Keynes and India, 1909–1913: a study on foreign investment policy

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1. Introduction

When we think of Keynes in relation to India, the first things that come to mind are his first job at the India Office in London and his book Indian Currency and Finance (ICF) (Collected Writings of John Maynard Keynes [CW], vol. 1; see Keynes 1971–1989). Keynes entered the India Office in October 1906, leaving in June 1908 to become a lecturer at Cambridge. The book came five years later, together with his appointment to the (Austen Chamberlain) Royal Commission on Indian Finance and Currency. This paper focuses on the period in-between, examining Keynes’s irregular but never interrupted research work on India after June 1908.

The man who left the India Office in 1908 was a mathematician deeply interested in the logic of probability. As an economist, he could only rely on his talent and a brief but significant ‘apprenticeship with Marshall in 1905’ (Raffaelli 2000). According to Skidelsky, he had very much to learn ‘on the job’ (1983: 206), and Moggridge observed that the Indian administration could offer valuable learning opportunities: ‘the problems on which Keynes could cut his teeth were, fortunately, Indian. […] [T]he matter of appropriate monetary arrangements for India was one of the most discussed issues among British monetary economists’ (Moggridge 1992: 201). This observation finds indirect support in the works of a small but authoritative group of economic historians who dealt with India, providing significant hints about Keynes’s activities before the war. A similar emphasis on India echoes in De Cecco’s Money and Empire (1974), where continuous references to ICF are made. More recently, Keynes’s name has become

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ubiquitous in three major works on Indian economic history by A. K. Bagchi (1989), Nabendu Sen (1992) and Sunanda Sen (1992). Although sometimes criticising him and the whole imperial establishment from an ethical point of view, these scholars have all unanimously acclaimed Keynes for his monetary analysis, in their perspective a privileged source of firsthand information and thorough interpretation. To my knowledge, Anand Chandavarkar is the only one who dedicated a book to Keynes and India (1989) as an independent issue, but he could not avail himself of the works by S. Sen and N. Sen (both issued in 1992), nor, do I think, of Bagchi’s contribution (published in the same year as Chandavarkar’s book). Apparently, he also made no reference to De Cecco. This paper instead, by focusing on the pre-war years, re-considers the subject initiated by Chandavarkar from the different point of view of the other scholars.

The Anglo-Indian relations in the age of empire have always been a matter of controversy. India is considered a case of imperial exploitation characterized by an unreciprocated ‘drain’ of resources from the colony or, alternatively, as an example of local development fostered by British rule and the influx of capital from London. Limiting our attention to the authors mentioned above, we find that De Cecco and Bagchi are very straightforward in adopting the former view, while N. Sen and S. Sen are more prudent in reviving the old nationalist claims of Dadabhai Naoroji and Romesh Chunder Dutt. Looking at India from Keynes’s viewpoint, Chandavarkar preferred to pay little attention to the drain thesis, on the ground that it ‘did not excite Keynes’s interest which was always in specific topics rather than in grand themes like metropolitan exploitation of the colonies’ (1989: 39), an approach that has been criticized in Skidelsky’s (1990) review of Keynes and India: ‘[i]t is hard for Indian economists like Chandavarkar, who have succumbed to the charisma of Keynes, to understand that their love was largely unrequited’; Keynes’s ‘connection with India was fortuitous; he never visited India; he had no interest in Indian culture, and he accepted without question the economic benefits of British rule’ (Skidelsky 1990: 1331–2). Whatever the case, the position expressed in this paper is that Keynes’s ideas bore consequences in India as well as in London, and that they can be properly assessed only if both the Indian and the British viewpoints on the question are taken into consideration on an equal footing.

Following this method, it is curious to discover that the celebrated author of A Tract on Monetary Reform and The Economic Consequences of Mr Churchill began his career with a defence of the rupee exchange rate stability, pursued via a rigid gold exchange standard, at the relevant cost of strong internal price fluctuations in India. As will be argued presently, this
outward contradiction depends more on the specific context than on a change of Keynes’s mind. For Keynes, the spell of inflation in the years 1903–1907 and the final steps towards a fully-fledged gold exchange standard in India are strictly related to the flow of capital from the motherland to the colony. More specifically, it is my contention that Keynes’s monetary analysis was based on the assumption of the economic relations between the two countries, and that these relations represented, for Keynes, a case of foreign investment policy implemented by the British Government in order to drive private British capitals into the colony. In a period of strong fluctuations in the relative value of the precious metals, the rationale of Keynes’s preference for exchange rate stability is that the exchange rate of the silver rupee in terms of gold sovereigns was a fundamental factor of the risk of investment.

The main difficulty with this account is that Keynes never expressed it in a succinct essay. It can be found neither in ICF nor in the works that preceded the book. Instead, it must be gleaned from different (and sometimes unrelated) sources. What follows is a preliminary survey of the main sources from which the above account will be derived.

In an article on ‘Recent Economic Events in India’ (CW, vol. 11: 1–22), which appeared in the *Economic Journal* in March 1909, Keynes attributed the spell of Indian inflation in the years 1903–1907 to the actual functioning of the gold exchange standard. Nonetheless, Keynes defended this system on the ground that the inflation was the side-effect of a continuous flow of money-capital, a huge amount of resources employed in the development of the colony. But every coin has two sides. The other side of the same coin was that England actually needed to invest abroad. At least, this is what Keynes thought at the time. His correspondence with *The Economist*, published early in 1909 (CW, vol. 15: 20–21), shows that, in the same weeks in which ‘Recent Economic Events in India’ was issued, the Cambridge economist was deeply involved in the assessment of British investments abroad, and particularly in India. One year later, in ‘Great Britain Foreign Investments’ (GBF) (CW, vol. 15: 44–59) – an electioneering article occasioned by the political debate on Chamberlain’s Tariff Reform campaign, issued in February 1910 in the *New Quarterly* – Keynes explained that it was in the interest of an old country to find new fields of investment abroad, especially if this could be done within the empire. GBF (CW, vol. 15: 44–59) is only an occasional paper, but the indication it provides is susceptible to further development. Moreover, even though there is no explicit link between the article on the Indian inflation and the one on British investments overseas, when they are taken together the two papers provide the background information for a more thorough understanding of ICF.
As is well known, a new model of gold exchange standard, managed through an ample and well-designed system of reserves, is the main topic of Keynes’s first monograph. In ICF, however, the British need for new fields of investment was perhaps taken for granted, while the Indian inflation and its consequences on the Indian people seem to disappear behind the conceptual framework of the longstanding discussion on monetary issues that occasioned the book. The theoretical context of ICF was the debate that followed the abandonment of the bimetallist project in 1893, a situation in which the echo of the Indian protest against inflation was scarcely perceived in London. Price fluctuations in India, as Keynes and the India Office saw them, depended on the inadequacy of the local financial institutions combined with the need to keep the exchange rate as stable as possible. With regard to the latter point, the crux of the matter was that the debtor nation (India) was on a silver basis while the creditor nation (Britain) was on a gold standard, and the relative price of the two metals was continuously fluctuating. Before the Chamberlain commission was formed, Keynes focused exclusively on the rupee external value and its stabilization. As I try to show in this paper, the reason Keynes did so is not only that he underestimated the consequences of the Indian inflation, as Chandavarkar (1989: 39–40) has shown, but also that the exchange rate was the fundamental price in the eyes of the British investor.

The scattered utterances that can be traced in ICF, the Keynes Papers (KP), and in volumes XI and XV of the CW, show that India was, in the eyes of Keynes, a significant outlet market for British capital. But there is further evidence on this point, which is to be found outside Keynes’s works and papers. In their attempt to reassess the drain thesis, N. Sen and S. Sen have shown the element that does not emerge in Chandavarkar’s book; namely, the India Office was becoming more and more active in the collection of funds in England to be invested in India, mainly in railways and other infrastructures. It is enough to compare this indication with the evidence available in the CW and in the KP to show that the young economist was a conscious and precious partner of the India Office in implementing this policy.

This paper speaks of Keynes’s first participation in a scheme of government intervention emphasizing that the problems on which he ‘could cut his teeth’ were not limited to high-level monetary engineering. Indeed, dealing with Indian monetary issues entailed a more general view of the British economy and its position in the world markets. Before entering Keynes’s analysis, the next section presents a brief account of the years preceding the publication of ICF and an overview of the debate in which Keynes participated from 1909 to 1913; Sections 3 and 4 consider Keynes’s analysis of the Anglo-Indian economic and monetary relations
within this context; Section 5 is a review of ICF in the light of the new perspective presented in this paper. In the last section, some conclusive remarks are given.

2. British and Indian perspectives on the thorny path of the Indian gold exchange standard

The reason Keynes is unanimously celebrated by economic historians nowadays is that he succeeded in making sense of the Indian monetary history at the turn of the century. When the evolutionary path of international monetary arrangements was determined by a continuous fall in the value of silver and a process of financial integration between nations (De Cecco 1974), the state of the art of Anglo-Indian monetary relations consisted of two partially contradictory Reports – submitted by the Hershell Committee and the Fowler Committee during the 1890s – along with the ongoing practice of the British Raj and its effort to adapt to unfavourable conditions. As Tomlinson (1993: 13) observed, ‘India was the largest purchaser of British exports, a major employer of British civil servants at high salaries, the provider of half the Empire’s military might, all paid from local revenues, and a significant recipient of British capital’. In these circumstances, the fall in the value of silver was felt as an additional burden on the Indian revenues:

The Government of India have yearly to remit a large sum to this country [UK] in discharge of their gold obligations. In 1873–74, before the fall [of silver] commenced, the amount remitted was £13,285,678, which at the rate of exchange of 1s. 10/351 d., was represented by RX 14,265,700. During last year [1892–93] the amount remitted was £16,532,215, which, at the average rate of exchange in that year, viz. 1 s. 2/895 d. required payment of RX 26,478,415. If this could have been remitted at the exchange of 1873–74 it would have needed only RX 17,751,920. The difference is thus RX 8,726,495. (Report of the Committee Appointed to Inquire into the India Currency, known as the ‘Hershell Committee’, HMSO, London, 1893; quoted in De Cecco 1974: 65)

The home charges, as the bulk of remittances was called, represented a debt contracted in gold that was to be met collecting silver rupees. The decision to suspend the free coinage of silver came in 1893, after ‘the breakdown of the negotiations for bimetallism’ (ICF: 1), followed by some contradictory resolutions about how to link the Indian currency to gold. In 1892, the Hershell Committee had pronounced themselves in favour of gold standard without gold circulation. But, immediately after 1898 – when

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1 A detailed account of the currency history of India up to 1900 is available in Brahmananda (2001).
the Indian government finally succeeded in raising the gold value of the rupee at the parity of 1s. 4d. (15 Rs. for £1), which was considered a satisfactory level – the Fowler Committee advocated the adoption of gold standard with gold circulation. Nor was this decision definitive. An attempt to introduce gold into circulation was effectively made in 1899, but the project was definitely dropped in February 1903, this date representing a watershed in Indian monetary history. After 1903, and quite erratically, the system finally reached an equilibrium that was not a classical gold standard, but a gold exchange standard:

The rupee remains the local currency in India, but the government take precautions for ensuring its convertibility at an approximately stable rate. The stability of the Indian system depends upon their keeping sufficient reserves of coined rupees to enable them at all times to exchange international currency for local currency; and sufficient liquid resources in sterling to enable them to change back the local currency into international currency, whenever they are required to do so. (ICF: 7)

The renouncement of gold circulation, together with the corresponding decision to concentrate on alternative devices for exchange rate stabilization, had been under way since 1900, when the procedures regulating the emission of the so-called Council bills were amended.

The Council bills were introduced in 1861 as a cheaper and safer means of payment. They enabled merchants and bankers, and the public administration as well, to effect their payments without any transhipment of treasury. The bills were sold for sterling in weekly auctions at the Bank of England. The receipts of each allotment remained on the Secretary of State’s account at the Bank, while the bills were sent to India and here converted into rupees at the expense of local revenues. In 1900, the Council bills system was integrated into the gold exchange standard:

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2 Placed at the head of the India Office, the Secretary of State for India in Council was the member of the British Cabinet responsible for the Government of India.

3 ICF provides an account of how the whole business was carried out in practice: ‘The home charges […] amount to £19 million or £20 million annually. But the amount which it is necessary to remit, apart from extraordinary remittances […], is usually less than this; for the amount of new capital raised by government in England usually exceeds their capital expenditure in this country on repayments and on railway materials, etc. Thus the amount which it is necessary to remit to England annually is from £15 million to £18 million. Rupees to this amount, being part of the revenue from taxation, etc., accumulate in the Indian treasuries. This value is remitted to England by selling for sterling in London bills which can be cashed in rupees in Calcutta. Thus the government of India pays out rupees in Calcutta when the bills are presented, and the secretary of state’s balances at the Bank of England are swelled by a corresponding amount’ (ICF: 72).
Up to 1900 the volume of sales of Council bills in any year was mainly governed by the amount required to defray the home charges [...]. Since 1900, however, the functions of the Council bills system have been enlarged, and it has now become a very important part of the general mechanism for the maintenance of the gold exchange standard. (ICF: 75)

With an unlimited issue of bills, the Secretary of State could control the exchange market. But there were difficulties connected to this scheme. Whatever the demand for rupees, the Council bills price could not change, because the Indian government was in any case compelled by law to change sovereigns at a fixed par, making it convenient to buy Council bills only if their correspondent rupee value was not lower than the fixed rate of exchange. The unlimited supply of Council bills was exactly conceived as a way to fix the gold value of the rupee, but the conversion of bills was financed by local revenues, which were obviously not unlimited. A second kind of difficulty emerged in years of bad trade, when the demand for bills was too low to keep the fixed par (see below, Section 3). Last but not least, in addition to these technical pitfalls there was a lack of transparency, because the ongoing practice was in contrast with the pronouncement of the Fowler Committee.

According to the Fowler Committee prescriptions, India should have absorbed gold for internal circulation. In ICF, Keynes explained this incongruity as the inescapable remedy for a wrong analysis, also providing an account of the attempts that had actually been made to introduce gold into circulation (ICF: chap. 4). It is maintained in ICF that they failed because the Indian market was not able to absorb gold, and Keynes provided evidence that the project was opposed by the powerful Treasury officials, in this way relieving the India Office of any responsibility. Thus, once it was made clear that gold circulation was neither expedient nor feasible, the gold exchange standard turned out to be the only solution. Keynes made no attempt to make Indian monetary policy consistent with the Fowler Committee prescriptions, nor did he consider the whole question from the broader point of view of the City, as the Fowler Committee and the Hershell Committee had done before him. Moreover, it is worth noting that there was also an Indian point of view on the whole matter.

Although the best available at the time, Keynes’s interpretation was inevitably biased. According to Bagchi and De Cecco, it was only representative of the India Office view. From the City point of view, for instance, any resolution relative to gold circulation in India had important

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4 In this case it would have been worth while to send gold to India. For the details of these operations, see Keynes (ICF: 75).
consequences on the world distribution of the metal and its market value. In turn, the City point of view may be in accordance or in contrast with the Indian interests. Thus, when the gold discoveries in South Africa raised the world supply during the 1890s, the City concern for the value of money momentarily matched the Indian nationalistic claim for a classical gold standard, gold circulation being a sign of independence in the eyes of Indian public opinion. But the Second Boer War (1899–1902) rapidly changed the situation, and when ‘the Bank of England’s gold reserve fell to an all-time low, the decision to introduce gold into Indian circulation began to look peculiarly ill-timed’ (De Cecco 1974: 69). After the Boer war, the City could no longer afford to let gold flow into India.

The whole topic becomes even more complicated when we examine the economic significance of the home charges and their legitimacy. In the India Office view, the home charges were the remuneration for the use of capital and commodities, and for the services of the administration as well. By contrast, other observers considered the annual remittances as an unreciprocated ‘drain’ of resources. A few years before Keynes entered the scene, this view was authoritatively expressed by Romesh Chunder Dutt, the president of the Indian National Congress for the year 1899 and a former member of the Indian Civil Service, who retired to become lecturer in Indian History at the University of London.

In the preface to the first edition of his *Economic History of India* in 1902, Dutt raised the far more general question of Indian economic decay under British rule, a negative trend in which the introduction of the home charges represented only the latest stage of a secular regression:

... the East India Company ... considered India as a vast estate or plantation, the profits of which were to be withdrawn from India and deposited in Europe. They reserved all the high appointments in India for their own nominees seeking a lucrative career in the East. They bought their merchandise out of the revenues of India, and sold it in Europe for their own profit. They vigorously exacted from India a high interest on their stock-in-trade. In one shape or another all that could be raised in India by an excessive taxation flowed to Europe, after paying for a served administration.

The East India Company’s trade was abolished in 1833, and the Company was abolished in 1858, but their policy remains. Their capital was paid off by loans which were made into an Indian debt, on which interest is paid from Indian taxes. The empire was transferred from the Company to the Crown, but the people of India paid

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5 ‘This theory, which was vigorously advanced by Indian analysts and economic historians like Dadabhai Naoroji and Romesh Chunder Dutt was also supported by radical British observers like John Strachey, as well as some British officials like Richard Wingate and historians like [James] Mill’ (Chandavarkar 1989: 38).
the purchase-money. The Indian debt, which was £51,000,000 in 1857, rose to £97,000,000 in 1862 [...] and now (1901) amounts to £200,000,000. The ‘Home Charges’ remitted annually out of the Indian revenues to Great Britain have increased to sixteen millions. The pay of European officers in India, virtually monopolising all the higher services, comes to ten millions. One-half of the net revenues of India, which are now forty-four millions sterling, flows annually out of India. (Dutt 2000: xiv–xv)

This classic picture of the Indian economy under the British Raj, along with the drain thesis, have been revived (Bagchi 1982, 1989) and sometimes reassessed by modern Indian historians. A clear result of these more up-to-date and accurate investigations is that – at least from a strictly economic point of view, and apart from the consideration that British capital was a resource that the Indian people never decided to purchase – England was in fact investing in India. More to the point, it clearly emerges that the Indian Government played a very active role in raising funds in England to be invested in the colony. Finally, there is evidence that Keynes was perfectly aware of what was going on.

Nabendu Sen (1992) attempted a closer analysis of the Indian debt and its composition over the second half of the nineteenth century and at the beginning of the twentieth century. The local government contracted debts both in sterling and rupees. The sterling debt consisted mostly of foreign productive loans for which the government offered a guaranteed yield. The rupee debt was contracted in prevalence with foreigner creditors as well, but at a higher rate of interest, paid as a sort of insurance against exchange fluctuations. Railways were the main field of investment and the object of increasing state control. Until 1880, railways were controlled by private stock companies, which could invest the funds raised in England exclusively under government permission. This indirect control was requested by the government as a *quid pro quo* for the 5% yield guaranteed to the British investors, and during the 1880s it became direct. The new contracts included a government option to buy the shares at their market value. As time went by, the government took up many of these options, spreading the disbursement of money over a period of many years, the annual remittance of which became part of the home charges together with the guaranteed yield of both public and private investments. N. Sen estimated at £18.9 million the average level of the home charges for the period 1899–1913: more than one-third of this sum (6.9 million) was spent on account of railways and irrigation; 4.1 million for military expenses (including pensions); 2.5 million for the maintenance of the administration; and 2.5 million as interest on the debt (N. Sen 1992: 51). These figures can be compared with the statistics available in the KP for the year 1907–1908: the total net revenue for this year
amounted to £50,744,208, including £19,104,638 from Land Revenue and a total of £22,229,805 from indirect taxation on various items (salt, stamps, excise, provincial rates, customs, assessed taxes, registration). The total net expenditure was £49,154,868, including £20,137,484 under military expenses and £20,934,818 for civil services (civil departments, miscellaneous civil charges, civil works including railways). The main headings under public works are railways and irrigation. According to the figures that Keynes conserved, on 31 March 1907 the permanent debt on railways amounted to £168,344 million, while the debt on irrigation works was around 28 million (KP: IA/3; see Keynes).

Dealing with the same issue of British investment, Sunanda Sen (1992) re-examined the traditional drain thesis, compared with the imperialistic apology supported by Keynes amongst others. Sen confirms that there was an ‘expropriation and transfer of surplus’, and that ‘almost the entire amount of the home charges could be regarded as unilateral transfer from India’ (S. Sen 1992: 15 and 18), pointing out that the traditional drain thesis was nonetheless ‘formally invalid’, as it assumed a completely ‘unilateral transfer’ (S. Sen 1992: 18) that is contradicted by the available evidence. Although India had never asked for anything, England was investing in her colony: ‘For Keynes, inflow of long term capital into India was solid evidence of what could be characterized as a “reverse” drain of wealth from England’ (S. Sen 1992: 18).

In Keynes’s perspective, Great Britain was heavily investing in the colony. As a supporter of the government in power, and an ex-member of the India Office staff, he shared a positive opinion of this policy, notwithstanding the fact that it committed the public administration to raise funds in England, invest these funds in the colony, and guarantee an appropriate return to the British savers. He was aware that, in these circumstances, the risk connected with investment was entirely assumed by the government, and that, India and the United Kingdom being on different monetary standards, the exchange rate represented a key factor of uncertainty, enhanced by the ongoing depreciation of silver.

3. Keynes’s earliest view: exchange rate stability versus price stability

Along with the secular question of underdevelopment raised by Dutt, the Indian people had to face more immediate emergencies. From 1903 to 1907 the country experienced a period of strong inflation followed by a severe famine in 1907–1908. The bad harvest, which found the people’s purchasing power already exhausted by the inflation, at the same time caused a collapse of the Indian exports and some very troubling tensions on
the exchange market. Keynes’s first contribution, Recent Economic Events in India (RE; see CW, vol. 11: 1–22), issued in March 1909, dealt precisely with the period of rising prices, the consequent slump in the export trade, and the measures taken by the India Office in order to prevent a fall in the exchange rate.

Although his aim was not to charge the Secretary of State with any responsibility, Keynes was probably the first to ascribe the inflation to the India Office policy. His analysis led to the conclusion that the fixed parity concurred to cause and prolong the upward movement of prices, but he nevertheless defended the gold exchange standard. The reason he could justify such a state of affairs was that, via the Council bills system, a great influx of capital reached the colony, to be employed in the development of the country. Hence, he reckoned the trade-off between exchange rate stability and prices fluctuations, but he considered inflation as a cost that ought to be paid. With respect to the Indian case, he never changed his mind on this crucial point.

RE relied on the available statistics on prices and the volume of currency from 1903 to 1908, considered in the light of an orthodox interpretation of the quantity theory of money. The rise in prices ‘began in 1903’ and became ‘altogether abnormal’ in 1905:

It is at least true that there was a substantial rise in the general level of prices in India during the three years preceding 1908, accompanied by correspondingly large issues of currency. It will now be argued that the recent weakness of exchange and the inability of the Secretary of State to sell his bills has been the natural result of these circumstances. (RE: 9)

In a period of export boom, ‘the sale of Council bills is large, and they can only be met by fresh issues of corresponding magnitude from the Mint. This naturally assists the rise of prices’ (RE, 9). There must be a time, however, when the rise of prices begins to hinder exports, acting as a check on the sale of Council bills: ‘the demand for bills on Calcutta is thus reduced and their price in London falls, and ultimately, if nothing intervened, it would become profitable to exchange rupees for gold and to export gold’ (RE, 9). But something intervened. A reduced demand for Council bills was expected to produce a fall in the sterling value of the rupee, and subsequently an increased rupee value of the home charges. Thus, the 1908 crisis stimulated the introduction of an additional

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6 It would be better to say Keynes’s first signed contribution. In the KP catalogue, an unsigned note on ‘Indian Currency’, which appeared in the Economic Journal of June 1908, is in fact attributed to Keynes (see Economic Journal, XVIII: 323–4; see also KP: A/08).
contrivance in the gold exchange standard management, a safety device to be used in periods of bad trade, when the exchange rate was forced down. The introduction of the so-called ‘reverse Council bills’ provided this device: before ‘it would become profitable to exchange rupees for gold and to export gold’, ‘the Government of India brings into use their reserves, and if necessary, their credit’; contemporarily, ‘the Secretary of State withdraws from the sale of bills in London, and offers bills on Calcutta [the reverse Council bills]’ (RE, 9). All these measures have the same effect of accumulating rupees ‘in the Treasury’ (RE, 9), and at the end of the whole process a significant amount of coins are withdrawn from circulation, with the result of forcing down prices. The connection between the Government intervention on the exchange market and the violent fluctuations in the purchasing power of the rupee in India was clearly admitted by Keynes:

During the whole of this period the exchange value of the rupee may have remained steady in the neighbourhood of 1 s. 4d., but the purchasing power of the rupee in India will have suffered the widest fluctuations. (RE: 10)

Apart from the delicate issue of the Secretary of State’s responsibilities, there was another question that remained unanswered: it took three years and a crop failure before the spell of rising prices could finally check exports, and such a long time in the operation of the transmission mechanism needed some further clarification, which Keynes found in the monopolistic structure of many of the leading Indian export trades:

As India possesses a partial monopoly of many of her staple exports, she can in the first instance reap a considerable profit. Whether or not exports are reduced in quantity, the fall in the total value will not be proportional to this, and it is possible that she may obtain as much or even more than before in exchange of them.

[...] India’s purchasing power over foreign goods, during the recent famine, has been greater than at any other previous period, however prosperous. This is most naturally explained by a high level of local prices combined with a rupee artificially maintained at the usual exchange. (RE: 10–12)

Thus, the monetary expansion could not immediately reverse the trade balance, although it assisted the rise of prices. The next step was to clarify ‘by what means the volume of currency was so rapidly expanded’ (RE, 13). An analysis of the Indian balance sheet led Keynes to connect the inflation both with the balance of trade and with a steady inflow of capital from the United Kingdom, and he finally came to the conclusion that ‘during

7 In 1913, Keynes insisted on the fact that, India being a debtor nation, this instrument was ‘the vital one’ (ICF: 5).
1903–7, the period of abundant coinage, the second of these causes was the more influential in causing the increase’ (RE: 14).

In RE, Keynes sought to defend the India Office at home, where it happened that the Secretary of State’s intervention on the exchange market had caused some disturbance on the City, but the same analysis was also of some use in the ‘drain’ controversy:

The flow of capital into India, which is admittedly of the first importance for the country’s economic development, is always likely to be followed by rising prices; and it is not at all improbable that present circumstances are largely due to such a cause. Indian politicians are fond of ascribing high prices in India to the ‘drain’ through which the government meets its liabilities in England. As a matter of fact, the reverse is the case; the Secretary of State’s need for remittances tends to keep prices low, and it is the influx of foreign capital, the ‘drain’ from England into India, which drives them up. (RE: 22)

Keynes conserved some of those reactions to RE that focused on the Indian side (KP: IC/3). Someone commented favourably (The Pioneer, 9 April 1909), others were of a different opinion:

What we mean by drain is far different from the actual transhipment of money from India to England, but of wealth without any adequate economic return. None has suggested that the drain has raised prices. On the contrary the forcible export of commodities from India to Europe to pay her debts should reduce the price for them which she would otherwise get. (Wednesday Review, 26 May 1909)

Another newspaper, the Madras Mail, did not dispute Keynes’s analysis but its implications. If the account given in RE is correct, it is argued in this review, there is an apparent responsibility on the side of the Secretary of State. Keynes provided a diagnosis that seemed to be likely, but no solution was proposed, and it was hard to be satisfied with the knowledge that such strong inflation was due to an influx of capital invested in the development of the country.

Keynes commented again on the 1908 famine a few months later, reviewing for the Economist the India Office ‘Annual Statement exhibiting the Moral and Material Progress and Conditions of India’ (CW, vol. 15: 34–8). According to Chandavarkar (1989: 39–40), the view expressed in this paper, asserting that the famine was due to a dearth of commodities, represents a misapprehension of famines in India, which were in fact due to a lack of purchasing power. Chandavarkar maintains that this aspect was widely recognized, and that Keynes should have known it. As we have seen above, although it is impossible to ascertain whether or not Keynes was acquainted with writers like Dutt or Naoroji, quoted by Chandavarkar, the KP confirm that he was, still in 1909, a reader of Indian newspapers. Furthermore, in his comment to the ‘Annual Statement’ he did make
reference to the people’s purchasing power, although he had to admit that there were no available figures relative to the rate of wages (see CW, vol. 15: 36–7).

It may be noticed, however, that such unconditional support of the policy implemented by the India Office is even more perplexing if considered in the light of the theoretical surroundings in which it was elaborated. Keynes was a member of the Cambridge school, and ‘[t]his tradition was, in a word, Marshallian […], with a preference for price stability’ (Moggridge and Howson 1974: 227). Yet there is no trace in RE of any proposal intended to reduce price fluctuations, notwithstanding the fact that Keynes himself reported evidence of a 43% increment in food grains prices from 1903 to 1907 (RE: 3). Nevertheless, by taking into account the nature of the Anglo-Indian economic relations, it is still possible to show that Keynes’s attitude was, in the end, not inconsistent with the Marshallian doctrine.

4. Foreign investment policy

Marshall considered price fluctuations from the point of view of their influence on accumulation and investment. He distinguished the two more favourable situations of steady and slow downward/upward movements of prices (which in turn help accumulation or act as a stimulus to investment) from the case of violent and unpredictable fluctuations, which are a chief cause of disturbance. In 1886, he reproduced the analysis of small fluctuations that can be found in Economics of Industry – according to which ‘a steady upward tendency in general prices conduces little more to the general well-being than does a tendency downwards, because it keeps industry somewhat better employed’, while ‘people of all classes […] spend their incomes more wisely when prices and money-wages are falling’ (Marshall 1926: 9) – perhaps putting a greater emphasis on the fundamental belief that ‘[a] great cause of the discontinuity of industry is the want of certain knowledge as to what a pound is going to be worth a short time hence’.

Turning back to India, we must remember that the colony was essentially considered an outlet market for British savings, and that the India Office task was to raise resources at home to be invested in the colony, as well as to

8 On the same occasion, Marshall proposed the adoption of ‘contracts for payments to be made in terms of units of fixed purchasing power’ in order to hamper speculation and support enterprise. Incidentally, before the same commission Marshall presented his version of Ricardo’s ‘Proposals for an Economical and Secure Currency’, later revived by Keynes (CW, vol. 15: 70; see also ICF: 21 and 51).
guarantee a fairly high return to British investors. Once it was decided to keep the two countries on different currency bases, the rate of exchange was the fundamental price that could render the investment of capital in India more uncertain. The more the sterling value of the rupee fell, the more difficult it was for the Indian Government to meet its liabilities in London (included in the bill were interests on funds and annuities that were paid for the shares that had been bought up). On various occasions, Keynes claimed that the Indian economic development could be triggered only by British funds, an additional reason to look after the defence of the exchange rate stability as a matter of overriding importance. Finally, once a safety device for years of bad trade was introduced, the monopolistic structure of many leading Indian foreign trades completed the picture by removing, or at least reducing, a possible cause of disturbance to the Indian balance of trade in case of an upward movement of prices.9 Together with a possible underestimation of the difficulties connected with internal fluctuations, as suggested by Chandavarkar, it seems plausible that price instability was, in the eyes of Keynes, the lesser evil. Or that, in other words, price fluctuations were the cost that ought to be paid to keep the influx of British capital at pace with the Indian demand for resources. Last but not least, Keynes’s conviction that British savings needed an outlet market is another and very important element.

The question about where the increasing British savings should be placed was one of the most debated issues of the time, especially in the dispute between the Liberals in power and the Tariff Reformers. To complicate the picture, heated discussions were also elicited by the lack of reliable statistical information about foreign investment: ‘the issue was one of both statistics – the magnitude of British foreign investment – and policy; that is, whether its size was optimal in relation to its possible benefits for the British economy, a classical problem of political economy’ (Chandavarkar 1989: 32). Keynes himself got involved in one of these discussions. Early in 1909, The Economist published an article on ‘Our investments abroad’, reporting two estimates of the exported capital. In the first of three letters to the Editor, Keynes questioned both these figures as overestimated, arguing on the basis of his knowledge of the Indian debt composition.

9 Keynes was aware of the importance of these favourable monopolistic positions, a valuable source of steady income for the colony, from the time he was a junior clerk at the India Office (see ‘The Position of the Jute trade’, CW, vol. 15: 5–11).
In this letter, issued on 27 February 1909, Keynes provided the following estimations, in which it is possible to appreciate the relative magnitude of the government debt:

The rupee and the sterling Government debt held in London in 1906 amounted, roughly, to £160 million. The ordinary debenture capital of companies working in India, but registered in London, was, in 1905, about £96 million, the greater part accounted for by railways, tea plantations, and mines.

Minor items were the capital of joint stock companies registered in India and the debt of municipalities and port trusts (£48 million, the bulk of which Keynes thought was mainly held in India), and £50 million of foreign banking capital employed in India (CW, vol. 15: 20–1; Chandavarkar, 1989: 32–7). Chandavarkar noticed that, although Keynes questioned both the estimates published by the Economist ‘as being too high’, he nonetheless conceded ‘that there had been a rapid inflow of capital into India’ (Chandavarkar, 1989: 32), in this way anticipating the view expressed in RE.

Together with RE, the letters to the Economist are symptomatic of a good deal of awareness and participation in the political debate as early as 1909. In February 1910, Keynes published GBF (CW, vol. 15: 44–59), in which he updated his view. GBF was a strong attack on the Tariff Reformers and a justification of the Liberals’ imperial policy, including new statistical estimations of the magnitude and structure of British investments abroad. Although not a piece of scientific research, GBF is the only evidence in which the guide lines of Keynes’s solution to the ‘classical problem of political economy’ suggested by Chandavarkar are gathered together. The gist of Keynes’s argument was that increasing foreign investments were unavoidable for such a country as Great Britain:

It is, in fact, ridiculous to suppose that any possible policy could make a small country, in which many thousand million pounds have been already invested, a better field, in all respects, for further investment than a new and undeveloped continent. And it is natural to expect, as we progress in wealth and as our annual savings increase, that we should tend in the course of time to invest a larger absolute amount abroad. (CW, vol. 15: 48)

10 It seems that Keynes’s participation in the dispute was a by-product of the work he was doing for RE: ‘Maynard has written for the Economic Journal an article on Indian currency & exchange. I spent a good deal of time discussing it with him this morning’ (Neville Keynes Diaries (NKD), 25 December 1908; see Keynes); ‘Finish going through Maynard’s article with him’ (NKD, 26 December 1908); ‘Maynard thinks he has found a surprising statistical confirmation of one of the most important conclusions at which he had arrived a priori in his Indian article’ (NKD, 20 January 1909).
GBF anticipates the ideas later expressed by David Williams about the ‘complementarity of the growth in overseas investment and international trade, which to some extent “self-financed” the burden of international indebtedness’ (1968: 283):

We sell a large amount of goods to those countries to whom we lend. Our export trade is carried on, that is to say, on a basis of credit. If we were to withdraw this credit the trade could not continue. Lastly, it would involve the slow decline of London as the financial centre of the world, as the volume of our foreign trade and of our foreign loans declined, and the work of opening up new countries fell gradually into other hands (CW, vol. 15: 55).

Finally, a brand new set of figures recently presented by G. Paish before the Royal Statistical Society served to show that:

England has loaned to Europe an almost negligible amount, and has spent her savings on railways, finance and land, in such countries as India, Canada and Argentina, from whence she obtains her food and the raw materials for manufacture, and in assisting colonial governments. […] Our investments have been directed towards developing the purchasing power of our principal customers, or to opening up and supplying with credit and the means of transport our main sources of food and raw material. (CW, vol. 15: 56–57)

5. The reserves system and the policy of foreign investment

These occasional statements about the empire are perfectly consistent with the ideas expressed about the gold exchange standard. Keynes was absolutely convinced that the new system was not an Indian anomaly but the general trend in international monetary arrangements, imposed by the increasing capital movements in a post-Ricardian world, and by the financial circumstances of the indebted countries in particular. International indebtedness was an obvious by-product of the prevailing distribution of financial resources, pooled in a few financial centres whose function was to allocate these funds all around the world. Thus, to the (limited) extent to which international debts may be a problem, the gold exchange standard was the proper solution, despite the ‘misapprehension regarding its true nature which exists in the mind of the public, but also of some government officials’ (CW, vol. 15: 67; see also ICF: 3).

ICF attributed the misapprehension of the gold exchange standard to the Bank Act of 1844 and the corresponding orthodox view. Keynes’s ideas on this point are well known. The Bank Act’s main objective was to prevent an excessive use of paper, but it ended up in causing the opposite problem, which in the ‘English-speaking world’ was overcome by an increased use of cheques. In the meantime, the function of the reserves progressively
changed. They were no longer held to meet ‘runs on the Bank’ but to provide liquid resources in case of a species drain from abroad. Relatively to this task, the financial position of a country is what matters. Great Britain is a creditor nation, and the Bank of England is able to check a drain by increasing the rate of discount, but in the case of debtor nations the bank rate is ‘ineffective’, and Keynes concluded that ‘England is in matters of currency the worst possible model for India; for in no country are the conditions so wholly different’ (ICF: 36). This confutation of the Bank Act doctrine reinforced the idea that gold circulation was not expedient in India, where alternative devices against species drains – namely, the gold exchange standard reserves – appeared to be a better solution. At the same time, ICF introduced some new elements, framed within the innovative view on banking and paper currency. In the book, Keynes opened his analysis of the Indian financial system’s main imperfection – recognized as the complete inelasticity of the base of currency – and laid down the guiding principles for a sound management of the reserves.11 With regard to both these subjects, Keynes reaffirmed his preference for exchange rate stabilization and his scant concern about inflation.

India presented strong seasonal fluctuations in the volume of transactions, making it more difficult to cope with the complete inelasticity of the local money market. As Keynes puts it:

> The Indian currency is internally (i.e. apart from the import of funds from other countries) absolutely inelastic. There is no method whatever by which the volume of currency can be temporarily expanded by some credit device within the country to meet the regularly recurrent seasonal demands of trade. (ICF: 40)

Although in ICF the inelasticity of the Indian currency is never related to the recent spell of rising prices, this feature was nonetheless deeply connected to the Indian endemic inflation. What happened was that, in the absence of a local market for short-term loans, this business was carried out by the City banks, who financed the merchants operating in India via the Council bills system. The exchange banks, together with other British financial houses operating in the same business, were the main purchasers of Council bills. As we have already seen, the bills were sent to India and here cashed in rupees, which entered into circulation to move the crops during the ‘busy season’. Once they had carried out their business, the merchants used part of their earnings to pay their creditors in London, but the rupees introduced into circulation at the beginning of each cycle

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11 Both issues were later developed in the Memorandum on Proposals for the establishment of a State Bank in India presented by Keynes before the Chamberlain Commission (CW, vol. 15: 151–211).

318
remained there, artificially keeping the level of prices higher. Such a system was capable of attracting money, but not of expelling the currency in excess during the ‘slack season’. As the 1908 unsigned note explains:

the Government committed itself to the task of keeping at a fixed par two metals which circulate under widely different conditions. Gold, when redundant, has only to be exported to find its level. A token rupee cannot be exported, and will never be melted. (KP A/08)

Yet, this relevant issue is never mentioned in ICF. Even in the sixth chapter, where strong expressions like ‘a career of furious coinage’ (ICF: 94) or ‘impetuous activity of the mints’ (ICF: 95) recur, the problem of inflation is ignored altogether. Once again, Keynes focused his attention on a selected class of prices; namely, the rates of interest on short-term loans.

Apart from the consequences on the general level of prices, the available sources of short-term money did not fit the British merchants: ‘if funds are to be attracted from abroad for a short period […], the rate of interest must be high enough to pay the cost of remittance both ways, which in the case of […] India and London is considerable’ (ICF: 41). Thus, it was exclusively for the sake of a lower and more stable rate of interest on short-term loans that Keynes proposed to use the reserves, under direct control by the Indian government, to fund these loans. This opened the most controversial topic of the reserves and their management.

The nature and composition of the reserves is a highly complicated matter. Here it is enough to rely on Keynes’s basic distinction between the ‘rupee reserves’ and the ‘sterling reserves’. The sterling reserve was by far the more important, for the same reason that India owed a debt to Great Britain to be paid in gold. ICF examines in detail the Indian debt in relation to her balance sheet, whose:

variable elements […] are chiefly (a) the excess of exports over imports, including treasure, i.e. the trade balance; (b) the amount of new fixed capital lent to India by European capitalists; and (c) the amount of short-period loans afforded to India by the European money market. (ICF: 118)

The 1907–1908 crisis remained the best evidence to show the essential feature of the Indian international financial relations; namely, the

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12 Keynes was convinced that the institution of a state bank would have been a better solution, also in view of the difficulties of the Indian banking system in general. As this proposal was known to be unpopular, however, Keynes immediately fell back on the less ambitious plan based on the gold exchange standard reserves. The project for the institution of a state bank was later developed during the work of the Chamberlain Commission.
equilibrium between the surplus in the trade balance with the rest of the world and the inflow of new capital from the United Kingdom:

in the normal state of affairs receipts and payments only balance after account has been taken of capital transactions; and if a certain amount of new capital has been flowing in every year, a slackening of this flow affects the balance as adversely as a reduction in the volume of exports affects it. In 1907–8 the adverse balance of indebtedness was largely due to a change in the trade balance [...]. But even on this occasion the adverse balance arose to a considerable extent out of changes in capital transaction under items (b) and (c). (ICF: 118)

Keynes argues that any guess about the adequate amount of reserves should take into account the predictable fluctuations in the items (a), (b), and (c), always taking for granted that, whatever these variations could be, the reserves represent a cost. Although he proposed the highest figure ever considered (£40 million), Keynes remembered that:

[i]n a country such as India, where all available resources are required for capital expansion, and where it is not sound or human policy to burden the present overmuch for the sake of the future, it is nearly as important to avoid extravagance in the reserve policy as to avoid undue parsimony. (ICF: 120)

Under this constraint, ICF prescribed in first place to defend exchange rate stability, in order to avoid disturbances on the influx of new capitals for long-term investments; in second place, came the possibility to put part of the reserves at the disposal of the local market during the busy season, so as to reduce the interest rate paid by the British merchants, and to indirectly support the trade balance surplus with the rest of the world; and in third place, and altogether ignored, came the question of price stability in India.

6. Conclusion

Ten years after ICF was issued, B. R. Ambedkar wrote:

there is no book but that of Professor Keynes which makes any attempt to examine its [of the Indian gold exchange standard] scientific basis. But the conclusions he has arrived at are in sharp conflict with those of mine. […] This difference proceeds from the fundamental fact, which seems to me overlooked by Professor Keynes, that nothing will stabilize the rupee unless we stabilize its general purchasing power. (1923: vi)

To prefer external stabilization, at the same time fostering the instability of the rupee purchasing power at home, was not an obvious deliberation. I have tried to bring to light the economic and political tenets underlying
this choice, examining the economic policy in which Keynes’s monetary analysis was framed.

This scheme is revealing of a heavily state-oriented apprenticeship in applied economics. Once we have put together all of the scattered utterances on several aspects of the same question disseminated in the CW and the KP, we find that, perhaps hidden and confused behind the white man’s burden ideology and the intricate technicalities of ICF and other writings, there was the public scheme of foreign investment investigated by N. Sen and the other historians. The young economist had the opportunity to ‘cut his teeth’ on the ‘classical problem of political economy’ identified by Chandavarkar; and his approach to this issue, as it is put forward in the 1910 article on foreign investment (CW, vol. 15: 44–59), confirms that from the beginning it was ‘a large volume of saving which does not lead to a correspondingly large volume of investment (not one which does) which is the root of the trouble’ (CW, vol. 5: 161). It would seem plausible that the ultimate reasons why Keynes and the India Office establishment sought the stabilization of the external value of the rupee, at the cost of violent fluctuations of the Indian currency purchasing power at home, are to be found in the 1910 article on foreign investment, and more precisely in the saturation of the British investment market. On the other hand, but for the fundamental problem of turning savings into investment, everything else seems to change when we move back from the early 1930s to the pre-war era. To use Keynes’s own words:

The investment of British savings in rails and rolling stock to be installed by British engineers to carry British emigrants to new fields and pastures, the fruits of which they would return in due proportion to those whose frugality had made these things possible, was not economic internationalism remotely resembling in its essence the part ownership of the A.E.G. of Germany by a speculator in Chicago, or of the municipal improvements of Rio de Janeiro by an English spinster. (‘National self-sufficiency’, CW, vol. 21: 237)

In the case of pre-war Anglo-Indian relations, the influence of the imperial state on the process of accumulation and investment was overwhelming. As the contemporary Indian historians emphasize, this control over markets was the by-product of the almost absolute political power exercised by London, and we may conclude that the privileged conditions in which Keynes and the India Office officials could work were in turn a by-product of this political supremacy. Their task was essentially to shape markets, and the financial market in particular, according to the exigencies of the British savers. They could provide in advance the proper conditions for what they thought was the best allocation for these resources, and they could do so because they operated in a world in
which ‘Every institution, however purely private, is ultimately dependent on the Government’s equitable regard for existing interests’ (CW, vol. 15: 172).

If compared with this kind of golden age of the public hand, many of the most celebrated proposals of state intervention that Keynes put forward in the course of his life appear a dim recollection of the past. By contrast, if we should believe Keynes’s own recollections of the past, we may reasonably conclude that his career began in the world of *laissez-faire* to continue in a new era, when this doctrine was progressively confuted by the events (see, for instance, *The End of Laissez-Faire*, CW, vol. 9: 272–94). A first and obvious qualification to this very simplified vision is suggested by Keynes’s education in economics, which was essentially Marshallian and miles from the catechism of Miss Martineau (Groenewegen 1995b; Raffaelli 2000, 2003). And we may now add a second qualification, proceeding from Keynes’s apprenticeship as an applied economist. This learning by doing experience simply excluded *laissez-faire*, being at the same time not a mere repetition of what could be learned in Marshall’s schoolroom, or in any other economist’s handbook, about this doctrine and its limits. Just on the basis of this very superficial observation, it must have been a very enriching opportunity. Finally, and for analogous reasons, the works on India remain at odds with the whole interpretation we are often given, not infrequently by Keynes himself, of the young man’s attitude towards economics and politics. We may dare to say that we know everything about the young Keynes but his economics and politics, just because we are accustomed to thinking that these matters could barely find a place in his youth. In the light of the present research, however, it seems unlikely that the weight of these matters could have been completely irrelevant, and the apparent contradiction between the earlier experiences as an applied economist, deeply connected with the real world of liberal administration, and the common idea of the young Keynes and his ‘unworldliness’ would deserve further consideration.

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Keynes's work on India before the First World War concentrated on analysis of the gold exchange standard and the stabilization of the rupee external value. Indian monetary arrangements were framed into a plan for...
foreign investment, implemented by the India Office in London. This policy, which was a typical example of public control over investments, occasioned Keynes’s first job as an applied economist. Although neglected by Keynesian scholarship, this learning by doing experience is likely to have played a significant role in the young economist’s training and education.

**Keywords**

Keynes, India, foreign investment, monetary policy, gold standard, gold exchange standard