The Speculative Consequences of the Peace

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1. Introduction

Thomas Carlyle once cast economics as the "dismal science." Few works better fit that characterisation than does John Maynard Keynes' *Economic Consequences of the Peace*. Beyond his general Malthusian pessimism, Keynes specifically warned that the Treaty of Versailles would render European life, "*inefficient, unemployed, disorganised" and "torn by internal strife and international hate, fighting, starving, pillaging, and lying."*[1]

The Economic Consequences provoked debate on everything from normative questions of international justice to the technical analysis of the "transfer problem." And it attracted criticism on every front. Mantoux (1946), for instance, highlighted inaccuracies in Keynes' assessment of Germany's capacity to pay reparations, while Ohlin (1929) challenged Keynes' underlying theoretical model. Yet, the controversies only further elevated the best-selling book. By 1921, it had become, the *Wall Street Journal* noted, "*the text book which the German economic experts used in basing their objections to the reparations clauses of the Treaty of Versailles"*.[2]

But while Keynes' detractors questioned his empirics, his theory, and even his patriotism, no serious critic questioned his integrity. Yet, Keynes' publication of *The Economic Consequences* coincided with his first great foray into the realm of market speculation. From the summer of 1921 through 1927, Keynes continuously traded major European currencies and the US dollar against the pound sterling, variously going short and long as he thought circumstances warranted. Previous writers have described Keynes' speculative activities and analysed his performance as a currency trader (Moggridge, 1983; 1992; Skidelsky, 1992; Accominotti and Chambers, 2016), but there remains little perspective on the interaction between his activities as a speculator and his theoretical and policy work as an economist. More broadly, Keynes is a particularly fascinating case given that he developed a revolutionary perspective on the gold standard, that he had almost peerless insight into the policymaking process at the time, and that he held the ear—and commanded the respect—of the most powerful policymakers in London.

1 Keynes, *Collected Writings*, 2:157.

2 *Wall Street Journal*, April 30th, 1921, "Keynes to Blame for Hun Reparations Tactics", p. 6.

This chapter explores how Keynes' ideas in *The Economic Consequences* related to his activities as a foreign exchange trader. We address two questions. First, how did Keynes' understanding of the post-war international economic and political situation influence his foreign exchange speculation strategy? Second, how did Keynes' experience as a speculator influence his political-economic theory in the years following the publication of his book?

To answer these questions, we utilise a dataset of all Keynes' currency trades developed by Accominotti and Chambers (2016). We then construct a day-to-day narrative exploring the interaction between Keynes' trades on the foreign exchange market and his work as an economist and public figure in the months from August 1919 to February 1920. Finally, we present some of our own speculations on how Keynes' experience in currency trading influenced his theories and views on financial markets over the years following.

2. The London forward exchange market and Keynes' speculation

Throughout the First World War, the risk of losing gold shipments to submarine attacks disrupted international gold movements. At the same time, the belligerents propped up their currencies through a mix of formal capital controls, informal moral suasion, and direct foreign exchange intervention. In early 1919, the UK government ceased propping up the pound-dollar exchange rate in the market and commenced liberalising the UK's capital controls—well before it had wrung out the wartime currency inflation.[3] This sent sterling sliding; but it also brought a dramatic resumption of foreign exchange activity in London. Indeed, the surge in exchange trading volumes---and exchange rate volatility--dwarfed anything seen in the pre-war years.[4] Many traders used the nascent forward currency market to hedge their foreign exchange exposure, but others, like Keynes, simply speculated in the pursuit of profit.

Keynes began currency speculation in the summer of 1919, just after the Treaty of Versailles was signed and just as he completed drafting *The Economic Consequences*. Using his friend Oswald Falk's brokerage

[3] Morrison (2021), Ch 8.

[4] London remained the leading foreign exchange market in the interwar period (Einzig, 1937) and over the rest of the twentieth century (Atkin, 2005).

firm, he sold/bought currencies against the pound sterling on the forward market (for future delivery). He also alternated between long and short positions on the US dollar (Accominotti and Chambers, 2016). Because of the dollar's unmatched link to gold at the time, this was partly a bet about the trajectory of the dollar but also partly a bet about the trajectory of the European currencies—including the pound—relative to gold. Typically, Keynes closed his positions a few days before the forward contract's maturity by buying/selling (on the spot market) the notional amount of foreign currency specified in the forward contract.

Accominotti and Chambers (2016) describe Keynes' foreign exchange speculation strategy during his two periods of active trading, 1919-1927 and 1932-1939. Drawing on Keynes' personal ledgers in the archives of King's College, Cambridge, the authors reconstitute his positions and assess his performance. It is clear from his positions and his correspondence that Keynes was a *fundamentals-based* trader. Simply put, Keynes tried to leverage his understanding of political economy (broadly construed) to out predict the market on the trajectory of particular exchange rates.

In general, Keynes' currency positions in the early 1920s followed from his pessimistic analysis of macroeconomic fundamentals in *The Economic Consequences*. There, Keynes warned that the (unavoidable) post-war adjustments would combine with the (unnecessary) burdens of inter-allied war debts and reparations to perpetuate the "menace of inflationism."[5] Keynes thus shorted the French franc, German mark, and Italian lira across the majority of the 1919-1927 period. Yet, he varied these positions based on his perceptions of the shifting political and economic winds.

In the long run, Keynes' earnt marked profits from his currency speculation, but his returns were extremely volatile. In May 1920, huge losses on several short positions of European currencies against sterling brought him to the brink of personal bankruptcy. However, with a loan from Ernest Cassel, Keynes maintained the same short positions and eventually made an overall profit. When comparing his returns to the risks he took, his performance as a currency trader during the 1920s can be judged as quite modest (Accominotti and Chambers, 2016).

[5] Keynes, *Collected Writings*, 2:157.

3. The political economy of Keynes' earliest speculation: a narrative

How did Keynes translate his analysis of the post-war economic order in *The Economic Consequences* into precise currency forecasts? Keynes' interchanges with Falk offers insights into his approach to some of his trades (Accominotti and Chambers, 2016). However, this information is far from exhaustive. In this chapter, therefore, we systematically situate his most important individual currency trades from August 1919 to February 1920 in the context of his political writings, remarks, and activities. [6] While one cannot read Keynes' mind, this contextualisation enriches our understanding of how a prominent – and politically well-connected - economist converted his analysis of the complex post-war economic and political order into an actual trading strategy.

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Learning from the treaty

As Keynes drafted *The Economic Consequences*, he hit upon several of the Treaty's most immediate, practical consequences for UK finances. He was no longer formally attached to the UK Treasury, but, in late July, he wrote to his former colleague, John Bradbury, one of the two Permanent Secretaries to the Treasury. The Treaty, Keynes explained, would require the UK to pay to the Reparation Commission the value of whatever warships it received from Germany. But this, Keynes feared, was likely to happen well before the Commission had settled most of the UK's own claims, leaving the UK "hav[ing] to pay over actual cash to Belgium" upfront.[7] The short-term effects were clear: such a significant capital outflow would put downward pressure on the exchange rate.

Before the war, 1 pound sterling traded at, or near, $4.86. Following the War, sterling was artificially supported at about $4.76 – 2.3% below the pre-war exchange rate parity. This lasted until late March 1919, when the UK ceased official foreign exchange market support. Within a week, sterling had dropped below

[6] We draw on Keynes materials in both *The Collected Writings of John Maynard Keynes* and in the John Maynard Keynes Papers collection in the archives at King's College, Cambridge. We also use materials from various collections in the National Archives and the Bank of England.

[7] Keynes, *Collected Writings*, 17:115.

$4.60. It then stabilised, and traded at around 5% below the prewar rate into the spring. In June, however, the slide resumed. By mid-July, sterling had fallen to $4.26 – 12.4% below the pre-war exchange rate.[8]

Keynes knew that Bradbury was committed to a strong pound. Arguably, Bradbury's was the single most influential voice on the Cunliffe Committee, which famously recommended (in 1918) that the UK return to the gold standard through orthodox (read: austere) fiscal and monetary policies.[9] So, even as the pound fell, Bradbury waged a principalled attack on the UK's remaining wartime capital controls. A week after Keynes wrote, Bradbury persuaded Lloyd George's Cabinet to significantly liberalise the gold export restrictions.[10] At the same time, he lobbied the Bank to begin implementing one of most important – and painful – provisions of the Cunliffe Committee recommendations: all new currency note issues would be matched by earmarking gold within the Bank.[11] It was a crucial step on the road back to the gold standard. Nevertheless, sterling continued its descent. On 20 August, the pound fetched just $4.12 in the exchange market – its lowest point since the Napoleonic Wars.[12]

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The next day, Keynes began speculating with two key ideas at the forefront of his mind. Firstly, he was certain that the disastrous economic consequences of the peace would preclude most of Europe from driving their currencies back to their pre-war gold values in the immediate future. Secondly, he doubted the pound's prospects. His insight into the particular economic circumstances of the UK–and, crucially, his familiarity with its leading policymakers–gave him the confidence to bet heavily against sterling.

Keynes's first trades

Keynes's first trade was a short sale of French francs. On 21 August, he sold 500,000 French francs on the forward market at the price of 34.06 francs to the pound. The delivery date was late November, and Keynes bet that the franc would continue to fall in the meantime. The next day, he bet that sterling would

8 Unless otherwise indicated, all exchange rate data is from *Global Financial Data*.
9 Morrison 2021, 31.
10 "Cabinet Minutes" ((UK) National Archives; CAB 27/71, July 24, 1919). 1919-07-24.
11 Henry Clay, *Lord Norman* (New York: Macmillan, 1957), 120.
12 Global Financial Data, "British Pound to US Dollar Exchange Rate (GBPUSD)."

continue its slide against the dollar, meaning gold.[13] The average market rate that day was $4.18; and Keynes entered into two forward contracts–each for $25,000–at the prices of $4.12 and $4.15 respectively. With delivery dates in mid-November, Keynes was betting that sterling would still not have recovered by then. He followed this three days later with a $40,000 bet that sterling would still be below $4.18 at the end of September. At the same time, Keynes also went long the Dutch guilder, betting £5300 that it would appreciate (relative to sterling) within a month. All told, Keynes had wagered more than £27,000 against sterling.[14]

At this point, sterling climbed back north of $4.20 and was becoming increasingly volatile. Yet, Keynes was undeterred. At the time, he was being courted by Henry Strakosch, one of the leading figures in the international gold market, to jointly form a bank. Keynes bowed out of the scheme to focus on his speculating.[15] On the 3rd of September, he bet another $50,000, this time at $4.18 with a delivery date at the end of November.

He made his boldest move yet just a few days later. On 8 September, he contracted to sell an even $100,000 in four weeks' time at an exchange rate of just $4.14. This was a supremely bearish move. The rate was sterling's lowest dollar (and thus gold) value in more than a century; but Keynes was confident that it would fall still further. The move effectively doubled down on that hunch, bringing his initial total in dollar speculation to nearly a quarter of a million dollars.

Keynes's first contract–on dollars–was scheduled to come due on the 30th of September. As the date approached, he expanded his bearish positions against the European currencies. On the 16th, he halved his short position against the franc. This gave him the space to take out a short position (of one month's duration) on £12,100 worth of Italian lire. The following week, he re-expanded his short on the franc. On the 25th, he went long again on the dollar, betting nearly £18,000.

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13 At this time, the dollar was the major currency most easily converted into gold. Also, the US had the world's largest gold reserves. Morrison (2021, Ch. 11) traces the shift from a fixation on the London gold price to the pound-dollar exchange rate in the years following the First World War.

14 Keynes's trades are recorded in ledgers among his papers at Kings College, Cambridge. They have been transcribed and compiled into a dataset described in Olivier Accominotti and David Chambers, "If You're so Smart: John Maynard Keynes and Currency Speculation in the Interwar Years," *The Journal of Economic History* 76, no. 2 (2016): 342–86.

15 Keynes's rationale is explained in a draft letter. Keynes, *Collected Writings*, 17:125-27.

By this point, Keynes had committed £75,000 on his dollar bets. It was unlikely that the dollar would sink and the pound rise so much that he could be wiped out; and, as was typical, he only had to put down a margin of 10% of the total.[16] But the sum is still enormous – more than thirty times Keynes's annual income.[17] In addition, he had also shorted £33,000 worth of francs and lire.[18] His potential losses in this case were theoretically unlimited.

Keynes's years in the Treasury ensured that he knew better than most the weakness of the UK's financial position. There were now vastly too many pounds and too little gold to keep the pound at its pre-war gold value.[19] Moreover, the investment prospects in the UK were less than rosy: there was too much inflation, too little real growth, and the public debt remained extraordinary. Keynes bet that these economic "fundamentals" would drive sterling's market value to new lows. Of course, he was right about the long-term trajectory of the pound. However, he underestimated the political power of the gold standard orthodoxy.

During the War, the Treasury had relied upon ever larger "Ways and Means Advances" from the Bank of England. This practice continued into 1919, but the new (Conservative) Chancellor of the Exchequer Austen Chamberlain was determined to restore the principles of sound finance. So when the autumn budget prompted him to make the now customary request of the Bank, he and Bank Governor Brien Cokayne agreed that the Bank would file a formal objection.[20] The two drafted the letter together and then Cokayne steered it through the Bank's Committee of Treasury and its Court of Directors on the 24th-25th of September.[21] As this strong, unified stance became more widely known, sterling rallied against the dollar. By the 27th of September, it had gone up several percent to $4.25–its strongest position since Keynes had begun speculating.

16 Donald Edward Moggridge, *Maynard Keynes: An Economist's Biography* (New York: Routledge, 1992) 349n.

17 Accominotti and Chambers, "If You're so Smart," 368.

18 Throughout, we estimate the pound value of Keynes's positions at various points using the spot rates (listed in *Global Financial Data*) at those times. In reality, closing a position early meant accepting whatever *forward* rate (for the original contract date) prevailed at the time. In this discussion, it would be simpler and more accurate to just describe the nominal positions themselves (e.g. "a short of 500,000 French franc with a delivery of 21 November"). But translating the position into pound terms grants the reader some (albeit imperfect) sense of the magnitudes of Keynes's various trades.

19 See the further discussion below.

20 Court of Directors, "Minutes" (Bank of England; G4/142, n.d.), 1919–09–18 and 1919-09-25.

21 ibid. 1919-09-18 and 1919-09-25. Committee of Treasury, "Minutes" (Bank of England; G8/54, n.d.) 1919-09-17 and 1919-09-24.

Keynes had not counted on this. His first dollar position was meant to close on 30 September. Having contracted for the dollars at the price of $4.18, he closed it on the 26th at $4.24, losing £150 on the trade. This was just the beginning. He had another $100,000 that was due to close on 10 October. That contract had the pound valued at just $4.14. On 6 October, however, Chamberlain raised the Treasury Bill rates a full 1%, bringing them in line with the Bank's interest rate. Sterling went from $4.19 to $4.22. Yet, Keynes was undeterred. The next day, he rolled over that contract, buying himself another month, and bought another £17,900 worth of dollars at $4.21. He closed his previous short of the lire due to close on 19 October. This dealt him a £39 loss, but it freed up betting capacity of £12,150. He gambled that much and more–£12,866–going long on Danish krone, further shortening his position on the pound.

A few days later, Keynes closed out a prior dollar position with a loss of £25. The pound was at $4.20; and most of Keynes's bets were now below this.

Insights in Amsterdam

The same day–11 October–Keynes travelled to Amsterdam, at the invitation of Dr Vissering, the Governor of the Bank of the Netherlands. There, Vissering mooted a bold proposal for an international loan to Europe. It would be "furnished mainly by America, but…the neutrals also were to contribute on a generous scale." Tellingly, he "put down Holland for as large a contribution as the United Kingdom, viz. $200 million." But, Keynes noted, "all those present, took an exceedingly pessimistic view of the whole situation and evidently regarded any attempt to carry out the treaty in any literal way as spelling disaster for Europe."[22]

In the final stages of completing the *Economic Consequences*, he solicited feedback from two of Vissering's guests: Dr Carl Melchior and Paul Warburg. The former had been a part of Germany's delegation to the post-war negotiations and had thus sat opposite Keynes on prior occasions.[23] The latter had helped to create the US Federal Reserve and then served on its board (1914-1918) and as a Vice-Governor (1916-1918).

[22] John Maynard Keynes, "Diary" (Kings College; PP/41/15, 1919) 1919-10-11. Keynes, *Collected Writings*, 17:128-129.
[23] Moggridge, *Maynard Keynes* pp 300-01.

He was, as Keynes described, "formerly the chief spirit of the Federal Reserve Board." With great pride, Keynes later recounted how his scathing portrait of Woodrow Wilson drew both laughter and tears.[24]

The trip reassured Keynes that his book would prove provocative. But it also unsettled his confidence in his speculations. Melchior and Warburg were two of the best connected, and most powerful, financiers in the world. Keynes shared their devotion to mitigating the economic disaster that he knew would follow from the Treaty's implementation.[25] If their reform efforts gained momentum, European currencies–including sterling–would appreciate against the dollar.

At the time, Keynes had shorted more than £21,000 worth of French francs. He had sold the first two thirds of the francs in August when it took just 34 francs to buy a pound. It was a long-term bet, with a delivery more than a month in the future; and with the exchange rate at 36.1 francs to the pound, it looked to be a winning one. Prior to the visit, Keynes had expanded this franc short position by £6986 at a rate of 35.75 francs to the pound. But now he considered the franc might not fall all that much further–particularly if the actions of he and his colleagues increased the prospects of a major international loan. Keynes wasted no time. On the 13th–even before he had returned from Amsterdam–he closed out the most recent franc forward position, locking in a £54 profit.[26]

Initially, Keynes took no action on the dollar position, but insights from Warburg changed his mind. Warburg, Keynes later suggested, "hated" President Wilson "for personal reasons." So, at the previous reading of Keynes's *Economic Consequences* in Amsterdam, Warburg had a "a chuckling delight" at the thought of Wilson's "discomfiture" during the Paris peace negotiations.[27] Warburg, however, was privy to one of the most important political secrets of the time. On the 3rd of October, Wilson had suffered a massive,

24 Keynes, *Collected Writings*, 10:427–29.

25 Warburg subsequently created the International Acceptance Bank (IAB) in 1921. The IAB specialized in providing short-term trade credits (bankers' acceptances) to foreign, especially German firms.

26 Keynes, "Diary." Keynes's appointment book reports that he left for Amsterdam the 11th. It is unclear from Keynes's appointment precisely when he returned from Amsterdam. But Keynes notes in his "biography" of Melchior that they met three days after he arrived in Holland (on the 12th). Keynes, *Collected Writings*, 10:427-29. The appointment book does not mention this or the other meetings in Amsterdam. Instead, it lists several of Keynes's usual commitments in England: his weekly lecture on Monday and the Wednesday National Mutual meeting, along with a (mistaken?) entry for a Tuesday National Mutual meeting. These entries, however, may have been written in advance and then simply rescheduled. Moggridge (1992, 356) also specifies the 15th as the date for the meeting.

27 Keynes, *Collected Writings*, 10:429.

debilitating stroke. Few people outside of the White House knew this; but, on the 17th of October, Warburg informed Keynes that Wilson was "pretty critically ill."[28]

Warburg only intended that Keynes should curb some of his sharpest criticisms. Keynes did follow that advice, and softened the manuscript. He also, it appears, incorporated this information into his currency trades. The same day, Keynes closed out a $75,000 long position on the dollar–a position initiated only ten days previously.[29] During that time, the pound had declined from $4.21 to $4.17. But now Keynes reconsidered whether the dollar would continue to rise across the remaining four weeks of the contract. So, several weeks early, he happily took a profit of £151 and reduced his overall sterling short position against the dollar (and the Danish krone).

Keynes distilled the insights from his Amsterdam discussions into a series of short "notes which he put to use in his private dealings." He described the "extraordinary scale" of speculation: "foreign holdings of marks [have] now reached the prodigious figure of 20 milliards [billion]." With the gold mark valued at 45 times that of the paper mark, Keynes thought that "a very disastrous collapse of the [exchange] rate might easily occur." This was a ripe opportunity for shorting the currency. But, at this point, Keynes held off. His other notes detailed the ambiguities in the Treaty, particularly concerning the title to property in Germany, in its overseas possessions, and beyond. Keynes recognised that the value of the mark in the coming weeks depended on how these largely political questions were resolved by the Reparation Commission and the Allied powers themselves. At the same time, law and order within Germany, "which was formerly quite incorruptible" was "getting down to the Russian level." Altogether, there was just too much uncertainty. Instead, Keynes made a simpler but more surprising trade: he shorted the dollar. In another note, Keynes warned of the growing American investment in Germany—and of the "good deal of criticism of America" when these contracts "come to be generally known."

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[28] Keynes, *Collected Writings*, 17:6.
[29] As discussed above, Moggridge's suggestion that he was still in Amsterdam on the 15th increases the likelihood that he was there on the 17th. If so, he would might have received Warburg's letter the same day.

The next day–21 October–Keynes bet against the US dollar for the first time. He sold $150,000 at the rate of $4.18 to the pound. The first $50,000 was to be delivered on 9 November. The next $100,000 was to be delivered six days after that.[30]

Thus, following this first visit to Amsterdam, Keynes became convinced that the dollar was going to plunge. He was horrified by the spectacle of special interests–like Standard Oil–capturing the apparatus of American foreign policy to secure monopoly privileges. Still a congregant in the church of *laissez-faire*, he was certain that such mercantilism would be punished. Inspired by his discussions, he was filled with hope that the USA would make a serious financial and political commitment to European stability. At the same time, he knew that Wilson's health was fading. Having construed Wilson as his principal impediment, he naively believed that a British-led European initiative could be foisted onto the Americans. This would save European civilisation even as it exacted a momentary depreciation in the dollar. Yet, Keynes' position was a short-term one and he expected the dollar to fall quickly.[31] One week later, he adopted a long position on the dollar, buying a two-month forward of $100,000 at the price of $4.16.

Fighting for international cooperation

On 2 November, Keynes returned to Amsterdam. Together with Warburg, he crafted an ambitious programme "to heal the unprecedented economic evils from which all Europe is now suffering."[32] The "very grave" problem was just as he had warned in the *Economic Consequences*. War debts and reparations–including "some…fictitious items"–had grossly inflated the public obligations, "lead[ing] to fear or despair on the part of some, and to recklessness on the part of others." The conventional means to redress the problem were a "decrease of excessive consumption and an increase of production and taxation." Without it, "the

30 Keynes, *Collected Writings*, 17:130-136.
31 On the 23rd, Keynes bought £18,150 in a long position on the Dutch guilder with a contract date of 13 November. This was implicitly a short of the pound over the same period. Taken together, we can infer that Keynes expected the dollar to fall (generally) rather than the pound to rise (generally).
32 The editors of Keynes's *Collected Writings* (17:136n) suggest that this work was drafted largely by Warburg and Keynes.

depreciation of money…[would] continue, wiping out the savings of the past and leading to a gradual but persistent spreading of bankruptcy and anarchy in Europe."[33]

Even this, however, would prove insufficient. This was a collective problem and so Keynes and Warburg called for "a great international act of co-operative assistance." Most ambitiously, they pressed "the United States and England [to] consider how far they can ease the burden of their Entente debtors either by abandoning interest charges or by cancelling a portion of the claims they hold…" They contended that this was "justifiable and could be written off as a legitimate war expense by the lending countries." After all, "a portion of these loans reacted to the benefit of the loaning countries, in waging what was a common cause."[34]

The proposal was immensely practical and eminently reasonable. Yet, it was hardly politically feasible. In the weeks that followed, the US representative in Amsterdam (Fred Kent) withdrew his signature from the proposal, effectively stopping it in its tracks. At the time, the US Senate had been considering the Treaty of Versailles for months. The following week, the Senate invoked cloture for the first time in its history. On the 19th, they voted overwhelmingly to reject the Treaty in its entirety.[35]

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It was a crushing defeat of the very internationalism that Keynes had championed. Whereas he had attacked the Treaty for doing too little to bind together the leading countries of the world, the US Senate was vociferous in asserting it would do too much. "Americanism shall not, cannot, die," Senator Henry Cabot Lodge proclaimed.[36]

Yet, somehow, Keynes remained optimistic. Closely following the debates, he nevertheless wrote to his Dutch colleagues, "it does not follow that America may not be prepared to do voluntarily a good deal to which she is not willing to bind herself in advance." In retrospect, the view was out of touch. Keynes was riding high following positive developments in his rather extensive conversations with colleagues in the

33 Keynes, *Collected Writings*, 17:136-141.
34 Keynes, *Collected Writings*, 17:136-141.
35 So far from securing 2/3rds of the Senate in favour, nearly 2/3rds voted against it. They voted 53-38 against ratification without reservation. And they even voted (55-39) against Henry Cabot Lodge's resolution of ratification, which included more than a dozen reservations to the Treaty.
36 Record, 66 Cong., I Sess., pp. 8777-8778; 8768-8769, 8781-8784. https://www.mtholyoke.edu/acad/intrel/doc41.HM Treasury.

French Treasury and Embassy. He may have assumed that leading individuals like Warburg could–and would–overrule the American public's zeal for disengagement. He thus resolved that they should "go forward boldly" "bring[ing] the issue to the bar of the public opinion of the world." "[I]f America quite deliberately decides that she is going to leave Europe to her misfortunes," he quipped, "she must say so openly and in so many words."[37]

Less hope, more big shorts

The hopefulness expressed in Keynes's correspondence did not match the bearishness of his speculation. Increasingly, his trades reflected his recognition that the USA would not come to Europe's assistance.

It was clear by the first week of November that Keynes had been wrong about a short-term decline in the dollar. So far from coming to Europe's assistance, the US moved to strengthen the dollar. On 3 November, the Federal Reserve raised interest rates from 4% to 4.75%. In response, the Bank of England raised its discount rate a full 1% to 6%. The next day, UK Treasury bills were raised 1/2%. This proved inadequate; and the pound began a one-month slide that would eventually take it to as low as $3.65.

It was a painful lesson for Keynes. The dollar had not appreciated enough over the past few months to do him any good on his long bets; but it was appreciating fast enough now to do a good deal of damage on his short-term short positions. On the 6th, Keynes closed out a three-month long position on the dollar at $4.17, one penny below his original purchase price. At the same time, he closed the first ($50,000) position on 6 November at $4.16 to the pound. This cost him £92.20. He ought to have closed the remaining $100,000 at the same time. Instead, he waited another week, closing it only after the pound had sunk to just $4.12. Altogether, these 20-day shorts lost him £540–more than £27,000 in 2019 terms.

Bitten by his having misread the US's trajectory, Keynes reeled in his bets and reassessed his position. Across the second week of November, he had less than £45,000 worth of contracts. This was down from his

37 Keynes, *Collected Writings*, 17:142-143.

high of £118,000 just one month earlier. Indeed, he had not had so little money on the table since the end of August.

In late November, Keynes despaired, "so far as finance is concerned, everything depends on the U.S. Without her we can do nothing effective. And at present the U.S. Treasury has vetoed even the discussion of the European financial problem."[38] He wrote to another colleague, "I…feel that if we wait until the Americans actually press us to go forward, we shall wait for ever."[39]

At the same time, Keynes contemplated the profound market consequences of continued US isolationism. The currencies of the Continental European belligerents–Germany, France, and Italy–would bear the brunt of it. Without the USA to referee their political squabbles and buoy their economies, they would all sink together. The UK could try to distance itself from this internecine conflict; but the pound, too, would suffer relative to the currencies of the neutral powers. Attending so dutifully to their own narrow interests, the Americans would ensure that the dollar would reign supreme. Across these next several months, Keynes's trades were all predicated upon the realisation of this Hobbesian world.

On the 11th of November, Keynes took a massive profit on his first speculation: the short against the French franc from 21 August. Keynes had sold 500,000 francs at the price of 34.06 francs to the pound. Since then, the franc had fallen nearly 12%. Closing this trade ten days early, it netted £1487.[40] Yet even this windfall could not prepare Keynes for the boom and the bust in the months to come.

The next day, Keynes speculated against the German mark for the first time. In less than a week, the mark fell from 149.5 to 165 marks to the pound. Keynes made £462 in just five days.

Keynes then poured these profits into further ambitious shorts of the continental belligerents' currencies. First, he shorted nearly £10,000 worth of Italian lire. The next day, he shorted £11,721 worth of French francs. He then expanded this by another £11,579 worth of French francs. More shorts followed along the same lines across the next week.

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38 Keynes, *Collected Writings*, 17:8.
39 Keynes, *Collected Writings*, 17:144.
40 This is equivalent to £75,422 in 2019 pounds.

In October, Keynes had bought £12,866 worth of Danish krone and £18,205 worth of Dutch florins. Into November, neither was appreciating much against the pound, contrary to his expectations. When aggressive rate hikes by the Bank of England and the UK Treasury did not stop sterling's slide into November, Keynes renewed his bets on the currencies of these two neutral powers, extending the delivery dates for each into December. In mid-November, he again extended both positions by another month.

Keynes's position on the neutral powers was less about their value and more about his expectations for the value of the pound. Because he was beginning and ending his trades with his local currency–the pound sterling–his shorts of these other currencies were relative to the pound in the first instance. At this time, he thought that the pound was also likely to depreciate relative to gold, so he simultaneously shorted the pound by going long on both the US dollar and the currencies of the European neutrals.

By late November, Keynes's total speculation approached £110,000. Of that, roughly half was in the form of shorts against the mark, the lire, and the franc. The other half was in the form of long positions on the dollar (£25,000) and on the Dutch florin and the Danish krone (£18,262 and £12,833 respectively).

These latter bets were proving disappointing. The pound was still sliding–now dipping toward the $4.00 threshold–but the currencies of the European neutrals were not behaving as he had expected. The Dutch florin was up, and so Keynes was able to take a profit of £498 at the end of November. But he lost more than this amount (£549) a few days later when he closed out the long position on the Danish krone.

In retrospect, Keynes might have known better. Even the neutral economies were inextricably tied to those of the belligerents. But their trajectories were unknowable *ex ante*. After all, the policies depended as much on politics. Even if those countries monetary authorities had the economic means to appreciate their currencies, they may have also wanted the requisite political will.

At the same time, the lessons of the franc, the lira, and the mark appeared clear. On the 18th and 19th of November, he shorted more than £25,000 worth of French francs.

Both contracts had one-month delivery dates; but the franc fell so fast that within a few weeks Keynes closed out these trades with an incredible profit of more than £2400. He took £753 profit on the mark across the same period. He might have realised large profits on the lire as well; but, instead, he expanded this position as he wound down his position on the neutral powers.

This became the new theme of Keynes's trades. He shorted the franc and the lire, took some profits, and expanded his bets against them. By the end of the year, more than £89,000 of the £116,600 that he had bet were in the form of short positions against these two economies' currencies.

Given his success, it is not surprising that Keynes was pleased to continue betting against the French and the Italians. But this does not fully explain his trading position. After all, every currency trade was necessarily a bet about two different things. Correctly predicting that the franc would fall relative to gold could still prove unprofitable if the pound simultaneously depreciated (relative to gold) by even more. Also, because Keynes was operating in the forward market, he was betting on his expectations relative to those of the market consensus.

Previously, Keynes had bet overtly against the belligerents *and* implicitly against the pound by betting on the dollar and the neutral powers at a ratio of about 1:1. He bet almost as much on the pound's trajectory relative to the dollar as he did on European belligerent currency trajectories relative to the pound. Across the last six weeks of 1919, however, Keynes had three times as much money riding on the depreciation of the franc and the lira (relative to the pound) as on the pound (relative to the dollar). We will see that, according to his own analysis at the time, this had less to do with his views about the dollar than with his views about the pound.

Securing the pound?

At the beginning of December, the Cunliffe Committee published its *Final Report.* For Bradbury, this was an opportunity to further pressure the government to continue the fiscal austerity and monetary contraction that he hoped would drive sterling back up to its pre-war gold value.[41]

[41] Cunliffe Committee, "Discussion Following Wright Testimony" ((UK) National Archives; T185/2, July 23, 1919), 664. As Permanent Joint-Secretary to the Treasury, Bradbury had already pressed this course vigorously onto the Cabinet. "Cabinet Minutes." 4.

The gambit proved successful. A few weeks later, Chancellor of the Exchequer Austen Chamberlain declared in Parliament that the government "agree with the [Cunliffe] Committee's view that increased production, cessation of Government borrowings, and decreased expenditure both public and private are the first essentials to recovery."[42]

At this point, Chamberlain held the keys to sterling's future. First and foremost, the Chancellor was preeminent in setting fiscal policy. With a public debt of nearly £7.8 billion–more than ten times its pre-war level–the government's budget and its approach to debt management would have a huge effect on the real value of sterling.[43] This is to say nothing of war debts and reparations, the approach to which was increasingly dictated by the government in general and the Treasury in particular.[44]

Throughout the War, the Treasury had massively expanded the money supply by printing its own "Currency Notes." By 1918, the Cunliffe Committee estimated that two-thirds (£259 million) of the £388 million in circulation took the form of such Treasury notes. Only 12% of these notes were backed by gold. Yet, the notes themselves were designated legal tender; and they were treated as such in the market.[45]

Naturally, the Bank disclaimed all responsibility for the Treasury notes. It was a private institution, after all; and it certainly did not relish sullying its standing by taking the government's paper notes (liabilities) onto its balance sheet. To avoid that "awkwardness," the Cunliffe Committee recommended:

"during the transitional period, the issue should remain a Government issue, but…such post-war expansion (if any) as may take place should be covered, not by the investment of the proceeds of the new Notes in Government securities, as at present, but by taking Bank of England Notes from the Bank and holding them in the Currency Note reserve." This joined the Treasury and the Bank at the hip, with the

42 Hansard vol 123, cc 43-46.

43 Prior to the War, the public debt was just £706 million. In his first year as Chancellor, Chamberlain was able to reduce the debt by 3.2% to £7.6 billion. Global Financial Data, "UK National Debt (GVGBRDEBT)."

44 During the War, sometime Bank of England Governor Cunliffe had proven instrumental in organising the first wartime Anglo-American loan; and he was one of the UK's representatives at the Paris Peace Conference on reparations. But this authority had been transferred (implicitly) to the Treasury that autumn, when Bradbury (from the Treasury) was appointed as the principal British delegate to the Reparation Commission.

45 Cunliffe Committee, *First Interim Report*, 5. Currency and Bank Notes Act, 1914 (4 & 5 Geo. 5, c. 14).

Treasury responsible for driving the currency notes out of circulation and the Bank with recourse to interest rate hikes to discipline the Government.

Thus, the Bank *could* dictate fiscal policy since the Chancellor would have to keep the interest rate on Treasury bills in line with the Bank's market rate to consolidate its wartime borrowing, let alone to issue fresh debt. In this early phase, however, the Bank's Governors chose *not* to exercise this control over the Treasury. Some within the Bank– questioned this surrender of its prerogative. In 1917, Governor-in-waiting Montagu Norman bitterly denounced Governor Cunliffe's deference to the Treasury.[46] The assertion of the Bank's autonomy–some would say supremacy–came to define Norman's 24-year reign as Bank of England Governor. At this point, however, even Norman followed the party line.[47]

For these reasons, Chancellor Chamberlain's public embrace of the Cunliffe Committee recommendations was massively important. Since April, when the government began liberalising the wartime capital controls, sterling had fallen from $4.76 to just $3.67. Following Chamberlain's announcement, the pound rose seventeen cents (nearly five percent) against the dollar.

In the midst of this, Keynes released the *Economic Consequences* into the world. He sent the better part of a hundred copies of the book to colleagues, friends, and anyone he thought might influence the course of events. Of course, he was sure to include Chamberlain among them. In the first instance, Keynes pressed the Chancellor so as to shape the realm of international finance. But when Chamberlain replied with some substantive thoughts, Keynes used the opportunity to encourage him to pursue orthodoxy in the UK's macroeconomic policy. "I was immensely glad to read of your decision about [removing the Treasury's] currency notes," Keynes wrote at the end of December. Keynes did warn him that the "drastic" policy "will have far-reaching consequences": "if it is maintained, [it] must logically end in a very high bank rate and

[46] Montagu Norman, "Diary" (Bank of England; ADM34/5, 1917), 1917–08–02.

[47] In January 1920, Danish representatives approached the Bank about issuing debt. Governor Cokayne refused to see them outright. Norman met with their representative from Hambros bank and explained the Bank's decision-making, as he recorded in his diary: "H Hambro-after failing to get appt with G[overnor]–came with 3 Danes to see me. Saw him alone–on subject of short or long Danish issue in [?]–but refused to hear the Danes or see them. Confirmed…our opposition to issue here by any Neutral, long or short: said such issue with[oul]d justify or require rise in B[ank] R[ate]: Said we sh[oul]d so advise Treasury, with object of preventing it, even if favoured by F[oreign] O[ffice]…He said issue with[oul]d probably be made by Barclays. I said Danes sh[oul]d go to N[ew] Y[ork]. (His position generally unpleasing)". Montagu Norman, "Diary" (Bank of England; ADM34/9, 1920) 1920-01-29.

corresponding rates for Treasury bills." Yet, Keynes endorsed it fully. "I was nearly moved to write to *The Times* in defence of the new policy; but decided that it had better work its remedy in silence for the present," he recounted. Nonetheless, Keynes did give some talks praising the austerity advocated by the Cunliffe Committee. Yet, he was under no illusion: "But it is a very drastic policy and one which cannot be pursued half-heartedly…"[48]

A few days after writing to Chamberlain, Keynes closed his long US dollar position (from the end of October). The pound had depreciated so much that he realised £2300 of profit in just two months' time. This trade alone accounted for more than a third of his total profit to date and finally tipped his dollar trading into a cumulative profit.

At this point, Keynes opted not to renew this position, and a two-month-long hiatus in any dollar-based speculation followed. Moreover, at the same time as closing his dollar position, he opened a £33,000 short position (with a delivery in late March) on the Indian rupee. Shifting from going long on the dollar to short on the rupee put Keynes firmly in the most bullish position he had yet taken on the pound. Just what was Keynes thinking?

Intellectualising exchange rates

In mid-January, Keynes spoke to the Manchester and District Bankers' Institute on the subject of the foreign exchanges. His remarks offer unparalleled insight into his thinking about the determinants of exchange rates in general. They reflect an early step on the road to his revolutionary critique of the gold standard. However, when it came to discussing the trajectory of specific currencies, Keynes was obtuse and appears to have pushed in the direction opposite to that of the speculative positions he held at the time.

Keynes's speculation had taught him that key elements of the pre-war system no longer operated. He denigrated "the popular delusion that the exchanges had a tendency always to swing back to par." Of course, the decline of the franc since the autumn was proof enough of this; and Keynes's (correct) predictions on that

[48] Keynes, *Collected Writings*, 17:179-184.

account had paid him handsomely. Keynes, nearing the crest of his first speculative wave, could not help but condescend. "Many ignorant people," he informed the bankers, "often spoke of the exchanges as though some psychological or psychical influence were at work determining the rates, whereas nothing moved the exchanges except the demand for a particular currency." He went so far as to question the cornerstone of the gold standard orthodoxy itself: "it was an elementary fact that gold could only affect the exchanges if the existence of the gold affected people's demands for the currency concerned."[49]

The traditional view–encapsulated in Hume's price-specie-flow mechanism–was that exchange rate movements triggered gold flows which, in turn, necessitated adjustments in the money supply. Over the ensuing century and a half, this system became intermediated by central banks and treasuries adjusting monetary and fiscal policy in response to exchange rate movements. But, by following these so-called "rules of the game," the international gold standard system would operate, as the Cunliffe Committee had put it, "automatically."[50] Yet, there were still limitations on the free movement of gold in the UK and abroad. These capital controls insulated governments from some of the market pressures, propping up their currencies' nominal gold values. More important, few governments were implementing the fiscal and monetary austerity necessary to appreciate their currencies. Thus, despite his overt remarks to the contrary, Keynes did recognise that the supply side was also crucial. Indeed, this became the main thrust of his critique of the gold standard in the years that followed.[51] At this early stage, however, Keynes fixated on reconceptualising the demand side of the equation.

He explained that there were three types of demand: the "trade" demand, "arising out of commerce;" the "investment" "demand of people who are going to make permanent investments in the currency in question;" and the "speculative" demand, "a sort of gamble" on the direction of exchange rate movements.

49 Keynes, *Collected Writings*, 17:172.

50 Cunliffe Committee, *First Interim Report*, p 9.

51 Obviously, macroeconomic policies affect the money supply and thus the real value of a currency. So, the commitment to maintain the gold value of a currency means that changes in reserve levels lead to changes in those all-important macroeconomic policies. At this point, however, Keynes was at pains to stress that both mattered *exclusively* in terms of their effect on speculators' psychology. "Again," he said, "if there were a large gold reserve in the country, that fact might create in the minds of speculators the idea that the gold reserve could be used to advantage some day, so that the gold reserve to that extent would be an inducement to speculation on the exchanges." "Just in the same [way], in a country like France, when the budget did not balance, that factor might deter people from investing in francs." Keynes, *Collected Writings*, 17:175.

The real gamble, Keynes asserted, actually existed on the trade side as "trading profits [were] frequently…swallowed up by changes in the rate of exchange." To allow traders to offload this risk on those willing to bear it–i.e. currency speculators–Keynes championed the active development of the forward market "in London and other parts of the country."[52]

Yet, Keynes's application of this framework to the currencies of Germany, France, and the UK all cut against the speculative positions he held at that time. In each of his discussions, he was honest but less than fully forthcoming. He largely confined his remarks to the economic dimension, while the trajectory of each exchange rate turned crucially on the *policies* adopted by that currency's monetary and fiscal authorities. His large speculative positions suggest that he held private opinions about this other dimension, but he did not share those opinions with the bankers.

Germany

As early as October 1919, Keynes had concluded that the German position was untenable. The war-weary Germans had an inelastic demand for vital imports but relatively few exports. This ought to have depreciated the exchange rate, and Keynes bet that it would, wagering about £5000 against the mark that autumn. When these shorts proved disappointing, Keynes revised his theory and reversed his position.

As he later explained to the Manchester bankers, "Immediately after the armistice, speculators in other countries…purchased mark notes, with the result that…Germany had practically paid for her imports out of the proceeds of this speculation." Of course, this was not entirely sufficient, and so the mark's gold value did decline. Keynes calculated that prices would have to rise "thirty times" above their pre-war level just to "keep pace with the fall in the exchange" rate. "[B]ut this was an absurd state of affairs." In the heady days of early 1920, Keynes could hardly imagine the hyperinflation to come. Instead, "the future value of the German

52 Keynes, *Collected Writings*, 17:171-179.

mark" depended on "what credit Germany would obtain from other countries," and "what the vast army of speculators were going to do."[53]

Keynes was unconventional in challenging the "automaticity" that was central to orthodox gold standard theory. But for the speculators, Keynes posited, the mark's exchange rate would have fallen even more than it had, and the prices in Germany would have fallen *much* more than they had done. In other words, the policymakers did not follow the rules of the game, and the speculators did not play the game the way it was meant to be played.

Just prior to this talk in Manchester, Keynes went long on the mark for the first time, entering into a six-week contract worth nearly £10,300. He ought not have done so. When the forward rate on the mark plunged, Keynes quickly liquidated his position–but not before he had lost £1230 in less than a week. It dwarfed the £448 he had lost trying to short the dollar. By the end of 1920, Keynes had lost nearly £6500 on the mark. Even as he clawed back some of his speculations over the next several years, he still lost £4354 (net) in his bets on the mark. Keynes the speaker appreciated what Keynes the speculator did not: "the situation [in Germany] was perplexing, as the elements determining it were very complicated."[54]

Commented [DC8]: Doesn't make sense

France

Keynes' remarks implied that France's position had much in common with that of Germany. For France, "The trade demand was the determining factor of the situation." And, like Germany, France was likely to run a negative balance of trade. Similarly, "prices had risen in France more than in this country, but not sufficiently to correspond with the fall in the exchange." Keynes offered a rough calculation from a "logarithmic table," which "showed a fall in the exchange of 4 per cent per month…" But, as ever, "there was the question as to how far France would be able to borrow in this country and America."

[53] Keynes, *Collected Writings*, 17:176-77.
[54] Keynes, *Collected Writings*, 17:177.

Keynes significantly understated his position. At the time, he had about £73,000 worth of short positions against the franc. Here again, there was much that Keynes thought about this currency that he chose not to divulge to his audience.[55]

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Why was Keynes so pessimistic about the franc? We can glean his perspective from a letter to a French critic of the *Economic Consequences*. For Keynes, it came down to politics. The French government refused to grasp the logic of his book. Keynes, "recognise[d] fully the necessity of a generous attitude...towards France," and he restated his commitment to forgiving France's external war debt . Furthermore, "[France] and Belgium should have first claim upon all payments made by Germany." Yet, "Frenchmen," Keynes lamented, still "refuse to consider...the general European situation" and, in particular, "Germany's real capacity to pay."

Time would prove that Keynes was not wrong. The conviction that Germany could–and would–be made to pay might deflect temporarily blame from French policymakers. But this "obstinate illusion" would lead to "economic and financial catastrophe."[56] Just as predicted, the franc did fall. And Keynes did profit—on the franc, at least.

The UK

Yet, Keynes' bets were not strictly about the gold value of the franc. He had eliminated his bets on the dollar and the currencies of the neutrals and thus bet that the pound would not continue to follow the franc down. He held this position because he was confident that the UK policymakers would drive the pound back onto gold.

Keynes, however, hesitated to broadcast this view. In his Manchester lecture, Keynes invoked the "very optimistic trade forecast…recently made by the Board of Trade," but he quickly deflated expectations. Such a positive "forecast…was probably a little too premature." Beyond this, Keynes just gave the standard

[55] Keynes, *Collected Writings*, 17:177.
[56] Keynes, *Collected Writings*, 17:22-23.

caution against foreign lending. Instead, the UK needed to use its purchasing power abroad to cover its foreign trade.

It is peculiar that Keynes, who pressed the Chancellor with such clarity and conviction to strengthen the pound, was so tepid–and unhelpful–in his comments on this occasion. In fact, he was more confident than ever about the trajectory of the pound. By this point, Keynes had reduced his bets on the dollar and the strong currencies of the neutrals to just £13,100 in total.

Evidently, Keynes's audience too were surprised by his remarks. The question of South African gold came up. Keynes conceded that the UK "obtained from South Africa about 3 million sterling of gold per month." At the time, this annual inflow was more than 20% of the UK's total gold holdings.[57] This, of course, ought to strengthen the pound and grant the UK more opportunities to consume and invest abroad. But, Keynes insisted, "This gold had been taken to a fairly large extent for the arts. A certain amount had gone to New York as exchange transactions, but by far the greater part had gone to India."[58] This last remark is particularly surprising given that, two weeks prior, Keynes had shorted about £33,210 worth of rupees. If Keynes thought this trend was going to reverse, he did not say so to this group of bankers. Here, again, was evidence that Keynes thought–in private, at least–that the pound would fare well.

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Safeguarding his biggest gamble

Three days after his lecture in Manchester, Keynes stretched further than he ever had done or would do in this period. He added another million (each) French francs and Italian lire to his short positions. For two brief days, Keynes had more than £173,000 on the table. When one of his franc positions closed–paying him a massive £1982 profit–he went into late January with nearly £146,000 in contracts. Of this, £133,000 was in the form of short positions, principally against France.

57 Estimating the UK's gold supply was difficult and fraught. The Cunliffe Committee put it at around £165 million, but their *First Interim Report* was (deliberately) vague. Cunliffe Committee, *First Interim Report*, p 5. Morrison 2021, 54-57.

58 Keynes, *Collected Writings*, 17:177.

On the 23rd, however, the Federal Reserve raised interest rates 1.25% to 6%. This was on a Friday. Typically, the Bank of England's powerful Committee of Treasury decided on rate adjustments at their Wednesday meeting.[59] But on Wednesday the 28th, the Bank decided not to raise its interest rate. That day, Keynes bought 500,000 French francs on the spot market to close out a short position he had on the franc. This was two weeks before the maturity date of the corresponding forward contract.

Although he was shaken, Keynes retained outward confidence that the pound would follow the dollar. On February 2nd, he gave a public lecture at Cambridge on "The Future of the Rate of Interest." His notes suggest a certain conclusion: "Fact must prevail in the long run. In the near, future interest rates must rise."[60] Certainly, Keynes's speculative position had assumed as much.

That same day, however, Chamberlain finally replied to Keynes's previous calls for further rate increases. "I am being strongly pressed to lower the [Treasury Bill] rate again," the Chancellor wrote to Keynes. He then challenged Keynes to reply "to [those] who argue that in the [current] special circumstances...the raising of the Bank or Treasury Bill rate has no effect upon borrowing or upon the exchanges except to raise the price of money against Government itself?" He hoped to discuss it with Keynes in person. Barring that, "I hope you can find time to write pretty fully," he wrote.[61]

Such wavering was not what Keynes wanted–or expected–to hear. Had not Chamberlain promised Parliament that he would implement the requisite austerity? Deviating now would doom the pound to fall. Keynes would make his case for austerity both in person and in writing. But, first, he closed out another short position by buying 500,000 French francs on the spot market that very day.

Keynes met with the Chancellor two days later. He was emphatic that the UK needed to raise interest rates. Following the Fed's action two weeks before, "rates for money in New York [were] 2 to 3 per

[59] Technically, the adjustments needed to be approved by the Bank's Court of Directors (which met the following day). This was largely perfunctory, however. Committee of Treasury, "Minutes." 1920-04-14.
[60] Keynes, *Collected Writings*, 17:180.
[61] Keynes, *Collected Writings*, 17:180.

cent in excess of the London rate."[62] Thus, "The danger of our exchanges now lies…in…[London] lending money she has not got to borrowers of unexceptionable character at a rate far below the real value of new capital." To defend the exchange rate, "it is above all necessary that money in London should be a little dearer than in New York."[63]

"Dear money," Keynes argued in highly orthodox fashion, "will do good by checking bankers' loans, diminishing foreign loans and...bringing the mind of the business world to a better realisation of the true position." "A continuance of inflationism and high prices will not only depress the exchanges," Keynes insisted, "but by their effect on prices will strike at the whole basis of contract, of security, and of the capitalist system generally."[64]

Naturally, the Conservative Chancellor wanted none of that; but he also did not want to trigger a national economic contraction. He was under pressure from Lloyd George to finance an ambitious housing scheme; and his predecessor (Reginald McKenna) had suggested that raising interest rates would do little to appreciate sterling but much to hinder government borrowing. Chamberlain wanted to be certain that the orthodoxy still applied "in the special circumstances of the time."[65]

Keynes conceded, "The old arguments in favour of dear money no longer hold in their entirety because a high bank rate has no immediate effect on the exchanges either by influencing the volume of bills offered for discount in London or by influencing the flow of gold." "It is also true," Keynes further admitted, "that a moderate increase of the bank rate may have very little salutary effect indeed and may merely make Government borrowing dearer without deterring other borrowers."[66]

But this really just meant that the old medicine had to be administered in stronger doses. An increase today of "1% perhaps only equals 1/4% pre-war." So, the rate hikes must be substantial: "a rate of even 10 per cent must be contemplated." Sensing Chamberlain's misgivings, Keynes agreed that it did not need to

62 In the meeting, Chamberlain noted an even larger difference: the "New York [interest] rate for good commercial borrowers is 8 or 9%" "Can't keep London steady if it is 3 or 4% below New York rate," Keynes is reported to have to said. [Austen Chamberlain], "Note of Interview with Keynes" ((UK) National Archives; T172-1384, February 4, 1920).

63 Keynes, *Collected Writings*, 17:180-184.

65 Keynes, *Collected Writings*, 17:180.

66 Keynes, *Collected Writings*, 17:180.

come all at once. "Such a very high rate may produce a crisis," but, Keynes assured him, such a crisis would "be only financial and not commercial…[I]t would not …cause any serious amount of unemployment."[67]

Keynes was hardly alone in clamouring for austerity. Prominent bankers and virtually all of Chamberlain's advisors echoed Keynes's recommendations. Among them, Bank Governor Cokayne followed a memorandum with a strongly-worded letter to Chamberlain. "[T]here are obviously limits to the accommodation which the Bank can continue to grant without applying the proper corrective of higher rates," Cokayne warned Chamberlain.[68]

The day that Keynes met with Chamberlain, sterling traded at $3.18–its lowest point in a century and the lowest point it would reach until the end of 1932. It was nearly a full dollar less valuable than it had been in August, when Keynes began speculating. But, contrary to all of Keynes' hopes and orthodox expectations, the Chancellor demurred. He deferred the hikes until April, when the Bank of France took their rate from 5 to 6% and Montagu Norman had taken the helm of the Bank. Chamberlain finally raised the Treasury Bill rate to 6.5%, and the Bank raised its rate to 7% the next day. This was the highest Bank rate had been in peacetime since 1907. It would not go this high again until 1967.[69]

Keynes must have known by the end of the meeting that the Chancellor was not going to raise interest rates. So, once again, he engaged in damage control by fully closing his lira position–netting a profit of £3373.

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By the next day–February 5th–Keynes had reduced his total position to £80,504. It was still a massive sum but only half of what it had been a fortnight prior. He ought to have gone further. As the US, and then France and the UK, raised interest rates, inflation gave way to deflation, which spread globally (Tooze, 2015, pp. 344-373). Whether due to "fundamental" or "sentimental" reasons, continental currencies recovered that

67 Chamberlain noted, "Mr. K. agrees dear money must come but not yet. Presses not to check trade now. But K. thinks you must check development." [Chamberlain], "Note of Interview with Keynes"; Keynes, *Collected Writings*, 17:183.
68 Brien Cokayne, "To Chancellor of the Exchequer" ((UK) National Archives; T172-1384, February 25, 1920).
69 *Financial Times*, 9 April 1920, "Bank of France Discount Rate Raised", p. 1. *Financial Times*, 16 April 1920, "Bank Rate Raised", p. 1. Committee of Treasury, "Minutes." 1920-04-14. Global Financial Data, "British Pound to US Dollar Exchange Rate (GBPUSD)." Even leaving the gold standard unexpectedly in 1931 did not take sterling this low.

spring.[70] It was only temporary; and they would resume their slide that summer. But, in the short-run, it nearly broke Keynes. Indeed, Keynes only scraped by with a £5,000 loan from the City financier Ernest Cassel.

Yet, Keynes was undeterred. Continuing to focus on the long-run, Keynes returned to his fundamentals-based strategy in June 1920.[71] Progressively, he recovered his losses and eventually earnt substantial profits through to 1925 (Accominotti and Chambers, 2016, figure 5). Moreover, most of the general predictions about European economies in *The Economic Consequences* also proved to be correct in the end. Thus, Keynes did prove successful as a currency speculator—despite that his strategy saw him taking substantial risks again and again. Perhaps more important, Keynes' practical experience likely proved invaluable intellectually.

5. Conclusion: Keynes' Lessons

Keynes' incomparable indictment of the Paris Peace Conference and his castigation of the Treaty of Versailles turned on an orthodox analysis of the economic consequences that would follow this "peace." As the years wore on after 1919, his dire predictions proved true again and again. The "Carthaginian peace" was not merely cruel and unusual. It was utterly unsustainable and broadly self-defeating to whomever attempted to impose it.

At first blush, Keynes appears to have been perfectly positioned to profit personally from this prescience. He had a virtually incomparable combination of academic training and practical experience. His decades in Cambridge combined with his years in Westminster to ensure that he was thoroughly versed both in orthodox theory and in how it played out in practice. Similarly, he remained intimately familiar with many of the most important policymakers of the day. As we have seen, he repeatedly made moves in the markets

70 *Financial Times*, 27 May 1920, "The Rise in Exchanges", p. 4.
71 Moggridge (1983, p. 7).

within hours of consulting the fiscal and monetary authorities of the UK, the US, and/or several of the continental economies.

And, yet, in light of these advantages, Keynes' speculative performance proves underwhelming. Why?

The answer appears to be that which comprised one of Keynes' greatest intellectual contributions: the all-important distinction between the short-run and the long-run. Keynes was right in 1919 that the Treaty would prove disastrous, just as he was right in 1920 that the mark would collapse. In both cases, however, Keynes learned that "obstinate illusion[s]"—about, say, Germany's capacity to pay—could persist far longer than a frank reading of the plain facts would have allowed. And so it was possible to be right but broken, or even "dead," "in the long run"—particularly if the "tempestuous" short-run proves particularly "violent."[72]

Keynes deepened these insights over the decades that followed. Reportedly, he warned, "Nothing is more suicidal than a rational investment policy in an irrational world." (Friedman and Schwartz 2008, 814) In the *General Theory*, Keynes concluded, "Investment based on genuine long-term expectations is so difficult to-day as to be scarcely practicable…Furthermore, an investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate on so large a scale, if at all, with borrowed money."[73] As we have seen, Keynes had learned this himself in the summer of 1920. Such lessons were costly—at times, literally. But they were also indispensable in propelling Keynes toward his world-shaping apostasy. In the longest run, this has proved to be the most valuable of the speculative consequences of the peace.

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