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Anatomy of a Tragedy

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Introduction

In 1914 Germany set out to correct the injustice it deemed had been perpetrated upon it inside its territorial area in Europe, and in its colonial position outside Europe. It wished to express the military, economic and cultural power that it had consolidated in the late 19th and early 20th centuries. "Tension seethed between the veterans in the colonial realm – Britain, France, Russia, Holland – and the hungry newcomers, such as Germany and Italy" (Talmon, 488). The spirit of Bismarck haunted Germany – unification (led by Prussia), statehood and militarism. "Fifty years were spent in the process of making Europe explosive. Five days were enough to detonate it," (Liddel Hart, 17)

Thirty-four years after that unfortunate, fateful event (and perhaps because of it), the State of Israel was established. Over its first decade the state forged and strengthened itself, under the prevailing spirit of Ben-Gurion – for unity (led by the Jews from Eastern Europe), statehood and "securitism." In 1982 Israel set out to correct the injustice it deemed had been perpetrated upon it from its northern border, and exercised its military and economic power in order to dictate the terms of peace to its neighbor in the north, establish its territorial area (about a third of which was under dispute domestically, and held no agreement from without), and "erase" the traumas of the previous war.

The nature of the two geopolitical situations, for all their differences (time, location and nation) and their similarities (mood of the people, intentions and dynamics of the process) dictated the manner of financing government expenditures. There is actually a financial connection between **loans on the offensive and taxes on the defensive**, and the proportions change according to the circumstances. War—any war—puts the economy into a trap; i.e., market output decreases while at the same time the means of payment increase. The inevitable outcome is inflation. With victory, the trap is eliminated (with additional resources); and with defeat it worsens.

A people's ability to free up economic resources from peacetime life to wartime life is the crucial part of the struggle. The army decides the battle, but the coffers decide the war. They say that when Louis XII was getting ready for war and asked his advisor what to prepare, the response was to obtain three things: money, money, and more money.

Most of the First World War in Germany was financed by loans and money-printing. The country did not possess the budgetary structure to handle the required financial load. The attempts at improvement did not succeed and in retrospect caused significant tax evasion and currency smuggling, which only aggravated the situation. The nation reached this state of affairs because the people had been promised that their soldiers would be home for Christmas.

Through a substantial national deficit, the desired connection between the citizen's intake and payment may be disassociated from the product called public service (including security). This means that social pricing is not carried out properly, also enabling the illusion (through loans and printing money) that the war exacts a price in blood (paid by a few), but not in money (paid by many). **Whoever seeks war should get out their wallet.** This motto was forgotten in Germany in 1914, and not by chance. That is what misled the nation into believing there is such a thing as a "nice war." Patriotism supplies the loans and the politicians (through the central bank) print money.

Table 1: German Government Budgets, 1914/5-1918/9
(For budgetary years, in thousands of million marks, at current prices)

Year	Expenses	Security Expenses	Intake	Deficit	% Deficit out of Expenses	% Security out of Expenses
1914/15	9.6	6.9	8.2	1.4	15	72
1915/16	26.7	23.9	24.0	2.7	10	89
1916/17	28.8	24.7	24.6	4.20	15	86
1917/18	53.3	42.2	37.1	16.2	30	79
1918/19	45.5	33.9	34.2	11.3	25	75
Total	163.9	131.6	*128.1	35.8	22	80

*Of these, 75% are short-term loans
Sources: Expenses and intake (Graham, 7); war expenses (Ranger, 67).

Table 2: Israel 1974-1984, Public Sector (Government, Jewish Agency and Local Authorities) (For calendar years, in billions of shekels, at 1980 prices)

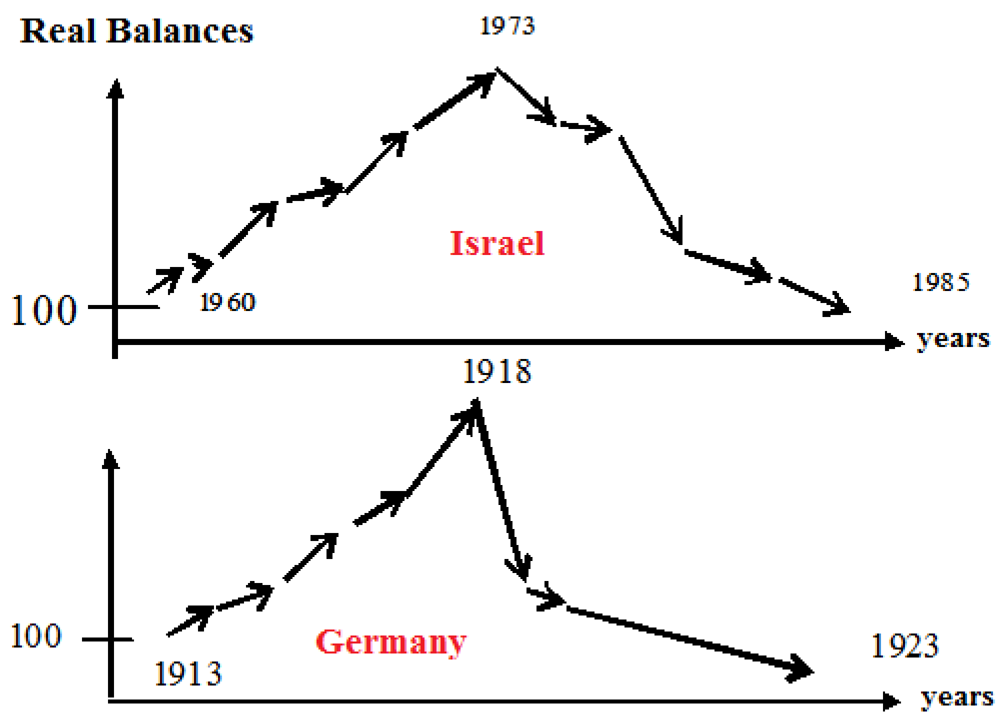
Year	Expenses	Security Expenses	Intake	Deficit	% Deficit out of Expenses	% Security out of Expenses
1974	48.8	24.4	33.8	15.0	31	50
1975	53.7	28.5	30.7	23.0	43	53
1976	50.0	25.0	37.5	12.5	25	50
1977	48.4	21.1	39.8	8.6	18	43
1978	55.1	24.7	38.4	16.7	30	45
1979	55.7	21.5	45.3	10.4	19	38
1980	57.6	24.5	46.0	11.6	20	42
1981	62.5	26.8	43.4	19.1	31	43
1982	59.4	24.2	50.5	8.9	15	41
1983	57.5	22.5	54.8	2.7	5	39
1984	57.5	23.7	47.4	10.1	18	41
Total	606.2	266.9	*367.6	138.6	23	44

*Taxes and transfer payments only.
Source: Author's own processing of Bank of Israel data for 1974-1983.

When the average amount of money per average output unit rises, sooner or later prices will also rise. In a war economy, however, in which currency exceeds output, then as long as the “cannons are heard and the muses are silent” the multiplying money hides as well, and the inflationary potential is not manifested (Bresciani-Turroni, 166). Yet when the cannons go silent and the Muses stir, the money also starts reveling. In victory resources increase and in defeat they decrease, and the inflationary potential is neutralized in victory and intensified in defeat.

The state of the economy may be characterized at any point in time, among other things, by its real balances (defined as the means of payment divided by the price index). When you take the development of this series relative to the time period that is considered a reasonable starting point for normal time (Germany in 1913; Israel in 1960), you notice that the Germany economy of then and the Israel economy now take similar courses. The different sizes need not be a factor, due to the relativity of the sizes. The laws of nature (and economics) hold for large- and small-scale systems alike; the heavier (and larger) the system, the smaller its ability to deviate from the law (from equilibrium) (see drawing).

Drawing: Means of Payment – Real Balances (Germany 1913-23, Israel 1960-84)



The drawing indicates that when the real balances reach saturation on one hand, and the war effort stagnates on the other hand, the inflationary potential (built up during the war) begins to be realized. More and more money starts chasing fewer and fewer goods. When this process starts and the public begins to notice it, Gresham's law begins to take effect. It especially and firstly manifests itself in the nation's foreign currency markets (Tamari, 1983). The situation deteriorates and the government, in its wish to avoid unemployment, feeds the system with more money. This causes another cycle of printing money and subsequent price hikes. At this stage the public is not amassing any more monetary balances but trying to get rid of them. The inflationary process gains acceleration, expressed in faster money turnover.

As the inflationary potential is forming, the government usually keeps the exchange rate too low (Schacht, 21), and does not do its job of recognizing the inflationary potential while still in the bud. Artificial appreciation of the currency rate sooner or later brings about a crisis in the balance of payments (due to cheap imports and expensive exports), an increase in foreign debts, and the overvaluation of financial assets in the economy. The result is an unfounded sense of "wealth," especially in international economic relations.

The policy of preventing unemployment at all costs (which later leads to rampant unemployment) causes the amount of money to "adapt" to any price level. This accommodating policy—which should be called passive due to its inherent helplessness—in relation to a given economic situation, results among other things from supply crises outside the economy.

The two geopolitical situations are also highly similar in the array of arguments made by the economic leaders (especially the central bank) upon attempting to handle the crisis. Perhaps this is but the belated economic embodiment of "the people feeling besieged" (whether justifiably or not), and reluctantly pushed into irrational activity to save themselves.

The reasons for the passive policy were:

a. The desire to prevent unemployment at all costs, in Germany to prevent the Bolsheviks from coming to power, and in Israel to prevent emigration.

b. Looking at the real balances as a measure of the desired amount of money which needs to match business activity, and not as they should be seen – as evidence of Gresham's law and its force – expressed in the accelerated of the velocity of money, while monetary control should be used through a nominal amount of the money (M1).

c. Viewing the currency rate as an impetus in forming inflation due to a deficit in the ongoing balance.

d. Ignoring, mainly in the early, critical stages, the accumulating and prolonged government deficits, and especially the impact of national debts created as a result of those deficits.

e. Adopting an accommodating monetary policy supposedly imposed on the central bank due to political and social constraints.

f. The illusion that a continuing government deficit may be neutralized (except for a short term of up to a year) by selling government securities. These were eroded by the inflation in German and rolled over to the future (like a rock at the top of a mountain) in Israel (Tamari, 1982; Bresciani-Turroni)

What Can Be Done

When real balances have started to decline after a prolonged accumulation of up to twice the usual amount, the velocity of the money turnover starts to rise, the currency exchange rate and value of money deteriorate, an economy must prepare itself for structural reform (if an active monetary policy and restrained government budget have not sufficed).

The purpose of the reform is to stabilize the government budget and bring the national deficit to the lowest possible minimum with regard to inflation and the highest possible maximum with regard to unemployment (approximately 2% of the annual GDP). The longer the reform is delayed, the more severe the steps required to amend the situation later. As put by former Minister of Finance Yigal Hurvitz, “Whatever we don’t block today with hoes, even bulldozers won’t be enough tomorrow.” Following are the main points of the reform and the minimal measures necessary when the economy has declined below the 100 line (see the drawing) in relation to normal:

1. **Balancing the budget**: Revising the tax system and raising taxes along with updating and decreasing expenses.

2. **Monetary restraint**: Limiting the public’s credit along with not discounting treasury bills.

3. **Normalizing currency**: Exchanging the currency, striking out zeroes, and restricting its nominal amount.

4. **Setting a realistic currency rate**: Adapting the exchange rate to close the gap between exports and imports.

5. **Debt settlement (domestic and foreign)**: Restructuring national debts domestically and abroad according to the ability of the payment balance (in paying foreign debts) on one hand, and the ability of the national budget (in paying domestic debts) on the other hand.

These five steps were indeed included in one form or another in the stabilization plan for the German mark in 1923. What was termed the “rentenmark miracle” was among other things a currency depreciation of 566%. The mark rate rose (in the Berlin stock exchange) from 630 billion marks to the dollar on November 12, 1923, to 4,200 billion marks to the dollar on November 20, 1923. At this rate, the system normalized so that a trillion (one thousand billion) marks equaled one rentenmark, and 4.2 rentenmarks equaled one dollar.

Debts to citizens at the time had actually already eroded due to inflation and the lack of debts being linked to any kind of actual value.

The failure of former Minister of Finance Yoram Aridor in the “dollarization” plan and its marketing, among other things, lies in not clarifying the issue of debt to the people. Dollarization without settling domestic and foreign debts is pointless and does not stand any chance of succeeding. Debt settlements and budgetary balance do not require dollarization.

The success of the reform depends on neutralizing the currency-printing mechanism, sourced in the government budget, debt inventories, and credit provision to prevent unemployment. The national problem (then and now) lies in the politicians’ (those with the authority to decide) inability to understand the depth of the crisis or its potential as it is forming. The difficulties appear to be solvable by relatively simple means (loans, printing money, aid and subsidies). Lack of timely clarity – regarding improper budgetary structure, irresponsible national debt policy, a flawed tax system and extravagant spending, passive and negligent monetary policy, extended appreciation of the currency rate – all exacerbate the problem. This is evident in the frequent turnover in administrations (and particularly ministers of finance), and the proliferation of all sorts of “solutions” such as “liberalization,” “proper economics,” “bubble economy,” “dollarization,” “package deals,” and so forth. It should be noted that the Israeli economy’s monetary difficulties began in 1970-1, when the governor was replaced, the settlement movement began, a package deal was signed, and at the same time the War of Attrition took place and a chain of fortification trenches were built (called the Bar-Lev Line).

Conclusion

An inflationary crisis that gradually turns hyperinflationary is the result of ongoing faulty budgetary policy that is accompanied by a failed attempt at war on one hand and political weakness (to address the problem at its inception) on the other hand. The inflationary potential first forms along with the government feeling it is “creating something out of nothing,” and it ends in a payment balance crisis, collapse of the national budget, unemployment, and the public feeling of “creating nothing out of something.”

An economic domino effect takes place: a prolonged budgetary deficit financed by loans and money-printing, leading to a loosening of monetary discipline, causing a drop in currency value, bringing about a deficit in the balance of payments and a rise in prices. An increase in the exchange rate and prices produces a loss in tax income, a rise in expenses in the state budget, and a drain of foreign currency. These generate further government and commercial deficits, met by printing more money. The influx of money activates Gresham’s law (meaning faster velocity of money) and loss of confidence in the currency.

When this process takes place, the economy slowly shifts from stability to inflation (the pace of the transition depends on the level of linkage and its application), and from there to hyperinflation. The slow pace of the process, especially during the initial stages, is what makes it hard to understand, identify and nip the problem in the bud.

Extrication from this situation (and the sooner the better) requires that the economy simultaneously employ all the aspects of the reform proposed above: **budgetary balance, monetary restraint, currency normalization, rate exchange adaptation and debt settlement**. Only partial implementation will not suffice, since the economic domino effect – which can begin at any one of the stages – will be set in motion anew.

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