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The Economic Consequences of the War and the Peace

PATRICIA CLAVIN

In 1917, the maverick American economist Thorstein Veblen captured the way in which societies’ expectations had changed as a result of World War I. “Peace,” he claimed, was no longer understood as a “space of time in which to prepare for war.” Instead, among democratic nations it had “come to stand in the common estimation as the normal and stable manner of life, good and commendable in its own right.” Veblen’s reflections in his book *An Inquiry into The Nature of Peace and the Terms for Its Perpetuation* were the result of his work for President Woodrow Wilson on the terms of a possible peace settlement. Striking a resoundingly contemporary note, Veblen suggested that peace was not absolute but “a relative matter, a matter of more or less.”

Central to these new expectations of what peace after a worldwide conflict would bring was the reshaping of the relationship between the state and society in the domain of economic policy. The scale and duration of the war had forced states across Europe to demand new sacrifices of its peoples. To secure that allegiance, governments, in return, had to expand their obligations to their citizens or subjects, and make the changes to their political systems that such promises implied. This process extended the democratic franchise across European nation-states—although not into European empires—in unprecedented ways. A fundamental change was that enfranchisement was no longer linked to the ownership of property. After the war, for the first time governments emerged in Europe that were dominated by members of working-class or peasant parties.

This new political power of the laboring classes underlined what was new about the political economy in the twentieth century: Government was now held directly responsible for maintaining a continuing level of economic activity, and political legitimacy was increasingly dependent on the ability to manage the domestic economy to the collective advantage of the electorate—an imperative that would increase the appeal of protectionism. When it came to economic policy, governments were becoming, as Veblen put it, “pugnaciously national.”

This nationalism would have important consequences for how governments around the world coped with the economic effects of World War I. The consequences were not confined to the war’s participants. Nonbelligerent Spain, for example, saw food and industrial exports rise markedly, especially citrus fruits and steel products from cities in the province of Valencia. Its gold imports rose and the national debt fell throughout the war. When the boom ended, however, civil unrest was widespread, helping to light the slow-burning fuse that exploded in civil war.

NO GUARANTEES

The modern, globalized economy had emerged with vigor and reach in the nineteenth century, but was no more a guarantor of domestic or world peace after 1918 than it had been in 1914. Britain, France, Italy, and Russia together had been Germany’s best customers, accounting for more than 36 percent of German trade in 1913. Across Europe, the decision to go to war in 1914 was made largely by a handful of people at the top of the respective political systems. It was war

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not by default but by design, and those who drew the plans were relatively realistic about the scale, character, likely duration, and eventual outcome. But commercial interests did not sway the men who took the world to war.

In 1914, businessmen and financiers everywhere were against the war, but no one in power paid much attention to their views. The general public, whose man- and woman-power was now harnessed to the cause of "total war," was taken by surprise. Public opinion was managed, not sought, to reinforce decisions already made by belligerent governments. As early as 1899, Ivan Bloch, a Polish banker and railway financier turned strategic analyst, had predicted that "the future of war is not fighting but famine, the bankruptcy of nations, and the breakup of the whole of social organizations." Like the best-selling British peace activist Norman Angell, Bloch claimed that the world's obvious economic interdependencies were in themselves a guarantee of peace.

If Bloch was wrong about that, he was right about the importance of the political economy. Although the effects of the British naval blockade on Germany drew a great deal of attention, what really damaged the German economy was its belligerence toward its major trading partners. In 1914, food imports counted for around 20-25 percent of the German population's calorific needs, while they constituted more than 60 percent of what the British people ate.

Difficult choices about how to pay for the war were postponed until it was won—or lost.

Britain's economic and financial relationships with its empire, the United States, and Latin American states were reinforced by its political relationships in a variety of alliances and guarantees. The British Empire system helped Britain win the war. Germany, by contrast, had fewer economic and financial ties with its allies in 1914 than with its enemies. It was the loss of former trading partners, more than the Allied naval blockade, which limited Germany's access to food and other essential commodities and proved disastrous for its war effort.

NEW SECURITY

The defeat of the Central Powers underlined the significance of food as a weapon of war. Adequate, reliable, and affordable food supplies shaped military and political outcomes everywhere. World War I showed how the meaning of security had evolved, starting in the latter half of the nineteenth century. It no longer meant simply protecting people and property against the threat of violence with the assertion of territorial control. Security was now related to the stability of the capitalist order and to the "intactness" of the human body, defined in biological and sometimes racial terms.

Adolf Hitler's *Weltanschauung* was among the most radical versions of this reshaping of security in the 1920s, a vision strongly influenced by his personal experience and understanding of the war, in which he served as a corporal. He declared himself a *Raumpolitiker*, a "spatial politician." His vision for security comprised a crude mix of biological and socioeconomic concerns positioned in relation to territorial control. It stood in contrast to the perspective of men of fixed horizons whom Hitler dismissed as mere *Grenzpolitiker* (border politicians).

First among them was the French Prime Minister Georges Clemenceau, *le Père de la Victoire* (the Father of Victory), who never tired of declaring that he believed, above all, in well-secured borders, and in having readily available and sufficient weapons, as well as trained soldiers, sailors, and—increasingly—airmen, to defend them. As the world succumbed to economic and diplomatic disorder after 1929, Hitler's vision of racially motivated command capitalism appeared to many to be a convincing, coherent, and effective answer to the crisis of German security.

INVISIBLE COSTS

But in 1918, most states and democratic political parties had yet to appreciate fully how the war had altered their relations with the electorate, in ways that also had big implications for relations among regimes on the international stage. Although major states during the war had become more involved in economic management than ever before, once peace came, governments withdrew to allow market forces heal the battered economies. The problems of such an approach were immediately laid bare by the destructive impact of rapidly rising inflation, unleashed by the war and exacerbated by the challenges of reconstruction.

Paradoxically, it was easier to recover from the visible costs of the war—the unprecedented number of deaths and casualties—than the invisible costs. These were the shifting patterns of trade that hit the European war zone hard, and, most important of all, the financial price of the war. Historians now put the number of war dead at between 9.4 and 11 million people, a figure that amounted to over one percent of Europe's population in 1913. On average, 5,600 men died every day the war continued, and injured soldiers returned home with some of the worst wounds ever seen. Approximately 755,000 British men and 1,537,000 German soldiers, for example, were permanently disabled in the war, and throughout Europe the care of disabled veterans posed important questions for the state and society. These losses had a dramatic impact on the supply of labor: France and Germany both lost around 10 percent of their male workforce; Austria-Hungary and Italy, over 6 percent; and Britain, around 5 percent.

The damage to infrastructure was more localized. Northern France was the hardest hit, and in the country as a whole, some 15,000 square kilometers were laid waste. Damage to French municipal, private, and industrial buildings amounted to $17 billion, the lion's share of a world loss of nearly $30 billion (nearly $500 billion in 2014 dollars). Much of the remaining physical damage was centered in western Russia, Poland, and Belgium.

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HISTORY IN THE MAKING 100 years 1914 - 2014

"The victor may secure indemnity for part of the loss, but not for all; he will, in spite of himself, be a net loser. Taxes will be a crushing burden, merely to secure funds with which to pay high interest on vast new war debts, to say nothing of funds with which to purchase new armaments—if again the nations are forced, by lack of international control, to resume the stupendous folly of racing each other in military equipments."

Irving Fisher
"What the Economic Effects May Be"
January 1915

Since these losses were geographically concentrated, it proved easier for Europe as a whole to recover from them than from the dislocation of its international trade and financial base. For Japan and the United States, Europe's preoccupation with the war, coupled with their own limited involvement, presented an unrivaled opportunity to supply the war-torn continent. Both countries' exports to Europe trebled during the war.

Just as importantly, the war enabled them to penetrate markets previously dominated by Europe's leading powers. US exports to Latin America rose by more than 75 percent in 1916; Japan expanded its volume of textile exports to the United States and China markedly, and, for the first time, exported textiles to Britain, the country that had previously led the world in mass-produced fabrics. As a result, tariffs and quota systems, employed on an unprecedented level during the war, were never abolished, despite the lofty aspirations to global free trade expressed in Wilson's Fourteen Points and in the Covenant of the League of Nations. Instead, after 1920 the protection barriers began to creep up once more.

Death and taxes

In the war of attrition that came to be a war of exhaustion, the most problematic legacy would be its financial costs. These turned out to be enormous. Belligerent states in Europe were forced to borrow money and tax individuals and business at unprecedented levels. But governments tried, and largely failed, to pay for the war out of their own coffers.

For a sense of the scale of that failure let us consider France, whose record was particularly poor. The amount of income generated by taxation actually fell by 60 percent in 1914 from prewar levels, and it was only in June 1917 that the law introducing an income tax, passed in 1914, finally came into effect. The German record was little better, given the widespread expectation that the enemy would be defeated and made to pay for the costs of the war effort. That assumption was based on the outcome of the Franco-Prussian War of 1870–71, following a practice of reparation that was common to earlier conflicts.

This logic dictated that difficult choices about how to pay for the war were postponed until it was won—or lost. It also shifted the problem from the national to the international sphere. This was true even where issues of war finance were managed more soundly, such as in Britain. Although the British state was better placed than the other belligerents to pay for the war through income and direct taxation, nonetheless, as with all belligerents, state debt increased dramatically. By 1920 Britain's national debt was £7.8 billion (1.3 times GDP), compared with £0.62 billion (0.25 times GDP) in 1913.

DEBT TRAP

Subsequent demands by the victorious states for reparations were a toxic, but not insurmountable, legacy of the war. The problem was compounded by the transformation of global financial relations that came about because the Allies accumulated large debts to their "Associated Power," the United States, and were forced to liquidate many of their overseas assets. This altered the global balance of power for good. Britain borrowed \$4.3 billion and France \$2.9 billion from the United States; they in turn advanced some of their resources to other allies. Britain, for example, loaned heavily to members of the British Empire; France provided money to Italy and to Russia, and had to write off the Russian loans in the wake of the 1917 revolution.

Political legitimacy was increasingly dependent on the ability to manage the domestic economy.

By 1918, the United States had not just transformed from a debtor to a creditor nation: It had replaced Britain as the world's banker and emerged as the premier financial power. New York competed aggressively with London to become the center of world finance. The United States' preference for short-term loans, compared with British habits of long-term finance honed in the empire, also had important consequences for global economic stability. When world markets turned down, the flow of US dollars dried up more quickly than sterling loans had before 1914.

Rising levels of state debt had profound consequences for political relations within and between nations. But it would take almost two decades before economists, bankers, and policy makers fully grasped the momentous implications of this change for the international monetary system, as well as for America and the world economy more generally. Taken together, the financial costs of the war meant that states that had accumulated large debts faced considerable pressures and constraints immediately after the war ended. It was imperative to slash spending and increase taxes and trade to earn the needed funds. (The alternative was to allow inflation to rise in order to scale back the debt.) At the same time, the political changes wrought by the war meant that societies' expectations for state policy in the realms of welfare and employment were greater than ever.

THE AUSTRIAN CRISIS

The first intimation of the challenges that this tightening of the fiscal-political vise posed to the world after 1918 came in Central Europe. The combination of financial, political, and social pressures culminated in episodes of acute hyperinflation that devastated the successor republics of the Central Powers, notably those of Austria, Hungary, Germany, and Poland. Austria was gripped by hunger and runaway inflation. Its empire had dissolved, and the rump state remained under blockade by the Allies and new, unfriendly neighbors until 1919, when the Paris peace settlement prohibited unification with Germany.

By October 1921, the Austrian schilling had descended into hyperinflation, with a monthly inflation rate of 46 percent, and unemployment had climbed to over 33 percent. At the time, the Austrian crisis garnered enormous international attention. Images of its starving children featured in the activism of women such as Eglantyne Jebb, who founded the international aid organization Save the Children in May 1919. Art produced by Austrian orphans adorned Christmas cards distributed by the International Red Cross as part of its campaign for food aid for the republic.

Of course, the reason Austria needed food aid was that the new state was unable to grow or buy the supplies it needed to feed the population. Much of its food had been grown in imperial territories that were now lost, and the republic had few financial resources of its own. The same men who had overseen the management of food, shipping, and finance for the Allies in World War I—notably Herbert Hoover, John Maynard Keynes, Arthur Salter, and Jean Monnet—brought the situation to official and public attention. Now members of the Allies' Supreme Economic Council, they became leading protagonists in organizing a petition of more than 150 leading economists and financiers, who argued that economic cooperation should be facilitated by the new League of Nations.

An agreement to that effect was reached at the Brussels Conference of 1920, where the Austrian crisis became the founding impetus behind the creation of the League's Economic and Financial Organization. This body, and the network of economists, financiers, and policy makers who sustained it, often from behind the scenes (many of them were Americans), provided the foundation on which future ideas about global economic and financial governance would be built. More specifically, the Austrian case was an important reference point for the practices of oversight developed by the International Monetary Fund, and subsequently by the European Union. The policies recently adopted by the European Central Bank toward EU member states that turned to it for financial aid in the euro zone crisis, notably Greece in 2010, were also based on this historic model.

Although the United States remained outside the League of Nations, it was still able to determine the conditions of the Austrian loan package forged by the organization. Favorable terms for US investors in Austria were backed up by a series of extraordinary political guarantees for a loan scheme that for the first time handed financial oversight of a nation-state to an intergovernmental organization. State expenditure was slashed. Some 50,000 civil servants lost their jobs, and there were continuing attempts to reduce the pension provisions of officials who once administered the empire.

BEGGAR THY NEIGHBOR

US loans enabled Austria to become the first nation to return to the international gold standard. This system of fixed exchange rates became the primary focus of international financial relations after 1920. It was widely believed that the gold standard had facilitated the great expansion of the international economy in the nineteenth century. It was seen as the only available means to combat the twin scourges of deflation and inflation.

Between 1924 and 1929, 45 countries joined the gold standard as currency stability became the primary focus of monetary and economic policy. It bound the fates of member nations more closely together. But technical problems with the system's global operation, combined with constraints imposed by orthodox economic policy on national budgets, made for a toxic mix when recession came in 1929.

The gold standard exercised a deflationary grip on the world economy that grew even tighter in 1930. It was only when countries abandoned gold that a recovery of sorts emerged. All attempts to do this on a coordinated, international basis failed. The nationalist genie that had been growing since 1918 was now out of the bottle. Farmers, primary producers, and workers lobbied for greater trade protection in a world of falling prices. The extension of the franchise and the wider definition of state security meant that "beggar-thy-neighbor" economics became the only game in town.

Neither the League of Nations nor the ideology of liberal internationalism that produced it was strong enough to hold together the global order they had helped to create. The world was increasingly divided into economic blocs that, at least in part, went on to form the power blocs that would soon fight another world war. Crucially, Britain, France, and the United States were economically estranged from one another for most of the 1930s in ways that made it hard to combat the Axis threat. "To talk peace in the parables of war," as Veblen put it in 1917, proved a mistake that helped pave the road to a Second World War within a generation of the First.

A hundred years later, we have a stronger sense that the factors that make up our security are broadly defined and interconnected. We know, for example, how economic crises precipitate migration flows that, in turn, imperil environments; and that war and its aftermath disrupt agricultural production and the distribution of food, resulting in hunger and malnutrition, which then lead to the spread of disease. The impact of the recent global recession, and the present crisis over Ukraine, have brought home afresh how trade, financial flows, access to raw materials, ethnic solidarity, and "hard" security all link together, and the degree to which societies' search for security, in all its manifestations, reaches across state boundaries. But the current world order struggles to act on this recognition with any more efficacy than its predecessor did in 1918. ■