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NIALL FERGUSON

The Pity of War

PENGUIN BOOKS

Comrade! The kulak [rich peasant] uprising in [your] five districts must be crushed without pity. The interests of the whole revolution demand it, for the 'final and decisive battle' with the kulaks everywhere is now engaged. An example must be made. 1) Hang (and I mean hang so that the *people can see*) *not less than 100* known kulaks, rich men, bloodsuckers. 2) Publish their names. 3) Take *all* their grain away from them. 4) Identify hostages . . . Do this so that for hundreds of miles around the people can see, tremble, know and cry: they are killing and will go on killing the bloodsucking kulaks . . .

Yours Lenin.
P.S. Find tougher people.[123]

Surprisingly, the Bolshevik leaders drew the line at prisoner killing: Trotsky explicitly forbade it in an order of 1919.[124] But the fact that the order had to be issued suggests that the practice of shooting captured Whites was widespread. In August of that year the Red Army Commander-in-Chief S. S. Kamenev ordered that 'no prisoners be taken' in repulsing an attack by Don Cossacks:

Wounded or captured [White] officers were not only to be finished off and shot, but tortured in every possible way. Officers had nails driven into their shoulders according to the number of stars on their epaulets; medals were carved on their chests and stripes on their legs. Genitals were cut off and stuffed in their mouths.[125]

Figes reproduces a picture of a Polish officer, captured by the Red Army in 1920, being hanged naked upside down and beaten to death.[126] This kind of barbaric behaviour may have proved effective against the ill-disciplined, dispersed and outnumbered White armies; against the Poles, however, it merely stiffened resistance. The Civil War thus represented a major advance on the terror tactics of the earlier world war. The next major war on the Eastern Front would be fought under these new 'rules': death for deserters; exemplary violence against civilians; and no quarter for prisoners. This truly was 'total' war: and to Hitler and Stalin, both of whom issued orders to these effects, it seemed the logical conclusion to be drawn from German and Russian defeat in the First World War. Of course, nothing could have been better calculated to make that war one of unprecedented violence, in which men on both sides fought to the end because they no longer had any alternative.

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How (not) to Pay for the War

ECONOMIC CONSEQUENCES

Imagine a country which, as a result of the First World War, effectively lost 22 per cent of its national territory; incurred debts equivalent to 136 per cent of gross national product, a fifth of it owed to foreign powers; saw inflation and then unemployment rise to levels not seen for more than a century; and experienced an equally unprecedented wave of labour unrest. Imagine a country whose newly democratic political system produced a system of coalition government in which party deals behind closed doors, rather than elections, determined who governed the country. Imagine a country in which the poverty of returning soldiers and their families contrasted grotesquely with the conspicuous consumption of a hedonistic and decadent élite; a country which one disgusted conservative could dismiss as:

a nation without standards, kept in health rather by memories which are fading than by examples which are compelling. We still march to the dying music of great traditions, but there is no captain of civilization at the head of our ranks. We have indeed almost ceased to be an army marching with confidence towards the enemy, and have become a mob breaking impatiently loose from the discipline and ideals of our past . . . We are . . . [a] nation of half-educated people, and it is the mark of the half-educated to be sceptical, apathetic, unimaginative, and capricious.[1]

The effects of inflation were most severely felt by the middle classes, as another post-war writer vividly lamented:

[A] whole body of decent citizens [is] slipping down by inexorable God-made or man-made or devil-made laws into the Abyss: as if a table was suddenly tilted slanting and all the little dolls and marionettes were sent sliding on to the floor . . . [T]he whole mass, despite resistance, is falling through the bottom of the world.

Here . . . is a complete and startling transformation of values; not slowly changing from one to another, but suddenly and almost brutally forced upon the life of millions by causes altogether outside their control . . .[2]

Middle-class spokesmen lamented the new 'corporatist' alliance of capital and labour which the war had forged – an analysis of the war's consequences since endorsed by historians.[3]

This was not Germany – as the reader may forgivably have assumed – but Britain, the supposed victor of the First World War, in the years immediately after 1918. The territory lost consisted of the twenty-six counties of Southern Ireland, where the spark of revolt ignited in Dublin at Easter 1916 had become a blaze of civil war in the 1920s, and where the *de facto* partition of 1922 had, by 1938, become *de jure* secession under the constitution of the Republic of Ireland.[4] The external debts were owed principally to erstwhile Allies, with the US accounting for the lion's share (slightly more than £1 billion in March 1919). The cost of living reached nearly treble its pre-war level in November 1920, and annual inflation touched 22 per cent; the unemployment rate reached 11.3 per cent the following year, higher than in 1930, and the worst figure since records had begun. Some 2.4 million British workers were involved in strikes in 1919, 300,000 more than in revolutionary Germany. In 1921 86 million days were lost in industrial disputes; the German figure was 22.6 million.[5] The electorate was increased from 7.7 million to 21.4 million by the 1918 Representation of the People Act, more or less giving Britain the franchise Germans had enjoyed since 1871 (universal male suffrage).[6] Lloyd George, who had come to power in 1916 as a result of a backroom coalition deal, called a snap election three days after the Armistice was signed. His coalition won; but he himself was turned out of office in October 1922 when Conservative MPs, meeting at the Carlton Club, killed the coalition. To writers like Harold Begbie and Charles Masterman – the authors of the passages quoted above – Britain seemed sick despite her victory.

Yet the great paradox was – and remains – the belief that Germany, the loser, was worse off. No doubt she should have been, having lost the war. Even then, British sympathy for the vanquished foe would be hard to explain. But in many ways Germany came out of the war no worse off than Britain, and in some respects better off. The one respect

in which post-war Germany did fare worse was that inflation ran completely out of control, so that the Reichsmark was worth virtually nothing by the end of 1923 (see Figure 18). At the nadir in December 1923 the cost of living index reached 1.25 trillion times its pre-war level (1,247,000,000,000). A loaf of bread cost 428 billion marks; a dollar 11.7 trillion. Though most combatant countries experienced some measure of inflation and few were able to return to their pre-war gold standard parity, this was the worst case. Poland did better despite having to fight a war: its price level rose by a factor of 1.8 million; even Russian prices went no higher than 50 billion times the pre-war level before the currency was reformed.[7] As we shall see, the Germans blamed their monetary troubles on the harsh peace terms which had been imposed on them; oddly, most educated British contemporaries seem to have believed them. In March 1920 the Oxford Union debated the motion 'That the Peace Treaty is an economic disaster for Europe': it was carried by a majority of 20 per cent. Three months later it voted by 80 to 70 votes for 'the immediate re-establishment of cordial relations' with Germany. The Union motions on foreign affairs in this period read like a chronicle of the genesis of appeasement. In February 1923 the Union voted by 192 to 72 votes to 'deplore the present policy of France' in occupying the Ruhr after the Germans had defaulted on reparations. In March a motion was carried which declared 'the overwhelming defeat of Germany a misfortune for Europe and this country'. Two months later a majority of 25 per cent of those in the chamber agreed 'That the selfishness of French policy since 1918 has condemned humanity to another war.'[8]

In reality, the peace terms were not unprecedented in their harshness and the German hyperinflation was mainly due to the irresponsible fiscal and monetary policies adopted by the Germans themselves. They thought they could win the peace by economic means. In British minds they did. The Germans were also more successful than any other country in defaulting on their debts, including the reparations demanded from them by the Allies. However, this victory was pyrrhic: it was won by democratic politicians at the expense of democracy and their own power.

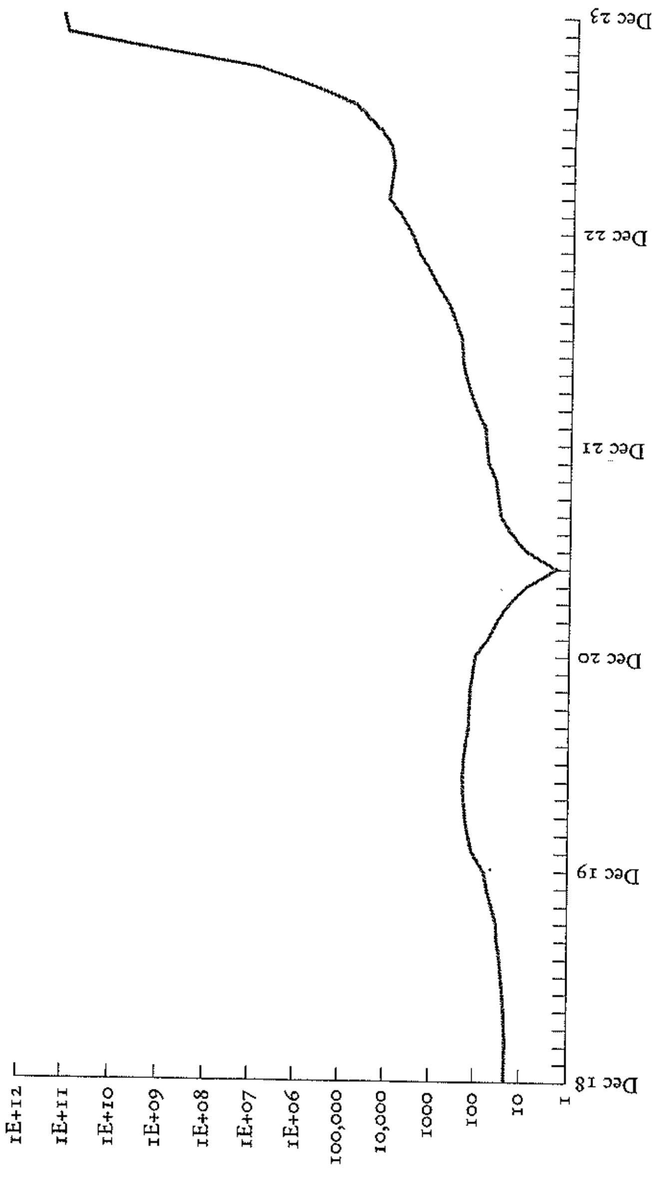

Figure 18 The German annual inflation rate (cost of living, log. scale), 1918–1923
Source: Statistisches Reichsamt, *Zahlen zur Geldentwertung.*

CAN'T PAY

The idea that the Versailles treaty imposed on Germany in 1919 was excessively harsh was a truth universally acknowledged in Germany itself; however, it would never have gained much credence outside Germany, and especially in Britain, had it not been for John Maynard Keynes, whose pamphlet *The Economic Consequences of the Peace* was (along with Lytton Strachey's *Eminent Victorians*) one of the bestsellers of 1919.

As we have seen, Keynes had become an influential voice at the Treasury thanks to his Cassandra-like utterances about British war finance. It was therefore logical for him to become involved in preparations for the peace once it became clear that the Germans wanted an armistice. The question of reparations had been a subject of debate even before the war's end.[9] Keynes soon emerged as the leading advocate of a relatively low indemnity, arguing as early as October 1918 that 20 billion goldmarks was a realistic total figure for reparations.[10] Although he doubled this figure in the memorandum he drafted in December 1918 'on the Indemnity payable by the Enemy Powers for Reparation and other Claims', he was careful to stress the problems that would arise from imposing such a burden. The Treasury memorandum acknowledged from the outset that even 'if every house and factory and cultivated field, every road and railway and canal, every mine and forest in the German Empire could be carried away and expropriated and sold at a good price to a ready buyer, it would not pay for half the cost of the war and of reparation added together'.[11] More importantly, Keynes's memorandum anticipated an argument which was to become central to the subsequent debate by distinguishing between 'two eventualities' which might arise from the transfer of reparations:

> The first, in which the usual course of trade is not gravely disturbed by the payment, the amount of it being approximately equal to the sum which would accrue to the paying country abroad in any case, and would have been invested abroad if it were not for the indemnity; the second, in which the amount involved is so large that it cannot be paid without . . . a far-reaching stimulation of the exports of the paying country . . . [which] must necessarily interfere with the export trade of other countries . . . In so far as this country receives the indemnity, there is a heavy off-set to this injury. But, in so far as the indemnity goes into other hands, there is no such off-set.

For this reason, Keynes advocated a policy of 'obtain[ing] all the property which can be transferred immediately or over a period of three years, levying this contribution ruthlessly and completely, so as to ruin entirely for years to come Germany's overseas development and her international credit; but, having done this . . . to ask only small tribute over a term of years'.[12] However, he also warned that a German fiscal crisis might lead to open debt repudiation or a break-up of the Reich.[13] In short, Keynes's intellectual reservations about excessive reparations were to a large extent established before he arrived in France for the armistice and peace negotiations.

There is, however, no question that a series of meetings with one of the German representatives at Versailles added an emotional dimension to Keynes's position. Carl Melchior was Max Warburg's right-hand man at the Hamburg bank of M. M. Warburg & Co.: a Jewish lawyer with a distinguished war record both on the battlefield and in economic policy-making. It may be that Keynes's subsequent declaration that he 'got to love' Melchior during the armistice negotiations at Trier and Spa obliquely alluded to a sexual attraction. As we have seen, Keynes was an active homosexual at this time. However, it seems more probable that Keynes was simply captivated by the sound of his own pessimism – the product of long-standing doubts about the morality of the war – being articulated by another.[14] Melchior (as Keynes later recalled) painted a bleak picture of a Germany on the brink of a Russian-style revolution:

> German honour and organization and morality were crumbling; he saw no light anywhere; he expected Germany to collapse and civilization to grow dim; we must do what we could; but dark forces were upon us . . . The war for him had been a war against Russia; and it was the thought of the dark forces which might issue from the Eastwards which most obsessed him.[15]

The implication was clear: the Allies risked unleashing Bolshevism in Central Europe if they treated their vanquished foe too harshly. These arguments struck a resounding chord with Keynes. As the German Foreign Office official Kurt von Lersner observed after Lloyd George seemed to change his mind on the question of financing food imports to Germany: 'Thanks to Dr Melchior's clear explanation, Herr Keynes has realised that there is a danger for the Allies in delaying [matters] and is trying to find common ground with us.'[16] Significantly, in the immediate aftermath of the conference, Keynes warned that 'an immediate rapprochement between Germany and Russia' might be 'the only chance . . . [of] central Europe being able to feed itself'.[17]

The most detailed – and, for Keynes, influential – statement of the German view came in the counter-proposals drawn up in May at Warburg's instigation in response to the Allied terms.[18] The central theme (developed in a 'Supplement on Financial Questions') was that the Allied terms meant 'the utter destruction of German economic life', condemning Germany politically to 'the fate of Russia'.[19] Given the economic constraints being imposed by the peace – in particular, the loss of industrial capacity, colonies, overseas assets and the merchant navy – Germany could not pay war damages as defined by the Allies; attempting to force her to do so would have dire consequences. On the one hand, to pay reparations from current government revenue would require that 'expenditures for the payment of interest on the war loans, for the allotments of the disabled German soldiers and for the pensions of the dependents of the fallen soldiers, must cease or be cut down, as well as the expenditures for cultural purposes, schools, higher education etc.'. This would simply 'destroy' German democracy: 'Any ability and inclination to pay taxes would disappear and Germany would be for decades to come the scene of uninterrupted social class struggles of the bitterest kind.' Financing reparations by borrowing, on the other hand, posed equally grave problems:

> In the immediate future it will be impossible to place German state loans in large amounts either at home or abroad, so that compensation [to the owners of assets expropriated for reparations] could be made only by means of large issues of notes. The inflation, already excessive, *would increase constantly if the peace treaty as proposed should be carried out. Moreover, great deliveries of natural products can only take place if the state reimburses the producers for their value; this means further issues of notes.* As long as these deliveries last, there could be no question of the stabilizing of the German currency even upon the present level. *The depreciation of the mark would continue. The instability of the currency would affect not only Germany, however, but all the countries engaged in export, for Germany, with her currency constantly depreciating, would be a disturbing element and would be forced to flood the world market with goods at ridiculously low prices.*[20]

Only if the Allies were to leave Germany with her territory, colonies and merchant fleet intact could reparations be paid.[21] Under these conditions, the Germans offered to pay interest plus amortization on bonds worth 20 billion goldmarks between 1919 and 1926; and amortization only on bonds up to a maximum of 80 billion goldmarks – the annuities 'not [to] exceed a fixed percentage of the German imperial and state revenues'.[22]

Whatever its significance for the history of German foreign policy,[23] the striking thing about this document is the way it foreshadows Keynes's subsequent critique of the treaty. This is perhaps not surprising. We know that Keynes was impressed by the refusal of the German delegation to sign the unamended peace treaty.[24] Indeed, he all but repeated the Germans' prophecies of doom:

> Germany's . . . industry will be condemned to stagnation . . . Germany will collapse economically . . . and millions of Germans will die in civil conflicts or will be forced to emigrate . . . The result will be an 'economic Balkans' in the heart of Europe which will create endless unrest and constant danger of its spreading to the rest of the world.[25]

That was the German version. This was Keynes's:

> The Peace is outrageous and impossible and can bring nothing but misfortune . . . They can't possibly keep the terms, and general disorder and unrest will result everywhere . . . Anarchy and revolution is the best thing that can happen . . . The settlement . . . for Europe disrupts it economically and must depopulate it by millions of people.[26]

Nor was Keynes out of touch with the Germans during the period when he was preparing his own prophecies for publication. In October 1919 he attended a small conference of bankers and economists in Amsterdam at the invitation of Warburg's American brother Paul.[27] Then he and Warburg jointly composed an appeal to the League of Nations which effectively called for a reduction in reparations, the cancellation of war debts and a loan to Germany.[28] However, by the time the final version of the memorandum was published in January 1920, it had ceased to matter. It had been overshadowed completely by the appearance of *The Economic Consequences*, a draft of which Keynes had read to Melchior and Warburg at Amsterdam.[29]

To say that Keynes's argument in this book was the same as that put forward by the German financial experts at the conference would be to exaggerate. But the resemblances are very close; nor did Keynes deny their influence on him.[30] Like them, he blamed the French for the 'Carthaginian' economic provisions of the Treaty and denounced the

Reparations Commission as 'an instrument of oppression and rapine'.[31] Like them, he insisted that Germany 'had not surrendered unconditionally, but on agreed terms as to the general character of the peace' (the Fourteen Points and subsequent American notes).[32] And like them, he stressed that the loss of Germany's merchant marine, her overseas assets, her coal-rich territories and her sovereignty in matters of trade policy severely limited her capacity to pay reparations. The Allies claimed compensation for damage and pensions amounting to some 160 billion goldmarks, which an asset-stripped Germany could only hope to pay out of her export earnings. Yet to turn the traditional German trade deficit into a surplus would put pressure on Allied business, while necessitating intolerable reductions in German consumption. Even leaving Germany with her essential assets (including the Silesian coal-fields), 41 billion goldmarks was the most she could be expected to pay, three-quarters in the form of interest-free annuities spread over thirty years.[33] Nor did Keynes omit the apocalyptic warnings he had heard from Melchior at Versailles, predicting a Malthusian crisis in Germany and the destruction of capitalism in Central Europe:

> The policy of reducing Germany to servitude for a generation, of degrading the lives of millions of human beings, and of depriving a whole nation of happiness [will] . . . sow the decay of the whole civilised life of Europe . . . 'Those who sign this treaty will sign the death sentence of many millions of German men, women and children.' I know of no adequate answer to these words . . . If we aim deliberately at the impoverishment of Central Europe, vengeance, I dare predict, will not limp. Nothing can then delay for very long the 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, whoever is victor, the civilization and the progress of our generation.[34]

Nothing short of 'a general bonfire' of international debts and a German-led programme of economic reconstruction in Eastern Europe, he argued, would avert this catastrophe.[35]

The setting of the final reparations bill – postponed at Versailles because of Allied dissension – prompted a new broadside from Keynes. In April 1921, after much haggling and prevarication, a definitive total bill was set at 132 billion goldmarks, backed by the threat that the Ruhr would be occupied if the Germans did not submit. This 'London Ultimatum' demanded that, beginning at the end of May 1921, Germany pay interest and amortization on so-called 'A' and 'B' bonds totalling 50 billion goldmarks in the form of a 2 billion goldmarks annuity. It also specified that, beginning in November 1921, a payment equal to 26 per cent of the value of German exports should be made; this implied a total annual payment of around 3 billion goldmarks. When German exports had reached a level sufficient to pay off the 'A' and 'B' bonds, non-interest bearing 'C' bonds with a face value of 82 billion goldmarks would be issued.[36]

Keynes's response to the London schedule involved some back-of-envelope sums. He estimated the burden of reparations at between a quarter and a half of national income, which, in purely fiscal terms, he considered impossibly heavy. 'Would the whips and scorpions of any government recorded in history have been potent enough to extract nearly half their income from a people so situated?' he asked readers of the *Sunday Times*.[37] In December 1921 he suggested that 21 billion goldmarks was the most which could be paid.[38] However, he remained sceptical about the possibility of any payment in hard currency as long as Germany was unable to run a balance of payments surplus: this was what would later be called 'the transfer problem'. Keynes doubted that Germany would obtain a loan from abroad to facilitate matters: by the time of the Genoa conference in April 1922 (which he 'covered' for the *Manchester Guardian*), he dismissed the German proposal for an international loan as 'an illusion [as big] as reparations on a grand scale'.[39] Nor did he believe that payments in the form of raw materials (as envisaged by Walther Rathenau) could ease the situation.[40] He also saw no possibility of a German export surplus in view of the country's large post-war appetite for imports. In any case, as he had already argued in 1919,

> [even] if Germany could compass the vast export trade which the Paris proposals contemplate, it could only be by ousting some of the staple trades of Great Britain from the markets of the world . . . I do not expect to see Mr Lloyd George fighting a general election on the issue of maintaining an Army to compel Germany at the point of the bayonet to undercut our manufacturers.[41]

In other words, the schedule of payments was unworkable. In the short term, Germany would only be able to raise the monthly payments by selling paper marks on the foreign currency markets; but this would inexorably drive down the exchange rate until the process became unsustainable.

It was in August 1922 that Keynes's influence on the reparations issue reached its zenith, when he was invited to address a gathering of politicians and businessmen at the Hamburg 'Overseas Week' – in effect, an unofficial conference on German foreign policy – shortly after the French President Raymond Poincaré's speech calling for 'productive pledges' at Bar-le-Duc on 21 August.[42] The response this elicited from Keynes five days later was extraordinary. Introduced as 'the man most responsible for the changed attitude of the English-speaking world towards Germany', he was cheered to the echo; and it is tempting to wonder how far the applause influenced the content of his speech. In it Keynes made a fateful prediction:

> I do not believe . . . France may actually carry into effect her threat of renewing war . . . One or two years ago France might have acted thus with the necessary inner conviction. But not now. The confidence of the Frenchmen in the official reparations policy is utterly undermined . . . They know in their hearts that it has no reality in it. For many reasons they are reluctant to admit the facts. *But they are bluffing*. They know perfectly well that illegal acts of violence on their part will isolate them morally and sentimentally, ruin their finances and bring them no advantage whatever. M. Poincaré . . . may make harsh speeches and inflict futile minor outrages . . . but he will not act on a big scale. Indeed, his speeches are an alternative not a prelude to action. The bigger he talks the less he will do . . .

To cap this, he dismissed the idea that inflation was causing 'the disintegration of German life':

> One must not lose sight of the other side of the balance sheet . . . The burden of internal debt is wiped off. The whole of Germany's payments to the Allies so far . . . have been entirely discharged by the losses of foreign speculators. I do not believe that Germany has paid a penny for these items out of her own resources. The foreign speculators have paid the whole of these liabilities and more too.[43]

His conclusion amounted to a repetition of the now-familiar German demands for a moratorium, a loan and a reduced reparations burden.[44]

In private, it is true, Keynes was rather less rash. But it was the public remarks which had the greatest impact; not least because he was telling the Germans what they wanted to hear. Poincaré's 'bluff' should be called: this was the message relayed to the government in Berlin.[45] Nor was this the speech's only significance. Keynes's prediction in the same speech that 'the day of scientific, administrative and executive skill was at hand . . . not this year, indeed, but next year' echoed earlier calls by Warburg and his associates that precedence be given to 'the men of business over the diplomats and politicians in all questions of world economics'.[46] These calls were answered in early November with the appointment as Chancellor of Wilhelm Cuno, Albert Ballin's successor as head of the Hamburg–Amerika shipping line.[47] Keynes in England was enthusiastic. Eagerly, he urged the new Chancellor to 'call . . . out in a clear voice', and confessed to 'envy[ing] Cuno his job'.[48]

It would, of course, be absurd to lay the blame for the French occupation of the Ruhr and the final, irretrievable collapse of the German currency solely on Keynes. But there is no question that he played a role in encouraging both. Nor was he dismayed by the revelation that Poincaré had not, after all, been bluffing. Throughout the early weeks of the French occupation of the Ruhr, he encouraged the Germans to 'hold out to the limit of [their] endurance' and the government to 'keep its nerve'.[49] Only in May 1923, with the French grip on the Ruhr showing no sign of weakening and the German economy plunging ever deeper into the hyperinflationary abyss, did Keynes admit that the strategy had failed.[50]

This is not the place to describe the events which led to Cuno's fall, nor the protracted process by which passive resistance was wound up.[51] Suffice to say that Keynes's own account in his *Tract on Monetary Reform* (published in December 1923) was a trifle harsh, given his intimate involvement with the decisions to confront Poincaré and wage passive resistance:

> It is necessary to admit that Cuno's failure to control incompetence at the Treasury and at the Reichsbank was bound to bring [his fall] about. During this catastrophic period, those responsible for the financial policy of Germany did not do a single wise thing, or show the least appreciation of what was happening.[52]

It is difficult to escape the conclusion that here Keynes was being wise after the event – having been rather unwise during it. For the counter-inflationary remedies he now urged – monetary restriction and a capital levy – had been conspicuously absent from his advice to the Germans prior to December 1923. Indeed, on a number of occasions, Keynes had congratulated the Germans on the large-scale expropriation of foreign wealth which had been brought about by the inflation. And

ultimately, it seems, he could not resist judging the inflation a success in terms of economic diplomacy:

> The remarkable experience of Germany during this period [he wrote in June 1929] may have been necessary to convince the Allies as to the futility of their previous methods for extracting reparations and was perhaps an inevitable prelude to the Dawes Scheme.[53]

As he put it in a speech in Hamburg in 1932 (exactly ten years after the Overseas Week appearance): 'I have often been doubtful during the past years about the wisdom of what you call the Policy of Fulfilment. If I had been a German statesman or economist, I think that I should probably have opposed it.'[54]

WON'T PAY

The man Keynes 'got to love' at Versailles called *The Economic Consequences of the Peace* 'magnetizing' and 'a landmark for a new development in . . . post-war history.'[55] In this Melchior was certainly right. Keynes's attack on the Versailles treaty without question contributed a good deal to that guilty feeling of having wronged Germany which so inhibited British diplomacy between the wars. Even today the idea that reparations were to blame for Germany's descent into hyperinflation continues to enjoy widespread scholarly support. The German budget was already badly out of kilter, Haller has argued, but the Allies' demand for cash reparations made matters much worse.[56] Because of a structural balance of payments deficit, Germany had no option but to buy hard currency by selling papermarks, thus driving down the exchange rate, pushing up import prices and hence the domestic price level.[57] Barry Eichengreen has put it bluntly: reparations were 'ultimately responsible for the inflation' because without reparations there would have been no budget deficit.[58] A conclusion frequently drawn is that German governments – expected by the Allies to raise taxes to pay for reparations which were almost universally unpopular – had no alternative but to seek to avoid paying. The most obvious way to do this was to allow inflation to continue, for, in Graham's words, the view was 'by no means without justification that improvement in the public finances would lead to still more severe exactions'.[59] It also supposedly made political sense to allow currency depreciation to continue unchecked, since that had the effect of boosting German exports.[60] This should have put pressure on the Allied economies, forcing them to accept that reparations could only be paid at the expense of Allied industry. Depreciation was therefore, according to Holtfrerich, 'in the national interest' – the most effective way of 'persuading the rest of the world of the need for a reduction of the reparations burden'.[61] Indeed, the strategy had a double advantage: because so much of the money lent to Germany in the period was never repaid, one historian has gone so far as to speak of 'American "Reparations" to Germany'.[62] In his definitive study of the German inflation, Feldman is unequivocal: the Allied peace terms 'made impossible demands and promoted intolerable choices'; reparations were 'a disincentive to stabilise'.[63] These are Keynes's arguments, alive and well eighty years on. Yet historians have failed to recognize the extent to which Keynes was manipulated by his German friends; and the extent to which he erred in his analysis of the consequences of the peace.

Those involved in the German government's peace delegation in 1919 were well aware that they faced a tough peace. After all, they would have imposed a tough peace on the other side if they had won the war. The American diplomat who wrote the following during the war was not far wrong:

> The Germans want somebody to rob – to pay their great military bills. They've robbed Belgium and are still robbing it of every penny they can lay their hands on. They robbed Poland and Servia . . . They set out to rob France and . . . if they got to Paris there wouldn't be 30 cents worth of movable property there in a week, and they'd levy fines of a million francs a day.[64]

Contemplating his country's burgeoning war debt in August 1915, the German Finance Minister Karl Helfferich had declared: 'The instigators of this war have earned this dead weight of billions . . . How this debt is cast off will be the biggest problem since the beginning of the world.'[65] Even the comparatively liberal Warburg had accepted this argument: in November 1914 he proposed 50 billion marks as an appropriate level of reparations for Germany to impose, assuming a war lasting just four months; as late as May 1918 he was still envisaging an Allied indemnity as high as 100 billion marks.[66] A supplementary financial agreement signed on 27 August 1918 had imposed on Russia an indemnity of 6 billion marks, despite the declaration in the original Treaty of Brest-Litovsk of March 1918 that there would be no reparations.[67] This was

in addition to huge cessions of territory: Finland and the Ukraine became independent, while Poland and the Baltic states of Lithuania, Estonia, Courland and Livonia became German satellites. (In the surreal atmosphere of 1918, German princes bickered over who should rule them: the Duke of Urach wanted to be king of Lithuania; the Austrian Archduke Eugen demanded the Ukraine; the Kaiser's brother-in-law Friedrich Karl of Hesse had his eye on Finland; while the Kaiser himself coveted Courland.)[68] The territory in question represented around 90 per cent of the Russian Empire's coal capacity and 50 per cent of its industry.[69] By comparison with this, the territorial terms of the Versailles treaty were relatively lenient. Besides her colonies, Germany lost around nine peripheral chunks of territory from the Reich itself;[70] but these amounted to just 13 per cent of its pre-war area, and 46 per cent of the population of these areas was non-German. The Germans lamented the loss of 80 per cent of their iron ore, 44 per cent of their pig iron capacity, 38 per cent of their steel capacity and 30 per cent of their coal capacity; but the Russians had lost more in 1918, while the Austrians, Hungarians and Turks all fared worse in terms of territory (the Hungarians lost 70 per cent of their pre-war area) and perhaps also economic resources under their respective peace treaties. The loss of Germany's colonies was a blow to prestige: but although extensive (just under 3 million square kilometres) and populous (12.3 million people), they were of little economic worth.

Despite their anguished protests when the Allies presented their terms, the Germans had known what to expect. 'The Entente conditions', Warburg commented when invited to join the German delegation, 'would doubtless be extremely hard.'[71] Eugen Schiffer, the new Finance Minister, and Carl Bergmann, the Foreign Office's reparations expert, talked of figures of 20 billion marks and 30 billion marks; but Warburg warned them to brace themselves for an 'absurdly high' figure. As he put it to the Foreign Minister Count Ulrich von Brockdorff-Rantzau in early April: 'We must be prepared for damned hard conditions.'[72] Indeed, Warburg assumed that Germany would be burdened with reparations for between twenty-five and forty years.[73] The only way such a burden could be shouldered, he argued, was by means of an international loan to Germany, which would allow her to pay a fixed capital sum in annuities spread over a period of twenty-five to forty years.[74] By April he was envisaging a loan of 100 billion goldmarks.[75]

The best argument to justify such relatively generous treatment, the

Germans believed, was that without it Germany would descend into Bolshevism, fulfilling the next stage of Trotsky's plan for world revolution. As Warburg's friend Franz Witthoefft noted, shortly after agreeing to join the German delegation to Versailles:

> Bread and peace are the preconditions for order and work; otherwise we are headed for Bolshevism, and that will be the end of Germany. Yet I detect in this very danger of Bolshevism a certain safety valve with regard to the efforts of the Entente to checkmate us absolutely. If this malaise spreads from Hungary over Germany, neither France nor England will be immune; and that means the end for all Europe.

During a meeting with ministers in Berlin in late April, Melchior argued that 'leanings towards Russia' must be contemplated as a future diplomatic strategy for Germany; a view which was endorsed by the Reich President Friedrich Ebert.[76] This was a very different tone from the apocalyptic one he adopted with Keynes. No doubt Melchior genuinely was worried about the political situation in Germany when he first met Keynes: after all, his home town was under the control of a Workers' and Soldiers' Council, and it was far from clear that the revolution of November 1918 was going to end in a compromise between Moderate Social Democrats, the more liberal 'bourgeois' parties and the old political, military and economic élites. Nevertheless, it seems clear that he did his best to exaggerate the Bolshevik threat for Keynes's benefit. The Red Army's successes in late 1919 and early 1920, and continuing social unrest in Germany, prompted renewed prophecies from Melchior of 'a kind of League of the Vanquished . . . between Russia and Germany'.[77] Melchior did not mean a word of this; he and Warburg were in fact appalled when Rathenau did a deal with the Russians over reparations during the 1922 Genoa Conference (the Treaty of Rapallo).[78]

At the same time, the Germans made no serious effort to balance their budget, the only way reparations could be paid in the absence of an international loan. To be sure, as Finance Minister, Mathias Erzberger made substantial changes to the German tax system, enhancing the fiscal power of the central government. He also attempted a drastic increase in direct taxation before his departure from office in March 1920: the 'Reich Emergency Levy' (*Reichsnotopfer*) taxed property at rates rising to 65 per cent, while the Reich income tax had a top rate of 60 per cent. Yet this did not suffice to reduce the deficit (which

averaged around 15 per cent of net national product between 1919 and 1923). Firstly, there was considerable evasion, much of it within the law. For example, the 'Emergency Levy' was payable in instalments over periods as long as 47 years, with interest charged at only 5 per cent after December 1920.[79] So long as inflation remained above 5 per cent, delayed payment was clearly advantageous. Likewise, those whose incomes were not paid as wages (from which tax was deducted at source) could easily defer payment of the new Reich income tax.[80]

This was not accidental: tax reform was deliberately botched out of the desire to avoid reparations. As Chancellor Joseph Wirth himself put it in arguing against a property levy (or 'seizure of real values', in the contemporary catch-phrase): 'The goal of our entire policy must be the dismantling of the London Ultimatum. It would therefore be a mistake if, by initiating a seizure of real values at this moment, we were [in effect] to declare the Ultimatum to be 80 per cent possible.'[81] The domestic debate on financial reform between May 1921 and November 1922 was therefore a phoney debate, as the Chancellor himself was not in earnest. Schemes like the property levy had to be discussed in order to appease the Reparations Commission, but they were never intended to 'close the hole in the budget'.[82] Similarly, the idea for a 1 billion goldmark forced loan was devised primarily in response to the Allies' demand for a financial reform plan at Cannes; the Finance Ministry fixed the multiplier for converting paper marks into gold at such a low level that the tax yielded just 5 per cent of the target figure.[83] State Secretary David Fischer captured the prevailing mood when he described the Reparations Commission's 'wish for a further increase in taxes' as implying a 'wish for the economic destruction of Germany'.[84] Real income from taxation actually fell in the second half of 1921, and rose only slightly in the first half of 1922.[85]

Keynes was too trusting. In November 1921, responding to the claim that the Germans were deliberately exacerbating inflation to avoid paying reparations, he wrote: 'I do not believe a word of the silly stories that the German government could be so bold or so mad as to engineer on purpose what will in the end be a great catastrophe for their own people.'[86] Unfortunately, those 'silly stories' were correct. The Germans believed that through continued deficits and continued currency depreciation they would be able to increase their exports; and these would, in the words of Melchior, 'ruin trade with England and America, so that the creditors themselves will come to us to require modification'.[87]

When the mark slumped against the dollar from 14 marks to 99 marks between June 1919 and February 1920, following the lifting of German exchange controls,[88] the Economics Minister Robert Schmidt was explicit about what he hoped this would achieve: 'The tossing out of German goods abroad at slaughter prices . . . will compel the Entente to allow us to bring our exchange into order.'[89] As Felix Deutsch of the electrical engineering giant AEG put it: 'Our good fortune in the midst of misfortune is our poor currency, which enables us to export on a large scale.'[90] In order to preserve this good fortune, the Economics Ministry took the step of intervening *against* the mark between March and June 1920, buying substantial amounts of foreign currency to limit the appreciation of the mark.[91] Warburg made the rationale of the strategy quite explicit in a speech he drafted in October 1920: 'Even at the risk of sometimes selling our own products too cheaply abroad . . . the world must be made to understand that it is impossible to burden a country with debts and at the same time deprive it of the means of paying them . . . The most complete collapse of the currency . . . cannot be avoided if the peace treaty is maintained in its present form.'[92]

COULD HAVE PAID?

The reality was that the economic consequences of the Versailles Treaty were far less severe for Germany than the Germans and Keynes claimed. Apart from the US, all the combatant countries had emerged from the war with heavy losses on their capital accounts. The sums owed by the prospective recipients of reparations to the US were already equivalent to around 40 billion goldmarks.[93] Similarly, it was not just Germany which had lost shipping: the total losses to world shipping during the war (the better part of them inflicted by Germany) had totalled more than 15 million tons. In any case, the significance of these lost assets should not be exaggerated: shipping in particular was swiftly replaced. In the short run the world economy boomed as businessmen rushed to replace inventories and plant run down during the war, and as trade links which had been disrupted by front lines, warships and submarines were restored. By 1920 international trade had recovered to 80 per cent of its pre-war level. The monetary expansion generated by war finance fuelled this upswing. Germany's net national product grew by an estimated 10 per cent in 1920 and 7 per cent in 1921.[94] Although her

agriculture continued to languish, indicators of industrial output show a sharp upward trend: up 46 per cent in 1920 and 20 per cent in 1921, with certain industries (notably shipbuilding and coal) experiencing especially rapid growth.[95]

From a foreign point of view, this combination of rapid growth and a weak exchange rate appeared contradictory, and invited speculation. As a result, the German trade deficit in 1919–20 was financed not by large-scale foreign loans but by numerous, small-scale purchases of paper marks by foreigners. Foreign deposits at the seven Berlin great banks rose from 13.7 billion marks in 1919 to 41.6 billion marks in 1921, and accounted for almost a third of total deposits.[96] Purchases of marks in New York totalled 60 million goldmarks between July 1919 and December 1921.[97] Keynes was dimly aware of this. 'The speculation', he noted in early 1920, was 'on a tremendous scale and was, in fact, the greatest ever known'.[98] But he wholly overlooked the likely impact this would have on the exchange rate. In March 1920 the mark suddenly ceased falling against the dollar and rallied, rising from a rate of 99 marks to a peak of 30 marks in June. In the following months all the trends of the previous eight months were reversed. Domestic prices in Germany fell by around 20 per cent from a peak in March 1920 to a trough in July, and then fluctuated at roughly thirteen times their pre-war level until the summer of 1921. In May 1921 the annual inflation rate sank to a post-war low of 2 per cent. At the same time the gap between German prices and world market prices abruptly closed.[99] This not only stopped the German export drive in its tracks.[100] It also cost Keynes over £20,000 (most, but not all, his own) which he had invested on the assumption that the economic consequences of the peace would be as he had forecast.[101] It was not until some time later that he fully grasped what had happened:

> [From] itinerant Jews in the streets of the capitals . . . [to] barber's assistants in the remotest townships of Spain and South America . . . the argument has been the same . . . Germany is a great and strong country; some day she will recover; when that happens the mark will recover also, which will bring a very large profit. So little do bankers and servant girls understand of history and economics.[102]

In fact, the slowing of inflation reflected more than just ill-informed speculation. This was a time of international deflation as the British and American monetary and fiscal authorities took the first steps to settle the bills run up during the war and to end inflation by raising taxes and restricting credit. Sharp price falls occurred in 1921 in both countries, and this deflation tended to spread to their trading partners.[103]

Nor can it credibly be maintained that the reparations total set in 1921 constituted an intolerable burden. Eighty-two of the 132 billion gold marks were to some extent 'notional', in that the 'C' bonds to that value would only be issued at some unspecified future date when German economic recovery was sufficiently advanced.[104] This cast a shadow over the future and certainly limited the Reich's ability to borrow on the international market, but it meant that Germany's immediate obligations in 1921 were less than 50 billion goldmarks – as little, in fact, as 41 billion (taking account of what had been paid after 1919). That had been the sum regarded by Keynes himself as payable in *The Economic Consequences of the Peace*. Moreover, inflation had already substantially reduced the real value of the Reich's internal debt by mid-1921 to around 24 billion goldmarks, so, as a proportion of national income, the Reich's total liabilities including the 'A' and 'B' bonds amounted to around 160 per cent. This was certainly a higher debt burden than France had faced after the Franco-Prussian War: if one adds together the indemnity demanded by Bismarck (5,000 million francs) and the existing French national debt (11,179 million francs), the total liability is equivalent to around 84 per cent of 1871 net national product. However, the German debt burden in 1921 was actually slightly *less* than the ratio of the total British national debt (internal and external) to gross national product in the same year (165 per cent). The ratio of debt to national income had been even higher for Britain in 1815: close to 200 per cent. Yet Britain had become the nineteenth century's most successful economy – and its most stable polity – despite that burden.

Nor was the annual payment being demanded from Germany excessive. As we have seen, annual reparations as scheduled by the London Ultimatum implied a total annuity of around 3 billion goldmarks. At least 8 billion goldmarks and perhaps as much as 13 billion goldmarks were actually handed over in the period 1920–23: between 4 and 7 per cent of total national income. In the hardest year, 1921, the figure was just 8.3 per cent (see Figure 19). This was far less than Keynes's guess of between 25 and 50 per cent of national income.[105] To be sure, this was a much bigger proportion of national income than that subsequently paid under the Dawes plan (at peak, around 3 per cent); and far outstrips the burdens imposed on developing countries by

international debt in the 1980s, let alone the sums currently paid by Western countries in the form of aid to the Third World.[106] But between June 1871 and September 1873, France paid Germany 4,993 million francs: around 9 per cent of net national product in the first year, and 16 per cent in the second.

Finally, it was not wholly fantastic to expect Germany to pay a lower annual burden over a longer period than had been the case in the 1870s. The Young Committee's report of 1929 is often ridiculed for proposing that Germany continue to pay reparations until 1988. But since 1958 Germany has paid more than 163 billion marks to the rest of Europe in the form of net contributions to the European Economic Community/ European Union budget. Of course, the annual sums involved have represented a very small proportion of national income; but the final total is rather more in nominal terms than was asked for in post-Versailles reparations; this was precisely the long, scarcely perceptible transfer the Young Plan aimed at.

Keynes was right on one point: reparations implied an acute international conflict of interests.[107] If Germany were to run a trade surplus of 3 billion goldmarks, there would have to be a drastic contraction of German imports and an expansion of German exports. But which of Germany's trading partners would pay the price for this? British and French business representatives repeatedly argued that measures should be taken after the war 'to prevent Germany, who will still be a most dangerous economic enemy, from flooding our markets'.[108] A Board of Trade report on post-war commerce discerned in January 1916

> a general fear that, immediately after the war, this country will be flooded with German and Austro-Hungarian goods, sold at almost any price, and that the competition in price which was going on before the war will be accentuated, with resultant serious difficulty to all manufacturers of goods of kinds exposed to this competition, and positive disaster to those manufacturers who have been encouraged to extend their operations, or engage in new branches of industry, with a view to capturing trade hitherto carried on by enemy countries.[109]

The issue of post-war discrimination against German trade was discussed and limited resolutions adopted at the Anglo-French conference in Paris the following June.[110] A committee of inquiry into post-war economic policy concluded in December 1917 that 'present enemy countries should not, for a time at least, be allowed to carry on trade

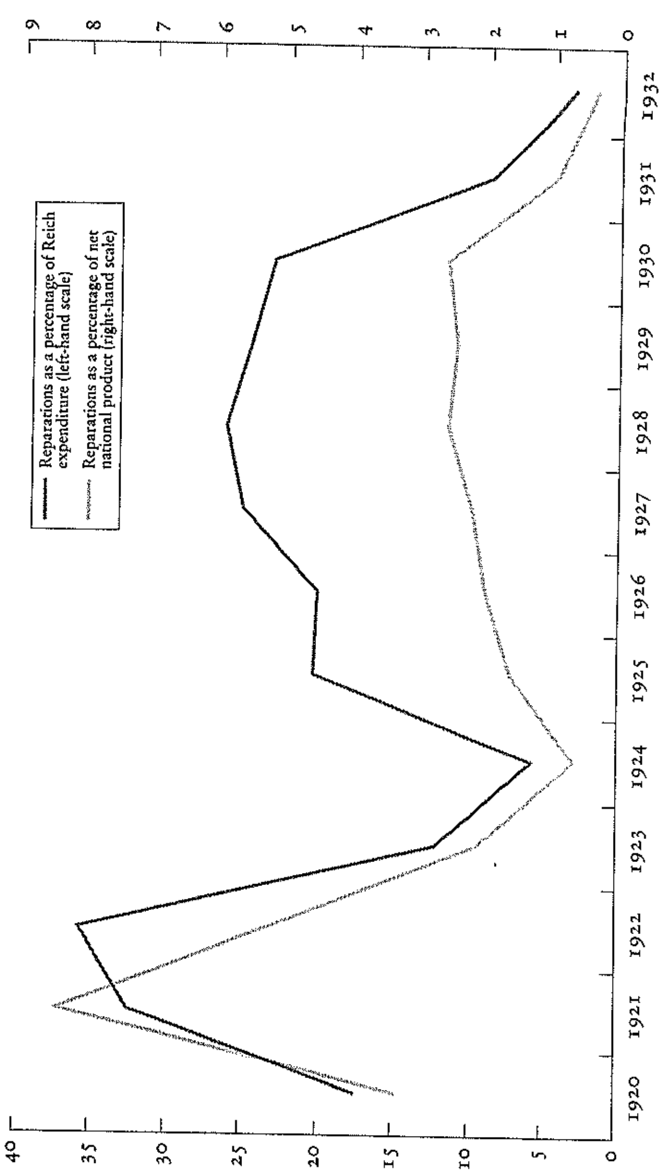

Figure 19 *The burden of reparations, 1920–1932*

Source: Ferguson, *Paper and Iron*, p. 477.

with the British Empire in the same unrestricted manner as before the war, or on terms equal to those accorded to Allies or Neutrals'.[111] Such resolutions manifested themselves after the war as special duties on German imports: the Germans called them 'hate discounts'.[112]

If, on the other hand, reparations were to be financed by loans to Germany, whose claims would take precedence – the reparations recipients, or the new lenders? As Schuker has argued, the Germans received at least as much in the form of loans from abroad which were never repaid as they themselves paid in reparations.[113] Between 1919 and 1932 Germany paid altogether 19.1 billion goldmarks in reparations; in the same period she received 27 billion goldmarks in net capital inflows, mainly from private investors, which were never repaid as a result of her defaults in 1923 and 1932.

Yet it does not necessarily follow from this that the German government was therefore right not to *attempt* to pay reparations. The question is not whether the transfer was sustainable; but whether the strategy adopted by the Germans and endorsed by Keynes was the best way of convincing the Allies that it was not. 'Economic revisionism' was supposed to pressurize the Allied economies by promoting a flood of German exports. This undoubtedly happened in 1919; but it did not last long. Even the very sharp depreciation of the mark against the dollar between May and November 1921 did not bring about a repeat of the immediate post-war 'fire sale' (*Ausverkauf*). True, the available export statistics point to a 35 per cent increase in the goldmark value of monthly exports in the year after May 1921, while annual figures suggest a two-thirds increase of exports in volume terms.[114] Graham's calculations for 43 categories of commodity also point to increases in exports.[115] But at the same time imports grew even faster. This was of critical importance, since only a trade *surplus* would have had the intended effect of exerting economic pressure on the Allies. Estimated annual figures point to a trade deficit of around 690 million goldmarks in 1921 and over 2,200 million goldmarks in 1922, compared with a tiny surplus in 1920.[116] Monthly figures provide a more precise record: the trade gap widened between May and September 1921, narrowed to record a small surplus in December 1921, and then widened again to reach a peak in July 1922. The data for trade volumes tell the same story, but suggest an even more dramatic widening of the deficit after February 1922, despite the fact that by this stage the proportion of semi-finished and finished goods had risen to a third of all imports.[117]

And these figures may actually understate the extent of the trade gap. While Economics Ministry officials continued to claim that exports were being underestimated and that the deficit in 1922 was negligible (claims which have misled later historians), there was 'complete consensus' in the Reich Statistical Office 'that the balance of trade deficit was being significantly underestimated'.[118]

In other words, contrary to the predictions of the proponents of economic revisionism, the trade deficit widened at the times of most rapid nominal exchange rate depreciation and narrowed when the mark stabilized.[119] Precisely when Germany was supposed to be putting the reparations collectors under pressure by flooding their markets with cheap exports, she was in fact relieving the pressure on them by providing a bouyant market for *their* exports.[120] This may well have been good for the world economy, helping to lift it out of a slump which might otherwise have become a depression;[121] but it was wholly counterproductive from the point of view of German diplomacy.

The reasons for the unexpectedly large German trade deficit are clear. Hostility to German exports abroad may have been a factor, but the real problem was that, although in nominal terms the mark clearly depreciated against the other major currencies, in real terms – allowing for changes in relative prices – there was no significant improvement in German competitiveness.[122] This reflected the low level of British and American prices, continuing foreign speculation in the mark and more rapidly adjusting German domestic prices and wages.

The idea that continuing depreciation would help Germany avoid paying reparations was thus fundamentally misconceived. If anything, it had the reverse effect. Inevitably, this begs the question: would not a policy of stabilization have been more effective in exerting pressure on the Allies by dampening German demand for imports? The experience of the period after 1930, when severely deflationary policies drastically reduced German imports, suggests that it might have been. After all, reparations survived the crisis of 1923 to be restored – rescheduled but not reduced – in 1924; but they were as good as dead and buried after the Hoover Moratorium in 1931. This was the pyrrhic victory of Weimar foreign policy: the moment at which Germany's external war debt – notionally worth around $77 billion in 1931 – was effectively cancelled at the expense of her former enemies (see Table 44). Considering that the total value of reparations actually paid by Germany cannot have exceeded $4·5 billion dollars, the conclusion seems clear. What hyper-

Table 44 Outstanding war debts and reparations liabilities in 1931 (£ thousands)

	suspended receipts	*suspended payments*	*net loss (–) or gain*
USA	53,600		–53,600
Great Britain	42,500	32,800	–9,700
Canada	900		–900
Australia	800	3,900	3,100
New Zealand	330	1,750	1,420
South Africa	110		–110
France	39,700	23,600	–16,100
Italy	9,200	7,400	–1,800
Belgium	5,100	2,700	–2,400
Germany		77,000	77,000
Hungary		350	350
Austria		300	300
Bulgaria	150	400	250

Source: Eichengreen, *Golden Fetters*, p. 278.

inflation did for the internal war debt, the depression did for the external burden imposed in the form of reparations. Having already fought the First World War on the cheap, the German Reich ultimately succeeded in avoiding paying all but a fraction of the war's financial cost.

CAN'T COLLECT

The real problem with the peace was not that it was too harsh, but that the Allies failed to enforce it: not so much 'won't pay' as 'can't collect'. In 1870–73 the Germans had occupied large tracts of northern France and linked the payment of the indemnity to their withdrawal: the faster the French paid, the sooner the Germans left. In 1919, by contrast, the Allies imposed the reparations total in 1921 after they had lifted the naval blockade, and with only a minimal force on the ground in the Rhineland. Rather than using occupation as an incentive to encourage reparation-payment, the Allies – or rather the French – sought to use the threat of a larger occupation as a sanction to discourage default. This was psychologically misconceived, as it encouraged the Germans to gamble that (as Keynes rashly suggested in 1922) the French were bluffing. The alternative course of action was – in effect – voluntarily to pay reparations; not surprisingly, democratically elected politicians were extremely reluctant to approve taxes for this purpose. The difficulty facing Weimar politicians – even those few who sincerely believed that Germany must fulfil the peace terms – was simple: they had to reconcile competing claims on the Reich budget from, on the one hand, their own electors, and on the other, Germany's former enemies. To put it simply: the Allies might want reparations for the damage done to them by the war; but German voters also felt entitled to 'reparations' for the hardship they had endured since 1914.

According to German budgetary figures, total real expenditure under the terms of the Versailles treaty in the years 1920 to 1923 amounted to between 6.54 and 7.63 billion goldmarks. This accounted for around 20 per cent of total Reich spending and 10 per cent of total public spending. Put another way, reparations accounted for a fifth of the Reich deficit in 1920, and more than two-thirds in 1921.[123] But even if one subtracts reparations payments, total public spending was still running at around 33 per cent of net national product, compared with around 18 per cent before the war.[124] And although without reparations inflation might have been lower and revenues therefore higher, it is still conceivable that there would have been deficits. It cannot be assumed that domestic spending would not have risen had reparations magically been abolished.

In addition to the dwindling real costs of servicing the funded debt, German reparations to Germans – which is how these domestic expenditures may be regarded – included higher spending on public sector pay, doles for the unemployed, of which the Reich paid half, subsidies for housing construction and subsidies to keep down the costs of food.[125] There was also the cost of paying pensions to over 800,000 war wounded, 533,000 war widows and 1.2 million war orphans.[126] The most notorious 'hole' in the budget, however, was the deficit run by the rail and postal systems: the deficit on the Reichsbahn accounted for around a quarter of the total Reich deficit between 1920 and 1923. In part, this was a consequence of purchases of new rolling stock and a failure to maintain the real value of fares and freight rates.[127] But it was also partly due to the government's concern to maintain employment levels, which led to chronic over-manning.[128] The situation was similar in the postal,

telegraph and telephone system.[129] In addition, the cost of reconstructing the German merchant marine (aimed at maintaining employment in the shipbuilding industry) accounted for as much as 6 per cent of total Reich expenditures in 1919 and 1920.[130] Such 'domestic reparations' were more important than actual reparations in generating the German fiscal deficit.

All the former combatants faced the same problem, of course: a debt burden so high that paying the interest on it precluded generous expenditures on welfare of the sort which had been dangled, carrot-like, before voters during the war. The 'shopping list' drawn up by the British Minister of Reconstruction Christopher Addison in February 1918 was typical:

> an adequate housing programme . . . involving purchases of materials and acquisition of land on a large scale . . . a considerable transfer of agricultural lands to public authorities for the purpose of small holdings, soldiers' settlements, afforestation and reclamation . . . the reconstruction of roads and the repair of railways and their equipment . . . the financing for a time in whole or in part by the State of certain essential industries . . . an extension of unemployment insurance to meet the dislocation of industry that is to be expected during the transition period . . . a strengthened health service both at the centre and locally.[131]

Addison opposed 'the view that everything should be subordinated to the paying off of debt', arguing instead that Britain should be 'prepared to incur expenditure essential for establishing at the earliest possible moment, the fullest measure of national productivity'. This was not so different from the arguments heard in post-war Germany. The difference was that in Britain the proponents of debt-service and amortization won; whereas in Germany the proponents of welfare spending did. That was why inflation gave way to deflation in Britain in 1921, while in Germany the printing presses kept rolling until the currency's final collapse.

As early as 1922 the German national debt had been reduced by inflation so much that in dollar terms it was almost exactly what it had been in 1914 ($1.3 billion compared with $1.2 billion on the eve of the war). By contrast, Britain's was almost ten times its pre-war level and America's more than a hundred times larger (see Table 45). Six years later, after the German hyperinflation and the British return to pre-war parity, the difference was even more pronounced. The combined debts of the Reich and states had been equivalent to around 40 per cent of GNP in 1913. In 1928 the figure was a mere 8.4 per cent. By contrast, Britain's national debt had increased from 30.5 per cent of GNP in 1913 to a crushing 178 per cent in 1928.[132] Despite the protests of advocates of full 'revaluation' in Germany, the Finance Minister Hans Luther had succeeded in effectively cancelling Germany's war debt. In drawing up the third Emergency Tax Decree of February 1924, which promised modest (10–15 per cent) revaluation of private mortgages and debentures, he explicitly ruled out similar treatment for the 60 million marks worth of war bonds still in circulation (until reparations had been paid). Georg Reimann's wartime prediction that Solon's *seisachtheia* would be re-enacted in Germany had been fulfilled.[133]

The choice between inflation and deflation had important macro-economic, and hence social, implications. In his *Tract on Monetary Reform* Keynes presented these as more or less straightforward: a government which balanced its budget and restored its currency to pre-war parity ran the risk of reducing aggregate economic output and employment; a government which continued deficit finance and therefore inflation, on the other hand, would boost output and employment levels, albeit at the expense of bondholders and other savers with paper assets. Thus in Britain the war was paid for – and more, in that the real value of the war debt actually rose – by imposing deflation and hence unemployment on the working class; while in Germany (and of course in Russia) it was the bondholders who paid.

But which was preferable? In his *Tract* Keynes suggested that though inflation was 'worse' than deflation 'in altering the *distribution* of

Table 45 National debts in dollar terms, 1914 and 1922

	1914	*1922*	*1922 as a percentage of 1914*
USA	1,338	23,407	1,749
Britain	3,440	34,251	996
France	6,492	27,758	428
Italy	3,034	8,689	286
Germany (Reich)	1,228	1,303	106

Source: Bankers Trust Company, *French Public Finance*, p. 137.

wealth', deflation was 'more injurious' in 'retarding the *production* of wealth.' Though he expressed sympathy for the middle class, 'out of which most good things have sprung', he therefore favoured the former, 'because it is worse in an impoverished world to provoke unemployment than to disappoint the rentier'.[134] In fact, Keynes explicitly identified as an exception to this rule 'exaggerated inflations such as that of Germany'; however, this important qualification has since tended to be forgotten. In the words of Frank Graham, for example, 'the balance of material gains and losses' of the German inflation was 'on the side of gains'.[135] This line of argument was developed in the 1960s by Laursen and Pedersen, among others. Not only did output increase in 1920, 1921 and 1922, they argued, but so did investment, creating a potential for sustained growth which only the depressed conditions of the post-1924 period prevented from being put to use.[136] A vital piece of evidence in this case is the fact that German employment levels were unusually high by international standards in the years 1920–22[137] – this was what Graham principally had in mind when he wrote that 'Germany accomplished the actual process of transition from the war to a stable post-war monetary structure at a lower real cost' than Britain and the US.[138] Most recent economic history textbooks have been at pains to stress these relative advantages of inflation, at least for the pre-hyperinflation period.[139] By implication, an alternative policy would have led to lower growth, lower investment and higher unemployment.

To explain the different policy choices in each country, historians have invoked a mixture of sociology and political culture. Thus it has been suggested that in Britain some social groups whose material interests were actually harmed by deflation nevertheless supported the 'conventional wisdom' of sound money for economically irrational reasons, equating Gladstonian orthodoxy with moral rectitude.[140] In France a middle course was adopted, which moderately devalued the national debt – a recognition of the relative but not absolute power of the *rentier* in French society. In Italy the distributional conflict proved impossible to resolve within a parliamentary system, so that the stabilization of the currency had to be undertaken by Mussolini's dictatorship. In Germany, by contrast, a crucial section of the bourgeoisie – entrepreneurs and the managerial business élite – defected to the side of the working class, supporting inflationary policies in the pursuit of a rapid physical expansion of German industry, but at the expense of shareholders, bondholders and banks. Whereas earlier accounts portrayed big business as the sole beneficiaries of the inflation, reaping the benefits of low real interest rates, low taxation and a weak exchange rate, it is now argued that workers also did relatively well.[141] The inflation was thus the unplanned outcome of a tacit 'inflationary consensus' between industry, organized labour and other social groups averse to deflation.[142] The loser was the rentier; but the overall effect was to make society as a whole better off and more equal than it would have been if deflation had been attempted.[143] This line of argument has political implications. In an influential article Hans Haller estimated that tax levels would have needed to exceed 35 per cent of national income to balance the budget without further government borrowing; a level of taxation we would now consider modest but which, according to Haller, would have been politically intolerable in the early 1920s. Inflation is thus said to have 'secured the parliamentary form of government for the period of the Weimar Republic', since any attempt to have stabilized fiscal and monetary policy would have led to a political crisis.[144]

In fact, all of these justifications for the inflation have their origins in the contemporary policy debate. At a meeting with the American ambassador in Berlin in June 1922, Rathenau (now German Foreign Minister) and the industrialist Hugo Stinnes offered two differing, but complementary justifications for German policy:

> [Rathenau] held . . . that inflation was no worse economically than controlling rents and maintained it only took from those who had and gave to those who had not, which in a country as poor as Germany was entirely proper. Stinnes . . . declared the choice had been between inflation and revolution and as between the two he favoured inflation.[145]

To Stinnes, inflation was 'the only way of giving the population a regular employment, which was necessary to secure the life of the nation'.[146] 'It was', he later told Houghton, 'politically necessary to put at work three million men coming back from the war. It was . . . a question of your money or your life.'[147] Melchior made a similar point:

> It was politically and socially necessary at the time and . . . could it have been controlled, no permanent harm would have occurred. It was not planned . . . It became involved in the creation of new capital to enable industry to hire the returning soldiers.[148]

Elsewhere he argued that the huge deficit on the publicly owned railways was necessary 'to avoid putting . . . 100,000 disposable employees . . .

onto unemployment benefit and thus handing them over to political radicalism'.[149] Writing in November 1923, Max Warburg underlined the point: 'It was always a question of whether one wished to stop the inflation and trigger the revolution.'[150] Nor were such views peculiar to businessmen. The trade unionist Paul Umbreit was essentially making the same point when he argued against cuts in social expenditures. 'If economic and social effects are set in opposition to one another, then the social interests have to be given precedence.'[151]

There are, however, good reasons to doubt the wisdom of these arguments. The inflation had far higher costs than Graham or Laursen and Pedersen appreciated. The Italian economist Costantino Bresciani-Turroni, who wrote one of the first serious studies of the subject in 1931, listed them as follows: falling productivity; a misallocation of resources; 'profound disequilibrium in the economic organism'; 'the vastest expropriation of some classes of society that has ever been effected in time of peace'; and declines in public health and morality:

> It annihilated thrift [he went on] . . . It destroyed . . . moral and intellectual values . . . It poisoned the German people by spreading among all classes the spirit of speculation and by diverting them from proper and regular work, and it was the cause of incessant political and moral disturbance . . . [Moreover,] by reinforcing the economic position of those classes who formed the backbone of the 'Right' parties, i.e. the great industrialists and financiers, [it] encouraged the political reaction against democracy.[152]

Although he had come down on the side of inflation, Keynes himself elsewhere expressed similar views. In his *Economic Consequences* he famously endorsed the view (which he attributed to Lenin) that 'the best way to destroy the Capitalist System was to debauch the currency':

> By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method, they not only confiscate, but they confiscate *arbitrarily*; and, while the process impoverishes many, it actually enriches some. 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. Those to whom the system brings windfalls . . . become 'profiteers', who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished not less than of the proletariat. As the inflation proceeds . . . all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism,

become so utterly disordered as to be almost meaningless ... There is no subtler, no surer means of overturning the existing basis of society ... In Russia and Austria–Hungary this process has reached a point where for the purposes of foreign trade the currency is practically valueless ... There the *miseries of life and the disintegration of society* are too notorious to require analysis; and these countries are already experiencing the actuality of what for the rest of Europe is still in the realm of prediction.[153]

The most modern research has provided ample support for these arguments. In particular, the claim that the inflation stimulated investment has been called into question by the work of Lindenlaub, whose detailed study of engineering firms suggests that rising prices (or to be precise, uncertainty about future prices) actually discouraged investment. The year of stable prices – 1920 – was when firms undertook new capital projects, and many of these had to be abandoned when inflation resumed in 1921.[154] More generally, it seems hard to deny that whatever benefits the inflation conferred in 1921 and 1922 were compensated for by the sharp falls in production and employment after hyperinflation set in. It has also been persuasively argued by Balderston that, because of its damaging effects on the banking system and the capital market, the inflation was indirectly responsible for the onset and peculiar severity of the 1929–32 Slump in Germany.[155] Economically, then, the costs of inflation seem to have outweighed the benefits.

The sociological explanations of the divergent national outcomes are too simplistic. They tend to overlook the fact that, in fiscal terms, the conflict which really mattered was between holders of government debt and tax-payers; and that these were far from being distinct groups. Everywhere the number of bondholders had been greatly increased by the war. If one adds together the total number of subscriptions to the nine German war loans, just under half were for amounts of just 200 marks or less; for the last four war loans the proportion of such small subscriptions averaged 59 per cent.[156] In 1924 around 12 per cent of the internal British national debt was held by small savers.[157] It is also sometimes forgotten that many of the biggest holders of war bonds were institutional rather than individual investors – insurance companies, savings banks and so on – whose large wartime purchases were effectively made on behalf of small savers. For example, 5.5 per cent of the British debt in 1924 was held by insurance companies and 8.9 per cent by the clearing banks.

At the same time there was an increase in the number of people paying direct tax. In Britain the number of income taxpayers more than trebled from 1,130,000 in 1913/14 to 3,547,000 in 1918/19, while the proportion of wage-earners rose from 0 to 58 per cent. To be sure, wage-earners only accounted for around 2.5 per cent of the net revenue from the income tax; but they could hardly be indifferent to the £3.72 each of them on average paid in 1918/19.[158] In Germany tax deducted from wages at source accounted for a steadily rising share of total direct tax revenue as middle-class taxpayers delayed payment of their tax bills, leaving inflation to reduce them in real terms. German working-class taxpayers were therefore even more concerned about direct tax. It is also vital to remember the post-war changes to electoral franchises, which had previously been restricted by wealth or income qualifications in most countries: democratization might have been expected to increase the political representation of voters who were neither bondholders nor direct taxpayers. In Britain, however, the ratio of voters to income taxpayers actually fell from 6.8 to 1 before the war to 6 to 1 in 1918 – the number of taxpayers had increased by more than the number of voters (by 214 per cent compared with 177 per cent).

Class analysis of the sort favoured by sociology therefore simply will not work because the crucial groups – bondholders, taxpayers and voters – had been too much altered by the war and overlapped in ways which defy the old class-based models. Winners in one respect could simultaneously be losers in another: in this German peasants were no exception.[159] Thus the sacrifices made by the rich élite in Britain before 1914 (in the form of super tax and death duties) and during the war were to some extent compensated for after the war in the form of a real increase in the value of their financial assets and the income they yielded. By contrast, the rich in Germany, who were so successful in opposing or evading higher direct taxation before, during and after the war, were penalized after the war by paying a massive inflation tax on their mark-denominated securities. In a sense, the 'choice' for Europe's middle class was whether to receive income in the form of interest on war bonds, but lose it in higher taxation, or avoid the taxation but lose the war bonds to inflation.

There is no question which was politically the more hazardous course. In Britain middle-class voters might whinge about the 'servant problem' and other signs of their relative impoverishment since 1914, but they remained solidly loyal to parliamentary Conservatism. In Germany, on the other hand, middle-class respect for parliamentary politics was dealt a fatal blow by the experience of inflationary expropriation: as the Prussian Minister of Justice Hugo am Zenhoff rightly foresaw in November 1923, 'such a failure of the legal order must lead to a serious shattering of the legal sensibility and confidence in the state'.[160] The disintegration of the 'bourgeois parties' in Germany can be dated from the elections of 1924; six years later many of the voters who had defected from them to form transient splinter groups like the Economy Party turned to National Socialism.[161]

Hitler's line on inflation was always tough. As early as 1922 he denounced 'this weak republic [which] throws its pieces of paper about wildly in order to enable its party functionaries . . . to feed at the trough'. The Nazi party's manifesto in 1930 – the year of the party's biggest electoral advance – stated: 'The other parties may have come to terms with the thievery of the inflation, may recognise the fraudulent republic [but] National Socialism will bring the thieves and traitors to justice.' 'I'll see to it that prices remain stable,' Hitler promised voters. 'That's what my stormtroopers are for.'[162] Though Nazi propaganda made much of the 'Unknown Soldier' Hitler's (and the fighter ace Goering's) own war service – even using parades by disabled veterans in election campaigns[163] – the movement was in fact only indirectly a product of the 'Front experience'. After all, around 38 per cent of those who voted Nazi in 1933 had been sixteen or younger when the war ended, while the biggest post-war veterans' association had been founded by the SPD.[164] It was the post-war economic crisis, not the war, which spawned Nazism; and with it the next war.

ALTERNATIVES TO HYPERINFLATION

The question remains whether the calamity of hyperinflation could have been avoided.

Clearly, any attempt to restore the mark to pre-war parity on the British pattern was out of the question; a drop in output of nearly 5 per cent and an unemployment rate of over 10 per cent (the effect of British deflationary policies in 1920–21) would, it seems fair to say, have been politically unsustainable. But could not the mark have been stabilized at, say, 50 marks to the dollar or 8 per cent of its pre-war value? Such a stabilization (not dissimilar from that which occurred

in Yugoslavia, Finland, Czechoslovakia and France) would not have entailed a British-style slump.[165]

The first step towards an enduring German stabilization in 1920 would have been a bigger (though not, it should be stressed, a total) reduction in the budget deficit.[166] As a proportion of estimated net national product, the deficit fell from around 18 per cent in 1919 to 16 per cent in 1920 and 12 per cent in 1921. More could have been done. Better-designed taxes could have raised more revenue: Webb has calculated that, if the revenues from income tax had not been eroded by renewed inflation after mid-1921, the real deficit (net of debt service) for the period July 1920 to June 1921 would have been just 4 per cent of NNP).[167] More practically, if Erzberger had also increased taxes on consumption, his whole tax package might have seemed less like 'fiscal socialization' to the middle classes. Under Erzberger's reforms, the share of Reich tax revenue coming from direct taxation rose to around 60 per cent in 1920/21 and 75 per cent in 1921/2, compared with just 14.5 per cent (including stamp taxes) before the war.[168] This was too high. What is more, higher taxes on consumption – though seen on the left as politically retrograde – would have been easier to collect. Some corresponding cuts in public expenditure could also have been made. To have halved the 1920 deficit would have required tax increases of around 1.5 billion goldmarks and spending cuts of the same order.

Fiscal policy alone cannot explain the failure of stabilization to endure, of course. Although monetary policy was largely influenced by the monetization of government debt, it was far from being a wholly dependent variable. The problem can be stated simply. In terms of currency in circulation, the rate of monetary growth was actually higher in 1920 than it was in either 1919 or 1921.[169] This expansion was only partly due to the continuation of government deficits, since a rising share of treasury bills was held outside the Reichsbank in the same period.[170] It reflected above all the high liquidity of the money markets and the static discount rate policy of the Reichsbank, which kept market interest rates at around 3.5 per cent and the discount rate at 5 per cent until 1922.[171] Although the Reichsbank actually threatened to stop discounting treasury bills in 1919,[172] it made no attempt whatever to tighten credit conditions for the private sector. Indeed, at the first sign of such a tightening, it stepped in to maintain business liquidity by discounting commercial bills.[173]

Yet there was an alternative monetary policy. The Reichsbank's traditional reserve requirements remained formally in force until May 1921. Admittedly, these rules had been substantially diluted by the decision to treat *Darlehnskassenscheine* (supplementary wartime notes) as equivalent to gold in the reserve. But by late 1920 the total volume of such notes had fallen by 12.5 per cent compared with the previous year; while the Reichsbank's gold reserve was almost exactly at its 1913 level at 1,092 million goldmarks – 19 per cent of the real value of currency in circulation, compared with 18 per cent in 1913.[174] A *de facto* stabilization of monetary policy could thus have been undertaken in 1920 without necessarily causing a significant real monetary contraction. To avoid the legal quagmire of an internal currency reform (with all the protests from creditors that would have elicited even in 1920), the easiest way of doing this would have been to peg the paper mark's exchange rate against the dollar at around 5 or 10 gold pfennigs.

Why was this not done? Some historians have tended to stress the low quality of German economic theory in this period; and certainly there were many economists who explicitly opposed policies of stabilization on thoroughly spurious grounds.[175] Yet politicians were not unaware of the risks they were running by letting inflation run out of control. On 28 June 1920 Chancellor Konstantin Fehrenbach urged Reichstag deputies 'to promote the reform of the Reich's finances with the utmost urgency':

> The relentless increase of our floating debt depresses the purchasing power of our money, restricts our credit and pushes prices to fraudulent heights. The volume of paper money is no sign of prosperity, (*Quite right!*) but a measure of increasing impoverishment. (*Renewed agreement.*) And the more the value of money collapses, the more violent become the struggles over wages and salaries, which despite everything are rarely able to keep pace with the rise in prices. An endless ratchet! It poses the gravest possible threat to trade and transport, to every branch of industry and labour. This danger must be countered with every available means, if we are to protect our people from the fearful misery of a collapse not only of the state finances but also of the nation's economy. God forbid that our people should only come to understand the full extent of our present plight as a consequence of [such] a collapse![176]

The expressions of agreement which greeted his remarks show clearly that German politicians understood the risks of deficit finance and knew what they had to do to stabilize the currency.

What were the arguments at the time against such a stabilization? There were some advanced specifically against devaluation. For example, it was argued, firms and individuals with wartime foreign currency debts would be deprived of the theoretical possibility of some longer-term recovery of the mark. More important, however, was the fear of a domestic liquidity crisis or 'credit shortage'. Even without a policy of stabilization, there were around two and a half times as many bankruptcies in the first half of 1921 as in the first half of 1920.[177] It was not, of course, bankruptcies *per se* which were feared, but the increased unemployment which would arise as a consequence. Yet the assumption that policies of retrenchment would have triggered a 'second revolution' merits reassessment.

There is no doubt that stabilization would have increased unemployment in the short term. In ending foreign speculation in the mark and deterring future investment in German-mark denominated assets, devaluation would also have ruled out that expansion in the German trade deficit which occurred in 1921 and 1922, thus placing a ceiling on domestic consumption. On the other hand, there is good reason to think that price stability and a devalued currency would have encouraged businesses to continue with the programmes of investment which they were beginning in 1920, but subsequently cancelled. Nor is there any reason to think that foreign lending would have ceased permanently. After all, it resumed very quickly in 1924, despite far heavier losses than a 1920 devaluation would have entailed. It seems reasonable to assume that any stabilization crisis in 1920/21 would have been less severe than the contraction experienced in 1923/24, when, in circumstances of complete monetary collapse, NNP fell by around 10 per cent and unemployment rose to a peak of 25 per cent of trade union members, not including more than 40 per cent who were on short-time work. Such levels of unemployment were not seen again in Germany until 1931. By contrast, unemployment in 1920 only exceeded 5 per cent in two months (July and August); for the year as a whole it averaged just 4.1 per cent. The experience of France, where a strategy of the sort suggested here was actually adopted, suggests that at most unemployment would have doubled in the event of stabilization. A rate of unemployment of around 10 per cent of trade union members would have represented a significantly 'softer landing' than that of 1923/24.

Weimar politicians' fears of the social consequences of such unemployment were exaggerated. To be sure, there were numerous small-scale demonstrations by the unemployed at the time of the mark's relative stabilization in 1920. Coming in the wake of the anti-Kapp general strike and coinciding as they did with sporadic consumers' protests against high prices, it is not surprising that these caused anxiety. Yet there was a certain illogic in lumping together these various manifestations of popular discontent as a single potentially revolutionary threat. For a policy of stabilization would have tended to reduce the radicalism of organized labour and the dissatisfaction of consumers precisely by stabilizing prices, reducing the incentive to strike for higher wages and adding a disincentive by pushing up unemployment. By contrast, the government's policy of subsidies to workers in sensitive sectors such as transport bought only the most illusory kind of social peace; for expanding the numbers and wage-packets of such workers only served to bolster the position of the more radical elements in the unions and the works' councils, to antagonize employers and hence to exacerbate industrial friction.

In practice, of course, too many economic interests were too well represented in the host of competing institutions which made Weimar policy for an even slightly deflationary policy to have stood a chance of success. Even in 1923–4, when Fehrenbach's worst fears had been realized for all to see, it was only possible to reform the currency by using the President's emergency power to rule by decree. This, of course, was precisely the instrument used after 1930 to emasculate the Weimar system. But perhaps it would have been better if Germany had had a more authoritarian government ten years earlier. If the mark had been successfully stabilized in 1920, rather than allowed to fall into the abyss of hyperinflation, German history might have taken a less disastrous course in the 1930s. As it was, Keynes all too soon had to start working out how to pay for the next war.[178]

Conclusion: Alternatives to Armageddon

At the end of *Crime and Punishment*, the nihilist murderer Raskolnikov has a feverish and clearly allegorical dream in which 'the whole world . . . suffered a terrible, unprecedented and unparalleled plague':

Those infected were seized immediately and went mad. Yet people never considered themselves so clever and unhesitatingly right as these infected ones considered themselves. Never had they considered their decrees, their scientific deductions, their moral convictions and their beliefs more firmly based. Whole settlements, whole cities and nations, were infected and went mad. Everybody was in a state of alarm, and nobody understood anybody; each thought the truth was in him alone; suffered agonies when he looked at the others; beat his breast; wept and wrung his hands. They did not know whom to bring to trial or how to try him; they could not agree on what to consider evil, what good. They did not know whom to condemn or whom to acquit. People killed each other with senseless rage. Whole armies were mustered against each other, but as soon as the armies were on the march they began suddenly to tear themselves apart. The ranks dispersed; the soldiers flung themselves upon each other, slashed and stabbed, ate and devoured each other. In the cities, the alarm bells rang for a whole day. Everybody was called, but nobody knew by whom or for what, and everybody was on edge. The most ordinary trades were abandoned, because everyone proposed his own ideas, his own criticisms, and they could not agree. Agriculture came to a halt. In some places, knots of people would gather together, reach some agreement, and swear not to separate; no sooner was this accomplished, however, than something quite different from what they had proposed took place. They started accusing each other, fighting each other, and stabbing away. Fires blazed up; hunger set in. Everything and everybody went to wrack and ruin.[1]

That vision was more or less realized in Europe between 1914 and 1918.

What, if anything, was achieved by this Armageddon? Belgium and