The Great German Inflation

I

All the misfortunes from which Europe has suffered in the last two decades have been the inevitable result of the application of the theories which have dominated the social and economic philosophy of the last fifty years. Our troubles are the upshot of much laborious thought. The German inflation, above all, was the outcome of the monetary and banking theory which for many years had obsessed the men who occupied the chairs of economics at the Universities, the men who governed the financial policy of the Reich, and the editors of the most influential newspaper and periodicals.

The central feature of these erroneous theories was a total rejection of the Quantity Theory¹ and of all the teachings of the Currency School.² The empirisch-realistiche Volkswirt,³ who distrusted every “theory”—especially theories imported from abroad—was firmly convinced that both the Quantity Theory and the Theories of the Currency School were nothing but an inexplicable blunder committed

¹[The Quantity Theory says that the general price level is primarily a function of the money supply—Ed.]
²[As Mises understood it both the British Currency School and the British Banking School, broadly speaking, were advocates of central banking. The Currency School, however, advocated rules for the expansion of money and credit with some theorists even favoring 100% specie reserves. The Banking School advocated a discretionary central banking policy with few or no rules concerning money and credit expansion—Ed.]
³[Translated as empiricist-relativist political economist—Ed.]
by Ricardo and his followers. The German *Kathedersozialisten* \(^4\) did not waste their time on the study of English political economy. Hence they were unaware of the problems which were the subject of the long-lasting controversy between the Banking School and the Currency School. The only source of their knowledge of the matter was the book published in 1862 by Adolph Wagner under the title *Theorie der Peel’schen Bankakte*. Wagner lacked absolutely the gift of economic ratiocination. He accepted without any criticism all the statements of the Banking School; from his book it was utterly impossible to gather what objections the Currency School had had against the theories of the Banking School.

The other leading authority on monetary and banking problems, Wilhelm Lexis, was still less endowed with the power of economic reasoning. He, like Wagner, was entirely innocent of any understanding of the Ricardian theory of the foreign exchanges—the "purchasing power parity" theory. Each firmly believed that the foreign exchanges are governed by the balance of payments.

Hence would-be economists who owed their education to the teachings of such men were prepared to accept without criticism the doctrines of Knapp and Bendixen, who in the years immediately preceding the outbreak of the war dominated German monetary and banking theory. Knapp, Professor of Political Science at the University of Strasburg, was a trained statistician and had devoted much time in archives to the study of Prussian policy concerning the peasantry. There is not the slightest indication in his writings that he had ever glanced at Ricardo or any other of the British monetary economists. The occasional allusions to Ricardo's ideas, which one finds in Knapp's writings, impute to Ricardo opinions which are rather the contrary of what we read in Ricardo's books and pamphlets. Knapp ignored absolutely the problem of prices. In his view the task of monetary theory is nothing else than the purely formal classification of the various kinds of currency. He had not the slightest idea that government interference in the mechanism of price-making is subject to certain conditions which cannot be controlled simply by governmental decree.

Not less fatal for the formation of German views on monetary theory was the influence of Bendixen, the manager of a mortgage corporation, who, inspired by Knapp, wrote some booklets, which

\(^4\) [Members of the "Younger" German Historical School who used their university positions as vehicles to advocate political intervention and reform in the economy. These professors were called "academic socialists" or "socialists of the chair"—Ed.]
expounded the principles of the Banking School. The most striking feature of Bendixen's contribution was that, being unfamiliar with monetary literature, he honestly believed he was enunciating something entirely new!

In passing under review the German monetary and banking policy from the outbreak of the war to the catastrophe of 1923, the most startling thing is the absolute ignorance even of the most elementary principles of monetary science on the part of literally all German statesmen, politicians, bankers, journalists, and would-be economists. It is impossible for any foreigner even to realize how boundless this ignorance was. For this reason, in the last three years of the German inflation, some foreigners came to believe that the Germans ruined their own currency of set purpose in order to involve other countries in their own ruin, and to evade the payment of reparations. Such imputation of secret satanism to German policy does it wrong. The only secret of German policy was Germany's total lack of any acquaintance with economic theory.

Thus Herr Havenstein, the governor of the Reichsbank, honestly believed that the continuous issue of new notes had nothing to do with the rise of commodity prices, wages, and foreign exchanges. This rise he attributed to the machinations of speculators and profiteers and to intrigues on the part of external and internal foes. Such indeed was the general belief. Nobody durst venture to oppose it without incurring the risk of being denounced both as a traitor to his country and as an abettor of profiteering. In the eyes both of the public and of the rulers the only reason why monetary conditions were not healthy was the lamentable indulgence of the government in regard to profiteering. For the restoration of sound currency nothing else seemed to be necessary than a powerful suppression of the egotistic aims of unpatriotic people.

It would be very interesting to show that this attitude was the necessary sequel to the whole system of social and economic philosophy as taught by the school of Schmoller. According to the étatistic outlook of this school, power (Macht) is the deciding factor in social life. That even the most powerful government is not free to do everything, that there exist certain unalterable conditions of human existence insusceptible to the influence of the most powerful intervention, are propositions which it never admitted. The study of economic theory, it said, was useless, for the various systems of theoretical economics all overlooked the fact that governments had the power to alter all conditions. It was ready to admit that the Ricardian system was a faithful description of the state of England
at his time, but it denied its applicability to Germany. In the realm
of the Electors of Brandenburg and the Kings of Prussia everything
was different. It therefore replaced the study of economic theory by
the history of Prussian administration in the academic curriculum.
It taught that there is nothing important in social life but power, and
its notion of power was very materialistic. Power in its eyes was
soldiers and guns. It had never understood Hume's discovery that all
government is founded on opinion.

But to trace this evolution would involve writing the entire history
of the transition of the German mind from the liberal thought of
Goethe, Schiller, and Humboldt to the militarist ideas of Treitschke,
Schmoller, and Houston Stewart Chamberlain. It would involve writ-
ing the history of the Prussian hegemony of the nation which has been
styled the nation of poets and thinkers, and the history of the Reich
founded by Bismarck and lost by Wilhelm II. It is obvious that this
would exceed the purpose of these lines.

II

In these circumstances it is easy to understand that the German
books dealing with the history of the Inflation Period are for the
greater part of little value. They are so full of prejudices, and are often
so entirely lacking in the theoretical insight which must necessarily
precede all historical description that they cannot even give an
adequate picture of the great historical event. For this reason this
work by a learned American is all the more welcome. In his Exchange,
Prices and Production in Hyper-Inflation: Germany, 1920-1923, Pro-
fessor F. D. Graham of Princeton University has taken great pains to
provide a reliable narrative.

In judging this valuable book we must bear in mind that all the
experience of the German inflation brought nothing that could puzzle
the theoretical economist. There were many things which were quite
inexplicable to the étatiste Volkswirt of the Schmoller type, nay, the
whole thing was quite inexplicable to them, but there was nothing
that had not been observed and satisfactorily explained by the theo-
rlist in previous inflations.

In reading Professor Graham's historical survey even those who
were witnesses of the inflation must again and again be amazed at
the incredible incapacity evinced in regard to the monetary problem
by all sections of the German nation. For the economist the most

5[Translated as a political economist who advocates total control of all economic
planning as a function of the government—Ed.]
astonishing fact is the inadequacy of the Reichsbank’s discount policy. This is Professor Graham’s verdict: “From the early days of the war till the end of June 1922 the Reichsbank rate remained unchanged at 4 per cent.; it was raised to 6 per cent. in July, to 7 per cent. in August, 8 per cent. in September and 10 per cent. in November 1922, to 12 per cent. in January 1923, 19 per cent. in April, 30 per cent. in August and 90 per cent. in September. But these increases were as nothing when measured alongside the progressive lightening in the burden of a loan during the time for which it ran. Though, after September 1923, a bank or private individual had to pay at the rate of 900 per cent. per annum for a loan from the Reichsbank, this was no deterrent to borrowing. It would have been profitable to pay a so-called interest, in reality an insurance, charge, of thousands or even millions of per cents. per annum, since the money in which the loan would be repaid was depreciating at a speed which would have left even rates like these far in the rear. With a 900 per cent. interest rate in September 1923 the Reichsbank was practically giving money away and the same is true of the lower rates in the preceding months when the course of depreciation was not quite so headlong. The policy of the Reichsbank authorities in encouraging the discount of commercial bills that they might thus mitigate the scarcity of credit was but further evidence of the Alice-in-Wonderland determination of the directors of that institution to run ever faster in order to keep up with themselves. The scarcity of credit was due solely to currency depreciation and the cure prescribed was to increase the volume of means of payment!”

But one should not forget that the Reichsbank was not alone in this folly. The private banks, too, lent money to every speculator who furnished collateral security. It was very easy to get rich by buying shares with the money borrowed from the banks. In this way some acquired big fortunes in a very short time and painlessly. Since then all these much-admired and envied profiteers have lost all that they won, and in many cases even much more—a proof that they were not gifted with great business ability. Indeed, no great business ability was needed to outwit any one of the big German banks. That their managers and directors were really incompetent has been proved by the subsequent failure of the institutions which they governed.

It took years for German business men to understand that the mark was no longer a suitable unit for economic calculations. For a very long time they really believed that the profits, which an account

\[6\text{Cf. p. 65 of Graham’s book.}\]
of profit and loss reckoned in Marks showed, were genuine earnings. They did not understand that a computation made in a more stable currency would lead to quite a different result. Of course the business men discovered this truth somewhat earlier than the general public. They then replaced the Markrechnung by the Goldrechnung. This was the beginning of the end. The Mark-currency had perforce to break down when its unrestrainable depreciation could no longer be overlooked.

As long as the inflation was working, socialist labor leaders and the socialists of the chair were all in its favor and taught that not the increase in quantity of money but the unpatriotic behavior of the profiteers was the cause of the depreciation of the Mark. After inflation was over they changed their minds. Now they accuse the "capitalists" of having of set purpose made the inflation to enrich themselves. For the German public mind every misfortune is due to the machinations of the "exploiter class."

III

For the economist the German inflation brought some interesting illustrations of his theoretical principles, but no experience which did not conform to them. In this instance monetary and economic theory had nothing new to learn. Of course, the German politico-economic science of the Schmoller-Knapp type had everything to learn from it. But in fact, with the exception of some of the younger men, they have declined to draw the conclusion. Unreachable as they are, they still believe in the theory which attributes changes in the value of a national currency to variations in the national balance of payments. The failure of the policy of inflation they attribute to lack of energy on the part of the government and to lack of patriotism on the part of the people.

Nor has the German politician learned a whit more from the inflation. The government and the Reichsbank both believe that monetary troubles arise from an unfavorable balance of payments, from speculation and from unpatriotic behavior of the capitalist class. They therefore attempt to fight the menace of depreciation of the Reichsmark by controlling dealings in foreign currency and by confiscating German holdings of foreign assets. They do not understand that the only safeguard against the fall of a currency's value is a policy of rigid restriction. But though the government and the professors have learned nothing, the people have. When the war inflation came nobody in Germany understood what a change in the value of the
money unit meant. The business-man and the worker both believed that a rising income in Marks was a real rise of income. They continued to reckon in Marks without any regard to its falling value. The rise of commodity prices they attributed to the scarcity of goods due to the blockade. When the government issued additional notes it could buy with these notes commodities and pay salaries because there was a time lag between this issue and the corresponding rise of prices. The public was ready to accept notes and to keep them because they had not yet realized that they were constantly losing purchasing power. This went on for years. But as they learned that the government was determined not to stop with the further issue of notes and that the increase of their quantity must needs lead to a progressive rise of prices their conduct changed. Everybody became anxious not to keep the money in his pocket. The service which money renders consists in its being the commodity which is saleable at the best terms. By keeping money in his purse everybody is enabled to buy in the most convenient way any commodity he may want one day. But when money loses purchasing power from day to day its retention involves a loss. Whoever gets money, therefore, spends it immediately—even by buying something for which he has no present use and maybe even no future use. In the last days of the inflation the employees got their payment daily. At once they handed it over to their wives and these hurried to spend it as quickly as possible by buying at any rate something or other. Nobody wished to retain money, everybody dropped it like a live coal. When this tendency, which on the Stock Exchange was called Flucht in die Sachwerte—flight into investments in goods—became general, so that even the least business-like people adopted it, the end was at hand. The Mark broke down. The government gained no further advantage by issuing notes because the depreciation then outran the increase.

A nation which has experienced inflation till its final breakdown will not submit to a second experiment of this type until the memory of the previous one has faded. No German government could succeed in the attempt to inflate the currency by issues in favor of the Treasury as long as the men and women are still alive who have been the witnesses and victims of the 1923 inflation. Made overcautious by what they suffered, at the very outset of the inflation they would start a panic. The rise of prices would be out of all proportion to the increase in the quantity of paper money; it would anticipate the expected increase of notes. The more money the government issued, the less it would be able to buy. The higher the salaries the civil servants and the soldiers drew, the less goods would they be able to
purchase. So the government would fail in the endeavor to ameliorate its financial position by issuing notes. From the point of view of officialdom, inflation would be nugatory.

The economist might urge that this lesson could have been learned at a lower cost from theory than from experience. Had the German people paid more attention to the teachings of economic theory they could have learned all these things without having to pay so dearly. This is a melancholy comment to have to make after the event.

But in any case the monetary history of the last three lustrums in Germany and many other European countries proves that no nation can afford to treat economic theory with contempt.