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THE EVOLUTION OF THE ECONOMIC THOUGHT CONFRONTED WITH WORLD WAR I AND THE REPARATIONS' ISSUE

FANNY COULOMB

The development of the neo-classical theory by the end of the 19th century had excluded issues of economic policy and international economic relations from the field of the mainstream economic analysis. The new “economic science” is apolitical and aims to explain the markets’ functioning within the framework of pure and perfect competition. In terms of doctrine, the Liberals advocate for a minimal state and free trade. But the First World War, that broke out in a context of unprecedented economic and financial interdependencies at the world level, raises questions about the liberal optimism regarding the pacification of international relations through economic links. Moreover, the Russian revolution of 1917 enhances the popularity of the Marxist theory, which directly competes with liberalism: it is the return to the “political economy”. Some heterodox theories arise out of this very period: as soon as the early 20th century, Hobson had criticized the imperialist policies of capitalist countries, within a perspective of reform. World War I accelerated the development of another major theoretical critic of capitalism, the one of Veblen, the founding father of institutionalism. The time is right for political debates, in which economists take part. Amongst Marxist economists, disagreements are numerous, in particular concerning the evolution of capitalism.

After the war, the issue of the reparations imposed on Germany by the Treaty of Versailles turned out to be important for the evolution of economic thought. Only in 2010 did Germany finish paying the last debts related to the post- World War I reparations, whose initial amount, determined in 1921 to 132 billion goldmarks, has never been fully settled. These debts resulted from foreign loans to Germany, along with the Dawes (1924) and Young (1929) plans, aiming at reducing the reparations’ burden on the German economy. In 1931, the payments were nevertheless interrupted, while only 20 billion had been paid; they resumed in 1953. Become an adviser to the British Treasury in 1915 and directly implied with the issue of war funding, Keynes argues in vain against the option of total war for Britain. He is almost about to resign from the Treasury when the British government launches the call for conscription. After the German defeat, his book *The Economic Consequences of the Peace (ECP)*¹, published in 1919, is a major criticism of the conditions of the Versailles Treaty, allowing him to play a central role in the debate on the economic future of Germany. In the 1920’s, the study of international economic relations developed a great deal, thanks to the debates on the issues of reparations and inter-allied debts, notably in France, Great-Britain and in the United States. The question of Germany’s capacity to pay poisoned interwar international relations and fed the resentment against the « diktat » of the Treaty of Versailles. Later, the partial waiving of reparations sent out a signal favoring the German rearmament. The peace through free markets

¹ Keynes J.M. (1920 [1919]), *The economic consequences of the peace*, New York, Harcourt, Brace and Howe.

remains far, capitalism being plagued by financial disorders resulting from the war. Keynes will seek in his reflection on the inter-war economic and financial problems some principles underlining the *General Theory*, notably his mistrust towards world financial interdependencies ruled by speculation.

This paper first presents the debates amongst Liberal as well as Marxist economists, fueled by the First World War, on the role of conflicts and wars in the capitalist system. A second part will show how the discussion on the post-war European order acted as a catalyst for the evolution of the economic thought, with the rise of Institutionalism and the foundation stones of Keynesianism, favored by the very lively debate between economists on the issue of the German reparations.

THE DISCUSSION ON THE REASONS FOR WAR IN A CAPITALIST SYSTEM

The explanation of the causes of the First World War is not easy for the liberal economists. In fact, the conflict occurs during an expansion phase of a Kondratiev cycle started in the last decade of the 19th century, with a first globalization began in the early 1870s and characterized by increasing international financial integration, facilitated by the stability of the gold standard system (but nevertheless leading to repeated financial crises), the rise in international trade interdependence and therefore the opening up of many economies, especially through investments in territories rich in raw materials. For the Liberals, why the pacifying effect of international economic relations has not worked is a challenge that few manage to overcome. The liberal theory is not the only one to question its doctrinal foundations. Marxism is indeed so challenged that strengthened by the world conflict, which arouses diverging interpretations. The theorists of imperialism in fact often disagree on the issue of the inevitability of inter-imperialist wars and on their destructive impact on the capitalist system.

The failure of the Liberals' assumption of the achievement of peace through economic interdependence

- ***The pacifism of liberal economists during the 19th: the influence of Bastiat***

The question of war and peace had been widely discussed by the Liberal economists during the second half of the nineteenth century, particularly in France. A disciple of Jean-Baptiste Say, Frédéric Bastiat, who is quoted by Karl Marx as “*the most superficial and therefore the most adequate representative of the apologetic vulgar economy*”², et who has been claimed as a reference by the enthusiasts of ultraliberalism in the 20th century, raised the issue in his writings, without however completing his chapter on the war in his *Harmonies Economiques*,

² Marx K. (1873), *Capital I*, afterword to the second German edition, quoted in Fine B., Saad-Fihlo A., Boffo M. (2012) *The Elgar Companion to Marxist economics*, Edward Elgar, Cheltenham, Northampton, p. 247.

the text titled "*Comment la guerre finit*" remaining unfinished (chapter XIX)³. But Bastiat represents those Liberals who consider that war can only come from the pressure of private interests to the detriment of the general interest, an idea already present in Adam Smith's *Wealth of Nations*⁴. The idea behind the Bastiat's thought is that wars will end when public opinion in European countries will acknowledge the superiority of liberalism and free trade, incompatible with international conflicts and their side-effects: economic disorganization, greater state control and disruption to international trade. He does not fear the invasion of France and even suggests the unilateral disarmament of the country in 1849⁵, to set off a wave of pacifism at the European level. In a letter titled *Propriété et Spoliation*⁶, defending the principle of ownership, Bastiat explains that it is the principle of dispossession, an inherent tendency of mankind, which is the origin of inequality among men: the economic freedom combined with the principles of justice can only lead to peace and global prosperity. All means of dispossession must be banned from human societies: not only war and slavery but also excessive taxation, public borrowing and war on capital.

In his wake, many proposals have emerged within the liberal current, for institutions capable of arbitrating international disputes, to avoid open conflicts that would increase the state control on public life⁷. By the end of the 20th century, many congresses for peace have been held, where economists' influence was great⁸. In 1901, the first Nobel Peace Prize was awarded to Frederic Passy⁹, a French politician and ardent pacifist aiming to mobilize public opinion to promote a culture of peace, together with the promotion of liberalism.

- ***Keynes' pacifism and support of Angell's views***

Keynes' critique of the Versailles Treaty in the *ECP* is precisely part of this liberal pacifist tradition. He did not hide his enthusiasm for the League of Nations, founded in 1920, which raised much Pacifists' hope in the interwar period, but which however quickly showed its limitations. Keynes had moreover welcomed, a decade earlier, the book of his compatriot Norman Angell, titled *The Great Illusion*¹⁰, which denounced the European arms race and criticized the principle of war reparations. The basic premise underpinning Angell's work is the idea of peace through economic globalization, given the fact that:

- The economic benefits of colonialism are illusory ;
- The potential economic cost of wars between industrial superpowers has become too great for policies of aggression to be considered, as economic isolation would very swiftly lead to economic exhaustion.

³ Bastiat F. (1893), « XIX : Guerre », in *Harmonies Economiques*, tome sixième, 10^{ème} édition, Librairie Guillaumin et Cie, Paris, p. 576.

⁴ Smith A. (1776), *An inquiry into the nature and causes of the wealth of nations*, London, Methuen & Co Ltd.

⁵ Bastiat F. (1849), *Paix et liberté ou le budget républicain*, Bastiat.org.

⁶ Bastiat (1848), *Propriété et spoliation*, July, www.Bastiat.org.

⁷ As for example Gustave de Molinari, a Belgian disciple of Bastiat and vice secretary of the Association pour la liberté des échanges (Association for free trade). See Coulomb F. (2004), *Economic theories of peace and war*, Routledge.

⁸ Coulomb F., Hartley K., Intriligator M. (2008) : "Pacifism in economic analysis : a historical perspective", *Defence and Peace Economics*, 19 (5).

⁹ Jointly with Henry Dunant, who created the Red Cross movement.

¹⁰ Angell N. (1910), *The great illusion*, G.P. Putnam's son, NY and London.

- The wars of predation are over, military conflicts' costs being too high because of destructions and induced economic disturbances, which cannot be fully covered by a potential war indemnity. Moreover, war indemnities can only be paid by the defeated country through an exports surplus that would compete directly with national products in the recipient country, with adverse economic consequences.

This questioning of war reparations' effectiveness has influenced Keynes, when he wrote the ECP. Enthusiastically welcoming Angell's work, Keynes supported his (successful) candidacy for the Nobel Peace Prize, in the early 1930s¹¹. But the liberal pacifist optimism expressed in Angell's work of 1910 was tempered in a second edition, published in 1933. For his part, Keynes had already ceased writing on the reparations issue since many years.

- ***An heterodox call for peace : Hobson's denunciation of the Western world's imperialism***

As explained above, the liberal thought on war at this time was focused on challenging its cost and economic non-sense, as well as on the idea that war can only result from a diversion of the State machinery to private interests: it is not the capitalist system that is at issue, as the free operation of markets should on the contrary generate a common welfare, making wars always more absurd.

But an alternative interpretation of the imperialist policies of capitalist countries had been suggested at the beginning of the twentieth century, by a British essayist supporting war resisters in the 1910s and, at that time, supporting the « new liberals » alongside Keynes¹²: this is John Hobson, whose book published in 1902, *Imperialism : a study*¹³, made him famous, all the more so as large parts of his analysis have been used by Lenin in his own analysis of imperialism.

In his book, Hobson condemned the fact that liberalism needed jingoism, which allows maintaining the docility of workers who are subjugated by an increasingly mindless labor. He also explained that colonial expeditions are not only made to respond to the megalomania of national leaders and to make the people dream; they also have a distinct economic objective: let the surplus of the capitalist production slim down in the international markets. This idea, which is already present in Marx's 1848 text *On the question of free trade*, will be largely taken up by Lenin. Hobson thinks that the solution is to raise public's purchasing power so as to create internal opportunities for the capitalist production; one of the main reasons of wars would therefore be eliminated.

Hobson has published several papers in the review *The Nation*, that was acquired by Keynes in 1922. But their political paths separated in the late 1910s, when Hobson joined the future

¹¹ Citer Alcouffe A., Coulomb C. (2014), *De la paix par le libre-échange à l'interventionnisme pour la paix : l'évolution de la pensée de J.M. Keynes de la première à la seconde guerre mondiale*, draft paper for the XV^e International Conference of the Association Charles Gide pour l'Etude de la Pensée Economique, Lyon, June.

¹² Dostaler G., Vignolles B. (2009), « Keynes et ses combats », *Idées Economiques et Sociales*, vol 3 n°157.

¹³ Hobson J. (1902), *Imperialism: a study*, James Pott and Company, New York.

Labor Party. However, in the *General Theory* (1936), Keynes pays respect to Hobson's ideas, emphasizing his "ardour and courage against the ranks of orthodoxy"¹⁴.

The discussion within the Marxist current on the issue of the interimperialist war

The Marxist analysis of war and militarism in the early twentieth century lacks of unity: there are considerable divergences between theoreticians, regarding notably the inevitability of a conflict's outbreak and its impact on the proletarian movement.

- ***From Marx's economic war to Lenin's inevitable collapse of imperialist powers***

Karl Marx himself did not write specifically on these issues, maybe because he reserved his analysis of militarism for the last volume (never written) of *The Capital*, dedicated to the issue of the state. However, in his speech *On the question of free trade* (1848)¹⁵, he states a central idea for the Marxist rhetoric during the 20th century: the world trade will become increasingly contentious as capitalist systems mature, because export markets represent an efficient counter-tendency to the rate of profit to fall, while imports of cheap foreign products allow to exert downward pressures on workers' wages. All capitalist countries at the same stage of development having the same commercial and colonial appetites, economic conflicts may occur and the class war transform into a war among nations. Mocking the optimistic and pacifist views of the Liberals, Marx writes:

*To call cosmopolitan exploitation universal brotherhood is an idea that could only be engendered in the brain of the bourgeoisie. All the destructive phenomena which unlimited competition gives rise to within one country are reproduced in more gigantic proportions on the world market*¹⁶.

However, free trade is considered more progressive than protectionism, which is viewed with distrust, as well as nationalism, chauvinism and independence movements, by Marx and Engels.

The Leninist theory of imperialism only partially comes from the Marxist idea of increased international disputes because of the transfer of internal economic contradictions on the world market. Besides, Lenin doesn't refer to the tendency of the rate of profit to fall in his theory of 1916, *Imperialism, the highest stage of capitalism*¹⁷.

It is the unequal development of national economies and of monopolies that lead to international relations' instability, at the stage of imperialism. With the rise in capital exports and in the economic concentration, the States are no more the central actors but the monopolies which

¹⁴ Keynes J.M. (1936), *The general theory of employment, interest and money*, Macmillan Cambridge University Press, chapter 23, VII.

¹⁵ Marx K. (1848), *On the question of free trade*, Speech to the Democratic Association of Brussels at its public meeting of January 9, www.marx.eserver.org

¹⁶ Op.cit.

¹⁷ Lenin V.I. (1916), *Imperialism, the highest stage of capitalism*, in Lenin's *Selected Works*, Progress Publishers, 1963, Moscow, Volume 1, pp. 667-766, www.marxists.org

control the world trade and make progressively disappear the free competition. The fight for raw materials exacerbates antagonisms on colonies' sharing; the new industrial powers, wishing to reverse the international economic hierarchy, are responsible for the outbreak of inter-imperialist conflicts, until the ultimate world war that will end capitalism.

- ***The non-orthodox scenarios of some Marxist economists***

Within the Marxist current, Lenin's theory was challenged by several competing and more or less incompatible analyses. If he does not criticize Hilferding, to whom he has borrowed the concept of financial capital but who had stated that, in the long term, an agreement between the more powerful capitalist interests, is very likely, Lenin targets Kautsky.

Hilferding is the theoretician of the "financial capital", appeared at the end of the 19th century¹⁸ : this capitalist model is characterized by a deterioration in competition, an increased concentration of industry and bank sectors and the growing power of just a few shareholders. The role of the state is enhanced because the state apparatus serves the interests of certain monopolies or cartels, with the setting up of protectionist measures that are circumvented by foreign direct investments. Moreover, the militarism is inherent to the financial capitalism, notably because the colonial expeditions allow to secure national economic interests abroad, the supply of raw materials but also to open foreign markets for domestic industrial goods. Only a strong pacifist opposition of the proletariat and of the medium class will permit to avoid a war between imperialist powers. However, in the longer term, the rise in firms' size and the internationalization of their activities, will lead to an agreement between the most powerful capitalist interests, beyond national borders, with the setting up of agreements between national cartels. The international agreements ensuring the inter-cartels peace must nevertheless be regularly reviewed, with the change in the balance of international power. This idea about an agreement between the most powerful interests, at the world level, was revisited by Kautsky, with the concept of « ultra-imperialism ».

Like Hilferding, Kautsky sees the state's power politics as being in the service of bourgeois interests, as it helps prevent the under-consumption crises and the proletarianization of the middle class. If Kautsky had an important role, from 1890 to 1914, within the Third International, he was no more considered an orthodox Marxist from 1915, when he published a paper in *Neue Zeit* that was fiercely contested by Lenin¹⁹. Kautsky indeed defended the hypothesis of another stage of capitalism, subsequent to imperialism: ultra-imperialism. At that stage, not yet been reached (and maybe will never be), it is likely that the struggle between national capital is replaced with a joint exploitation by a worldwide integrated financial capital, therefore limiting incentives for an arms race between capitalist economies. This theory irritated Lenin, who called Kautsky an "ex-Marxist".

¹⁸ Hilferding (1910), *Finance capital, A Study of the Latest Phase of Capitalist Development*. Ed. Tom Bottomore, Routledge & Kegan Paul, London, 1981, Marxists.org.

¹⁹ Karl Kautsky (1915), *Die Neue Zeit*, 30 avril 1915, p. 144. This article is quoted in Lenin (1916), *Imperialism, the highest stage of capitalism*, VII, www.Marxists.org.

Another Marxist economist attracted the attention of “official” theorists : N. Kondratiev, whose long wave theory, exposed as soon as 1925, portrays capitalism as a system always ready to be reborn from its ashes²⁰. In this theory, wars and political or social conflicts are more likely to occur in upward phases of long cycles, notably because economic growth exercises a pressure on the supply of raw materials. The downturn in raw materials’ prices is therefore an early sign of the beginning of a new long economic crisis. If it is known that Kondratiev was deported to Gulag and executed by the Stalinist regime, because of his pessimist views concerning the inevitability of capitalism’s disappearance, his reputation was enhanced by the works of Joseph Schumpeter based on his long-term cycles’ theory. Schumpeter is focused on the issue of major innovations liable to initiate a new phase of long-term economic growth: he rejects the idea that wars are important determinants for the gestation of those innovations, opening up a still current debate²¹.

Lastly, the First World War and the previous arms race, by requiring an increasing interventionism, have addressed the problem of the role of the state in the evolution of capitalism. Hence, in his 1915 book *Imperialism and world economy*²², Nikolai Bukharin develops the idea according to which capitalism has reached a new stage of its development, the one of “State capitalism”, with a strong control of the state apparatus on economic activities, inducing the continuation of interventionism by the time peace returns. In the context of the worldwide fall in the rate of profit, illustrated by the internationalization of firms’ activities, the state plays an essential role in the promotion of national interests on world markets; but the diverging interests of the various nations may create the conditions for international economic disputes, the economic war being liable to end in an open military conflict, inter-imperialist agreements being unlikely. Bukharin’s views on international conflicts do not correspond to the pure economic determinism of Lenin’s thesis of 1916, as states as able to change the world markets’ structure through their foreign policy²³. The historical materialism therefore indirectly comes into question.

THE DEBATE ON THE POST-WORLD WAR I EUROPEAN ORDER, A CATALYST FOR THE EVOLUTION OF THE ECONOMIC THOUGHT

In the ECP, Keynes was in favor of reducing the reparations’ burden for the German economy, in view of the double objective of a quick recovery of the European economy and of the durability of democracy. His position was criticized in two ways : by Veblen, who accused him of defending the statu quo of an unfair and ineffective capitalist system and whose thought on inter-war international relations was pivotal in developing his institutionalist theory; by Ohlin and other economists, who challenge Keynes’ analysis of reparations, opening the way to a highly-focused debate on international transfers.

²⁰ Kondratiev N. (1993 [1925]), *Les grands cycles de la conjoncture*, Paris, Economica.

²¹ Coulomb F. Bensahel L., Fontanel J. (2011), “Economists’ Controversies about the Causality between War and Economic Cycles”, in Chatterji M. ed., *Business, Ethics and Peace*, Emerald.

²² Bukharin N. (1915), *Imperialism and the world economy*, London, Martin Lawrence Ltd

²³ Howard M.C., King J.E. (1989), *A history of Marxian economics*, Vol 1, Princeton, pp. 245-250.

Veblen's attack on the institutions of capitalism through the question of war

- ***Veblen's critique of Keynes' ECP***

Keynes will strongly mark the debate among economists on the relevance of the Treaty of Versailles' clauses on the reparations imposed on Germany, with the publication of his 1919 book, *The Economic Consequences of the Peace*. He incisively denounces the French position aiming at economically weakening the defeated country to prevent its rearmament and he advocates for a reduction in the reparations' burden, giving ammunitions for the supporters of the idea that Germany has no capacity to pay. Keynes is concerned with the political consequences of the Treaty, fearing a power takeover by reactionary forces both in Germany and in Russia, leading to their rapprochement.

*From the military point of view an ultimate union of forces between Russia and Germany is greatly feared in some quarters. This would be much more likely to take place in the event of reactionary movements being successful in each of the two countries, whereas an effective unity of purpose between Lenin and the present essentially middle-class Government of Germany is unthinkable.*²⁴

This position supportive of a political statu quo in Germany has been criticised by an heterodox economist, founding father of the institutionalist political economy, Thorstein Veblen. In his review of the ECP published in 1920, Veblen condemns the fact that the Allies' policy is more aimed at combating Soviet Russia than at reforming German institutions, as the victors are eager above all to safeguard the capitalist interests. He writes:

*“So also his oversight of this paramount need of making the world safe for a democracy of absentee owners has led Mr Keynes to take an unduly pessimistic view of the provisions covering the German indemnity.”*²⁵

Veblen there resumes a concept developed twenty years earlier in a key work, *The theory of the leisure class : an economic study of institutions* (1899)²⁶. It was an analysis of the capitalism's functioning, highlighting the predatory behavior of the ruling class (absentee owners), which is losing contact with the concrete labor, left to engineers: speculation and economies' financialization are the inevitable outcomes.

- ***The critique of capitalism through the analysis of the role of patriotism and warlike spirit***

The outbreak of WWI brings to maturity Veblen's theory, already inclined to address war and militarism's issues, as it inquires into the internal factors of societal evolutions. In a key work published in 1915, *Imperial Germany and the Industrial Revolution*²⁷, Veblen introduces the

²⁴ Keynes J.M. (1919), *Economic consequences of the peace*, Cosimo Classics, 2005, p. 289.

²⁵ Veblen T. (1920), “Review of John Maynard Keynes, *The Economic Consequences of the Peace*”, *Political Science Quarterly*, 35, pp. 467-472.

²⁶ Veblen T. (1899), *The theory of the leisure class : an economic study of institutions*, Macmillan.

²⁷ Veblen T. (1915), *Imperial Germany and the industrial revolution*, Augustus M. Kelley, New York, 1964.

distinction between predatory dynastic states (like Germany) and modern states (Great-Britain, USA).

The predatory instincts of man have had a major impact on societies gone beyond the primitive stage, provoking the wars and conflicts that have marked the history of humanity and the changes in the institutions, the weakest ones being eliminated. Far from being mutually exclusive, war and trade have always interacted with each other, in spite of a perennial competition between commercial interests (prevailing in modern societies) and dynastic interests (prevailing in dynastic societies of industrially less developed countries). In dynastic societies, mental habits inherited from the feudal period (sense of duty, subordination, preparation for war...) still prevail, leading to more warlike policies than in modern societies : these latter being long accustomed to peace have benefited from an evolution in the mental habits, and are consequently more likely to develop peaceful activities, like trade or finance. The differences in the political systems (autocratic or democratic) result from these institutional differences and there is a risk of an international conflict initiated by dynastic states.

However, Veblen's theory is evolutionary but not determinist. The « normal » evolution of societies should in the long term transform all of them into modern States, as the changes in mental habits with the shifts in economic structures lead to institutional and social transformations. But as the evolution of societies ensues from a permanent adjustment between instincts and institutions, it is impossible to predict their future direction. In the dynastic states, forces of change (modernization) are exerted thanks to industrialization and technology boom, while in modern societies, the predatory instincts may spring back to life at any moment and lead to aggressive foreign policies.

This latter point is studied in detail in a book written two years later, *An inquiry into the nature of peace and the terms of its perpetuation* (1917)²⁸, in which Veblen develops the three following ideas:

- In dynastic societies, the preparation to war should cause organisational changes in dynastic societies, because of the growing sophistication of armaments needing advanced technologies and skilled manpower: these are factors for them to become modern societies (chapter 1), that are more peaceful than dynastic ones.
- In modern societies, the evolution of the economic system tends to erase all economic solidarity (the ordinary man becomes always more mindless) ; Only remains patriotism to federate the system. Modern societies are thus forced to maintain a kind of warlike spirit in the population, capable of bringing up one day feudal instincts prone to war. (chapter 2)
- The last chapter (7) develops a strong critique of the evolution of capitalism, which fosters a concentration of wealth in the hands of a few. International initiatives for peace, and notably international institutions, are therefore regarded with caution by Veblen, even if he doesn't venture to predict the future of the economic system.

²⁸ Veblen T. (1917), *An inquiry into the nature of peace and the terms of its perpetuation*, Augustus M. Kelley, New York, 1964.

Veblen's attack on patriotism and institutions has arisen hostile reactions, of which the one of Roosevelt²⁹. Veblen's thought is however said to have had an influence on the content of the New Deal, through its critical approach of the institutions, even if there is no direct link³⁰.

The influence of Veblen was more direct on the Technocratic movement, created by Howard Scott in the 1920s³¹ and very popular in the United States in the 1930s; this movement advocates for solutions largely inspired by Veblen's 1921 book, *The Engineers and the Price System*³², in which he recommends the abandonment of the price system and the seizure of power by engineers and experts, who are the only ones capable of managing the production with a long-term vision, without being permanently focused on profit maximization.

A further point to note is that Hobson was a huge fan of Veblen, to whom he devoted a book published in 1936. Both were heterodox authors rejecting the liberal theory and aiming at proposing alternative social models, out of the Marxist current.

The debate on reparations and the premises of the Keynesian theory

The reparations imposed on Germany were a key issue in interwar international relations. The non-payment of indemnities by the Weimar Republic, undermined by hyperinflation, caused the occupation of the Ruhr by France (until 1925, following the German refusal to pay the sums due for 1923), while the Dawes Plan (1924) confirmed a restructuring of the indemnities, in contradiction of France's demands, to allow the stabilization of the German currency and prevent the return of hyperinflation caused by money printing: lower amount of annuities, vagueness about their duration and, above all, an international loan of 800 millions (consisting mainly of bonds with a maturity of 25 years), to ensure the payment of the first annuity. Unable to generate lasting trade surpluses, Germany soon carried a heavy debt-service burden³³. For the critics of the debt relief solution, this initiative has made it possible for Germany to pursue a rearmament program much more costly than the amount of indemnities set in 1921. The diagnosis about the German economic collapse in the 1920s was therefore wrong: it is a French economist, Etienne Mantoux, who has expounded this idea in « La paix calomniée ou les conséquences économiques de Monsieur Keynes » (written in 1943 and published in 1946)³⁴. The complete renunciation of reparations decided in 1932 was held to have given to the German public opinion the signal of a permissiveness concerning the rearmament issue: Clémenceau has thus denounced in 1930 the revenge and militaristic spirit of the German elites in the aftermath of the defeat, and the immediate secret rearmament³⁵.

²⁹ About the debates to which Veblen's books have given rise, see: Daniel Borus, *Twentieth-Century Multiplicity: American Thought and Culture, 1900-1920*, 236-237

³⁰ Tilman R. (2004), *Thorstein Veblen, John Dewey, C. Wright Mills and the Generic Ends of Life*, Rowman & Littlefield Publishers, 61-63.

³¹ Veblen was besides member of the first movement founded by Howard Scott in 1919, The Technical Alliance.

³² Veblen T. (1921), *The engineers and the price system*, B.W. Huebsch

³³ Fiore M. (2002), *Les banques suisses, le franc et l'Allemagne*, Genève, Paris, Droz, page 37.

³⁴ Mantoux E. (1946), *La paix calomniée ou les conséquences économiques de M. Keynes*, Paris, Gallimard.

³⁵ Clémenceau G. (1930), *Grandeurs et misères d'une victoire*, Paris, Librairie Plon.

- *The Keynes-Ohlin debate*

It is this issue of Germany's capacity to pay the reparations that has concentrated the economists' concerns at that time. This debate was called the « transfer problem », because the challenge for Germany was to get enough foreign currencies and gold to be able to transfer due amounts to recipient countries. Its most famous episode is probably the publication of an article written by Keynes in the *Economic Journal* in March 1929, titled « The German Transfer Problem »³⁶ and Ohlin's answer in the same review, in June³⁷. The French economist Jacques Rueff has also contributed to the debate in this review (September)³⁸, directly criticizing Keynes' view and supporting France's position.

The arguments presented during the course of the debate have been subsequently discussed at very great length, so much so that this debate has become quasi mythical. It is known that Keynes did not use arguments compatible with the *General Theory* published in 1936 : his argument is based on a classical view, with the anticipation of negative terms-of-trade effects for Germany as a result of the transfers³⁹.

Besides, the issue of the international loans to Germany expected from the Dawes Plan has also launched a controversy. According to the American economist H.G. Moulton, the induced debt may become dangerous for the German economy and these loans are high risk. But the American bank lobby dismissed his arguments, while the largest financial institutions transferred the risk on those loans to small financial institutions and ignorant investors⁴⁰.

Ohlin blamed Keynes for not having taken into account the existence of these loans to Germany from 1924, and to have kept on analysing the reparations issue in the same way as in 1919. Ohlin argues that the capital flows to Germany, mainly American, have rendered erroneous the assertion of Germany's inability to pay, as the United States have invested in Germany twice as much as the amount paid by Germany for reparations.

Concerning the structural consequences of these payments, Keynes and Ohlin had two different interpretations. Keynes' argumentation is similar to that of ECP in 1919 : in Germany, the devaluation and/or the deflation induced by the additional taxes financing reparations will not be enough to generate the trade surplus necessary to transfer the owed amounts, as marks must be converted to foreign currencies: indeed, the problem with Germany is that it is a key importing country, with a not export-oriented economy. If the industry of exports grows to the detriment of the domestic production, the flow of German products on the world market can lead to falling prices and to a worsening of the terms of trade for Germany. The burden of reparations on the German economy is therefore much more important than it seems at first sight. Keynes rejected the idea that the American loans have settled the transfer problem, contrary to what Ohlin thought.

³⁶ Keynes J.M. (1929), "The German transfer problem", *Economic Journal*, 39, March, 1-7

³⁷ Ohlin B. (1929), "The reparation problem: a discussion", *Economic Journal*, 39, June, 172-178.

³⁸ Rueff M.J. (1929), « Mr. Keynes' views on the transfer problem », *Economic Journal*, 39, September, 388-399.

³⁹ Brakman S., Van Marrewijk C. (2007), *Transfers, non traded goods and unemployment, an analysis of the Keynes – Ohlin debate*, *History of Political Economy*, 39 (1), p. 122.

⁴⁰ Fraga A. (1986), *German reparations and Brazilian debt : a comparison*, Princeton University, page 25.

For Ohlin, the lack of any significant change in Germany's structure of production in the 1920s (high production of capital goods for the home market without a development of the export goods' sector) is explained by the size of American loans to Germany: the issue of its capacity to pay has become irrelevant.

Ohlin challenged Keynes' view on reparations by using an analysis the development of incomes in the different involved countries : the rise in taxes in Germany for the reparation payments induce a decrease in incomes and demand in the country and therefore a fall in imports ; conversely, the recipient countries benefit from a rise in factors incomes and therefore favors German exports. There is no transfer problem nor change in the terms of trade.

According to Metzler⁴¹, Ohlin's « orthodox » explanation is innovative because international income transfers were mentioned for the first time. From a theoretical perspective, it represents an intermediary between the classical theory and the Keynesian one²² : Keynesian because it deals with trends in purchasing power and Classical as it assumes full employment and the validity of the Say's law.

In the opinion of Robert Mundell⁴² Ohlin was the clear winner of the debate with Keynes.

One year earlier, in 1928, the French economist Jacques Rueff⁴³ had contested the existence of a transfer problem, by reference to the automatic adjustment of balance of payments' mechanism, related to the quantity theory of money. The purchase of foreign currencies by Germany on financial markets (financed through a rise in taxes or by loans) would cause an increase in German currency and therefore its decline in value against other currencies. The weaker Reichsmark has a stimulating effect on German exports, which would enable the transfers. Rueff put forward again this point in the *Economic Journal* in September 1929, in addition to the Keynes-Ohlin debate.

- ***The transfer problem and the emerging Keynesian thought***

Keynes' analysis of the transfer problem was not "Keynesian" yet. However, three key ideas are reflected in it:

- The fear of an « economic war » : Keynes thought that Germany's necessity to create a trade surplus would induce a price war damaging for the whole European industry ;
- The fear of a decrease in the people standard of living in Germany : for him, honoring the debts is less important than public welfare, rampart against fascism or communism;
- The distrust of capital international flows: loans to Germany has been a key element in the overexpansion of the world financial sphere, leading to the great crash of 1929.

Regarding this third point, the transfer debate was major in the genesis of the Keynesian theory. According to Robert Skidelsky⁴⁴, Keynes' analysis of the transfer problem contributes to the

⁴¹ Metzler L.A. (1973) , *Collected Papers*, Harward University Press, p. 109.

⁴² Mundell R. (2002), "Keynes and Ohlin and the transfer problem", in Findlay R. et al. (eds), *Bertil Ohlin: a centennial celebration 1899-1999*, MIT Press, pp. 227-262.

⁴³ Rueff J (1928), « Une erreur économique : l'organisation des transferts », dans *Théorie monétaire*, pp 181-200, p. 183.

⁴⁴ Skidelsky R. (2012), *Keynes, Hobson, Marx*, October 10, <http://www.skidelskyr.com>

debate on the nature of the imperialism of capitalist economies : the superiority of Keynes' approach compared with the Hobson/Lenin thesis of imperialism is to have shown that the export of savings is not offset by an induced rise in foreign investment. Yet, according to Hobson's theory, only foreign investment can lead to a rise in exports preventing crises resulting from over-production.

Skidelsky explains:

Keynes pointed out that the expansion of exports which a net transfer of money abroad required could be blocked at both ends: the capital exporting country might be unwilling or unable to increase its competitiveness sufficiently to allow the 'real' transfer of goods and services to take place; and the capital importing country might not be willing to suffer the loss of its own competitiveness. His argument was conducted in terms of a fixed exchange rate system, but it can be adapted to a system of managed floating.

According to Skidelsky, Keynes' mistrust in capital exports results from his analysis of unemployment in Great Britain in the 1920s, which stems directly from his thinking on the transfer problem linked to reparation payments imposed on Germany. The transfer debate has therefore proved essential in the emergence of an original Keynesian thought.

Conclusion

The interwar period was a favorable time for economists' discussions, which were important in the history of economic thought. The liberal orthodoxy is weakened by the outbreak of WWI, which refuted its optimistic view concerning the peacemaking effects of economic globalization. The Marxist theory, which has incorporated Hobson's analysis of imperialism, is significantly challenged by an abundance of contradicting interpretations regarding the evolution and survival of the capitalist system. The emerging Institutionalist theory is enriched by Veblen's critical analyses of international relations, based on a categorization of countries' institutions. Arising from the Treaty of Versailles, the debate on reparations reveals the prominent place of economists in the political debate of the period, concerning the Allies' policy towards Germany; and also, the complexity of interwar financial and trade linkages and the great volume of international capital flows.

On both points, Keynes' view prefigures the idea of public welfare as a major objective of public policy and the mistrust towards international finance, paving the way for his subsequent critic of financial markets, expressed in the *General Theory*.

Lastly, one final remark is that this debate has revealed the vagueness of the data on national economies and international economic flows, at that time. It will only be dispelled with the progressive upgrading of national accounting systems, based on Keynes' works, well after the Second World War.

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