate of Interest”, (CWK 20: 395).

¹⁵ “A British View of the Wall Street Slump”, *The New York Evening Post*, 25 October 1929 (CWK 20: 2); see also CWK 20: 372, 395.

¹⁶ “The Future of the Rate of Interest” (CWK 20: 398).

entrepreneurs sustain the costs of production and when they reap the earnings from the sale of their products. In order to start their business, to enlarge it, and even only to maintain it, they must, therefore, borrow money. Entrepreneurs are structurally borrowers. A fall in prices causes a loss to borrowers (on capital account), because it increases the fixed monetary value of their liabilities in relation to the reduced monetary value of their assets. A continuous fall in prices causes a further loss to entrepreneurs (on current account), because it reduces earnings reaped at the end of the productive process in relation to costs sustained at the beginning.¹⁷ However, if a fall in prices is expected, businessmen have the possibility to avoid this further loss by refraining from production. In this way, the expectation of falling prices causes a depression in investment and economic activity, hence further deflation. «The *fact* of falling prices injures entrepreneurs; consequently the *fear* of falling prices causes them to protect themselves by curtailing their operations» (CWK 4: 34).

What Keynes recognised as a possibility in 1923, he regarded as the primary cause of the slump in 1932.

«The immediate causes of the financial panic – for that is what it is – are obvious. They are to be found in a catastrophic fall in the money value not only of commodities but of practically every kind of asset, – a fall which has proceeded to a point at which the assets, held against money debts of every kind including bank deposits, no longer have a realisable value equal to the amount of the debt»¹⁸.

Liabilities are reckoned at their face value, in terms of money (unit of account); assets, held as collateral against those debts, are reckoned at their market value, in terms of money (means of exchange). The credit structure of modern economies depends upon confidence in the maintenance of the margin, i.e. of a positive difference between the market price of an asset and the money value of the loan by which it was acquired.

Now what do margins depend on? The first, fundamental factor is the value added through enterprise and labour. However, in the «financial structure of modern capitalism», there is also a second factor: the change in the purchasing power of money. Not the possibility of a moderate and unexpected change, but the continuous changing, which induces general expectations of further changes, which in turn favour the actual occurrence of the anticipated changes.

«We are now in the phase where the risk of carrying assets with borrowed money is so great that there is a competitive panic to get liquid. And each individual who succeeds in getting more liquid forces down the price of assets in the process of getting liquid, with the result that the margins of other individuals are impaired and their courage undermined. And so the process continues... The *competitive struggle for liquidity* has now extended beyond individuals and institutions to nations and governments».¹⁹

This «competitive struggle for liquidity» provides a crude picture of what we now call the ‘liquidity trap’: a situation in which money hoarding proceeds unrestrained, and conventional monetary policies are incapable of reversing or even arresting it. Any injection of liquidity is immediately drained by the unquenchable thirst of individuals and governments, without appreciable expansionary effects on expenditure, prices, or

¹⁷ On the contrary, rising prices allow entrepreneurs to reap unexpected profits, transforming them in ‘speculative borrowers’, or ‘profiteers’, as Keynes had observed already in 1919, in *The Economic Consequences of the Peace* (CWK 2: 220).

¹⁸ *The Economic Prospects 1932*, lecture to the International Economic Society of Hamburg, 8 January 1932 (CWK 21: 39).

¹⁹ CWK 21: 40; italics added.

production. Consumption and investment are postponed, as long as there is an expectation of a further fall in prices. However much money may be put into circulation, it immediately stops circulating: it is neither spent nor invested, but merely hoarded.

It is interesting to note that, in the same years in which Keynes refers to the Marxian concept of monetary production in the elaboration of the *General Theory* (Sardoni 1997), he comes so close to Marx even in his description of the monetary factors underlying the crisis, particularly where, in *Contribution to the Critique of Political Economy* and in *Das Kapital*, emphasis is laid on the role played by the hoarding of money: ‘now the cry is everywhere: money alone is a commodity... the only wealth’ (Marx 1867: 155).

What is peculiar to Keynes is the analysis of the effect of the increased propensity to hoard on the rate of interest. As long as prices continue to fall, the real rate of interest remains higher than any possible return on investment, however low the Bank rate may be set. The burden of borrowing, measured in real terms, discourages investment on working capital (short-term). The prospect of a further decline in prices, and hence of low profits, produces a lack of confidence that restrains investment on fixed capital (long-term).²⁰

Although the liquidity trap may be explained by different sets of causes that have to do with market forces driving up the rate of interest, there is a factor that necessarily precedes all of them: the assumption that the rate of interest is a market price, and specifically the market price for money. This is the necessary condition for the occurrence of a liquidity trap: the identification of money with liquidity, i.e. an asset that may be either kept, or spent or lent, and the price of which in the latter uses (measured by the purchasing power and by the rate of interest respectively) depends on the degree in which it is devoted to the former.

In the light of Keynes’s analysis, therefore, the liquidity trap appears as the situation of impotence in which the monetary authority entraps itself, by conceiving money in terms of liquidity. The trap is liquidity itself. And liquidity is the name of money, when it may be used as a store of value rather than as a means of exchange, when it may be held as an asset. As long as individuals have the possibility of holding their assets in the form of money, they may actually decide to do so, rather than spend it or lend it, if they expect its value (measured either by the purchasing power or the rate of interest) to rise in the future. And if they do so, prices will fall and interest rates will rise, whatever inflationary measure the monetary authority may take in the attempt to counterbalance market forces.²¹

The solution to the problem requires more than a reduction of the rate of interest or an increase in the supply of money. In a context of deflation, it requires to restore the stability of the price level. Even more, it requires the confident expectation of stable prices.²² It is not just a matter of stabilising prices *ex post*. The value of money—considered in any of its

²⁰ “The Industrial Crisis”, *The Nation and Athenaeum*, 10 May 1930, (CWK 20: 346).

²¹ The opposite case, with expectations of rising prices inducing a reduction of money holdings and hence an actual increase of prices, is described by Keynes in relation to German hyperinflation (*Lecture to the Institute of Bankers*, 15 November 1922, CWK 21: 14). In the *General Theory*, Keynes uses the same argument to explain the level of interest, suggesting that expectations may become the sole determinant of the prevailing rate: «For its actual value is largely governed by the prevailing view as to what its value is expected to be. Any level of interest which is accepted with sufficient conviction as *likely* to be durable *will* be durable» (CWK 7: 203; 170).

²² As Keynes will show in the *General Theory*, even the efficacy of monetary policy may depend on the capacity of monetary authority to influence expectations—although this does not always occur in the desired direction (CWK 7: 197-8).

meanings, as the purchasing power, the rate of interest, or the exchange rate—must be decided in advance, or it is too late. It must be made the object of deliberate decision.²³

Escaping the liquidity trap entails not just the injection of a given quantity of money, and not even a given conduct of monetary policy, but first and foremost the acknowledgement that money as a measure has to be truly *given* in order to allow the payment of debts. This is the rationale for Keynes's proposals of a monetary reform, as the only way of restoring true equilibrium.

The flaws of capitalism did not imply for Keynes overturning the system along Marxian lines, but not even mere marginal adjustments in the form of Keynesian policies of monetary and fiscal expansion: saving the economic system from structural crises entailed for him a radical reform of the monetary system. However, before turning to his reform proposals, let us consider the remedies that he suggested within the framework of existing monetary institutions.

II. Remedies

Keynes's contribution to addressing economic depression lies not primarily in the suggestion of a cure. Despite a common opinion, according to which his thought (whether praised or dispraised) inspired the adoption of active policies to contrast the trade cycle, Keynes did nothing more, by his own admission, than assemble proposals already circulating: «When we come to the question of remedies for the local situation as distinct from the international, the peculiarity of my position lies, perhaps, in the fact that I am in favour of practically all the remedies which have been suggested in any quarter».²⁴

This is particularly true for the measure, which is most frequently associated with the name of Keynes, namely public investment. The first time Keynes mentioned it was in two articles published in *The Nation*, on 24 May and 7 June 1924: considering the failure of automatic mechanisms to restore equilibrium, he pointed to investments in capital goods as a possible way out of the slump. He was not, however, the first to propose such remedies. On the same periodical, just over a month before, a programme of public works had been advocated by Lloyd George. Keynes merely intervened, as Skidelsky observes, «in support of his old *bête noire*» (Skidelsky 1992: 184).

Another measure, more peculiar to Keynes, was the regulation of money. As Tily (2006) appropriately observed, 'for the whole of his life, Keynes was primarily concerned with monetary not fiscal policy'. Well before announcing *The End of Laissez-Faire* in the domain of investment, and economic activity at large, Keynes had advocated it with respect to the value of money:²⁵ the latter ought to be fixed so as to assure investments equal to savings and effective demand equal to supply, at the level of full employment. The main instruments to this effect that Keynes envisaged within the existing monetary regime were (1) the stabilisation of prices and exchanges, (2) the establishment of a forward exchange

²³ As Keynes advocated in the *Tract*, where he specified that the decision need not be made once and for all, but ought to be adjusted, from time to time, to allow the payment of debts (CWK 4: 35-6).

²⁴ *Economic Advisory Council: The State of Trade* (CWK 20: 375).

²⁵ «It is not safe or fair to combine the social organisation developed during the nineteenth century (and still retained) with a *laissez-faire* policy towards the value of money» (CWK 4: 16). It is worth noting, moreover, that even in the essay entitled *The End of Laissez-Faire*, Keynes indicates control on money and credit as the primary field for intervention (CWK 9: 292).

market, and (3) the maintenance of discriminating interest rates on domestic and foreign investments.²⁶

(1) As we have seen above, falling prices were considered by Keynes one of the major causes of the slump. But where did deflation come from? Keynes had no doubt in blaming the preoccupations of the British governments to restore the gold standard at pre-war par. Sterling had greatly depreciated, in relation to the dollar, during and after the war. If it were to climb back to \$4.86, a strong deflation appeared to be inevitable. Keynes questioned this common opinion on three different grounds.

First, even if convertibility was to be restored, it didn't necessarily have to be at the old par. Keynes strongly advocated a stabilisation of all depreciated currencies at their current rate of exchange. At the 1922 Genoa Conference, that he attended as a journalist for the *Manchester Guardian*, Keynes didn't lose the occasion to present a plan for devaluation: «Genoa approved it in principle, but all the countries most affected repudiated it in particular».²⁷ Nonetheless, Keynes remained convinced that, especially for countries whose currencies had depreciated significantly during the war, it was better to fix the current exchange rate rather than restore the old rate at the cost of deflating the domestic economy.

Second, even if there was a choice between external and internal stability of the value of money, internal stability was to be preferred. The stability of the foreign exchange concerns only those who are engaged in foreign trade, while the stability of prices is a matter of distributive justice within the state as a whole (CWK 4: 126, 132). Moreover, measures to promote external stability could put deflationary pressures on the domestic economy, without even benefiting exchange. On 5 July 1923, the Bank of England raised the Bank rate from 3 to 4 percent, apparently to contrast the fall of the dollar exchange. Keynes immediately dismissed it as «one of the most misguided movements of that indicator which have ever occurred».²⁸ The increase would discourage business without even improving the exchange rate: the worst of both worlds. Indeed, even if interest rates were to follow entirely the one percent rise of the Bank rate, this would represent only a mild benefit for international investors—clearly insufficient to offset the exchange risk in a period of widely fluctuating rates. Keynes's suggestion was to pursue internal price stability, even at the risk of depreciating the exchange.²⁹

Third, there was no need to choose between internal and external stability, because it was possible to have both. Under conceivable monetary systems, the stability of prices and the stability of the exchanges are not alternatives. «Can we get the best of both worlds—stability of prices over long periods and stability of exchanges over short periods?... I believe that we can go a long way in this direction if the Bank of England will take over the duty of regulating the price of gold, just as it already regulates the rate of discount» (CWK 4: 149). What Keynes advocated, in view of reconciling internal and external equilibrium, was a system in which the monetary authority would have the task of regulating the relation between unit of account and gold.³⁰ The price of gold ought to be regarded as an

²⁶ Only later, during World War II, did Keynes develop another, more direct remedy to high interest rates through debt management and monetary policies (Tily 2006: 663-7).

²⁷ *Lecture to the Institute of Bankers*, 29 November 1922 (CWK 19: 45).

²⁸ «Bank rate at four percent», *The Nation and Athenaeum*, 14 July 1923 (CWK 19: 100).

²⁹ *Letter to the Editor of The Times*, 1 August 1923 (CWK 19: 112).

³⁰ Something similar to what governments could accomplish through the enhancement of the currency within the monetary regime of Medieval Europe (Fantacci 2008), incidentally but not accidentally praised by Keynes slightly above, as «the best available expedient for meeting the currency problem», and indeed an even

instrument of monetary policy: just as the Bank rate was used to correct an internal imbalance, the gold rate would be used to face an external imbalance. It would have to be changed according to circumstances, not fixed once and for all: the task of monetary authority would be to 'regulate', not to 'peg' (CWK 4: 149-50).

(2) While opposing the fixed exchange rate regime of the gold standard, therefore, Keynes did not favour flexible rates as an alternative. On the contrary, he was persuaded that surrendering entirely to financial markets the task of determining the relative value of currencies would increase uncertainty, drive up the costs of borrowing and reduce still further the effectiveness of monetary policy. However, even in a context of fluctuating exchanges, Keynes believed that monetary authorities had the duty and the possibility to regulate *ex ante* the (external) value of the currency: «You will not get a steady exchange until you have a 'pegged' exchange... It is no good therefore to think, as some people do, that you must first of all wait for the exchanges to be stable, and after you have seen them stable for a year or two you will then fix them. They will never be stable until you have fixed them».³¹ And, according to Keynes, monetary authorities had indeed a practical way of fixing exchanges (and expectations on exchanges), even in a system of flexible rates, by operating on the forward market: a central bank need only quote a spread between spot and forward rates, at which it would stand ready to sell its currency spot and buy it back one or three months later. The operations could be financed by a revolving fund of much lesser magnitude than what would be required to support the currency by spot purchases. This, in turn, would strengthen the credibility of the central bank's commitment to the maintenance of the designated rate.

By ensuring foreign exchange stability through the forward market, central banks would also gain an additional degree of freedom for domestic monetary policy. Just as they regulated the interest on home balances through the discount rate, they would be able to regulate, *on different terms*, the interest on foreign balances through the forward market (CWK 4: 112). Of course, as Keynes recognised, the spread between spot and forward rate should normally be set equal to the interest rate differential, otherwise there would be a possibility of arbitrage. However this was true only in equilibrium, when there were no pressures on the exchange rate—hence when there was no reason for the central bank to differentiate interest on foreign balances from interest on domestic loans. Forward market operations may therefore be regarded as an early proposal to address the issue that Keynes later indicated as his principal object: to allow each state the «policy of an autonomous rate of interest» (CWK 7: 349).

(3) Since the beginning of the Great depression, Keynes indicated discriminating rates of interest for home and foreign investments as a possible way out, as an alternative to state intervention.³² If Great Britain (or any other country) didn't want an excessive outflow of capital to deplete its gold reserves and put pressure on its exchange, it was forced to align interest rates with international markets. On the other hand, the rate of interest prevailing abroad was higher than prospective returns on new enterprise at home. A slackening of private investment appeared to be the necessary consequence of balance of

more efficient method of dealing with the regulation of money than more recent proposals, such as the 'compensated dollar' advocated by Irving Fisher (CWK 4: 131).

³¹ *Lecture to the Institute of Bankers*, 22 November 1922 (CWK 19: 57). The argument is restated, in very much the same terms, in the *Tract*: «If, therefore, the exchanges are not stabilised by policy, they will never come to an equilibrium of themselves» (CWK 4: 93).

³² "The Industrial Crisis", *The Nation and Athenaeum*, 10 May 1930 (CWK 20: 348).

payment constraints—and public investment seemed to provide at least a temporary supplement. Keynes aimed more radically at loosening the strain by differentiating rates on home and foreign lending, and indicated two methods to achieve this goal: subsidies to domestic investments and taxation on foreign investment.

The first line of action involved the government providing loans to ‘approved enterprises’ at favourable rates, below the level of interest on international bond markets.³³ Keynes advanced this proposal in May 1930, in an article on *The Nation*, a copy of which he sent to the Governor of the Bank of England, Montagu Norman. The Governor objected that «it would at present be hard to find many ‘approved enterprises’». ³⁴ However, as Keynes didn’t omit to mention in his reply, this was precisely the task entrusted to the Bankers’ Industrial Development Company, which had been set up just one month before, and of which the Governor was the chairman.³⁵ The question was not if there were new enterprises that could yield adequate returns at subsidised conditions, but rather if there was someone willing to take the risk of selecting enterprises eligible for the subsidy.³⁶

The second method to discriminate domestic and foreign lending was to penalise the latter by increasing taxes, such as stamp duties on foreign issues or income taxes on interest gained on foreign bonds. Such measures were introduced during the war in Britain, and after in France, «with great success». ³⁷ They provided the additional advantage of an increased revenue to the Treasury, whereas the first solution implied a cost, which could however be easily covered by saving on unemployment benefits.³⁸

All the remedies proposed by Keynes shared the common objective of promoting new enterprise, in order to fill the gap between saving and investment, and restore full employment. Money tended to be drained from domestic investment by hoarding at home and abroad. It tended to be deviated from productive to unproductive purposes: instead of financing new enterprise, it was used to pay interest on old debts; instead of contributing to capital development, employment, and the production of increased income and wealth, it merely effected a redistribution of income from enterprise and labour to the owners of bonds.

In face of this continuous drain of money into hoards and into the payment of interest, it was not enough merely to increase the supply of money. Policies of monetary expansion are currently dubbed ‘Keynesian’, just as policies of fiscal expansion—and just as undeservedly. Keynes was not Keynesian. He did call for inflationary policies, but he did not believe that they were always necessary, nor that, being necessary, they would always be sufficient.

Keynes had to defend himself repeatedly from the charge of being an inflationist, against the apostles of strict monetary orthodoxy: «To be sometimes in favour of dearer money and sometimes in favour of cheaper money seems to them like being sometimes a Protestant and sometimes a Roman Catholic». ³⁹ His reply was straightforward: the only

³³ Something like the ‘funding for lending’ programme of the Bank of England and the ‘Targeted Longer Term Refinancing Operation’ of the European Central Bank, adopted in the wake of the current crisis (Amato and Fantacci 2014: 61-2).

³⁴ *Letter from Montagu Norman*, 20 May 1930 (CWK 20: 349).

³⁵ *Letter to Montagu Norman*, 22 May 1930 (CWK 20: 354-5).

³⁶ «Surely they cannot maintain that England is a finished job, and that there is nothing in it worth doing on a 5 per cent basis» (“A Drastic Remedy for Unemployment: Reply to Critics”, *The Nation and Athenaeum*, 7 June 1924, CWK 19: 228; see also above, 225).

³⁷ *Economic Advisory Council: The State of Trade*, 21 July 1930 (CWK 20: 382-3).

³⁸ *Economic Advisory Council, Committee of Economists, Draft Report*, 6 October 1930 (CWK 20: 446-7).

³⁹ “The Bank Rate”, *The Nation and Athenaeum*, 7 March 1925 (CWK 19: 336-7).

true principle of sound money was the stability of prices, for the comfort of the only “true faith”, which was the confidence in the maintenance of the purchasing power of money. Hence, it was right to be inflationary, when this was needed to stabilise prices.⁴⁰ Keynes was an inflationist only because he happened to live through decades of deflation.

The problem was that, in the midst of the crisis, inflationary policies might not be sufficient to achieve the goal. Any inflationary policy could be offset by an increase in the liquidity preference. It was thus not merely a question of quantity. What was needed was not more money, but a different money: not monetary expansion, but monetary reform.

III. Reform

The measures generally designated as ‘Keynesian policies’, were originally proposed by Keynes merely as countermeasures to depression, within the given monetary system. The latter was, in Keynes’s view, the primary cause of structural imbalance—yet, fortunately, it was not the only conceivable system. Criticisms of current monetary arrangements and proposals for radical reform are to be found throughout Keynes’s works. Even in this respect, his early writings are consistent with the principles that he repeatedly indicated as the pillars of monetary reform and that represent the foundations of his later proposals: (1) subjecting the standard of value to deliberate decision, (2) adjusting the relationship between unit of account and means of payment to allow the payment of debts, and (3) distinguishing internal and external money to balance the domestic economy with foreign trade. It is worth taking a closer look at how these principles were formulated, throughout Keynes’s non academic writings of the period under investigation, well before being integrated in the proposal for the Clearing Union presented at Bretton Woods.⁴¹

(1) Ever since his first writings, Keynes had pointed to the stability of the value of money as an essential feature of economic and social equilibrium.⁴² In the current system, where the definition of the value of money was left to market forces, it could only be *supported* by monetary authorities with counterbalancing interventions. In a reformed system, according to Keynes’s recommendations, the value of money should be *stabilised* in advance by deliberate decision.⁴³

The alternative between stabilising and supporting a currency was staged emblematically in November 1922, when a committee of experts was summoned in Berlin, to advise the Wirth government on how to restore its ailing currency. It was a chance to cure the suppurating wound left open by the Treaty of Versailles, and to accomplish the appeasement of Europe, by redefining the terms of international settlements. As referred by Lord D’Abernon, English ambassador to Berlin, «the Commission was made up of some ‘very clever men’ (Keynes, Cassel, Brand, and Jenks) and the ‘requisite ballast of dull

⁴⁰ “Bank Rate and Stability of Prices—A Reply to Critics”, *The Nation and Athenaeum*, 21 July 1923 (CWK 19: 104).

⁴¹ The proposal consisted in the institution of an international money different from gold (*bancor*), that could not serve as a store of value (bearing symmetric charges on positive and negative balances), in view of distinguishing different payment circuits (current and capital account), and different economic areas (national and international).

⁴² See, in part., *Tract*, Ch. 1 ‘The Consequences to Society of Changes in the Value of Money’ (CWK 4: 1-36).

⁴³ Already in the *Tract*, Keynes had claimed that the regulation of the standard of value ought to be the subject of «deliberate decision» (CWK 4: 36). In the *Treatise*, he clarified that the decision concerns, more precisely, the relation of the means of payment to the standard of value for the payment of debts (CWK 5: 3).

ones to lend respectability' (Vissering, Dubois and Kamenka)» (Skidelsky 1992: 118). Only the first group signed the majority report, which was drafted by Keynes.

The purpose of the proposal was the immediate *stabilisation* of the mark. An appropriate rate of exchange should be fixed and an official body should be prepared to buy and sell unlimited quantities of foreign currency at rates slightly below and above the par; the same body should also set a forward exchange, at which it would stand ready to repurchase one or three months forward the marks sold spot. These provisions would serve to stabilise not only the rate of exchange, but also the expectations concerning its future level. As Keynes stated presenting the plan to the Institute of Bankers just a few weeks after returning from Berlin: «that would knock out any hopes from speculation».⁴⁴ The alternative plan, laid down by the three official experts, was instead designed to provide *support* to the currency. According to this scheme, the Reichsbank should form a special fund, partly from its own gold reserves and partly from a foreign loan, to purchase marks on the exchange market and contrast bear speculations.

The two plans represent most clearly the opposite notions of stabilising and supporting a currency. The latter view assumes that the exchange rate of a currency is a market price, which may be influenced by authorities only by intervening on the market on one side or the other, buying or selling the currency against foreign exchange. In this view, it is the quantities of currencies offered and demanded that determine their relative prices. Instead, to stabilise a currency means to fix its price in advance, being prepared to adjust its quantity in accordance. Only this second approach provides a way out of instability, by attacking its cause (uncertainty) and not merely its symptoms (speculation).⁴⁵

(2) Monetary rule required the value of money to be fixed, in relation to a given standard, so that the productive process would not be biased by speculation. However, Keynes repeatedly observed that a true monetary rule should allow not only to enter confidently into obligations, but also to discharge them. Keynes regarded the variation of the relation between unit of account and means of payment as the second, essential feature of monetary rule.⁴⁶ Such variation was not opposed, but complementary, to stability. The decision on the value of money could not be taken once and for all. The authority would have the responsibility of balancing stability and change, in view of a twofold task: to allow the creation of debts and to loosen their burden when it became intolerable; to enforce the payment of debts and to make them payable.

In the *Economic consequences of the Peace* Keynes impugned the Versailles Treaty for having failed to establish a new international monetary rule along these lines. A true peace would have required not only to enforce the payment of debts, but to decide the measure and means by which debts should be made payable. Keynes explicitly suggested that a change in the purchasing power of the unit of value would allow Germany to pay a higher reparations bill: «If a gold sovereign comes to be worth what a shilling is worth now, then, of course, Germany can pay a larger sum... measured in gold sovereigns» (CWK 2: 189).⁴⁷

What Keynes advocated in 1919 as a means for restoring international peace, he restated in 1923 as a principle of economic equilibrium within national economies. The relation of

⁴⁴ *Lecture to the Institute of Bankers*, 22 November 1922 (CWK 19: 37).

⁴⁵ «It seems to me that if you do not fix the thing [the exchange rate], you will preserve the whole of the existing state of uncertainty, and it is quite likely that you would dribble your resources away without having got anything like stabilisation because you would not have knocked out speculation» (CWK 19: 40).

⁴⁶ In the *Tract*, Keynes indicated currency depreciation, together with capital levy, as a legitimate instrument of distributive justice, for alleviating excessive indebtedness (CWK 4: 56).

⁴⁷ In quite the same terms Adam Smith describes the rule of monetary law: «A positive law may render a shilling a legal tender for a guinea, because it may direct the courts of justice to discharge the debtor who has made that tender» (Smith 1776, book II, chapter 2, §100).

the unit of account to the means of exchange should be varied to alleviate the debts of entrepreneurs, and limit the pressure of rents, allowing a redistribution of gains «between past accumulations and the fruits of present efforts» (CWK 4: 58). In 1930, the variation of the value of money by act of authority was presented by Keynes as an essential feature of a true monetary regime: «it is the State or community not only which enforces delivery, but also which decides what it is that must be delivered as a lawful or customary discharge of a contract which has been concluded in terms of the money of account» (CWK 5: 4).

(3) The decision between stability and change need not concern together the internal and the external value of money. The use of different currencies for different purposes would allow to devalue one, while preserving the stability of the other. The third pillar of a well-designed monetary system, according to Keynes's recommendations, rested on the distinction between national and international money. With a dual currency system, each country would be able to pursue an autonomous monetary policy in view of domestic prosperity, while remaining open to foreign trade.

To supplement the devaluing paper rouble, the Soviet government had introduced, in December 1922, a new currency unit called *chervonetz*, freely convertible according to the principles of the gold exchange standard. Keynes regarded it as «an instructive example» of dual currency system, with sound money for international trade, and small change for daily life. The latter was subject to a rate of depreciation which could be regarded as a tax on cash balances and represented a tolerable percentage of total cash payments (CWK 4: 49).

Keynes advocated the adoption of a dual currency system in Germany, following the Soviet example: «The best course, therefore, is to remain content for a little longer with an unsound money as a source of revenue, but to introduce immediately a steady unit of account (the relation of which to the unsound money could be officially fixed daily or weekly) as a preliminary to the restoration of the normal sources of revenue» (CWK 4: 52).

What all these measures share is the intention to deprive money of its character of store of value. This appears to be a permanent concern throughout Keynes's writings, from *A Tract on Monetary Reform*, where he advocates scientific methods to depreciate money, to *The General Theory*, where he expresses appreciation for Gesell's stamped money, to the *Proposal for an International Clearing Union*, where bancor surplus balances are subject to a sort of negative interest rate (Fantacci 2013: 185-6).

If the root of economic disequilibrium is the hoarding of money, the task of economists is to reform money, so that it may not be hoarded. This was Keynes's lifelong pursuit, carried on throughout years of writings and activities, and culminated in his proposal for the Clearing Union.

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