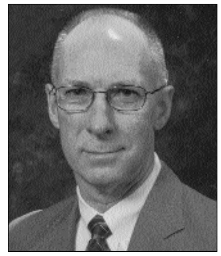
From the Armistice to the Great Depression



BY ROBERT HIGGS

When the Armistice took effect on November 11, 1918, bringing World War I to a close, the belligerent nations of Europe were economically almost prostrate—their labor forces and capital stocks depleted greatly, their domestic economic structures distorted grotesquely, and their old arrangements for international trade and investment shattered.

To make matters worse, the Versailles Treaty, signed on June 28, 1919, required that Germany make huge reparations payments to France, Great Britain, Italy, and Belgium. To earn the wherewithal to make these annual transfers for the next several decades, Germany needed to sell great amounts of its goods abroad, but doing so was nearly impossible, given the country's economic devastation and its loss of important territories and other resources to the victorious powers—not to mention the barriers other countries erected to protect their own producers from foreign competition. It soon became clear that the reparations would be paid only if Germany borrowed large amounts from other countries, and the only lenders capable of providing sufficient funds were the Americans.

In effect the Germans borrowed from the Americans and then handed over much of the proceeds to the French and the British, who in turn sent some of the money back to the United States to repay loans received during the war.

Therefore, in effect the Germans borrowed from the Americans and then handed over much of the proceeds to the French and the British, who in turn sent some of the money back to the United States to repay loans received during the war. This scheme held so little charm for the Germans, who got nothing out of it but more debt, that they resorted to engineering a hyperinflation of the German currency in 1922–23 to ease the government's fiscal woes. Unfortunately for the German people, especially for middle-class people, who held monetary assets such as bonds, insurance policies, and bank accounts, this inflationary eruption proved devastating not only to the economy but, in the longer run, to the moral fortitude of the bourgeoisie, which felt that the rug had been pulled out from under frugal, respectable people. By creating disaffection with the Weimar Republic, the hyperinflation helped to prepare fertile ground for the growth and eventual triumph of Hitler's party.

After the hyperinflation was stopped, new international lending arrangements were hastily concocted, but each such band-aid served only as a temporary means of stanching the bleeding. The reparations regime was simply not viable in the long run; the only question was precisely how it would break down and what would replace it. From the start, according to economic historian Peter Temin's *Lessons from the Great Depression*, the German government "struggled ceaselessly for the reduction and elimination of its reparations obligations." After the Germans defaulted in 1923 and the French army occupied the Ruhr district in response, the payments were rescheduled in 1924, scaled down in 1929, then delayed, and ultimately, after Hitler came to power in 1933, repudiated along with every other German obligation under the Versailles Treaty.

At the same time that the economically advanced countries were dealing with the reparations problem, they were striving to reconstruct the international financial

Robert Higgs (rhiggs@independent.org) is senior fellow at the Independent Institute (www.independent.org), editor of The Independent Review, *and author of* Depression, War, and Cold War *(Independent Institute).*

regime they had wrecked during the war by suspending the gold standard and issuing vast quantities of fiat money. The general assumption was that the European nations ought to return to the gold standard, and one by one they did so during the latter half of the 1920s. The monetary system to which they "returned," however, was not the old prewar gold standard, but a "gold-exchange" standard that lacked essential attributes of the old system, such as circulating gold coins and domestic convertibility. Murray Rothbard called it "a bowdlerized and essentially sham version of that venerable standard." Unlike the classical system, it was subject to constant "management" by central bankers who sought to achieve new goals, such as price stability or a low rate of unemployment.

When Great Britain finally resumed international convertibility of the pound sterling into gold in 1925, it made a serious mistake by setting the official value of the pound at the old, prewar parity. Because of the rise in prices that had occurred in Britain during the war, however, the pound in free exchange was no longer worth as much relative to the U.S. dollar as it had been worth before the war. By officially overvaluing the pound (at £1 = $4.86, when the prevailing free-market rate was approximately $4.40), the British made their exports—goods priced in terms of the pound sterling—relatively expensive and hence difficult to sell overseas. British export industries, such as coal, steel, textiles, and shipbuilding, suffered accordingly, and workers in those industries, traditionally reluctant to go far afield in search of jobs, endured high rates of unemployment. Many workers subsisted on the infamous "dole." The British economy languished, and investment funds tended to flow out of the country, especially to the United States, putting even more pressure on the overvalued pound.

To help the British succeed in their resumption of gold convertibility, central bankers in the United States, led by Benjamin Strong, who headed the Federal Reserve Bank of New York, pursued monetary policies that would reduce interest rates in the United States, thereby diminishing the relative attractiveness of U.S. investments for British investors and causing them to reduce the pressure they would otherwise put on the pound's exchange value by trading pounds for dollars.

These U.S. policies, however, also had effects on the American economy. The "momentous decision of forcing a regime of cheap money," as Lionel Robbins described it, caused the U.S. money stock to grow faster than it otherwise would have grown, kept interest rates lower than they otherwise would have been, and thereby encouraged domestic investors to make certain investments—in new structures and other long-lived producer goods—that they otherwise would not have made. In short, U.S. monetary policies, aimed at assisting the British monetary authorities, had the effect of bringing about "malinvestments" in the United States, distorting the structure of the U.S. capital stock in an unsustainable fashion (because investments in structures and other long-lived capital goods will ultimately prove economically unwarranted when they have been made in response to artificially low interest rates, and such projects will go bankrupt).

A Feeding Frenzy

U.S. central bankers also began to worry in the late 1920s that by keeping interest rates artificially low, their policies were feeding a frenzy to buy corporate shares and creating a stock-market bubble destined to pop with destructive effects on the real economy. Accordingly, in 1928 and especially in 1929 they moved away from their "cheap money" policies, adopting policies of higher interest rates and exerting direct pressure on commercial banks to stem what they saw as "speculative excesses" and diversions of bank loans from economically sound purposes. Most economists now believe that this change of monetary policy triggered the U.S. economic downturn that occurred in mid-1929 and the stock-market crash that followed later in the year. Others believe that the prior ("cheap money") policies themselves presaged the downturn, because the malinvestments that those policies had fostered would have to be liquidated sooner or later by means of bankruptcies and reallocations of resources to more sustainable uses, a process marked by economic disruptions and transitional unemployment.

After the initial downturn in 1929, owing to a succession of extraordinarily detrimental government actions, the recession mushroomed into the Great Depression, a catastrophe that contributed greatly to the rise of Hitler and ultimately, in 1939, to the onset of a second, even more horrendous phase of the fighting that the Armistice had ended in 1918.