Chapter 2

Origins and factors for hyperinflations

2.1) Introduction

This chapter discusses from a broad perspective the policies and assumptions underlying the actions towards the problem of reconstructing the international economy in the 1920s and more specifically the nature of the adjustment problems to be addressed in the countries to face hyperinflations. It starts, in the next section, from the conventional observation that the adoption of the practices and rules developed during the pre-1914 gold standard as the basic point of reference for stabilization policies revealed that the authorities of the time failed to assess the extent to which the pre-war "normalcy" had been permanently destroyed. The most obvious consequence of such assumptions was to assign an excessive emphasis to the financial aspects of the stabilizations in detriment of more substantial forms of adjustment. This is clearly revealed by the efforts of concerting international action conveyed by the international financial conferences of the time. The excessive emphasis on finance would result in preserving a substantial degree of non-adjustment during the 1920s, especially in the few countries subject to fundamental and adverse changes in their economies, i. e. their frontiers and external positions. By and large, however, these disequilibria could be sustained, as suggested in section 2.3, in view of the abundance of foreign capital observed during the second half of the1920s, which allowed otherwise painful restructuring processes to be evaded. Indeed, all the hyperinflation countries, with the obvious exception of the Soviet Union, became heavy borrowers in international capital markets after their stabilizations.

Borrowing was certainly not a solution it itself as changes, reconstruction and dislocations in these countries competitive positions required investments addressing the needs of adjustment. Thus, the medium run viability of such indebtedness trajectory would depend on investment activity, or on the allocation of foreign capital to uses conductive not only to the repayment of loans but also to the solution of original imbalances. This is actually where one finds a very significant contrast between the 1920s and the experience of reconstruction following World War II. The stabilization loans of the 1920s served mostly to recompose international reserves so as to allow a return to the gold standard, and the ensuing capital inflows did not seem to be committed to any sort of adjustment effort. After World War II the large capital inflows under the

Marshall Plan were specifically addressed to investment needs related to the elimination of Europe's dollar deficit. The contrast between the two experiences is extraordinary and the outcomes of the two episodes, the collapse of the 1930s and the long prosperity of the 1950s and 1960s is by no means independent from the reconstruction strategies following the respective wars. The last section offers a brief comparative discussion of the post World War II international stabilization experience.

2.2) Stabilizations in the 1920s: an international perspective

During the first half of the 1920s most of the problems directly related to the war, such as the rehabilitation of the devastated areas and the reconversion of economies to peacetime patterns, had already been resolved; but this by no means implied that economic life in Europe had been normalized, and even less that the pre-war levels of production and productivity had been regained. Indeed, as late as in 1927 the Geneva International Conference would sadly recognize that "the dislocation caused by war was immensely more serious than the actual destruction"[1]. Three sorts of dislocations would present challenges to postwar planners. First, the financial legacies of war finance in the belligerent countries appeared to many commentators as an essential obstacle for economic stability in Europe. Second, the peace settlements had originated entirely new problems, such as, for example, the adjustment to the new frontiers in Eastern Europe, and the collection of reparations. Third and less apparent than these, a number of problems of a more structural nature related to the position of European economies within the world economy started to be increasingly felt during the 1920s. These problems had been partly generated by permanent changes determined by the war in the geographical distribution and commodity composition of international trade, notably by the spread of industrialization outside Europe and by the ascendancy of the US and Japan; they were also due to longer term developments related to the pattern of technological innovations *vis à vis* existing industrial structures in some European countries[2]. These problems, whose perception and assessment was variable among

[1] H. Clay (1957) p. 225.
[2] I. Svennilson (1954) pp. 22-25.

observers, constituted the core of the international stabilization problem that would challenge policy-makers for the whole decade.

Those of the first group, i. e. the financial problems, have been most usually emphasized, which expressed the fact that the usual attitude towards the issue of rebuilding the European economy was that it involved mostly a problem of monetary stabilization rather than the redefinition of whole new international economic order. The much professed "return to normalcy" provided actually a powerful indication of the latitude of the assumption that the pre-war *status quo* had not been fundamentally changed; it was implicitly assumed that issues as reparations and war debts would eventually find a satisfactory diplomatic settlement, so that except for disorderly finances, nothing would prevent the restarting of economic life where it stopped in August of 1914.

The usual verdict about the stabilizations of the 1920s was that they were "from the international point of view, a piecemeal process carried out by one country after another in a completely uncoordinated manner"[3]. There followed, for instance, that "the pattern of exchange rates that emerged was hardly consistent in the sense of allowing the constituent parts of the world economy to experience normal rates of growth at reasonably high levels of employment without balance of payments difficulties" [4]. It was generally agreed that a "simultaneous and coordinated international action" [5] could minimize the strains to which the international economy would be exposed along the process, but such course of action had been explicitly scorned by the leading authorities of the time, which seemed to favor a “country by country approach” [6]. Though something along these lines effectively took place in a limited scale as regards central bank cooperation [7], constraints like the US isolationism and the uncertainties in European diplomacy, especially as regards Germany, considerably reduced the scope for international policy coordination.

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[3] LN (1944) p. 116.
[4] D. E. Moggridge (und.) p. 37.
[5] LN (1944) p. 117.
[6] Benjamin Strong, influential president of the Federal Reserve Board, explicitly favored a "country by country approach" in opposition to a "general scheme", as countries differed in the degree to which they adhered to what he deemed the fundamental conditions for currency stabilization, namely balanced budgets, moderate currency inflation, small government debts, a "sound" bank of issue, a fairly large gold reserve and a "reasonably well balanced foreign trade". Cf. L. Chandler (1958) p. 281.

Although uncoordinated, the international stabilization experiment during the 1920s was not chaotic; the observation of individual instances clearly reveals common guidelines and procedures that, as long as the overall experiment was concerned, would characterize, at least *ex-post*, a well defined stabilization strategy. This "strategy" was largely dominated by the authority of the practices and institutions of the pre-war gold standard, whose reconstitution at an international level quickly became the crux of the international stabilization problem; a symbol of the pursuit of the lost normalcy. Doctrinal and political economy considerations were important to establish the target of reconstituting the gold standard [8] as easily demonstrated in the proceedings of the international monetary conferences of these years - Brussels and Genoa.

The Brussels Financial Conference in 1920, for instance, was mostly oriented towards the principles based on which individual stabilizations should be undertaken. It is significant in this respect that some concrete steps were taken as regards international credits under the so-called Ter Meullen plan, which would develop later into the League of Nations plans for Austria and Hungary. The Conference, however, was very superficial on issues other than financial. This was not entirely due to some doctrinal overemphasis on financial remedies, which certainly existed; issues like reparations and war debts had been withdrawn from discussion much under French request, thus reducing considerably the scope for more substantial resolutions [9]. The Conference's report proclaimed, however, that its members "were conscious that, limited to the sphere of finance both their terms of reference and their personal qualifications they could only deal with a part of the problem that faced the governments and the peoples of the world. Finance is after all - the report continued, only a reflection of commercial and economic life - a part only, though an essential part of its mechanism" [10]. But the realities of the international stabilization problem would eventually reveal that behind these careful disclaimers the general attitude of those involved in the problem was that most fundamental imbalances would be mostly self-corrective provided that "sound" financial conditions prevailed. In general there was a deep faith on the balance of payments

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[7] S. V. O. Clarcke (1967) and B. Eichengreen (1984).

[8] S. V. O. Clarcke (1973) pp. 11-13; F. Costigliola (1977) pp. 914-915; D. P. Silverman (1982) pp. 50-61 and D. E. Traynor (1949) pp. 136-139.

[9] D. P. Silverman (1982) pp. 275-276.

adjustment mechanisms implied by the gold standard, largely emanating from Britain [11].

The Conference, in its resolutions and also in the Joint Statement of the Experts [12], strongly reaffirmed the need for balanced budgets, for the funding of floating debts[13], for "inflation of credit and currency" to be ceased, for central banks independent from governments - which should be established where still inexistent - to conduct business on the basis of "prudent finance" and avoid "artificially low bank rates, out of conformity with the real scarcity of capital" [14]. The experts' account, certainly influenced in this point by Cassel's contribution, included the notion that "the level of exchanges tend to correspond with relative internal values of currency of the several countries", thus offering a solution for the issue of the choice of parities, which would be more fully developed in Cassel's "Memorandum on World's Monetary Problems" presented in the conference[15].

The stabilization programs implemented under the League of Nations auspices in Austria and Hungary provided a clear and direct illustration of such attitudes. In Austria, for example, the League's experts explicitly recognized that apart from the financial problems "there remains the problem of the fundamental economic position of Austria", which, however, they saw as related to the Austrian balance of payments and consequently outside their province[16]. Their judgment was that "if the appropriate financial policy is adopted and maintained, the Austrian economic position will adjust itself to equilibrium, either by the increase of production and the transfer of large classes of its population to economic work, or economic pressure will compel the population to

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[10] LN (1920a) p. 9.
[11] D. E. Moggridge (und.) p. 22.
[12] The five experts presenting individual memorandums and signing a joint statement were Gustav Cassel, A. C. Pigou, Charles Gide, M. Pantaleoni and G. Bruins.
[13] Though these recommendations have been somewhat vague for countries undertaking reconstruction of devastated areas, cf. LN (1920a) p. 22 and D. E. Traynor (1949) pp. 46-47.
[14] *Idem, ibid.* Our emphasis.
[15] In LN (1920b), and later reproduced in G. Cassel (1921). See especially pp. 44-48 of the earlier edition, or pp. 36-49 of the later one.
[16] LN (1926a) p. 186. They argued that "Austria cannot permanently retain a sound financial position, even if she attains it for the time, and to maintain her present population, unless her production is so increased and adapted as ... to give her equilibrium also in her balance of trade ... all possible measures, whether by the amelioration of the international economic relations, the encouragement of the conditions which would increase Vienna's entrepot, financial and transit business, and those which will attract further private capital towards the development of her productive resources are therefore, of the greatest importance".

emigrate or reduce it to destitution" [17].

Quite the same *laissez-faire* approach was adopted by the League in Hungary. As in Austria it had been established that the League action "should be definitely and expressly limited to remedying the budgetary, and therefore the financial position" and although they argued that "this is not to suggest that the Committee considers the economic restoration as of secondary importance, nor even that the League itself can do nothing to assist it", their point was that "the necessary economic adaptation must be effected by Hungary herself" [18]. The experts notwithstanding left clear their thoughts on the nature of the "adaptation" program by arguing it should consist, on one hand, of an effort to conclude commercial treaties with the countries in the Danubean area to which the League would actively contribute, and possibly remove unilaterally its trade restrictions[19]. On the other hand, as far as domestic adjustments were concerned, the experts were mostly vague and when they ventured to say something they paid lip service to conventional textbook liberalism by criticizing Hungarian efforts to foster industrialization[20]. In any event, the League schemes thus defined have been generally considered - for example by Montagu Norman, certainly one of the most influential personalities of these years - as a recipe to be freely administered to the distressed economies of Central Europe[21].

This *laissez-faire* approach would seem especially clear as regards attitudes towards trade imbalances. Cassel, for example, was voicing mainstream ideas when argued that trade imbalances would be largely self-corrective, since with the appropriate choice of exchange rates the "adverse balance of trade" would be but a temporary

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[17] *Idem, ibid.*

[18] LN(1926b) pp. 56-57.

[19] *Ibid.* pp. 75-76.

[20] According to the experts' report, 'the most vital thing for Hungary is that she should achieve the best production of - and find markets for - the products for which her natural resources and her natural aptitudes best fit her. To the extent to which she diverts her resources in labor and in capital to producing what can be more cheaply obtained from abroad at the expense of what she can produce better than other countries there must be a net economic loss". *Idem, ibid.*

[21] In a letter to Benjamin Strong of April 9th, 1922 speaking of the good prospects of the floatation of the Austrian loan, Norman argued that "if we can thus set up Austria, we must tackle Hungary so as to establish one by one the new parts of old Austria ... and perhaps the Balkan countries. Only by thus making the various parts economically sound and independent shall we reach what I believe to be the ultimate solution for Eastern Europe, viz. an economic federation to include half a dozen countries in or near the Danube free of custom barriers, etc." . *Cf.* Henry Clay (1957) pp.189-190, emphasis in the original.

phenomena[22]. This was a very significant expression of the faith on the "classic" balance of payments adjustment mechanism under flexible exchange rates (or under inconvertible paper currency) that had been mastered by Taussig and his students[23]. Capital movements, trade impediments and also wage "rigidities" were often mentioned as possible obstacles to this process, but the idea was that these problems would all disappear with the normalization of economic life[24]. Cassel was the origin of the notion that the appropriate procedure for choosing parities after 1918 would be to correct the 1914 parities by the rates of inflation observed in the interval[25]. Such widely employed procedure implicitly assumed that the real exchange rates of 1914 still secured external balance after the war, which was not necessarily true. It has been convincingly argued by Moggridge, as regards Britain, that the method was misleading to the extent that it failed to take into consideration the changes in the country's competitive position[26]. The procedure would be the more misleading the more a country had been "changed" in the meantime; for many Central European countries in particular, the procedure was entirely meaningless. In any event purchasing power parity calculations have been extensively used during the 1920s, being actually one of many instances in which the assumption of the existence of a fundamentally undisturbed pre-war "equilibrium" was clearly taken for granted.

The Genoa Conference in 1922 would reaffirm the principles and policy guidelines - the "pious platitudes" as put by Hawtrey[27] - previously laid down in Brussels and extend them in several directions. Much weight was placed on the resolutions calling for active cooperation on independent central banks as regards issues as credit policies aiming at price stability and also joint actions as regards international credits[28]. This actually reflected the fact that central bankers had assumed a dominant position in the process of

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22 G. Cassel (1922) pp. 163-186.
23 See F. W. Fetter (1968) for a review of these developments.
24 G. Cassel (1922) p. 165.
25 Cassel argued that, assuming an initial equilibrium position and that some inflation had occurred during a period of time, an "adverse" balance of trade could exist only if the actual exchange rate was for some reason "overvalued" with respect to its purchasing power parity value, or the real exchange rate was overvalued, *Ibid.* p. 166.
26 D. E. Moggridge(und.) *passim.* and (1969) pp. 69-75.
27 R. G. Hawtrey (1926) p. 122.
28 *Ibid.* p. 123, S. V. O. Clarcke (1967) p. 42 *passim* D. E. Traynor (1949) p. 82, R. S. Sayers (1976) p.157, H. Clay (1957) p. 223 and L. Chandler (1958) p. 285.

international stabilization, performing a role their governments were reluctant to play; it also expressed the notion that the process should be conducted in a "technical" or "business-like" manner without the involvement of politicians[29]. For no other reason men as Norman, Strong, Schacht and Moreau played such an important role in these years.

Second, in the name of preventing the scramble for gold reserves the conference proposed a pattern of distribution of international liquidity by means of which some financial centers, specifically London and New York, would become gold centers while others would hold their international reserves mostly as balances against these centers; this arrangement would become known as "the gold exchange standard" [30]. The proposal was regarded as favoring British interests in detriment of other secondary financial centers, Paris in particular; conflicts in this account would be serious but would only be apparent by the late 1920s[31]. Third, the conference showed much more pragmatism as regards the fixing of exchange rates to the extent it proposed stabilizations close to the actual market rates, which resulted in creating a favorable atmosphere for devaluations, at this point considered to be inevitable for many countries including France and Italy[32].

Lastly, the conference attached much importance to the issue of financial help for countries with weak currencies and in this respect reproduced the Brussels concern about the guarantees and conditions under which such credits could be granted[33]. The Brussels solution, embodied in the Ter Meulen plan, of placing a "productive asset" under international administration proved too stringent and did not attract any borrowers. Much under the influence of Norman and Strong the notion of conditionality, or "control", as it was called at the time, evolved towards the idea that countries undertaking stabilization should be given support in the form of credits, provided that "sound" policies were adopted and that the credits were extended to the central bank and not to the

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[29] L. Chandler (1958) p. 286 *passim*. Norman specifically managed to carry the principles of central bank autonomy to extremes. According to Sayers "he was always glad to meet central bankers, but would refuse all contact with foreign ministers of finance or their officials: if some were in the same room when he met central bankers he would confine his conversation to the latter". *Cf.* R. S. Sayers (1976) vol. 1 pp. 159-160.

[30] R. G. Hawtrey (1926) pp. 126-127, D. E. Traynor (1949) p. 82 and S. V. O. Clarcke (1973) p. 14.

[31] Especially after the franc and the pound being stabilized, the French found themselves displeased with the obligation of holding a very large proportion of their reserves in the form of sterling. The French then increased the portion of their reserves held on gold, which resulted in putting London, and consequently the international economy, into great strains. LN (1944) chapter 4 *passim*.

[32] D. E. Traynor (1949) p. 86 and S. V. O. Clarcke(1973) p. 15.

[33] D. E. Traynor (1949) pp. 71-75.

government[34]. Such attitudes, in view of the weight Norman and Strong carried, enormously influenced the behavior of private international banks. The account of a leading historian of this period is unambiguous in this respect[35]:

> *[a borrowing country] would usually have found impossible or at least very difficult, to float foreign loans if its stabilization program failed of approvals of Norman and Strong. In many cases the great international banking houses, such as Morgan's, Rothschild's and Baring's, refused to float stabilization loans if the borrowing nations central bank did not at the same time received a credit from foreign central banks. Norman's approval could almost assure a nation's ability to borrow in London; his disapproval could close the market for such loans. Strong's influence with New York investment bankers was great though less dominant. A former partner in Morgan's told ... that his firm would never float a loan that Strong disapproved, and that Strong's approval always weighted heavily. Strong's views were probably less influential with some of the newer and less conservative investment banks.*

During the 1920s a definite and explicit link was established between the adoption of orthodox stabilization plans and the access to international credits. Very commonly bankers argued that they only imposed procedures that the borrowing countries would have to follow anyway if they aimed at stabilizing their currencies[36]. The presumption was that there has been no alternative outside the principles developed in Brussels and Genoa, and the reasons for that are not simple. Doctrinal considerations certainly played a part, as very often during the 1920s the authority of the "superior" financial practices and institutions of countries like Britain, for example, was confronted with the confused finances of continental Europe, not to mention those of Latin American countries. The choice of stabilization policies often involved the technical advice of foreign economists and financial "experts", a work that was described by one of the leading financial experts of the time as one of using "scientific imagination in the application of sound economic

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[34] L. Chandler (1958) p. 285.
[35] *Ibid.* pp. 285-286.
[36] According to Strong's biographer, Norman and Strong "believed that the requirements they imposed were only those that would have to be met in any case if the country was to succeed in restoring and maintaining gold payments", *cf.* L. Chandler(1958) p. 286. Similar arguments have been repeatedly made as regards the League schemes in Austria and Hungary, for which the protocols and conventions often remarked that these countries could not by any means have avoided undertaking the "comprehensive reforms" if the stabilizations were to be attempted, *cf.* LN (1926a) and (1926b).

theory to unsound and often very strange economic practices" [37]. The 1920s effectively marked the heyday of the "experts", an unambiguous reflection of the "business oriented" or "scientific" approach that Britain and the US had assigned to international stabilization[38]. The "money doctors" and their missions actually represented an important link in the expansion of international investment in this period, for they framed informed and detailed stabilization programs, sold domestically and internationally as "impartial" advice, on which international loans were made contingent[39]. Very often the borrowing countries took the initiative of calling such missions, not exactly because of the quality of the advice, as the recipe was old and well known, but because it impressed favorably international capital markets. Poland, for example, invited foreign experts to report on Polish finances in three occasions between 1922 and 1927, all of which related to the objective of securing international credits[40]. It has also been the case of most of the celebrated Kemmerer missions in Latin America during these years[41].

The "experts" of these years, despite the understandable bias towards conservative thinking, included professional economists of indisputable competence and reputation[42]. Yet not only the "technical" problem in itself was very difficult[43], but it is important to observe that the problem of international stabilization was an important part of a process of redefinition of spheres of economic influence and political leverage[44]. The "comprehensive programs" prescribed by international bankers following the Genoa guidelines, served the overall purpose of rebuilding an international financial system

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37 E. W. Kemmerer (1927) p. 5.

38 F. Costigliola (1976) and J. H. Wilson (1971) chapter 1.

39 As regards missions of experts in Latin America, see R. Seidel (1972) and P. Drake (1979). It is also interesting to see Kemmerer's account of his work in E. W. Kemmerer (1927) p. 5.

40 British expert Edward Hilton Young was invited in 1922 when the Polish government was seriously considering floating a loan in London. Later the Poles invited the peripatetic professor Kemmerer in two occasions, the first under influence of American bankers Dillon, Reed & Co, responsible for a large loan floated in New York in 1925. The second time, just after the Pilsulski coup in 1926 led eventually to the floatation of an international stabilization loan in 1927. Their respective reports are E. H. Young (1924) and Republic of Poland (1926a).

41 R. Seidel(1972) and P. Drake(1979) *passim*.

42 Keynes himself along with Cassel and some others was invited by the German government in 1922 to present an expert report on German finances. The mission reported in November of 1922 arguing that at that point the stabilization of the mark was possible "by means of Germany's own efforts" and remarked that the "success of any scheme of stabilization must depend not on a foreign loan but rather on industrial and budgetary developments within Germany", *cf.* L. L. B. Angas (1923) pp. 126-133. Unquestionably the report did not differ in nature and content from the several others manufactured by the priests of "sound money".

43 The fragility of the assumption that the "experts" were better equipped to understand the economic problems of the early 1920s is very convincingly exposed by Dan P. Silverman (1982) pp. 10, 41 *passim*.

centered in London and New York. These programs seemed to fit well economies which had little policy autonomy to exercise, but would find decisive resistances in larger economies, such as France, Italy, Germany and to a certain degree Poland, for which a position of passiveness towards external developments, let alone subordination to London or New York, would be clearly inappropriate. Countries of the so-called “periphery” would seemingly do better on a more flexible setting, for example under some sort of managed floating with some scope for insulation; but the European experience with flexible exchange rates had not been very rewarding, and even at a domestic level the idea of managed money would have to wait another decade[45]. It is unfortunate, though, that recent scholarship has done much to perpetuate "the mythology of the superiority of Anglo-Saxon principles of sound fiscal, financial and monetary policies" [46], as for example in Stephen Schuker account of French finances[47] or in the usual reference to the "economic illiteracy" [48] or the “intellectual failure”[49] of German authorities.

The disproportionate emphasis on "sound finance" and the *laissez-faire* attitudes of the leading financial authorities of the time would eventually result in leaving medium run adjustment problems to be solved by "market forces". This would mean that adjustment was mostly evaded by the countries with the most serious imbalances for these have become heavy borrowers in international capital markets. It seems natural to conjecture that the tragic outcome of the lending episode of the late 1920s could be associated with the fact that more fundamental adjustment problems were swept under the rug by the rebuilders of the gold standard. In this connection, some of the blame for the collapse of the early 1930s could be put on the ill conceived stabilization strategies of the early 1920s.

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[44] *Ibid.* pp. 41, 58 *passim.*
[45] LN (1944) *passim* and D. E. Moggridge (und.) p. 19.
[46] D. P. Silverman (1982) p. 53.
[47] According to Schuker, "most of the French elite at the time were abysmally ignorant even of rudimentary principles of economics. A few specialists on the Paris law faculty ... were doubtless as sophisticated as any economist in the world. But the education of the Third Republic's governing class was oriented towards literature and the humanities. Economics simply did not figure as standard part of the curriculum. What little economics middle aged man in positions of responsibility remembered from their youth generally was irrelevant to monetary problems in the postwar world". *Cf.* S. Schuker (1976) pp. 45-46.
[48] As in D. E. Moggridge (und.) p. 36.
[49] LN (1946) p. 17.

2.3) Adjustment and Borrowing in the 1920s

The excessive amount of attention the authorities of the 1920s devoted to financial problems might have been effective to provide for a quick resolution of the financial legacies of the war, but did little or nothing on account of the more fundamental problems faced by Central European economies. Adjustment to post-war conditions generally required major sectorial shifts of resources and large scale programs of investment addressed to issues like modernization of agriculture, acceleration of industrialization and to more specific problems such as in the cases of the Austrian energy problem or the Polish railways, as seen next chapter[50]. By and large "sound finance" stood as an obstacle to that for it not only restricted these governments' role in the process but it also meant to maintain these economies in a chronically depressed state that was not conductive to private initiatives in this regard. This is most clearly noticed in Austria and Hungary, for example, for which the large stabilization loans they contracted have been expressly earmarked for budgetary purposes and only at a great difficulty some parts of the unused resources were spent in investment programs. Austrian historian Edward Marz reported that the League program in Austria, despite its financial success, left behind a "gravely disequilibrated economy" as it dealt only with what he termed "the surface problems of the Austrian economy" [51]. Another account with a broader focus makes the same point about the overall character of financial reconstructions in Central Europe: "the financial reorganizations carried out in the mid 1920s could overcome economic confusion but were in themselves unable to solve the domestic problems of economic reconstruction or to create possibilities of home accumulation on a level required to achieve economic recovery" [52].

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[50] The point has also been made by I. Svennilson (1954) p. 46.
[51] E. Marz (1948) p. 619.
[52] I. Berend & G. Ránki (1974a) p. 222.

Table 2-1
Capital Inflows and Indebtedness , 1923-1928
(percentage ratios)

	Curr. acc. deficit/GDP		Capital inflows/exports		Debt service/exports	
	1924-26	1927-28	1924-26	1927-28	1924-26	1927-28
Austria[a]	8.4	6.1	45.6	34.3	9.5	4.8
Hungary	2.8[b]	7.7	12.7b	63.1	5.3b	16.3
Poland	0.5	4.8	17.9	30.1	4.9	13.6
Germany	2.6	4.9	22.3	35.2	9.1[c]	18.9

SOURCES and OBSERVATIONS: (a) Includes 1923: we take 1923 GDP as equal to the one for 1924. (b)There are no figures available for 1925. (c) Including reparations as "debt-servicing". Balance of payments figures from LN (1927) pp. 58-59, 141-151, (1928) pp. 180-190, (1930b) pp. 91-93,149-151, (1931) pp. 52-53, Bank of Poland (1930) pp. 95-96 and R. Nötel(1984) pp. 156,182. GDP figures from B. R. Mitchell (1978) pp. 409-412, A. Eckstein (1956) p. 14 and S. Andic & J. Veverka (1964) pp. 241-242.

One probable consequence of this excessive emphasis on finance would be to preserve a considerable degree of non-adjustment throughout the 1920s, at least to the extent that the Brussels-Genoa guidelines were strictly followed; some indications in this respect can be gathered from Table 2-1. The table distinguishes two periods, the first corresponding to the three (four) years following the stabilization and the later period coinciding with the last two years of the lending bonanza of the late 1920s. Figures for earlier years are generally not available. It is interesting to observe that all four countries were heavy borrowers, especially in the later period, as shown by the third and fourth columns in Table 2-1. The implied growth in indebtedness is responsible to a significant extent for the increase in current account deficits observed in the second period. The apparent exception is Austria, but this is due to a statistical problem. Capital inflows into Austria were predominantly of short-term nature so that they are hardly recorded in the balance of payments statistics; in general it is assumed that the large unaccounted inflows observed in these years roughly correspond to these inflows. By doing so we obtained capital inflows/exports ratios of the same order of magnitude of the other countries for the latter period, but for the earlier period we obtained a number that seems high. This is explained by the fact that our procedure implies in including returning "hot-money" movements that were excluded from the capital inflows considered for the other countries. In any event this statistical problem explains the apparent reduction in the debt-

servicing ratio and on the current account deficit observed in the later period.

Austria and Hungary are the countries for which the shortcomings of the reconstruction strategies we have been discussing should be the most relevant, for both stabilized under programs implemented by the League of Nations. Austria actually provides the best expression of the Brussels-Genoa principles and their implied consequences; she shows a large current account deficit for 1923-1926, amounting to 8.4% of GDP, that was basically sustained by capital inflows. Hungary and also Poland and Germany show a considerably smaller current account deficit; it should be observed that for these three countries, in contrast to Austria, some form of "adjustment" was accomplished during the inflation/stabilization period. The nature of such "adjustments" varied a lot. For Hungary "adjustment" was less related to the League program than to the authoritarian government that ruled during the 1920s. The latter would actually establish a contrast with Austria in at least two instances: first, the levels of unemployment in Hungary during 1924-1926 averaged 15.4% annually[53] while in Austria the 1924-1926 average was 6.0%[54]; and second, while in Austria real wages remained at levels about 20% to 30% <u>higher</u> than the 1914 levels in 1924-1925, in Hungary real wages would be maintained at levels 20% to 30% <u>below</u> pre-war levels during 1924-1925[55]. As late as 1929 real wages in Hungary barely recovered 85% of 1914 levels[56]. Hungary, therefore, managed to effect some "adjustment" mostly through unemployment and through forced reductions in workers target real wages. In the later period, as unemployment was reduced, real wages made some gains and indebtedness grew current account deficits increased very significantly.

Adjustment in Poland and Germany followed courses somewhat different from the Brussels-Genoa benchmark, as we will see in some detail in Chapters 9 and 10. Poland's current account deficit was very small in 1924-1926; it was 1.8% and 2.9% of GDP in 1924 and 1925 respectively, and in 1926 it was turned into a surplus of 3.3% of GDP. Three basic factors explain that: first the Poles attitudes towards reconstruction and stabilization contrasted very sharply with the corresponding attitudes in Austria and

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[53] Computed from figures from J. Vagö (1925) p. 348 and LN (1926b) p. 50 under the assumption that union membership did not change during 1925 and 1926.
[54] E. Wicker(1984) p. 14.
[55] ILO (1926) pp. 41-43 and 90-92.

Hungary. They strongly emphasized investment expenditure and structural adjustment in detriment of "sound finance", as a result of which some "true" adjustment, in the sense of closing the foreign exchange gap, would be achieved. Second, the annexation of the industrial district of Upper Silesia in 1922 would represent a major improvement on the country's payments position. These two factors, which we will examine in great detail in Chapter 9, would explain the small current account deficits observed in 1924 and 1925. Third, a major recession would play an important role in producing the current account surplus observed in 1926. The drastic changes in commercial policy would determine a reduction in imports of nearly a half from 1925 to 1926. The recovery of the economy, the removal of trade restrictions and the increased indebtedness would determine a sharp increase in the current account deficit in the later period.

Germany also shows relatively small current account deficits in the earlier period which is explained by two factors: one is the rescheduling of reparations payments determined by the Dawes Plan; payments in this account were reduced from around 75% of exports during 1921-1922 to 3.6% in 1924 and 10.9% in 1925-1928, as shown in Table 2-4 ahead. Yet even so current account deficits corresponded to 2.8% and 4.9% of GDP in 1924 and 1925 respectively. In 1924 the unemployment rate was 13.5% and in 1925 it was reduced to 6.7%; in 1926 a major recession increased unemployment to 18.0% and reduced the current account to a near balance. Like in Poland, this effort was dismissed afterwards as the abundance of foreign capital turned current account balance unnecessary. In his much heralded exchange with Keynes, Ohlin explicitly argued as regards Germany that these capital inflows not only blocked but reversed the balance of payments adjustments and consequent resource reallocation ordinarily required to effect the transfer of reparations[57].

The abundance of borrowing opportunities during the 1920s would represent a "permanent" improvement in these countries' balances of payments position that would

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[56] I. T. Berend & G. Ránki (1974b) p. 159.

[57] Ohlin's argument was that capital inflows largely in excess of reparations payments reversed the transfer mechanism to the extent income effects as well as exchange appreciation would work towards a trade deficit, not a surplus. Furthermore it would not signal resources to migrate to sectors producing tradables. Strong capital inflows therefore "largely explain why Germany's productive resources have to such an extent been used for production of capital goods for the home market and have not increased the output and marketing of export goods", B. Ohlin (1929) p. 172 *passim*. The same point can be easily made from Kindleberger's point

turn much easier the reconciliation of the demands of the labor movement and the requirements of external balance. Borrowing would perform a key role in the Austrian and Hungarian stabilizations, though for the latter an important part of the adjustment was inflicted on workers by force. Borrowing would certainly be important for Germany and Poland yet both managed to accomplish considerable degrees of adjustment during the inflation/stabilization period. The reopening of international capital markets offered these countries the opportunity to smooth or to evade their more fundamental adjustment problems; in this connection the character of the problem of stabilization was changed for the short run problem of stopping inflation was dissociated from the fundamental imbalances that had created the inflationary problem. The problem of stabilization was turned into a struggle to gain access to international capital markets, or to swallow or compromise with the tough recipes of Brussels-Genoa. In any event, even if the conditionality problem was solved there remained the problem of how to address the fundamental imbalances these countries faced. This was actually the crucial issue as far as the outcome of the episode of international lending in the 1920s was concerned.

The growth of external indebtedness could certainly play a meaningful role in the process of adjustment provided that the allocation of external resources was sympathetic with the needs of domestic resource reallocation determined by the adjustment problems at hand. It has been often observed that if international loans are to be repaid at all its resources have to be allocated to uses compatible with generating equivalent earnings in foreign currency or in tradable goods[58]. In the present case, international loans would have to meet not only these conditions, but they also would be required to do away with the "initial" current account imbalances existent at the onset of the lending episode. Whether undisturbed market forces would be able to observe this intertemporal budget constraint is very debatable from a theoretical standpoint[59]. The relevant issue for our

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that capital inflows into Germany recycled reparations payments reducing the need for real adjustments. *Cf.* C. P. Kindleberger (1984) p. 303.

[58] This point has been repeatedly made in several contexts. It was stressed during the 1930s as a rationale for the widespread defaults of these years, as in Royal Institute of International Affairs (1937) pp. 67-68 *passim* . It was also argued during the 1950s and 1960s when international lending was predominantly project lending under multilateral agencies or direct investments, by H. B. Chennery & A. M. Strout (1966) *passim* for example. And it was again brought by the recent literature bearing on the lending episode of the 1970s and reschedulings of the early 1980s, such as for example in J. Sachs & R. N. Cooper (1985).

[59] It could be argued, for example that an autonomous capital inflows would force an appreciation of the exchanges, or an increased money supply and worse terms of trade, and increased income so as to generate a

purposes is to verify whether the allocation of external resources were compatible not only with repayment but with closing the "structural" trade deficits; this is often what is involved in the issue of whether external resources were put into "productive" uses.

In general the attitude among commentators is to consider the notion of "productive" uses very broadly, but it is often very unclear what those "productive" uses should be. A detailed and authoritative British investigation of 1937, for example, presented the sweeping conclusion that "capital invested in Europe was very largely used for unproductive purposes, it resulted in a rise in the standard of living in the borrowing countries, but did not increase the efficiency of their export industries to an extent sufficient to enable most of them to meet the full service payments on their indebtedness" [60]. Another more recent investigation with an essentially Eastern European focus offered very similar conclusions, arguing that only between 30% to 50% of the public foreign indebtedness employed in that area went to productive uses[61].

A more detailed account of Hungarian indebtedness reports that from the total amount of public and private loans of long term nature raised between 1924 and 1929 around 40% was directly related to interest and amortization of past debt, 15% was devoted to public health, education and building, 25% found use in consumption goods and only 15% would have been used for "productive" purposes[62]. As regards Germany, for example, the performance appeared to be similar: "much of the foreign investment in Germany between 1924 and 1930 was of an unproductive nature, and an even larger proportion was of a kind which added nothing to the available supplies of foreign exchange" [63]. The much-blamed villains have been the loans to provinces and municipalities[64], which together with the typically "unproductive" stabilization loans such

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trade deficit thus effecting the "transfer" of the external resources in terms of goods. This argument can be clearly associated with the earlier work on the transfer problem, as in F. Machlup (1976) pp. 396-432 for example, and it is very interesting to observe that such mechanism seems not compatible with the idea that autonomous capital inflows should correspond to discounted future trade surpluses, the basic assumption for repayable international loans.

[60] Royal Institute of International Affairs (1937) p. 279.

[61] V. N. Bandera (1964) p. 66. The author obtained these numbers by excluding from the total state debt the values correspondent to stabilization loans and war and relief debts, and including short term credits. According to this method it is estimated for example that around 90% of Hungarian state loans contracted after the war and about half of the Polish state loans would have been "productive", *ibid.* p. 67, what is a clearly an overly optimistic account.

[62] I. T. Berend & G. Ránki (1979) p.134 and (1974a) p. 230.

[63] Royal Institute of International Affairs (1937) p. 235 and also C. R. S. Harris (1935) pp. 4-5.

[64] C. R. S. Harris (1935) p. 5.

as the Dawes and the Young loans represented nearly half of all Germany's postwar indebtedness[65].

The failure of the experiment of international stabilization, and of the spurt of international lending it entailed, could be otherwise attested by the strains observed after 1929 and the defaults and moratoria that followed[66]. It is true that the collapses of the early 1930s might not be entirely attributed to ill directed lending, for lending could have been self-liquidating but in a longer horizon. But it seems out of question that lending was effectively misallocated and the prototypical stabilization policies greatly increased external vulnerability. In sum, the overemphasis on "sound finance", a *laissez faire* approach to the more fundamental problems faced by many European economies and ill directed lending ruined the experiment of international stabilization in the 1920s.

2.4) *Contraponto:* Stabilization loans after World War II

The comparison between the strategies of reconstruction and stabilization following the two World Wars is quite revealing especially if one notes that the outcomes - the Depression and the long prosperity of the 1950s and 1960s - differ very sharply. The list of contrasts between these two experiences is so very extensive and so very illuminating, and it is certainly worth exploring it at some length for the remainder of this chapter.

The first observation about the aftermath of the Second World War, is that, much in contrast with the events after 1918, it was a *planned* outcome for which the concern about avoiding the mistakes of the 1920s played a major role[67]. Planning for the peace actually started as early back as in 1941 with the Atlantic Charter, and already in the spring of 1943 two comprehensive plans of international monetary stabilization, the Keynes and the White plans, had been given to public opinion. Both plans were highly innovative with respect to the practices of the 1920s, since both conceived an

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[65] Royal Institute of International Affairs (1937) p. 237.

[66] Considering only the dollar issues of governments, provinces and cities in 1933 the total debt outstanding for Austria, Hungary and Germany summed to 53.4 million, 80.5 million and 524.4 million dollars respectively and the amounts of interest and sinking fund in arrears summed up to 4.8 million, 7.4 million and 16.7 million respectively. Poland did not have arrears at this point but would a little later in 1936. *Cf.* M. Winkler (1933) pp. 182-197.

international mechanism to accommodate balance of payments difficulties, including provisions for international liquidity and rules for adjustment, which on one hand was independent from the private international banking establishment and on the other carried an explicit concern with the maintenance of high levels of employment[68]. Indeed, the attitudes and policy assumptions of those involved in postwar planning during the 1940s in both sides of the Atlantic contrasted very sharply with those of the 1920s. On the American side, for example, financial planning was mostly conducted by the Treasury Department under a distinguishing New Deal philosophy. Henry Morgenthau and Harry White, the dominant figures at the Treasury, "were not believers in *laissez faire* - as argued by a historian, they shared the beliefs of most New Deal planners that government had an important responsibility for the successful direction of economic life. To some extent they were under the influence of Keynesian economics ... In their view the events of the 1920s and early 1930s had discredited private finance. They considered government control of financial policy the key to the objective of high employment and economic welfare"[69]. Apart from that the swing of public opinion had been remarkable. Though the old isolationism was still present it was much less influential as regards issues as the White plan, the British loan and the Marshall Plan than the opposition of the financial orthodoxy, notably from the New York financial community[70].

On the British side it is essential to observe that the dominant figure as regards international financial planning was perhaps the sharpest and most qualified critic of the attitudes and modes of thought of the 1920s, especially as regards the notion of the unrestricted sacrifice of domestic levels of employment on the altar of the gold standard. Apart from that John Maynard Keynes had been responsible for a still ongoing revolution

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67 R. N. Gardner (1969) pp. 4, 76 *passim* , E. F. Penrose(1953) p. 217 *passim* and J. H. Williams (1947).

68 The new institutions could obviously be managed according to "sound banking principles" and in this case we would not have much change with respect to the 1920s. Indeed, a few years later, the experience of stabilization programs under the Fund's supervision would clearly indicate that the passing of the keynesian momentum was quicker than one would expect. Already in the 1960s, and consistently later on, the Fund was prescribing good old sound orthodox programs all over the world. As regards the late 1940s however the distinguishing feature seemed to have been the attitudes of postwar planners.

69 R. N. Gardner (1969) p. 76. It is curious that while during the 1920s much attention had been given to the shift of financial leadership from London to New York, at this point Morgenthau aimed much higher, namely "to move the financial center of the world from London and Wall Street to the US Treasury and to create a new concept between nations in international finance *", idem, ibid.* See also F. L. Block (1977) pp. 38-40.

70 R. N. Gardner (1969) pp. 74, 129 *passim* and F. L. Block (1977) pp. 34, 52-54. See also C. S. Maier (1981) p. 341.

in economic ideas, which had had a devastating effect over the standing of orthodox or "classical" economists[71]. As regards public opinion, the obstinate concern about full employment, about the ability to insulate from adverse developments abroad and the strong recriminations against the gold standard and its champions, all of which revealing the influence of Keynes in some degree, marked an extraordinary contrast with British attitudes during the 1920s[72]. It is true, however, that, according to a participant's account, "political expediency" resulted often more relevant than the advice of professional economists [73]. But let us not forget, however, the maybe not yet classical remarks that "madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribber of a few years back" [74]. This was extraordinarily true at this juncture, when the principal of these "voices" was not only still alive but very intensively participating in postwar planning.

It is significant that both the Keynes and the White plans clearly distinguished a problem of monetary stabilization and a longer term problem of reconstruction and recovery[75], which came to be later embodied in the division of labor between the Fund and the Bank, again in sharp contrast with the 1920s when the later problem if not wholly ignored was not properly considered. But on their way to compromise the plans merged into a much more conservative being the new institutions having their role considerably reduced during what was called the "transitional" phase, the period between the end of the "relief" phase and the moment in which a peacetime "equilibrium" would be restored[76]. These developments elicited thoughts that "the early promise of postwar planning was not fulfilled" [77], but the feeling would be short-lived, as an unprecedented program of stabilization, aid and investment, the Marshall Plan, would fill the gap.

The contrasts between the Marshall Plan and the "uncoordinated and piecemeal" stabilizations of the 1920s start with the fact it was a coordinated effort, to the extent it joined 17 countries into one organization, the CEEC (Committee of European Economic

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[71] Such as, for example, his fellow Cambridge professor A. C. Pigou, a member of the Cunliffe Committee and of the group of experts reporting in the Brussels conference.
[72] R. N. Gardner (1969) pp. 98, 122 *passim*.
[73] Though professional economists "played an immensely greater role in the affairs of the state than ever before". *Cf.* E. F. Penrose (1953) p. 362.
[74] J. M. Keynes (1936) p. 383.
[75] R. N. Gardner (1969) p. 75 and E. F. Penrose (1953) p. 348.
[76] F. L. Block (1977) pp. 47-55, R. N. Gardner (1969) p. and E. F. Penrose (1953) pp. 181-182, 352.

Cooperation, later the OECD), which in view of specific needs and problems of each member country and the overall compatibility of these demands and projects, presented a consolidated program to the US government calling for some US$ 29.2 billion in four years as aid and proposing the allocation of such funds [78].

The Plan's priorities contemplated principally an effort to restore quickly pre-war levels of production and growth and an attempt to solve Europe's dramatic dollar deficit, primarily through the expansion of exports. In addition to that the Plan also sought to foster economic cooperation and integration in Europe and the "creation and maintenance of financial stability" [79]. Most essentially however the Plan's conception revealed a gigantic adjustment program whose most distinguishing feature was that it was "primarily a program of investment" [80]. The allocation of funds should obey a strict "project procedure" oriented towards the investment projects proposed by the individual countries through the CEEC, and most significantly the Plan's administrators explicitly stated the "local currency counterpart releases for investment were to be maximized; for general financial purposes, minimized" [81], an astonishing contrast keenly noted by Austrian historian Edward Marz[82], with the stabilization plans of the 1920s.

There has been strict conditionality but little tension as regards the allocation of funds, as after all the projects had been proposed by the European themselves; the only point of friction was related to commercial policy and European integration [83]. Some more noticeable tensions had arisen between the plan's priorities on industrial investment and the need to maintain inflations under control, but though inflation had been high in some countries it resulted not to be a major concern at least until the start of the Korean war[84]. Even in the presence of inflation, "sound finance" has not been a priority, not only

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[77] E. F. Penrose (1953) p. 357.

[78] As an illustration it is interesting to note that total governmental loans outstanding in 1946 summed US$ 14.5 billion including the British Loan of US$ 3.7 billion, Eximbank loans, lend-lease credits and many other types of loans. The US alone was responsible for approximately US$ 9.0 billion, the rest being provided mostly by Canada, UK, Sweden, Argentina and Switzerland. It is revealing that the corresponding total for intergovernmental loans in 1919-1920, when the price level was nearly the same as of 1946, was of only US$ 3.8 billion, *cf.* M. A. Kriz (1947) pp. 2, 13, though it should be observed that the level of world trade in 1946 was some 40% greater than its 1919-1920 levels.

[79] H. B. Price (1955) p. 37.

[80] *Ibid.* p. 116.

[81] *Ibid.* pp. 116, 316 *passim.*

[82] E. Marz (1982) p. 190 . This was also observed by G. Harberler (1982) p. 62.

[83] H. B. Price (1955) p. 315.

[84] *Ibid.* pp. 152-154.

in view of the fact that the Plan's administrators believed that inflation could be kept under control by a "high degree of planning of investment decisions[85], but also in view of the Keynesianism of the times, the concern about full employment and some skepticism about the old recipes. Quite significantly finance was hardly a theme in these years while it was the issue during the 1920s.

A further contrast to be mentioned is the handling of the reparations issue. The experience of the 1920s loomed large and was certainly a moderating influence; yet problems in this regard would be created by the Soviets, whose demands on account of reparations were described as "more curbed than those advanced by the Versailles victors under less aggravating circumstances" [86]. The East-West antagonism would play a major role in this issue for it led the Allies towards a strategy of reviving Germany, instead of a proposed "pastoralization", and it would also produce moderation as regards reparations. Germany would eventually pay yearly sums that averaged 0.72% of national income and 3.1% of exports during 1953-1965; Japan and Italy would be assigned similar burdens [87]. These payments represented very light burdens to these countries especially if compared with the sums paid in the 1920s. It was even argued that these reparations payments have had a positive impact to the international economy for the recipients were small or underdeveloped countries for which these payments were very significant. During 1953-1965, for example, German reparations payments to Israel represented an annual average of 12.8% of Israeli national income (27.1% of imports). Italian reparations represented between 0.4% and 2.6% of national income (1.4% to 7.5% of imports) every year for Ethiopia , Greece and Yugoslavia and Japanese payments contributed with 0.1% and 1.3% of national income (0.6% to 7.8% of imports) for seven Asian countries[88]

2.5) Conclusions

This chapter aimed at providing the historical context within which the stabilizations of the 1920s should be seen. In this respect we discussed the assumptions

[85] F. L. Block (1977) p. 91.
[86] M. Gottlieb (1950) p. 26.
[87] B. J. Cohen (1967) pp. 285-287.
[88] *Ibid.* p. 288.

and attitudes held by the authorities of the time and their evolution from the concepts developed in connection with the pre-war gold standard. The dominating attitude towards these problems in the core economies was essentially *a laissez faire* one: it seemed that by maintaining finances on a "sound basis" the imbalances to be found especially in the “new” countries of Central Europe would eventually be resolved. Yet, foreign capital should have to play a key role in this respect for it would have to be put to uses not only compatible with its own repayment but also to remedy the original imbalances. The whole experience with international lending in the 1920s seems to indicate that nothing of this sort effectively took place. The outcome of this lending episode was disastrous and this further reinforces the contrast we discussed between reconstruction in the 1920s and following the World War II.