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The gold standard and the euro: A reflection from a reading of *A Tract on Monetary Reform*

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Abstract This paper makes a comparison between the gold standard and the euro through a study of Keynes's views on the need to manage the macroeconomic situation of an industrial economy. The essay centers on Keynes's first relevant economic work of the post World War I years, *A Tract on Monetary Reform*, analyzing its theoretical and practical content. The situation of monetary instability and the choice of exchange regime (to return or not to the gold standard, with the parity prior to the war) were the factors that attracted Keynes's attention in those years. Similarities between the gold standard and the present euro system bestow a certain interest on Keynes's ideas and on the economic discussions that took place in Great Britain during the postwar years (1919−1925).

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El patrón oro y el euro. Una reflexión a partir de la lectura de *A Tract on Monetary Reform*

Resumen El trabajo lleva a cabo una comparación entre el patrón oro y el euro a partir de un estudio de las ideas de Keynes sobre la necesidad de gestionar la situación macroeconómica de una economía industrial. Así, el ensayo se centra en la primera obra económica relevante publicada por Keynes en los años posteriores a la Primera Guerra Mundial, *A Tract on Monetary Reform*, analizando su contenido teórico y práctico. La situación de inestabilidad monetaria y la elección de régimen cambiario (volviendo o no al patrón oro, con la paridad anterior a la guerra) fueron los factores que atrajeron la atención de Keynes en esos años. Algunas similitudes entre el patrón oro y el actual sistema del euro confieren un cierto interés a las ideas de Keynes y a las discusiones económicas que tuvieron lugar en Gran Bretaña durante los años de la posguerra (1919-1925).

1. Introduction

This paper arises from a rereading of the first major economic work of Keynes: *A Tract on Monetary Reform* (1923a). This reading of *A Tract* led to the idea that the current euro system shows some characteristics that resemble more closely the ''old'' nineteenth century gold standard than a modern single currency system. Thus, some of the limitations under which the European Central Bank (ECB) has had to operate have been due to the ECB's regulatory design and its great reluctance to implement discretionary policies. Of course, differences must also be taken into account; thus, for example, under the gold standard, the modification of the parity of a currency with gold or exit from the system was easier to carry out than a potential ''euro exit'', as mooted on several occasions for some economies of southern Europe.

Moreover, the measures taken by European policymakers do not appear to take into account traditional Keynesian policies despite, paradoxically, many European countries exhibiting high levels of unemployment. Reduction in unemployment does not seem to be a primary objective of the European Union (EU). On the contrary, the problems that focus the attention of European monetary authorities are inflation and public deficit. This has been shown by the most vigorously pursued policy by the EU and European governments, which has been fiscal consolidation, and, in general, a defence of austerity measures.

There is a widely spread notion that public sector growth during the decades following World War II has resulted not only in the excessive size of this sector, but also and, above all, in great rigidity in its ability to act. This has limited the stabilizing capacity of the state to stabilize economic activity, making it more appropriate to reduce the degree of regulation and public intervention in the economic system. In fact, European governments consider their most pressing problems are with public budgets, and not with a lack of economic growth.

This political position has arisen from the great confidence deposited in the equilibrating mechanisms of the markets, i.e., in the belief that the private sector is much more stable than Keynes thought. Moreover, this position seems to defend the idea that the proper functioning of these mechanisms are hindered by the excessive regulatory zeal of the welfare state. In short, the current orthodoxy is based on the idea that the private sector and in particular markets without intervention are relatively quick at making adjustments. Thus, measures to expand demand are often seen as negative, since many consider that they would only generate inflation. Therefore, independence is only granted to central banks to pursue policies of price stability.

In *A Tract* (1923a), Keynes's put forward his view on the need to manage the macroeconomic performance of an economy. The origin of this was, according to Keynes, the break up of the economic organization of Europe following WWI: the ''delicate'' organization that had previously operated up to 1914 could no longer be maintained, and the ''*laissez-faire* system'' was a thing of the past. It was no longer possible to go back in search of a world that had disappeared forever. After WWI, Keynes's perspective experienced a profound transformation and he lost confidence in the self-regulation of the market. Thus, an industrial economy should be managed in a conscious way: the era of non-intervention of the state in economic affairs had ended, as expressed in the title of one of his works – The End of Laissez-Faire (1926).

At Cambridge, Keynes had as his teachers, Marshall[2] and Pigou. Furthermore, from a theoretical point of view, Keynes believed in the balancing abilities of market forces, at least in the long term. Even more so, considering his analysis of the UK economy in the 1920s in which he highlighted the monetary system as the main hinderance to the process of resource allocation.

In *A Tract*, Keynes rejected the return to the gold standard, arguing that fixing the exchange rate should not

[2] According to Schumpeter, since 1909, Keynes ''taught straight Marshallian doctrine with the Fifth Book of the *Principles* as the center, the doctrine that he mastered, as few people did, and with which he remained identified for twenty years to come.'' (1946, 497).

be the main objective of the Bank of England. Internal balance could not be forced from the outside by imposing an accelerated return of European currencies, including sterling, to the gold standard. On the contrary, he argued that the authorities should focus on obtaining internal monetary equilibrium. Moreover, Keynes maintained that exchange rates would reach their correct levels naturally, once European countries had achieved an internal balance.

This paper uses *A Tract* to describe similarities and differences between the economic situation in the 1920s and the early years of this century. Thus, in Section 2 a presentation of *A Tract* is provided, placing it both in its historical period and in the circumstances that defined the economic thinking of its author. Furthermore, this work makes a comparison between the gold standard and the euro, highlighting the failure of the United States in the first case, and Germany, in the second, in their role as creditors. A part of Keynes's approaches lost some of their interest and practical importance with the return of Britain to the convertibility of the pound against gold in April 1925, mainly because that return was carried out at prewar parity levels. Despite this new institutional framework, Keynes devoted his energies to finding the most appropriate economic policy measures to the new situation. Thus, in Section 3 some conclusions are drawn about the role of *A Tract* in the evolution of Keynes's thought, noting in particular the need that the market economy be directed through appropriate policies. This also allows some reflections to be made on aspects of the ECB's role in the management of the eurozone. Finally, Section 4 presents some final thoughts.

2. A tract on monetary reform

A Tract was born from several articles that Keynes published during 1922 in a series of Manchester Guardian Commercial Supplement, entitled *Reconstruction in Europe*. His articles, especially those collected (revised and expanded) in *A Tract*, constituted an attempt to respond to the difficulties of adapting European economies to the situation of peace after WWI. ''The delicate organization'', as Keynes had written in *The Economic Consequences of the Peace* (1919), which characterized the European economic system had emerged from the war in a deteriorated state. Particularly serious, from his point of view, was that ''the investment system'' that Britain's prosperity had been based on for a century had been affected negatively. The immediate economic cause was, Keynes argued, price volatility. These fluctuations, especially the processes of inflation suffered by European economies, had destroyed the conditions under which savings had been channeled into productive investment.

Inflation had affected those that ''call to the aid of their enterprises ... the savings of the whole community''(5),[3] since they had become speculators who bought merchandises and raw materials, which they later hoped to sell at higher prices. In addition, in this period individuals' debts were reduced by the decline in the value of money. Thus, the ''investing system'' so characteristic of the nineteenth century had disappeared because of the effects of inflation on the savings and investment mechanism. Later, the subsequent deflation generated unemployment due to a fall in the level of economic activity, as businesses cut production. As a result, individuals had a profound lack of confidence in the value of money and, therefore, in the ability of the system to create the conditions that would allow the normal operation of the economy.

Moreover, given the economic situation prevailing at that time, Keynes argued that it was ''not safe or fair to combine the social organization developed during the nineteenth century (and still retained) with a *laisser-faire* policy toward the value of money''. If ''we are to continue to draw the voluntary savings of the community into ''investments'', we must make it a prime object of deliberate state policy that the standard value, in terms of which they are expressed, should be kept stable'' (16).

Inflation was dangerous for social stability and from the consumer's perspective, ''the business man's exceptional profits appear as the cause (instead of the consequence) of the hated rise of prices'' (23). ''To convert the business man into the profiteer is to strike a blow at capitalism, because it destroys the psychological equilibrium which permits the perpetuance of unequal rewards''. In fact, ''the business man is only tolerable so long as his gains can be held to bear some relation to what, roughly and in some sense, is a contribution to society'' (24). Thus, the depreciation in the value of money does not only destroy the incentive to save but, ''also discredits enterprise'' (25). On the contrary, when there was deflation, unemployment occurred because employers would decrease their operations and keep their stocks of goods at the lowest possible levels; at the same time, they avoided all possible advance purchases of raw materials and intermediate goods. Consequently, there was a decline in the level of activity.

The economic situation in 1923 was such that most economists, if not all (also including non-economists), looked at the years before WWI as the most desirable situation of the European economy. It is no wonder then that they saw in the gold standard a panacea that would restore price stability: the ''return to gold'' would restore the conditions for the stable operation of the international economic system. In fact, the return to the gold standard (with prewar parity) was the official thesis of the British government; this thesis was based on the proposals of the *Cunliffe* Committee appointed for this purpose.

By contrast, Keynes proposed in *A Tract* a series of measures that surprised most, and some considered as radical (Sprague, 1924, 770). Keynes maintained that a deliberate policy of monetary management was required by the Bank of England if they wanted to achieve the desired price stability.[4] He, therefore, deviated from the general opinion on how to rebuild the monetary equilibrium of Britain.

[3] In the citations only pages are given when they refer to *A Tract of Monetary Reform*.

[4] Keynes always showed a firm belief in the possibilities of economic engineering: ''... the absurdity of labor being from time to time totally unemployed, in spite of everyone wanting more goods, can only be due to a muddle, which should be remediable if we could think and act clearly'' (1923b, 113). This attitude has been highlighted by Moggridge: ''Keynes always believed that 'a little

A Tract ''had a special meaning in terms of its affirmation of national monetary autonomy'' (Rogin, 1956, 629).

What was Britain's main problem in Keynes's opinion in the early years of the 1920s? It was the high level of unemployment that had occurred as a result of price deflation that the British economy was experiencing at that time. However, this was the immediate cause, the deeper cause should be sought, as noted above, in the price volatility that had greatly deteriorated the equilibrium of that delicate ''investing system'' that had presided over the expansion of the British economy for a century.

Keynes did not waste time in useless lamentations about the glorious past.[5] Once accepted that the past was gone, he began to work on practical proposals that would help the British economy overcome the monetary problems that beset it. In *A Tract*, Keynes supported the policy recommendations that were part of the theoretical knowledge he had received from Marshall.[6] As written by Austin Robinson, during the nineteen twenties, Keynes ''thought of himself, primarily as someone who had to an unusual degree the capacity to apply to the economic problems of the day the *corpus* of economic thinking which he had inherited from Marshall'' (Robinson, 1947, 35).[7]

The effects of the instability in value of money were important enough for Keynes to consider that it would not only generate a deterioration in production and the organized exchanges in markets, but also the possible destruction of the capitalist economy (1923b, 117). In 1919, Keynes had already written that:

> ''There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.'' (1919, 207).

In *A Tract*, the quantity theory of money and the theory of purchasing power parity constitute the analytical basis of the study on the value of money.[8] Thus, using the Cambridge approximation of money demand, Keynes followed the tradition developed by Marshall.[9] The traditional form ''of exercising a stabilizing influence'' in the market by a central bank had been through the manipulation of the bank rate ''but it is doubtful whether bank rate by itself is always a poweful enough instrument'' (68), so to achieve that influence the use of open market operations to offset the procyclical behavior was proposed. However, as a critic of *A Tract* (Angell, 1925, 270) pointed out, the task Keynes demanded of the authorities was new at the time, requiring them to evaluate in advance the changes in the demand for real balances to then take the appropriate measures.[10]

The perspective of Cambridge, unlike the quantative theory in the version of Irving Fisher,[11] highlighted the demand side of money markets. This demand was made to depend exclusively on transaction and precaution motives. Speculative movements only appeared in the analysis of the forex market (90 and 107–109).

Keynes used the theory of purchasing power parity, while accepting that this only gave approximate predictions. In the short term, exchange rates were often much ''more sensitive and volatile'' than the theory of purchasing power parity predicts. But ultimately, the real determinant of the exchange rate is the domestic purchasing power of a currency, and this ''quickly reflects the monetary policy of the country'' (79). Thus, Keynes assigned to the Bank of England the responsibility for determining the exchange rate, although this task should be carried out indirectly through monetary policy. So if the central bank's objective was price stability and this goal was achieved, the exchange rate of a currency would appreciate or depreciate depending on what happened to price levels in other countries. Thus, his proposal involved the central bank concentrating on internal stability through a conscious and autonomous policy.[12]

clear thinking' or 'more lucidity' could solve almost any problem'' (1980, 39).

[5] Keynes ''was not given to vain regrets. He was not in the habit of bemoaning what could not be changed'' (Schumpeter, 1946, 505).

[6] The only criticism that Keynes made about the quantity theory in *A Tract* is very indirect; by rejecting the interpretation of it that, even in the short term, variations in the amount of money only affect the price level, without affecting the demand for ready cash. This, he argued, will be true in the long run, ''but this *long run* is a misleading guide to current affairs. In the *long run*, we are all dead.'' (65).

[7] In the Introduction that Keynes wrote in 1922, for the *Cambridge Economic Handbooks*, he said that ''Before Adam Smith this apparatus of thought [the *corpus* of economic thinking] scarcely existed. Between his time and this, it has been greatly enlarged and improved ... It is not complete yet, but important improvements in its elements are becoming rare. The main task of the profesional economist now consists, either in obtaining a wide knowledge of *relevant* facts and exercising skill in application of economics to them, or, in expounding the elements of his method in a lucid, accurate, and illuminating way, so that, through his instruction, the number of those who can think for themselves may be increased'' (cited by Robinson, 1947, 35).

[8] Some commentators of *A Tract* have noted that the theoretical part is unnecessary for understanding the argument of the book, and because it did not reflect well the thinking of Keynes at that time (Patinkin, 1987, 20–21), and even for being less original than the formulation of Pigou (Bigg, 1990, 76) or Robertson (Bridel, 1987, 89).

[9] ''The book [*A Tract*] is strictly in the quantity-theory tradition as developed by Keynes's teacher Alfred Marshall, to whom he pays repeated tribute'' (Friedman, 1983, 35).

[10] ''The main divergence before 1931 was that the monetary reformers believed that the central bank could control the quantity of money, and central bankers insisted that the only feasible control mechanism was the gold standard.'' (Skidelsky, 2016, 16).

[11] Keynes regarded Fisher as one of the most brilliant and original economists. Thus, he published in the *Economic Journal* in September 1911, a review showing the high esteem that he had for Fisher, but yes, criticizing that he had not taken into account the role of bank lending in the transmission mechanism from money to prices (Keynes, 1911, 376–377). In 1925, he wrote to Fisher that ''all students of Monetary Theory and advocates of Monetary Reform will always recognize you as the leader and pioneer of this movement'' (cited by Skidelsky, 1992, 168).

[12] Keynes's position was different from that of Hawtrey, Robertson and Pigou (Eshag, 1963, 99).

The ''primary objective'' to be adopted by the monetary authorities should be the ''stability of sterling prices'' (147), using the discount policy and open market operations; the amount of money would then depend on the needs of the productive activity. Under certain conditions, this goal should not prevent them from also trying to achieve the ''secondary objective'' of stability in the exchange rate. To achieve this, Keynes proposed that the gold reserves, once gold had been delinked from printing money, would be used by the Bank of England to ''correct the influence of a temporarily adverse balance of international payments'' (153). The Bank of England would take upon itself the task to ''regulate', but not 'peg' the price of gold'' (149) publishing prices for buying and selling, in the same way as the bank rate was announced. Moreover, if the US admitted that it no longer had a system of gold standard but a dollar standard, which in practice the authorities of the Federal Reserve were already doing, the stability of the exchange rate could be a target to achieve ''by co-operating [the Bank of England] with the Federal Reserve Board in a common policy'' (147).

Keynes also saw the nineteenth century as an example of great stability. Though this stability was due to the stability of the price of gold, more so than the rest of the institutional circumstances that characterized the nineteenth century. Keynes argued that even if it were true that price stability throughout the nineteenth century had been due to the existence of the gold standard, the conditions after WWI prevented the return of the British economy to that system because the value of gold was experiencing substantial instability. Gold itself had become a currency regulated and directed by the monetary authorities of the Federal Reserve,[13] due to its policy of buying all the gold that was offered. In addition, this gold was then sterilized by the fear of US monetary authorities to unleash in their country similar inflationary processes that European economies had experienced. So, ultimately, the US did not fulfill its proper role in the gold standard for countries that experience an increase in their gold reserves.

Something very similar is argued today regarding the performance of Germany and the European Central Bank (ECB) in relation to the management of the euro during the so-called Great Recession. Thus, it would seem that the most appropriate action to take in the economic circumstances of Germany and the eurozone in general would have been the development of expansionary measures. However, to the contrary, the argument used was that such policies would generate inflation and increases in real interest rates in the long-term, which would end up distorting the allocation of resources.[14]

The performance of Germany in recent years has been characterized as contrary to the ''golden rule of a monetary union'' by following a deflationary wage policy (Bibow, 2012), and some have even called it a ''mercantilist'' one (Cesaratto, 2010; Cesaratto and Stirati, 2011). Thus, Germany's continued maintenance of a high trade surplus has imposed excessive costs on other eurozone partners (and especially on those who need an internal devaluation in real terms) by failing to take expansionary measures and not allowing increases in its imports. In short, Germany has been implementing measures to maximize production and minimize consumption, achieving full employment by keeping prices and wages down.

Although the existence of a deliberate strategy by Germany may be doubted, it is, however, true that the euro system exhibits a similar asymmetry to that of the gold standard. Under the latter system, to increase the amount of money, countries needed to previously swell their gold reserves, but having more gold available did not forced them to augment their money supply. In fact, as argued above, Keynes drew attention to the failure of the Federal Reserve regarding the requirements arising from gold inflows and as reserves increased they were sterilized. Similarly, in the current European single currency, debtor countries are forced to reduce their deficits, their prices and wages, but, on the other hand, creditor countries are not required (and, actually, do not) to take expansionary measures.

An additional factor to consider, and one which obviously differs from the 1920s, is found in the origin of the monetary union that was established by the major economies of the EU (except, precisely, the UK) and culminated in the introduction of the euro. This factor is the failure to consider the lessons derived from the theory of optimum currency areas (Mundell, 1961), in which the requirements to be met to form a monetary zone are described. Thus, apart from countries having similar economic cycles and mobility of capital and labor; mechanisms are also required to share the risks through, for example, the existence of a common fiscal and banking authority. In fact, the use of a currency, such as the euro, with no tax authority implies the loss of monetary sovereignty within the Economic and Monetary Union (EMU) without any clear counterpart being in place.[15]

Mundell's hypothesis was used by some critics of the euro to point out that the countries that were forming the monetary union were sufficiently different as to be subject to asymmetric shocks in the future evolution of this union. What they did not expect was that economic policy measures implemented by the EMU member countries would be basically the same, regardless of the phase of the economic cycle that was happening in each country. So, as all countries shared the sole objective of budgetary consolidation and austerity, a second recession was generated.

3. *A tract* and after

The instability of the British monetary system in the years following the end of WWI was characterized by an inflationary boom that once broken in 1920, gave way to a recessionary situation, with ups and downs that lasted

[13] ''With the existing distribution of the world's gold, the reinstatement of the gold standard means, inevitably, that we surrender the regulation of our price levels and the handling of the credit cycle to the Board of the Federal Reserve of the United States''(139).

[14] The monetary measures (traditional or not) taken lately by the ECB and, above all, the Fed did not cause increases in inflation or interest rates. On the contrary, prices have been closer to deflation and the price of money has been reduced to its lowest level in recent history.

[15] The stability and growth pact in Europe has an explicit no-bailout clause between the signatory countries.

almost until the beginning of WWII. The recession was so long largely due to the deflationary policies followed by the British government. These policies were aimed at achieving the return of the pound to the convertibility of pre-war parity. This was even more necessary after its effective restoration (April 1925), due to the overvaluation of the exchange rate.

There are parallels to the current situation in the eurozone. Maintaining an overvalued exchange rate of the euro, as several countries in southern Europe currently have, is forcing them to carry out a real drop in prices and wages.[16] However, history has shown us that these reductions require extended periods of time to complete the task. Hence, the objective would be much faster to achieve if, as Keynes argued, a country was not obsessed by fixing the external value of its currency and could, if necessary, devalue when required by the situation of its real economy – something that obviously cannot be done within a Monetary Union. Moreover, this task would also be faster (and much less damaging in terms of employment) if northern Europe and, in particular, Germany took expansionary measures and not accompanied by policies of fiscal consolidation, thus hampering economic growth in southern Europe.

In addition, Europe continues to focus its economic measures on controlling non-existent inflation, which has not appeared in recent years. It is true, however, that the differential in interest rates between countries in the single currency rose to convert a (serious) problem of balance of payments and private debt into a problem of public deficits and sovereign debt. This has required austerity policies and the consequent curtailment of economic growth. In short, it has become a widespread crisis due to both a misdiagnosis and the use of insufficient European ''medicines'' to mitigate the recession in Europe.

Keynes's analysis introduced a new aspect in 1924: the differentiation between ''sheltered'' industries which do not compete with imports, and ''unsheltered'' ones, i.e., those open to international competition (Keynes, 1924b, 221; 1925a, 208–211). This distinction was important since wage costs had led to a reduction in exports, damaging the industries producing tradable goods and reducing production and employment in these industries. Under these conditions, Keynes proposed public works that would alleviate unemployment. From his point of view, these works might absorb part of the capital that was heading abroad in search of more profitable investments. Moreover, this would soften the reassignment of workers by providing jobs for those who were suffering most from the crisis in export industries. In turn, this would facilitate a structural change that would end up prioritizing those sectors that directed their production exclusively to the domestic market.

In 1924, Keynes began defending government support for projects with ''high costs and moderate profit'' and sharing the risk with private capital. Specifically, Keynes rejected that only subsidies should be granted to interest rates. On the contrary, he argued for the need to reduce the uncertainty associated with major infrastructure projects, which could not attract private capital because of their relatively low profitability except with the help of state intervention (Keynes, 1924a, 229–230).

The depth of the changes as a result of WWI can be seen in the transformation undergone by Keynes himself, who in 1913 held that an industrial economy exhibited a tendency to over-investment, induced by the banking system (Keynes, 1913),[17] whereas in 1924, he was more concerned by the lack of domestic investment opportunities and in reducing exportation of capital.

The return to the gold standard in April 1925, restoring the prewar parity between the pound and the dollar, meant, in fact, a reevaluation of at least 10% at that time.[18] This made it necessary to contract the volume of credit in order to obtain a reduction in prices and salaries: ''The policy can only attain its end by intensifying unemployment without limit, until the workers are ready to accept the necessary reduction of money wages under the pressure of hard facts'' (Keynes, 1925a, 218).

One thing to consider was that monetary policy requiring the return to the gold standard would be more damaging to unprotected sectors of international competition; precisely those who already paid reasonable wages,[19] probably due to increasing levels of unemployment. By contrast, in the sheltered sectors, it was very doubtful that the wage reduction required could be achieved.

The restoration began in 1925 and ended in September 1931 with the final departure of the pound from the gold standard, and its subsequent devaluation. Even so,

> ''the British Economy did not recover in 1932 ..., British production stagnated. Though not lifting Britain out of the Depression, devaluation lifted it out of the contraction. The Depression was not shorter, but it was milder than in other countries. This was due in part to the continuation of deflationary policies in Britain, even after the need for them was gone. Both Germany and Britain fought an inflation that did not exist (Robbins, 1934; Kindleberger, 1986, 158–164).'' (Temin, 1989, 82).

The focus of *A Tract* on stabilizing prices was due, as we have seen, to Keynes's belief that the central bank could act on the public's expectations regarding the evolution of prices. The bank rate had proven very effective in 1920 in the credit crunch and, in fact, it had helped

[16] The serious difficulties experienced by some euro countries stemmed from factors that have affected in varying degrees each country: a housing bubble, a high current account deficit that allowed financing at very reduced costs of the said bubble, a consequent expansion of bank balance sheets and a large increase in short-term public revenues, as the latter was linked to the construction sector and to real estate and financial activities.

[17] This position seems to have been taken under the influence of the work of Robertson (1915).

[18] Between 1920 and 1925, the pound was revalued by 33%, from $3.66 (Meltzer, 1988, 31).

[19] In reply to questions of the Parliamentary Committee on Industry and Trade, July 9, 1925, Keynes argued that ''it is the wages in the sheltered industries which are the problem, whereas the wages on which you are bringing pressure to bear are in unsheltered industries which are very likely quite reasonable already until the wages of the other industries may be brought down. If you could reduce the wages in sheltered trades that would reduce the cost of living and then you could then legitimately ask the colliers to take a lower wage'' (1925b, XIX, 394).

cause the subsequent deflation. However, the bank rate was clearly insufficient to generate the desired recovery. Keynes, finding that the authorities[20] did not have sufficient capacity to influence long-term interest rates, moved away from purely monetary measures; something which is already apparent in the *Treatise*, but which is more noticeable in the *General Theory*.

We must make an important caveat: Keynes thought that the problems of British industry were derived almost exclusively from the overvaluation of sterling. However, this view was overly optimistic as some of these problems were deeper; in fact, many British companies had become obsolete. Keynes does not seem to have realized the significance of microeconomic factors to understand the competitive difficulties Britain's economy had to face, since the country was losing ground to other more modern and productive industrial structures. In fact, British industry exhibited a dearth of entrepreneurial impulses to develop the competitive factors necessary to return to a path of growth.

The international financial crisis and its impact on the eurozone have shown deficiencies in how the EMU functions. Thus, the replacement of national central banks by an institution like the ECB, which does not meet several of the key functions that had been performed by national central banks, has prevented better management of the euro. This has been revealed in the performance of the ECB both in setting the interest rate as well as by its lack of concern about the exchange rate or about the deficit problem of eurozone governments. Thus, the behavior of the ECB has not been the traditional one of a central bank; in fact, there have been marked differences in its performance compared to other central banks.

As in the 1920s, the eurozone situation today is such that the monetary and banking problems need to be addressed, as these must be solved as soon as possible. Choosing a strategy contrary to economic growth has caused liquidity problems that have become solvency problems, thus making it even more difficult to recapitalize banks and normalize the credit situation to sustain domestic demand. Growth of demand still appears to be difficult as there continues to be emphasis on wage deflation and austerity.

The role of Germany and other northern European countries has become crucial in forcing indebted countries to rely solely on growth in external demand. In turn, the curtailment of this growth due to widespread austerity policies has led to an extension of the difficulties which derive from the fall in GDP (Mastromatteo and Rossi, 2015). For example, the end of high deficits in the current account balance had to be carried out mainly by way of reduction in imports rather than by increasing exports, as a direct result of European recession.

The imposition of the austerity policies in the EU has led to Europe as a whole to depend on the evolution of external demand from the rest of the world. So the EU has also failed to meet its international commitments in relation to taking measures to enhance economic growth. This behavior has been widely criticized for its negative impact on the international economy, as Europe is ''too big too fail'' and thus is generating increased global risks, not to mention the difficulties that the EU is imposing on the least developed countries of the world.[21]

4. Concluding remarks

Unlike other studies conducted in recent years, which focused on Keynes's *General Theory*, this paper has emerged from a review of Keynes's first major economic work. This review of *A Tract* has led to the idea that the eurozone shows some characteristics that resemble the gold standard system. Thus, for the operation of both these monetary systems, the existence of a central bank that could implement discretionary policies was not considered necessary. Although many believed that the ECB would act as the Federal Reserve, to the contrary, its behavior has shown a great automatism. In addition, its unfounded fear of inflation, due to its commitment to the quantity theory, has curtailed, until recently, the use of countercyclical measures.[22]

Even the return, in 2011, to a recession with high unemployment did not prompt European economic authorities to use Keynesian fiscal policies. Reducing rising unemployment was not the primary objective of EU action; on the contrary, the problem that focused the attention of the authorities were public deficits. This was clearly evidenced by the most vigorously pursued economic policy by the EU and European governments, which has been one of fiscal consolidation, in a context of defense of austerity.

Keynes believed that the economic system of the nineteenth century had definitely gone bankrupt with the advent of the war and, above all, with the ''economic consequences of the peace''. Thus, he concluded that an economy of ''individualistic capitalism'' would no longer work without the direct, rational and methodical intervention of the monetary authorities. Moreover, Keynes thought it was possible to design a new institutional framework where private economic agents could perform efficiently. The main obstacles to the reforms Britain needed were the prejudices and beliefs that governed the behavior of economic agents and, especially, economic and political leaders. Still, Keynes believed in rational ''persuasion'', i.e., in an intelligent discussion to change the ideas of those in charge of British society.[23]

Keynes considered that the ''evils of uncertainty'' inherent in a modern monetary economy could be corrected through decisive action by the authorities and by assuring economic agents that the main purpose of any policy

[20] For a study of the evolution of the practical advice given by Keynes in the twenties, see Howson (1973) and Moggridge and Howson (1974).

[21] ''Turning Euroland into the ''sick man of the world economy'' creates a global ''too big too fail'' threat and corresponding moral hazard that is challenging the global community to the utmost''. (Bibow, 2012).

[22] Unlike the Federal Reserve, the ECB is the bank of a monetary unión made by different and divergent countries.

[23] Rationality was a hallmark of Keynes's personality; also he supposed rationality in others, and that led him to reject the dictates of tradition or mere chance in the government of human beings. In fact, even if we had achieved an institution, such as the gold standard, functioning properly, being dominated by its automatism was not for Keynes the most desirable situation.

measure would always maintain stability of prices. Thus, there would be a reduction in uncertainty ''for the substantial period between the beginning of production process and the consumer getting the goods and paying for them'' (1924a, 184—185).

The need for adequate monetary management of the economy also appeared in the *Treatise* and the *General Theory*. However, in the *General Theory* ''the central controls'' left aside the monetary variables to focus more directly on the evolution of investment as the determining variable of production and employment in an economy. In his writings, Keynes never questioned the ability for microeconomic adjustment of a market economy, generally accepting Marshall's analysis (1936, 378—379). Thus, in the opinion of Harrod, Keynes:

> ''had never believed that his doctrines about aggregate demand and full employment were incompatible with the classical doctrine according to which, given a suitable structure, private enterprise and the international division of labor ensured optimal allocation of productive resources.'' (Harrod, 1968, 420).[24]

Another aspect of Keynes's analysis that distinguished it from other approaches on the study of the fluctuations was his view that the main problem of an industrial economy was in the uncertainty in which individuals had to move. Thus, in the *General Theory*, it was the ignorance and uncertainty about the future that made individuals demand an excessively high price for liquidity. In fact, the relatively low expected return of many investment projects would not cover the payment of the comparatively high liquidity premiums. Furthermore, as argued in the previous section, Keynes began to propose ''risk-sharing schemes'' to justify public intervention, which, in any case, should be designed to support investment, not consumption. However, he does not seem to have justified a permanent increase in public spending to maintain a high level of demand, especially if this level is achieved through growth in social spending.

Keynes believed that government intervention was the only way to get to the British economy out of the deflation in which it found itself. Thus, he considered that a stabilization policy would generate greater flexibility or, at least, increase the absorption capacity of the savings generated internally, which were going abroad. Here we can find one of the reasons why today many think that Keynesian policies would not be feasible: the size of the welfare state has reduced the effectiveness of stabilization policies.

Additionally, that something is justified, or even desirable, like government intervention, did not mean that it was possible or convenient to act accordingly. The rejection of *laissez faire* as a dogma was in fact in line with the Cambridge tradition, but the difficulties inherent in state intervention were also highlighted. Keynes, however, did not think that the costs of intervention were going to be so high; in fact, in most instances, he saw them being small compared to the social benefits obtained from such intervention. A position which, as mentioned above, was very favorable to the possibilities of economic engineering.

Keynes's standpoint on the costs of economic management was very close to rationale already discussed. Thus, he believed that society could not, with the level of scientific and technological development achieved, allow itself to be dominated by the forces of nature. On the contrary, it was possible to govern if ''thinking clearly'' and with ''greater clarity'', and making better use of the knowledge available to tackle the root causes of social problems. To achieve this, the British enlightened elite would have to persuade and guide public opinion toward the right targets. Keynes believed, therefore, that the responsibility for public affairs should rest with the intellectual aristocracy, who were really responsible for the political and economic functioning of society.[25] Therefore, the automaticity of mechanisms could not be used as an excuse, such as the system of the gold standard, which supposedly could not be controlled consciously and directly by human will.

Keynes's confidence in rational discussion and persuasion leads to a final point that ought to be highlighted about his thinking: his assumption that it was possible to change the beliefs and motivations of individuals. Repeatedly, Keynes showed great hope both in individuals' capacity of understanding and their capacity to change their behavior. A trust that was demonstrated at that time, as excessive; for example, the widespread belief in the goodness of the British monetary system of the nineteenth century only disappeared by the force of economic phenomena that seemed uncontrollable, like the Great Depression of the 1930s. By contrast, Keynes seemed to believe that both the capacity to reason and the flexibility to adapt to new circumstances[26] were common characteristics of humankind or, at least, the governing elites.

Nowadays, the EU economic authorities seem to have given up on interventions that go beyond ''saving the euro'', which means implicitly that they have agreed to keep the poor institutional design with which EMU was created. Attempts to launch a tax authority and even, more modestly, to go toward the establishment of a banking union are still being put off. Thus, the possibility of improving both the economic union of Europe as well as turning the ECB into a real central bank to ensure the effectiveness of the monetary management of the economy is still rejected.

The flexibility demanded by Keynes in his time does not seem to have been precisely one of the characteristics shown by European policymakers during the recent ''Great Recession''. On the contrary, after a first phase of clear bewilderment at the speed and virulence with

[24] Harrod continued saying that, in the thinking of Keynes, such optimal allocation depended on an adequate supply of international liquidity, i.e., a greater supply than that existing before the war¨(1968, 420), referring to WWII and the position Keynes defended in the long negotiations that led to the Bretton Woods agreements.

[25] ''This romantic view of the possibilities of selfless action by moral individuals acting in the public interest, and the neglect of incentives that reinforce personal codes of conduct, is characteristic of much of Keynes's political thinking throughout his life'' (Meltzer, 1988, 37).

[26] ''Keynes was unusually quick and flexible-both in his mental reactions and in the policy positions he adopted ... Keyneś flexibility and fine-tuning propensities ...'' (Friedman, 1983, 36).

which the international financial crisis became a general economic crisis, most of these authorities have taken refuge in their own ideas about the need for greater or less public intervention, deriving their actions from ideological positions. Thus, the actions taken, on numerous occasions, ignored what was actually required by the real economy, and any economic policy measures that have been taken have been slow and insufficient to resolve the problems of the eurozone.

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