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Describe the factors that caused hyperinflation in Germany in the 1920s. How was the currency finally stabilized?

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Abstract

This paper explores the profound hyperinflation crisis in Germany during the 1920s and the subsequent stabilization efforts. It delves into the multitude of factors that contributed to the economic turmoil, emphasizing the punitive reparations imposed by the Allied powers after World War I. The analysis highlights how these reparations, combined with the German government's extensive money printing and the general post-war economic vulnerability, precipitated unprecedented inflationary pressures. The research underscores the role of the Treaty of Versailles and the Allied policies in exacerbating Germany's financial distress, where the economic strategies were more punitive than reparative. The study also details the stabilization mechanisms that were implemented to halt the hyperinflation spiral. It discusses the pivotal role of policies introduced under the guidance of Dr. Hjalmar Schacht, including the introduction of the Rentenmark and fiscal tightening measures that eventually curbed the hyperinflation. Through a detailed examination of historical economic data and policy documents, the paper provides a comprehensive account of the hyperinflation period, offering insights into the economic dynamics and policy decisions that shaped Germany's post-war economy.

Keywords: Hyperinflation, reparations, treaty of Versailles, rentenmark, economic stabilization, allied powers

Introduction

The Great War came to an end on 11th November 1918. By October, the exhausted military with the continuously disintegrating support from civilians back home decided to turn over power when counterattacked by the Allied forces. Millions of men lay dead by the end all over Europe, around 2.3 million belonging to the British and French forces and another 2 million from the German armies. The entire continent had been hit by mass destruction to human life, uncountable civilians had been lost to hunger, poverty, diseases and the cold. So many were still wounded and struggling to make it. The Western front (the British battlefield stretching from the Belgian coast to the Swiss and French borders) was faced with horrendous damages to property, factories and farms with reconstruction costs amounting to nearly \$7 billion (Ahamed, p.99) ^[1].

The war came as a blessing to the United States while the others could barely manage any resistance to major economic contractions. Germany and France suffered a GDP contraction of a whopping thirty percent throughout the war. Four long years of obsessive battles and conspiracies burdened Europe with an overflowing ocean of debt. Approximately two hundred million dollars had collectively been washed away by European governments, distorting the entire map of the continent in anticipation of their respective victories. Owing to this, they were not left with many options but to either rely on the wealthy Americans, raise taxes or go on printing more money to fund these unjustifiable expenses. As a consequence, money supply in Britain and France doubled-tripled, while in Germany, which was constantly disintegrating, it quadrupled (Ahamed, p.100) ^[1].

The legislation and far reaching financial alterations adopted by the Reichsbank (the central bank of Germany from 1876 until the end of 1945) for engaging in the hostilities of the war clearly paved the way for the economic difficulties awaiting Germany. The total circulation of marks including coins was estimated to be approximately six billion in mid 1914.

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This monetary circulation number ended up being more than five times reaching 32,936,700,000 marks by the end of 1918. (page 5). German public finances had without a doubt been exhausted due to the adversities of the war. Although loans were relied upon in large proportions, even in 1918 the country's debt burden wasn't considered heavily skewed compared to the others.

Due to its low creditworthiness during the war, Germany

was unable to raise any long-term foreign debt and even its short-term debt did not exceed four billion gold marks (meaning four billion dollars). The Reichsbank was able to fund all its debt obligations and pay them off in the first few years of the war itself. Thus, there was no reason to question the administrative and financial health of Germany particularly, (refer to Table 1) even by the end of the war (Graham, p. 6) ^[3].

Table 1: Expenditures, revenues other than from short-term borrowing, and deficits of the Reich; 1914-1919 (Billions of marks)

Fiscal Year (April I-March 31)	Expenditures	Revenues Other Than From Short-Term Borrowing	Deficits (Covered by Short-Term Borrowing)
1914-1915	9.6	8.2	1.4
1915-1916	26.7	24	2.7
1916-1917	28.8	24.6	4.2
1917-1918	53.3	37.1	16.2
1918-1919	45.5	34.2	11.3
Totals	163.9	128.112	35.8

12 of this amount approximately 97 billion marks had been obtained through long-term loans

Post War: Table 2 shows a comparison of prevailing price levels and dollar exchange rates in the UK, France and Germany with the benchmark being The United States. A primary fact emerging from the table is the large price level

hike in all countries including the US. However, a sharp change occurred in 1921, when the US and UK witnessed deflation, price levels in France fell by 40% but price levels in Germany increased by 2300%. (Dornbusch, p.4) ^[2].

Table 2: Comparative Price Levels and Exchange Rates (Indices 1914 =1, annual average)

	U.S.	U.K.		France		Germany	
	P	P	e	P	e	P	e
1914	1	1	1	1	1	1	1
1919	2.6	2.5	1.1	3.4	1.4	3.9	7.8
1920	2.6	3.1	1.4	4.9	2.8	14.1	13.5
1921	1.4	2	1.4	3.4	2.6	18.1	10.2
1922	1.3	1.6	1.3	3.1	2.4	323.3	101.8

Note: P denotes the wholesale price index, e the index of the local currency price of the U.S dollar

Emerging from the war and the Treaty of Versailles (concluded in June of 1919), Germany was overshadowed by huge territorial losses, demilitarized army, domestic political turmoil and burden of reparations that were to be decided by the Reparations Commission. These uncertainties were also reflected in the volatile behavior of the Mark-Dollar exchange rate (shown in Figure 1). In the brief period from the end of 1919 to March 2020, the value of the dollar almost tripled compared. This stark depreciation in the value of the mark was a result of the uncertainties surrounding the economic and political future of Germany (Dornbusch p. 5) ^[2].

The Germans had gauged that the longer they could stretch along the reparations bargaining process, the lesser they would end up paying, so they set up negotiating in bad faith and declining all proposed plans as their primary strategy. Finally, in May 1921 officials from the British Territory

came up with a proposal they thought would be reasonable for the Germans to accept. The reparations bill was set at 12.5 billion dollars that was equivalent to approximately 100 percent of the pre war GDP of the country. Apart from this, the new debt interest and principal payments required a payment of roughly 600- 800 million dollars annually which was nearly 5 percent of Germany's annual GDP. The German delegation led by Foreign minister Walter Rathenau finally accepted this proposal at the London conference. Despite the liberal terms of the new bill, German officials continued to believe that these amounts were a monstrous burden on the already injured country. They could only manage to make the first payment due after the Settlement in London post which they were back in arrears in a period of six months and were pleading the Commission for more time and relaxation (Ahamed, p. 118) ^[1].

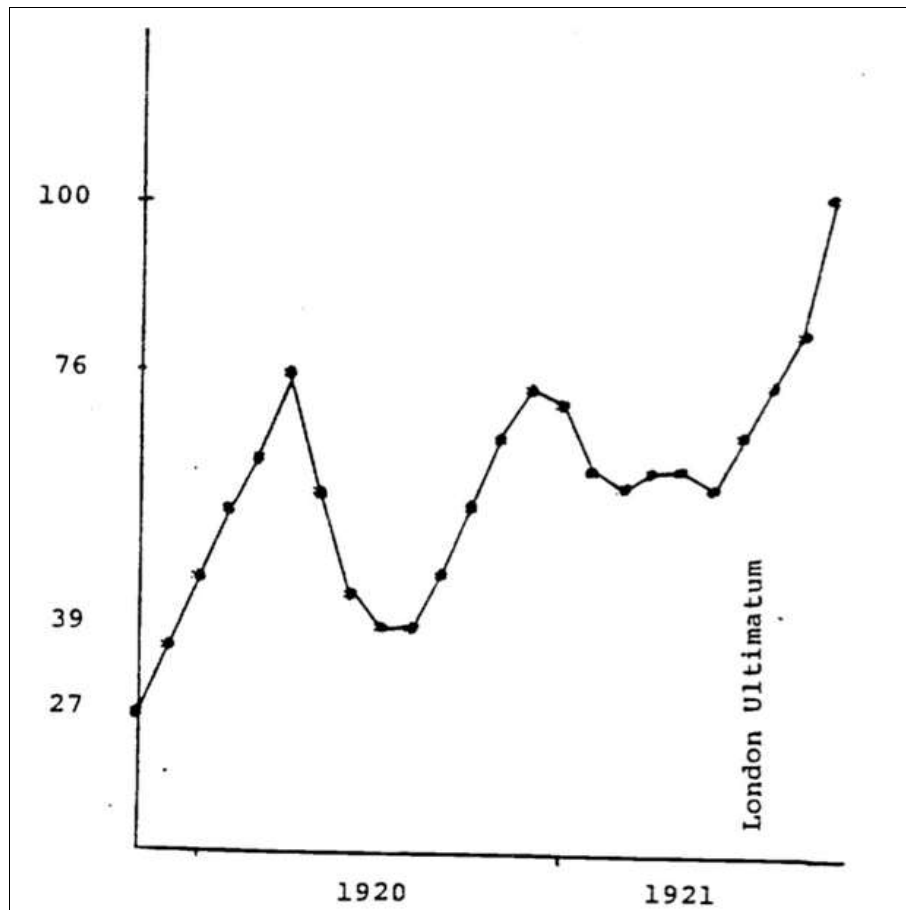


Fig 1: The dollar exchange rate (Oct 1919 – Sept 1921)

The Hyperinflation

The reparation payments that led to the collapse of the public financial system are far away from the sole reason for Germany's fiscal difficulties. The roots of the hyperinflation go back deep into the Treasury portfolio of the war administration. The Vice-Chancellor holding the Portfolio, Helfferich was extremely influential with his unbothered attitude towards the inflationary policies and private as well as government borrowing. The value of the internal government borrowing went on piling up during and post the war which could only be translated into perpetually high tax levels. Surprisingly, the inflationary policies pursued by the government had gained support throughout business circles, where people were of the view that the falling value of the mark was required to regain foreign trade markets and rebuild the German industries. Thus, several administrations in the early 1920s made efforts to grapple with the rising inflation but all these efforts were evidently half-hearted, in light of the opposition from powerful business leaders and resentment of trade unions. A state of panic came up only after

the profits and wealth of the general public were avalanched with uncertainties and losses and the need for stabilization was realized and stressed upon with conviction (Graham, p. 11) ^[3]. Germany's political losses were considerably equivalent to being cut down at the knees, with losing one tenth of its population, all its colonies and one eighth of its territory in Europe.

Majority of these areas were concentrated with necessary raw minerals with advancing industrial growth and agricultural productivity owing to good land fertility. The per capita burden economic burdens thus increased on a smaller population as obligations to foreign governments increased. Furthermore, the capturing of Alsace and Lorraine by the French led to dislocation of a large industrial area required for advantageous uses of coal and iron required for the production and export of finished goods. Germany's foreign trade balance and value of the currency was impacted by the surrender of its agriculture districts, Posen and west Prussia. Failure to provide food to its own population, the Reich had to turn to foreign supplies yet again which added to the already imbalanced trade deficit (Graham, p. 19) ^[3].

The success or failure of the Reich was going to be determined by its ability to restore financial order amidst the rising prices driven by interest payment defaults and the continuously changing course of foreign exchange rates. The government had to procure foreign debt in fixed intervals for funding the reparation payments. The cost of these were dependent on the rates prevailing in the market at the time of purchase and inevitably increased with the depreciation of the mark. In such circumstances it became impossible for the Reich to estimate the burden on the government budget which led to the vicious cycle of the administration finding its way back to the Reich that issued notes and funded the loans (Graham, p. 8) ^[3].

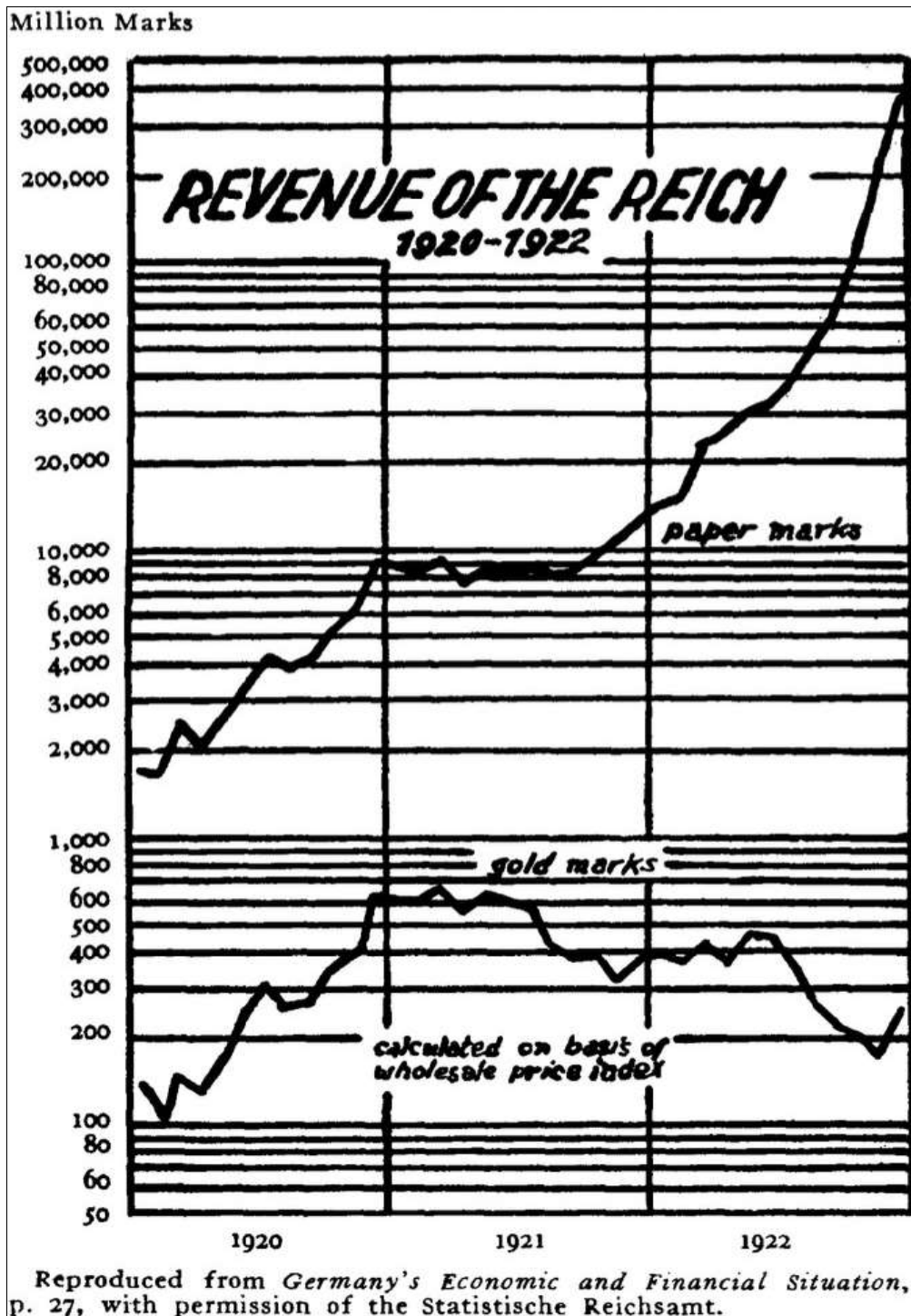


Fig 2: Revenue of the Reich, 1920-1922, in paper marks and in gold marks calculated on the basis of the wholesale price index

'Inflation had been fluctuating between 28-89 percent a month till the January of 1923 until it suddenly hiked to 111 percent in the following months of February and March. A few interventions by the Reichsbank in the exchange markets by the end of March and April brought in a short period of currency appreciation and price stability. However, this ended soon as inflation accelerated in May, totalling up to an unimaginable 30,000 percent per month. This translated into 20 percent inflation per day according to which price levels doubled in 3-4 days and the German economy disintegrated at a precarious pace and the currency depreciated unstoppably. Table 3 presents the dollar exchange rate (paper mark per gold mark) and the rate of depreciation and inflation per month (Dornbusch, p. 7) [2].

Table 3: The German Hyperinflation in 1923 (Percentage Change from Previous Month)

	Whole sale Prices	Exchange Rate
May-23	57	95
June	137	131
July	286	221
August	1162	1307
September	2432	2035
October	29586	25957
November	10133	8462

The country was in a constant state of political and economic turmoil. Over the next few months, the German monetary value went down a spiral of great destruction. A

dollar was worth 620,000 marks in August 1923 and by November of 1923, a dollar was worth 630 billion marks. Everyday goods and basic necessities were priced in billions, people were seen carrying around bags and drums full of currency notes everytime they stepped out of their homes. The prices had started to double in hours, just as long as it would take to finish a cup of coffee or a glass of beer at a bar. Price levels at a point had no significance because of how rapidly they changed and the buying power of the currency went on declining by the minute (Ahamed, p. 121) ^[1]. 133 firms were printing money for the German government on almost 1800 printing machines to be able to meet the growing demand for the currency notes (Dornbusch, p. 8) ^[2]. The social structure of the society was completely overturned, with rich industrialists becoming richer as the value of their real estate holdings and other assets soared. Worst hit came to the democrats and the highly educated professionals whose investments in government bonds and bank deposits saved over lifetimes evaporated. The traditions and values of communities dwindled away as the order of things in the nation completely transformed. (Ahamed, p. 123) ^[1].

The Stabilization

Plans for stabilization came as a blessing under the much hailed Dr. Hjalmar Schacht who brought about this monetary miracle. In mid- October 1923, The Renten Bank was established as a semi-public body, functioning to extend credit to the government and private sector. The limit for the loans was set at 2400 million Renten (gold marks), half of which were extended to the government. Of these, nearly 300 million were put aside to help pay off the outstanding debt on the government extended by the Reichsbank. (Dornbusch, p. 10) ^[2].

Starting its operations on November 15th, the Rentenbank started issuing the Renet Mark. Back in August the government had issued a 500 million gold mark loan in small denomination bonds that started circulating as hard currency in the markets. The issuance of the loan was linked to the efforts of restricting the cash crisis that had completely depleted the real money supply in the economy. Queues outside banks grew longer and longer as the demand for paper money continued to go unmet and payment systems completely collapsed. Thus, a 1:1 link was established between the Renten Mark and the gold marks such that 500 Rentens could be converted into a bond with a nominal value of 500 gold marks. Apart from this, the Reichsbank was no longer authorized to discount government bills and the Reichsmark was supposed to be backed by third gold and the rest by commercial paper (Dornbusch, p. 11) ^[2].

Within one month it was observed that exchange rate and prices had started to near stability to some extent. The government's efficient fiscal planning with increased taxation and restoration of the real value of tax started displaying its benefits by January 1924. Constant credit crunch checks had to be put in place because of how fast credit expended between late 1923 and early 1924, which threatened the comeback of depreciation and inflation. It is applaudable how well the stability was managed with the credit of the Reichsbank increasing fourfold and money supply of the Reichsmark doubling around the same time (Dornbusch, p. 11) ^[2].

Political stabilization by August 1923 that put an end to

passive resistance is considered to be a fundamental contributor to the process of combating hyperinflation. The mechanism through which the government was forced into maintaining a budget balance by incorporating institutional limits on monetisation of deficits is an important ingredient as well. Tabel 4 shows the successful budget under fiscal stabilization (Dornbusch, p. 13) ^[2].

Table 4: The Budget (millions of goldmark)

	1922	1923*	1924	1925
Expenditure	3951	5278	7220	7444
Receipts	1508	588	7757	7334
Budget Deficit	2442	4690	-537	110
Receipts/GNP				10.4%

*To October 31, fiscal year April-March

Could this have been prevented?

The adoption of the Dawes Plan by the Allied Powers and Germany for easier borrowing from abroad eased the impact of the reparations on the German national income. The Dawes plan stipulated by an American Banker and politician, Charles G. Dawes was aimed at improving German economic recovery. It provided for reducing the short term amount of the reparations to 50 million pounds per year and the US extending a 25 billion dollar loan to Germany to meet its productive capacities and start rebuilding its trade relations apart from easier revenue generation from taxes. It renegotiated the heavy burden of huge reparational amounts by considering the declined position of the country in the transformed international economic front and made the obligations achievable without facing severe difficulties ("The Dawes Plan (1924) ^[4] | Reference Library | History).

A school of thought often highlights how the failure and delay on part of the Allied powers for finalizing the reparation amounts till May 1921 led to a complete destruction of any credit Germany could have otherwise managed to gather. On top of the chaos caused by the amounts, the demand and threats for making immediate payments caused enormous panic back home. With having no credit avenues open for foreign exchange and an absolute lack of necessary volumes of commodities for exports, Germany's shot at making these instantaneously large payments was bound to depress the mark's exchange value. The purchasing power of money was inevitably going to drop with the volume of paper currency being printed. The monetary disorder and fluctuation in price levels was sharply pushed ahead by the entire reparations experience for Germany. In the absence of such rigorous demands, the convertibility of the currency into gold and its exchange value could have been manipulated using carefully targeted taxation policies (Graham, p. 8) ^[3]. The ethical gameplay involved in the process of reparation negotiations and demands remains controversial and open to critique till date. Thus, in Germany's case alone, its fiscal management and inflationary experience got out of its hands due to the insatiable pressures put on it constantly from outside its own borders.

Conclusion

The hyperinflation crisis in Germany during the 1920s was a multifaceted catastrophe driven by several interrelated factors. The punitive reparations imposed by the Treaty of Versailles, the excessive money printing by the German

government, and the overall economic vulnerabilities following World War I were primary contributors. These reparations exacerbated Germany's financial distress, as the country struggled to manage the overwhelming debt and interest payments required by the Allies. The hyperinflation was further fueled by the internal fiscal policies and borrowing practices during the war, which created a massive debt burden and led to perpetual high tax levels.

Germany's economic turmoil was compounded by political instability, loss of productive territories, and a disrupted foreign trade balance. The Reichsbank's policies, which included extensive borrowing and money printing, failed to stabilize the economy. Inflation spiraled out of control, reaching astronomical levels where prices doubled every few days, rendering the currency virtually worthless.

Stabilization efforts led by Dr. Hjalmar Schacht brought the much-needed monetary discipline. The introduction of the Rentenmark, backed by real assets, and fiscal tightening measures played a crucial role in curbing hyperinflation. The creation of the Rentenbank and the pegging of the Rentenmark to gold helped restore confidence in the currency. Additionally, political stabilization and fiscal reforms, including increased taxation and stringent budget controls, were essential in achieving economic stability.

The adoption of the Dawes Plan in 1924, which eased the reparations burden and facilitated foreign loans, further supported Germany's recovery. This plan reduced short-term reparations payments and provided the necessary financial aid to rebuild the economy. Despite the severe initial impacts, these measures collectively brought an end to the hyperinflationary period, setting Germany on a path towards economic recovery and stability.

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