Slouching Towards Utopia?: An Economic History of the Long Twentieth Century

VIII. After World War I: Restoring? Civilization?

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8.1: Inevitability and Chance

From 1870-1914 we can see global economic history as by-and-large following a logic that was if not inevitable at least probable. Luck and probability gave humanity an opening around 1870 in the form of a quadruple breakthrough: the ideology and policy of an open world, the transportation breakthrough, the communications breakthrough, and—most important the coming of the research laboratory to more than double the pace of invention plus the large corporation to greatly speed the deployment of new technologies. Thereafter to 1914 the economic logic rolled forward nearly inescapably: trade, the international division of labor, and global growth (but also the creation of a low-wage periphery, and the concentration of industrialization of wealth in what is still the global north); the beginnings of the demographic transition that curbed the tendency for technological progress to be nearly entirely eaten up by greater numbers; the shift of work from farm to factory; and the coming of sufficient (if ill-distributed) prosperity to raise the possibility that someday not that far away humanity, in the rich economies of the global north at least, might attain something that previous eras would have judged to be a genuine utopia.

From 1870-1914 we can see global political-economic history as by-and-large following a possible if not an overwhelmingly likely or near-necessary path. We see the threading of the needle in the creation and maintenance of an increasingly liberal order within the economies and polities of the global north: expanding suffrage, growing rights, increasing prosperity, increasing inequality accompanied by political movements in or near power that sought to curb such inequalities, and an absence of large-scale revolution. We see the conquest of the rest of the world into formal and informal empires as the power gradient between the North Atlantic and the rest became overwhelmingly huge. Both of these could have been otherwise. But it is not that surprising that they were what they were.

But in the politics of war's outbreak and war's progression we enter pure chance and contingency. World War I did not have to happen—the 1914 Bosnian crisis might have been finessed, or the war might have ended with a quick decisive victory for one side or the other, or governments and elites might have come to their senses. Whether some such catastrophe like World War I was probable or whether humanity was unlucky is harder to judge. However, the fact that we had two world wars in the long 1870-2016 twentieth century gives us good reason to fear that there was a deep flaw at the heart of the "western" civilization that had dominated the world from 1870-1914.

To much of the industrial world—especially to those engaged in commerce, trade, and enterprise—World War I had seemed impossible to imagine beforehand. While it was going on it felt like a nightmare. And afterwards seemed like a new, very different, and very bitter life. The British economist John Maynard Keynes saw the war as a previously-unimaginable horror. He saw his own participation in its planning as he worked at the British Treasury as contemptible: He wrote to his friend David Garnett that he "agreed that there was a great deal of truth" in Garnett's denunciation of Keynes's role as an analytical "genie taken… out... by savages to serve them faithfully for their savage ends, and then—back you go into the bottle.... Oh... our savages are better than other savages.... But don't believe in the profane abomination."

After the war, Keynes scorned the naivete of the upper-middle class pre-World War I inhabitant of London "for whom life offered, at a low cost and with the least trouble, conveniences, comforts, and amenities beyond the compass of the richest and most powerful monarchs of other ages" who had seen "this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable". He was, of course, speaking of himself. He and his had seen "the projects and politics of militarism and imperialism, of racial and cultural rivalries, of monopolies, restrictions, and exclusion, which were to play the serpent" as "little more than the amusements of his daily newspaper… [with] almost no influence… on…

economic and social life." And they had been wrong, with awful consequences for the world.

World War I did not have to end as it did—with Germany defeated but not conquered, and with Germany's right wing ready to propagandize that it had not been beaten in a fair fight but rather stabbed in the back by the diplomats, socialists, liberals, and Jews who made up the "November criminals"; with the United States withdrawing into isolation; with Russia in revolution; and with Britain unwilling and France too shell-shocked by the horrendous casualty roll to take on the task of hegemon stabilizing Europe.

Thus after World War I humanity faced a huge problem: Could it pick up the pieces and try again? Could it do something like restore the pre-World War I order, fix the flaws that had generated the catastrophe of World War I, and resume its tasks—the economic task of advancing and deploying technology and organization for a rich and truly human world and the political-economic task of managing to keep domestic and international peace by satisfying people's desires to have and exercise the rights they thought they had that were more than just property rights? Or would human progress in the direction of something that some might judge as a utopia greatly slow, or even come to a screeching halt?

After the guns fell silent at the eleventh hour of the eleventh day of the eleventh month of 1918 after fifty months of World War I, statesman's choices and pure chance no longer ruled absolutely. History once again acquired more of a logic, as large groups of people acting collectively formed alliances and made decisions about how to regulate the economies that had to be reformed and rebuilt. There was great opportunity: 1/3 of the belligerents' production—2/9 of world production—was no longer devoted to killing people, maiming people, and blowing things up. Structural factors and underlying trends made their influence felt. But they did so in a not-good way. There was no return to normalcy. There was no lifting the locomotives of economic growth, prosperity, and human flourishing back onto their pre-World War I liberal-order tracks.

8.2: Exhaustion

8.2.1: The Belle Époque Broken

It was not until 1940 in French and 1947 in English that people would start to refer to 1870-1914 as the *Belle Époque*—the Beautiful Era. But long before the coining of that phrase society had made its judgment that, with the catastrophe of World War I, something precious and beautiful had been permanently broken. 65 million men had been mobilized for military service, out of total belligerent populations of perhaps 100 million adult males and 400 million total. Of these, perhaps ten million were killed and 21 million wounded. (Civilian casualties were less than ten percent of military casualties. Things were to be different in World War II. Then civilian deaths would exceed military deaths.) Plus there were all the casualties of the Russian Civil War that erupted at the end of 1917.

8.2.2: The End of Aristocracy

8.2.2.1: The Aristocrats Rolled the Dice

Even though Europe in 1914 was a Europe of national populations, of industrialists and socialists, of factory workers and technicians, Europe's governments in 1914—especially the defense and foreign affairs ministries—had been populated by aristocrats, ex-aristocrats, and would-be aristocrats. And landed, aristocratic, military elites had control of many of the levers of propaganda and power. Moreover, the aristocrats had had help. Industrialists and entrepreneurs were eager to provide their political support in return for economic benefits, as in the 1879 German "marriage of iron and rye": the imposition of tariffs on imports of British steel (to protect the positions of German manufacturers) and on imports of American grain (to protect the positions of German landlords).

On the eve of World War I, these landed military service aristocrats, ex-aristocrats, and would-be aristocrats increasingly found themselves members of a social caste that had no societal function. They could look forward only to continued erosion of their influence and status, erosion of their relative wealth, and erosion of their self-respect. Or they could go to war, and recover a function.

Power—in the form of office and of vast (if declining relative) wealth—and propaganda—in the form of pageantry and the press—were reinforced by ideologies: Social darwinism was nationalized and democratized by the claim that all Germans (or Frenchmen, or Britons, or Italians) had a powerful interest in making it that the Saxons (or the Gauls, or the Anglo-Saxons, or the Lombards) would become the superpower of the twentieth century that would leave its imprint on all future civilizations. Plus there was the rejection of Enlightenment and Christian (however much, historically, they had been honored in the breach) values of peace, fraternity, and charity that is often given the name of Nietzscheanism: the name of the game was "creative domination, exploitation, and subjugation", and any thoughts that one might be in a win-win situation was an obvious and offensive mystification by those who were too weak to meet the strong in open and fair contest. And it was probably Jewish as well.

So the political and military elites of Europe rolled the dice in 1914, half-understanding that in the losing country the political and social order that had given them influence and wealth would be destroyed.

8.2.2.2: Populations Responded

The forces of war had rallied mass support by creating a powerful echo chamber. We can read how humane and sane a civilized man German author Thomas Mann was in his novels *Buddenbrooks* and *The Magic Mountain*. But under the spell of right-wing propaganda Mann could also right about how Germany's World war I was totally justified and popular, entirely caused by German's envious adversaries, a necessity to level and replace a deeply corrupt prewar world that had not been worth preserving, and a source of national unity and moral elevation. He could write that Germany's opponent France needed to be degraded and dominated because while it had a democratic civilization, it had no culture. He could write that Britain posed an existential threat to Germany because of its desire to re-educate Germans using Gurkhas and Hottentots.

And so the people responded. They truly did see, at the beginning of the war at least, the world as made up of nations in conflict. They were willing to risk death to make sure that the mayor of Strasbourg (or Strassburg) spoke *their* language. But after the war those who had served in the mass conscript armies were eager to look for someone to blame. Initially, at least, the emperors, their camarillas, and the aristocrats found themselves in the crosshairs.

8.2.2.3: Emperors and Aristocrats Lost

Thus the end of World War I saw the end of four dynasties and four empires. The monarchic-aristocratic orders of Germany, Austria, Russia, and the Ottoman empire had embraced war as a way of rallying working and middle classes behind their rule. They had all lost. They were all gone. Plus the Italian politico-economic order was very shaky.

Russian Czar Nicholas II Romanov abdicated in March 1917. The semi-socialist Kerensky government that followed tried to continue the war against Germany on the side of Britain, France, and America; and organized an election for a constituent assembly to write a constitution for a democratic-socialist Russia. In late fall 1917 it was overthrown in a coup by Lenin's Bolshevik (Majority Faction) Communist Party. Lenin was not interested in democracy. Lenin was interested in taking the burden of rule upon himself and his faction. Lenin sent the constituent assembly home at bayonet point, and decided to form Marx's dictatorship of the proletariat—although how you could have an industrial working class that barely existed run a dictatorship was unclear.

German Kaiser Wilhelm II Hohenzollern abdicated in November 1918. A democratic republic was proclaimed, with Socialist Party leader Friedrich Ebert as its provisional president. The German army high command agreed to support and defend the republic, if the political leaders of the republic would suppress any social revolution that would expropriate and nationalize property and redistribute wealth. Germany's relatively moderate socialists and social democrats agreed. Their leaders then turned out to be more ruthless and more "Leninist" than their more left-wing comrades. German socialist leaders Karl Liebknecht and Rosa Luxemburg called for not just a political but a socialist republic. Their "Spartakist" demonstrations were quickly suppressed by ex-soldiers hastily organized into a militia. Luxemburg and Liebknecht were arrested. Then they were shot—without even the pretense that they were trying to escape.

The left wing of the Socialist Party of Germany split off to become the Communist Party of Germany. They never forgave. They never forgot. From then on the principal adversary of those on the left wing of German socialism was not the monarchists, not the plutocrats, not the center-right, not the fascists, but rather the social democrats.

The Austro-Hungarian Emperor Karl I Habsburg likewise abdicated in November 1918. His regime was carved into individual nation-states very roughly following ethno-linguistic borders.

And the last to fall was Mehmed VI Vahideddin (Revelation-of-Faith), Sultan, Caliph, Commander of the Faithful, Caesar of Rome, and Custodian of the Two Holy Places. He had been girded with the sword of imperial dynasty-founder Osman (1299-1324). He hung on until power was taken up by Mustafa Kemal Atatürk in the spring of 1920.

8.2.3: Really Existing Socialism Was Born

8.1.3.1: The Dictatorship of the Proletariat

The Communist Bolshevik régime of Vladimir Lenin in Russia was the first seizure of power by disciples of what was to become the most murderous of the totalitarian ideologies of the twentieth century—Communism, or perhaps we should call it what it called itself: *really existing socialism*, implemented as something called the *dictatorship* of the *proletariat.*

That first word, *dictatorship*, meant for Lenin—as it had meant for Karl Marx and Friedrich Engels—the temporary concentration of authority, and the temporary suspension of checks-and-balances, procedural impediments, and established powers of resistance to the will of the government. Marx and Engels saw Abraham Lincoln's January 1, 1863 Emancipation Proclamation as an act of such a *dictatorship*: in spite of the lack of any authority anywhere in the U.S. Constitution for the federal government to interpose itself between any "person held to service or labor" and the owner of the property right to benefit thereby, Lincoln freed 4 million slaves in the eyes of U.S. law by a stroke of a pen. On what authority? His power as commander-in-chief in a time of "war or insurrection" and his judgment that emancipation was a military necessity. Lenin believed that Russia needed a similar act of emancipation: freeing workers and peasants from wage slavery by nationalizing and socializing the land and property of nobles and industrialists, and so reconstituting patterns of economic control, production, and exchange.

But in whose interest was the economic order of Russia to be reconstituted? That is the second word: *dictatorship.* Rule was, in Lenin's—and earlier in Marx's and Engels's—mind to be administered of and for the *proletariat.* Why the proletariat? Why not just have a dictatorship of the people—a democracy? Because, Lenin believed—and Marx and Engels had believed before him—all other classes of society had selfish interests that would block the progressive evolution of society toward true socialism. The bourgeoisie, the petty bourgeoisie, the peasantry, the aristocrats were all "reactionary", hence did not deserve a voice or a vote. To allow them any political power during the initial post-revolutionary *dictatorship* could only bring trouble.

Perhaps Lenin had hoped that the democratically-elected constituent assembly could be convinced or browbeaten to accept his leadership. They did not. And what happened when the industrial working class—the *proletariat* itself—did not support his policies? Even that did not matter. For Lenin, legitimacy and power were not derived from any sort of mandate from the masses; or from the expressed will of the sole progressive class, the industrial working class; or even from strange women in ponds handing out magic swords in some farcical aquatic ceremony. Legitimacy proceeded from the conformity of policy to history and historical necessity, as those had been determined by the Marxist-Engelsian sciences of dialectical and historical materialism.

8.1.3.2: Political Theology and Its Consequences

As American literary critic—and then believing communist—Edmund Wilson was to write in 1940, this was bonkers. Lenin's and Trotsky's statements about what they were doing and why it was justified made, as Wilson put it, absolutely "no sense whatever unless one substitutes for the words *history* and *dialectic of history* the words *Providence* and *God*."

The right take on what Lenin was doing, and in its prospects for success, was made in advance by German-Polish left-wing socialist Rosa Luxemburg before her murder by the right-wing militia who were servant-masters of German moderate socialist and Weimar Republic President Friedrich Ebert. Red Rosa's voice has not been heard enough, and is certainly worth hearing:

> Without general elections, without unrestricted freedom of press and assembly, without a free struggle of opinion, life dies out in every public institution…. Only the bureaucracy remains…. A few dozen party leaders of inexhaustible energy and boundless experience direct and rule…. An elite of the working class is invited from time to time to meetings where they are to applaud the speeches of the leaders, and to approve proposed resolutions unanimously–at bottom, then, a clique affair…. Such conditions must inevitably cause a brutalization of public life: attempted assassinations, shooting of hostages, etc…

For:

> Freedom only for the supporters of the government, only for the members of one party–however numerous they may be–is no freedom at all. Freedom is always and exclusively freedom for the one who thinks differently. Not because of any fanatical concept of "justice" but because all that is instructive, wholesome and purifying in political freedom depends on this essential characteristic, and its effectiveness vanishes when "freedom" becomes a special privilege...

8.1.3.3: Failed Left Revolutions Elsewhere

Lenin and his comrades confidently expected their revolution in Russia to be followed by other, similar Communist revolutions in the more advanced, industrial countries of western Europe. They would then provide substantial aid to poor, agrarian Russia, and so make it possible for him to stay in power and rapidly guide Russia to a stage of industrial development where socialism might function the way Marx had imagined it would. Lenin pinned his hopes on the most industrialized country in Europe, with the largest and most active socialist political party: Germany.

Lenin might have been correct had more of the leaders of the left, "violent action" wings of western European socialist movements been like Lenin. A Communist republic briefly held power in Hungary. Another briefly held power in Bavaria, in southern Germany. But the Russian Revolution was the only one that stuck. Really existing socialism at the end of World War I thus found itself under the leadership of Vladimir Lenin and confined to one country—albeit a very large country—and to a very poor country in which few had ever imagined any form of socialism might be attempted.

Many—most prominently British Communist historian Eric Hobsbawm, in his *Age of Extremes*—take Lenin's Bolshevik coup and the construction of really existing socialism in Russia as the axis on which twentieth-century history turns, and as the starting point for the history of the century. Under this interpretation, the main thread of twentieth-century history covers the period 1917-1990 and is the three-cornered struggle of liberal quasi-democratic capitalism, fascism, and really existing socialism. Perhaps this story is an epic: the good guys win. Perhaps this story is tragic: really existing socialism was crippled by the particular circumstances of its birth, grew strong enough to rescue the world from fascism, but then decayed and became decadent and in its dissolution closed off humanity from the true road to a genuine and good socialist utopia.

I do not take this view. In some sense, I am more optimistic: I see the build-out of technology and organization plus the social learning about how to manage modern economies as more important and more positive things to focus on, and faction fights within the post-1917 Kremlin as secondary or tertiary. In some sense, I am more pessimistic: I do not see the struggle for human liberty and prosperity as won even in the limited sense that those are delivered by liberal capitalist democracy.

But those who write of a 1917-1990 short twentieth century do have reason for what they do.

8.1.4: Storing Up Trouble

I see the Bolshevik coup and the subsequent stabilization of the really existing socialist régime in Russia as storing up a great deal of trouble for the future.

Along many dimensions World War I and the subsequent attempts at reconstruction did little but store up trouble. It stored up trouble by eliminating Russia's last chance to largely peacefully transform from an archaic and poor absolutist monarchy to a modern industrializing semi-democracy or constitutional monarchy. The Communist regime ruled for 36 years by Lenin and Stalin that emerged from Russia's revolution during World War I may not have been the worst regime to rule a major world power in the twentieth century, but it was plenty bad.

I see World War I and its end as storing up great deal of trouble in other dimensions as well. World War I destroyed the key underpinnings of international economic arrangements. After World War I it was not possible to put it back together the way it had been. Yet governments and central banks spent a lot of time trying to do so. Results were mixed in the short and disastrous in the long run: without World War I's dislocations and the subsequent failed attempts to rebuild a structure that could not be rebuilt, there would have been no rapid propagation of the Great Depression.

In the last analysis, World War I destroyed much and settled nothing. Whatever political patterns it created were ephemeral, and fell to pieces a decade later. The longer-run issues of the relative place of Germany in Europe, and of how European governments were to settle their disputes and adjust their differences were settled only after another, bloodier war in which French, British, Russians, and Americans faced another, much worse German regime—Adolf Hitler's Thousand-Year Reich that ended in the ruins of devastated Berlin in 1945.

8.2: A Land Fit for Heroes

8.2.1: Expanded Suffrage

After political-economic right was out of power, in retreat, and disorganized. The political-economic left was also not in power (except in Russia, and there only if really existing socialism is in any real sense "left"), but it was strongly energized. For if the stabilization of the really-existing-socialist Bolshevik régime in Russia did nothing else, it had demonstrated that another world was possible: There were other ways to organize modern industrial societies than unequal if quasi-democratic liberal capitalism.

In the broad center, post-World War I political economy focused on somehow appeasing those who had just lived through World War I: those who had been maimed, those who had been starved, and those whose brothers, fathers, husbands, and sons had died in the trenches. Political leaders tried to respond by taking steps to try to create a "land fit for heroes"—a government commitment to social welfare and infrastructure programs to make life better, plus franchise extensions. Working-class soldiers had died in enormous numbers for the state. Those who returned could not be deprived of the vote. Plus women's suffrage reached critical mass. This had consequences. In Britain, for example, where less than half of adult males could vote before World War I, the socialist Labour Party multiplied its vote sevenfold in the election of 1918.

8.2.2: Proportional Representation

The war had arisen because of the suppression of nationalities by the old empires. A just post-war system, therefore, had to protect minority rights. Hence—except in Britain—proportional representation. Proportional representation meant that candidates did not have to receive a majority in a particular constituency, but just a sizable enough proportion of the total national vote.

Proportional representation encouraged the multiplication of parties: the principal incentive for politicians to group together into parties was always that if you did not combine you stood no chance of office, and proportional representation greatly reduced this incentive. First-past-the-post systems encourage the growth of two grand coalitions—one just to the right and the other just to the left of center. Proportional systems encourage the growth of many parties, each one finely calibrated to a particular voter mass point on the ideological spectrum.

Proportional representation would turn out to reinforce currents hostile to political democracy: "we vote and vote, but nothing changes," critics charged, because the only outcome of elections was a small shift in seats in parliament, and a small reshuffle of portfolios among centrist ministers. It was much easier to make the argument that the democratic franchise had real meaning in first-past-the-post systems. Why? Because it did. A first-past-the-post election might produce a leader and a government that had little correspondence with the wishes or the needs of the center of the electorate. But only an idiot or a grifter would wish to say that the choice between a Lincoln and a Douglas, a (Theodore) Roosevelt and a Taft, a (Franklin) Roosevelt and a Hoover, a Gore and a Bush, or a Rodham Clinton and a Trump, or, indeed, a Jeremy Corbin and an Alexander Boris de Pfeffel Johnson did not matter.

8.2.3: Providing for Societal Well-Being

A land fit for heroes required governmental policies that would recognize the gift that the people had made the nation during the war. Disability insurance for war veterans, unemployment insurance (so that returning soldiers did not have to beg in the street because postwar readjustment was slow), mammoth government expenditures (to repair war damage), more mammoth government expenditures (to make up for all the infrastructure and other investments not made during the war), plus even mammoth government expenditures (to pay off the war debts). Governments were asked—people demanded—to give people value for their property rights when much property had been destroyed or lost its value from war-induced dislocations. And people still demanded their Polanyian rights that the liberal market order had never satisfied well in the first place, especially given the accelerated pace of economic, political and social change: people's perceived rights to a stable or improving community, to an income consonant with what they deserved, and to stable employment and life situations. Old-age pensions, public housing, and public health insurance moved on to the agenda. Satisfying and vindicating these rights would have taken many more resources. Yet the world, individual economies, and their governments were all poorer than they had been in 1914.

How were these going to be paid for? These questions put stresses on and required action from governments orders of magnitude greater than had been seen before.

Governments were not up to the task.

Governments were desperate above all to assure their voters that at least others were not getting a larger share of resources. And in attempting to make sure that others were not unfairly getting more, they would up insuring that all would up getting less.

8.3: Public Finances

8.3.1: Who Was Going to Pay?

8.3.1.1: A Peace "without Annexations or Indemnities"

The peace settlement would, American President Woodrow Wilson had promised, be a "peace without annexations and indemnities". But war damage was immense. And there were other sources of loss as well besides war damage. Perhaps the equivalent of a fifth of a year's national income for France disappeared with the Bolshevik repudiation of the Czarist debt. Export markets for European goods had atrophied as European production had been switched to war production.

The victorious allies did not think that they should bear the cost of having been the battlefield in World War I. Somebody had to be charged: somebody had to pay.

The United States had lost 50,000 killed in battle in World War I. France had lost 1.5 million. The British empire had lost 1.1 million. Nearly everyone in America thought that it should not have to sacrifice anything for the victory in World War I—that its ex-allies Britain and France should pay back all the private and public finance they had borrowed during World War I at full pre-World War I gold standard values. They had hired the money, hadn't they?

Britain believed that France should pay back its war debt: Britain had come to France's rescue. Britain thought that Germany should pay enough to fund its repayments to America and to fund the "land fit for heroes" in Britain. To accomplish this, British Prime Minister David Lloyd George said, required that Germany be squeezed "until the pips squeaked"

Britain and France could agree that America and Germany should pay: America by forgiving war debts—the allies had incurred very heavy casualties in what had been a common cause—and Germany by paying reparations.

Germany believed that it had not surrendered, but merely made an armistice based on Woodrow Wilson's outline of what a peace would entail. The German center-left thought that it should be treated as an ally and a comrade by Britain, France, and America, for the core politicians of the Weimar Republic had never held office in the pre-World War I imperial Hohenzollern régime, and the core supporters of the SPD had been viewed by the ex-Kaiser, his coterie, and his ministers as (internal) enemies—albeit not as much enemies as the (external) Russians and French. And the now out-of-power German right viewed themselves as betrayed: by Americans who had promised a peace "without annexations and indemnities" and then broken their word, by Britons and Frenchmen who wanted to extract resources and keep Germany poor, by the socialist November criminals who had somehow stabbed the German army in the back, and (somehow: how it was not clear) by the Jews.

There was near universal belief among the citizens and the statesmen of the allies that Germany was 100% responsible for the war. Moreover, "Germany" did not mean the semi-democratic German régime of 1914. Rather, it was the German *people* "moved by insane delusion and reckless self-regard" who had destroyed prosperity and “overturned the foundations on which we all lived and built.” That was British economist John Maynard Keynes, in the very first paragraph of his *The Economic Consequences of the Peace.* But Keynes diverged from general allied-power opinion in that he was one of the view who also believed that it was essential to let bygones be bygones, for if the allied powers sought to make Germany pay and keep Germany poor, “the spokesmen of the French and British peoples… run the risk of completing the ruin… by a Peace which… must impair yet further… the delicate, complicated organization, already shaken and broken by war, through which alone the European peoples can employ themselves and live.”

8.3.1.2: Reparations and Versailles

In 1919 the statesmen of Europe and America gathered outside Paris to set out the peace settlement—the Treaty of Versailles. The victorious allied powers promptly found a dodge: instead of requiring that defeated Germany pay “indemnities”, they merely demanded “reparations”: two years’ worth of German national product. It would have required all of Germany's pre-World War I export earnings for 30 years to pay this reparations burden. Germany might pay reparations by shipping goods to Britain and France. But the goods that Germany could ship would substitute for the heavy industrial productions of Britain and France. Britain and France did not want them: accepting them would cause mass unemployment and was a non-starter.

The problem could have been finessed: Germany could have paid reparations, France and Britain could then have used those reparations to buy assets in Germany, the assets in Germany would have been offered for sale by Germany’s rich, and the German government would have levied the taxes that the rich would have needed to sell assets to raise the money to pay. But that required a German government strong enough to levy heavy taxes on the rich. And that required a German government willing to try to pay rather than to resist the reparations burden.

The bulk of the reparations burden was never paid. What was paid was more than offset by loans from the U.S. to Germany after World War I that were also never paid, but forgiven during the Great Depression. Since the notional imposition on Germany of a reparations burden weakened the Socialist Party which had signed the allied peace terms, and their weakness was key to the failure to stop the rise of Hitler, the imposition on Germany of the post-World War I reparations burden turned out to be the most costly political decision of the entire World War I era.

8.3.1.3: Keynes's Protest

John Maynard Keynes was one of those staffing the British delegation, headed by Prime Minister David Lloyd-George. He watched in horror as the project of post-World War I reconstruction then went wrong, when the object seemed to be to extract as much in plunder and reparations from Germany as possible. Keynes's biographer Robert Skidelsky quotes South African politician Jan Christian Smuts on the atmosphere at Versailles:

> Poor Keynes often sits with me at night after a good dinner and we rail against the world and the coming flood. And I tell him that this is the time for Grigua's prayer (the Lord to come himself and not to send his Son, as this is not a time for children). And then we laugh, and behind the laughter is [Herbert] Hoover's horrible picture of thirty million people who must die unless there is some great intervention. But then again we think that things are never really as bad as that; and something will turn up, and the worst will never be. And somehow all these phases of feeling are true and right in some sense…

Keynes exploded with a book called *The Economic Consequences of the Peace*. It condemned the political maneuvering of Versailles and the treaty that resulted in the strongest possible terms. He excoriated short-sighted politicians who were interested in victory rather than peace. He outlined alternative proposals. And he prophesied doom—if the treaty were carried out and Germany kept poor for a generation:

> If we aim deliberately at the impoverishment of Central Europe, vengeance, I dare predict, will not limp. Nothing can then delay for long that final civil war between the forces of reaction and the despairing convulsions of revolution, before which the horrors of the late German war will fade into nothing, and which will destroy... the civilization and progress of our generation...

And, indeed, in the 1930s and the 1940s, doom would come in the form of the Great Depression and World War II.

8.3.2: Post-World War I Economic Disorder

8.3.2.1: Budget Deficits

Post-World War I governments faced limited tolerance for taxes but enormous demands for expenditures. Countries that had been defeated found their citizens with limited appetite for taxes: wasn't having suffered and been defeated enough? Countries that found themselves victorious also found their citizens with limited appetite for taxes: what was winning for, if not that life would be good and other people could be made to pay the costs?

What happened when there was a large and permanent gap between the goods and services citizens wanted the government to pay for and the value of the taxes that taxpayers were willing to pay? Governments had to fill the gap. Governments could do so directly by printing non-interest paying money. Governments could do so indirectly by printing interest-paying bonds and selling them for cash. After that a number of things might happen, depending on the expectations of the people—mostly financiers—holding the money and the bonds about what future government policy might be, and depending on the psychology of the financiers. How patient were they—how long might they be willing to let governments run up its tab before they themselves decided to liquidate their money balances and turn them into something of use value? What kind of reward would they demand forr holding on to rather than dumping the interest-paying government bonds? And would the government take steps to run a surplus so that it could extinguish the money and liquidate the bonds when financiers decided that they were no longer willing to hold on to them?

8.3.2.2: The Fiscal Theory of the Price Level

In the aftermath of World War I, financiers had limited patience and demanded healthy returns. When that is the psychology of financiers, the most likely outcome is what economists call *the fiscal theory of the price level*. Prices rise, and so the money and bonds issued by the government in francs, marks, lira, or whatever becomes worth less in terms of the useful commodities it will buy. Thus those holding the cash and the bonds are implicitly taxed by this process of inflation. Overall prices double, triple, rise sevenfold, rise to whatever is needed to make the real-commodity value of the government's financial obligations in debt and cash equal to the available financing that is the real-commodity value of the future budget surpluses the government is willing to run. In the limit of *hyperinflation* "worth less" becomes "worthless": the money printed and the bonds sold by the government turn out to have no value at all.

8.3.2.3: Hyperinflations

The first post-World War I *hyperinflations* took place in the successor states to the old Austro-Hungarian empire, Germany's ally that had shattered at the end of 1918 under the pressures of military defeat and southeastern European nationalism. Italy grabbed a chunk. Serbia grabbed a much larger chunk—Slovenia, Dalmatia, Croatia, Bosnia, and Herzegovina—and became the Kingdom of the South Slavs, Yugoslavia. THungary-ruled but largely Roumanian-speaking Transylvania was annexed by Romania. Poland grabbed some of largely Polish-speaking Austro-Hungarian Galicia. The Czech and Slovak lands formed a new republic of Czechoslovakia. What was left that was Magyar-speaking became Hungary. What was left that was German-speaking became Austria. The Austro-Hungarian empire had been a single economic unit. Now it was split among seven countries, each with its own different currency, and its own high tariffs. The regional division of labor unwound, with the predictable consequences.

The Austrian economy turned down and the finances of the Austrian government collapsed first. Vienna had been the administrative and industrial hub of a great central and southeastern European empire that no longer existed. Moreover, the war debts piled up by the entire 53 million population Austro-Hungarian Empire plus reparations payments demanded were all imposed on the successor country of 7 million: democratic Austria. Before the war ended, the then 34-year-old Austro-Czech economist Joseph Schumpeter had set out the problem:

> The material goods needed by the armies… has been… and will be provided during… the war. After the war, we will be left only with a 'monetary problem'… in the position of an entrepreneur whose factory burnt down and now has to enter the losses in his books…

And the losses could be taken either by taxing in order to raise the resources to pay off the bonds and absorb the excess currency, or by inflation and the resulting implicit state bankruptcy.

1919 found Joseph Schumpeter as finance minister of the new Austrian Republic. His policy was for an immediate and substantial wealth tax on all real, industrial, commercial, residential, and financial property. The rest of the cabinet, behind by Minister of Foreign Affairs Otto Bauer, said yes to the wealth tax. But they wanted the proceeds to be used for "socialization": to buy up large Austrian companies, make them more efficient, and then use the profits from higher efficiency to (a) raise workers' wages and (b) pay off the debt. Schumpeter parried that if socialization was "efficient" then it did not need to be financed by the wealth tax: it would be what we now call an LBO, a leveraged buy-out, and efficient LBOs finance themselves. Schumpeter was fired. The cabinet dissolved into squabbling. The wealth tax was never levied, and so was not used either to buy back debt nor to buy up companies.

Instead, the Austrian government printed money. Before World War I, the Austrian crown had been worth a little less than twenty cents. By the late summer of 1922 the crown was worth 1/100 of a cent. The 1918 obligations—cash and bonds—of the Austrian government had become worthless. The League of Nations—the international organization and United Nations precursor established at the end of World War I—provided a hard-currency loan on the condition that the Austrian government surrender control over its own currency and finances to the League. The Austrian government was willing: it could no longer print money that anyone would accept, and it could no longer borrow, so control over its own currency was useless. Austria's currency was pegged to gold. In 1924 the krone was replaced by the schilling. The budget was balanced by severe cuts in expenditures and higher taxes. And Austria remained depressed, with high unemployment, for half a decade after the end of the inflation.

In Germany prices rose one trillion-fold: what had cost 4 Reichsmarks in 1914 cost 4 trillion by the end of 1923. The final reparations bill presented was tied to Germany's "ability to pay," heightening uncertainty about its true magnitude. One proposed schedule for repayment had Germany paying an average of 7.5 percent of its national product over forty years in reparations—and still, in 1962, owing a debt to the allies equal to Germany's entire 1921 national income.

With respect to other countries, financiers had limited patience with and demanded healthy returns for lending money after World War I. With respect to Germany, financiers had next to no patience and demanded exorbitant returns. The debt of the German government looked very risky to them, for the western allies wanted to extract resources from Germany, and it seemed a gamble to lend money to Germany in the belief that whatever resources Germany earmarked to service your loan would escape the allies. The usual sources of credit to the government dried up. Germany had the standard post-WWI demands for expanded social-welfare programs. Germany had a substantial amount of political chaos. Germany paid some reparations, and faced recurrent threats from the allies if it did not pay more. The government found that it could not issue interest-bearing debt to gain currency to pay its bills. Its only alternative was to print more and more banknotes. As government workers and suppliers presented their bills to the Treasury, it paid them off with newly-printed pieces of paper.

But what did the workers and suppliers do with these pieces of paper? They held onto banknotes not because they are a good investment (after all, they pay no interest) but as a convenient, readily-spendable form in which to hold purchasing power. Put more banknotes in the hands of the public, and they spend them. Let people recognize that the longer they hold their banknotes, the greater the proportion of their real value they will lose as prices rise, and they spend them faster: the rate at which prices rise outruns the rate of money printing. And the amount of power to purchase commodities in the hands of businesses, bosses, workers, and savers falls.

The fall in “real balances”—in the money supply divided by the price level—is a very damaging consequence. Money is liquid trust: the ability to make one-shot deals with producers and consumers you may never see it again. Lower real balances, lower trust, and so the societal division of labor breaks.

Before World War I the German Reichsmark had been worth 25 U.S. cents. At the end of World War I in November 1918 it was still worth 6 U.S. cents. That is an average inflation rate of 43% per year: enough to make holding any substantial chunk of your wealth in non-indexed debts a very bad idea. But it is not enough to disrupt your life on a day-to-day basis: 43% per year means that the cash in your strongbox on one day would still worth 97% of what it had been worth a month before, and 99.9% of what it had been worth the previous day.

The end of 1919 saw the Reichsmark with not 6 cents but only 1 cent. That is an inflation rate of 500% in that year—but that is still only 16% inflation in an average month, and only 0.5% per day. And the mark recovered: it was worth 2 cents at the end of 1920. But the government kept spending. And the government kept printing. The mark was worth 1/3 of a cent at the end of 1921—a 1921 inflation rate of 500% per year, 16% per month, 0.5% per day again. The mark was worth only 0.0025 cents by the end of 1922—a 1922 inflation rate of 13000% per year, 50% per month, 1.35% per day.

For a while the government welcomed the inflation: easier to finance spending by printing money than by actually trying to collect taxes. Industrial and mercantile interests also benefited from inflation: they borrowed from banks, and repayed them in badly depreciated marks. For a while labor benefited too: unemployment almost vanished, and in the early stages of the inflation at least real wages and thus workers’ purchasing power did not fall.

By January 1923 the French government was fed up with Germany’s failure to meeting the reparations payment schedule. It send in the French army to occupy the Ruhr Valley, and collect commodities at the points of its guns, if necessary. The German government responded with passive resistance: the inhabitants of the Ruhr struck to prevent the French government from extracting reparations deliveries from the occupied area. And the German government printed even more money to try to maintain the incomes of the passive resisters. The mark was worth 0.000000000025 cents by the stabilization at the end of 1923—9999999900% per year, 364% per month, 5% per day

At the end of 1923 the German mark was stabilized by a currency reform, that struck twelve zeroes off of the currency, so that one new mark was equal to one trillion old marks. An international loan was made so that Germany could make some reparations payments and build up its hard currency reserves. The new mark was strictly limited in supply—no more printing of bank notes at the request of the Treasury. And with the budget now balanced and the expectation of future money-printing was gone, the inflation was over.

In the German post-WWI inflation prices rose a trillion-fold. In Russia prices rose four billion-fold. In Poland prices rose 2.5 million-fold. In the Austrian inflation prices rose two thousand-fold. In France in the 1920s the inflation was only sevenfold: investors in French government debt in 1918 could still in 1927 buy 1/7 as much of real commodities with their bonds as they could have had they spent rather than invested their money in 1918.

8.3.2.4: Consequences

How much of a difference did these hyperinflation make? From a narrow economists perspective, an inflation is simply a tax, a rearrangement, and a confusion. It is a tax on cash because your cash becomes worth less between when you acquire and when you spend it. It is a rearrangement as those who have borrowed pay back their loans in depreciated currency while those who lent have to accept the depreciated currency. And it is a source of confusion, as it is more difficult to calculate whether what you are doing truly makes economic sense because the same numbers entered into your account books at different dates correspond to different amounts of real purchasing power.

Yet for societies inflation—and especially hyperinflation—are very big deals. They are symbols of government incompetence. And they are destroyers of trust in the society and the economy. John Maynard Keynes hit the nail on the head with respect to the political danger from government resort to inflation in 1919, well before Germany embarked on the road that carried the value of the mark from $0.25 to $0.00000000000025. He attributed to Lenin the claim that "the best way to destroy the Capitalist System was to debauch its currency" through hyperinflation; and he wrote of how inflation not only:

> confiscate[s wealth], but... confiscate[s] arbitrarily.... The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth.... [It] engages all the hidden forces of economic law on the side of destruction, and does so in a manner which not one man in a million is able to diagnose…

Keynes concluded that the European governments which had resorted and were resorting to inflation were:

> fast rendering impossible a continuation of the social and economic order of the nineteenth century. But they have no plan for replacing it…

People who are not rich but are well-off-pillars of their community, in middle-age, who have done well in economic life and saved enough to feel comfortable-are usually the strongest supporters of relatively democratic, relatively liberal governments. They have done well enough that they see no great need to move to the right, and they have no particular interest in redistributing income away from the working to the employing class. They fear the redistributionist plans of the left. And they value individual freedoms and social peace. They also tend to not be terribly sophisticated investors: the erosion of nominal forms of wealth disturbs them. They fell cheated—and if they hold government bonds, they feel cheated by the government. And their Polanyian right to stable finances giving them the standard of living they deserve is disrupted.

The professional and mercantile upper middle classes of Germany appear to have concluded that the social-democratic governments since 1918 had not been competent. Those classes should have been the principal support of the post-World War I democracy—the "Weimar Republic"—that had emerged from the collapse of the monarchical, militaristic, semi-democratic German Empire at the end of World War I. They were not.

8.3.4: The Gold Standard

Looking around after World War I, nearly everyone with power or property sought a return to what American President Warren G. Harding called "normalcy'. The pre-World War I system had, after all, produced faster economic growth and more prosperity than I never been seen before. Then had come military political economic catastrophe. Clearly job one was to get the machine back on tracks and to get steam up again. So whatever had gotten broken during World War I needed to be fixed.

One key thing that had gotten broken during World War I was the gold standard.

8.3.4.1: The Gold Standard Before World War I

For the half-century before World War I, international trade and finance had operated according to a certain set of rules. The largest trading countries had committed themselves to maintaining a fixed parity for their currencies in terms of gold. This meant that international trade was not exposed to significant exchange rate fluctuations—except in currency-crisis emergencies. This meant that monetary policies were very tightly constrained, for any tendency toward inflation would generate, through capital flight or high import demand, a line of bankers at the central bank trying to turn the country's currency into gold—and a resulting unwinding of inflationary pressures. Only Britain, in the central position and with the Bank of England as the conductor of the international gold standard order, got to raise and lower interest rates at home in order to fit the supply of liquidity in the money market to the needs of trade.

This seemed to be a good system for British and other investors worldwide. This seemed to be a good system for Britain. This seemed to be a good system for world trade. This did cause some problems for countries, especially on the periphery of the world economy, that might have to deal with a gold outflow. But all-in-all the pre-World War I gold standard was a functioning and not obviously disruptive feature of a system that had produced the fastest and broadest half century of economic growth of any era up to then.

And what problems the gold standard before World War I had produced were greatly alleviated after the mid-1890s. Before, there had been deflation: producers on average forced to cut the prices at which they sold, and employers forced to cut the wages they paid—often by firing workers to show that they meant business. The deflation was slow and erratic, averaging 2% per year. But, still, most people getting on a semi-regular basis the news that their nominal incomes were going to fall did not make for societal harmony. But the major mining of gold in South Africa's Witwatersrand began in the mid-1890s. Thereafter the world economy as a whole had an inflationary bias of about 2% per year. That made the 1895-1914 period one in which financial crises and economic downturns were fewer and shorter, and in which what economists call *money illusion* made a great many more confident and more happy with their place in the economy than the underlying real commodity flows of production, distribution, and use fully warranted.

8.3.4.2: World War I Broke the Gold Standard

During World War I, European finance ministers discovered the benefits of inflation—indeed the necessity of inflation given governments' unwillingness to raise taxes sufficiently to fight the Great War on a balanced-budget basis. But you could not inflate if you kept your gold standard promise to buy and sell your currency for its fixed gold parity. So with the exception of the United States, countries dropped the gold standard during the war. And, on average, the world price level in 1920 was twice as high as it had been in 1914.

After the war countries sought to return to the gold standard. If the world's countries were to return to gold at their pre-war parities, the world's gold cover would have been only half as large relative to world financial flows as what it had been before the war. Think of the gold reserves of the world as a shock absorber. Shipments of gold (and speculation based on the expectation of such shipments) were what covered temporary imbalances in trade and investment flows. Moreover, different countries had inflated during World War I to different degrees. If they restored the prewar system of exchange rates, some countries would have had exchange rates that were much too high. Other countries would have had exchange rates that were much too low. So the need for shock absorbers would be greater.

8.3.4.3: Letting the Market Decide Exchange Rates—for the Moment

In the immediate aftermath of World War I, the British government decided it should not fix the gold value of the pound but instead let the market decide what the value of the pound would be.. By the end of 1919 the pound sterling settled at \$3.80, some twenty-five percent less than its pre-World War I parity of \$4.86. Restoring the gold standard at the pre-World War I level, would, it seemed require cutting all wages and prices in Britain by about one-third. And Britain was a country that had, relative to the United States, experienced little relative inflation since 1914.

All countries agreed that they had to peg their currencies back to gold. And, once they had dealt with their internal problems of debt management, all counties sought to do so. They took three roads to stabilization:

Countries that had experienced hyperinflation simply pegged their currencies to the dollar and to gold at whatever the free-market value was at the end of the hyperinflation. (For example, Austria, Germany, and Hungary.)

Countries that had seen their value against the dollar drop by more than half (but that had not experienced hyperinflation) gave a small sop to creditor interests by recovering a part, but only a small part, of their currencies' values against the dollar before stabilization. (For example, Czechoslovakia, France, and Italy.)

Countries where freely-floating currencies were only a few tens of percent below their pre-World War I dollar values dealt with the problem of stabilization by returning to par: deflating their economies and incurring domestic unemployment in order to restore the pre-World War I peg against gold and the dollar, in the hope that by so demonstrating their credible commitment to the gold standard they would reap increased stability, greater confidence, and lower interest rates. (For example, Britain, the Netherlands, and Scandinavia.)

8.3.4.3: Britain's Return to the Gold Standard

The ruling politicians chose to do so. But it is still not clear to me why, for Britain, it had to be not just a stabilization but a *return:* why the stable exchange rate had to be a the pre-World War I rate of $4.86 to the pound. Reducing the level of nominal wages and prices by one-third was bound to carry with it unemployment, bankruptcy, and labor unrest. It might well destroy whatever government undertook it, for the short-term costs to the electorate were immense—whether to workers rendered unemployed by the depression accompanying deflation, or to manufacturers rendered bankrupt by competition from abroad at an unrealistic exchange rate. With a newly enlarged electorate for which high employment was a strong value, it seemed to be a silly bet to make for a country whose politicians were always looking forward to the next democratic election.

The decider was Winston Churchill, who we have seen before—the son of American heiress and immigrant to Britain Jennnie Jerome, and Randolph Spencer-Churchill the younger son of the Duke of Marlborough. Churchill was Chancellor the Exchequer (Finance Minister, or Secretary of the Treasury). His Private Secretary was a man named P.J. Grigg. Grigg reports a dinner in 1924 hosted by Churchill at which supporters and opponents of return argued. The opponents of returning to gold at the old parity, Reginald McKenna (himself a former wartime Chancellor of the Exchequer) and John Maynard Keynes painted a grim picture of return hobbling exports, creating unemployment, putting substantial downward pressure on wages, and triggering waves of strikes.

John Maynard Keynes? But hadn't John Maynard Keynes burned his bridges with the British establishment by his denounciation of the British government's negotiating position after World War I in the strongest possible terms? Hadn't he written of his boss, then-British Prime Minister David Lloyd George, bamboozling naive American president Woodrow Wilson thus as Lloyd George sat there:

> watching the company, with six or seven senses not available to ordinary men, judging character, motive, and subconscious impulse, perceiving what each was thinking and even what each was going to say next, and compounding with telepathic instinct the argument or appeal best suited to the vanity, weakness, or self-interest of his immediate auditor…. The Old World was tough in wickedness anyhow; the Old World's heart of stone might blunt the sharpest blade of the bravest knight-errant. But this blind and deaf Don Quixote was entering a cavern where the swift and glittering blade was in the hands of the adversary…

So how did he still have entrée into the corridors of power—or at least of dinner?

The Economic Consequences of the Peace made Keynes famous. His horror at the terms of the peace treaty won him powerful friends—for example then-current Harvard Law School intellectual baron, Franklin Roosevelt confidant, and future Supreme Court Justice Felix Frankfurter, a powerful molder of opinion in the United States. Keynes's biographer Robert Skidelsky rightly characterizes Keynes as propelled by "passion and despair" and so speaking "like an angel with the knowledge of an expert" showing an extraordinary mastery not just of economics but also of the words that were needed to make economics persuasive.

Before *The Economic Consequences of the Peace* Keynes was primarily an academic (with some government experience) with a lot of influential literary friends. Afterwards he was a celebrity. Keynes counted. And so he had to be conciliated, which meant listened to, or at least creation of the appearance that he was being listened to.

And he needed conciliating. For after World War I Keynes was under a *geas* to use what power he could command to—don't laugh—try to restore civilization. The world had been in a good place: economically, socially, culturally and politically. The ruling elites had broken it. The road back was, in biographer Robert Skidelsky's attempt—which I believe correct—to get inside Keynes's mind, to undo "the brutality of the closure applied in 1914... to restore the expectation of stability and progress in a world cut adrift from its nineteenth-century moorings."

But simply winding back the clock to the 1914 exchange rate parity of £1 = $4.86

would not do the job. Fundamentals had profoundly changed. And smart adaptation was needed.

Our knowledge of what went on at Churchill's dinner party is inadequate. Our only witness is P.J. Grigg, who thought that McKenna and Keynes did not argue their case very well. But Grigg's introduction to his own memoirs contains a bitter denunciation—what we would now call a "subtweet"—of John Maynard Keynes as teaching Britain to "live beyond its means on its wits" and had turned "political economy into a *vade mecum* for political spivs."

It is doubtful that Grigg would have found Keynes and McKenna convincing no matter how well they argued their case.

If we move the camera back we can see more of why Keynes, McKenna, and company were unconvincing to the great and good with their hands on the levers of power:

- On the one hand we had a power elite confident that the underlying system was fundamentally sound, looking back on an era in which the old system was overwhelmingly believed to have been a stunning success—concerns about the distribution of income and wealth in the Belle Époque being absent from the radar screens of the elite—believing that enough expedients had already been tried, and knowing that economists had always preached *laissez faire* except in truly exceptional circumstances.

- On the other side you had a few economists and fellow travelers arguing that it was journalists who had claimed that economists had always preached *laissez faire* (real economists being more nuanced), that it was necessary to make the restoration of full employment and rapid growth priority #1, and that everyone needed to think clearly about how to revise institutions and to change practices in order to make that happen.

- Parallels with Europe and the United States from 2007-2020 seem unavoidable: there, too, an echo chamber of those seeking to return things to "normalcy" as fast as possible and an unconcern for taking extra steps to ensure the rapid return of full employment and rapid growth ruled the counsels of the great and good.

- Moreover, the pre-WWI parities were thought to be more credible. Investors would have more confidence that they would be maintained than that any set of newly chosen parities (corresponding to real exchange rates in "fundamental equilibrium") might be.

In the last analysis the political risks of postponing the return to the gold standard seemed large and immediate. The economic risks of return seemed vague, distant, and uncertain. The benefits of setting out on a path of further experimentation seems unnecessary.

Thus the decision was made to return Britain to the gold standard after World War I.

The jump in the value of the pound from its early-1920s average value of approximately $3.80 to its par value of $4.86 had taken place without any shift in the relative level of British prices. Thus British industries from coal mining to textile to chemical and steel manufacturers found themselves facing severe competitive difficulties. Britain's return to gold in 1925 resulted in unemployment in export industries, and a push for wage reductions to make industry more competitive.

Moreover, sterling speculators could see what the Bank of England could not: that returning to the gold standard at an overvalued parity created a vulnerability and weakened the pound sterling. They began to pull their money out of Britain. In order to balance its payments, the Bank of England had to keep British interest rates above American interest rates. Higher interest rates depressed investment, further increasing unemployment. The slow growth and double-digit unemployment that plagued the British economy in the late 1920s were in large part the result of the decision to return at the pre-World War I parity.

8.3.4.4: Consequences of Return

The old system had been restored—not just the gold standard, although that was the most important part, but the web of interconnections and expectations. And so the governments of the North Atlantic and elsewhere breathed a sigh of relief and looked for the return of the Belle Époque.

Great Britain returned to the gold standard in 1925. The French franc was stabilized and its inflation halted in mid-1926. The Italian lira was stabilized and its inflation halted by the end of 1927. Latin American countries whose commitment to the gold standard and been shaky and tenuous before World War I recommitted themselves afterwards, expecting to benefit from renewed growth and international trade. But they did not reckon on the fact that the starvation of world trade between

1914 and 1918 had led their people to build up industries making the manufactured goods they had imported from Europe and North America before 1914, and that a restoration of previous trade patterns would put those industries under immense pressure.

Social conflict in Britain broke out over the distribution of the adjustment burden: there was a General Strike of 1926.So the British government began to subsidize its declining and uncompetitive industries. But if the economy did not adjust to changed circumstances by moving people to places and sectors where the market was giving a green light rather than a red light, how would the economy ever boom?

Moreover, while Britain had an overvalued currency, France and the United States had undervalued currencies. They exported more than they imported, loaned some of the surplus abroad, and used the rest to acquire more gold.

According to the "rules of the game" of the gold standard, a country that receives an inflow of gold is supposed to use it to back an expansion of its money stock. Inflow countries then experience inflation. And that inflation makes them import more and export less, so trade rebalances. But neither the U.S. nor France was willing to tolerate the domestic inflation that would have restored balance, and removed the tendency for their two countries to continue to accumulate gold. they squirreled the gold away in their government's vaults. And both—undergoing export booms—were very happy with the situation. Both began to view their gold reserves not as shock absorbers, but rather as national treasures: every month in which gold flowed out of France or America was viewed by the central Bank of France or the recently established U.S. Federal Reserve as a month of defeat.

Recall that under the gold standard the world's stock of gold serves as a shock absorber: it is the ultimate safe asset that redistributes itself around the world to create confidence and liquidity. A country that finds itself without a large enough share of the world's monetary gold will be forced to let its interest rates rise, its employment level fall, and its imports fall as well: depression and poverty until the gold returns. The United and France held more than 60 percent of the world's monetary gold by 1929; their share of world trade was less than one-third that proportion. The global price level was twice what it had been in 1914. Outside the United States and France, the monetary gold cover for the world economy was inadequate: countries undertaking to trade 1.6 times the total nominal world pre-World War I flew with only a fraction of 0.4 of the gold.

A single gold coin or gold bar thus had to do four times the work of cushioning shocks, providing liquidity, and creating trust.

Once again, the parallels between post-World War I and the North Atlantic 2007-2020 suggest themselves. An open, globalized world economy required safe assets in large enough quantities to provide for liquidity and trust. Instead, a safe asset shortage imposed substantial deflationary pressures. In our day, hiistory would once again rhyme.

8.4: Conclusion

Before the interwar period, the idea that the aggregate health of the economy was the government's business was a fringe idea: part of socialist, but not of mainstream politics. There were panics, depressions, and deflations, but they were regarded more as acts of nature than as acts to be prevented by government. Public works in time of depression were beneficial in the same sense that flood relief was beneficial. But the idea that a government could and should manage the economy as a whole was as foreign as the idea that a government could and should manage the weather.

World War I and the decade after ought to have changed this. But it did not. The belief by the ruling elites was that restoring the institutions and practices of the pre-World War I era—especially including taking a *laissez faire* attitude to the business cycle and the distribution of income—would restore the pre-WWI prosperity and march toward utopia. Leaders assumed that the economy would take care of itself after the clock had been rewound, and so they focused on the territorial and the political rather than on the economic and financial.

John Maynard Keynes protested yet again, uselessly: "the croaking of a Cassandra who could never influence the course of events in time" was how he looked back on his attempts to influence events: "Prophecy… more successful than the Persuasion… regarded… as extreme and reckless utterances" but not because they were wrong but "because they… ran directly counter to the overwhelming weight of contemporary sentiment and opinion." If only leaders had recognized that:

> perils… lay not in frontiers or sovereignties but in food, coal, and transport…. Problems… could not be solved by greed. The possibility of their cure lay in magnanimity.

and by a willingness to experiment.

But in the end not even Keynes had a workable plan. In the end, Keynes hoped that America would be willing to tax itself to fund the reconstruction and rebuildng of Europe, out of a combination of benevolent magnanimity and of a recognition that a stable, prosperous, growing, and peaceful world and world economy would be an asset to American national security and even to the American economy. But that was a fantasy. That was not what America was in 1919. And as the 1920s ticked on, peoples in western Europe waited and hoped for the true return to "normalcy". And whenever there was a shock to push prosperous normalcy further away, they began to question.