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Business Under German Inflation

by Ludwig von Mises

Paper money inflation and credit expansion never fall upon a people like an act of God. They are always the outcome of a deliberate policy. The governments and the parties in power take recourse to inflation because they consider it as a blessing or at least a minor evil when compared with the effects either of cutting down public expenditure or of choosing other methods of financing. This applies to both peace and to war. Inflation as such does not contribute anything to winning battles. It does not produce arms and other equipment. It is merely one of the methods available for financing the huge expenditure caused by war. The other methods are taxation and borrowing from the public (and not from the commercial banks). If a government prefers inflation, it must not plead as an excuse that there was no other way left.

Of course, the term inflation has fallen into disrepute. All governments and all political parties emphatically announce that their main concern is to fight this dreadful thing called inflation. In fact they are not fighting inflation, but only its symptoms and necessary consequences, namely the rise in prices. And this struggle is doomed to failure precisely because it is merely a tampering with symptoms. Nothing is done to end the root cause, i.e., the increase in the quantity of money and the expansion of credit.

The truth is that the propensity to inflate is nowadays greater than it ever was before. It is only that the advocates of inflation and credit expansion have resorted to new terminology. They call the thing expansionism, an easy money policy, unbalanced budgets, or functional finance. The British paper which inaugurated in 1943 the action which resulted in 1944 in the Bretton Woods agreement explicitly declares that the aim of the new international institution is to bring about "an expansionist pressure on world trade." It expects that this expansionist policy will perform "the miracle . . . of turning a stone into bread."

The idea that monetary and credit expansion make business good, create "full employment," and bring general prosperity was the essence of the ideas of Mercantilism. The fallacies implied were utterly exploded by the economists whom the Prussian Historical School and their modern followers, Keynesians and the American advocates of unbalanced budgets, disparage as orthodox. A new systematic analysis and thorough refutation of the defects of the doctrine of expansionism certainly is not needed. Those interested in such a critical examination are referred to the writings of Professor B. M. Anderson, of the late Professor Edwin Kemmerer,[1] and of many other brilliant American economists. The goal of this article is

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Ludwig von Mises (1881–1973) was the foremost Austrian economist of the twentieth century, an adviser to FEE, and the author of Human Action. *This is the major part of an article originally published in the* Commercial and Financial Chronicle, *March 7, 1946.*

A 20,000,000 mark (August 1923)

merely to stress an aspect of the problems involved which is often neglected. It seems expedient to exemplify the issue with the case of the German inflation of 1914–1923, the classical expansionist experience of our century.

A Mark Is Always a Mark

Among the gravediggers of the German people's prosperity and the German currency, Friedrich Bendixen occupies an eminent place. He was a bank manager and the author of many books and articles dealing with monetary matters. His prestige and his influence on the course of the Reich's financial policy were enormous.

When in the first World War the mark's purchasing power declined and concomitantly foreign exchange rates went up, Bendixen trumpeted that this was a rather fortunate event. For, he said, it made it possible for the Germans to sell their holdings of foreign securities at a profit.

Let us consider an example. A German owned on the eve of the war a Dutch security which was traded on the bourse of Amsterdam at 100 guilders, at that time by and large the equivalent of 240 marks. The price of the stock dropped and the German sold it at 90 guilders. This involved in gold a loss of 10 percent. But in the meantime the price of the guilder in Berlin had risen from 2.40 to 3 marks; 90 guilders represented now 270 marks. The German capitalist made in marks an apparent gain of 30 marks or 12.5 percent. However, the average Germans and their spokesman Bendixen were not shrewd enough to see things in the right light. With them a mark was still a mark. They smilingly pocketed an alleged gain.

The same phenomenon presented itself in every branch of international economic relations. The champions of expansionism assign to rising foreign exchange rates the power of stimulating export trade. It was this idea that impelled many European countries in the inter-war period to devalue their domestic currencies.

Such a devaluation at one stroke makes foreign exchange rates rise. But domestic commodity prices and wage-rates lag for some time behind the rise in foreign exchange rates. In the interval, before the price structure on the domestic market becomes adjusted to the new state of monetary conditions, some export projects, which were unprofitable before, appear seemingly profitable. The exporter makes an apparent profit—in domestic currency—although he may sell at a lower price in foreign currency. But what really goes on is that he gives the domestic products away at a price which enables him only to buy a smaller quantity of foreign products. It is true, the nation whose currency has been devalued exports more during this interval, but it gets in exchange only less or, at least, not more than previously for a smaller quantity exported.

This is what the economists have in mind when speaking of "apparent" gains. These gains are the result of false reckoning and self-deception.

The Huge Inflationary Profits of Business

It is asserted again and again that German business flourished in the years of the great inflation. In fact, the annual reports of the big German corporations and the big German banks showed fat profits, and high dividends went to the stockholders. (The German banks were not merely banks, but at the same time holding companies owning a controlling part of the common stock of many manufacturing corporations.)

However, these gains were often apparent only, a mere product of the fact that the businessman's economic calculation employed the mark as a common denominator. When translated into a less fluctuating foreign currency, for instance, into dollars, they revealed themselves frequently as losses.

It did not matter for German business whether prices in gold and in dollars were rising or falling. Prices in marks were rising whatever the movement of prices on the world market was. The sale of the products and inventories netted big paper profits because prices in marks were soaring ceaselessly.

A second source of paper profits was provided by insufficient writing off of depreciation. The goal of laying aside a portion of the annual earnings in a depreciation fund is to provide the means for the replacement of industrial equipment worn out in the process of production. Failure to provide such funds adequately makes the profits appear larger than they really are. If such apparent surplus profits are dealt with as if they were real profits, the result is capital consumption. As German business was slow in discarding the old custom of writing off annually a fixed percentage of the original costs of equipment, it virtually reduced the amount of capital invested.

With the rapid progress of inflation more and more businessmen began to comprehend that their methods were suicidal. They started what was called "the flight into real values" (*Flucht in die Sachwerte*). They began to reinvest the apparent profits in their plants. It did not matter for them whether these investments were reasonable or not. Their only concern was to get away from the mark at any cost. Later events have evidenced that a great part of the investments made in the years of the inflation by the German banks and the independent business concerns were malinvestments. German business emerged from the trial of the inflation period financially weakened. The big German banks were already in 1924 on the verge of insolvency.

Of course, the Germans, steeped in the monetary fallacies of Bendixen and Knapp,[2] were not aware of this fact. Neither were the foreign bankers and investors shrewd enough to judge correctly the plight of the German big banks and of many of the big German business concerns. In the twenties foreign loans to the Reich, the member states, the municipalities and to the banks and big business amounted to about 20 billion Reichsmarks. Besides, foreigners invested $5 billions directly in German business. This huge inflow—against which reparation payments of about $10.8 billions had to be held—disguised for a few years the frailty of the big banks. When the depression ended foreign lending to Germany, the collapse of the banks could no longer be delayed. It occurred in 1931 as the payoff both of inflation and of ignorance of fundamental economic issues.

> The belief that a sound monetary system can once again be attained without making substantial changes in economic policy is a serious error. What is needed first and foremost is to renounce all inflationist fallacies. This renunciation cannot last, however, if it is not firmly grounded on a full and complete divorce of ideology from all imperialist, militarist, protectionist, statist, and socialist ideas.
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> —LUDWIG VON MISES
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> "Stabilization of the Monetary Unit—From the Viewpoint of Theory" (1923), reprinted in *On the Manipulation of Money and Credit*

One of the reasons why public opinion misconstrued the economic consequences of the German inflation was the emergence of a class of inflation profiteers.

The profiteers were those speculators who were quicker to realize the true meaning of the inflationary boom than were the managers of the banks. The interest rates charged by the banks, although high when compared with normal conditions, were ridiculously low when compared with the stock exchange profits a speculator could earn on a market at which prices skyrocketed on account of the inflation. No matter what stock he bought, the speculator netted a gross profit which exceeded by far the interest he had to pay to the lending bank. As long as the inflation went on there was no risk for him in embarking upon bull transactions with borrowed money.

Germany Financially Wrecked by the Inflation

The inflation favored the debtors at the expense of the creditors. It made a very small group of smart speculators rich. It impoverished the immense majority of the nation.

The losses of the losers by far surpassed the total amount of the gains of the profiteers. The per capita wealth of the Germans was reduced, in spite of the fact that they had succeeded in unloading a part of their losses on the shoulders of foreign capitalists, especially American and Swiss.

The excess of inflation losses over inflation gains stemmed from three different sources:

The nation consumed more than it produced: it lived on its capital. The greater part of the apparent profits was eaten up either by the speculators and businessmen themselves or by the Government which collected under the misleading label of income and corporate taxes funds which were in fact taken away from the capital invested. The wastefulness of municipal administration was so outrageous that even Schacht[3] could not help criticizing it. Many labor unions succeeded in raising nominal wage rates above the rise in commodity prices. They booked the resulting rise in real wage rates as "social gains." In fact, these workers shared in the capital consumption. They thus contributed to a later fall in the productivity of labor and thereby of market wage rates.

Germany dumped cheap exports on the world market. It happened again and again that German manufactures, produced out of imported raw material, were exported at prices which—when calculated in dollars—did not even cover the price of the raw materials contained. Yet, the German exporter was convinced that he had made a good deal.

A great many of the investments made during the critical years were malinvestments. . . . □

1. See Benjamin M. Anderson, *Economics and the Public Welfare: A Financial and Economic History of the United States, 1914–1946* (Princeton: D. Van Nostrand Company, Inc., 1949) and Edwin W. Kemmerer, *The ABC of Inflation* (New York: McGraw-Hill, 1942).

2. Georg Friedrich Knapp, author of *The State Theory of Money* (1924 [1905]).

3. Hjalmar Horace Greeley Schacht, German financier who held a number of positions in German government, 1923–1943, including president of the Reichsbank and minister of economy.