

INDIAN CURRENCY AND BEYOND

The Legacy of the Early Economics of Keynes in the Times of Bretton Woods II

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Abstract

In the paper, we revisit the focus and method of “Indian Currency and Finance” (1913) and the rationale of Keynes’s proposal for an international monetary system combining cheapness with stability. In particular, we centre on the management of exchange reserves and the pattern of relationships between creditor and debtor countries, to suggest that Keynes’s fresh look at Asia in the first years of the twentieth century may provide useful hints for an overall rethinking of the major faults of today’s Bretton Woods II system as well as the rationale for a global monetary reform.

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Introduction

The 13th Raúl Prebisch Lecture (2005) by the Nobel Laureate in Economics Lawrence Klein was significantly entitled “South and East Asia: Leading the World Economy”. The East Asian collapse first, and Asian spectacular growth performances in the post-crisis period then, and above all, have critically contributed to the awareness of the “new features of global interdependence” (Unctad 2005; see also Reisen, Grandes and Pinaud 2005) stemming from the increasing relevance of Asia’s role in world economy. In one of the most intriguing, though highly disputed interpretation of the current world scenario, the international “non-system” (Williamson 1983) of the post-1971 era is replaced by a “Bretton Woods II” regime (Dooley, Folkerts-Landau and Garber 2003) which – like its historical predecessor – fosters growth with stability while helping peripheral countries (then European nations and Japan with respect to the US and Britain, now Asia) to fill the gap with Western nations and come near to the centre of the system. To argue that Asia is currently compelling Western economists to get consciousness of the so far overlooked complexity of international economic relations seems no exaggeration. But the true reason for this might be that the prominent role played by Asian countries in world economy poses the challenge of the global imbalances. True, the current financial crisis is not the one – dollar plunge, sudden stop of capital flows from emerging markets to the US and global austerity programme – which had been predicted by the critics of the “Bretton Woods II” view about global imbalances, Nevertheless, Dooley *et al.* (2009) may be excessively optimistic when arguing that the system can continue to happily sustain, after the crisis, persistent and growing international imbalances such as those prevailing just before the 2007 subprime collapse.

For the first time, perhaps, after the demise of Keynesianism in the Seventies, Keynes’s thought is becoming fashionable again and has been invoked as a possible remedy against the economic juggernaut of the current crisis. The last and highest of Keynes’s intellectual achievements in international economics, the final configuration of that global monetary reform he

had been trying, without success, to promote throughout the whole of his career in economic diplomacy, Keynes's plans for Bretton Woods rightly deserve the attention they are attracting at the present time. Nevertheless, if such rediscovery is destined to improve our understanding of the current pattern of international relations, there might be reasons to rethink, more in general, the "focus and method" of Keynes's work as an international economist (Vines 2003). This amounts on the one side to enlarge the perspective to include the whole bulk of analyses he advanced to interpret international economic relations during substantially different economic epochs (from the pre-war gold standard to the return to gold in the Twenties, to the interwar period, to WWII and the transition to the new order) and the evolution of his reform schemes. On the other side, one should investigate on the possible persistence, over the different times and circumstances of Keynes's writings and diplomacy, of a "method" of coping with the complexity of international relations, and speculate about the benefits which today's policy-makers could derive from Keynes's "vision" being offered a second chance.

Accordingly, this paper deals with Keynes's first major work, *Indian Currency and Finance* (1913), which fully shows the crucial role played by the dissemination of economic ideas from the periphery to the core of the global system in shaping a new vision about international monetary relations. Keynes's fresh look at Asia (not only India, but also China and, on a general level, the whole continent) in the first years of the twentieth century provided him an alternative way of looking at the global order and the chance of using the Indian model to draw the lines of a qualified reform of the gold standard. In the attempt to revisit *Indian Currency and Finance* as such, that is as an essay in international economics belonging to the first era of globalization and a proposal for international reform, we stress the methodological continuity between this analysis and Keynes's general treatment of the economic material and his way of reasoning about it, which are inspired in their turn to his approach to probability as a guide for action (see Carabelli 1988). In line with previous works on the method of Keynes's international economics and economic diplomacy (Carabelli and Cedrini 2008, 2007; Cedrini 2008), we thus focus in particular on those aspects of

complexity, interdependency among economic variables and rationality of policy on which the analysis of *Indian Currency and Finance* is built. Among the most important questions treated by Keynes while suggesting to use the Indian model as the cornerstone and an incentive for a European monetary reform, the nature and holding/hoarding of international reserves as well as the dynamics between debtor and creditor countries occupy prominent positions and are consequently dealt with in detail in the paper.

It will not be difficult to recognize in these latter topics the two most controversial issues of the current “Bretton Woods II” system, large hoarding of international reserves by emergent nations, Asian countries *in primis*, coexisting with – and actually strengthening – huge, persistent deficits of the reserve country and locomotive of world growth. Intrigued by the parallel between Keynes’s early look at Asia for hints of monetary reform and current, Asia-driven new features of global interdependence, combining valuable opportunities for world economy with significant threats to the stability of its growth patterns, we argue that the bequest of Keynes’s *Indian Currency and Finance* might prove appreciably useful to speculate about the sustainability of global imbalances and encourage the search for a new, Keynes-inspired global economic architecture.

The spectacular effects of “a change of ideas in Asia”

Although the target of powerful well-founded criticisms, the “Bretton Woods II” hypothesis is not without merits, as indirectly confirmed by the increasing use of it as a starting point for analyses of current global imbalances and, perhaps more directly, by its persistence despite the crisis (see Dooley et al. 2009). The narrative induces to recognize the limits of unilateral views about global imbalances such as the “twin deficits” (Chinn 2005) and the “global saving glut” (Bernanke 2005) hypotheses, and helps rather to reason about today’s world economic landscape in systemic terms (Eichengreen 2004). Moreover, the hypothesis shows awareness of the multilateral character of the imbalances, in line with more sophisticated views like those advanced, among others, by Mann (2005) – the imbalances would result from a general pattern of “global co-dependency”

transforming the US into a foreign source of growth for the rest of the world – and Kregel (2006), who argues that their origins are to be found in national or even regional policy choices, Europe and Japan too playing a relevant role in this sense.

Still, the most controversial assumption of Bretton Woods II is that global imbalances appear less troublesome if one argues that the world has never abandoned its most successful monetary system. Export-led growth strategies supported by undervalued exchange rates, capital and trade controls, and international reserves accumulation are held to be functional to Asian countries' desire to cover that same road Europe and Japan traversed in the post-war period to regain a central position in the world economic system. The "trade account" region's desire to export to the US requires Asian willingness to acquire US securities, whereas the "capital account" region, formed by Europe, Canada, Australia and Latin America, all currency floaters, is primarily interested in defending its international investment position. That both regions have helped the central country finance its deficit, the former through accumulation of dollar reserves and the latter's investors pushing up the dollar until 2002, should come as no surprise. Asia would thus be expected to displace Europe in exporting to the US markets, and to buy out European claims on the US. Once its path to the centre is completed – hundreds of million underemployed workers still wait to be absorbed into the modern sector – the revived Bretton Woods system would engage in reloading other peripheries like India.

Dooley et al. (2003) explicitly focus on the willingness of the periphery to accumulate claims on the core, that is on the US, the reserve country. As many observers point out, the 1997 Asian crisis has in fact taught developing nations that "undervaluation-cum-intervention" strategies (Unctad 2006), or self-protection through increased liquidity (Feldstein 1999) provide them with a powerful way out of the new Triffin paradox they were caught in during the Nineties, when foreign borrowing to achieve the desired growth rates exposed developing countries to larger external imbalances, raising the risk of reversals in capital inflows and consequent financial crisis (Kregel 1999). Asian countries' accumulation of export surpluses and their foreign lending through

exchange reserves have produced “the largest foreign aid programme in world history” (Wolf 2005: 25) and, together with increased surpluses in European economic giants, Japan, oil producers and other developing countries, allowed the US, the deficit-importer of last resort, to systematically live above its means. With the result, however, that unless one give credit to the view that despite the US financial crisis, the Bretton Woods II system permits the presence of large imbalances almost indefinitely over time (see Eichengreen 2004 and Roubini 2006 for criticisms to this belief), the leading superpower is compelled by its deficits to a severe readjustment, which may have extremely painful repercussions for the American economy as well as for multilateralism, through the recessionary effects of the required global rebalancing.

Although contrary to standard economic theory, as well as to the rationale of the Washington Consensus as “policy prescription for development” (Williamson 2004), the so-called “paradox of capital” (Prasad, Rajan and Subramanian 2007) – capital should flow from rich to poor countries to exploit greater investment opportunities, thus easing the latter’s development strategies – seems not the historical accident of current times, but the rule of the post-war period (Kregel 2004). The truly new phenomenon is rather that such outflows from emergent countries take the form of accumulated international reserves (mostly low-yielding short-term US Treasury securities), which contribute to the financing of the US external deficit at low interest rates (see Summers 2006). There is widespread consensus on the use by emergent countries of large foreign currency reserves for precautionary motives – the need to avoid currency attacks as those which led to the 1997 collapse, in the absence of a global lender of last resort – but Asian nations in particular are generally blamed for holding and hoarding exchange reserves as part of mercantilist strategies (see e.g. Bergsten 2007). “There is no question”, writes Eichengreen (2004: 3), “that their accumulation of reserves is a concomitant of intervention in the foreign exchange market to keep their currencies down, which is in turn a concomitant of the strategy of promoting exports as a way of stimulating growth”. Within the Bretton Woods II framework, it is exactly the intervention of Asian economies required to contrast their appreciation which on the one hand keeps exchange rates

stable thus saving the dollar standard despite global imbalances and, on the other, allows the US to run continuous current account deficits, ultimately to the detriment of Asian countries' interest in avoiding capital losses on their reserves. In Bergsten's (2007) somewhat radical words, in particular, "China's currency policy has taken much of Asia out of the international adjustment process" (ib.: 1).

As said, the view is not consensual: supporters of "the US deficit is logical" – i.e., it will persist over time – argument like Cooper (2006), among others, argue that global imbalances have relatively little to do with official support to the US deficits; international reserve accumulation would thus be a second-order issue (Caballero 2006). After recognizing that the growth in reserves may be in some cases "the incidental by-product of an active exchange rate policy", Cooper (2006) states that by buying exchange reserves, Asian monetary authorities are in truth "investing abroad on behalf of the public", due to limited investment opportunities at home and financial repression (in the case of China) and acting, due to higher yields on foreign assets (in the case of Japan) as financial intermediaries, "converting what private savers want now into what they will need in future years" (ib.: 7). In short, high savings relative to investment opportunities and the attractiveness of US financial assets would be responsible for large amounts of foreign funds in the US. A main problem with this interpretation is that, as pointed out by Roubini (2006), foreign central banks, rather than private investors, have provided a large part of the recent net financing for the US deficit, while private purchases of foreign assets by Americans more than compensate for private purchases of US assets by foreigners (see Eichengreen 2006).

In general, it seems difficult to deny that reserves accumulation has played and still plays a supportive role with respect to global imbalances: as Summers (2006) convincingly argues, the buildup in US net foreign debt is mirrored in dollar reserve accumulation by Asian and emerging countries. "It is an irony of our times that the majority of the world's poorest people now live in countries with vast international financial reserves" (ib.: 8). Yet, IMF's October 2008 *World Economic Outlook* reports the astonishing 5,552.7 billion dollar bulk of emerging and developing

countries' reserves, and expects them to raise to 6,459.5 in 2009 – they combined to a total of only 801.1 billion dollar in 2000 and 1,0729 in 2002. According to this data, developing countries hold two thirds of the global international reserve, whose magnitude increased from 1 trillion dollar in 1990 to more than 5 in 2006; they account for the most part of the increase in global reserves-GDP ratio, from 5 (in 1980) to about 30%, while the ratio of industrial countries has been stable at 4% over the last decade. China accounts for an impressive 40% of total emerging countries' reserves; her reserve/GDP ratio increased from 1% in 1980 to 41% in 2006. India and developing Asia excluding China and India show similar reserves growth patterns (see Aizenman 2007, IMF 2008). China's reserve/imports ratio raised over unity in 2004 to reach 166% at the end of 2008; the global ratio too increased from 44.9% in 2000 to 84.7% (IMF 2008). The traditional rule in this respect – reserves should be able to cover three months of imports – is thus enjoying overdue respect. The same goes for the Guidotti-Greenspan rule – countries should hold reserves equal to foreign liabilities coming due within a year – (Rodrik, 2005).

On speculating about the Bretton Woods II hypothesis, most observers have commented that should international markets initiate the adjustment process through a US slowdown, as it happens in current times of financial turmoil and exceptional uncertainty, emerging countries would probably realize that their exclusive reliance on export-led growth is likely to come at a high cost for their economies. Complementarity between the portfolio choices of private and public investors means that should central banks move away from the dollar, private investors would quickly follow, and move even faster (Roubini 2006); moreover, should “nervous” foreigners doubt about the sustainability of the US position, central banks may find more and more difficult to cope with private portfolio adjustment (Eichengreen 2004). As noted by Krugman (2008), capital losses would prove to be larger than investors expect at the moment, if the decline of the dollar – gradual but fast enough to prevent not sustainable US debt accumulation – were to pose an end to global imbalances. Feldstein (2008) points out that this is the only available solution to produce the desired rebalancing, which will benefit from a surge in US savings driven by decreasing household wealth

and the credit crunch. However, this amounts to recognizing that “the Chinese, with about \$1 trillion of U.S. bonds, are taking a risk that would have to be called imprudent” (ib.: 8). Allowing for these risks, why should then the “future of global economy [be] increasingly defined by a large flow of official lending from developing nations to the world’s largest and richest economy” (Summers 2006: 8)?

A possible answer is that “Bretton Woods II still defines the international monetary system” (Dooley *et al.* 09). After all, as recognized by DeLong (2009), among others, “all of us from Lawrence Summers to John Taylor were expecting a very different financial crisis. We were expecting the 'Balance of Financial Terror' between Asia and America to collapse and produce chaos. We are not having that financial crisis”. Not only the crisis would be “not directly or indirectly caused by international imbalances that preceded it”, but “the incentives that drive the Bretton Woods II system will be reinforced by the crisis and, looking forward, participation in the system will expand and the life of the system will be extended” (Dooley *et al.* 09: 1). Relying on the reasonable expectation that countries with large reserves may perform better in the context of a global financial turmoil (see Aizenman 2009; Obstfeld, Shambaugh and Taylor, 2009), Dooley *et al.* go so far as to predict that “emerging markets will be even more convinced that reserve accumulation and export-led growth are the safest development strategy in an uncertain world (ib.:14). We will come back on the issue later on; for the moment, let us take a closer look at the literature on the puzzle and the costs of exchange reserves which has developed in recent years.

Once identified the opportunity cost of excess dollar reserves in the cost of external borrowing for a country investing in US securities (see also Stiglitz 2003), Rodrik (2005) defines the “social cost of self-insurance” as the far from negligible spread between yields deriving to central banks from liquid reserve assets and the private sector’s cost of borrowing abroad. Excluding from the computation the reserves required to satisfy the three-months rule, 1 percentage point of GDP annually for developing countries is found by Rodrik to be lost in the process of reserve accumulation: “a multiple of the budgetary cost of even the most aggressive anti-poverty

programs implemented in developing countries. And it is roughly the same order of magnitude as the projected gains for developing nations from a successful conclusion of the Doha round of trade negotiations” (ib.: 9). Moreover, he argues following Feldstein (1999), reserves accumulation is only one among various alternative strategies to increase liquidity, such as reducing short-term debt. Failure to combine this two strategies thus reveal another opportunity cost of reserves hoarding, and induce to reason in terms of moral hazard problems and macroeconomic risks (see Cruz and Walters 2008). Seen from a more general perspective, however, the puzzle of reserves is clearly connected with the new financial architecture that has emerged in the aftermath of the Nineties crisis. Developing countries were induced to opt for different policy choices within the open economies trilemma, i.e. managed exchange rates, greater monetary independence and deeper financial integration: “hoarding international reserves is a key ingredient enhancing the stability of the emerging configuration in an era of greater financial integration” (Aizenman 2007: 2). Besides providing self-insurance against the possibility of sudden stops – increased sterilization in developing countries since the Asian crisis acts as a signal that emerging markets value the benefits of sterilization much higher than its costs – hoarding international reserves contribute to mitigate the magnifying effects, for exporters of natural resources, of terms of trade shocks on real exchange rate volatility (ib.).

Now, as conveniently stressed by Cruz and Walters (2008), “for many countries the adoption of a reserve accumulation strategy was taken in the context of the decision to adopt or reinforce the neo-liberal strategy of rapid financial liberalisation, unrelated to the development of either deep financial markets or mature and effective regulatory structures” (ib.: 666-67). Excess reserves are thus fully embedded in the general recent story of shrinking policy space in the global environment (see Chang 2006): the rationale of the strategy would fall had aggressive financial liberalisation not so heavily reduced policy space and national autonomy. This suggests that alternative strategies such as capital controls and restrictions on currency convertibility .

While the precautionary motive may well apply to the case of Latin America, self-insurance seemingly plays a lesser, though significant role in Asia – the leading region in accumulating international reserves. Aizenman (2007) suggestively advances that in the “Bretton Woods II” framework, coordination failures may engage countries adopting export-led growth policies into a “hoarding game” in which each mercantilist country seek to improve its own competitiveness on Western markets at the expenses of its neighbours (though running the risk of falling in a beggar-thyself trap) by the use of reserve hoarding as economic weapons. A number of reasons may explain why China, in particular, is playing this zero-sum game: the seize of her market, low sterilization costs, a magnitude of growth with no historical precedents. As Rodrik (2005) points out, however, even mercantilist countries could refrain from accumulating excess reserves, if only they were able to control capital inflows effectively and prevent appreciation in a direct manner. “From this perspective too”, he argues, “there is a tradeoff between financial globalization and avoiding the cost of high level of reserves. Holding high reserves is the price to be paid for not managing the capital account more directly” (ib.: 4): a circumstance well-known to both foreign investors in China, attracted by expectations of renmimbi appreciation, and Chinese monetary authorities, who fear that exchange rate volatility may lead to overheating of the economy and foster inflation.

In many senses, the puzzle of reserves can be used as a privileged access point to the dynamics of the Bretton Woods II system. Neither the cornerstone of a balance of terror nor, at least in the current crisis, the triggering mechanism for a world collapse driven by dollar plunge, capital losses for accumulating countries with consequent sudden stop of capital flows to the US, reserves hoarding rests a fundamental distinctive trait of the Bretton Woods II system. If the latter , even after the crisis, (still) defines the international monetary order, reserves hoarding (still) defines the Bretton Woods II system. This means that although reserves hoarding may be justified as a rational strategy of self-insurance voluntarily chosen by individual countries in an open financial environment, it still has to pass the test of rationality once it is considered, as it should, as the

outcome of that tacit coordination Dooley *et al.* place at the basis of the Bretton Woods II system itself. After revisiting *Indian Currency and Finance*, where Keynes addresses the problem of reserves hoarding in his proposal to look at Asia for a rational global monetary reform, we argue that Dooley *et al.* are probably right about the persistence of the BW2 system despite the financial crisis but wrong to reject a reform of the international order designed to overcome the major faults of today's system.

A second glance at Keynes's early international economics

On reviewing the factors which make the current situation highly different from the golden era of Bretton Woods – capital flows dominating trade flows, large accumulations of international debt and volatile exchange rate – Kregel (2006) maintains that “the current environment looks much like the pre-Depression world that the architects of the Bretton Woods System were trying to banish from existence and in which it was commonly held that trade flows were determined by international capital flows. And earlier, in the 19th century, it was understood that British foreign lending existed in order to finance the export of British capital goods. Indeed, British exporters often organised the borrowing to support the lending themselves” (*ib.*: 154). Keynes's *Indian Currency and Finance* may be regarded as a theoretical bridge between these two epochs of our monetary history, the pre-war gold standard and its evolution during the interwar period on the one side, and the Bretton Woods world on the other. According to Dimand (1991), in fact,

Keynes's proposal for a central bank and a managed currency rather than a return to the gold standard foreshadowed the advocacy of a managed currency in *A Tract on Monetary Reform* (1923), his opposition to Britain's return to gold at the pre-war parity in 1925, and the celebrated ‘Auri Sacra Fames’ sections in *A Treatise on Money* (1930) and *Essays in Persuasion* (1931) on the irrational importance given to gold. The gold exchange standard that Keynes expounded, and contrasted with a gold standard, in *Indian Currency* was a precursor of the Bretton Woods system (*ib.*: 29-20).

The challenge is thus to find out reasons to believe – *despite* the time elapsed and the orthodoxy of Keynes's thinking in those times, with respect to the revolution he was going to launch in the Thirties – that Keynes's 1913 proposal for a European monetary reform as a precursor of the

Bretton Woods system may offer valuable insights to rethink about the current “Bretton Woods II” system.

At the epoch, the Indian currency system was one of the most discussed issues among British monetary economists (Moggridge 1992). It is then not surprising that first-order contributions to monetary thought come from analyses of the Indian standard and its appropriateness for the country (Chandavarkar 1989). By 1870, the core countries of the international monetary system had abandoned bimetallism and adopted a gold standard, thus reducing the international demand for silver at a time when its value had strongly depreciated following the new supplies from mines in the American west. On a monometallic silver standard since 1835, India closed her mints to free coinage of silver in 1892. The value of the rupee was thus divorced from the value of the metal contained in it. The volatility of the gold value of the rupee had caused problems for both foreign traders and the government, which was under obligation to make large payments (the Home Charges) denominated in sterling. The government pegged the rupee to gold by maintaining sterling balances in London and a gold reserve at home, while money circulation took the form of token silver and paper currency. However, the Indian Currency Committee (the Fowler Committee) of 1898-99 emphasized the internal circulation of gold as a fundamental pillar of the gold standard system on the British model, and prompted for a reform to endorse it, but the practical attempt to introduce gold sovereigns into circulation failed. The Government of India then opted for shipping a vast part of the gold reserve to London, while the gold-exchange standard was maintained almost undisturbed until WWI. The main target of *Indian Currency and Finance* was to support the so-called Lindsay scheme (after the name of the deputy secretary of the Bank of Bengala) in favour of the gold-exchange standard as against the government’s opinion, and practical attempts to introduce a pure gold standard on this basis, that the currency system as it had evolved after 1893 was but a preliminary step towards the implementation of the London model (see *The Collected Writings of John Maynard Keynes* – hereafter: *CW* – I: 45-49).

As is widely known, claiming that India was “in the forefront of monetary progress” (CW I: 69), Keynes came to describe the gold exchange standard as “the ideal currency of the future” (ib.: 25). Both the book and Keynes’s contributions to the Indian Currency Reports were widely acclaimed – not only by Marshall, who described the latter as “a prodigy of constructive work” (CW XV: 268). Notwithstanding its success, the book has received less attention than *The Economic Consequences of the Peace* and *The General Theory* (Dimand, 1991). Though substantial reasons can obviously be argued for this, part of the literature shows a certain degree of reluctance to rescue *Indian Currency and Finance* from the oblivion in which it seems to have fallen, as if either Keynes’s early loyalty to the quantitative theory of money in its Cambridge formulation (see CW XI: 18, Moggridge and Howson 1974; and Kregel, 1985), or the Indian-based focus of the essay (Williamson 1983; Sayers 1972 criticizes this view) make it almost impracticable to speculate about the continuity between the intuitions he made public in *Indian Currency and Finance* and his later suggestions for international monetary reform. And yet, corroborated by the use of some far-reaching essays on this topic, a second glance at Keynes’s “early economics” (Johnson and Johnson 1978) may provide reasons to stress this continuity and substantiate the “back to Keynes” tendency of our troubled times.

By focusing in particular on *The Economic Consequences of the Peace* and Keynes’s economic diplomacy in the aftermath of WWI, as well as on the most controversial episode of the latter, i.e. his call for an American Gift to Britain in 1945, we advanced elsewhere (Carabelli and Cedrini 2008; Cedrini, 2008), the hypothesis of consistency between, on the one side, Keynes’s conception and practice of economics, which qualifies him as a thinker of complexity (Marchionatti 2009), and the “method”, i.e. the way of reasoning in economics (Carabelli 1988) underlying his approach to the complexity of international economic relations. It is quite easy to view his criticisms of the Treaty of Versailles and the multilateral approach he envisaged for the settlement of international imbalances brought about or consolidated by the war as shaped by the use of a method reflecting the characteristics of the complex material he had to investigate on. A method, in

other words, enabling Keynes to tackle organic interdependence among the variables of the European system without theoretically reducing its complexity¹. This paper aims to enlarge our focus to *Indian Currency and Finance*, which was explicitly defined by Keynes as an essay in complexity: the attempt to bring out the fact, he wrote in conclusion, that

the Indian system is an exceedingly *coherent* one. Every part of the Indian system fits into some other part. It is impossible to say everything at once, and an author must needs sacrifice from time to time the complexity and interdependence of fact in the interest of the clearness of his exposition. But the complexity and the coherence of the system require the constant attention of anyone who would criticize its parts. This is not a peculiarity of Indian finance. It is the characteristic of all monetary problems (CW I: 181-82).

A similar concern for the complexity of the material under investigation appears in Keynes's first published article, *Recent Economic Events in India* (1909), where he had praised the virtue of the Secretary of State's action in supporting exchange on the London money market at a time of unfavourable trade balance for India. Criticisms of the government's action were based on "a mistaken view of the connection of events", he stressed, but even

those who have tended to support the official policy have treated the question of exchange and the balance of trade as an isolated problem rather than as part of a complex phenomenon presenting other sides of far-reaching importance (CW XI: 1).

Thus, the attribute of complexity ideally opens and closes Keynes's treatment of India's "intricate and highly artificial system" (ib.). Complexity affects in truth the whole of Keynes's work on this topic, and helps to enlarge our perspective of readers in search of his lessons for today's world.

It should be firstly remarked that Keynes's look was not confined to India. While making a study, during 1910 and 1911, of British gold reserves (see CW XV: 60), Keynes wrote a *Memorandum on a Currency System for China* in favour of the proposal of the US government to introduce a gold exchange standard into China and other silver countries. Indian "not yet [...] ideal system" appearing (though not yet discussed at length) on the background of *Recent Economic*

¹ Three major attributes of Keynes's notion of complexity are inquired into detail in Carabelli and Cedrini 2008: i) organic interdependence, which underlies the whole analysis developed in Keynes's pamphlet; ii) "tragic" dilemmas and fallacies of composition between particular and general interests, and iii) the need for "public" or social – that is, beyond the reach of the individual – solutions to be provided from external sources of relief but conceived, at the same time, as mechanisms to promote "shared responsibilities" approaches to international imbalances.

Events in India is taken as a model for China in need of a currency system for internal circulation which must be able to prevent excess fluctuations of exchange and their harmful effects on foreign trade, i.e. it must “bear some fixed relation to the standard of nearly all other countries, namely gold” (ib.: 61). While gold shall be the standard, Keynes argued, the proper medium for circulation is found in silver, mostly because China would experience major difficulties in obtaining the quantity of gold required for internal use. Keynes notes that “the monetary history of recent times has been steadily tending, especially in Oriental countries” (ib.), to a gold exchange standard. Since few countries were prepared, after the demise of bimetallism, to endorse pure monometallism, the widespread adoption of a hybrid model had popularised the use for internal circulation of silver coins whose value was maintained at par in relation to gold by means of a gold reserve to be used in case of a substantial drain of gold from the country for international payments, tending to depreciate the silver token coins. However,

more recently, a more scientific and economical system than this has come into use. If the gold is only required for foreign payments and not for internal circulation, it is cheaper to maintain a credit at one of the great financial centres of the world, which can be converted with great readiness into gold when it is required, and which earns a small rate of interest when it is not required (ib.: 62).

The latter was “a very vital point”, he observed with respect to China. The new silver coins should be “absolutely inconvertible” (ib.: 63) in the interior of the country; rather, the profits on the new coinage would be sufficiently large to form an adequate reserve; part of the proceeds of the sale in London of Chinese bills to foreign traders (on the model of Indian Council bills sold in London to the benefit of British importers) would have been used for the purchase of silver bullion from Chinese mints, while the rest could be invested in English Treasury Bills in London as a reserve. The profits, he added, would be so enormous that some part might be devoted to capital expenditure in China.

According to Keynes, this evolution was common to Holland and Austria-Hungary in Europe; Mexico and Panama in America; India – “where it has been very severely and successfully tested during the last two years” (ib.) –, Philippines, Straits Settlements, Indo-China, Siam and Java

in Asia; to which one should add Japan, whose system was not formally, but in practice a full gold exchange standard (the same for Russia). In short, it was “the prevailing form of currency in Asia” (ib.: 70), he was later to write in his article *Recent Developments of the Indian Currency Question*, which would have been expanded in the 1913 book. And truly, almost the whole world, except for Britain, “have introduced some form or other of the gold-exchange standard upon the Indian model” (ib.): a significant example was that of Germany, who was now opposing her own previous policy of pushing gold into circulation and rather transferring it in her central reserves.

Already in *Recent Developments*, Keynes stressed that “while a gold *standard* has become almost universal, a gold *currency* is becoming rapidly obsolete” (ib.). He traced the origins of the rationale of the gold exchange standard back to the list of the system’s advantages given by Ricardo in the epoch of the Bullionist controversy, and quoted Mill and Goschen at its own support: the new system

arouses out of the discovery that, so long as gold is available for payments of *international* indebtedness at an approximately constant rate in terms of the national currency, it is a matter of comparative indifference whether it actually forms the *national* currency (ib.).

Its distinctive features were thus:

first, that the actual medium of exchange is a local currency distinct from the international currency; second, that the government is more ready to redeem the local currencies (rupies) in bills payable in international currency (gold) at a foreign centre (London) than to redeem it outright locally; and third, that the government, having taken on itself the responsibility for providing local currency in exchange for international currency and for changing back local currency into international currency when required, must keep two kinds of reserves, one for each of these purposes (CW I: 7-8).

Keynes believed that the costs of gold circulation were simply not sustainable, while large economies could derive from the use of cheaper substitutes; “and it has been found further that gold in the pockets of the people is not in the least available at a time of crisis or to meet a foreign drain. For these purposes the gold resources of a country must be centralised” (CW I: 50-51).

This leads Keynes to discuss more in detail the question of Indian reserves. The stability of the system, he stressed, simply depends on the Secretary of State’s keeping an adequate amount of

reserves of coined rupees (liquid reserves in sterling) to enable him to exchange international currency (local currency) for local currency (international currency, when required). India's complicated reserve system at those times included a currency reserves, depending on the amount of notes in circulation, and a gold standard reserve, depending upon the profits deriving from coinage of token silver rupees. The reserve of coined rupees was held partly in the currency reserve, and partly in the gold standard reserve; the reserve of gold was held in the currency reserve, while the reserve of loans at call was held in the gold standard reserve. Finally, sterling securities were held partly in the currency, partly in the gold standard reserve. The rationale of the system was that the currency reserve kept rupees which might have been required to meet a reduction in the volume of notes, while the gold standard reserve kept those rupees which should have left India in case of unexpectedly huge sales of Council bills in London. According to Keynes, "the only point of importance is that the aggregate reserve of coined rupees should not be larger than is necessary, and its location is mainly a matter of book-keeping" (ib.: 74).

As Keynes himself had emphasized in a letter to the Editor of *The Times* on December 14th, 1912, the proper object of a good currency "is to combine cheapness with stability" (CW XV: 91). The *Indian Currency and Finance* proposals point at both. The gold exchange standard, Keynes remarked, worked not differently from a pure gold standard with respect to the level of prices, while its indirect effect on prices was similar to the effect of the use of any other medium of exchange so as to economize gold. As to the margins of discretion allowed by the system in excess with respect to its pure version, they were limited to the choice of the magnitude of the reserve of coined rupees and to temporary postponement of the demand for rupees (CW XV: 76-77). It is precisely to combine cheapness with stability, however, that a currency system is required to prevent gold circulation.

A preference for a tangible gold currency is no longer more than a relic of a time when governments were less trustworthy in these matters than they are now, and when it was the fashion to imitate uncritically the system which had been established in England and had seemed to work so well during the second quarter of the nineteenth century (CWI: 51).

Keynes observed that the Indian people destined huge amounts of their wealth to the barren accumulation of gold, and that gold was “hoarded, used as jewellery, as gilding, even [...] as medicine” (ib.: 54). Even sovereigns displacing rupees in some parts of the country after their importation in 1912, he stressed, were serving purposes of hoarding, rather than being employed as medium of exchange. The same for the amount of sovereigns introduced into circulation in line with the Fowler Committee in 1898, which was partly exported (half was returned to the Government), while the rest (the greater part of the total amount) reached bullion-dealers. Keynes was against both the proposal for coinage of sovereigns at Bombay and, as said, the government’s attempt to force sovereigns into circulation.

“India, as all we know, already wastes far too high a proportion of her resources in the needless accumulation of the precious metals. The Government ought not to encourage in the slightest degree thus ingrained fondness for handling hard gold. By import taxes on *both* precious metals and by their elimination, to the utmost extent that public opinion will permit, from amongst the circulating media of the country, they ought to counteract an uncivilised and wasteful habit” (CW XV: 81).

“Extravagant and wasteful” as it may be, the Government’s proposal would “diminish, and not, as its advocates claim for it, increase the stability of the currency system as a whole” (ib.: 63). Indeed, he was in favour of abolishing, rather than extending facilities for the use of gold in the country. Otherwise, Indian would have unduly renounced to the 21 million sterling coming from rupee coinage, as well as to interests on the invested portion kept in the currency reserves (£300,000 annually). Moreover, with gold replacing notes – i.e. the cheapest available tool, strongly supported by Keynes, for allowing the currency the desired degree of seasonal elasticity – both the currency and the gold standard reserves would have been weakened. Keynes exposed a further, subtle argument against the proposal. “It is tacitly assumed”, he stressed, “that the greater part of what has to be withdrawn from the circulation at a time of crisis would come from the gold portion of the circulation” (CW I: 64). But he believed this to be contrary to general experience: “at a time of crisis it is the fiduciary coins which the public are most eager to part with” (ib.). Bankers and the

public would keep their currency surplus in the form of gold, thus weakening the existing reserves without reducing the amount of prudential reserves the government should keep.

Keynes's main argument against financial purists is that it is not possible to devise in abstract, i.e. without precise reference to the specific evolution and nature of a country's financial institutions and capital and money markets, *the* ideal currency system valid for all contexts, times and circumstances (see Vicarelli 1989; Ferrandier 1985). Peculiar position in the international money market, the relation to financial centres and even national customs with respect to currency add to these factors to make the ideal system country-specific. Chapter 2 of *Indian Currency and Finance* derives its strength from Keynes's analysis of the respective peculiarities which distinguish the "core" system of Britain, a creditor country and "the envy of the rest of the world" since 1870 (*CW XV*: 77), from the "peripheral" system of India, a debtor nation. The "tacit assumption" recalled above is a powerful example of how misleading might be the proposal of favouring of gold circulation if the British model is unduly applied, with no qualification, to the Indian system: "the conventional idea of 'sound' currency is chiefly derived from certain superficial aspects of the British system" (*CW I*: 11). Although the 1848 Bank Act had been successful in preventing gold economies by the use of notes, its main purpose was almost nullified by the development of cheques as medium of exchange, which led to "a monetary organisation more perfectly adapted for the economy of gold than any which exists elsewhere" (*ib.*: 11-12). The main problem of uncritical imitation of the British model, of its form rather than substance, by a country like India (and most European nations) lies in that

the position of a country which is preponderantly a creditor in the international short-loan market is quite different from that of a country which is preponderantly a debtor. In the former case, which is that of Great Britain, it is a question of increasing the amount lent; in the latter case it is a question of increasing the amount borrowed. A machinery which is adapted for action of the first kind may be ill suited for action of the second. Partly as a consequence of this, partly as a consequence of the peculiar organisation of the London money market, the 'bank rate' policy for regulating the outflow of gold has been admirably successful in this country, and yet cannot stand elsewhere unaided by other devices (*ib.*: 13).

The “other devices” are: large gold reserves, suspension of gold payments and keeping foreign credit and bills which can be withdrawn in case of outward drain of gold. It is typical of countries with limited financial strength such as European countries except for France (using the first two methods) and Germany (using the last two), Keynes maintained, that their central banks largely depend on holdings of foreign bills and foreign credit. This particular form of holding reserves was a growing tendency at the epoch. Its rationale was to be found in that while Britain, as an international short-term lender, could quickly reduce its loans to foreign countries and reduce the balance of indebtedness in her favour by the use of bank-rate policy,

in countries where the money market is already a borrower rather than a lender in the international market ... A direct policy on the part of the central bank ... must be employed. If the money market is not a lender in the international market, the bank itself must be at pains to become to some extent one... by itself entering the international money market as a lender at short notice, place itself in funds, at foreign centres, which can be rapidly withdrawn when they are required. The only alternative would be the holding of a much larger reserve of gold, the expense of which would be nearly intolerable. The new method combines safety with economy ... This is not the expedient of second-rate or impoverished countries; it is the expedient of all those who have not attained a high degree of financial supremacy – of all those, in fact, who are not themselves international bankers (ib.: 18-19).

Keynes even offered a realistic map of the international monetary system, a much more detailed one than that we are reporting here, with Britain and France, short-term creditor countries, at the one end of it, and Germany, a creditor in relation with her neighbours but a debtor in relation to the great creditors (Britain, the US and France) in an intermediate position. Then Russia and Austria-Hungary, “rich” debtor nations. “From the currencies of these it is an easy step to those of the great trading nations of Asia – India, Japan, and the Dutch East Indies” (ib.: 19).

To say that the gold-exchange standard merely carries somewhat further the currency arrangements which several European countries have evolved during the last quarter of a century is not, of course, to justify it. But if we see that the gold-exchange standard is not, in the currency world of to-day, anomalous, and that it is in the main stream of currency evolution, we shall have a wider experience on which to draw in criticising it, and may be in a better position to judge if its details wisely ... The proper solution for each country must be governed by the nature of its position in the international money market and of its relations to the chief financial centres, and by those national customs in matters of currency which it may be unwise to disturb. It is as an attempt to solve this problem that the gold-exchange standard ought to be judged (ib.: 21).

Although country-specific (as for the amount itself of reserves, which in India must be exceedingly large because of wide fluctuations in prosperity and trade, and the lack of international stock exchange securities against large foreign liabilities), different choices in matters of currency did not diverge so much as to prevent Keynes from declaring that there were prevailing tendencies to introduce a gold exchange standard both in Europe and in Asia, containing at least “one essential element – the use of a cheap local currency artificially maintained at par with the international currency or standard of value (whatever they may ultimately turn out to be) – in the ideal currency of the future” (ib.: 25).

Nonetheless, in the case of India, this requires intensification of the public effort against hoarding, which would otherwise lead to lose and substantially waste gold resources required in the event of crisis. Keynes admits that the suspicion with regard to the holding of Indian gold in London is perfectly legitimate, although for the Secretary of State it would be easy to dispose of part of this gold even if the latter was kept in India. Again, a debtor in relation to Britain, India should necessarily use its gold reserves to discharge its debts in case of stringency in the London market, since Britain would quickly dry up new loans to the Indian market or decide not to renew the already existing ones. India would be thus forced to add gold to its exports in view of paying what she owes: holding gold reserves in London would amount to save time and lead to much less onerous financial operations (Keynes was later to stress that the gold exchange standard had enabled India to meet the August 1914 crisis better than any other country. See *CW XI*: 275).

Gold reserves are meant to be used in times of difficulty, and for the discharge of pressing obligations. It is absurd for a man with a large balance at his bank to default to his creditors, because a feeling of jealousy, in regard to any one in whose favour he draws a cheque, prevents him from ever drawing one. Mr. Bagehot certainly did England a great service in dissipating from the minds of her financiers this primitive prejudice – for wonderfully few other countries have yet learn that gold reserves, although no doubt they serve some purpose when they are held for show only, exist to much better purpose if they are held for use also (ib.: 125).

“Various stirring of the original sin of mercantilism”, India’s “jealousy of the too powerful magnates of the London money market” as well as of the Secretary of State, and even Britain’s

“jealousy” of Indian gold, which she could consider as “her own war chest”: “all combine to make a powerful, natural, and yet unfounded prejudice which it is exceedingly difficult to combat” (ib.: 125-26).

The sink of precious metals, according to Jevons’s well-known dictum, India was functional to Western interests in price stability. India’s “love” of gold, “ruinous though it has been to her own economic development, has flourished in the past to the great advantage” (ib.: 70) of Europe. Keynes stressed that Indian demand for gold had been and was, “at a time of plentiful gold supply like the present, a true friend to the City and an enemy of inflation” (ib.). In *The General Theory*, however, he was to stress that “the history of India at all times has provided an example of a country impoverished by a preference for liquidity amounting to so strong a passion that even an enormous and chronic influx of the precious metals has been insufficient to bring down the rate of interest to a level which was compatible with the growth of real wealth” (CW VII: 337). Chandavarkar (1989) notes that Keynes did not fail to envision “futuristic scenarios involving a reversal of roles” (ib.: 91). His proposed reforms for the country were based on Indians’ learning “to leave off their infertile habits and to divert their hoards into the channels of productive industry and to the enrichment of their fields” (CW I: 70). Should this occur with Indian demand for gold reducing gradually over time, Europe would be no more insulated from abrupt changes in world prices. “Yet if the change comes at a time of big new production, she may involve the world, nevertheless, in a very great inflation of world prices” (ib: 70-71). But Keynes is doing more than evoking a futuristic scenario.

If India is thus to turn the tables on the West, she must not delay too long. The time may not be far distant when Europe, having perfected her mechanism of exchange on the basis of a gold standard, will find it possible to regulate her standard of value on a more rational and stable basis. It is not likely that we shall leave permanently the most intimate adjustments of our economic organism at the mercy of a lucky prospector, a new chemical process, or a change of ideas in Asia (ib.: 71).

The various “futuristic” scenarios drawn by Keynes in his writings are more often than not an attempt to promote reform plans designed to revolutionize the present rather than a pure speculation

about changing times and circumstances requiring, in the future, different ways of coping with given problems. Not to mention but a well-known example, even his *Economic Possibilities for Our Grandchildren* were published as one of the *Essays in Persuasion*: the core message of the writing is posed at the service of public action reversing the “progress towards negation” (CW XXI: 40) policy followed by the government – see a 1931 letter to W.S. Woytinsky of the German Trade Union Federation, where Keynes admits that he wrote the *Essays in Persuasion* “for popular consumption against deflationists in this country” (reported in Ruiz 2009: 2-3; see Carabelli and Cedrini 2009). As we argue in below, the prospected reversal of role between Asia and the West in *Indian Currency and Finance* thus appears as a device introduced by Keynes, consistently with the use he made in all his writings of this word, to reinforce the case for European monetary reform driven by, and based upon, rationality.

Indian Currency and beyond

The discussion reported above on the effects of the dynamics between creditor and debtor countries for the international monetary system should suffice to cast doubts on Williamson’s criticism about Johnson and Johnson's (1978) interpretation of Keynes's early economics. According to the former, the latter would be wrong to pose *Indian Currency and Finance* at the basis of Bretton Woods and possibly Keynes’s International Currency Union plan, because in the book “Keynes was quite unambiguously concerned with exploring the rational policy for a single country that was sufficiently small to take the systemic behavior as parametric” (Williamson 1983: 109). Williamson notes that Keynes’s proposals for the 1922 Genoa conference did not even mention withdrawing gold from circulation and centralizing it in reserves available for international payments. Moggridge (1986) suggests that the explanation for this is probably to be found in Keynes’s concern, at those times, for excessive rather than deficient international liquidity. On the contrary, by examining Del Vecchio’s review of *Indian Currency and Finance* in 1920, De Cecco (1985) notices that Keynes had simply failed to realize that although a gold exchange standard could be a viable solution for

colonial territories, sovereign countries enabled to politically manage foreign exchange balances would have not accepted it. According to De Cecco, Britain's Genoa proposals for the establishment of a London-led gold exchange standard was a conscious "policy of despair" (ib.: 51) driven by pessimism on the use of bank rate, which the Cunliffe Report considered as operating through changes in the volume of output and employment, as a tool for international monetary policy.

Indirectly, De Cecco confirms that *Indian Currency and Finance* is also an essay on international monetary reform. It seems quite difficult to deny validity to Dimand's (1991) view that *Indian Currency and Finance* already shows Keynes's "desire to devise a stable international monetary system that would be more flexible and less wasteful of resources than the gold standard and his emphasis on the crucial role of central banking in managing such a system" (ib.: 34). In the book, Keynes advocates the creation of a State Bank of India substituting for the Presidency Banks of Bombay, Calcutta and Madras. The Indian monetary system had "much to learn from what is done elsewhere" (ib.: 182) in matters of banking arrangements, management of note issue and in the relation of the government to the money market. The mind easily goes to the US and the establishment of the Federal Reserve System. Both India and the US were in fact large agricultural countries with cyclical fluctuations in the demand for funds to move the crops but inelastic supply of money-proper and no countervailing elasticity in bank money. To eliminate fluctuations, the government should have hold unduly voluminous amounts of exchange reserves so as to be able to meet the swings in the demand for credit between busy and slack seasons in the crop cycle. Keynes's proposal was thus to improve elasticity of domestic money supply, thereby avoiding volatility of discount rates (see Chandavarkar 1985; for a comment on the presumed conservative character of Keynes's scheme, see Moggridge 1992; Johnson and Johnson 1978). In Mehrling's (2009) words, Keynes was trying to "improve banking institutions in order to reduce the social cost of banking operations, both in terms of price volatility and risk premiums, but in general it will not be possible or desirable to drive the risk premium to zero by absorbing all the risk on the

government's balance sheet. In this respect, it is remarkable that Keynes holds out India's gold exchange system as an innovation to be admired" (ib.: 7). Taken together with his suggestions to counteract the hoarding of gold, this proposal by Keynes – the main target of the memorandum on the Indian State Bank he attached to the Royal Commission report required after the Marconi scandal, as Johnson and Johnson (1978) argue, was to establish an economical currency system, i.e. "one that would not tie up an excessive amount of resources in barren reserves" (ib.: 114) – was the first of a long future series based on recognition that "instead of having rigid rules shackling the economy's performance, monetary institutions should be molded with sufficient flexibility to allow the pursuit of domestic targets" (Cesarano 2003: 492).

A proper analysis of the "method" – in the sense used by Ferrandier 1985 and Vines 2003 – used by Keynes to deal with the complexity of the Indian system and the international monetary order which the widespread application of that model would have given life to may offer support to the view that *Indian Currency and Finance* provide clear continuity with Keynes's later reform schemes. As seen, a key concept in Keynes's analysis is that of rationality. *Recent Developments of the Indian Currency Question* (the same goes for *Indian Currency and Finance*) begins with extremely interesting comments by Keynes on the evolution of the Indian currency system since 1899, which had been

silent but rapid. There have been few public pronouncements of policy on the part of the Government, and the legislative changes have been insignificant (ib.: 67).

"Yet a system has been developed", he remarked,

which was contemplated neither by those who effected nor by those who opposed the closing of the mints in 1892 and which was not favoured either by the Government or by the Committee of 1898, although something resembling it was brought before them (ib.).

Lindsay's revenge, in other words. After all, notes Keynes, he had always maintained: "They *must* adopt my scheme despite themselves" (ib.: 71). Although that of the Indian system was undoubtedly a positive, unintended evolution,

the fact that the Government has drifted into a system and has never plainly set it forth, is responsible for a great deal of the misapprehension regarding its true nature which exists in the minds not only of the public, but also of some Government officials (ib.: 67).

This could compensate the advantages deriving from the fact that

The details of the gold standard are difficult and complicated, but there is not the least need for anyone who uses the coin to understand the system on which it is based. In India very few traders even understand it. Only those who actually control the system need appreciate the details (ib.: 63).

This digression on the unintended effects of currency policy (of a similar kind of that concerning Britain's 1848 Bank Act, cited above) induces to rethink the use Keynes makes of the concept of rationality. In his introduction to the Series of *Cambridge Economic Handbooks*, 1922-3, Keynes writes: "The theory of economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method rather than a doctrine, which helps its possessor to draw correct conclusions" (CW XII: 856) and to avoid falling into logical fallacies in reasoning, like the fallacy of composition. Keynes's way of reasoning in economics is in fact a non-demonstrative logic, based upon probability, which is but a logical relation between propositions or arguments, between premises and conclusions. The material of probability consists of propositions, i.e. on reasons, grounds or evidence supporting the relation of probability. For Keynes, limited knowledge does not rule out the possibility to form individual reasonable judgements: having "some reason" (ground or evidence) "for expecting" and acting, he writes in the *Treatise on Probability*, is a sufficient condition to form a reasonable judgement and a reasonable action (CW VIII: 277). *Indian Currency and Finance* is one of the best example (consider CW XV: 69, line 11: "I will endeavour to give reasons for thinking...", and line 22: "I will ... give reasons against...") of Keynes's belief that "in economics you cannot *convict* your opponent of error – you can only *convince* him of it. And, even if you are right, you cannot convince him, if there is a defect in your powers of persuasion and exposition or if his head is already so filled with contrary notions that he cannot catch the clues to your thought which you are trying to throw to him" (CW XIII: 470). The mind easily goes to

purists' views about gold circulation. Likewise, Keynes held that it was only under the influence of a major crisis that proposals for a state bank could be given the due attention (see *CW I*: 168).

For Keynes, probability is the hypothesis upon which it is reasonable for us to act in condition of limited knowledge (*CW VIII*: 339; see in general Carabelli 1988), so that the general principles which rule human conduct are also those which rule probable reasoning. The above passages about the unintended consequences of currency policy give an illustration of Keynes's belief that what matters is reasonableness – neither absolute rationality nor truth – of judgement and action, and that reasonableness does not depend on the success or fulfilment of expectations: mere luck does not turn foolish judgements into reasonable judgements. Moreover, reasonableness is contingent to changeable cognitive circumstances. In politics and economic policy-making, we have to take a decision without knowing the truth, and deliberate on the basis of probability and likeness. This does not translate, however, into arbitrariness or irrationality of political decisions. As Carabelli and De Vecchi (2000) point out, Keynes constantly opposes the idea of natural order and selection, and always rejects policy spontaneity, which is always negatively associated, in his thought, with instinct, blindness and chance, i.e. absence of deliberation. In fact, Keynes distinguishes between institutions and spontaneous social practices, which rely on habits and traditions. The former are collective agents having a mind and a will, depending on partial reason and probable judgement: “in cases of social need, institutions should compete with and try to contrast ethically undesired social practices and conventions” (ib.: 231), and “schemes conceived by the mind” replace “undesigned outcome of instinct” (*CW XVII*: 453). Take the main message of the

Monetary Reform:

we must free ourselves from the deep distrust which exists against allowing the regulation of the standard of value to be the subject of *deliberate decision*. We can no longer afford to leave it in the category of which the distinguishing characteristics are possessed in different degrees by the weather, the birth-rate, and the Constitution, – matters which are settled by natural causes, or are the resultant of the separate action of many individuals acting independently, or require a Revolution to change them (*CW IV*: 36).

Endowed with partial knowledge and reasonableness, institutions are deliberately designed social remedies, that is remedies beyond the reach of the individual, and should be guided by their capability to oppose the negative effects of complexity and organic interdependence characterizing society and economic organization, such as fallacies of composition, market failures, conventional expectations derived from uncertainty and ignorance. The economists' task is to find out new tools and principles of policy to control and intervene in the working of economic forces, with the aim of promoting social stability and justice.

Social rules themselves should be made the object of revision on more rational criteria. Policy should in fact be "wise", i.e. reasonable. Consider again the *Monetary Reform*: the alternative to gold, "our golden opportunity", was just "our existing system, but worked self-consciously and for a wise, deliberate purpose" (ib.: 161). Wisdom here refers to practical human reasonableness and prudence, i.e. to assigning due attention to changing circumstances. Policy should be based upon correct principles like cleverness and goodness, reason and intellect; since "they mould the future and cannot be loyal to the past" (Carabelli and De Vecchi 2000: 238), however, public institutions should show non-conformist and non-conventional attitudes. Since they possess a greater store of knowledge, though still partial, than the individual, they are best placed to decide and act precisely in those cases in which uncertainty and ignorance force the latter to adhere to average opinion and conventions: state intervention acts to modify public opinion so that a new, less harmful convention may be established. Discretionary policy, Keynes adds, is a "rational construction", in need of "constructive proposals" (CW XXVII: 138).

A direct illustration of this in *Indian Currency and Finance* is provided by Keynes's argument for moderating the amount of India's total reserves: "it would be extravagant [for India] to maintain a reserve adequate for all conceivable emergencies" (CW I: 120), since the Secretary of State could always borrow by issuing India bills. In India, he stresses, all available resources are required for capital expansion: it is "not sound or humane policy to burden the present as much as for the sake of the future" (ib.). Of course, this owes much to the fact that "few countries have so

good a market for their loans at a foreign centre as India” (ib.). As seen, however, *Indian Currency and Finance* is more in general an illustration of Keynes’s belief that not only ignorance about the future should not paralyze public policy but also, and most of all, that “the future will be what we choose to make it” (CW XXVI: 260). Compare *Indian Currency and Finance* insights with Keynes’s comments on the 1914 crisis. In his reconstruction, the collapse is due to foreign debtors’ inability to remit funds to meet their obligations to Britain. Specie payments had been suspended, and the ability of the Bank of England to draw gold severely impaired: due to the “uncertainties of war”, in fact, “as usual, most countries refused to use their gold reserves and preferred sterile hoards to the fulfilment of their obligations” (CW XI: 259):

“although many countries hold large quantities of gold, there are but few which pursue a rational policy in regard to it. At considerable cost they build up large reserves in quiet times presumably with a view to the next crisis; but when the crisis comes mistaken policy renders them as little able to use gold as if it were not there at all” (ib.: 247).

The rationale of the enormous accumulation of gold reserves during the last fifteen years before the crisis, Keynes noted in November 1914, had been “only dimly conceived by the owners of them. They have been piled up partly as the result of blind fashion, partly as the almost automatic consequence, in an era of abundant gold supply, of the particular currency arrangements which it has been orthodox to introduce. The actual amount of gold held in reserve has been in only a very few cases the result of a deliberate choice” (ib.: 312). Occasionally, he added, panic had been the motive underlying a revision of ideas about reserves. True, the management of reserves is not a science. Due to the vague nature of the contingencies motivating the holding of reserves, “the problem of assessing the proper ratio [is], within wide limits, indeterminate” (ib.: 313). Nonetheless, though Britain is a relevant exception in this respect (this will be the lesson of WWI and Inter-Allied finance),

a gold reserves is thought of as being some sort of charm, the presence of which is valuable quite apart from there being any idea of dissipating it, – as the emblem, rather than the prop, of respectability. It would be consistent with these ideas to melt the reserve into a great golden image of the chief cashier and place it on a monument so high that it could never be got down again. If any doubt comes to be felt about the

financial stability of the country, a glance upwards at the image will, it is thought, restore confidence. If confidence is not restored, this only shows that the image is not quite big enough (ib.: 313-14).

While wondering why European countries had deliberately abandoned the “purposes for which it is rational to hold a reserve” (ib.: 315), Keynes speculated about the fallacy of composition which the “extreme force of circumstances” (ib.: 317) may engender. Alternatively, the War could lead to a radical innovation in matters of currency, and impose a new international regulation. To innovate is “practicable, as soon as people in general believe it to be so. The intellectual and scientific part of the problem is solved already. Only the will and the belief have not yet come”. Better, perhaps, to wait for “a catastrophic change”, causing gold to be “deposed from its despotic control over us and reduced to the position of a constitutional monarch”, until

a new chapter of history will be opened. Man will have made another step forward in the attainment of self-government, in the power to control his fortunes according to his own wishes. We shall than record the subtle, profound, unintended, and often unnoticed influences of the precious metals on past historical events as characteristic of an earlier period (ib.: 320).

Conclusions

Keynes devoted his whole life to the attempt to reform the international monetary system. With its search for a more rational and stable basis than gold for the international currency standard, *Indian Currency and Finance* is founded on a critique of the model of commodity money (Cesarano 2003) which Keynes was to deepen throughout his career of international economist and negotiator. Suffice it to say that in his plans for Bretton Woods – the regime itself was to coincide with “the final stage in the transition from the commodity money to the fiat money” (Cesarano 2006: 3) – Keynes prompted for overseas transactions passing exclusively through the hands of central banks and cleared through a new international institution, the International Currency Union (ICU). International clearing account would have been denominated in a new unit of account and international currency, the bancor, expressed in terms of gold. But gold convertibility should have been one-way, i.e. the metal could only flow from national banks to the clearing bank. In short,

bancor would have been the ultimate reserve asset of the system. As Keynes's optimism with regards to the 1914 crisis makes quite clear, Sayers (1972) is right to emphasize that *Indian Currency and Finance* is a book of the first quarter of the twentieth century, when Keynes and his contemporaries "tacitly regarded the international gold standard as a system in which the strains of international maladjustments could be taken care of by international capital flows properly influenced by central banks, and it was for this purpose that all major countries should have central banks" (ib.: 594). The interwar period would have required much different instruments against fundamental disequilibrium.

In the book, Keynes offered the picture of an international monetary system able to conciliate, aptly managed through the use of exchange reserves held at the international financial centres of the core, the interests of debtor countries with those of creditor nations. After all, the pre-war gold standard was characterized, to a certain degree, by multilateralism and dynamism (De Cecco, 1975). Relying on Britain's ability to make the Empire finance its deficit with Europe and the US, and on the use of the discount rate as a means of attracting gold from the continent to match the "new" countries' rapid development, the system ensured its reserve countries the possibility to face their short term balance-of-payments deficits while investing long term in peripheral countries. Though Keynes could scarcely be aware of it at the epoch, *Indian Currency and Finance* configured the first of a series of reform plans attempting to revive, under different forms, the "lost paradise" (Dimand, 2006: 175) of the pre-1914 internationalization he had so brilliantly described in the opening pages of *The Economic Consequences of the Peace*. WWI posed an end to the first era of globalization and, ruled out by the unbalanced international distribution of gold which resulted from war and uncooperative accumulation policies in the creditor countries, the gold exchange standard never materialized.

Declining "from being the conductor of the international orchestra ... to less exalted status" (Moggridge 1986), Britain discovered the truth – she was victim, as any other country, of the "dilemma of the international monetary system" (CW VI: 272), i.e. the apparent impossibility to

satisfy the double need to “preserve the advantages of the stability of the local currencies of the various members of the system in terms of the international standard, and to preserve at the same time an adequate local autonomy for each member over its domestic rate of interest and its volume of foreign lending” (ib.). Once a relevant pillar and a fundamental stabilizing factor of the pre-war gold standard, foreign lending, namely the “process by which rich countries spread the proceeds of their wealth over the world, and thus is internationally desirable”, could no more “be strongly supported on nationalist grounds” in the post-war gold standard, as Keynes would argue in his 1929 lectures (in Fleming, 2000: 142; see also Dimand, 2006). The system’s lacking a responsible leadership on the model of Britain in the pre-war period, Keynes’s view of economic history progressively became that of a permanent conflict between creditors and debtors (De Cecco, 2001) which the ICU plan for an was destined to counteract through the issue of a supranational money replacing gold at the international level and the establishment of the principle of clearing with more symmetric rules for adjustment, as well as increased international liquidity.

In the paper, we try to show that the legacy of Keynes's “Bretton Woods 0”, i.e. the international monetary system as shaped in its essential traits in *Indian Currency and Finance*, may still prove useful today, in the times of the Bretton Woods II system, to help policy-makers focus on some of the latter's major faults. Keynes's awareness of the changes occurred in Asia at the beginning of the twentieth century parallels our inability to cope with the global imbalances which have developed as the spectacular effects, to use Keynes's words, of “a change of ideas in Asia”. True, this change, i.e. the passage from external borrowing to “undervaluation-cum-intervention” as development strategy, has been almost forced by the West on developing countries and deficit nations after the East-Asian crisis through the imposition of the tenets of neoliberalism and aggressive financial liberalisation. In a way, Asia has now “turned the tables on the West”, as Keynes observed in the prospected reversal of roles he pictured in *Indian Currency and Finance*, but the West has not yet learnt how to avoid leaving “the most intimate adjustments of our economic organism at the mercy of ... a change of ideas in Asia”. By focusing on Keynes's book as

an essay in international economics, it is possible to show that the legacy of his fresh look at Asia in the first years of the Twentieth century, of the “focus and method” of his analysis of the Indian monetary system and his proposal of a new regulation of the European standard on a more rational and stable basis than the gold standard, may help rethinking the need for a “rational” international monetary reform.

Contrary to the desired outcomes of Keynes's suggested reform, today's Bretton Woods II system combines expensiveness with instability (see Ocampo 2007). Not only should one care about the social costs of excessive exchange reserves – as seen, both the latter and their high costs are prominent features of Bretton Woods II. The mix of expensiveness with instability is due, on the one hand, to the use of a national currency, the US dollar, as the global reserve currency and the instrument for international payments. Since non-reserve countries' demand for reserves grows with international transactions and reserves can only be accumulated by running balance-of-payment surpluses, as argued by Greenwald and Stiglitz (2006), “as long as non-reserve countries attain their desired levels of reserve accumulations, the reserve money currency country ... will be faced with chronic growing deficits (ib.: 7). In effects, the golden age of Bretton Woods owes much to the US willingness to comply with the rules of the Keynes plan. The ultimate creditor country, in Davidson's (2008) words, was willing and able to offer a permanent free lunch for all by accepting the major responsibility for solving international payments imbalances. A deflationary environment is on the contrary bound to result from the Bretton Woods II system and mercantilist tendencies on the part of many of its main players. On the other hand, the system's instability has much to do with emergent countries' demand for self-insurance, i.e. with accumulation of exchange reserves for purposes of protection from pro-cyclical capital inflows accompanied by limited possibilities, for emerging markets, to adopt counter-cyclical policies. The two recalled factors appear inescapably destined to produce an inequitable system and a not sustainable pattern of international economic relations, whose persistence increases the magnitude of the global austerity programme following the US financial crisis. Due to the inherent asymmetries of the global reserve system, the only

possibility to avoid “fallacy of composition effects that feed into global imbalances” (Ocampo 2007: 12) lies in the US willingness to act as the deficit-importer of last resort and raise her indebtedness at intolerable levels.

It is by adopting the “systemic” point of view, both for the past and the present, that we can appreciate the saliency of Keynes's analysis in the times of Bretton Woods II. Somewhat in line with Keynes's own attempt to ground the ICU on the virtues of the pre-war gold standard while avoiding its vices (see *CW XXV*: 40-66), it can be argued that what he himself considered as the legacy of his early international economics for his reform plans in the Forties is the need for international reform to achieve a system combining cheapness – as opposed to the costs unduly produced by the global reserve system – with stability – as opposed to the deflationary environment which it naturally tends to produce – and able to establish, in the name of the beneficial effects of economic interdependency, more sustainable patterns of relationship between debtor and creditor countries.

Keynes's early essays in international economics were quite firm in their attacks on sterile and costly hoarding of gold, severely impairing the possibility to use it as a means of discharging international obligations, as well as on any rationale of reserves accumulation significantly deviating from “reserves are to be used not shown”: countries were required by the ICU plan to make available for purposes of international adjustment those resources which they choose to leave idle. Contrary to Keynes's message, the economic anxieties produced by financial globalization and the Bretton Woods II system unduly reduce the degrees of freedom available to its member countries. It reinforces tendencies to adopt mercantilist policies of the kind of those which the ICU was intended to oppose and induces less aggressive emergent countries to self-insurance strategies coming at high costs for themselves and for the stability of the whole system.

Obstfeld *et al.* argue (2008) that the growth of international reserves demanded by emergent markets should be understood as the attempt, on the part of the central bank, to protect countries from “double drain” crisis scenarios with banking problems and capital flights (that is, sudden stop

of foreign financial flows plus domestic runs on currency) working together against stability to promote sharp currency depreciation. They find (2009) that in the first year of the current crisis, countries with small war chests have tended to depreciate, while those with more reserves relative to the size of the banking system have even appreciated. After comparing the different responses to the crisis given by three hoarding countries, i.e. Brazil, Chile (more limited use of reserves) and South Korea (active use), Aizenman (2009) concludes that the success of the general strategy elaborated by countries opting for financial integration and managed exchange flexibility illustrates the importance of the self-insurance provided by reserves. Reserves have ensured hoarding countries a soft landing and the needed self-insurance. However, Aizenman notes that “the reluctance of many countries to draw on their reserve holding raises the possibility that they may now suffer less from the well-known ‘fear of floating’ than from a ‘fear of losing international reserves’, which may signal a deterioration in the credit worthiness of a country. Mitigating this concern should be the prime responsibility of the international financial institutions” (ib.: 17).

Here is another reason why the endeavour to discuss the reasonableness *à la* Keynes, more than the rationality, of current informal international architecture should be performed exactly (and contrary to the advice of Dooley *et al.* 2009) in the times of the Bretton Woods II system. What can be rational for individual countries – the mix of self-insurance with mercantilist policies – might lead to a fallacy of composition at a global level, as argued by Ocampo (2007) with reference to the role played by reserves hoarding in aggravating global imbalances. Moreover fear and the forced, unnecessary and ironically inefficient adoption of neoliberal strategies are at the basis of the rationality of reserve hoarding in the Bretton Woods II system. In economics, regulation – deliberate decision, in Keynes's words – is an antidote to fear (see Stiglitz 2001). It is not difficult to find suggestions for a Keynes-inspired proposal of global monetary reform: the world needs a true global currency as a new, more rational and stable store of international value (Ocampo 2007), reserves accumulation should be decoupled from the deficit positions of reserve countries while more symmetrical rules for international adjustment would help the global economy to reduce its

seemingly permanent imbalances (Greenwald and Stiglitz 2006). As known, Davidson (2008) even proposes to update Keynes's ICU original plan for today's world, stressing the need to avoid a lack of a global effective demand due to excessive reserve hoarding and to provide each nation the possibility to monitor or even control capital movements against financial contagion. What we have tried to show, however, is simply that revisiting *Indian Currency and Finance* offers us a valuable opportunity to look differently at the Bretton Woods II system as well as to rethink the need for international monetary reform.

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