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Had We Paid Attention to Keynes?

Working Paper No. 16

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Prepared for Professor John Hall

Abstract: This inquiry seeks to establish that a host of problems could have been averted had we paid attention to Keynes. In the view of Keynes (2013, pp. 23-28), the Versailles Treaty was unnecessarily punitive towards Germany. He explains that the terms negotiated during the Paris Peace Conference were at odds with the agreement that took place during the Armistice when both sides decided to lay down their weapons and end fruitless battling. Consequently, following the Wall Street Crash of 1929, Germany registered as one of the most nations most tragically affected by the Great Depression. This is partially because of what Keynes (2013, pp. 23-30) foresaw through the Treaty of Versailles. He believed Germany would be in an extremely vulnerable position because of the extensive reparation costs. With high inflation and other signs of instability, Germany was left unprotected and no other nation proved willing to assist, leaving space for the far-right parties to make their way into power.

***Journal of Economic Literature* Classification Codes:** B1, B22, B31

Key Words: Fascism, Great Depression, John Maynard Keynes, Paris Peace Conference, Treaty of Versailles

This inquiry seeks to establish that an array of problems could have been averted had we paid attention to Keynes. Following the horrors of World War I, Europe could have found peace and flourished once again. The process began with the Paris Peace Conference leading to the Treaty of Versailles signed on the 28th of June 1919. The conference originally sought out to repair the extensive damage that Europe endured during the war, as well as accounting for the catastrophic loss of life. However, the victors of the war very quickly became vindictive as they aimed for retaliation, wanting to ensure the demise of the defeated no matter what the potential cost may be. This led one very important individual representing the British Treasury to resign in indignation and rage over the direction the representatives of these countries decided to take. This crucial person, by the name of John Maynard Keynes, expressed his views of disillusionment through several publications in order to make sure the world understood the errors of the Paris Peace Conference. He insisted the world should know the Peace Conference failed at the task at hand by neglecting to reestablish life and soothe the trauma brought to many countries during the war. We are therefore going to examine the Treaty of Versailles to perceive the grave mistakes made. Furthermore, we will analyze the Great Depression as well as the rise of fascism leading to World War II that could potentially have been averted had the victors of the war listened to Keynes.

Understanding the Treaty of Versailles

As individuals, we tend to believe that the social state we are in will endure and we resist change, planning our lives accordingly without considering the possibility of instability upon which our systems are founded. We become complacent and build our political systems as well as social advancements on the basis that nothing can deeply uproot our society and everything is permanent. As John Maynard Keynes (2013, pp. 2-4) explains, this particular misconception came to an abrupt halt and was overturned though the German people's complete self-indulgence and disillusion. This led all Europeans to be deprived of the foundations their lives were assembled around. However, the legacy of destruction is not solely in the hands of the Germans but also in that of the victors of the war who allowed for the total destruction of the organizations that govern our world rather than restoring them to allow us to rebuild the existing extremely vulnerable societies. This destruction was granted by the Paris Peace Conference that had severely damaging implications because the countries on the European continent have allowed themselves to thrive and come to their demise together. Essentially, these countries constitute one vast organization and civilization. This is why Keynes (2013, pp. 2-4) suggested that the implications of the Paris Peace Conference would be immensely devastating to European societies, excluding England where the silent tremors do not extend to. He thought the abuse of power of the victors could lead them all to their demise.

Following World War I, the fundamental objective of the countries involved was to return to their previous comforts. As Keynes (2013, pp. 8-10) describes, with certain survivors of the war seemingly richer, citizens planned to intensify and expand their comforts through an increase in spending and declines in savings for the rich and work for the poor. However, the Paris Peace Conference left these aspects uncertain through extremely questionable decisions. With France taking the lead by putting forward the most extreme proposals in order to find a satisfying compromise, England and America were oblivious to the legitimate issues at hand as their interests were not vigorously implicated. This led to the first crucial and dangerous error of not granting the Germans the possibility of being involved in the discussions, eliminating the prospect of reconciliation. With no inclusion of economic stability or rehabilitation between allies and countries in Europe, Keynes decided to resign as the British financial expert during the negotiations. He believed the terms agreed upon were irrational because they would cripple Germany and would not allow for reconciliation and healing. As Keynes (2013, pp. 23-26) mentioned, the lack of stabilization between the countries was one of the Treaty's largest shortcomings. They were not concerned about their future lives but were obsessed with borders and power, which was a colossal oversight that led to decisions that severely impacted the world in the years to come.

In the view of Keynes (2013, pp. 23-28), the Versailles Treaty was unnecessarily punitive towards Germany. He explains that the terms negotiated

during the Paris Peace Conference were at odds with the agreement that took place during the Armistice when both sides decided to lay down their weapons and stop the atrocities. The Armistice was agreed upon in very different terms to the original draft of the Versailles Treaty. In their acceptance to lay down arms, the defeated were led to believe they would be treated with dignity, diplomacy and avoidance of extreme punitive measures. However, this was not the case once the Paris Peace Conference came to an end. Certain terms were modified following outrage from the Germans regarding the original draft of the Treaty, but the essential components were still the same with the allies giving Germany an ultimatum to accept it if they wanted to avoid war and the end of the Armistice. With these terms the German government collapsed, swiftly forming a new government that agreed to sign the Treaty of Versailles that doomed their country. The conditions agreed to were vindictive as Germany lost its colonies as well as part of their territory due to changing borders, which led to German citizens being left behind in new States. The Treaty also included extreme reparation payments starting with an initial payment of 20 billion gold marks. The actual amount to be repaid was not only determined during the Paris Peace Conference, but also was decided by a commission comprised of allies. This allowed them to specifically examine all of Germany's economic and industrial activities to conclude on the actual amount owed to each country which totaled 132 billion gold marks. Keynes (2013, pp. 44-48) contemplated that the amounts demanded by the allies could never be paid and it would lead to protectionist

measures, as well as preventing Germany from rebuilding its society. As the final amounts were uncertain for several years, it forced Germany to postpone the rehabilitation of their society and pushed their currency to collapse.

Keynes (2013, pp. 23-30) pointed out various other errors of judgment such as the choice of location for the peace talks. They were held in Paris which is located in one of the crucial countries that took part in the war, France. This meant that the conference took place on non-neutral territory where delegates could be influenced by locals and the press. This also affected the German delegation as they were attacked and stoned by Parisians when arriving in Paris. This shows a clear error in judgment and set the tone for the peace process. The press primarily affected the American President Woodrow Wilson who was resented by the French as he wished to settle differences between the opposite sides and resolve all conflict, whereas the French people were vengeful. This led to Wilson's and America's diminishing power to negotiate with the allies to fight for a less punitive agreement and enabled countries such as France and Britain to mediate to their advantage. Moreover, Keynes (2013, pp. 23-30) viewed the naval blockade put into place by the British during the war that continued during peace talks, preventing supplies reaching Germany, as immoral. It was an attempt to force Germany to cooperate, but it primarily affected the most vulnerable German citizens such as women and children who had no access to food supplies. This went against their Armistice agreement that was supposed to ensure Germany had access to essential supplies. For these

reasons, the Paris Peace Conference was named *Carthaginian Peace*, as the allies sought to ultimately annihilate their enemy without thinking about future repercussions and the devastation it could cause.

Averting the Great Depression

Following the end of World War I and the Treaty of Versailles, Germany was left in an extremely vulnerable position with devastating debts to pay towards the victors of the war. As Karl Polanyi-Levitt (2014) explains, following the war, currencies in the majority of European countries were associated to gold to generate a certain stability across the continent. This was only possible because of austerity precautions as well as credits from large influential countries such as France and Britain. However, this was not sufficient for Germany, as they had to pay extensive reparation costs during a time of destruction and poverty. This is why the United States decided to offer them substantial credits to allow them to begin repaying their debts towards the victors of the war. These various loans enabled the German economy to slowly rebuild following the devastations of the war. Unfortunately, this all came to a catastrophic halt following the Wall Street Crash of 1929. The day now known as Black Tuesday, occurred on the 29th of October 1929 when the New York Stock Exchange crashed leading to the failure of several banks in America. As numerous European countries were economically linked to the United States, their banks began to collapse shortly after, leaving an already crippled Germany in a precarious predicament. The

United-States could no longer afford to help Germany and Britain chose to dissociate the pound from gold to preserve the value of their currency.

Moreover, during this time of crisis, Keynes once again became an important figure among governments. During this time of economic devastation and the crash of international trade, he offered his views for new economic policies that were previously ignored and overlooked. Karl Polanyi-Levitt (2014) describes Keynes as being intrigued by Washington and the creation of a new form of organization rather than following socialism like a number of other economists at that time of capitalist failure. Keynes was a very observant economist and as he saw the increasing struggle his homeland was facing during the 1920's, he advised the government to try to avoid complete devastation. As he saw the pound sterling being overvalued to encourage investments and exports no longer being competitive due to other currencies being devalued, he observed disarray within communities. Miners were particularly badly affected as they were expected to bear the burden of decreasing exports by increasing their productivity as well as accepting a decrease in pay. This led to outrage and strikes across the country. This enabled Keynes to acknowledge the real issue, which was not one of currency but of class, because the top classes were being favored over the bottom ones as they were expected to take the fall and cover the damages for everyone.

Furthermore, following his intuitive observations, Keynes gave the British government policy advise. As Kari Polanyi-Levitt (2014) mentions, Keynes

believed the government should generate central bank credits to decrease unemployment by creating public work. This would allow the unemployment rate to drop and give people spending power which enables the economy to grow and function normally. However, this plan was rejected as European countries believed they should follow austerity policies to avoid the inevitable increase in interest rates and imports, as well as a decrease in investments. They were not willing to comprehend the effects of the increase in spending power on the financial health of businesses, investments and the economy. The British government wanted to maintain their budget to the grave demise of the British people and the unemployment rate. This lack of support from the government led Keynes to believe that as long as they are willing to follow old classical ways, they will not take his advice no matter the situation or his arguments. Therefore, he devoted his time and research to ensure he was able to break the cycle of the classical economists such as David Ricardo and John Stuart Mill to lead Britain out of this time of depression. The advice he gave the British government was not only applicable to them, but could have also helped several countries such as the United States through their time of economic depression. During this period, countries chose austerity policies as they did not wish to understand the intentions behind public spending and how it could positively impact unemployment rates and the whole economy.

Furthermore, Germany was one of the most catastrophically affected countries by the Great Depression. This is partially because of what Keynes

(2013, pp. 23-30) foresaw through the Treaty of Versailles. As previously mentioned, he believed Germany would be in an extremely vulnerable position because of the extensive reparation costs. As they were closely intertwined with the United States' economy through the loans provided by the U.S. to repay their debt, their economy was the first in Europe to collapse following the Wall Street Crash. As Albrecht Ritschl (2012) concludes, Germany had an extensive foreign debt issue that was increasing yearly. In order to avoid complete default on their reparation repayments, they focused essentially on their fiscal policy by trying to balance their budget. For this particular aspect it was a successful plan, however, by avoiding the consequence of defaulting on their reparation debt, they increased commercial foreign debt which entailed other difficulties. This created a demand from foreign creditors to pay back their loans and the demand for default from their citizens because they were already in an extremely vulnerable position and could not realistically afford to pay their debt without taken even more drastic measures. By avoiding foreign creditors, they sought to obtain help from the Central Bank. However, this required extreme cuts in wages, budgets and public spending. These policies were disastrous for the economy and led to unemployment and extreme inflation in a country that already had been weakened by the Treaty of Versailles. This economic climate put Germany and German citizens in a difficult situation with very few solutions or help provided from other countries who were enforcing protectionism and austerity policies at that time.

Averting the Rise of Fascism Preceding World War II

As Europe struggled to recover from the Great Depression, fascism found its place in a continent suffering increasing desperation and persistent poverty. In particular, Germany was severely affected, as this nation had not fully recovered from the consequences of implementing the Treaty of Versailles. As Polanyi-Levitt (2014) explains, the negotiations that took place during the Paris Peace Conference, that led to the treaty of Versailles, had clear repercussions. The Treaty undermined the German and Italian governments creating an immense disequilibrium. As previously observed, rather than stabilizing international relations, the Paris Peace Conference weakened them, allowing for the possibility of festering anger potentially leading to another war. The Germans believed they were humiliated during the Paris Peace Conference and the outcome was intended to destroy them. They never entirely accepted it because it was imposed on them without room for negotiation. These concepts left a void open for a vindictive extremist leader who could potentially save them from the disastrous position they were in. With high inflation and no stability, Germany was left unprotected and no other country was willing to help, leaving space for the far-right parties to make their way into power.

Furthermore, as William A. Pelz (2016) suggests, this concept of the rise of the extreme right parties was not solely observed in the case of the defeated nations. With the increasing fear caused by the Bolshevik Revolution, European

countries became increasingly violent in preventing the expansion of the revolution. Governments wanted to gain growing amounts of control and power over their citizens to prevent their loss of authority. This often meant cooperating with new, younger and more vigorous members of far-right parties to avoid losing power. For example, this was the case in Italy and Poland, where former socialists managed to seize power against the current governments. Poland's new leader's name was Marshall Pilsudski. He had formerly gained support from the left party, before transforming his power into a dictatorship with the support of the Church because he secured their interests. This same type of evolution in power took place in Italy through Mussolini and the rise of an authoritarian leader in Greece by the name of Ioannis Metaxas. In capitalist countries, where workers were crippled by the Great Depression because of unemployment and hyperinflation, citizens were divided with the anger of the working class growing. Additionally, the gap between rich and poor was expanding with the poorer working class citizens carrying the burden of lower wages and higher unemployment that widened that chasm between rich and poor.

Moreover, when we look more specifically at Germany, which is often the example used regarding the rise of fascism, we can see the desperation of the population that led to the empowerment of an authoritarian leader. In a country that was left in ruins by the victors of World War I and the Great Depression, citizens were divided between two crucial parties, the Social Democratic Party

and the Communist Party. Through this great separation, the Nazi party was able to push their agenda thanks to their impressive following of middle-class bourgeois citizens and violence. Germans were in a time of desperation and were open to any leader that could potentially offer hope to them in a time of despair. With the Nazi fight against the Communist Party becoming increasingly poignant, they started to receive and demand more powers by setting them up and blaming communists for the burning of the Reichstag. With a lack of opportunities to campaign and increasing fears of being reprimanded, the Communist Party slowly dissipated giving way for the Nazi Party to be democratically elected. With increasing powers, the Nazi Party began their reign of terror through violence and laws preventing opposition to rise. This allowed them to implement their anti-democratic and anti-liberal ideas that eventually no one could oppose without risking their lives.

Furthermore, as we know, this rise of fascism throughout Europe led to extremely severe consequences that Keynes could not have predicted when writing *The Economic Consequences of the Peace* [1919]. The mass casualties and the overwhelming destructive war that shook the world for years could not have been foreseen. However, Keynes (2013, pp. 99-109) suggested that the Treaty of Versailles and the Paris Peace Conference could have enormous implications for future generations, hence he wrote about the possible remedies. He sought to repair the damage done during the peace talks by modifying the treaty and giving Germany a chance for rehabilitation, as well as offering

Europe a chance for reconciliation. He believed the treaty should be reviewed because it is not sustainable as the reparation costs are too high and Germany's rights are impinged upon. Through the change in reparation amount, the distribution among allies should also have been rearranged to allow for a more just appropriation of reparations. An international loan should have been offered to offset the burden of paying substantial sums at once and allowing several generations to carry it out more proportionally. In regards to international relations, the relationship between Central Europe and Russia should have been an important component to repair as they are both extremely important powers in the world.

Conclusion

This inquiry has sought to establish that an array of issues, including world tragedies, could have been averted had we paid attention to Keynes. It was Keynes who perceived and also cogently argued that the Treaty of Versailles was narrow-minded and short-sided, wholly failing to account for long-term implications associated with crippling a country such as Germany. As we have observed, the treaties signed following World War I rendered Germany humiliated and also crippled as an industrial power. The associated difficulties that Germany's difficulties and also vulnerabilities were intensified with the commencement of the Great Depression. The associated application of protectionist policies overrode any efforts to assist Germany through its deep

crisis. This sequence and unfolding of events could have been prevented through a less punitive treaty, combined with more favorable international relations during the Depression years. In addition, public expenditure rather than austerity and protectionist policies – as Keynes had suggested – could have helped to avert dangerous void Germany experienced, that can readily be associated for allowing for the rise of fascism and the massive losses incurred during World War II.

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