Reason and Reasonableness in Keynes: Lessons from *The Economic Consequences of the Peace* 90 Years Later

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Abstract The crisis that has hit the world economy has made once again topical the principles that Keynes advocated to address the loss of market confidence and the decline in production and employment. A re-reading of the *Economic Consequences of the Peace* points along a path parallel to the one usually associated with Keynesian policies - deficit spending and public investments - which relies on the concept of *reasonableness*. This paper outlines the context in which the *Consequences* was written and then traces Keynes’s approach back to the Bloomsbury background. It is argued that the distinction between reason (or rationality) and reasonableness, to be seen also in Rawls, is one of the characteristic features of Keynes’s economic thought which can be used to trace out a parallel between the humiliation of the conquered at Versailles and the debtor mortification inflicted on Lehman Brothers. The conclusion is that the return to Keynes we should wish for is not only a matter of supporting demand in order to avoid general deflation, or reform of the international monetary system to avert the effects of the present world imbalances, but more extensive application of the Keynesian concept of *reasonableness* against the so-called *rationality* of individuals and markets.

The Return of Keynes

Within just a few months from its publication, in December 1919, *The Economic Consequences of the Peace* was enjoying a resounding success (selling about 100,000 copies) and bringing fame to its author. Ninety years later, the argumentation

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and presentation still prove arresting and persuasive, particularly in the present crisis with Keynes back on the world scene, his thought once again seen as a source of inspiration and stimulus for reappraisal.

This return to Keynes may be accounted for by his role as the major exponent of an approach to economics based on the conviction that markets and economic behaviour are to be guided by a logic of coordination and rules, rather than left to the pursuit of individual interests and to the freedom resulting from the lack of public intervention and regulation by the institutions.

We owe to Keynes the recipes and remedies to fight mass unemployment, turbulence on the financial markets and in international trade, and the disorder of markets in the absence of coordination among the supranational institutions. The tools he used were those of persuasion and reasonableness, the means he applied to convince and to create scope for freedom of action where others - economists, above all - saw only constraints and the limits of resources. This approach was formulated and brought to ripeness as Keynes thrashed out his ideas over time, from the end of the First World War, during the years of the Great Depression and then of the Second World War, and on to the design of the new world order a few months before his death in the April of 1946.

Keynes was not only an outstanding theoretician but also an economist intent on seeking concrete remedies and solutions in his work for the British Treasury, as a representative of the United Kingdom in negotiations with the United States during the Second World War, and as a freelance journalist and operator on the financial markets. The 1930s saw him a speculator on the foreign exchange and commodity markets; this led him to the conclusion that market instability was an endemic feature of economic systems, to be curbed with interventions coordinated between the supranational institutions and the central banks. He drew up plans to bring order to the functioning of the raw material market, of multilateral exchange between countries and the regulation of international payments.

In his long activity as government adviser and leader of public opinion, Keynes was ever guided by the idea that the economic system was not regulated by immutable and eternal laws, but rather as a result of conventions, convictions and prejudices which the reformer had the task of moulding through persuasion.

The Economic Consequences of the Peace, written when Keynes was only 36 (he was born in 1883), anticipates and, in his attitude to the economic problems to be addressed at the end of the war, affords glimpses of an approach that was to mature in his subsequent writings, such as the Tract on Monetary Reform (1923), the Treatise on Money (1930), and the General Theory of Employment, Interest and Money (1936).

The book was a desperate attempt to persuade the public and governments that the Treaty of Versailles was to be modified on the basis of the principle of reasonableness, and not of the victor's revenge, "to avert the misfortunes which impend otherwise" (Keynes 1971b, CWK II, p. xxii). A concluding phrase sums up the intention, namely "The assertion of truth, the unveling of illusion, the dissipation of hate, the enlargement and instruction of men's hearts and minds..." (Keynes 1971b, CWK II, p. 188).

The Carthaginian Peace

In the 1918 armistice the United Kingdom and France included a clause to the effect that Germany was to pay "reparations" to the Allies for the damage inflicted on the civilian population. In his first Memorandum, October 1918, to the Treasury, where he had been on leave from teaching at Cambridge University since the outbreak of war, Keynes lost no time in making it clear that, in determining the magnitude of reparations, due account should be taken of Germany's effective capacity to pay. In other words, the country's productive capacity was not to be destroyed, for this was the only way to ensure that Germany could pay the Allies.

Thus there were essentially two accounts to be reconciled: the extent of the damage caused by Germany and the probable magnitude of its productive capacity. While the former could be ascertained with a fair degree of certainty, the latter could only be estimated approximately. But - and this was the point Keynes stressed - there was not a reason in the world why the two sums, i.e. damage undergone and capacity to pay, should coincide, and, on the basis of Keynes's estimations, they did not coincide at all.

The UK General Election of December 1918 saw the victory of Lloyd George, and a parliament of nationalists was formed which found itself in perfect accord
with the revanchism of the French allies under the leadership of an implacable Clemenceau. France and the United Kingdom were both set on making Germany pay the cost of the war, and not only the war damage, as established by the armistice: if there was anything left to discuss, it was how to share out the spoils, while a severely depleted Italy could only hope that reparations might get the country back on its feet. Dominating the whole scene, now, was the United States, without whose contribution there could have been no victory for the Allies, and the philosophy of President Wilson, who, with his 14 points and the promises of the League of Nations, had set the terms of the armistice.

In Paris the “Four” victors (United States, France, United Kingdom and Italy) and their delegations were called upon to give concrete content both to the principles of self-determination and freedom for the new nations and to the claims for reparations to be made by the defeated to the victors—a hard and contradictory task.

Such was the scenario opening before Keynes’s eyes when he arrived in Paris on 10 January 1919 as the representative heading the delegation of the British Treasury, sent to handle the financial aspects of the transition to peace.

The first opportunity to gauge the difficulty was a journey to Germany with the representatives of the US, Italian and French Treasuries to meet a German delegation. The meeting took place on a train. The German delegation was headed by the President of the Reichsbank, but it was another member of the delegation who made a strong impression on Keynes, namely Carl Melchior, a partner of the German Warburg Bank. Keynes was later to write a splendid memoir on him, published posthumously (Keynes 1971c, CWK X, p. 389–429).

Keynes found the French at the Conference insufferable. He found them arid, incompetent and absurd in their demands on Germany, reserving particular loathing for their finance minister, Kloz. In March 1919, in an effort to persuade Lloyd George to revise demands for reparation, Keynes reassessed the ratio between what was being demanded and what might realistically be expected of Germany, but the British delegation showed scant response. By the month of May the draft of the Peace Treaty drawn up by 58 economic experts with the deliberations of the Council of Four (United States, France, United Kingdom and Italy) was ready, and Keynes was shocked. He decided to resign within the space of 2 or 3 weeks, bereft of any illusions about the possibility of obtaining “substantial modifications” (in his own words) to the terms contemplated.

And in fact, when the Treaty of Versailles was signed on 28 June 1919 Keynes had already left Paris for the peace and comforting familiarity — unorthodox, but typically Bloomsbury — of Charleston, the country house where Vanessa Bell, Duncan Grant and David Garnett enjoyed a ménage à trois, and had started work on his book. It took 3 months to finish; Keynes drafted it during the summer, and as the text took shape he read passages from it to his Bloomsbury friends (Moggridge 1992, p. 321). I will return to the subject in the following section.

The theme of the Consequences is how the war had damaged the delicate economic mechanism thanks to which Europe had been able to live in prosperity before 1914, and how the Treaty of Versailles had not repaired it but completed its destruction: “My purpose in this book” — wrote Keynes — “is to show that the Carthaginian Peace is not practically right or possible” (Keynes 1971b, CWK II, p. 23), going on to point out (Keynes 1971b, CWK II, p. 40):

I am 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.

Here I would like to dwell on the words “wisdom” and “consequences” as the yardstick Keynes always adopted to evaluate any intervention in the economic sphere, particularly in times of crisis or major upheavals. The word “wisdom”, vague as it may seem, actually refers to a guiding principle of human behaviour that breaks away from individual utilitarian calculation, which brings apparently some but occasionally illusory advantages. It is a principle invoked to curb the forces that threaten to disrupt the social order, and, rather, to favour the settlement of conflicting interests with the logic of social civility.

Keynes based his analysis of the consequences of economic decisions or measures on the interrelation between, on the one hand, the production of wealth and its distribution, and, on the other hand, the social organisation upon which it rests. Disruption of the orderly, progressive increase in individual and collective well-being generates obscure and irrational forces that undermine security and freedom within society.

In the Consequences, as in the General Theory and in his addresses to the British Parliament calling for approval of the Bretton Woods agreements — that is, the architecture of the international monetary system in the aftermath of the Second World War — Keynes would invariably arm himself with these means to alert against the risks and dangers of high unemployment, growing foreign debt drastically squeezing consumption, mortifying national identity on sanctioning the subjection of one country to another.

Keynes never abandoned the ideal of a civilisation based on individual freedom but not at the expense of collective good; in vain, all too often, he sought to demonstrate that this was not practicable if founded solely on the pursuit of private interest — whether of individuals or of nations — following a homo homini lupus rationale in a market without rules or an international organisation devoid of institutions deputised to settle conflicts.

In the Consequences the need is summed up thus (Keynes 1971b, CWK II, p. 60):

... particular interests and particular claims, however well founded in sentiment or in justice, must yield to sovereign expedience.

Let us now look more closely into Keynes’s reasoning in relation to the issue dealt with in the Consequences, namely the Treaty of Versailles, which brought an
end to one of the bloodiest wars Europe had seen, and how the victors set about addressing the economic and social devastation in the aftermath to set things aright.

The conceptual and political cruze of the peace of Versailles lay in the victors’ demands that the defeated should bear the cost of the war, to sap the strength of a powerful and dangerous enemy forever by crippling the sovereignty and economic influence of Germany and, at the same time, burdening the country with the cost of reparations, as if its productive and financial potential had remained intact at the pre-war level.

But let us see in detail how Keynes came to this conclusion. His estimates of the war damage – deriving from close, painstaking examination – are summarised in the following figures (all in millions of pounds sterling): Belgium (500), France (800), United Kingdom (570), Other Allies (250) for a total of 2,120. Set not only on claiming reparation for material damage, France and the United Kingdom, riding the wave of hate and vengefulness, were also determined to include in the reparations of pensions and benefits to be provided at home, bringing the overall bill to about 8,000 million pounds sterling.

In defence of such a sum, which Clemenceau and Lloyd George rhetorically held sufficient to satisfy the public sentiment and their electorates, was the hypocritical conviction that this was also what Germany – whose economic power was to be overthrown – was effectively able to pay.

But, according to Keynes’s estimates, how much would Germany have in fact been able to pay? Taking into account the immediately transferable wealth (gold, ships and foreign properties), property present in territories ceded or surrendered on the basis of the armistice, and exports yielding foreign currency to pay the Allies, the figure came to no more than 2,000 million, and thus the reparation demand by the Treaty were certainly “not within the limits of reasonable possibility”.

The force of Keynes’s arguments is inescapable: a peace based on the principle that “Germania delenda est” was neither just nor, above all, practicable, not only as a matter of human justice, which does not authorise nations to “visit on the children of their enemies the misdoings of parents or of rulers” (Keynes 1971b, CWK II, p. 142), or of the political consequences that humiliation of the defeated can entail for the victors, too, but also on account of the jeopardy unleashed on the overall economic order. Depriving Germany of sovereignty, its foreign possessions and internal productive capacity meant in practice preventing the country from meeting the demands for war damage reparation. Deprived of its colonies, of trade relations, merchant fleet, ten percent of its territory and population, a third of its coal production and three quarters of its iron production, with two million killed in the war, its currency reduced to a seventh of its value, and a huge public debt, how was it possible for Germany to pay an indemnity calling for a level of economic activity actually higher than had been achieved by the country before the war?

The sheer folly of the demand – ferociously advanced by France (i.e. by Clemenceau), feebly opposed by the United States (i.e. by Wilson) and cynically supported by the United Kingdom (i.e. by Lloyd George) – lay in the misappraisal of Germany’s effective capacity to pay and the short-sightedness of statesmen whose preoccupations related not to the future of Europe but solely to “frontiers and nationalities, to the balance of power, to imperial aggrandizements”.

The consequences of the political and economic destruction of a country were not seen to extend to the inevitable impact on its trading partners, who would also be sucked into a vicious circle of stagnation.

Characteristically, Keynes’s analysis entails identification of the remedies – in this case, essentially a matter of lightening the burden placed on Germany to allow for recovery in production and trade (and the other countries needed to be able to benefit from Germany’s recovery to sustain their own); settlement of inter-ally indebtedness to avoid internal constraints on the victorious countries in their policies to relaunch their economies, and an international loan to help boost all the economies (Keynes 1971b, CWK II, p. 169):

... an economic system, to which everyone had the opportunity of belonging and which gave special privilege to none, is surely absolutely free from the objections of a privileged and avowedly imperialistic scheme of exclusion and discrimination.

And yet today Keynes’s remedies strike us as far from having any chance of being taken up as they were at the time. Asking the United States to forgo the repayment of loans granted above all to France and the United Kingdom, to sustain the war effort as precondition to ask these two countries to forego reparations from Germany, and actually proposing and inter-ally loan to get the economies moving after the devastation of 4 years of destructive fury, attests to Keynes’s great economic wisdom, but also, perhaps, to a certain political naivety. On the other hand, it might be seen as an example of that appeal to “reasonableness” that could be interpreted in modern terms of reciprocity (as in Rawls, for instance) or, more probably, associated with that concourse of ideas upon which Bloomsbury thrived.

The Bloomsbury “Civilisation”

Bloomsbury is a district of London where there lived – in many cases living together – a group of friends who shared a lifestyle and a passion for art and literature, holding social conventions and the morals of their time in contempt. At the core of the group were Vanessa, Virginia and Adrian Stephen, Clive Bell (who married Vanessa), John Maynard Keynes, Lytton Strachey, Duncan Grant

2 According to De Cecco “at the Paris conference strangling economic conditions were imposed on Germany ... [but] there was no intention to respect them ... what happened at the peace table was dictated not by the stupidity or wickedness of the protagonists, so much as the need to give the masses which their political classes had drawn into the war proof that the sacrifices had not been in vain” (De Cecco 1983, pp. 18–19, my translation). Keynes, according to this thesis, became aware only “dully of the scandalous ‘political exchange’ that was taking place” (p. 20).

3 In the pungent description by the most authoritative biographer of Bloomsbury, Michael Holroyd, “all couples were triangles who lived in squares” (Holroyd 1967, p. 413).
(with whom Vanessa had a daughter, who eventually married David Garnett), Desmond MacCarthy, Roger Fry and Leonard Woolf (who married Virginia). Then there were the other, outer members, like the writer E. M. Forster, James Strachey (brother of Lytton and translator of Freud), the painter Dora Carrington (who lived with Lytton Strachey) and many other exponents of twentieth-century British culture.

These friends met regularly, exploiting the occasion of dinners, receptions and travels to discuss common ideas rooted in the absolute value attributed to aesthetics and bearing witness to a religion that saw the highest form of human expression in art. Roger Fry and Clive Bell, drawing upon certain aspects of the philosophy of G. E. Moore, theorised the principles of “Civilisation” based on “reasonableness and a sense of value” (Clive Bell (1928) Civilisation, p. 54, cited in Goodwin 2006, p. 223).

A cornerstone of this “civilisation” consisted of the life of the imagination, which Fry and Bell identified with artistic activity. We may, however, also interpret it as an activity that surpasses the constraints and limitations of biological and material existence through the transformations and sea-change that art – but also science – can achieve. There is an echo of this in one of the concluding sentences of the Consequences: “setting in motion those forces of instruction and imagination which change opinion” (Keynes 1971b, CWK II, p. 188).

During the First World War Keynes came under heavy criticism from his Bloomsbury friends – many of them conscientious objectors – for working for the government and for a war that had come about to defend a world and lifestyle they detested. We must also bear in mind that Keynes often exploited the privilege of his position to help his friends obtain exemption from military service and to find jobs for them in the civilian world as a sort of refuge from the war. And it was this book, written and read within the sphere of the Bloomsbury group, that reconciled Keynes’s two commitments: to the world of his friends and to public life within the institutions.

As we have seen, most of the book was written at Charleston during the summer of 1919. We know the date when he started – 23 June – from a letter by Keynes to Oscar Falk (Skidelsky 1983, p. 376), and of the end of the first draft – 11 October – (Skidelsky 1983, p. 382).

The book was greatly appreciated in Bloomsbury. Lytton Strachey wrote to Keynes on 16 December 1919, 4 days after its publication (quoted in Dostaler 2007, p. 150):

As to the argument it is certainly most crushing, most terrible ... To my mind the ideal thing would be to abolish reparation altogether – but of course that is not practical politics.

Virginia Woolf wrote that it was a book that influenced the world without being in the least a work of art: a work of morality” (quoted in Goodwin 2007, p. 275), but even more significant is her letter to Benedict Nicholson, of 24 August 1940: “Maynard is Bloomsbury. He wrote the [Economic] Consequences of the Peace” (quoted in Goodwin 2007, p. 290).

What characterised Bloomsbury, as defined, for example, by Quentin Bell (1968), was the ideal of reason in the service of enjoyment of the pleasures of life, trusting in the exchange of different points of view – in a word, placing their faith in “rational conversation” as a means of finding off the irrational urges prompted by religion, nationalism or superstitions. This, essentially, was what belonging to Bloomsbury meant, not only for this particular book, but for Keynes’s entire output.

And yet in My Early Beliefs (the essay read in 1938, but published posthumously – as Keynes had expressly wished it to be – and addressed to the Bloomsbury friends), Keynes stated that he had subsequently abandoned his “juvenile creed, incubated in the sphere of the Apostles (the forerunners of the Bloomsbury group), and in particular the conviction that “human nature is reasonable” (Keynes 1971b, CWK II, p. 447). According to R. E. Braithwaite, however, Keynes had no intention of including the moral principles of Moore’s Principia Ethica in his own convictions (Braithwaite 1975, p. 245), least of all the tenet that an action can be judged to be just solely in the light of its consequences (“good as a means”). This interpretation of Keynes’s position finds confirmation in the celebrated dictum in the Consequences which we have already met (Keynes 1971b, CWK II, p. 40, italics added):

I am mainly concerned in what follows, not with the justice of the Treaty ... but with its wisdom and with its consequences.

Thus it was not in reason – the Bloomsbury creed – that Keynes continued to place his trust, for it does not always succeed in guiding behaviour which may be prey to the obscure and irrational forces of both individuals and groups, but in reasonableness as moral criterion, as judgment of the consequences of choices.

If Keynes subscribed to a consequentialist ethic, just how this sat with his rejection of utilitarianism and whether or not he continued to embrace Moore’s ideas unwaveringly are questions beyond our scope here. I merely wish to point up the idea that behaviour guided by “wisdom” with a view to the consequences is indeed that “reasonable and fair” behaviour to which Keynes attributes the value of right choice and moral duty. In the words of A. Carabelli, who studied the issue in depth (Carabelli 1994, p. 219):

... the problem of right conduct or moral duty in ethics is by Keynes, so to speak, dissolved into that of reasonable action ... Right action or duty is simply reasonable action. Keynes maintains that what matters is the reasonableness, not the absolute rationality of action.

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4The essay was published together with Dr Melchior: A Defeated Enemy, in a book entitled Two Memoirs, in 1949. David Garnett, who wrote a brief introduction, recalls that “Over a long period, we met together two or three times a year, dined at a restaurant, and after dinner revived our memories of the past listening to one, or more often two, memoirs read aloud by different members of our company” (Keynes 1971c, CWK X, p. 387).
Reason and Reasonableness

At the end of the Second World War, when the Treasury was again getting to grips with war finances and post-war economic conditions – but now also as negotiator with the Americans – Keynes took a position strikingly similar to the approach he had taken in the Consequences. As a principle of justice and wisdom, he asked the United States to waive payment of the debts incurred by the United Kingdom, which had “long borne the costs alone”. He suffered a resounding and indeed crushing defeat, falling in his efforts while also having to get the British Parliament to ratify conditions far worse than he had himself anticipated (Marcuzzo 2008). But let us take a brief look at the facts.

A fortnight after cancellation of the Lend-Lease programme⁵ – subsequent to the Japanese surrender – Keynes returned to Washington in September 1945 for his fifth mission as Treasury envoy; he had outlined his strategy to secure US aid in a Memorandum of 18 March of that year, evoking the scenarios opening up for the future UK economy as Starvation Corner, Temptation and Justice. Starvation Corner described the effects of efforts to be financially independent of the United States through a policy of rationing and controls following a line of economic autarchy and isolationism; Temptation was the choice to ask the United States for a commercial loan in return for a commitment to multilateralism and dismantling imperial preferences, but it was the third solution – Justice – that Keynes saw as the only “reasonable alternative” (Keynes 1971d, CWK XXIV, p. 291). The Americans were, as an act of justice, to grant financing in the form of a “free gift” allowing the United Kingdom to return to normal peacetime conditions of production and consumption, and to embark upon multilateralism in payments and international trade (Carabelli and Cedrini 2010).

If the repayment of UK debts had been negotiated on purely commercial bases, as the Americans were set on demanding – and eventually they had their way – the United Kingdom would have to squeeze internal demand drastically, and this would lead to deflation with worldwide repercussions. As we know, such consequences were to some extent avoided thanks to the Marshall Plan and massive American aid for the reconstruction of Europe.

The argument in favour of the “free gift” followed much in the line of the Consequences reasoning (Keynes 1971d, CWK XXIV, pp. 291–292, italics added):

It is only by a more comprehensive settlement, which attempts to offer everyone what is reasonable, and so far as we can make it, fair, that the financial consequences of the war can be liquidated. This is the aim, namely, that as between the partners in the war, its financial consequences, in so far as they affect future economic intercourse between them, should be so far as possible liquidated.

In this Memorandum of March (circulated in revised form on 15 May at the Treasury) Keynes once again takes up disclosure of the truth, awareness of the consequences and the arms of persuasion against the obscurity of politics, ignorance of realities and entanglement of interests.

The negative conclusions to draw from a possible American refusal also echo the judgment of the allies’ intransigence on reparations passed in the Consequences (Keynes 1971d, CWK XXIV, p. 293):

The Americans would have lost the sense of magnanimity for a financial benefit which is useless to them and even perhaps injurious. This variant would only appeal to those who believe that their duty to God and to mankind requires that every action must be at least dressed up to look like “business”.

As we have seen, Keynes systematically applied the term reasonable, often in contrast with the reasons of the victor or creditor, to a guideline not characterised by utilitarian calculation, which may prove only apparently to be in the individual interest. Thus reasonable action is guided by judgment, taking into account contingent, mutable circumstances as far as our knowledge can encompass the facts (Carnell 1994, p. 219).

The same term was used by Rawls in defining the characteristics of a plural and just society. In his book Political Liberalism we find this definition (Rawls 1993, p. 58):

The reasonable is an element of the idea of society as a system of fair cooperation and that its fair terms be reasonable for all to accept is part of its idea of reciprocity.

But how exactly are we to take the term reasonable? Habermas interprets it as distinguishing between those who accept the principle of fairness and cooperation and those who act rationally on the basis of their own (i.e. individual) conception of what is good and just. Thus being reasonable is a moral quality lacking in those who behave in a solely rational way.⁶

This, according to Habermas, is the source of the distinction between moral and ethical questions (Habermas 1995, p. 125):

Questions of justice or moral questions admit of justifiable answers – justifiable in the sense of rational acceptability – because they are concerned with what, from an ideally expanded perspective, is in the equal interest of all. Ethical questions, by contrast, do not admit of such impartial treatment because they refer to what, from the first-person perspective, is in the long run good for me or for us – even if this is not equally good for all.

The sense Keynes attributes to the term reasonable shows a strong analogy with the quality described by Rawls and interpreted by Habermas as moral, but it is anchored to the structure of his economic theory. In fact, Keynes takes the example of the fallacy of composition to show why the rational pursuit of individual interest does not guarantee the collective good, in this case identified as full employment.

⁵The US programme (voted in 1941) to supply the UK with what it needed “not in exchange for money but acknowledged by some ‘consideration’ to be negotiated later” (Moggridge 1992, p. 652).

⁶"What rational agents lack is the particular form of moral sensibility that underlies the desire to engage in fair cooperation as such, and to do so on terms that others as equals might reasonably be expected to endorse” (Rawls 1993, p. 51).
For example, attempts to reduce real wages or increase the saving of individuals on the basis of an individual rationale will not achieve the aim if undertaken by all, since aggregate prevails over individual effect. However, the impasse of failure to achieve the aggregate effect of full utilisation of resources can be remedied with a set of direct and indirect instruments designed to overcome individual inertia and generate the level of demand necessary to raise the level of employment.

In the case of the reparations and debts consequent upon the two world wars, the fallacy of composition is manifested in the form of a deflationary potential for all the economies - a level of demand kept drastically low within a country to satisfy the reasons of the victor or creditor. Thus lack of reciprocity or reasonableness leads to consequences not only morally reprehensible but also economically disastrous for anyone who has looked for guidance solely from the individual point of view.

In his introduction to the Italian edition of the *Consequences*, Marcello De Cecco applied Keynes's categories during the 1973–1974 crisis to denounce the policies of the International Monetary Fund, which, faced with the enormous debt run up by the international private banking system, required the "principal debtor countries to adopt policies entailing brutal deflation of the internal demand" (De Cecco 1983, p. 21). In my rereading of the *Consequences* I would like to add another example of victor policy, suggesting comparison with the episode that sparked off the latest crisis.

**Was it Reasonable and Fair to let Lehman Brothers Go Bankrupt?**

A number of authoritative commentators see in the decision to let Lehman Brothers go bankrupt the origin of the spate of devastating consequences on production, employment investment and consumption, and thus on exports (especially in Germany and Japan) that was only stemmed by the turnaround in public intervention policies.

The collapse of New York's banking giant on 15 September 2008 was the most spectacular bankruptcy in the history of the United States, and probably of the world, with $613 billion worth of banking debts and 155 of bond debts. The shock to the financial markets brought Standard & Poor's 500 Index plunging in the sharpest annual fall since 1938, froze the credit market, forced Goldman Sachs to apply to Warren Buffett for an investment of $5 billion in preferred shares and triggered a run on Treasury Bills that set yield slumping below zero for the first time (Stacy-Marie Ishmael in the *Financial Times*, May 4, 2009).

Comparing the Lehman Brothers bankruptcy with the reparations forced on the country that lost the First World War (as was the case of Germany in 1918) or the demand that the country that won the Second World War repay her debts (like the UK in 1945) is indeed audacious and perhaps farfetched, given the different scale on which social and economic ills and the tragedy of so many human lives entailed by the wars are measured. And yet the consequences of the decision - apparently taken on the basis of economic rationality - of letting Lehman Brothers crash are of a systemic and moral order such as to suggest reconsidering the matter with the categories applied by Keynes on those two occasions.

We might even use the scheme of the *Consequences* and, if only we could, imitate the style of the celebrated portraits of Lloyd George, Clemenceau and Wilson to tell the story, with its protagonists (Paulson, Geithner, Bernanke, Fuld), of how Lehman Brothers was eventually left to crash on that fateful week-end of September 2008.

Two days after the publication of the figures for the third quarter, showing losses amounting to close on $4 billion in the Lehman Brothers' balance sheet, the Federal Reserve convened an urgent meeting in its New York premises, inviting all the major investment banks of Wall Street. It was Friday 12 September. Hosting the meeting were Hank Paulson (Dartmouth and Harvard MBA), US Treasury Secretary, and Tim Geithner (Dartmouth and Johns Hopkins MA), President of the New York Fed. It was immediately made clear that the Bush administration held that it was not up to the taxpayers but rather to the Wall Street banks to throw the rope to haul Lehman Brothers up from the precipice.

Subsequently Paulson defended himself asserting that the Fed statute the government could not grant loans without collateral (which Lehman Brothers could not provide), and the point was also borne out by Bernanke, Chairman of the Federal Reserve, in an interview a few weeks later.

However, accounts of the meeting reported by the press and emerging from the official statements give a rather different picture of Paulson's reasons why Lehman could not be saved. As he himself put it to the journalists on that Monday 15 September when application was submitted for recourse to Chapter 11, the US bankruptcy law which allows firms using it to restructure in receivership: "I never once considered it appropriate to put taxpayer money on the line". The US government would not come in to save firms on the brink of bankruptcy because it "would just invite more foolish risk-taking. It would create a "moral hazard"." 8

Moral hazard applies to that behaviour which seeks to maximise gains, characterised by risk propensity or scant care about avoiding or minimising losses, encouraged by the conviction that State intervention would be inevitable in the case of failure.

But let us return to that Friday 12. In the Lehman Brothers premises the CEO Dick Fuld (University of Colorado and New York Stern Business School) was waiting in his office convinced that the game was going in his favour. Six months before, JP Morgan had saved Bear Stearns with a Fed loan (Tim Geithner playing a

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8A public-sector solution for Lehman proved infeasible, as the firm could not post sufficient collateral to provide reasonable assurance that a loan from the Federal Reserve would be repaid, and the Treasury did not have the authority to absorb billions of dollars of expected losses to facilitate Lehman's acquisition by another firm" (http://www.aanews.com/blogs/the-homefront/2008/10/15/ben-bernanke-why-we-didnt-bail-lehman-out.html).

leading role), and in early September the Fed had taken over control of Fannie Mae and Freddie Mac, the two giants of the real estate mortgage market, also on the brink of bankruptcy. If they did not manage to find a buyer – for weeks Fuld had been desperately searching for one – after the South Koreans withdrew from negotiations, it was widely believed (not only by Lehman, but by many banks the world over) that the Fed or the government would certainly intervene. Fuld was not invited to the meetings, and his vice Bart McDade was leading the Lehman delegation (Sorkin 2009, p. 306). Fuld was continuing his quest in the market environment. One possibility was to make a proposal to the Bank of America, and Fuld immediately set about contacting the Chairman, Ken Lewis, but at the very same time Lewis was finalising an agreement with John Thain, Chairman of Merrill Lynch, to acquire that bank. He would not call Fuld back; Lehman Brothers was not able to offer the system of retail brokers that the Bank of America was interested in. Subsequently it came to light that it had been Paulson who prompted Thain – a Goldman Sachs work associate – to meet Lewis for the possible acquisition of Merrill Lynch. It is worth adding that an inquiry of the Committee on Oversight and Government Reform is now (June 2009) in progress.

...investigating the events surrounding Bank of America's acquisition of Merrill Lynch and the role the Federal Reserve Board (the Fed) and the Department of the Treasury played in that transaction.9

On Sunday morning Fuld played his last card with Barclays, the big British bank, but there was the complication that nothing could be ratified without the shareholders' assembly; Paulson no longer answered Fuld's phone calls. So it was that when McDade brought an end to the "weekend of fear" with the Fed and government top officials that Sunday, bankruptcy had to be declared before the European and Asian markets opened the following day, and there was nothing left to do.

Thus Hank Paulson, nicknamed "the hammer" – a non-smoking teetotaller, Christian Scientist and keen bird watcher, of the Harvard and Goldman Sachs tribe, got the better of Dick Fuld, nicknamed "the gorilla", a floor trader with state-school education who attended MBA evening classes, and a gambler with a penchant for risky bets. Was this a clash between two ethical codes, two world views,10 or simply the liquidation of a rival in the world of investment banking that was to be restructured? This was the indictment launched by Dick Fuld, who stated before the Waxman Committee11 on 6 October 2008:

On the same day Lehman Brothers prepared to file for bankruptcy, the Federal Reserve significantly broadened the types of collateral all banks were able to pledge to the Federal Reserve to create additional liquidity, the lifeblood of our system, and the Federal Reserve also adopted, on a temporary basis, the type of exemption that Lehman Brothers had applied for earlier. Had these changes been made sooner, they would have been extraordinarily helpful to Lehman Brothers. A few days later, the Federal Reserve took expedited action to approve applications of Goldman Sachs and Morgan Stanley to become bank holding companies.

It was Ben Bernanke (Harvard and MIT), who had studied the Great Depression bank crashes in depth and upheld the effectiveness of the New Deal regulations,12 who prevented total collapse by opening the Fed coffers – with loans amounting to $1 trillion – and persuading Paulson to go before a recalcitrant Congress to gain consensus for exceptional measures.

The week-end after the one so fateful for Lehman Brothers, AIG was saved by the government with an outlay of $85 billion and control of an equity stake of 80% of the capital. Just a month later, the considerations that had stood in the way of saving Lehman Brothers did not apply, or no longer applied. Bernanke submitted two arguments to justify intervention, in this case, by the Fed:

In the case of AIG, the Federal Reserve and the Treasury judged that a disorderly failure would have severely threatened global financial stability and the performance of the U.S. economy. We also judged that emergency Federal Reserve credit to AIG would be adequately secured by AIG's assets.13

With regard to the first point, the Fed and Treasury deemed that in the case of Lehman Brothers bankruptcy would not have "severely threatened global financial stability and the performance of the U.S. economy"; unfortunately, the argument proved ungrounded and the suspicion remains that the judgment was prompted by another motivation, namely reprisal against the debtor, given an exemplary answer at the level of market law rationale.

Questionable, too, is the second point, i.e. that Lehman Brothers lacked sufficient collateral to obtain credit, if it is in fact true that when it crashed Lehman had book equity amounting to $26 billion, as also emerges from the evidence given by Luigi Zingales to the Waxman Committee:

The Lehman CEO will likely tell you that his company was solvent, and it was brought down by a run. This is a distinct possibility. The problem is that nobody knows for sure.14

9 At www.oversight.house.gov.
10 At the time of writing (7 June), the magazine Time carried out an opinion poll among its readers on the 25 people to blame for the financial crisis, and among them appeared the names of Fuld and Paulson; of the two, the more blameworthy according to the number of votes was the Treasury Secretary.
11 Statement of Richard S. Fuld before the United States House Committee on Oversight and Government Reform, Causes and Effects of the Lehman Brothers Bankruptcy, October 6, 2008 (at www.oversight.house.gov).
12 It might be argued that the federally directed financial rehabilitation – which took strong measures against the problems of both creditors and debtors – was the only major New Deal program that successfully promoted economic recovery” (Bernanke 1983, p. 273).
14 According to Zingales, “the doubts about the value of its assets combined with the high degree of leverage created a huge uncertainty about the true value of this equity. It could have been worth $40 billion or negative 20%” (United States House Committee on Oversight and Government Reform, at www.oversight.house.gov).
The case of Lehman Brothers – the only investment bank left to go bankrupt in the USA or Europe – has yet to be studied, its darkest corners scrutinised, above all in terms of the reasons of its protagonists.15

Some Tentative Conclusions

The distinguishing feature of the Keynesian approach is a conception of economics as extension of possibilities, as opposed to behaviours guided by particular interest, proposing remedies to safeguard the general interest as condition for prosperity and social harmony.

Forging his approach under the enlightening influence of Bloomsbury and Moore’s Principia, Keynes combined the criterion of consequentialist justice with criticism of the fallacy of composition, which he saw in classical economic theory, to contest the equation: individual interest = collective good.

The return to Keynes repeatedly called for in the emergency of the economic earthquake that began in 2008 and the economic crisis persisting into 2009 has taken the form of large-scale public intervention, extraordinary injections of liquidity and abandonment of the rhetoric about the superiority of the market. There is, however, an aspect of Keynes’s approach that does not seem to have received as much attention. Economic rationality seems to authorise demands to bring debts to book, imposing indiscriminate sacrifices, ignoring the pleas of the weakest, invoking rigorous laws and threatening social protection and security. By contrast, Keynes’s reasonableness appeals to judgment on the basis of the circumstances, to exercise of the imagination and creativity in seeking solutions characterized by analysis of the consequences from the overall point of view.

Forgoing exorbitant war reparations from Germany and cancelling the UK debts – solutions proposed as conditions for a common future of prosperity – are examples of the philosophy that Keynes promoted and pursued. The same principle of reasonableness should have guided the decision to save Lehman Brothers, abandoning the logic of uncertainty about the true value of its assets and the idea of sending a message to the investment banks or simply defeating a formidable competitor. Consideration of its consequences for the stability of finance and economic growth should have been allowed for.

Comparing the Lehman Brothers crash with the decisions taken at Versailles and in the Anglo-American negotiations of 1945 serves the purpose of drawing upon the lesson of the Consequences and Keynes’s teaching. The contexts are manifestly

15The conclusion of a recent and very well documented account of the events in: “It cannot be denied that federal officials – including Paulson, Bernanke, and Geithner – contributed to the market turmoil through a series of inconsistent decisions. They offered a safety net to Bear Stearns and backstopped Fannie Mae and Freddie Mac, but allowed Lehman to fall into Chapter 11, only to rescue AIG soon after. What was the pattern? What were the rules? There didn’t appear to be any…” (Sorkin 2009, p. 353).

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different, but we can see prevailing the same logic of confrontation between personalities (Wilson, Clemenceau and Lloyd George in the first case; the American Morgenthau, Secretary of Treasury, White, Treasury Director of Research, and Keynes in the second; Fuld, Paulson and Geithner in the third), and contrasting interests (the Allies against Germany, the Americans against the British, the Treasury and the Fed against Lehman) rather than a solution that was and should have been seen as reasonable.

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