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JOHN MAYNARD KEYNES'  
*THE ECONOMIC CONSEQUENCES OF THE PEACE:*  
A CENTENNIAL REVIEW\*\*

“I fought that war to preserve justice in this world. As far as I understood,  
I wasn't taking part in a vendetta against the German race”.

Lord Darlington, *The Remains of the Day*, Ishiguro (1989, 67).

## 1. INTRODUCTION

It was November 1919 when John Maynard Keynes, perhaps one of the most celebrated economists of the 20<sup>th</sup> century, submitted the manuscript of his *The Economic Consequences of the Peace* to the publisher.<sup>1</sup> Not only did the book become an extraordinary publishing success, with an outstanding number of copies sold and numerous translations into other languages, but it had an enormous impact on both the general public and decision-makers; the impact that, especially in

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<sup>1</sup> The book was originally published by MacMillan and Co. Limited, London, 1920, in the first quarter of that year. It is the reprint published by Freeland Press in 2017 that is used for this review. All pages of the book in the review refer to the 2017 reprint.

the case of the former, has lasted to the present. Academics were not indifferent to it and because all of this, the book was a springboard for the author's ascent to the status of world-wide celebrity economist, perhaps the first in the history of the trade.

The book and its insights have been recurrently revisited in the past 100 years, like on the occasions of the economic and military ascent of Germany under the National Socialist regime, the end of the Second World War and reconstruction of Europe, and the recent eurozone sovereign debt crisis, for example. Doubtless, it has provided food for thought for decades, perhaps a full century.

The aim of this review is to, with centennial hindsight, analyse the book and its academic contribution. The review is not to evaluate the impact of the book on the general public opinion and in that way on the policies that were formulated, though that significant impact is to be acknowledged. Accordingly, the review deals only with the methodological issues of the book, with its features as an academic contribution, and with ten select, non-exclusive fallacies that the book has created. The character of the book is then evaluated and some possible explanations regarding that are suggested. The conclusion follows.

## 2. METHODOLOGICAL ISSUES

The author is very specific about the purpose of the book. It is “to show that the Carthaginian Peace is not *practically* right or possible” (Keynes, 1920, 14–15; italic in Original). Of course, the term “Carthaginian Peace” refers to the peace treaty with Germany (i.e. the Treaty of Versailles, hereafter the Treaty) and both its economic and, up to a point, political consequences. Keynes is even more specific in describing his approach, underlining that he is “mainly concerned in what follows, not with the justice of the Treaty, – neither with the demand for penal justice against the enemy, nor with the obligation of contractual justice on the victor – but with its wisdom and with its consequences” (Keynes, 1920, 26). The author's concern regarding the future occupies both his mind and the pages of his book to such an extent that the reader occasionally feels as if the war did not happen at all and that the Paris Peace Conference (hereafter the Conference) is or at least should be a gathering of old friends to discuss their common future. That feeling is reinforced as Keynes does not restrict himself to specifying the aim of the book, so he also offers his view about the task of the Conference itself: “to honor engagements and to satisfy justice; but not less to re-establish life and to heal wounds” (Keynes, 1920, 10).

The book is based on a very strong personal touch of the author who was, in his own words, “temporarily attached to the British Treasury during the war and was their official representative at the Paris Peace Conference up to 7 June 1919” and he “also set as deputy for the Chancellor of the Exchequer on the Supreme Economic Council” (Keynes, 1920, i). Accordingly, there is no doubt about Keynes’ active role at the Conference as a senior official, a person in a position to influence the outcome. Such a role usually produces at least two outcomes: one is an abundance of relevant information collected during many eventful days at the Conference and through access to various information hidden from the public; the other is a personal touch in writing about the Conference – which is not always the ally to the author.

The latter is evident. Perhaps it is mostly the personal touch that provides vivid sketches of the main characters: the crucial participants of the Conference. For example, Woodrow Wilson, the US president “was not a hero or a prophet; he was not even a philosopher; but a generously intentioned man, with many of weaknesses of other human beings, and lacking that dominating intellectual equipment which would have been necessary to cope with the subtle and dangerous spellbinders...” (Keynes, 1920, 16). Even worse for the US president “...this blind and deaf Don Quixote was entering a cavern where the swift and glittering blade was in the hands of the adversary” (Keynes, 1920, 17). Whoever the adversary was, perhaps the US president would not have been blind and deaf had he followed the authors’ advice.

The sketch of Clemenceau is not only very detailed, but at least ostensibly very gracious, since for Keynes, he is “by far the most eminent member of the Council of Four and he had taken the measure of his colleagues” (Keynes, 1920, 11). The author obviously likes the way Clemenceau talks, behaves and even dresses, but the problem with the French prime minister is not with him personally but with his aims as he believes “in the view of German psychology that the German understand nothing but intimidation... Therefore you must never negotiate with a German or conciliate him; you must dictate to him” (Keynes, 1920, 13).<sup>2</sup> Although the author provides no evidence for such Clemenceau’s beliefs, very early on in the book the reader is provided with a prime suspect for the Carthaginian Peace, brought on by the Conference.

There is no detailed sketch of UK Prime Minister Lloyd George,<sup>3</sup> but the author assesses him as a seasoned and skilful politician. He

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<sup>2</sup> Annoyed with such an intrusion in the personalities of the Conference participants, Taussig (1920, 383–384) in his review of the book points out that “This degree of intimacy with the character of the actors is vouchsafed only to writers of fiction”.

<sup>3</sup> The reasons for Keynes’ decision not to include a sketch of Lloyd George in the book are provided in Harrod (1971). The sketch is not magnanimous to Lloyd George

possesses “swiftness, apprehension and agility” (Keynes, 1920, 17) and “his natural instincts are... right and reasonable” (Keynes, 1920, 53). All the problems stemming for the UK prime minister are due to his decision to call for general elections immediately after the Armistice, which Keynes considers “an act of political immorality” (Keynes, 1920, 52). In the election campaign Lloyd George promised substantial wealth transfer from Germany to the UK constituency and because of this harsh reparation terms were imposed on Germany in the Treaty. In short, the UK prime minister is a political opportunist whose immoral behaviour made him a secondary suspect for the Carthaginian Peace.

Although the book does not contain sketches of any members of the German delegation, there are extensive and affirmative quotations of the main address by the head of German delegation, Foreign Minister Ulrich von Brockdorff-Ranzau, emphasising the values of the German reply with the “justice and importance of much of its content” and a “truly broad treatment and high dignity of outlook” (Keynes, 1920, 26). Alas, these qualities were not relevant with the ardent determination of the two to make the Carthaginian Peace and the blindness and deafness of the US president preventing him from stopping them in their endeavour.

As in many other cases, the bold judgments and uncompromising insight of the author are not followed by any evidence or at least the evidence is not cross-checked. Many of the insights are nothing but assumptions treated as axioms, like those of the motives of the peoples and nations. For example, “it was the policy of France to set the clock back and to undo what, since 1870, the progress of Germany had accomplished. By loss of territory and other measures her population was to be curtailed; but chiefly the economic system, upon which she depended for her new strength, the vast fabric built upon iron, coal, and transport, must be destroyed” (Keynes, 1920, 14).<sup>4</sup> Furthermore, on a more personal level, “Clemenceau’s aim was to weaken and destroy Germany in every possible way,... he had no intention of leaving Germany in a position to practise a vast commercial activity” (Keynes, 1920, 58). Keynes provides no evidence supporting that insight. Contrary to this insight, it is far more logical, taking into account the situation in his country after winning the war, that Clemenceau’s aim was, in the short term, to facilitate

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(“this half-human visitor to our age”), especially regarding his motives. Skidelsky (1983) provides the omitted part of the book on Lloyd George.

<sup>4</sup> Nonetheless, in the other section of the book, considering the issue of the Allies countries’ public expectations, Keynes himself contradicts this insight. “The more extravagant expectations as to Reparation receipts, by which Finance Ministers have deceived their publics, will be heard of no more when they have served their immediate purpose of postponing the hour of taxation and retrenchment” (Keynes, 1920, 36). So, according to this insight, it is about domestic public opinion, not about destroying Germany after all.

reconstruction of the French industrial (primarily mining) facilities and infrastructure, destroyed by the German armed forces, as well as to ensure that France will service its financial obligations to the creditors (mainly the US), and in the long term to obtain sustainable national security for France against Germany and its invasion. With centennial hindsight and with insight in an abundance of documents, historiography confirms this very logic (MacMillan, 2001; Tooze, 2014; Neiberg, 2017; and Sharp, 2018).

Not only is evidence not provided throughout the book, but there is patronising attitude towards the countries on the winning side. For example, Keynes specifies that “If the European Civil War is to end with France and Italy abusing their momentary victorious power to destroy Germany and Austria-Hungary now prostrate, they invite their own destruction also, being so deeply and inextricably intertwined with their victims by hidden psychic and economic bonds” (Keynes, 1920, 1–2). Not only that, according to the author, although uncorroborated by evidence, destruction is the aim of France and Italy, but the leaders of these two countries are not aware of their own destruction in due course, if they accomplish that aim.

In cases when evidence is provided in the book, it is not cross-checked. For example, Keynes points out that the official at the Conference “learnt from the lips of the financial representatives of Germany and Austria unanswerable evidence of the terrible exhaustion of their countries” (Keynes, 1920, 3). It is undisputable, nonetheless, that there were strong incentives for the financial representative of the two countries not to tell the truth, not to be unbiased and to overestimate the difficulties and exhaustion in their own countries, not only hoping, but actively trying to achieve that the peace terms regarding reparations are not so harsh for them. Nonetheless, the author takes these testimonies for granted and builds his case of that evidence, without any independent testimony. One way or the other the word *incentive* is hardly mentioned in the book. The economics of the time, obviously, did not understand properly the role of incentives, but that methodological drawback can lead to the wrong conclusions.

From time to time, Keynes claims that his own strong value judgments, whatever the ground for them is, are widely accepted, almost a conventional wisdom. “The judgment of the world has already recognized the transaction of the Saar as an act of spoliation and insincerity” (Keynes, 1920, 33). It is hardly probable that the world was very focused on the transaction of the Saar in spring of 1919 and it is very unlikely that France, no doubt a part of the world, shared that very value judgment.

Taking into account these methodological drawbacks, it is not surprising that the book produced a number of fallacies. With centennial

hindsight, this review addresses only ten of them. The analysis of some of these provides evidence on further methodological flaws of the book.

### 3. FALLACIES OF *THE ECONOMIC CONSEQUENCES OF THE PEACE*

#### 3.1. 1<sup>st</sup> Fallacy: The Treaty is Not Fair to Germany

Keynes first objection, that the Treaty is not fair to Germany, is based on the procedural grounds as the author takes into account the sequence of events that have led to the Treaty. After a military disaster on the Western Front and the collapse of the German Army, though not mentioned by the author, it was the German Government, based on the advice of the military leaders, which on 5 October requested the ending of the war, in a note to the US president, accepting the Fourteen Points. Following the exchange of notes, and after the final note of the US administration (signed by Secretary of State Robert Lansing, on the behalf of the president) on the behalf of all the main Allies on 5 November, stipulated that the peace terms will be based on the Fourteen Points (formally referred to as the speech of 8 January) with some additional provisions. One of them is that “compensation will be made by Germany for all damage done to the civilian population of the Allies and their property by the aggression of Germany by land, by sea and from the air”.<sup>5</sup> Based on that note, the German Government formally requested negotiations for an armistice on 7 November. On 11 November an armistice agreement was signed and became effective on the same day.

According to Keynes, the Treaty is essentially a breach of “the Contract between Germany and the Allies resulting from the exchange of documents” and the contract provisions are “plain and unequivocal” (Keynes, 1920, 24). The first problem with that insight is that there was no contact whatsoever between the governments and the only document that the German side signed is the Armistice agreement.<sup>6</sup> The exchange of notes cannot be considered a contract and no contractual obligations for the parties can be generated from such an exchange. Furthermore, many provisions of the Fourteen Points and subsequent speeches of the US president are nothing but principles. Even Keynes writes about “spirit, purpose and intention” (Keynes, 1920, 25) and these elements simply do

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<sup>5</sup> The document is retrieved from: <https://history.state.gov/historicaldocuments/frus1918Supp01v01/d385> (last visited 10 January 2020).

<sup>6</sup> The Armistice Agreement is not very extensive on economic issues. There is only one general provision in the Agreement: “Reparation for the damage done” (Article XIX). It is quite impossible to demonstrate that such a general provision had been violated by any peace treaty based on the Agreement.

not constitute contractual obligations, so obligations of that kind cannot be violated. Finally, Keynes does not specify which of the Fourteen Points (some of them impose very specific obligations on Germany, like the one of the returning of Alsace-Lorraine to France) have been violated by the Treaty. The reason is obvious: none of them were.

Cornered with all the arguments against his thesis regarding breaching of the Contract, Keynes conveniently (for him) jumps on to other territory – the vague one of international morality. “The German commentators had little difficulty in showing that the draft Treaty constituted a breach of engagements and of international morality comparable with their own offence in the invasion of Belgium” (Keynes, 1920, 26). Leaving aside unbiasedness of the German commentators and invasion of Belgium as a comparison yardstick, it is now evident that even Keynes is not taking his notion of the contract violation seriously but moves to the elusive territory of “international morality” and its violation. The standard of proof in that territory is, how conveniently, very flexible.

This section of the book is, however, very informative. It is now evident that the German side was informed *ex ante*, i.e. before the armistice negotiations started, that compensation would be made by Germany for all the damage done to the civilian population and their property and that the German war was one of aggression.<sup>7</sup> Based on this information, among other things, the German side accepted the terms and started the armistice negotiations. As to the procedural fairness of the peace process, and the Treaty as its outcome, this section of the book, whatever the intention of the author may have been, demonstrates that the process was not unfair.<sup>8</sup> Whether the sides were satisfied with the outcome is an entirely different question.

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<sup>7</sup> The concept of compensation of the damage to the civilian population and its property stipulated by Wilson’s speeches and the note, and employed by the Conference is quite distinctive to the concept of indemnity in which one side (a defeated one) covers all the war costs of the other, winning side. Germans enforced that very concept about eight months before the Armistice, in the Treaty of Brest-Litovsk with Russia. There was a long tradition of Germans adhering to this concept, as indemnities were paid by France after the Franco-Prussian War in 1871, as stipulated by the peace treaty imposed by Prussia/Germany. This tradition was shared by other nations.

<sup>8</sup> It is a bit puzzling that Keynes does not mention in the book a specific feature of the Conference that could be the ground for considering the peace process unfair: there were no negotiations with Germany, i.e. its representatives, over the terms of the Treaty. Instead, as Clark (2017, 290) points out “draft terms formulated in copious detail were presented to the Germans, in effect on a take-it-or-leave-it basis”. That was not the idea at the beginning of the Conference, at least not the idea of the British and American representatives, but it prevailed by March 1919. Sharp (2018, 38) provides the reasons why the crucial decision makers changed their opinion during the Conference, being aware of the fragility of their alliance. Whatever the reasons were, the take-it-or-leave-it approach of the Allies provided grounds for German’s public relations effort to proclaim that the Treaty is nothing but a *Diktat*.

### 3.2. 2<sup>nd</sup> Fallacy: The Great War Did Not Happen at All

Surprisingly, there is no chapter on the war in the book. Chapter II, “Europe Before the War”, is followed by Chapter III, “The Conference”, as if nothing happened between Europe before the Great War and the Conference. For a hypothetical *tabula rasa* reader of the book, the main question would have been what was the Conference about, because there is virtually no information in the book about it.

Here and there, though, there is some information, for example, that Germany invaded Belgium, although there is no information about the invasion of France, and that the British merchant fleet suffered some losses, though it is not mentioned that these losses were due to the unrestricted submarine warfare by the German Navy. Nonetheless, apart for this scattered intelligence, there is no general information about the war. Not only is there no information on the role of Germany in starting the Great War, or information that the war was not conducted on German territory, but also there is no information that it had virtually no effect on German industrial capacities, infrastructure and its merchant fleet.

What is particularly missing from the book are the insights about how the war damage to the civilian property on the occupied territories had been created. It was “Germany’s deliberate sabotage of mines, factories, orchards and other property in the 1918 retreat and even after the Armistice...” (Sharp, 2018, 37) that are not mentioned in the book. It was the deliberate flooding of coal mines in northern France, the source of its cooking coal, during the 1918 German retreat, that had a substantial impact, because it took a decade to restore normal production. Furthermore, “during the fighting, whole industries were removed to Germany from France and Belgium” (Marks, 2013, n. 52). After the Armistice, some of the property that could be moved easily, like rolling stock, agricultural equipment, seed and cattle, was deliberately moved to Germany after the Armistice and contravening the Agreement, as a segment of “economic warfare” even subsequent to the straightforward one (Marks, 2013, 643 and n. 52). Accordingly, the damage done to civilian property in Belgium and France was not damage that was the unintended consequence of warfare, i.e. legitimate military activities, restricted to the battlefield, but the result of deliberate, widespread and very well-organized actions by the German armed forces. In short, it was the intentional infliction of damage unrelated to the war effort.

Although unrestricted submarine warfare practice by the German Navy was not an unintended consequence of naval warfare, but its essential and unavoidable part, it was also a deliberate, widespread and very well-organized activity directed at the destruction of civilian property. None of these events and actions are even mentioned in the book. As the author is obsessed with the future, this could be an explanation for neglecting the



past, although in that case Chapter II “Europe before the War” should not have been included in the book. It would be highly speculative to consider the reasons for such inconsistency. One way or the other, according to the book the Great War did not happen at all.<sup>9</sup>

### 3.3. 3<sup>rd</sup> Fallacy: Death Sentence for Many Millions

In response to the draft Treaty that was delivered to the German Government, its Foreign Minister Ulrich von Brockdorff-Rantzau addressed the Conference with a three-hour response. Keynes extensively quotes this address with its final sentence: “Those who sign this Treaty will sign the death sentence of many millions of German men, women and children” (Keynes, 1920, 90), and finally subscribe to the view, as Keynes’ following sentence in the book is simply “I know of no adequate answer to these words” (Keynes, 1920, 91). In short, millions will die.

In hindsight, there is no evidence that a single German man, woman or child died as a consequence of the signing the Treaty.<sup>10</sup> But this insight is a bit trivial. What is much more important is what is missing in the book: Keynes does not comment on the features and results of the German approach to addressing the Conference. The author is, to use his own words describing the US president, blind and deaf in this case. For a side that would like to change the draft Treaty, this approach was far from effective. Three hours of the speech in legalistic German, described as pedantic, with the speaker sitting contrary to diplomatic protocol (Tampke, 2017, 139), and the content full of accusation of the Allied countries, their governments, i.e. the participants of the Conference that Brockdorff-Rantzau was addressing, did not go well with them. On his way out the US president commented: “Germans are really a stupid people. They always made the wrong thing... They don’t understand human nature. This is the most tactless speech I ever heard” (Tampke, 2017 139; Neiberg, 2017, 73). Lloyd George agreed: “it was deplorable to let him talk” (Tampke, 2017, 139) and confess to Clemenceau that “the speech at long last made him understand why French hate the Germans as much as they did” (Neiberg, 2017, 73).

So, there is no doubt that Brockdorff-Rantzau did a poor job of making Germany’s case at the Conference and convincing the representatives of the Allies to be more benevolent to his country in the

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<sup>9</sup> Nonetheless, as demonstrated by Boff (2019), even focusing only to the ostensible consequences of the war, i.e. the aims accomplished by the war, the book played a major role in constructing the image in Great Britain of the Great War as “a mass slaughter of epic futility”.

<sup>10</sup> Mantoux (1944), also in hindsight, provides a list of Keynes’ predictions from the book that proved to be wrong, especially those regarding iron and steel output, and the output and productivity of the coalmines in Germany and Europe.

terms of the Treaty. Nonetheless, that does not necessarily mean that Germans are stupid, to use the words of the US president, but perhaps that the priorities of von Brockdorff-Rantzau and the German government were something else. The content of the speech, its structure (he made his own Fifteen Points, one more than Wilson) and the information that he leaked the speech to the press before the Conference counterparties have a chance to see it (Neiberg, 2017, 73), infer that this speech was nothing but a public relations exercise and that “was chiefly addressed to the German domestic audience” (Tampke, 2017, 139).

Such an orientation of the German Government delegation was rather rational in the time when it was inevitable that Parliament was about to take a vote on ratifying the Treaty that would be imposed on Germany, so it was the executive government’s legitimate policy to ensure that none of the members of the cabinet were labelled as traitors in the wholesale political accusations that could be expected. Accordingly, this specific government policy is not a problem. The problem is that the author of the book fully subscribed himself to such a policy, and the PR activities in its implementation. And that very subscription made his predictions, not only about the many millions of deaths, quite wrong.

#### 3.4. 4<sup>th</sup> Fallacy: The Role of German Fleet and Colonies

Keynes is appalled by a provisions of the Treaty that “Germany has ceded to the Allies all the vessels of her mercantile marine exceeding 1600 tons gross, half vessels between 1000 tons and 1600 tons,...” and “has ceded to the Allies all her rights and titles over her oversea possessions” (Keynes, 1920, 27). The reason for such attitude on the part of the author can found in his insight that “The German economic system as it existed before the war depended on” among other things “Overseas commerce as represented by her mercantile marine, her colonies... and the overseas connections of her merchants” (Keynes, 1920, 27).

The problem about this author’s insight is that he himself undermines it in the book. The statistics on the first and second largest customer as well as the first and the second largest source of supply includes only European, most of them neighbours, not overseas countries, let alone colonies (Keynes, 1920, 7). German investments were focused in Russia, Austria-Hungary, Bulgaria, Rumania and Turkey (Keynes, 1920, 7) – hardly overseas countries, and definitely not German colonies. A table on the regional structure of German foreign trade in 1913 (Keynes, 1920, 77) identifies the United Kingdom, Russia and the United States as the main foreign trade partners – although the US is an overseas trade partner; there is no foreign trade role of German colonies whatsoever.

Although the author himself undermines the case for economic relevance of Germany overseas trade and the economic role of German colonies, he believes that requisition of the vast segment of German merchant fleet would have adverse effects on German economy. “Germany will have to pay to foreigners for the carriage of her trade such charges as they may be able to exact, and will receive only such conveniences as it may suit them to give” (Keynes, 1920, 27). The reader is confounded by this sentence. It is not clear what the problem is: the sheer fact that foreign shipping companies will transport German export and import or the fare that the German exporters and importers will bear, or both. As to the first issue, merchant fleet is not a navy; it consists of companies that provide maritime transportation services on the international market on commercial grounds and it provide it to the foreign trading commercial companies, not to nations. Hence, it is irrelevant whether German export or import, arranged by the foreign trade companies, is transported by a German or, say, a US shipping company and which companies are paid for that service. As to the fares, there is a single equilibrium price on the international maritime shipping market, established by competition of the maritime shipping companies in that market, and there is a no evidence that there was any incentive for price discrimination against transportation of German merchandise, either its export or import.

The equilibrium price of international commercial shipping at the time was most likely higher than before the war, due to the lack of supply of the service, because of the capacity constraint created by unrestricted submarine warfare of the German Navy, and destruction of substantial shipping capacity of the merchant Allied fleet, especially Great Britain’s. Nonetheless, Keynes just does not mention these losses, nor that these losses were quite a justified rationale for the requisition of the German fleet in order to compensate for the damage done to civilian property – merchant ships,<sup>11</sup> let alone that in due course high equilibrium prices of maritime transportation provide incentives for shipbuilding and expanding the supply of this commercial service, bringing the prices down.

Finally, the quoted sentence reveals Keynes’ mercantilist attitude: Germany should have its own merchant fleet and only that fleet should be used for the maritime transportation of German exports and imports, i.e. it should not “pay foreigners” for that service, even if the foreign companies are more efficient and thus, due to competition, provide better commercial terms. The same attitude can be spotted in the case of the coal industry and Keynes’ attitude towards border rearrangements that would award Upper Silesia to Poland. “Economically it is intensely

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<sup>11</sup> In another chapter Keynes specifies that the total losses of the British mercantile vessels numbered 2,479, with an aggregate of 7,759,090 tons gross (Keynes, 1920, 50). Keynes does not provide the comparable figures for the requisition of the German merchant fleet, so the reader cannot conclude which part of the British merchant fleet losses had been compensated by the requisition of the German merchant fleet.

German; the industries of Eastern Germany depend upon it for their coal; and its loss would be a destructive blow at the economic structure of the German State” (Keynes, 1920, 34). As if those coalmines did not have incentive to earn profit by exporting the coal to traditional customers in eastern Germany, supplying it with coal instead of searching for virtually non-existent new customers in their own nation state. Obviously, Keynes downplays or even neglects the virtues of free international trade, violating one of the Fourteen Points, and implicitly subscribing to autarchy as a preferred option, at least for Germany.<sup>12</sup>

In short, Keynes’ writings in the book about German colonies and its merchant fleet could be described, by borrowing the title “much ado about nothing”.

### 3.5. 5<sup>th</sup> Fallacy: The Damage Done and the Reparations

Keynes does not doubt the principle that “compensation will be made by Germany for all damage done to the civilian population of the Allies and to their property by the aggression of Germany by land, by sea, and from the air”, as there is a clear difference between the concept of compensation to the civilian population and indemnities for the general costs of the war. The devil is, as usual, in the details, with three specific interrelated questions. First, what constitutes the damage? Second, how should the damage be calculated? Third, what is the amount of damage?

As to the first question, physical damage to the civilian population property is beyond dispute. The implication is that the physical damage is limited to the direct actions of the German armed forces, i.e. the German Army in the occupied parts of Belgium and France, and the German Navy on the sea against Allies, mainly the British merchant fleet. Nonetheless, the expectations of the British constituency were higher, taking into account that France and Belgium would receive bigger amount of compensation due to the occupation of their territory. So, it was the UK prime minister’s idea that the compensation should include amount of the allowances granted during the war by the Allied Governments to the families of mobilised persons and the amount of the pensions and compensation in respect to the injury and death of combatants, payable by these governments. Keynes opposes the idea and rightly so. This is not compensation of civilians, but the compensation of governments. The author rightly points out that, by using the same logic, general costs of war are costs to the taxpayers, i.e. civilians, hence indemnities for the general costs of war should be treated as compensation of the civilians for the

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<sup>12</sup> As demonstrated by Aly (2005) and Tooze (2006), escaping international trade and creating self-sufficient autarky – since Germany must control everything – was precisely the economic motive for the imperial expansion of Nazi Germany, especially in the East. Acquiring the *Lebensraum* is exactly that – gaining resources and organising their exploitation, including the slave labour, under own terms.

damage (increased taxes) done to them because of the war. Nonetheless, the political economy argument won, and these compensations were, at least in principle, included in the reparations.

The second question is how the damage should be calculated. Keynes is annoyed with the various high figures circulated by the representatives of the Allies and he boldly steps forward with his own estimate, done in a vague way that is incomprehensible to the reader, ostensibly based on the pre-war census data of the national wealth of Belgium and France.<sup>13</sup> His back-on-the-envelope calculation of the physical damage ends up with US\$ 10.6 billion, rounding it down to 10 billion, concluding that “it would have been a wise and just act to have asked the German Government at the Peace Negotiations to agree to a sum of \$10,000,000,000 in final settlement, without further examination of particular” (Keynes, 1920, 51). Nonetheless, as to the figure, the proper way to calculate the damage is to calculate the replacement costs of the civilian property. That procedure takes time to complete and the result definitely could not have been delivered during the Conference. It is very likely that this very method was used by the US Army Corps of Engineers, which finished its report in 1921, estimating the total damage to the Allies, excluding Czechoslovakia, Russia and Poland, at US\$ 40 billion (Brunett, 1965, 46), four times more than the Keynes’ own estimate.

The German counter-proposal, made during the Conference, before any figure was stipulated by the Allies, at US\$ 25 billion is embarrassing for Keynes, as it is two and a half times larger than his own calculation, so he downplays the proposal, evaluating the proposal as “somewhat obscure, and also rather disingenuous” (Keynes, 1920, 86). Furthermore, Keynes is patronising towards German delegation, specifying that “... [they] would have done better if they had stated in less equivocal language how far they felt able to go” (Keynes, 1920, 87). But Keynes substantially downplays the German counter-proposal with figures. First, the author subtracts US\$ 10 Billion from the amount Germany offered ostensibly on various credits (four kinds of them) in their counter-proposal. Keynes just specifies that US\$ 10 billion figure is a rough estimate of all the credits, although he provides no clue to how he came to that figure. One way or the other, this reduces the amount to US\$ 15 billion. Then, according to Keynes, one should “halve the remainder in order to obtain the present value of a deferred payment on which interest is not chargeable. This reduces the offer to \$7,500,000,000” (Keynes, 1920, 87).<sup>14</sup>

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<sup>13</sup> The only transparent Keynes’ calculation is the compensation for the sunk British merchant fleet vessels, calculated at the US\$ 200 per gross ton (Keynes, 1920, 50).

<sup>14</sup> Unfortunately, Keynes does not provide the elements for his calculation of the present value: time frame and discount factor, so that it may be repeated based on other nominal values.

Ostensibly, this makes the German offer (US\$ 7.5 billion) for reparations smaller than Keynes' recommendation (US\$ 10 billion) and the embarrassment will hopefully disappear. The only problem is that the comparison of these two figures is not methodologically correct, since Keynes compares nominal, i.e. face value, of his recommendation with the present value of the German offer. Accordingly, Keynes' recommendation should be expressed in terms of its present value. The author breaks down his recommendation into the following elements: (1) Further credit of US\$ 2.5 billion on various grounds, leaving its nominal value to US\$ 7.5 billion. (2) The remaining balance "should not carry interest pending its repayment, and should be paid by Germany in thirty annual instalments, beginning in 1923" (Keynes, 1920, 102). With a discount factor of 3% (quite reasonable for the time), the present value of the figure of the reparations Keynes recommended is US\$ 3 billion. With a methodologically correct comparison, i.e. comparison of the present values, the German offer to the Conference was 2.5 times greater than Keynes' recommendation for reparations.

At the end of the day, the Conference did not specify any figure or formula for German obligations but left the task to the Reparations Commission. The amount that was set for paying by the Reparations Commission in London in May 1921 was effectively US\$ 12.5 billion,<sup>15</sup> slightly more than what was Keynes' recommendation in the book and much less than US\$ 40 billion, the amount that, according to his "rough estimate, the Treaty demands of her [Germany]" (Keynes, 1920, 87).

As to the reparations, the crucial conceptual question is: was it better to have a round and finite figure however it may have been calculated, or to have the decision on the number that is flexible, that would in due course take into account Germany's changing capacity to pay. Keynes insists that the Conference should have set a defined figure of the reparations and should not have left it to the Reparations Commission. Insight from the modern theory of economic regulation suggests that the finite figure is better as it creates an incentive for efficiency, as the surplus above that figure is left to the regulated entity. The problem with that approach is that such a figure can be set too high, above the damage done and the other party's capacity to pay, or too low, below both values. The probability of both errors increases if the job is done hastily, during

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<sup>15</sup> This was the total amount of A and B bonds (with thirty years maturity) issued by Germany to the Reparation Commission. Nominally, the amount of the reparation was US\$ 33 billion and that included C bond. It was obvious that these bonds would never been issued and that the total figure of the German reparation was set only for calming down domestic constituency in the UK and France. According to Feldman (1995), information that the C bonds would not be issued was communicated to Germany through diplomatic channels. Germany's annual obligation was set at US\$ 500 million plus 26% value of its export. Marks (1969) considers this outcome as tremendous victory for Germany.

the Conference and under pressures from the constituencies of the Allied countries.

It is reasonable to conclude, following Marks (1969) and Ritschl (2012), that the decision to postpone setting the figure to 1921 made the reparation figure smaller than it would have been had it been set during the Conference, since the passions and expectations of the Allies public opinion moderated.<sup>16</sup> Furthermore, skilful presentation of the Reparations Commission decision in terms of public relations made constituency of the Allied countries happy with the nominal figure that looked like substantial – it was far above Germany’s actual burden. There was no room for such a compromise at the Conference.

The Reparations Commission established that the annual burden of Germany should have two tiers: one fixed and the other variable, specified as a percentage of its export. On one hand this does not violate Keynes’ idea of a definite figure for reparations, and on the other it takes into account German capacity to pay, measured by its export. Not only that the notion of capacity to pay is taken into account, but such a scheme takes into account that this capacity is variable in time.

It is now the very concept of capacity to pay – the central topic of the book – that should be thoroughly explored.

### 3.6. 6<sup>th</sup> Fallacy: Germany’s Capacity to Pay

Perhaps the most famous or rather infamous argument associated with Keynes’ book is the one about Germany’s capacity to pay the reparations. In a nutshell: Keynes’ position is that German capacity to pay reparations was limited to US\$ 10 billion, by strange coincidence, exactly the same figure that Keynes presents a few pages earlier as the amount of damage done by Germany, and far below what Keynes expects that the total amount of German obligations would be (US\$ 40 billion). That very coincidence, and the round and definite figure, and the lack of any methodological explanation how the calculation was done, undermines the credibility of both figures and the methodology by which Germany’s capacity to pay was estimated.

The first methodological problem of the book is that the concept of capacity to pay employed by Keynes in completely static, based only on the foreign trade balances recorded in that last pre-war year, adjusted only for Germany’s (estimated) territorial losses. Effectively, according to Keynes, a country’s capacity to pay does not change in time, economic agents and government do not respond to incentives, for example those

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<sup>16</sup> As Marks (1969, 357) put it “The preference for leaving the sum unsettled stemmed not only from political difficulties but also from the hope that, as wartime passions abated, a more moderate settlement would be possible”.

created by the reparations, or to external shocks. With such an attitude, it was inevitable to conclude that Germany's capacity to pay was constant and rather low.<sup>17</sup>

The second methodological problem of Keynes' analysis is that there is no time frame for paying the reparations, i.e. capacity to pay is not considered over time. The same amount of the obligation spread over say 20 or 40 years is something completely different as the capacity to pay is ultimately linked to the GDP of the country and its share of the annual instalment, i.e. the outflow to the GDP that matters. After all, capacity to pay is nothing but the share of the GDP that can be extracted from a country without a detrimental effect on its day-to-day economic life and economic growth. In addition to that, the longer the time frame, the more time there is for economic agents and the economy as a whole to adjust to the new conditions, to grow and to increase their capacity to pay.

Neglecting the link between Germany's capacity to pay and its GDP/GNP is the third methodological weakness, as Keynes considers the capacity to pay only as the foreign trade surplus, as the reparations payment "can only be made by Germany over a series of years by diminishing her imports and increasing her exports, thus enlarging the balance in her favour which is available for effecting payments abroad" (Keynes, 1920, 72). Based on this insight, Keynes wrongly assesses Germany's pre-war trade balance as the only ground for evaluating its capacity to pay, entirely neglecting the relationship between reparatory obligations and the GDP.<sup>18</sup> Furthermore, Keynes neglects that the reparations are paid (by the government) inevitably from the budgetary surplus, and such a surplus must be achieved for the reparations to be paid.<sup>19</sup> In hindsight, it is clear from the sequence of events following the Treaty that Germany's

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<sup>17</sup> Even an episode unrelated to the German economy demonstrates that even static (asset based) capacity to pay is not constant, as the destructive capacity of the German military elite should not be underestimated. The capacity to pay is diminished by scuttling the ships of the captured German Navy, which the German counterproposal identified as assets that would be counted as reparation to the Allies, due to a decision of Admiral von Reuter's decision to scuttle, a few days before signing the Treaty, the whole German squadron interned at Scapa Flow. Keynes does not mention this event in his book.

<sup>18</sup> Ritschl (2012) calculated the ratio of public debt in 1921 to the GNP for France, Great Britain and Germany (including reparations), demonstrating that the German ratio (147%) was only slightly higher than the British (144%) and French (135%). Furthermore, if this, international economics approach is accepted, it is not trade balance that should be considered, but the payment balance, both the current and the capital, since it is the flow of finances (money) that is relevant, not the flow of goods.

<sup>19</sup> For this consideration, it is irrelevant how the budgetary surplus is achieved. For example, it can be achieved by decreasing domestic consumption, both private (by increased taxation, decreasing the level of available income) or public. Alternatively, it can be achieved by borrowing either domestically or internationally, for example by



frequent defaults on reparations were due to a budgetary deficit (Tooze, 2016), and that the deficit was primarily due to the low taxes (McMillan, 2001).<sup>20</sup>

Ten years later, and following the Dawes Plan, the author accepts (Keynes, 1929) that there is not one but two separate problems, a budgetary and a transfer problem, and that budgetary surplus is a necessary condition for paying reparations. Then Keynes focuses to the transfer problem, i.e. the way that the budgetary surplus is transferred to the other countries, neglecting that Germany in the 1920s had recorded a surplus on the balance of payment, as the total inflow from abroad, mainly due to the US loans, had been greater than the outflow. Keynes specifies that decreasing German real wages is inevitable for increasing export, generating the trade balance surplus and solving the transfer problem. Nonetheless, as demonstrated by Ohlin (1929), the problem is not on the supply, but on the demand side, as surplus on the balance of payment increased the German demand for domestically produced goods (consequently decreasing German export) and increased the German demand for imported goods (increasing German import and undermining the foreign trade balance surplus or generating its deficit). Accordingly, the surplus on the payment balance (including reparations as the outflow) creates the transfer problem.<sup>21</sup> The political consequence of elimination of the balance of payment surplus would be the decrease in the purchasing power of German consumers and their living standard.

The problem with Keynes' concept of Germany's capacity to pay was recorded immediately after the publication of the book. Day (1920, 305) points out: "The question of what the Germans 'can' pay involves social and political factors which are going to have immensely more influence on the sum that Germany actually does pay than are economic theories or antiquated economic facts". Hence, the alternative concept of Germany's capacity to pay could be a political economy one, basically a concept of willingness to pay. As demonstrated by Sharp (2018, 40), there are three basic disagreements between the Allies and Germany at the Conference and after the signing the Treaty: "that its [Germany's] pre-

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emission of bonds. Hence, the broad concept of budgetary surplus is used in this paper, irrespectively of the political consequences of how the surplus is achieved.

<sup>20</sup> MacMillan (2001, 196) provides a political explanation of the low taxes in post-war German, inherited from the war period, as the war effort was funded by bonds based on domestic borrowing from the population, with the idea that indemnities paid by defeated countries will provided cash flow for paying back the war loans. The terms of the Treaty of Brest-Litovsk and the Treaty of Bucharest support this explanation.

<sup>21</sup> Carlson and Jonung (2019) provides a thorough and detailed review of the debate between Keynes and Ohlin in the transfer problem, as well as the opinion of Swedish economists of Keynes and his contributions, and not only the one discussed in this paper. Coming back to the transfer problem debate, according to the economists they refer to, there is no doubt that Ohlin won the argument.

war behaviour was the main cause of the war; that it has fought the war using foul means; and that the military outcome was a decisive defeat". For the German political elite and constituency, none of these statements were true and they both saw no reason to pay the reparation because, according to them, Germany did not start the war, did not lose it and fought it in a legitimate way. Accordingly, Germany's political economy capacity to pay was very low, if not zero, because this, according to German public opinion, was something unjustly imposed to Germany.<sup>22</sup> The consistent efforts of various German governments to act according to the preferences of the constituency and to sort out the reparation issue during 1920s indirectly confirmed this conjecture.

The insight that Germany's willingness to pay is much more important than its capacity to pay is nothing new. The recent contribution to the reparation debate (Ritschl, 2012) frames the issue within the modern theory of sovereign debt theory (Eaton, Gersovitz and Stiglitz, 1986) based on insight of incomplete contract, i.e. imperfect and costly mechanism for creditors to extract payment of contract obligations. The conclusion is that these mechanisms were rather feeble and agree with Manutoux (1944), and his insight that German reparation defaults basically were due to lack of willingness to pay on the part of the Germans and lack of determination to enforce the payment on the part of the Allies, due to the substantial costs of that enforcement, as demonstrated in the occupation of Ruhr, induced by Germany's default on reparation obligations.<sup>23</sup>

In short, in hindsight, it is evident that Germany was not missing capacity but rather the willingness to pay the reparations.

### 3.7. 7<sup>th</sup> Fallacy: All-out debt relief and investment fund as a panacea

In addition to his counter-proposal regarding German reparations, already discussed in the Section 3.5, Keynes proposes two additional

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<sup>22</sup> This is also the position of Marks (2013) who claims that in 1921, when the reparation burden was specified, Germany could not pay it, as it was politically and psychological impossible, because of the intense public emotions. These emotions were created by the German political and military elite. One of the mechanisms used to achieve this was that Article 231 of the Treaty stipulates that the Germany accepts responsibility for the losses and damages to property "by the aggression of Germany", which German elite interpreted as "the war guilt article", i.e. as Germany accepting responsibility for the outbreak of the Great War. Nonetheless, Article 232 specifies that it is "by the aggression of Germany by land, by sea and from the air", the same formulation that was used in Lansing's note. The word aggression in these articles obviously refers to the character of German military operations, i.e. to the property on the territory of the Allies and ships under Allies' flags, not to the responsibility for the outbreak of the war.

<sup>23</sup> Ritschl (2012) goes far beyond this insight and constructs different periods regarding Germany's incentives to service the reparation obligations during 1920s and early 1930s, with the implementation of various financial schemes (the Daws Plan, the Young Plan, etc.) up to Hoover Moratorium on debt/reparations in 1931.

international financial schemes for post-war Europe, both deeply affected the United States.

The first proposal is “for the entire cancellation of Inter-Ally indebtedness (that is to say, indebtedness between the Governments of the Allied and Associated countries) incurred for the purpose of war” (Keynes, 1920, 106). Keynes believes that this proposal “to be absolutely essential to the future prosperity of the world” (Keynes, 1920, 106), although he does not provide any evidence to support this bold declaration.

Undoubtedly, the level of Inter-Ally war-generated public debt is significant, about US\$ 20 billion, according to Keynes, about double of what he thinks is the war damage done by Germany.<sup>24</sup> The United States is only a lender (US\$ 10 billion); the United Kingdom is a net lender (US\$ 4.5 billion), but a debtor to the United States; France is net debtor (US\$ 3.5 billion); and the biggest net debtor is Italy (US\$ 4 billion). Although Keynes does not mention this explicitly, it is evident that reparations paid by Germany are crucial to France and, to some extent Italy, to service their debt obligations to the United States. Hence, the reader is tempted to infer that if there is a cancellation of that kind, then both the pressure for Germany to pay the reparations would be reduced.

Keynes has no dilemma that in this field, America is a key player. “It is from the United States, therefore, that the proposal asks generosity” (Keynes, 1920, 107). But what is that the US administration will gain from it? Keynes points out that “A debtor nation does not love its creditor” (Keynes, 1920, 109), more a declaration of a poet than an economist, but perhaps the US administration, at the time of rising isolationism in the country, considered preserving these financial assets abroad as a reasonable leverage for at least some influence in European affairs. What would be the cost for the US government for such a move? Keynes does not provide the answer to this question, but it is easy to grasp. Because most of these loans were based on Liberty Bonds purchased by US households, the US Government would have to compensate them and that would mean more taxation of its own constituency, now or in due course – Riccardinan equivalence stands. Hence, only costs, with no political benefit whatsoever. It was not strange that Keynes’ proposal was turned down by the Americans.

At the end of his plea for debt cancelling Keynes points out: “The existence of the great war debts is a menace to financial stability

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<sup>24</sup> The figure specified in the book is not accurate because Soviet Russia, which is only a debtor, proclaimed sovereign default on 4 February 1918 (ten months before the manuscript of the book went to press) with repudiating all the obligations of Imperial Russia, meaning all of Russia’s sovereign debt. Keynes does not mention that default or intention of the Soviet Government in the area of international finance. Accordingly, the total amount of the debt should be reduced by roughly US\$ 3.8 billion. Malik (2019) provides substantial details and a thorough analysis of the sovereign default of Soviet Russia in 1918, that includes all international and domestic obligations of the Government.

everywhere. There is no European country in which repudiation may not soon become an important political issue” (Keynes, 1920, 109). In hindsight, it is evident that Keynes’ prediction was wrong. Again.

The other Keynes proposal is an international loan of US\$ 1 billion: a working capital loan for European countries, because “It will be very difficult for European producers to get started again without a temporary measure of external assistance” (Keynes, 1920, 111). Keynes supports the idea of what should be “an international loan in some shape or form” (Keynes, 1920, 111) and he “does not propose to enter on details” (Keynes, 1920, 112), but he is positive about two things. First that the lender should be the US Treasury and that this is a working capital loan, i.e. not a reconstruction loan. In short, and between the lines, since French and Belgium industrial capacities, as well as the UK merchant fleet, will be reconstructed by the German reparations, by earmarking the loan as working capital, Keynes effectively send the signal that there is no need for reconstruction of German industrial capacities and German economy altogether. For an obvious reason: there was no destruction whatsoever.

As to the feasibility of the loan, Keynes had no second thoughts about it. “In short, America would have postponed her own capital developments and raised her own cost of living in order that Europe might continue for another year or two the practices, the policy, and the men of the past nine months” (Keynes, 1920, 111). Then, Keynes is even more explicit: “If I had influence at the United States Treasury, I would not lend a penny to a single one of the present Governments of Europe” (Keynes, 1920, 112). Hence, the author himself spotlights the infeasibility of his own proposal. Being aware of it,<sup>25</sup> Keynes proposes a long-run solution. “A great change is necessary in public opinion before the proposals of this chapter can enter the region of practical politics, and we must await the progress of events as patiently as we can” (Keynes, 1920, 113). Nonetheless, the issue is that the solution for the short-term problem, if it occurs at all, is inevitably long-term, due to a timeframe of the change of public opinion. The lack of working capital cannot wait for years to be solved. It will be solved one way or the other, by adjustments of economic agents; it could be inferior (with lower level of output), but it will be solved. Hence, the grand scheme that Keynes proposed several years, which enables the public opinion to change, would just be useless.

### 3.8. 8<sup>th</sup> Fallacy: Soviet Russia is Neglected

Russia was not represented at the Conference, there is no question about that. Among other good reasons why it was not invited, the most

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<sup>25</sup> In hindsight and with Paris bridges 1968 graffiti flavour, this kind of proposal appears to be consistent with the notion of “Be realistic, demand the impossible!”, the guideline attributed to Ernesto Che Guevara.

important one was a dilemma whom to invite: the Soviet Government or the White rebels fighting against it. Within that framework, Keynes is not necessarily concerned with the long-run prospects for Russia, but for short-run consequences of economic prosperity of the two countries: Germany and Russia, ostensibly for some of their neighbours.<sup>26</sup>

For Keynes the biggest and perhaps the only problem is how to obtain the export of Russian wheat for the European market in 1920. He had some clues that there were some problems with agricultural production in Russia. Keynes stuck to euphemisms, both for the description of the problem: “The present productivity of the Russian peasant is not believed to be sufficient to yield an exportable surplus on the pre-war scale”. (Keynes, 1920, 115), as well as the explanation of its causality: “The reasons for this are obviously many, but among them are... absence of incentives to production caused by the lack of commodities in the towns which the peasants can purchase in exchange for their produce” (Keynes, 1920, 115). This is Keynes’ contribution about something that historiography recorded as the massive famine in the Russian Civil War, due to the substantial drop of the agricultural output. This happened because peasants were killed and/or drafted by the both sides; crops and farms were looted and burned, transportation lines and distribution centres were destroyed, privately property rights massively violated, to use contemporary language, in the conditions where new (international) wars had been either going on or could be expected soon near the western borders of the new Russia, irrespective of whether it would be Soviet or not. In such conditions, peasants had only one incentive: to save their own lives and the lives of their families. It is the hindsight of historiography that provides all these details, but it is documented (MacMillan, 2001; Tooze, 2014, Sharp, 2018) that substantial information about developments in Russia, including the agriculture, reached Paris in the spring of 1919 and the Conference, as their participants discussed them and exchanged views about the future of Russia and what the position the Conference should take on it.

Nonetheless, Keynes even at the end of 1919 (when the manuscript of the book had been submitted to the publisher), subscribed to the view that the main reason for the lack of exportable surplus of Russian agricultural products is the lack of commodities in towns that peasants can purchase. His recommendation was straightforward and for the already experienced reader (the Russian issue is mentioned in the last chapter of the book) hardly surprising: “Germany... has the experience, the incentive, and to a large extent the materials for furnishing the Russian peasant with the goods of which he has been starved for the past five

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<sup>26</sup> Keynes description of some of them is sarcastic beyond good taste even at that time. “Yet, unless her great neighbors are prosperous and orderly, Poland is an economic impossibility with no industry but Jew-baiting” (Keynes, 1920, 114).

years” (Keynes, 1920, 115). It is as if there is no problem with working capital (the reason for the recommended international loan), no problems regarding the civil war in Russia and its consequences, etc. A sarcastic reader might comment that perhaps the Brest-Litovsk Treaty should be resurrected to provide the institutional background for the suggested arrangement.

Irrespective of to what extent Keynes’ recommendation is plausible, it is evident that he was completely focused on the short-run issues, and only one of them: supplying grain to the European market for 1920/1921. He was not concerned with the long-run future of Russia, political or economic, the future of the Revolution and Bolshevism, its impact to Central and Eastern Europe. In that way, his position is completely consistent with his credo “In the long run we are all dead”.<sup>27</sup>

### 3.9. 9<sup>th</sup> Fallacy: The Treaty and the Rise of National Socialism

Considering the rise of National Socialism in Germany, and the outbreak of the Second World War as an almost inevitable consequence of the Treaty, is definitely not a fallacy of the book, but the widespread fallacy that the book had contributed to. There is only a vague guess in the book about the possible political consequences of this sort.<sup>28</sup> It is in reading the book in hindsight that a causality chain can be established. The harsh economic terms of the Treaty, i.e. outflows due to reparations well beyond Germany’s capacity to pay, destabilised Germany economically, undermined its economic potentials, that denied post-war Germany economic growth, so it plunged into wholesale recession, which impoverished substantial segments of society and these segments became the power base for the advent of the National Socialist Party and Adolf Hitler himself. Marks (2013) provides an extensive list of historians who have subscribed to this view (though not necessarily to every detail of the causality chain), and Sharp (2018) provides such a list of diplomats, including George Kennan, Henry Kissinger and Douglas Hurd, as well as *The Economist* which in the millennial special specified that “The final crime was the treaty of Versailles, whose harsh terms would ensure a second world war”.

Obviously, the impact of Keynes’ book on this school of thought cannot be underestimated. But the crucial question is whether there is any evidence to support the mentioned causality chain. As to economic

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<sup>27</sup> It was von Mises (2005, 130) who responded to this motto saying “nearly all of us outlive the short run and... spend decades paying for the easy money orgy of a few years”.

<sup>28</sup> “You cannot restore Central Europe to 1870 without setting up such strains in the European structure and letting loose such human and spiritual forces as, pushing beyond frontiers and races, will overwhelm not only you and your ‘guarantees’, but your institutions, and the existing order of your Society” (Keynes, 1920, 15).

growth, in hindsight, there is no evidence to support it, because the average annual growth rate of the Germany economy in a decade that followed the Treaty was 5.8% – quite a high growth rate.<sup>29</sup> Obviously, the reparation burden was not a significant constraint to the dynamics of the German economy. This insight is supported by the data on the outflows due to the reparations expressed as the share of the GDP. In only two years (1921 and 1922) it was more than 5%, and the average for the period was 3.4% of the GDP.<sup>30</sup>

This clearly demonstrates that the reparations obligations were well within the German capacity to pay, that the capacity was not a static concept and the only proper way to express it was as the share of the GDP. The other important point was that it was not the total amount of the burden that mattered; what mattered was the outflows to service that burden compared to the GDP and the prospects for financing that outflow by borrowing funds. What actually happened in the 1920s was that Germany, with the conclusion of the Dawes Plan, started to borrow from the Wall Street, i.e. United States private financial institutions, and that the inflow of funds was greater than the total outflow, reparations included. Hence, in the decade after the Treaty and before the advent of the Great Depression to Germany (it was effectively in 1931), the country recorded substantial economic growth. Had the Treaty's economic terms been really harsh, there would have been no economic growth in Germany in the first decade after the Treaty. Nonetheless, the growth was substantial.

The other important fact was the election results of the Germany far-right political parties and their representatives. The National Socialist party candidate for the president, a war hero, at least for Germans, recorded only 1.1% of the votes in the 1926 presidential elections, and the National Socialist Party, whatever name it used, was not able to get more than 5% of votes on the parliamentary elections before the 1930s. The political success of the party came only after the full-blown Great Depression in 1931. Had the Treaty's economic terms been really harsh, there would have been mass impoverishment and emergence of the winning far-right in Germany in the first decade following the Treaty. Nonetheless, there was no political success of the far-right in Germany at that time.<sup>31</sup>

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<sup>29</sup> Based on data from Tooze (2014, 369) who compiled data from Schuker (1988) and cross-checked it with Bresciani-Turroni (1937) and Webb (1989). The data is on the national income, which was at the time the equivalent measure of the GDP. The annual average growth rate included the negative growth rate of -14.3% for the year 1923 – a hyperinflation year. According to Ritschl (2012, 5), after hyperinflation, Germany experienced its own version of the Roaring Twenties.

<sup>30</sup> Tooze (2014, 369). Reparation outflows are specified as reparation items in the German balance of payment and this outflow included cash transfers, payments in kind and all other charges.

<sup>31</sup> This is not to deny that the Treaty produced substantial grievance of Germany's constituency, not only because of the reparations, but also because of the loss of colonies

### 3.10. 10<sup>th</sup> Fallacy: The Relevance of the Book for Modern Sovereign Debt Crises

Naturally, this is not the fallacy of the book itself, but the fallacy created by the admirers of Keynes and the book. The wisdom of Keynes from the book is praised even today and is seen as missing in the consideration of the modern sovereign debt crisis and other economic and social evils of the time. Moore (2012) even titles his contribution, a review of the book, as “Keynes’ wisdom is perfect for the eurozone”, though from the text it is not clear what is the specific wisdom of the book that the author has in mind and why it is perfect for the eurozone. Pettifor (2019, 492), who thinks that the book is “a bold, eloquent work unafraid of the long view”, even considers that the “Golden Age” period, during the several decades after the Second World War, was due to economic policies Keynes recommended in the book. Carabelli and Cedrini (2014) focus to Keynes’ suggestion regarding the magnanimity related to debt forgiveness as a possible precondition for building trust for cooperation, overcoming antagonisms between the actors with the eye on the Europe’s sovereign debt crisis in the 21<sup>st</sup> century.

It is a bit surprising that a hundred years of development of economics is simply neglected and Keynes’ insights from the book are used for policies that should tackle modern issues. Development in the field of sovereign default theory and methodological development in the debt sustainability analysis have been substantial since the early 1920s, as well as development of financial markets and instruments used on these markets. The debate on the sustainability of Greece’s sovereign debt clearly demonstrated that modern methods of economic analysis provide a rather clear answer to the question. Why these answers were neglected by policy decision makers is provided by modern political economy.<sup>32</sup> There is hardly a need for Keynes’ topical insights, provided 100 years ago, for proper consideration of contemporary sovereign debt crises.<sup>33</sup>

This concludes a non-exclusive list of fallacies of Keynes’ book.

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and territory (about 13% of its pre-war area), take-it-or-leave-it approach of the Allies, and general treatment of Germany as a country that lost a war. These sentiments, fuelled by effective public relations strategy of German political elite, sustained in the whole interwar period. It was in the aftermath of the Great Depression that these sentiments paved the way for the German far-right to win the power, but it is indisputable that the Treaty did not produce the Great Depression. Hence, acknowledging the grievance of Germany’s constituency does not provide any evidence for the economic hardship due to the Treaty – advent of National Socialism causality link.

<sup>32</sup> Alesina, Favero and Giavazzi (2019) provide a comprehensive review of the debate and the results of the Greek sovereign debt crisis and its impact to eurozone stability.

<sup>33</sup> Annas, Pienkowski and Rogoff (2020) provide a thorough insight of modern sovereign debt theory and best practices, demonstrating how advanced this discipline



#### 4. POSSIBLE SOURCES OF THE FALLACIES

What is the source for these and other fallacies of the Keynes book? The straightforward answer is the character of the book. It was noticed in a very early review of the book that “It is written by an economist on an economic subject, but it is not, and cannot have been designed to be, a contribution to economic literature. It is a political tract. ...it is meant to rouse public interest and to force political action, and to reach that end it follows methods which are far removed from those of the strict scientist”. (Day, 1920, 301).

In modern language, Keynes’ book is an advocacy piece, not a well-balanced academic contribution. And it was a very powerful advocacy piece, as “It was the power of its political polemic rather than the cogency of its economic analysis that generated its reputation” (Clark, 263). The book was aimed at and was very successful in swinging public opinion, primarily in Britain, against the Treaty and for a lenient reparation policy towards Germany. There was no need to swing German public opinion, and the French was unlikely to change. The effects of that swing have endured for many years as well as the reputation of the book. As Marks (1969, 364) points out “It is probably impossible to exaggerate the influence of *The Economic Consequences of the Peace*. A whole generation of the intelligentsia, especially in the English-speaking world, came to believe that the reparations burden under the Versailles Treaty was both vicious and unpayable”. It is precisely because the book is an advocacy contribution that the fallacies were very likely created.

The durability of the effects of the book on the public opinion is a bit puzzling, as the book was obviously written with the short-run objective: swinging public opinion and shaping policies towards Germany immediately after the end of the Conference. Such an orientation means that the recommendations of the book are followed by predictions of what would happen if the recommendations are not implemented, basically a threat of what would happen if the recommendations are not accepted.<sup>34</sup> In principle, this is a risky strategy of the author, because if that does not happen, if the predictions do not come true, the book loses its credibility in the long run. Although it is evident in hindsight that many of Keynes’ predictions did not come true, the main one being about the gloom and doom of Germany’s economy post-Treaty, the impact of the book on public opinion has been very durable, and for the general public at least,

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of economics is. Browsing this book provides information on what is missing from the Keynes’ analysis of Germany’s capacity to pay.

<sup>34</sup> This approach is based on the assumption of the inevitability of the events, the inevitable cost of advocacy approach. Modern historiography has demonstrated (MacMillan, 2009) that nothing is inevitable in history.

the credibility of the book has not been undermined. This puzzle is yet to be explained, especially taking into account that there is evidence that Keynes himself regretted having written the book.<sup>35</sup>

The other important question is why a splendid economist, endowed with all the methodical knowledge in the economics of that time, decided to write an advocacy book with all the methodological shortcomings, some of them identified in early reviews (Day, 1920; Taussig, 1920) and some of them referred to in this review. An additional question could be why write an advocacy book favouring Germany. One could explain that by his inner moral need. Kasper (2010) points out Keynes' legacy as a public intellectual, motivated throughout his lifetime by an inner moral need to voice the truth in times of social crises. Even if this idealistic view of Keynes is accepted, the question remains regarding the "voice of truth", as truth can hardly be discovered through advocacy, but rather through rigorous academic study. This is obviously not a promising way of considering the answer to the question why the book was written in the way that it was.

Neither is an opposing view about Keynes as a moral villain, a German agent who deliberately worked for the German cause because his Germanophile sentiments, not divergent from the attitude of his social class and peer group and perhaps due to the conflict of interest, as suggested by Tampke (2017).<sup>36</sup>

Even if Germanophilia is not a proper word, sympathy for Germany, its culture, accomplishments and civilisation were not missing from British society and especially its intellectual elite at the end of the 19<sup>th</sup> and the beginning of the 20<sup>th</sup> century, as described by Clark (2013), who takes that attitude into account in the analysis of the environment in which the decisions that eventually lead to the Great War were made

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<sup>35</sup> According to the testimony of Wiskemann (1968, 53), after 1936, when Germany was in full economic and political swing, under the new National Socialist administration: "I met Maynard Keynes at some gathering in London. 'I do wish you had not written that book', I found myself saying (meaning *The Economic Consequences*, which the Germans never ceases to quote) and then longed for the ground to swallow me up. But he said simply and gently 'So do I.'"

<sup>36</sup> The ostensible conflict of interest was due to Keynes who "fell in love with a German financial delegate to the conference, the banker, Dr. Melchior". (Tampke, 2017, 206), an event mentioned by Skidelsky (1983). Clark (2017, 289) quotes Keynes' words "In a sort of way, I was in love with him" from the essay to be read to the Bloomsbury group, explaining that Keynes "fed Bloomsbury appetite for sexual innuendo". MacMillan (2001) downplays the whole affair, being sceptical that anything like that really happened. Ferguson (1998, 400–401) shed more light on the relations between Keynes and Melchior, providing evidence that the Keynes proclamation of love refers to the Melchior intellect and his analysis. It seems that the conflict of interest explanation is not found on facts, though its consideration provides additional evidence of Keynes' unconstrained belief in accuracy of the inputs provided by the German representatives.

– a process that he characterised as sleepwalking. Keynes was a part of that elite and shared its value judgments. Furthermore, Keynes was a member of Bloomsbury Group, whose members shared a pacific stance and perhaps his engagements in the UK Treasury during the war created the need for redemption. One way or the other, Keynes personality was complicated and a simple answer to the question of motives for such a book will apparently be lacking.

Furthermore, it is inevitable to take into account the strong personal touch in the book, originating, among other things, from the frustration and perhaps even malevolence of the author whose ideas were rejected at the Conference, or at least not fully appreciated by the crucial decision makers of the Treaty. Perhaps this frustration, which does not necessarily contradict the genuine feeling of injustice, can explain some of the passages in the book, its bitter style and main findings. It is understandable – John Maynard Keynes was only human, save the view of his most ardent supporters.

Perhaps the story of the motives should be moved to fiction and *The Remains of the Day* character of Lord Darlington (Ishiguro, 1989). It was he, a noble, honest and old fashion English gentleman, a man of virtue, who participated in the Great War, but he thinks that after his side won, there should be no more animosity between England and Germany. He feels sympathy for the suffering of the Germans, and genuine regret and guilt about the post-Versailles treatment of Germany, hence he decides to do something about it. Darlington Hall is a place of these efforts, but he never understood the true German agenda and the way he has been used in it. Perhaps the biggest difference between Lord Darlington and Lord Keynes is that the former ended up being labelled a Nazi sympathizer and a traitor, which ruined his reputation and left him a broken and disillusioned old man at his death. Contrary to that, Lord Keynes' glory as an economist of a superior mind and a person of superior morality lived on to our days.

## 5. CONCLUSION

John Maynard Keynes' *The Economic Consequences of the Peace* is an advocacy book and because of this it is inevitably biased. Its target audience was the general public, aiming to create the public opinion that would support recommended policies, favouring Germany. It made no academic contribution whatsoever.

In hindsight, it is evident that the book created many fallacies, some of them considered in this review, and that many of the predictions from the book were wrong. Perhaps the most important wrong prediction was

that Germany would be economically ruined by the terms of reparations imposed by the Treaty. Contrary to that, Germany bounced back after the Great War. The thesis that the harsh economic treatment of Germany by the Treaty is to be blamed for the advent of National Socialism is at odds with the facts.

Perhaps the greatest puzzle is why an advocacy book that was so wrong about so many things made such an extraordinary impact on both academia and the general public opinion for so many years. Its reputation is alive and well, it seems, even after 100 years. This is the puzzle that remains to be solved.

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