§1. Foreword.

The aim of this work is to examine one of the steps in the path through which Keynes freed himself from the orthodoxy in which he had been brought up. A crucial step in this path was the 1929 Crash and its aftermath. We could say that without the events of 1929 and after, we should not have had, as it were, the ‘revolutionary’, in theoretical sense, Keynes. The point analyzed here is the discussion held just before the Crash, between Keynes and various correspondents, among whom O.T.Falk, his business associate, and his friends Hawtrey and Robertson; a discussion spanning from the Spring of 1927 to the Summer of 1929, analyzed in its strategic aspect of a succession of logical moves and counter-moves.

The starting point in the Spring 1927 is the situation of the American Stock Exchange, particularly whether it is leading to an inflationary situation; a danger acutely felt by American monetary authorities, full-heartedly shared by almost all the participants to the discussion. This conviction is based on flat adherence to the main tenets of the Fisherine approach to the Quantity Theory of Money. Keynes questions his opponents point on two aspects. The first is his definition of inflation as mainly represented by an increase in prices of consumer goods. This criticism leads him to reject the usual test of inflation based on the increase of the global quantity of money, or in those time parlance, of credit. The second aspect is even more interesting, for we are

A great part of this discussion is based on materials belonging to the Keynes Papers kept in the King’s College Modern Archives, which I thank together with the Archivist, for the kind cooperation in searching them. I thank the British Library for the kind permission to quote from the unpublished Keynes files. I thank Dr. Anna Pettener for her precious help in the final redaction of this paper.

1 This article is part of a greater work, centered mainly on the Treatise on Money, the aim of which is to analyze the reasons that had been driving Keynes from each step to the next.

2 The following discussion is mentioned, to my knowledge, in two relevant biographies of Keynes: that of Hession, and the classic account of Skidelsky; in Harrod’s biography we find only an unclear reference to the period in which the discussion took place. In Hession’s work the discussion is given only a cursory glance, maintaining that Keynes was “employing the…analysis which he was…developing in the Treatise”: Actually, Keynes was then far from ‘developing’ these tools, he was only on a distant preliminary step in the path towards the Treatise, see Hession, Charles H., John Maynard Keynes. A PERSONAL BIOGRAPHY OF THE MAN WHO REVOLUTIONIZED CAPITALISM AND THE WAY WE LIVE, London: Collier Macmillan Publisher, 1984, pp.238-39. To that episode Skidelsky devotes a long mention (pp.340-342) in a paragraph of a chapter on the Slump, see Skidelsky, John Maynard Keynes. The Economist as a Saviour 1920-1937, London: Macmillan, 1992, Part Two: The Cross of Gold, Chapter 11 The Slump, §1. Did He Foresee It? His approach is quite different from mine. In the frame of his grand biography, from a historical point of view, Skidelsky appears to be interested to give a more equilibrate assessment of Keynes stance towards the Great Depression, in between with respect to Harrod adoring biography and some subsequent too prejudiced critiques. My point of view is quite different. Being concerned with the steps and fractures of a theoretical path, this episode, in my opinion, is of great relevance, helping to clarify the genesis of one of the more important theories of Keynes, the theory of the liquidity preference.
witnessing from these documents the movement of Keynes thought from his early theory of speculation, based on the Bear-Bull relation, to the ‘liquidity preference approach’, through the bearishness theory of the Treatise on Money.

Starting from these two points he develops a diagnosis of the situation which leads him to point to a possibility of a depression in case the monetary authorities should have tried to tame the speculation forcibly. It follows that the interesting point of the whole discussion is that Keynes diagnosis is based on a criticism of the standard monetary quantitative approach to inflation, but above all upon the elaboration of the germs of his subsequent and mature theory of the liquidity preference.

§2. Keynes’ steps in Monetary Theory.

Keynes began his academic career, starting from 1908 after his resignation from the India Office, lecturing on Money and Speculation in the shades of Marshall’s and Fisher’s theories of money. I will stress here only those points that will give origin to subsequent developments relevant for the discussion under scrutiny.

Fisher is widely known for his summing up a long lasting Quantitative approach to money with his Quantity Equation, in which the paramount relation is between the global quantity of money M and the overall level of prices P, provided that some assumptions, on the so-called velocity of circulation V and the total transactions T, are satisfied. This was, at the times of Keynes beginning, the only publicly elaborated account of a monetary theory with a fully worked out concept of the general level of prices in order to explain the causes of its variations.

Marshall’s version of the Quantitative Theory, though prior to Fisher’s, carried on a rather undercurrent life in those years. Since his early attempt, being unsatisfied by the commonly accepted approach, he wished to ground the theory of monetary prices on the theory of value, making the price-level depend from the choice at

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3 Which he will develop till the ‘real’ (excess-demand) approach of the Treatise on Money
4 See for the published materials: Keynes, John Maynard, Collected Writings [CW], volume XII, Economic articles and correspondence: investment and editorial, London: Macmillan: Cambridge University press, 1983, Chapter 5, Keynes’s Early Lectures, pp.689-783; for the unpublished ones collected in the King’s Modern Archives see above all: Keynes Papers [KP], UA/6.
8 “But, when we come to theory of money we are told that its value depends upon its amount together with the rapidity of circulation”, see Whitaker, Early, p. 166.
the margin between money and goods, in term of their relative marginal utility. The concept of ‘rapidity’\textsuperscript{9} of circulation was not suitable; therefore he introduced the ‘money balance’ concept.\textsuperscript{10} Here there is a novelty which he as usual concealed. Namely, that the public may have a role in determining the general level of prices, insofar this last is what equalizes the quantity of money put at disposal of the public by the monetary authorities on one side, and its willingness to keep it on the other. Later on, Pigou gave an explicit account of Marshallian monetary theory in his 1917 article\textsuperscript{11}. Claiming not to be “a hostile critic of Professor Fisher's lucid analysis”, he continues: “…the pictures that we both paint are of the same thing, and the witness of the two, as to what that thing in essentials is, substantially agrees”; indeed, in his view, ‘velocity’ $V$ and $k$, the hallmark of the ‘balance’ approach, were almost nothing but substitutable algebraic variables ($V = 1/k$).

From the very beginning Keynes, for all his praise for Fisher, contrariwise to Marshall and Pigou stressed the differences with his theory. He was critic on Fisher’s approach as overstating the role of supply in monetary equilibrium\textsuperscript{12}. Besides, he maintained that the Means through which money affects prices\textsuperscript{13} were not specified in Fisher’s theory, reviewing whose book Keynes writes: “the most serious defect in Professor Fisher’s doctrine is to be found in his account of the mode by which, through transitional stages, an influx of new money affects prices”\textsuperscript{14}. From this it follows that the mere exhibition of a rise in the quantity of money does not in itself give the evidence of a threat of inflation, as the followers of the Quantity Theory firmly believed\textsuperscript{15}.

The Lectures on Speculation, of the same period, are interesting here insofar there two dramatis personae that will have a prominent role in this discussion do appear: Bears and Bulls. Bulls and Bears are not simply agents willing to be long or short in some speculative item. “A man who sells a promise is a bear/A man who


\textsuperscript{10} The level of these balances was defined to be in a certain proportion, $k$ - the Cambridge $k$ - to wealth; but it was unclear whether it had to be referred to a flow or to a fund. See, Patinkin, Don, Keynes Monetary Thought. A study in his development, Durham: Duke University press, 1976.

\textsuperscript{11} Pigou, Arthur Cecil, “The Value of Money.” 1917, Quarterly Journal of Economics, 32(1).

\textsuperscript{12} Keynes, in his Early Lectures, writes: “The use of the name ‘Quantity Theory’... has certainly tended to overemphasize the influence of supply as compared with that of demand”, Keynes, CW XII, p.693.

\textsuperscript{13} As many titles of his lessons sound, see Keynes, CW XII, p.776 ff. To lay down explicitly such ‘channels’ became his theoretical aim; this was the inner motive force leading him, through a complicated path, from his Early Lectures to the Fundamental Equations of the Treatise.


\textsuperscript{15} Connected with it is the role of induction in testing the theory, a role in which the adherents of the theory, as Carl Snyder - an outstanding participant to this discussion - with conviction believed. On the contrary Keynes maintained that “The inductive verifications of the adherents of the theory have been, I think, nearly as fallacious as those of its opponents”. Keynes, CW XII, p.765.
buys a promise is a bull”\textsuperscript{16}, he writes, but he adds: “If the speculator has relatively little capital he must borrow the shares, if he is a bear, in order to fulfill his...deliveries, and he must pawn the shares, if he is a bull, in order to obtain the purchase money \textsuperscript{17}. Bull and Bears are tightly connected by means of the two sides of a bet. They even do not perceive their connection, but this is what “really happens”\textsuperscript{18}. What is still divided in his Lectures: Speculation and Money Market on one side, and the Theory of Money, Prices and Interest on the other, will conflate during this discussion.

The second outstanding episode in the development of Keynes Monetary Theory relevant for this discussion is the \textit{Tract on Monetary Reform}. In this work he begins to radicalize the Marshallian theory of money. There he was stressing, as never Marshall or Pigou did, the demand aspect of the monetary equation, the importance of which becomes apparent in his analysis of the post-war hyperinflation\textsuperscript{19}. His conclusions are expressed with the utmost clarity in his \textit{Lectures to the Institute of Bankers}\textsuperscript{20}: “The depreciation of the Germany money...could not be cured by merely reducing M. You have to get k back to...normal”, and adds: “the main thing you have to do is to increase k\textsuperscript{21}. The general point is here put one the right track: the variations in the quantity of money are not the sole cause of inflation, and a diagnosis based solely on this factor is deemed to be wrong. In the \textit{Tract} there is one more relevant point, which will come back in the following discussion: namely that ‘deflation’ is an evil at least of equal range as inflation\textsuperscript{22}. In the orthodox view ‘deflation’ is something like a ‘price’ to be paid to have ‘sound’ money. But Keynes puts here a new stress on \textit{deflation} as something which is to be avoided with the same determination as inflation.

After the \textit{Tract} Keynes was busy with economico-political affairs.\textsuperscript{23} From a theoretical point of view, he began in these years\textsuperscript{24} working on what was intended to

\begin{enumerate}
\item \textit{KP}, UA/6/3 p.81.
\item \textit{Ibidem}, p.81. Due to this further bilateral relation, the bound between the two becomes a sort of a “double bound”.
\item Brokers and banks stand in the background, the firsts making the bet run smoothly, the second, supplying their floating funds, see \textit{Ibid.}, p.83.
\item Keynes, John Maynard, \textit{Tract on Monetary Reform, Collected Writings}, vol. IV. London: Macmillan, 1971. The occasion of this book was the discussion on the return to Pre-War Gold Parity.
\item \textit{Ibidem}, p.13. In one of the first unpublished index projected for the new work on money, the future \textit{Treatise on Money}, we read:” it [i.e. an increase in $k$] can only...[be done]...by creating expectations of falling prices”, see Keynes Papers TM/3/2, p.4.
\item Till the \textit{General Theory} the term ‘deflation’ will remain ambiguous: its first meaning is simply the converse of inflation, i.e. a decrease in prices, but connected with this there is also the meaning of a decrease in income and employment.
\item The problems of German Reparations, and the ensuing discussion, the revaluation of the pound, performed by Churchill, against whom he wrote the \textit{Consequences of Mr. Churchill}.
\item While superintending Dennis Robertson’ writing of \textit{Banking Policy and the Price Level}.
\end{enumerate}
be his *magnum opus* in Monetary Theory. As it results from the series of tormented indices\(^{25}\), the elaboration of the work that ended in the *Treatise on Money* was continuously changing in title, content and even in its theoretical core. It is already known that, after the 1929 Crash and the first steps of the ensuing depression, Keynes deeply rewrote the theoretical chapters of the *Treatise*. What emerges from the whole bulk of documents, published and unpublished belonging to this discussion is that not only did the *Crash* influence Keynes thought but so did also the events that, as we know now with the benefit of hindsight, were leading to it.

§ 3. *The Discussion*: First Round.

The discussion started when the American boom of the Twenties was still in full steam, but worries were beginning to spread about the explosion of Stock Exchange prices. Given the expansion of the Money Market, especially of the call-loans to brokers which were deemed to feed speculation, some quarters feared that the Federal Reserve would feel obliged to tame the speculative mania in order to avert a supposedly impending inflation\(^{26}\).

§ 3.1. *Enter Falk.*

The first omen of the ensuing debate is a *memo* - dated November 4\(^{th}\) 1926 - from W.W.Stewart\(^{27}\), a correspondent of Oswald T. Falk, himself associate of Keynes in the management of the National Mutual Life Assurance Society, and in business relation with him in his capacity of a manager of the brokerage firm Buckmaster & Sons\(^{28}\). The Stewart *memo* was quite reassuring about the current American situation, especially on money matters. But exactly five months after, a *memo* of Falk himself entitled “The American Stock Market Position” rang a totally different note.

His *memo*, dated April 4\(^{th}\) 1927,\(^{29}\) was prompted by a suggestion of another member of the Board to enter the American Stock market. As a starting point of his argument, he states: “the present credit position in America was one of my main reasons for fearing a reaction in the stock market”\(^{30}\). His stance is established there with the utmost clarity: an impressive Stock Exchange boom has happened associated with a parallel expansion of bank credit to stock investors or brokers, an expansion deemed detrimental to the credit to productive activity.


\(^{26}\) The most known, *post-factum* and *post-Keynes*, classical accounts of the Great Depression are those of Thomas Wilson, Arthur W. Lewis, Lester Vernon Chandler and Charles P. Kindleberger.

\(^{27}\) *Keynes Papers*, SE/2/5, *memo* from W.W. Stewart to Oswald T. Falk, p.179-80.

\(^{28}\) The firm through which Keynes mainly carried on his speculative activities.

\(^{29}\) See Oswald T. Falk *memo* to the Board of the National Mutual, an insurance firm of which Keynes was the Chairman, and Falk a member of the Board, see “The American Stock Market Position. April, 1927”, *Keynes Papers* NM/2/1, pp.143-152; .

\(^{30}\) *KP* NM/2/1, p.143.
However, his point is not only that it was dangerous to invest in a "market which has been booming for several years"\textsuperscript{31}, a point which should have and indeed was agreed by Keynes, as the stressing that the boom had occurred “on the basis of borrowed money”\textsuperscript{32}. It was its monetary side which was making the situation particularly dangerous. Falk supported his argument by enclosing extracts from various reports. The point raised in Appendix A\textsuperscript{33} is that a source of credit expansion has been the shift, made by the public at large but also by big companies in particular, from demand deposit to time deposit; one of the points around which, during this discussion, Keynes will develop his critique of the Quantitative view\textsuperscript{34}. According to the author of the Appendix, this tendency of credit creation due to a shift from demand to time-deposits has worked in the past years, thus creating an ‘artificial demand’ channeled toward building construction, instalment buying and export. Moreover, the author thinks that a conservative policy from the Federal Reserve is more likely to be pursued, that will check the expansionary tendency stemming from the shift.

Appendix B reaffirms the “decline in the demand deposits…while time deposits have continued to show a rapid increase”, and states that “Figures indicate that private bankers, foreign banking agencies and corporations having [idle funds] have been an important factor in the New York money market”\textsuperscript{35}; a fact on which Keynes will heavily rely for his thesis of an alleged balance between Bears and Bulls on the stock market.

The figures of the New York Industrial Stock Index, which appear in Appendix C\textsuperscript{36} are particularly interesting insofar they give a direct insight of the ranking in the boom of the industrial sectors. The ranking goes as follows: Automobile and Auto accessory stock-price increased six times since 1921onward; Chain Stores increased more than five times; Chemical, Electrical Equipment, Food, Mail Order three times; Railroad Equipment and Traction Gas and Power, along with the general index increased more than two times; figures which give a vivid feeling of the impressive boom in stocks.

Falk’s general conclusion for what concerns the monetary side of the question is that “it would be unwise to count on any additional support for the Stock Market coming from bank credit expansion, and that the market is extremely vulnerable [idle funds]”\textsuperscript{37}, and continues “there is nothing...which renders impossible or even

\textsuperscript{31} KP NM/2/1, p.143.
\textsuperscript{32} Ibidem, p. 143. Echoing the preoccupation mentioned also by Stewart that “the demand for credit for commercial purposes had to compete with the rapid increase in the demand for funds for stock exchange purposes, see SE/2/5 p.179.
\textsuperscript{34} Consequences of this shift will be also having a not irrelevant room in the discussion between Robertson and Keynes about the Treatise. The point will disappear from the General Theory, but the present discussion makes it clear that Keynes was aware of the fact.
\textsuperscript{35} Appendix B, Extract from Federal Reserve Bulletin for January 1927, Ibidem, p.150.
\textsuperscript{37} KP NM/2/1, p.145.
improbable…a withdrawal of bank funds from the Stock Market and a price reaction [undln-GP]”. Moreover, there is something only hinted by Anderson, namely that the credit expansion has outpaced the expansion of savings, paving the way to an indefinite monster named ‘artificial demand’ for assets not representing ‘real capital’; a fear that will be barely dismissed by Keynes.

§3.2. Enter Keynes.

Keynes answer will be elicited the 14th April 1927. Broadly speaking, at this moment Keynes position is rather minimizing about the American situation, as compared with the concerns emerging from Falk memo, which reflects similar worries in some American quarters. “Mr. Falk’s Memorandum - he writes - may be to produce an impression that the situation in the United States is more precarious and dangerous than in my opinion it really is.”

The main point he raises is about the rate of interest. Falk suggestion is that, since the commercial and Stock market expansion would continue and one cannot expect an accommodating behaviour by the banking system, this would lead to a rise in the rate of interest; therefore, it is better to wait before investing in the American market. Keynes broadly agrees on a policy of wait-and-see with regard to the American securities, but takes quite another view on the rate of interest.

What is interesting in this connection is that the difference arises from a still implicit deep divide on the theoretical aspect of monetary matters. Keynes argument runs as follows. There has been a large and increasing “volume of investment financed directly or indirectly [undln-GP] by bank money”, but this is due more to the fact that “the American public have been entrusting…their new saving [undln-GP] to their banks”, rather than to “any inflation of credit”. In this sense the expansion of time-deposit is a sound one, and the Federal Reserve Board should not “interfere…by restricting the basis of credit”, lest a deflation could creep in.

Owing mainly to the saving accruing to them, banks were compelled to find an outlet for these funds, either investing directly, or lending on the money market - the call-money loans - to investors on borrowed money. Accordingly, he sees nothing particularly “alarming in the evidence as to American position”. However, he continues by warning as above that “A reversal of policy by the Federal Reserve Board,

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38 KP NM/2/1, p.145.
39 Memorandum by Mr J.M.Keynes for the Board Meeting, 20th April 1927, THE AMERICAN STOCK MARKET POSITION – APRIL, 1927, KP NM/2/1, pp.154-58. For the negative development of their personal relations see various point of the above mentioned Skideslky biography.
40 Falk is preoccupied also for the real side of the economy: “the risk appears…that in some directions the pace may slacken”, KP NM/2/1, p.145, since “there are signs that both in automobile and building boom are nearing to an end”, Ibidem, p.146.
41 Keynes’ memo, KP NM/2/1, p.155.
42 Ibid., p.155, i.e. either people keeping time-deposits did use them to buy securities, or the banks made loans to the stock market or themselves invested in securities.
43 Ibid., p.155.
44 Ibid., p.157.
involving a curtailment of credit...could produce unfortunate consequences...and a...change of banking habit by the American public, if left counteracted by the Fed...would equally lead to inconvenient consequences”\(^{45}\). But even if withdrawn from banks, savings if held in liquid form do not impinge on commodity prices. Indeed, while commodity prices have fallen, stock prices had not, adds Keynes. In such conditions “It would be a...unprecedented thing if a serious slump were suddenly to supervene”\(^{46}\), for “none of the usual symptoms preceding serious malaise exist at the present time”\(^{47}\). The word ‘slump’ is here mentioned for the first time; but it will come back repeatedly in the following interchanges.

Neither does Keynes agree with Falk as to the ‘real’ situation. Industrial prosperity, he says, is not limited to the most buoyant sectors, which - namely auto and building - underwent a mild set-back in 1926, so the situation is for the better. Only a year later would he accept from Falk that a slowdown of the most fast-growing sector could be a problem if combined with credit restriction. For the time being he takes into account only the interplay between the money market and the Stock market. Keynes conclusion, accordingly, is the opposite of Falk’s. Not being any sign of slump on sight, the money market being liquid due to the enormous American savings, and not to any inflationary cause, what is to expect is that “the balance of probability is in favour of a lower rate of interest”\(^{48}\). What remains of Falk argument is the only fact that an investor must not enter a stock market for the first time unless it is in recession. But this is a practical argument, while all of Falk’s rational arguments had been crushed.

It must be remembered that Falk did not mention any danger of ‘inflation’, though it was implicit in his worry about the growth in bank money. Apparently Keynes took notice of this albeit unmentioned note, and stressed that the state of bank reserve was sound, owing to falling commodity prices, at variance with stock prices\(^{49}\). This unapparent and almost casual observation on the distinction between the stock and commodity prices starts one of the most debated issues of the whole discussion\(^{50}\).

§4. The Discussion: Second Round.
§4.1. Enters Inflation.

“There is no currency inflation in the United States in the ordinary sense”\(^{51}\). In spite of the softening clause ‘in the ordinary sense’, the sentence sounds as a trumpet...
blare. In this way the memo addressed to the Board\(^{52}\), dated July 29\(^{th}\) 1928, begins. This sentence was to become the title, with a mitigating question mark, of the following report of 1\(^{st}\) September.

The Second Round took place more than a year after the first interchange. Therefore, the first step in Keynes argument was to state that, between January 1927 and July 1928, the total basis of credit, i.e. the active side of the Federal Reserve member banks, had not increased. Yet, there was a shift in its composition. From January to July 1928, the amount of bill discounted had doubled, being compensated by a diminution in gold, in the holding of securities and in purchases of bills. Keynes concludes that “so far as these figures go, there would have been a severe deflation if member bank borrowing had not increased”\(^{53}\) the discount\(^{54}\). The constancy of the overall sum of the basis of credit is relevant as a signal that the situation is not out of control. Keynes asks: “What then is the matter”\(^{55}\)? Since the public, “have shown an increasing predilection for investing their saving through their banks”\(^{56}\), the outcome is that “the public is investing”\(^{57}\) a huge sum “more than a year ago through time-deposit and call-money”\(^{58}\), adding: “To say that these savings are not real, but… artificial…is…rubbish”\(^{59}\). By this Keynes is beginning to question the diagnostic value of the Quantitative Theory for what concerns the dangers of inflation.

At this very point enters Keynes’ Speculation theory; here the two theoretical strands, money and speculation, begin to conflate. An anonymous report\(^{60}\) in Keynes Papers can suggests why now he is calling in the theory of speculation to support his argument. The report makes a point against the fear “of money being ‘withdrawn’ from business and ‘diverted’ to speculation”\(^{61}\). However, the reason given for that could not satisfy Keynes, since it was based on the fact that the “endless swapping of pieces of paper, bonds or stocks, neither increases nor decreases the total of…the funds with which trade is carried on”\(^{62}\); consequently “…there are rarely idle funds of

\(^{52}\) KP N/M/2/2, p.28. From Keynes’ accompanying letter of 29\(^{th}\), July, 1928, we know that it refers to a discussion with Falk which took place in the Board some days before.

\(^{53}\) Ibidem, p.29.

\(^{54}\) Hardly could this conclusion sound convincing. More likely, it was the autonomous doubling of the discount that rather could have been considered as compensated by purchases and variations in holdings. Increase in discount can be taken as a signal of ebullience in borrowing, driven by stock market expectations; this was what was worrying his correspondents.

\(^{55}\) Ibid., p.30

\(^{56}\) Ibid., p.30.

\(^{57}\) Ibid., p.30.

\(^{58}\) Ibid., p.30.

\(^{59}\) Ibid., p.30-31.

\(^{60}\) The ideas in this report are considered only as a specimen of an influential view, which Keynes cannot but polemize with. Confidential, 7\(^{th}\) August 1928, STOCK MARKET LOANS AND LEGITIMATE TRADE, The Widespread Belief That Speculation Draws Money Away From, or Place a Burden upon Trade, Appears To Have Little Foundation In Fact, KP N/M/2/2, p.109-114.

\(^{61}\) Ibidem, p.110.

\(^{62}\) Ibid., p.110.
any great moment...in the banks”63 for “...Wall Street speculators borrow to buy stocks. The funds raised go to another speculator...and so on...hundreds of times [undln-GP].”64

On the contrary, Keynes held that idle balances do exist: “A lends his savings to B who buys securities, B cannot re-sell his securities unless A buys them and, until A buys them, A can do nothing with his money except lend it to B”.65 Then Keynes connects the bet between the Bears and Bulls with the money market question: “…If B sells to A, there is a fall in the amount invested via the banks or via call-money, and an equal increase in the amount invested direct; call loans fall and so do time deposits”.66 Bulls take call-loans, while Bears keep time-deposit; their relationship does happen through banks till the bet ends when Bulls re-sell the stocks to Bears.67 Hence his conclusion that if the Federal Reserve authorities think important that a contemporary reduction in time-deposits and call-loan should happen, this must be due to the confusion between “the effect of an increase in time-deposits with the effect of an increase in cash and demand deposits - which may be inflationary[undln-GP].”68 As we should say today, after the General Theory: due to the confusion between speculative and transaction demand of money.

It follows that, if the cash and demand-deposits are not in excess of trade needs, any attempt to curtail them must lead to a curtailment of trade. Keynes quantifies the consequence: “to reduce the volume of bills rediscounted by $500.000... would mean reducing the wage bill by...10 per cent”69, similar to that “of the greatest slump on the record”70[undln-GP]. Though Keynes is saying that he believes “that the Reserve...will try to stop short of this [the slump-GP]”71, he continues with the first explicit, though hypothetical, forecast of the Depression: “If they [Fed. Res. Banks-GP] succeed in stopping new capital investment, it may cause a serious set-back to business and employment”72. A forecast he did not expect he would confirm in September 1930: “I trace the collapse of world prices primarily to the restriction of in-

63 KP N/M/2/2, p.111.
64 Ibidem, p.111.
65 KP N/M/2/2, p.31. It must be taken into account that A and B are not individual, but group, or rather a specimen of group, representing one and only one kind of action. This point will often escape the discussant’s notice.
66 Ibidem, p.31.
67 The bet is referring to the market on a whole. So the bet does not end when one Bull sells his stock to another more bullish Bull; either if the Bull sells one kind of stock to buy another one, or if it takes a Bear position. The bet is simply carried on in another form. The bet ends when the Bulls, on the whole, liquidate their positions, and accordingly call-loans and time-deposits are canceled out. A point completely missed by the other discussants, see CW XIII, p.53.
68 KP N/M/2/2, p.31.
69 Ibidem, p.32. The figure of $500.000 has been calculated by him with regards to reserve requirements of the Federal Reserve member banks.
70 Ibid., p.32.
71 Ibid., p.33.
72 Ibid., p.33
vestment due to the high rates of interest which have prevailed, culminating in the exaggerated dear money of 1929"\textsuperscript{73}.

The reason why he was still so confident was, most likely, that he relied on Benjamin Strong\textsuperscript{74}, Governor of the Federal Reserve in New York. Unluckily, his friend and willing listener was about to fall deeply ill, dying later in October, a death which severed his ties with the Fed, as it is witnessed by the cold answer of W.R. Burgess, from the Federal Reserve Bank of New York, after receiving Keynes report of 1\textsuperscript{st} September 1928\textsuperscript{75}.

\section*{§4.2. Falk again: practical vs. wishful thinking.}

Falk’s answer is a short \textit{Memorandum}\textsuperscript{76} refraining from discussing Keynes points on the basis that the Board hardly “would want to listen a controversy…as to…Central Banking policy”\textsuperscript{77}. His was, Falk continues, simply an “endeavour to discover what the Central banks are aiming at”, in order “to base action…upon that, rather than on any view…as to what Central Banks ought to do”\textsuperscript{78} [undln-GP]. After having quoted again Mr. Anderson\textsuperscript{79} about the “immense expansion of bank credit flowing into the Securities’ Market”, he continues: “From January, 1928…the Federal Reserve…have been working with steadily increasing vigour toward restraining the movement”\textsuperscript{80}. Concluding, he keeps stuck to the apparent point at issue, namely whether to invest or not in the American Security market, since even the Fed did give up this policy “I should submit another set of arguments again entering the market. I believe that a reaction has got to come and if it doesn’t come now, it will come later and be much more severe”\textsuperscript{81} [undln-GP].

The problem was, that this was not the real point at issue. Keynes agreed that they had to refrain in investing in the American Stock market. Actually, Keynes and Falk did not clash in the Second Round on this choice. They rather implicitly joined issue on the underlying diverging theories. Keynes was making use of his progressing researches on money to put a question mark on the \textit{naive} version of the Quantitative

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\textsuperscript{73} See Copy of a note written by J. M. Keynes - 9.9.1930, Letter to O.T.Falk, from Tilton, 18/9/30, British Library Manuscript Room - Add. 57923, p.21. Keynes wrote: “Here is a note which I have recently written about my view of the phases of the Credit Cycle which are now in”.

\textsuperscript{74} Benjamin Strong jr., (December 22, 1872 – October 16, 1928) American banker; Governor of the Federal Reserve Bank of New York for 14 years. His policy of lowest interest rate put in operation, at European central bankers request, was strongly criticised, in particular after the Crash, by President Hoover (see his \textit{The Memoirs of Herbert Hoover. The Great Depression, 1929-1941}, London: Hollis & Carter, 1953). It seems that Falk should have been sensible to the opinion of American quarters hostile to him.

\textsuperscript{75} See below, §6.2, \textit{An unheeded Warning}.

\textsuperscript{76} Oswald T. Falk, \textit{MEMORANDUM}, July 31\textsuperscript{st}, 1928, KP NM/2/2 pp.35-36.

\textsuperscript{77} \textit{Ibidem}, p.35

\textsuperscript{78} \textit{Ibid}, p.35.

\textsuperscript{79} Mr. Anderson is the author of the report referred to in Appendix A of the first Falk \textit{memo}.

\textsuperscript{80} \textit{Ibid.}, p.35.

\textsuperscript{81} \textit{Ibid.}, p.36.
Theory. He was questioning the diagnostic value of the Quantitative Theory as to the future economic evolution; i.e. he denied that measuring the expansion of credit is in itself sufficient to infer a threat of inflation. But this was exactly what the authorities quoted by Falk were saying.

§5. The Discussion: Third Round.
§5.1. Speculation to the fore.

One month later Keynes wrote another report\(^\text{82}\) that he did circulate among a series of correspondents\(^\text{83}\). May be he had realized from Falk’s answer that his argument did not impinge on the crucial theoretical, though implicit, issue: the relation between the general price level and the overall quantity of money. Indeed, Keynes’ point was that the symmetrical increase in the two sides of the balance-sheets was neutral with respect to inflation suitably defined. “To the extent that these [time-deposit & call-loans] can be set off one against the other it is, from the point of view of the supply of real credit a washout…[undl-GP]\(^\text{84}\)” What was therefore needed was to make explicit the reasons of the alleged neutrality, together with the meaning he was intending for ‘inflation’.

At variance with his previous report, Keynes begins directly with speculation: “Let us suppose that in 1926 A held common stocks worth 100… By 1928 he finds that they are worth 140… He sells them to B …The 140 deposited by A as time-deposit gets lent, directly or indirectly to B as call-money…nobody has “saved” this 140. Such time-deposits do not represent real-saving…A has not saved the 140, neither has his bank lent…for new investment”\(^\text{85}\). His aim is to distinguish sharply\(^\text{86}\) the savings - entrusted to, or invested through, banks - from the time-deposits of the Bear-Bull bet\(^\text{87}\), the sums implied in which are not saved nor invested. Concluding this point he asks whether the bet is inflationary.

At last we are given a clear definition of inflation: “Inflation…means that the stream of consumers’ buying is increasing faster than the stream of finished goods available”\(^\text{88}\). “In so far as time-deposits such as A’s use up reserve resources, it might

\(^\text{82}\) IS THERE INFLATION IN THE UNITED STATES?”, September 1\(^{\text{st}}\), 1928, CW XIII, pp. 52-59.

\(^\text{83}\) They are listed in CW XIII, p.52, note 1; only part of them will be taken here into consideration: O.T.Falk (not listed there), Carl Snyder, Professor C.J.Bullock, another American Professor, W.M. Persons, and his old friends D.H.Robertson and R.G.Hawtrey.

\(^\text{84}\) Letter to Geoffrey Mark, actuary and director of the National Mutual Insurance, 12\(^{\text{th}}\) September, 1928, KP NM/2/2, p.65.

\(^\text{85}\) Keynes, CW XIII, p. 52.

\(^\text{86}\) In a note he reinforces his case. If there is a corporation which saves, and a bank which independently buys new issues, then one can say that, in a complicated roundabout way, A’s time-deposits had reached B and savings did find their outlet in the new issue, Ibidem, p.52, note 2.

\(^\text{87}\) Here probably begins the long lasting Keynes attempt to distinguish between saving and liquidity; a mission almost impossible, as he will experience in the discussion on the finance motive after the General Theory.

\(^\text{88}\) CW XIII, p. 53.
be deflationary"^{89}, but as they are not spent “it cannot possibly... increase the stream of buying power”^{90}. The bet has nothing to do with the stream of buying power: “Either it continues indefinitely, or...it ends some day”^{91}, but while in force “it adds nothing to...credit...for business or new investment”^{92}.

Then Keynes asks: if inflation is not an actual one, but only latent, are there any ways by which the bet may contribute indirectly to develop an open inflation? The answer to the question: “what causes inflation?” is: over-investment, in the sense of the excess of investment over savings^{93}. Thereafter the question of the relation between overinvestment and inflation is dealt with. The sequence is: the excess of bullishness stimulates investment in excess to savings and, with a time-lag, induces a rise of the ‘stream of buying’ faster than the supply of disposable goods. Yet there is a missing link in the argument: the bet may generate over-investments by means of what Keynes will define in the Treatise as profit inflation, i.e. the difference between the market - i.e. Stock exchange - price and the cost of capital goods^{94}. After all, Falk and the others had some reasons on stock inflation^{95}. However that correction does not amount to a recantation of his argument. Over-investment was not actually there; therefore the link represented by the missing profit inflation was ineffectual^{96}.

Bullishness induces overinvestment insofar there is a greater^{97} difference of opinion between the two sides. Since according to him there was a “powerful opposition to the bull market”^{98}, the stimulus to over-investment was weaker than it should have been, hadn’t the opposition been there. Now, there is a question of fact whether prices had increased during the previous two years. According to Keynes, the evidence of the retail and the cost of living indices^{99} is in the negative. Moreover, “the rate of saving in the United States...is now so enormous...that under-investment is

\begin{footnotesize}

89 CW XIII, p. 53.
90 Ibidem p.53.
91 Ibid., p.53. See above note 67.
92 Ibid., p.53.
93 A meaning not to be confused with another one, commonly mixed with the first during this discussion - i.e. the building of productive capacity in some sectors in excess to the capacity of absorption of the market -; the first excess is inflationary, while the second is deflationary; see Letter to Snyder, 2\textsuperscript{nd}, October 1928, CW XIII, p.64.
94 In December 1929 he writes: «P’ is determined by the degree of capital inflation which depends on rate of interest and bull-bear sentiment» [undln-GP] CW XIII, p.120. ‘Bear-Bull sentiments’ that later he will call bearishness.
95 In the Second volume of the Treatise, devoted the Applied Theory, in Chapter 30, Historical examples, §VII, United States 1929-30, while confirming the analysis of this discussion Keynes recognizes that ‘a true profit inflation’ was developing from the of 1927 and the Summer of 1929.
96 What was relevant was that the missing acknowledgment of this fact did weaken the persuasiveness of his argument.
97 CW XIII, p. 54. Here there must have been a slip in writing: instead of ‘much less’ difference of opinions, it must be read ‘much more’.
98 Ibidem, p.54; ‘powerful opposition’ represented in his mind by the rise of time-deposits.
\end{footnotesize}
much more probable than over-investment”, then it follows also that the probability of increasing consumer prices is small.

Keynes asks: “Is the Federal Reserve Board called upon to interfere in the *bet* between A and B?“\(^{100}\) and answers: “it would be unwise to take sides on the ground of the existence of inflation and of inevitable monetary developments issuing...from it”\(^{101}\). Exactly the opposite of Falk’s argument; above all because for Keynes there are no actual inflationary threats. “I should be inclined...to predict that stock...would not slump severely unless the market was discounting a business depression. Continued monetary stringency might easily bring about such a depression”\(^{102}\). Here he was right, things went just that way. But he was right not really believing in this possibility. Indeed, while Falk was right in predicting Federal Reserve behaviour, his guess instead was: “…as the autumn develops and the spring approaches, the F.R.B. will do all in its power to *avoid* a business depression”\(^{103}\). He could not understand “…how can it be maintained that it is the duty of the Federal Reserve Boards...to force B to his knees by producing the actuality of business depression”\(^{104}\). A non-interventionist Keynes, whom we are not used to, then suggests: “if...stocks are destined to go to a figure which is too high on any reasonable criterion...they will, in due course, boil over of themselves”\(^{105}\).

\section*{§5.2. An unheeded Warning}

One of the most important personalities whom the report was sent to, was Governor Strong. But owing to Strong illness, the answer came from Burgess, Assistant of the Federal Reserve, who was rather dismissing\(^{106}\): “I can only say that I disagree with the conclusion but I want to take more time to give you...my difference of opinion. I do not think we have had a serious inflation in this country but I do think we have been in grave danger of it”\(^{107}\)[undln-GP]…I have just seen Snyder’s\(^{108}\) letter and memo with 98 per cent of which I agree”.

This answer of Carl Snyder to Keynes report is untraceable as such, neither in the published nor in the unpublished material. However, in two unpublished and anonymous documents recollected in *Keynes Papers* - perhaps attributable to Snyder...
himself\textsuperscript{109} - we can find the most elaborated theoretical arguments against Keynes view. Besides Keynes friends, Hawtrey and Robertson who made only marginal observations, other two economists from Harvard, C. J. Bullock and Warren Persons\textsuperscript{110}, participated into the discussion. Broadly speaking, they both put forward almost only rather conventional arguments about the dangerous expansion of credit. Therefore, the thesis of the above mentioned anonymous reports will be discussed here as the major opposite view to Keynes. Falk’s answer will be first mentioned here for its importance as a practical judgment about the American situation.

§5.2.1 Falk’s fading clouds.

His, of 10\textsuperscript{th} September 1928\textsuperscript{111}, is the first answer to Keynes. Falk agrees on the first three paragraphs but to a closer reading his agreement appears to be based rather on misunderstandings. For instance, when Falk says that ‘the growth of deposits did not represent real savings’\textsuperscript{112} he is meaning quite an opposite thing than Keynes. He, following the accepted view, means that these sums however spent, not previously set aside by an act of saving, cannot be but inflationary giving rise to an ‘artificial demand’, while Keynes intends that they are neither real nor artificial savings: they have nothing to do with savings, nor with inflation.

The same applies when he says: “I also agree with your paragraph II as long as you are restricting the use of the term inflation to commodity price inflation”\textsuperscript{113}. Actually, Keynes definition does not amount to any ‘restriction’, as rather it is a definition, still implicitly rejecting the validity, theoretical and practical, of the concept of a general level of prices. Then Falk concludes, not surprisingly, with the usual statement that “although there has been no…general commodity price inflation there has in the aggregate been some inflation in my sense of the word”\textsuperscript{114}.

A second document in this discussion is a longish report, dated 27\textsuperscript{th} October, titled “Economic Conditions in the United States. With Special Reference to the

\textsuperscript{109} Confidential, September 18\textsuperscript{th}, 1928, IS THERE INFLATION IN THE UNITED STATES. Mr. J.M. Keynes, the English Economist, Discusses the Question and Answers in the Negative, KP NM/2/2 pp.75-79; Confidential, November 7\textsuperscript{th}, 1928, WHAT TEST FOR FEDERAL RESERVE POLICY. Commodity Prices do not seem to Correspond to Changes in the Volume of Credit; while the General Price Level does, Keynes Papers TM/2 pp.344-349. From the published and unpublished letters from and to Carl Snyder, belonging to this discussion, it may be inferred that all the documents labelled Confidential could be attributed to him.

\textsuperscript{110} C. J. Bullock (1869-1941), was an Harvard economist, pioneer of economic forecasting and publisher of a weekly newsletter, The Harvard Economic Service; Warren Persons (1878–1937), statistician and economist, developed The Harvard forecasting model. Keynes collaborated with the Harvard newsletter, published by Bullock, and this is probably one of the reasons of his sending the report on American inflation to them, for observations.

\textsuperscript{111} KP NM/2/2, pp.59-62.

\textsuperscript{112} Ibidem, p.59.

\textsuperscript{113} Ibid., p.59.

\textsuperscript{114} Ibid., p.62
Stock Market”\textsuperscript{115}; this is one of his routine reports to the Board of the National Mutual on the prospect of American investment. It begins with a survey of American opinions as to the Stock market. Only one of the asked is a bull, the others are more or less bearish and divided about the probability of a break in the market: the majority thinks “the market too high and a reaction, though not a big break, likely but not certain”\textsuperscript{116} [undln-GP].

There follows a recollection of the situation of the Stock exchange, the banks resources, the state of loans, etc... One of the most interesting points is the seventh: “There was and there still is, although in a diminishing degree [undln-GP], a belief that the Federal Reserve authorities will keep up the pressure of high money rates”\textsuperscript{117}. Falk himself seems questioning the F.R.B. policy: “there is little or no commodity price inflation….Why is it then that the best authorities…expect a break in the stock market”\textsuperscript{118}?

It seems that the worries, so strong in his first report, are weakening; moreover he says that “confused and conflicting”\textsuperscript{119} ideas are held as to the why of higher rates. The Federal Reserve, according to Falk, is responsible of that situation, speaking with “different voices”\textsuperscript{120}, alternating warnings about the growth of credit and statements on the soundness of banks position. Answering implicitly to Keynes question as to the ‘interference’ of the F.R.B. on the bet Falk reports that: “they [the authorities-GP] have made it abundantly clear that it is the credit situation and not the stock market [undln-GP] at which they have been aiming their blow”\textsuperscript{121}. Accordingly, Falk’s view on what Reserve authorities are thinking has changed: “they now hope to allow the volume of trade to catch up the volume of credit”\textsuperscript{122}, instead of the other way round, as he was thinking in his first report.

The clouds of worries seem to clear up, and he says he believes “in the economic prosperity of the United States for many years to come”\textsuperscript{123}. For all that he continues to think the probabilities of a break in the American Stock market very high and accordingly he is still advising a delay in the purchase of American stocks. However, he does not refrain from a mockery to Keynes concerns about deflation: “The risk of American demand reaching saturation point and leaving a vast production machine without a market sufficient…is much less than an economist in his armchair might suppose [undln-GP]”\textsuperscript{124}. He seems not to have caught that the

\textsuperscript{115} KP NM/2/2, pp.155-163.
\textsuperscript{116} Ibidem, p.155.
\textsuperscript{117} Ibid., p.159.
\textsuperscript{118} Ibid., p.156.
\textsuperscript{119} Ibid., p.159.
\textsuperscript{120} Ibid., p.159.
\textsuperscript{121} Ibid., p.160.
\textsuperscript{122} Ibid., p.161.
\textsuperscript{123} Ibid., p.161.
\textsuperscript{124} Ibid., p.161. A caricatural sketch of Keynes in an armchair is widely known; we may wonder whether the use of this rhetorical image by Falk is a mere coincidence.
possibility of a depression in the United States predicted by Keynes has nothing to do with saturation of demand, as rather with the slackening of it.

§5.2.2 Snyder’s Stonewall.

The first document is a letter in which Snyder announces an answer to Keynes report. “Dear Mr Keynes - he writes - I was very much interested in the memorandum you enclosed. It is to me a novel and, I confess, somewhat alien point of view”126. In a sympathetic mood with Snyder’s feeling, Keynes writes: “I have been spending the last four years trying to write a Treatise on Money…My… researches have led me…into unfamiliar ways of looking at things…I cannot hope for those I am talking with…to follow my line of thought - since what I say…leaves out all sorts of necessary explanations”127.

That Keynes approach was alien to the author of the Confidential report - Snyder allegedly128 - is apparent from the way in which he is tackling Keynes definition of inflation: “…price…of “finished goods” are an end result… The “stream of consumers’ buying” is obviously…the money supply and its velocity…more briefly: the volume of bank credit and its rate of turnover…”129. Obviously not130. In a stroke Keynes thesis is reduced to the accepted, i.e. Quantitative, view. Inflation is traced back to “a growth of bank credit at a rate faster than the growth of trade”131; this is, according to him, the beginning of the process of inflation. In his review of Fisher’s book, Keynes had pointed out one weakness of his theory: “Professor Fisher never explains how new…[money]…raises prices in the first instance”132. For ‘beginning’ Snyder apparently means the growth of money supply, in a Fisherine mood; exactly what Keynes thinks unsatisfactory.

Keynes had stressed the confusion between “the increase in time-deposits” and “the effect of an increase in cash and demand deposits” holding that only the latter is inflationary133. The opponents had, therefore, to re-state that “…In due time [undIn-GP]…the influence of this excess of [global] bank credit is felt everywhere over the

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125 Letter from C. Snyder, 20th September, 1928, CW XIII, p.60-62 (see KP NM/2/2, pp.73-74).
126 Ibidem, p.60.
127 Letter to Snyder, 2nd October, 1928, CW XIII, pp.62-65, (KP NM/2/2, pp.81-85). Comparing the texts it seems to be Keynes’ answer to the Confidential Note.
128 From here onward, only for sake of simplicity, it will be avoided the use of periphrases mentioning only the name of the ‘apparent’ author, without any precautionary clause.
129 Confidential, KP NM/2/2, pp.75-76.
130 In an undated and unpublished index of the projected Treatise, which could be guessed as compiled in 1928, we find mentioned: “(i) The Flow of Consumers’ Income, and (iv) Quantity of Money versus Flow of Income”; a symptom of a rising contrast between the old Quantitive approach and his new one in progress, KP, TM/3/2 p.29.
131 KP NM/2/2, p.76.
132 CW XI, p.377. Fisher’s account regards the new gold, entering the monetary system, but it may be easily applied to every new supply of money. In his Preface to the second edition of his book, Fisher acknowledged Keynes criticism, and maintains to have tackled it.
133 KP NM/2/2, p.31. See above, p.10.
whole country”\textsuperscript{134}. In the same vein Bullock writes: “I have thought that, before we got through, commodity prices would ultimately be inflated; but it hasn’t happened yet”\textsuperscript{135}. Sooner or later the speculation in securities makes itself felt in the price of commodities, through speculation in commodities\textsuperscript{136} for “there is...no dike...which limits the effect” of the global increase in loans, which eventually will “work out...to Mr. Keynes ‘stream of finished goods’”\textsuperscript{137} [undln-GP].

Actually, according to Keynes, there is such a dike. According to all the discussants, once the inflationary process is put in motion by the expansion of credit, it has to be stopped before propagation reaches its logical end: inflation. But a question is implicit in Keynes treatment, namely whether each step is necessary or there are interruptions in the propagation process. For his discussants the whole of money supply is always, albeit with delay, necessarily exchanged with something: goods or assets\textsuperscript{138}. For him, instead, Bearish behaviour creates monetary buffer stocks, the time-deposits, which do not come back in the spending circuit. The consequence is that, from the point of view of the whole economy, there always exist a money buffer, so that the dimension of the alleged propagation is reduced to the revolving pool exchanging with goods. This is the wholly new meaning that Keynes tries to disentangle from the Bear-Bull bet. To assert the opposite view it is necessary to emphasize the relationship between the growth of overall credit and the movement of the general price index. Indeed, Carl Snyder, in a letter\textsuperscript{139} to Keynes announced the sending of a ‘further memorandum’ dedicated to the question whether commodity prices, as maintained by Keynes, should be considered the ‘sole test’ for the banking policy.

The report analyzes at length the movements of various kind of prices from 1919 onward. But the main target of the Confidential report is expressed in its subtitle “Commodity Prices do not seem to Correspond to Changes in the Volume of Credit; while the General Price Level does”. The weight of the argument supporting this target relies mainly on a graph\textsuperscript{140}. The graph compares the short term variations of the bank credit - i.e. money supply - with various price indices, to answer the question “whether the short period movements of prices had corresponded very closely with

\begin{itemize}
\item \textsuperscript{134} Confidential, KP NM/2/2, p.77.
\item \textsuperscript{135} Letter from J.C.Bullock, 22\textsuperscript{nd}, September,1928, CWXIII, pp.66-70; p.69. (See also KP NM /2/2 pp.86-89).
\item \textsuperscript{136} KP NM/2/2, p.79.
\item \textsuperscript{137} Ibidem, p.77.
\item \textsuperscript{138} In the Confidential report we read: “there is a wide variety of other things which are bought for credit, than “finished goods”...[i.e.: a] vast volume of securities”, Ibid. p.77.
\item \textsuperscript{139} Letter from Carl Snyder, 31\textsuperscript{st}, October, 1928, KP NM/2/2 pp.144-146.
\item \textsuperscript{140} An oddity must be cited. Snyder’s letter is dated October 31\textsuperscript{st}, but the memorandum in Keynes Papers (“WHAT TEST FOR FEDERAL RESERVE POLICY”, see note 94) which seems to be referred to, is dated November 7\textsuperscript{th}, 1928. There is another Confidential report dated October 30\textsuperscript{th}, 1928, the same date of the letter, entitled THE FEDERAL RESERVE IN THE EYES OF EUROPE, KP NM/2/2 pp.121-126; but hardly could it be the report designed as ‘enclosed’, for its theme is not that of this discussion.
\end{itemize}
similar variations in the growth of bank credit”\textsuperscript{141}. From 1924 to 1928 bank credit shows no relevant oscillation around the long-term average, and the Index of General Price Level is closely associated “with the volume of credit outstanding, while commodity prices show no such close correspondence”\textsuperscript{142}. There was indeed a correspondence, as visual evidence\textsuperscript{143}, but there was no inflation. A point which he seems to have missed, though it should have been his main concern.

§5.3. Keynes again; to no avail.

To no avail was Keynes trying to make his discussants suspect the novelty of the view he was elaborating, or at least raise some doubt on their convictions in the old view; therefore he eventually declined to continue the discussion\textsuperscript{144}. Notwithstanding, he had tried to minimize the differences of opinion agreeing that “the seeds of inflation are sown some time before inflation actually exists”\textsuperscript{145} and that consequently the relevant thing is the “diagnosis of the circumstances which are liable to develop price inflation if they are left unchecked”\textsuperscript{146}. A point he treated in his answers was whether the increase in the volume of overall credit is a reliable test to infer the possibility that inflation will develop. Doing so “an error - he says - is liable to creep in”\textsuperscript{147}, for he denies that “the amount of call money used by the stock exchange is a test of the degree of the inflationary tendencies”\textsuperscript{148}. The crucial question is which is the true test for that. On this subject he was doomed to be misunderstood. No one of his opponents could resign from the common shared view that “total loans and investments of the commercial banks” are a true “measure of the expansion of bank credit”\textsuperscript{149} and therefore of inflationary tendencies. He asks: “Are there…any noticeable signs of over-expansion?... American investors and financiers seem at the present time to be divided into two parties - those who are ready to hold bonds and stocks…and those who think it wise to keep liquid…The greater the difference between the two parties, the greater will the volume of call money be”\textsuperscript{150}. His Bear-Bull bet analysis brings him to deny the validity of the ‘the volume of overall credit’ test for the danger of inflation: “I was not clear - he says - that a high stock market, dear

\textsuperscript{141} Confidential, KP TM/2, p.348.
\textsuperscript{142} Ibidem, p.349.
\textsuperscript{143} Actually he built the graph upon some unplausible assumptions. However, Keynes did not in his answers point out the methodological weaknesses of Snyder alleged evidence.
\textsuperscript{144} Letter to Carl Snyder, 13\textsuperscript{th}, November, 1928, KP NM/2/2 p.154: “I must not try to continue the argument further. It is...too big a matter for correspondence”.
\textsuperscript{145} KP NM/2/2, p.143; letter to W.M.Persons, 7\textsuperscript{th}, November 1928.
\textsuperscript{146} CW XIII p. 71, Letter to C.J. Bullock, 4\textsuperscript{th}, October, 1928, CW XIII p. 70-73 (KP NM/2/2 pp. 90-92).
\textsuperscript{147} CW XIII, p.62. Letter to Carl Snyder, 2\textsuperscript{nd}, October, 1928, CW XIII, pp.62-5 (KP NM/2/2 pp.81-85).
\textsuperscript{148} Ibidem, p.64.
\textsuperscript{149} Ibidem, p.71. On these points see also another letter to Bullock, 28\textsuperscript{th}, October, 1928, CW XIII pp. 73-75 (see KP NM/2/2 pp.100-102).
\textsuperscript{150} CW XIII, p.63; letter to Carl Snyder, 2\textsuperscript{nd}, October, 1928.
call money, and large sum employed on the call market were [not\(^{151}\)] necessarily symptom of this, unless they were causing or caused by over-investment”.

A second point is the stress on the fact that “overinvestment in particular directions is quite a different thing from the general over-investment which is associated with inflation”\(^{152}\). Over-investment, namely the excess of investments over savings, is for Keynes the true test for expecting a development of inflation. General over-investment has nothing to do with the fact that “many new building were unlet…or…many cars were unsold…or plant going out of employment”\(^{153}\). In this case the problem is the excess of savings over investments, not the other way round. Consequently, his conclusion is that “money should be as cheap as possible”\(^{154}\).


The discussion had a tail-end, some eight months after the last letters. In June 1929 surprisingly Falk writes in his Note on the Financial Situation: “…the banking position is [now] far stronger than it was a year ago…one may now buy American Common Stocks with greater safety… there may be some slowing down of American business … but a trade recession, though it may affect some stocks…will not necessarily affect them all”\(^{155}\) [undln-GP]. To that Keynes commented: “I seem to be destined to disagree with Mr. Falk…It is just ten months since I wrote a memorandum for the Board arguing that a very bearish view of the market, based on the intentions of the Federal Reserve Board, was not really justified and that there was at the time no reason to expect a severe slump of stocks. Since then the whole body of… Common Stocks have increased in price by the astonishing…25%…the market now seems to me a much more dangerous one for Bulls than I thought it then”\(^{156}\) [undln-GP].

One may wonder why Falk so corrected his stance with respect to the first memo of April 1927. We have seen that his concerns about the Federal Reserve policy had been already appeasing, and we have to remember that, quite reasonably, he was heavily relying on American quarters who, most likely, were getting accustomed to a course of events which had previously raised dreadful worries in them. Moreover, they held that a “Hoover victory will mean prosperity”\(^{157}\), so that the concerns for a dramatic set-back in the Stock market were appeasing in the worst of moments.

The evolution of Keynes stance was much more linear. In his 1927 reply to Falk he began playing down, may be too much, the preoccupations about the American economic situation. He grew more and more worried that the Federal Reserve policy could bring in a business depression, a consequence more dangerous for him than

\(^{151}\) A slip: the ‘not’ has disappeared, Letter to Persons, 7\(^{th}\), November, 1928, KP NM/2/2, p.143.

\(^{152}\) Ibid., p.64

\(^{153}\) CW XIII, p.64.

\(^{154}\) Ibidem, p.64.


\(^{156}\) Comment on Falk by J.M.Keynes, 2\(^{nd}\), July, 1929, KP NM/2/3, pp.14-16.

\(^{157}\) See his memo of 27\(^{th}\), October 1928, KP NM/2/2 p.156. Conversely they feared that a “Smith victory [will mean] trouble” Ibidem, p.156.
the inflation it intended to avert. Finally, in his last comment to Falk, Keynes utters a strong warning about the dangers in the situation of the American Stock market, just two months before the beginning of the events leading to the Crash: “...just as a year ago I thought it dangerous to predict a slump of the market on the basis of the deflationary intentions of the Federal Reserve...so to-day I think it dangerous to predict a further boom merely on the basis of a cessation of these deflationary efforts”\textsuperscript{158}.

§7. A Theoretical Summing-up.

The discussion between Keynes and his correspondents has been closely followed to show where the impulse towards a new theory was stemming from. He was attempting not only to analyze a new situation, as also to elaborate new tools. This, while he was trying to fix his own ideas on monetary theory and the genesis of the economic cycle\textsuperscript{159}. We have seen the clash between his still evolving ideas on monetary theory and the orthodox view based on Fisher’s approach to Quantitative Theory. We have seen him questioning the real value of this accepted view as a guide in diagnosing the situation which was then developing in the United States and as a guide to a right monetary policy. However, the most important aspect emerging from the analysis of the discussion is Keynes’ new elaboration of his monetary theory which constitutes the first step towards the turning point summarized in the \textit{Treatise} by the term \textit{bearishness}, with respect to his previous work, the \textit{Tract}.

Indeed, the main theoretical difference between the two texts is that in the \textit{Tract} the demand of money is functionally undifferentiated. The only difference in the \textit{money balances} is typological: i.e., between cash and bank-deposits in the hands of the public\textsuperscript{160}. We have seen how Keynes had analysed the post-war hyperinflation by means of this undifferentiated demand for money. In a manuscript preceding the \textit{Treatise} we find two fragments\textsuperscript{161} in which for the first time a functional difference emerges between \textit{transactive balances} and the others: on one side money-deposits, with their correlated ‘efficiency’ - i.e. velocity - and on the other, investment-deposits, without any reference to velocity. These two pools are still lumped together insofar global demand of money is equalized to the supply by means of the price-level. In

\textsuperscript{158} \textit{KP} NM/2/3, p.14.

\textsuperscript{159} In his explanatory Note to Falk on the economic situation at the end of 1930, Keynes expresses his doubts as to “whether it [the Note] is intelligible without the background of my main theory as to the \textit{genesis} of Credit Cycles”, British Library, Manuscript Room - Add. 57923, p.21

\textsuperscript{160} In the third chapter of the \textit{Tract} Keynes gives his version of the Cambridge equation \(n = p(k + rk')\), where \(n\) is the nominal quantity of purchasing power put at disposal of the public, \(k\) and \(k'\) are the number of ‘consumption units’, i.e. \textit{quanta} of ‘real’ demand of money that the public desire to keep in liquid form respectively in cash and bank-deposits, and \(r\) is the bank-reserve coefficient.

\textsuperscript{161} “Our fundamental equation of price then becomes: \(P=M/(C^1 + WT)\)”, where \(C^1=\text{demand of real balances not transactive}, WT=\text{demand of transactive real balances}”, \textit{KP} TM/2/350 6. In the galley proofs of an unknown chapter on foreign equilibrium we read: \(P = M_1V_1 / O + (I_1+F-S) / O\), a mix of a traditional \textit{Quantitative} approach and of the \textit{real} approach of the \textit{Treatise}, see \textit{KP} TM/4/(unreadable number).
the Treatise the investment-deposits will become the saving-deposits. But connected with these a new motive of keeping them will appear: bearishness.

We have seen that in the Lectures on Speculation the Bear-Bull bet had already appeared. In these Lectures the bet had the function to give a deeper insight into speculation. The Bears borrow stocks, and the Bulls pawn stocks; the brokers synchronize the two actions with the aid of the banking system. Here we see at work the Marshallian connection in Keynes thought. Marshall always emphasized two ultimate ends of an economic relation: e.g. on the one end, the consumer whose choices are driven by utility considerations and, on the other, the producer whose choices are driven by effort considerations. All what lies in between: intermediate producers, dealers and traders, are set aside, for their actions are driven by the interplay of the two basic leading forces. The same with Keynes. The two ends are the ultimate Bear and the ultimate Bull: brokers, banks and all those who buy and re-sell stocks are set aside as if the two players did trade directly together.

The question arises why during this discussion he felt it was helpful to resort to the theory of speculation to strengthen his position. Falk, together with the authorities he quoted, was voicing concerns under two titles: inflation and over-investment, lumping together the explosion of Stock exchange speculation, building speculation, growth of credit to the Stock exchange (call-money loans), excess supply in certain directions (e.g. cars and buildings), concluding that inflation was threatened. Keynes first answer to Falk’s memo maintained that the increasing “volume of investment financed directly or indirectly [undln-GP] by bank money”, is a sound one and the Federal Reserve Board should not “interfere…by restricting the basis of credit”. However, his initial observations on the relation between (money) savings and investment did not match the question of speculation and the associated increase in bank credit, which was mainly worrying his discussants. To face this aspect of the problem of credit expansion, previously neglected by him, Keynes had to put forward the conflation of his earlier theory of speculation with the monetary problem at issue; i.e. whether inflation was threatened by a credit expansion due to speculation.

To deny this possibility it was necessary to make a step further with respect to the traditional approach of different velocities attached to different parts of the money pool. The Bear-Bull bet did serve to the aim, insofar the Bears are detaching their money balances - committed to speculative purposes - from the money pool impinging on commodity prices. There was an implicit shift to be done in the approach to money itself. The traditional approach considered money as a mean, to serve chiefly the function of being exchanged with something else: i.e. with wealth either as a commodity or as an asset. A mean cannot rest unused for long; the existence of an

162 KP UA/6/3, “This is clear if we imagine a bull and a bear…directly with one another for the carryover.”, p.82, “What I have described so far about borrowing and pawning, is a picture of what really happens [undln-GP]. The fashion in which it appears to the speculator is…different”, p.83.
163 KP NM/2/1, p.155.
164 See above, p.13; the time-deposits of the Bears “cannot possibly in itself serve to increase the stream of buying power”, CW XIII, p.53.
idle balance cannot be considered but temporary. But if money itself is the general form of wealth, the time of keeping it as wealth, cannot be considered only a lapse of time from receiving and transferring it. Accordingly the bet was taken into consideration insofar one side was locking a pool of money for this purpose, removing it from transaction use. Purposely the Bear is locking money\textsuperscript{165} and the reasons of this deliberate action are not to be confused with the casual or habitual delays in transferring money.

The crucial explanatory point of Keynes treatment, with respect to this discussion, is the severing of the ties between speculation and investment, which were obssessing his discussants. This is what the whole elaboration on the bet between A e B is aiming at: that call-money and time-deposits match together, and do not impinge either on inflation or on investments (better, on over-investment). However, the bet approach, though introducing a theoretical novelty, had some drawbacks. Time-deposits and call-loans ‘wash-out’, he said: “In short, a Bull transaction of an existing security must always use up exactly the same amount of funds through borrowing by the purchaser as it releases to the seller [undl-GP]\textsuperscript{166}. From this he drew a factual consequence, hardly convincing, that these balances did mean a ‘powerful opposition’ to the Bull-market; a judgment questioned by Hawtrey\textsuperscript{167}, and rebutted by the impressive increase in stock prices the following year. The second weakness was that though the relation Bear-Bull represented the two ends of a speculative relation, in a Marshallian way, hardly could this relation represent the two ‘ultimate’ ends of a monetary relation. As Bullock and Persons objected, money from call-loan in the hands of a Bull does circulate again and again. The direction of the relation from time-deposits to call-loans, in the sense that the firsts generate the seconds, paved the way to this objection. A true ultimate monetary end was needed, the Bull being actually only an intermediate actor to be set aside. This end is the banking system, which has to be properly considered the supplier of what the Bears are demanding.

This inversion, from time-deposits generating call-loans to call-loans generating time-deposits, was performed later in the Treatise, by means of the bearishness connecting the public, demanding money for other than transaction purposes, to the banking system. Later on, in the General Theory, by the liquidity preference\textsuperscript{168}. But the seeds of these wholly new theory were laid during this discussion, when Keynes realized that even his interpretation of the Cambridge approach to the demand for money was unsuitable to match the problems raised by the extraordinary American situation; problems regarding not only the industrial boom in the Twenties as even

\textsuperscript{165} “The cash A has realised is immediately locked up in the loan to B”, CW XIII, p.53 [undln-GP].

\textsuperscript{166} Letter to Marks, 12\textsuperscript{th}, September, 1928, KP NM/2/2, p.66.

\textsuperscript{167} “I should also disagree as to the existence of a ‘powerful opposition to the bull market’”, Letter from Hawtrey, CW XIII, p.76.

\textsuperscript{168} Keynes liquidity preference is grounded his ideas about uncertainty. But at this very initial stage uncertainty is still behind the scenes as only implicit in the bet. On its turn the bet is based on judgments of the kind Keynes analized in his Theory of probability.
more the Stock Exchange boom with its associated revolution in the portfolio and monetary behaviour of the public at those times.

However, though Keynes was striving to elucidate and clarify this new conceptual field, he did not yet find out the name for his new theory. It was Hawtrey who did. In commenting the behaviour of big corporations making loans to brokers, loans to be considered ‘bear speculation’ as in Keynes bet-scheme, Hawtrey says: “I believe the predominant motive is the desire for liquidity [undln-GP], not to the desire to wait for a more favourable opportunity to invest”\(^{169}\). It seems that Keynes conflation of two strands, the monetary theory and the theory of speculation, did lead Hawtrey to draw a clear-cut conclusion, and to give the proper name to a theory which would only later take due shape.

§8. Conclusion.

Only two points here will be touched. The first, what is the answer to the question, implicit in the title, whether Keynes had diagnosed the Depression. The second is an attempt to understand why, for all his display of capacity in persuading, he did not succeed in it and was obliged to recognise “I am not clear… whether our minds really have met as yet”\(^{170}\).

In his July 1928 report we have seen the first explicit forecast of the Depression: “If they [Federal Reserve Banks-GP] succeed in stopping new capital investment, it may cause a serious set-back to business and employment”\(^{171}\). This sentence was such a hypothetical, in the sense of unreality, that it was borderline with a counterfactual. But afterward the tune was changing sensibly. In an October letter to Bullock he says: “If too prolonged an attempt is made to check the speculative position by dear money, it may very well be that the dear money, by checking new investments, will bring about a general business depression. Unless you think that at this very moment, and in the foreseeable future, new investments are being floated faster than the savings of the public can absorb them, I say that there is more risk of creating a business depression than there is necessity for avoiding a business boom [undln-GP]”\(^{172}\). The situation could not have changed during the two months elapsed from the first report; what had changed was his feeling of the lack of willingness of his correspondents to grasp the real danger of the situation, a danger which must be made more explicit.

To answer to the first question we have to recollect Popper demarcation criterion; an assertion is scientific when it implies risky predictions. So are Keynes forecasts. Keynes sentences were conditional, and could have been refuted by the follow-

\(^{169}\) CW XIII, p.77.
\(^{170}\) Letter to Persons, 7\(^{th}\), November, 1928, KP NM/2/2 p.143.
\(^{171}\) KP NM/2/2 p.33. This quotation taken from his July draft is absent from the final September version published in CW XIII.
\(^{172}\) Letter to Bullock, 4\(^{th}\), October, 1928, CW XIII p. 72. Actually there is plenty of these warnings, of varying intensity, all along the materials of the discussion; to quote them all here would be quite redundant.
ing events. The point is not whether the Federal Reserve policy had caused the Depression, a point lively debated afterward, but whether his conjectures upon the consequences of the intended - and after pursued - F.R.B action, compared with those of his contemporaries, did grasp a rational possibility of evolution of the situation that his discussants did not even imagine.

The second question regards his apparent inability to persuade his correspondents. We have already seen the theoretical diverging rail which prevented a ‘meeting of minds’, in Bloomsbury parlance. However, it is apparent that, under the surface there must have been something else, some kind of an emotional stumbling block standing on the way of their mutual understanding. We read, for instance, in the October 1928 letter of Snyder the same feelings and concerns which Falk had already voiced at the beginning of the discussion: “Owing to the expansion of credit… speculative loans …had an enormous expansion…accompanying the greatest rise in stock prices which this market has ever seen…This has culminated in the wildest outbreak of speculation since 1901…This mania has swept the whole country, penetrating even to the most distant and smaller towns”.

To these feelings Keynes answered with a rational and acute dissection of the situation: you must not - he said - take into consideration the whole of credit expansion, there is no danger of over-investment, there is no inflation, etc... By denying that the boom in stock prices ought to be regarded as inflation, as he recognized later under the title of profit inflation, Keynes couldn’t but weaken his position in the eyes of his correspondents, who were appalled by something of which he was denying the very existence. Moreover, his answer was couched in the cryptic language of the Bear-Bull bet that only after the Treatise and the General Theory we can fathom out. His analysis brought home the right diagnosis of the situation, but failed completely to dispel the clouds of their fears; they could even accustom themselves to cohabit with their fears, to

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174 See Skidelsky, loc. cit.. Its classical locus is Schwartz’ and Friedman’s U.S. monetary history. There has been also a recent debate in which the President of the Federal Reserve Ben Bernanke had been involved; but this episode had mainly the aim to test the ability of mainstream economics to ‘explain’ the sources of the Great Depression.

175 CW XIII, pp.60-61. Snyder mentions here some impressive cases of the nationwide diffusion of the speculative mania. For a different, rather minimizing, view, see Galbraith, Crash, Chapt.5, §.5.

176 Neither due to Stock exchange boom nor to the real estate values boom; the last is only “another case of a bet between A’ and B’”, CW XIII, p.57.

177 Also his friend Robertson, though broadly agreeing with him, seemed more sympathetic towards Keynes’ correspondents feelings that the situation was such that “if unchecked will lead to a collapse”, Letter from D.H. Robertson, 18th, September, 1928, CW XIII p. 65-66.
endure in them; but to convince them one had to speak to, as it were, their underskin feelings.

For all his intention and capacity in persuading, and for all his efforts, he did not succeed in doing it. He was decidedly too Olympian for his fearful discussants. May be this was the main obstacle that prevented him if not to persuade them, at least to make them doubt.