



AgEcon SEARCH
RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search

<http://ageconsearch.umn.edu>

aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

WIDER WORKING PAPERS

**The Importance of Being Earnest:
Early Stages of the West German
Wirtschaftswunder**

Ardo H. Hansson

WP 94

September 1991

*World Institute for Development Economics Research
of the United Nations University*

**THE IMPORTANCE OF BEING EARNEST:
EARLY STAGES OF THE WEST GERMAN WIRTSCHAFTSWUNDER**

by

Ardo E. Hansson

World Institute for Development Economics Research
of the United Nations University (UNU/WIDER)

and

Department of Economics
University of British Columbia
Vancouver, B.C., Canada

May 1991

This paper is an outcome of the research project entitled Transformation of Centrally Planned Economies: The Lessons for Developing Countries under the auspices of the **United Nations University's World Institute for Development Economics Research (UNU/WIDER)** with financial support from the **Finnish International Development Agency (FINNIDA)**.

I am very grateful to Anders Åslund, Homi Kharas and Jeffrey Sachs, and to seminar participants at the Institute for National Economy, Warsaw, for helpful comments. All errors are my own.

I. INTRODUCTION

The rapid post-World War II growth of the West German economy is frequently called the *Wirtschaftswunder* or 'economic miracle'. Its origins are most often traced to the 'Erhard reforms' of June 1948, which combined radical currency and fiscal reform with extensive liberalization.¹

The term 'economic miracle' has both appropriate and dubious connotations for describing the subsequent West German performance. On the one hand, it correctly conveys the many immediate and longer-run successes. Almost overnight, normality was restored to a distorted and unstable economy. Over the medium-run of the first four years, and starting from extreme stagnation, measured real GNP and industrial production rose by 67 and 110 percent, respectively (Hardach, 1980,161). Finally, strong growth was subsequently sustained for several decades.

At the same time, the *Wirtschaftswunder* is also often seen as an unique, almost painless process involving few real trade-offs. One can be left with the impression of a well-chosen initial policy package placing the economy on a smooth path of development, the success of which was always assured.

While reviewing successful aspects of German performance, we will focus on the second set of issues. While most

1. Prof. Ludwig Erhard, then Economic Director of the Allied Economic Council, played a major visible role in designing and carrying out the reforms. As he shared responsibility with other German and Allied officials, the term 'Erhard reforms' is not strictly correct. Dahrendorf (1990,91-2) identifies a constellation of persons, including Alfred Müller-Armack as the chief theorist and Chancellor Konrad Adenauer as the savvy politician providing 'cover' for the others.

judgements about the *Wirtschaftswunder* are based on broad long-run performance viewed with the benefit of hindsight, we examine two less explored perspectives:

- 1) The short-run view. For policy makers then and now, success is measured in results produced over months or quarters. There can be little comfort in knowledge that a set of policies will produce great improvements only after many years of waiting.
- 2) The *ex ante* view. Most policy choices, and the political pressures which influence them, are determined by forward-looking prospects in an uncertain world.

In this study, we describe the successes, failures and political pressures of the first two years of the 'Erhard reforms', drawing on academic studies and contemporary descriptions of The Economist. Based on these, we shall argue that from the short-run and *ex ante* perspectives, positive developments come with enough difficulties to make the period successful but far from miraculous. There is no evidence of success being a foregone conclusion. With new and weak policy instruments and an enormous transformation, the period exhibits alternating waves of inflation and unemployment. Most important, these years show numerous social groups strongly pressuring the government to retreat from the announced policy via reflation or recontrol.

In undertaking this study, we are motivated by the possible lessons of the German experience for the current transformations in Eastern and Central Europe and the Soviet Union. In an earlier paper (Hansson, 1990), we compare the initial conditions, microeconomic structure, and available macroeconomic instruments of 1948 West Germany and the current

Soviet Union. While noting clear differences, we argue that sufficient similarity exists for meaningful and instructive comparisons to be made.

However, when some policies work over time and present difficult dynamic trade-offs, existence of fertile ground is necessary but not sufficient. Here, one must look beyond the initial steps to the government's ability and determination to stick with policies that have immediate painful effects and benefits which come largely in the future.

In this paper, we round out the analysis of the German reforms by focussing on just these aspects, proceeding in several stages. Section II details the immediate and medium-run successes of the 1948 reforms. Section III examines the economic developments from the short-run and *ex ante* perspectives. Section IV describes and dicusses the various political pressures to pursue alternative policies. Finally, Section V presents conclusions and lessons for current East-Central European and Soviet transformations.

II. SUCCESSES OF THE ERHARD REFORMS

The German reforms of June 1948 had three key parts:

- 1) A currency reform which reduced stocks of money and financial assets by between 10:1 and 15:1, replacing the Reichsmark (RM) with the Deutschemark (DM).
- 2) A neutral or regressive tax reform aimed at stimulating savings, investment and overtime labour.
- 3) Elimination of most price controls, except on primary products and basic consumer expenditures.²

2. The actual policies are described in numerous sources, including Klopstock (1949), Mendershausen (1949), Hansson (1990) and Mayer and Thumann (1990).

These policies were very successful in two ways. First, they immediately restored reason to the economy, bringing back "elements of normality to lift the nightmare of German existence" (EC:040948). This cannot be captured by statistics, but rather by effusive descriptions of the immediate effects which have contributed greatly to the mystique of the *Wirtschaftswunder*. Two examples are:

The immediate results of the currency reform were so dramatic as to be almost unbelievable. One day there was nothing to buy in the shops; the next day the shops were full of merchandise. One day nobody would sell anything for marks; the next day no one would sell except for marks. Goods which had not been seen since the war appeared in the shops; new shops were opened; people were again willing to work and sell both goods and services for this new money.³

The day following "Day X", as it was known, euphoria engulfed most Germans at the sight of goods and food items they could only dream about in the past. Bakeries miraculously produced delicious cakes; vegetables, butter and eggs appeared in abundance. Goods that had obviously been hoarded secretly and had been available on the black market only, suddenly appeared in display windows.⁴

Six weeks into the reform, the picture was similar:

The new spirit of optimism (is) still strong, particularly among business men. Ordinary citizens are still enjoying the sight of goods in shop windows...The restaurants...are no longer crowded; and the railways, once crammed to the buffers, are reducing passenger rates to attract traffic...With better food and real money wages, the individual worker's output has also risen...Already, black market cigarettes, and smuggled coffee, are undercutting the legal market (EC:070848).

The reasons for the sudden change are straightforward. A large monetary overhang combined with expectation of currency reform (Klopstock, 1949, 278) eroded the role of money as a medium of exchange and store of value. This produced black

3. Jones (1953, 425). See also Lutz (1949, 131-2) and Wallich (1955, 68-73) and (EC:030748, EC:210848).

4. Bark and Gress (1989, 201).

markets, barter trade, hoarding, reduced work effort, a large external imbalance and general social disruption. Elimination of the overhang brought aggregate demand close to balance with aggregate supply at the prevailing price levels, mitigating these symptoms and restoring incentives to save, work and export.

Microeconomically, price liberalization permitted relative price adjustments to correct cumulative distortions from twelve years of imperfect price control. Concomitant tax reforms added incentives to save, invest and work.

Beyond these immediate effects, there are at least four clear indicators of success when viewed over the first two years as a whole:

1) The index of industrial production doubled from 54 to 100 (1936=100). While the measured growth rate is biased upwards by the rechanneling of hoarded goods and black and barter market trade to the official recorded economy, the true rise would still be positive and large.⁵

2) The official cost of living index was identical at the beginning and end of the period, changing only from 98 to 99 (1950=100). Resulting inflation measures have an upward bias, since the decline of the black market, with high prices that elude official recording, would bring some hidden deflation.

3) Exports grew from \$25 million in January 1948 and \$60 million in August 1948 to \$154 million in June 1950.⁶ Their composition also changed from predominantly raw materials to manufactures, moving Germany back towards its pre-war pattern

5. For a discussion of underlying sources, see Lutz (1949,133-4).

6. For reasons, see Hansson (1990).

of trade. The share of coal, earlier half of Bizonia's exports, declined rapidly (EC:150149,EC:250649).⁷

4) Recorded employment rose from 13.5 million in June 1948 to 13.8 million in June 1950. Changes in this figure have some upward bias, as they also capture a return to the official labour force by former black and barter market participants (EC:150450). For the same reason, official unemployment rate changes are also upwardly biased.

III. AN UNCERTAIN RECOVERY: THE SHORT-RUN AND EX ANTE VIEWS

These successes depend on both hindsight and the choice of a sufficiently long period. *Ex ante*, and over shorter horizons more relevant for stabilization, the picture is different in three ways:

1) The recovery was always uncertain and **precarious**. This is evident in a chronology of articles in The Economist. In September 1948, the economy was deemed 'precarious and unstable' (EC:040948). In October, West Germany was 'on its feet, but still shaky' (EC:021048). In November, the economy stood 'at a crucial point between conflicting inflationary and deflationary influences (where) one or two more major mistakes in policy may bring the fine hopes of revival to an end' (EC:271148). Even in February 1950, twenty months after the initial reforms, difficulties 'in investment, foreign trade and employment (mean that) the German community (is) faced with exceptional problems which one might assume only exceptional measures could overcome' (EC:040250).

7. 'Bizonia', or the Bizone, was the economic union of U.S. and British occupation zones from January 1947.

This is also captured by academic writers of the time. Heller (1950,531) writes: "Looking beyond the first eight months, one finds little basis for complacency." Klopstock (1949,272) notes: "It (is) apparent that the maintenance of monetary stability will call for much wisdom and financial statesmanship and that the gains so far achieved can be preserved only by continual vigilance."

Finally, modern accounts also describe a precarious economy. Owen Smith (1983,11) notes: "The fragile nature of the monetary and fiscal recovery during the period of re-adjustment should not be underestimated. In spite of the 50 per cent increase in output during the last half of 1948, recovery was by no means assured. Money supply, credit and prices all seemed to be getting out of hand." Finally, Bark and Gress (1989,205,264) argue that in early 1950, "it appeared unlikely that economic recovery would take place soon, and few could imagine that it would happen at all....It was not until early 1951 that the economic upswing was permanently under way and those doubting Erhard's vision became convinced of his foresight".⁸

2) Growth came at the expense of heightened **inequality**.

Workers experienced alternating waves of declining real wages and rising unemployment (see Figure 3), while the new-rich

8. Erhard later described a CDU meeting of October 1950 as follows: 'It was a time when opinion seemed registered to the ruin of West Germany...Opposition at home joined with international criticism...With prices rising day by day, and the foreign trade balance becoming ever more unfavourable, to speak of such things was possible only through a deep conviction that the market economy was right. It still took months before the change became apparent, but this turn towards salvation was, as a result, all the more positive and lasting.' Erhard, Ludwig (1954) Prosperity Through Competition, pp.45-6. c.f. Bark and Gress (1989), p. 267.

spent conspicuously on luxuries. Part of this redistribution came from tax evasion and illegal activity, and part from profits from sale of hoarded goods immediately after the currency reform (Bark and Gress (1989,263), EC:180649). The bulk was a conscious policy outcome, as tax laws were made more regressive to promote savings and investment, which reached 'levels one would have thought out of reach of an impoverished country'.⁹

3) Over shorter periods, indicators show much **volatility** around these trends. In particular, overall price stability comes from six months of high inflation followed by a longer period of falling prices (see Figure 2). To examine this more closely, we divide the first two years of the transformation into three sub-periods; an initial inflationary stage, a longer period of deflation, and a short period of recovery.

a) June-December 1948--Inflationary Growth

The period from June to December 1948 is characterized by a marked acceleration of measured inflation. Having averaged 6 percent per year from October 1945 to May 1948, official inflation reached a 30 percent annual rate during this time (Figure 2).¹⁰ As a freeze on wage increases was in place until November 1948, measured real wages also fell. Near the year's end, high inflation even brought back the monetary disorder of the pre-reform period, with new expectations of currency

9. Wallich (1955,79). These included a switch from income to consumption taxes, accelerated depreciation allowances and retained earnings exemptions (Denton and others (1988,188)).

10. Again, the caveats about measurement difficulties mean that true inflation was not as high.

reform leading to hoarding and black market trade, especially in food products.¹¹

At the same time, indicators of real activity, such as measured industrial production rising at a 114 percent annual rate (Figure 1), gave the period all the markings of a demand-driven boom. The sole exception is found in labour data. As the previous false full employment was terminated, growth of the official labour force simultaneously permitted rising employment (up from 13.5 million in June to 13.8 million in December) and a higher unemployment rate (up from 3.7 to 5.3 percent) (Figure 3).

The expansion was an unexpected result of the currency reform. In spite of a 93.5 percent reduction in money supply, initial DM balances proved too great to maintain constant prices. Subsequent money growth was fuelled by unblocking of some converted balances, and by the credit expansion based on the reform's creation of excess reserves.

While the real wage effects did precipitate a one day general strike on 12 November, no serious strike action was resorted to. This partly reflects living standards declining less drastically than official statistics indicate (see Section IV). Other factors include a genuine reluctance to interfere with recovery, the continued price controls on basic goods, a reservoir of unemployment, and currency reform's decimation of strike funds (Wallich (1955,75), Hardach (1980,171) and EC:021048). The restraint of organized labour, which continued after the end of the wage freeze, is widely

11. In November, an estimated 25 percent of the grain quota had been diverted to the black market (Klopstock, 1949,289; EC:070849).

viewed as an invaluable contributor to the recovery.¹²

b) January 1949-March 1950--Deflation and Unemployment

The government resisted most pressures to recontrol (see Section IV) and finally responded in December 1948 with an orthodox and 'devastatingly effective' monetary contraction (EC:260349). This was aided by the ending of blocked RM conversions into DM, the growth of tax revenues, the demand effect of falling real wages, and a world economic slowdown (Hardach, 1980,182).

The result was deflation, slower growth and increased unemployment. From December 1948 to March 1950, the official cost of living index fell from 112 to 100 (see Figure 2), while black market prices fell even further. The external value of the DM also began to consolidate, as reflected on the free market in Zurich. Beginning from a low of 17.5 Swiss francs for 100 DM, this rose to a February 1949 price of 41.5 Swiss francs (EC:190249, EC:230449).

Measured annual growth of industrial production, which had reached 114 percent during the previous six months, slowed to a 20 percent rate (see Figure 1). Consumers cut back expenditures and firms faced increased cancelled orders and bankruptcies.¹³ "The intoxicated spree of buying, stimulated by successive injections of new money, seems to have spent itself" (EC:190249).

12. Hardach (1980,170-1), Bark and Gress (1989,264), and EC:230449. Support for this includes the 75% of all investment during the first year of reforms which was financed via retained earnings or short-term credit (Milward,1984,108).
 13. The latter had been nearly absent in the immediate post-currency reform period (EC:260349, EC:230449).

The most significant and alarming development was growing joblessness, especially among refugees. The measured unemployment rate, which had stood at 5.3 percent in December 1948, rose steadily to 12.2 percent in March 1950 (Figure 3).

The Economist summed up the first half of 1949 this way:

The artificial boom is now over. The currency reform...has worked like a delayed action bomb. The bare bones of the German economy are now showing...Despite the immense unsatisfied demand that still exists, manufacturers and traders...are finding it comparatively difficult to dispose of their stocks (EC:180649).

As the unemployment rate grew, the central bank, the *Bank deutscher Laender* (BdL), faced growing criticism of its policies (see Section IV). It initially responded by easing up modestly, lifting credit ceilings in March 1949, removing restrictions on rediscounting of acceptances in May, and reducing reserve requirements and lowering the discount rate in July (Wallich, 1955,84-5). However, "even as it was easing up on credit it managed to convey an atmosphere of restraint and financial austerity...Its over-all policy plainly gave expression to the primacy of currency stability and balance of payments equilibrium over full employment" (Wallich, 1955,85).

The modest easing had little apparent effect. By autumn, the economy faced both rising unemployment and a balance of payments deficit. The latter heightened government resistance to expansion, which was seen to worsen the foreign balance.¹⁴

14. European currencies had been generally devalued against the US dollar in September 1949. However, as the DM's 20 percent devaluation was lower than the 30 percent drop in the pound sterling and other monies, it appreciated within Europe. At the same time, western Germany's membership in the OEEC required it to take part in a removal of all quantitative restrictions from roughly one-half of its intra-OEEC trade by mid-1949. By the autumn of 1950, about 60% of all imports had

By early 1950, unemployment had risen to 2 million, and "the social and political implications of mass unemployment could no longer be resisted" (Wallich, 1955,85). The government was finally forced to back down and adopt a reflationary stance. In February and March, it announced a planned employment and housing program along with a new round of tax cuts, especially on investment, to become effective in June. This would cost DM 3.4 billion, of which DM 1 billion would be financed by the BdL.

c) April-June 1950--Non-Inflationary Recovery

During the last three months of the full two year period, the economy underwent an unexpected non-inflationary boom. Industrial production grew at a 52 percent annual rate (Figure 1) while the cost of living remained stable (Figure 2). Employment and unemployment moved favourably and in opposite directions, with the latter falling by 2.2 percentage points over the three months (Figure 3). A sudden improvement in the trade balance also stemmed the loss of reserves of the previous months.

The boom was unexpected since, while expansionary fiscal measures had been announced in early 1950, the normal implementation lags of countercyclical policy meant that most would only come on stream in June, and could have had little direct impact on the economy. Instead, the boom has only two possible interpretations:

1) There was a policy announcement effect. Knowing of the

been freed (Hardach, 1980,172). The combined effect of the exchange rate and trade liberalisation steps was a surge in imports and a fall in both the trade balance and net official reserves. For more, see Milward (1984,353).

future fiscal shifts, citizens responded by increasing expenditures even before the policies were enacted, thereby stimulating aggregate demand.

2) In what amounts to a positive supply shock, the economy began to rebound itself from the previous disruptive sectoral adjustments which arose from relative price shifts and stabilization. New investments were coming on stream, labour had been reallocated to more effective uses, and general efficiency had increased. In this spirit, Wallich (1955,86) notes:

The revival in the spring of 1950 has shown...that the monetary authorities were right in trusting to the natural dynamics of the economy to lift output without central bank prodding. But had Korea not occurred there might have been reason to wonder, nevertheless, whether conservatism had not been carried a little too far.¹⁵

As a demand-driven explanation cannot be reconciled with the non-inflationary character of the recovery, the supply rebound thesis is the more likely of the two. If in fact true, it very importantly implies that the eventual success of the 'Erhard reforms' rested crucially on the government's resolve and ability to resist reflation pressures long enough for the beneficial effects of the reforms to begin emerging.

15. We end our analysis with the beginning of the Korean War, as this important shock complicates analysis of the subsequent period. Its initial impact was panic buying of raw materials, producing a greater external deficit. Over time, as orders for German capital goods grew, this turned into an export boom (Wallich, 1955,87). The role of the 'Korea factor' in the *Wirtschaftswunder* is much debated, but its 'luckiness' is not (see Bark and Gress (1989,263)). The boom was enlivened when the expansionary fiscal actions decided in the winter kicked in, at which time "whatever had been right in planning became a source of embarrassment in execution" (Wallich, 1955,85). This would subsequently lead to a deflationary policy in October 1950.

Over all three sub-horizons, the fragility of recovery strongly reflects the bluntness of the new macroeconomic policy instruments which replaced direct controls, and the government's inexperience in their use. Both factors clearly ruled out any prospects of economic fine tuning.

Fiscal policy adjustments were restricted by legal limits on the size of deficits and the degree to which they could be money financed (Wallich, 1955,76). Monetary authorities had few instruments, most of which "did not bite very sharply" (Wallich, 1955,77). The absence of marketable securities in the hands of the BdL, public and commercial banks ruled out open market operations until 1955. Use of discount rates and minimum reserve requirements was hampered by the currency reform, which left many banks flush with reserves and immune to these instruments, yet others very dependent on this channel. This left direct quantitative credit restrictions as key instruments of monetary policy.

In a new environment, macroeconomic policy was also experimental. For monetary policy, "too many unknowns remained: changes in the velocity of circulation, the rate at which hoarded goods would come to market, the future course of production--these, among other salient factors, could be only roughly guessed" (EC:230449). Experimentation and learning increased the potential for large cycles.

IV. THE PRESSURES TO ABANDON THE REFORMS

From the *ex ante* and short-run perspectives, uncertainty, inequality and volatility make this period successful but far from miraculous. These symptoms had a further indirect effect, since by heightening social tensions, they raised pressures to

retreat from the reforms. In fact, the whole two year period featured a persistent debate on the future of Germany as either a liberal or controlled economy. This became especially intense in late 1949 when, over a year after the currency reform, pressure grew to move boldly against unemployment. At this time, Heller (1950,532) wrote:

The easier part of economic recovery has been achieved, and the harder part lies ahead. Conflicts among various policy aims have been brought into the open, and sharp differences have developed with respect to both causes and cures.

Pressures came from many sides. First, before enactment Erhard's found almost no support for his views, except among a small pro-market group influenced by the 'ordo-liberal' writings of Müller-Armack, Eucken, Röpke and others.

Support from the party he would eventually lead, the Christian Democrats, would be long in coming. In February 1947, the CDU had accepted the so-called Ahlen Programme, which espoused a 'Christian socialism' of worker-managed enterprises, and which saw Germany as a bridge between East and West. Only over time, and especially after the reforms won some clear popularity, did the CDU come on side. Not until the 'Dusseldorf Principles' of July 1949 did the notion of a 'social market economy' finally appear in the CDU programme. Even then, the actual programme which Erhard implemented would scarcely warrant the term 'social' (Dahrendorf,1990,90).

Second, and especially after the 1949 downturn, business put pressure on the government to reflate the economy. "It would be hard to overstress the concerted persistence with which the German economic and business world is campaigning for capital" (EC:180649).

After the initial reforms, the Allied authorities had been among the most supportive of the new liberal policies. This changed when unemployment reached critical levels in early 1950. After the Germans presented the OEEC with their plan for the next two years of Marshall aid,

began a phase of acute criticism of German economic policy, during which--to the Germans' especial chagrin--American officials in the Economic Co-operation Administration were most vocal and dissatisfied...Unhappily for understanding and good will in the west, criticism of the German plan, which began as a reasoned comment on certain inadequacies in the programme, soon developed into a violent political argument over the merits and demerits of *laissez faire* and planning (EC:110350).

The Germans, fearing inflation, had opted for a modest investment programme and vehemently opposed controls.

Again and again in discussing the actions that might be taken to offset this or that result, the Government declined to consider intervention by the state, on the grounds that 'German economic policy is as a matter of principle against regimentation and most controls are now withdrawn' (EC:110350).

The Americans argued that the projected investment was insufficient for sustaining proposed consumption and export levels and accused the Germans of having virtually no plans to counter unemployment. The more the German position deteriorated, the more vocal this criticism became.

The most natural opposition came from organized labour, which "bitterly protested about inflation and growing inequality" and "opposed the dissolution of the old price control system, and demanded the reestablishment of a central price administration".¹⁶

16. Mendershhausen (1949,669), Wallich (1955,74-6) and Owen Smith (1983,12). Over a longer horizon, labor pressure continued. Germany's hardest and most important post-war

Finally, pressure to recontrol was always felt from the opposition Social Democrats, who argued that 'the worker is not getting his fair share', that 'he has a daily struggle to meet his basic needs' and 'the goods are there, but only the man with marks can buy them' (EC:021048). Some of this took place in the Bizonal Economic Council, where a major conflict emerged "between the adherents of centralized direction of the German economy and those who preferred to rely on the market mechanism, with the latter successfully resisting attempts to reintroduce controls on industrial prices" (Klopstock, 1949,289).

However, the election of August 1949 shows that the state of the economy was neither a great bonus or drawback for any party. Going in, it was unclear which side would prevail. Afterwards, the Christian Democrats' 139 seats, only slightly above the 131 of the Social Democrats, can appear as a narrow victory for opponents of the reforms. However, if one includes the 52 seats of the Free Democrats, who generally supported the reforms, the result becomes a modest victory for liberalism over planning. This election outcome provides some of the strongest proof that economic performance was seen as neither miraculous nor disastrous.¹⁷

strike began on 28 August, 1950, and was finally settled by a 10 percent wage hike. This was followed by many other strikes. 17. However, growing unemployment would soon erode the new Adenauer government's public support, giving it what would become the lowest popularity ratings in West German history. "Had an election been held in 1950, it undoubtedly would have produced a large victory for the SPD" (Bark and Gress, 1989,264).

The pressures for retreating from the reforms were heightened by three features of the subsequent period. The first was **inaccurate measurement of economic performance**. Given the drastic reduction of black market trade and redirection of output and employment into legal channels, official statistics presented a distorted picture.

Both positive and negative trends were exaggerated. Industrial production, unemployment and the price level all appeared to grow more than they actually did (see Section II). For instance, the true inflation rate, which was fiercely disputed, would depend on the degree to which one could previously transact at official prices. As the pre-reform 'non-white' economy was large, this ability was typically not great, making the true pre-reform price level much higher. The reforms reduced black market premia, such that even with a large rise in official prices, most actual prices rose more slowly or even fell.

Investigators, who come to Germany...are misled by a flood of statistics which apparently prove that the cost of living has risen dangerously since controls were lifted...The prices which should be compared are those of goods now freely obtainable in shops with the black market prices before currency reform; or the present black market prices with those prevailing before June 20th. It would then be impossible to declare that the cost of living has yet risen beyond bearing (EC:021048).

Exaggeration of successes and failures heightened tensions by providing fertile ground for populism and political polarization.

The German economy has been painted in some peculiar colours in recent weeks, the supporters of free enterprise heightening the effects that please them most--the sharp rise in output, the incentives to work and earn, the tendency of the price of consumer goods to fall--while the defenders of the planned

economy point to houses unbuilt while building workers are idle, to great contrasts in riches and poverty, to luxuries imported and produced before necessities and, above all, to the mass of unemployed (EC:110350).

Second, the economy suddenly faced the **qualitatively different problems** of a surplus economy. As the earlier shortages, distortions and black markets faded from memory while new problems remained visible, the public's view of the policy's overall impact was unbalanced and arguably too negative.

The German working man, and, still more, the pensioners and refugees, see little beyond the fact that they can hardly make ends meet. They have almost forgotten that before currency reform, though they had plenty of money, there were practically no goods to buy at the 'legal' prices. All they can grasp is that prices have risen, but not wages. To a people used for decades to the system of 'buying permits' and coupons, it seems plain that the state which provides the goods must give the money to buy them (EC:271148).

Nobody seems to remember that during the last three years one couldn't buy any eggs.... When no eggs at all were available in the stores, hardly anyone took offense. But an uproar develops, when eggs are displayed everywhere, however costing as much as 60 or 70 pfennig per egg, and, therefore, cannot be bought in the desired quantity.¹⁸

Third, the reforms had two aspects of a **stagflationary supply shock**:

- 1) They produced large relative price changes (Lutz, 1949, 135). As this made some activities uneconomic, part of the existing stock of capital and skills became obsolete. Until adjustment was complete, this would produce structural unemployment.
- 2) The combination of wartime destruction of capital and a large influx of refugees reduced the aggregate capital-labour

18. Vaubel, Ludwig (1984) Zusammenbruch und Wiederaufbau: Ein Tagebuch aus der Wirtschaft, 1945-1949, p. 175. c.f. Bark and Gress (1989), p. 205.

ratio, acting to lower average labour productivity relative to pre-war levels. This required general real wage reduction to maintain employment and capital accumulation, which was 'not at all obvious to the German public' (EC:271148).

These 'structural' factors worsened the menu of attainable short-run macroeconomic outcomes, directly raising the potential for tensions. Combined with concomitant monetary stringency, they also gave ample evidence to support any view of the prime cause of unemployment, precipitating a fierce debate between what we would now call the Keynesian and classical views.

Social Democrats argued that the existence of idle labour meant that expansion was unlikely to lead to much inflation and that this was a calculated risk worth taking.¹⁹ Along with the unions, they requested expansionary monetary and fiscal policy to pursue full-employment. Conservatives, especially in the government and BdL, stressed currency stability and external balance. They questioned the extent to which idle manpower could be employed, as most unemployment was 'structural' rather than cyclical. As expansion would bring inflation without extra output, causes had to be cured directly.²⁰

V. CONCLUSIONS

Having initiated an *ex post* success in a world of failed economic transformations, the 1948 West German policies have

19. Wallich (1955,81-2). Negative impacts on the balance of payments were seen as solvable via direct controls.

20. The Economist espoused the structural view, arguing that losing control of money growth was among the most serious dangers. "'Structural causes'...are, indeed, so important that, when they are considered, a total of 2,000,000 workless appears astonishingly small" (EC:021048,EC:271148,EC:150450).

become a potential model for countries undertaking fundamental reforms. As these moved Germany from a controlled to a liberal economy under severe macroeconomic instability, the experience is especially relevant for current Eastern European and Soviet reform efforts. However, drawing parallels requires a deeper understanding of what exactly took place.

In this paper, we have argued that the *ex post*, long-run *Wirtschaftswunder* looks much less miraculous from the *ex ante* and short-run perspectives relevant to policy makers. From these viewpoints, its first two years were an uneasy amalgam of successes and difficulties. The state of the economy was always precarious. As several groups clearly suffered, this period was far from a social success. Finally, as policy makers were only learning to use indirect macroeconomic instruments, short-run cycles of unemployment and inflation were pronounced.

The coexistence of normalization and obvious success with deep problems, led to a combination of broad general support with intense opposition from negatively affected groups. The opposition grew over time, giving the government ample reasons to retreat via reflation.

Eventually, it did just that. However, before these policies could come on stream, and twenty months after the start of reforms, the positive effects of the earlier structural transformations began to appear. These natural dynamics produced a non-inflationary boom, making the adopted expansionary policies redundant or even destabilizing.

In other words, the eventual success of the Erhard reforms is almost certainly crucially linked to Erhard's

earnest resolve, combined with the long implementation lags of fiscal policy.²¹ Had the government heeded the numerous calls to reflate the economy six months earlier, the eventual outcome may well have been reflation, recontrol and another example of a failed transformation.

The German experience suggests three ways for governments choosing similar paths to reduce political pressures and improve the likelihood of success. The first is construction of accurate price indices during the transition. This would reduce exaggeration of negative trends, which gives reform opponents ammunition of dubious validity but obvious power.

The second is frequent reminders of the true state of the pre-reform economy, to counter the rapid fading from memory of earlier problems which produces an overly negative view.

Third, and possibly most important, is honestly conveying the transition's difficulty to the public. If even the reforms with the greatest aura of success were very difficult at the beginning, other attempted transformations will be no different. As The Economist wrote immediately after the currency reform:

To subject the economy to a cold douche of financial orthodoxy and of hard money, may be an essential condition of ultimate reconstruction and indeed of survival; but the immediate shock is bound to cause much friction, local unemployment and hardship. It would be well for the Allied and German authorities now launching the reform to emphasise and publicise this aspect of the problem from the outset. Propaganda blaring from the East will not fail to seize on each symptom of transitional difficulty... There will be plenty of material for it to exploit, for in truth the more the new regime hurts in its early stages the better it will do its job (EC:260648).

21. The role of key personalities in the success or failure of various transformations, a subject little explored by economists, is almost surely an important factor in this and many other cases.

BIBLIOGRAPHY

Bark, D.L. and D.R. Gress (1989) A History of West Germany (Oxford: Basil Blackwell)

Dahrendorf, R.G. (1990) Reflections on the Revolution in Europe (London: Chatto & Windus)

Denton, G., Forsyth, M. and M. Maclennan (1968) Economic Planning and Policies in Britain, France and Germany (London: George Allen & Unwin Ltd.)

Economist, various issues.

Hansson, A.H. (1990) "The 1948 West German Economic Reforms: A Model for Eastern Europe?" University of British Columbia, Department of Economics, Discussion Paper 90-05, March.

Hardach, K. (1980) The Political Economy of Germany in the Twentieth Century (Berkeley: University of California Press)

Heller, W.W. (1950) "The Role of Fiscal-Monetary Policy in German Economic Recovery." American Economic Review 40, May, pp. 531-47.

Jones, H.P. (1953) "Currency, Banking, Domestic and Foreign Debt." In E.H. Litchfield, ed., *op. cit.*, pp. 419-38.

Klopstock, F.H. (1949) "Monetary Reform in Western Germany." Journal of Political Economy 57, August, pp. 277-92.

Litchfield, E.H. (1953) "Emergence of German Governments." In E.H. Litchfield, ed., Governing Postwar Germany (Ithaca, NY: Cornell University Press), pp. 19-58.

Lutz, F.A. (1949) "The German Currency Reform and the Revival of the German Economy." Economica, May, pp. 122-42.

Mayer, T. and G. Thumann (1990) "Radical Currency Reform: Germany, 1948." Finance and Development 27, March, pp. 6-8.

Mendershausen, H. (1949) "Prices, Money and the Distribution of Goods in Postwar Germany." American Economic Review, pp. 646-71.

--- (1955) Two Postwar Recoveries of the German Economy (Amsterdam: North Holland)

Milward, A.S. (1984) The Reconstruction of Western Europe 1945-51 (London: Methuen & Co. Ltd.)

Mott, R.L. (1953) "Public Finance." In E.H. Litchfield, ed., *op. cit.*, pp. 326-60.

Owen Smith, E. (1983) The West German Economy (London: Croon Helm)

Wallich, H.C. (1955) Mainsprings of the German Revival (New Haven: Yale University Press)

Zink, H. (1957) The United States in Germany 1944-1955 (Princeton, NJ: D. Van Nostrand)

FIGURE 1

WESTERN GERMAN INDUSTRIAL PRODUCTION

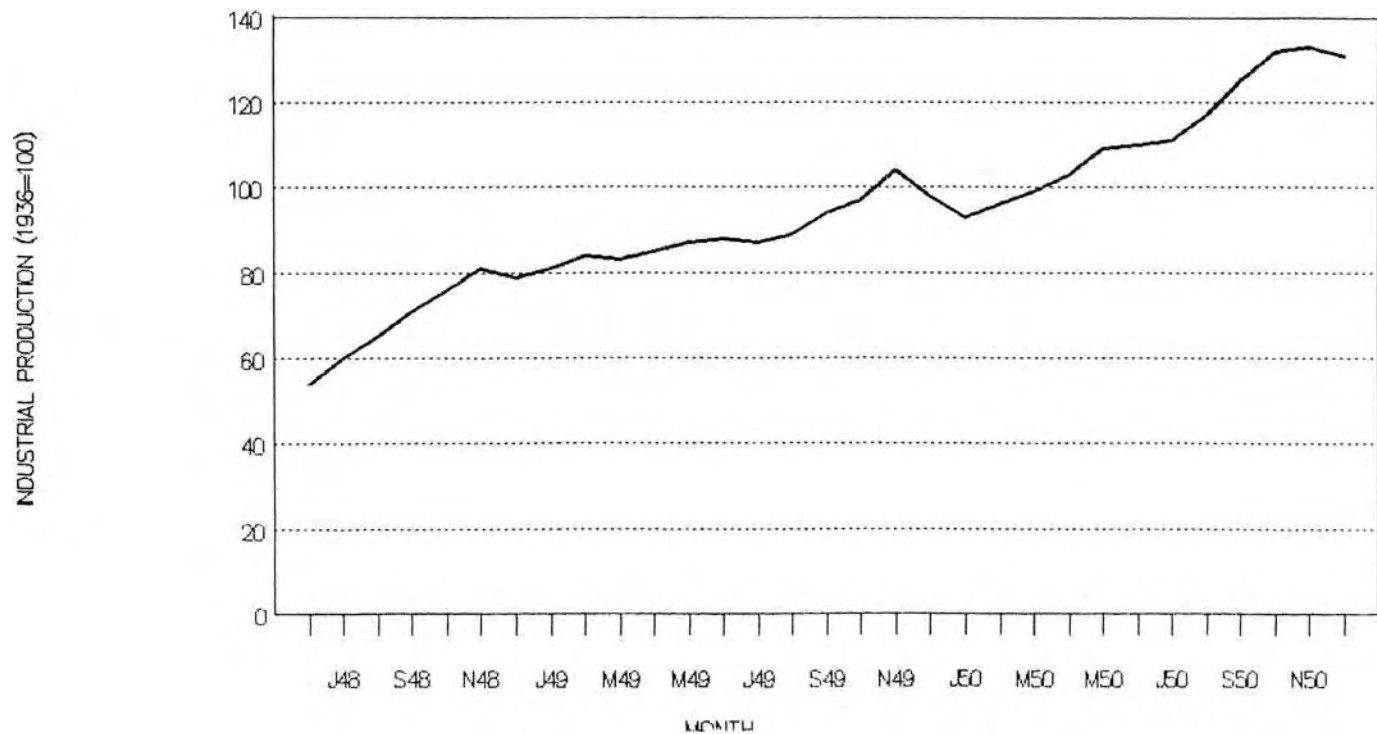


FIGURE 2

WESTERN GERMAN COST OF LIVING

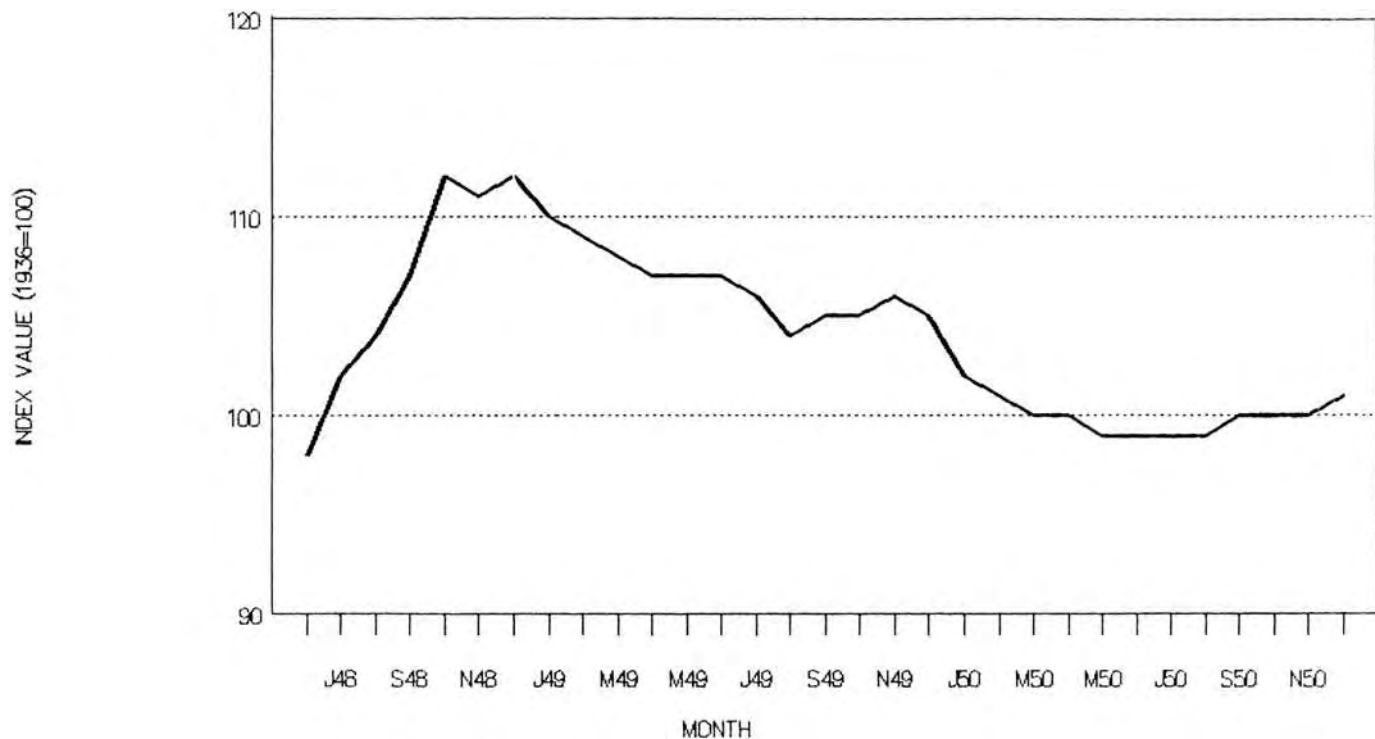
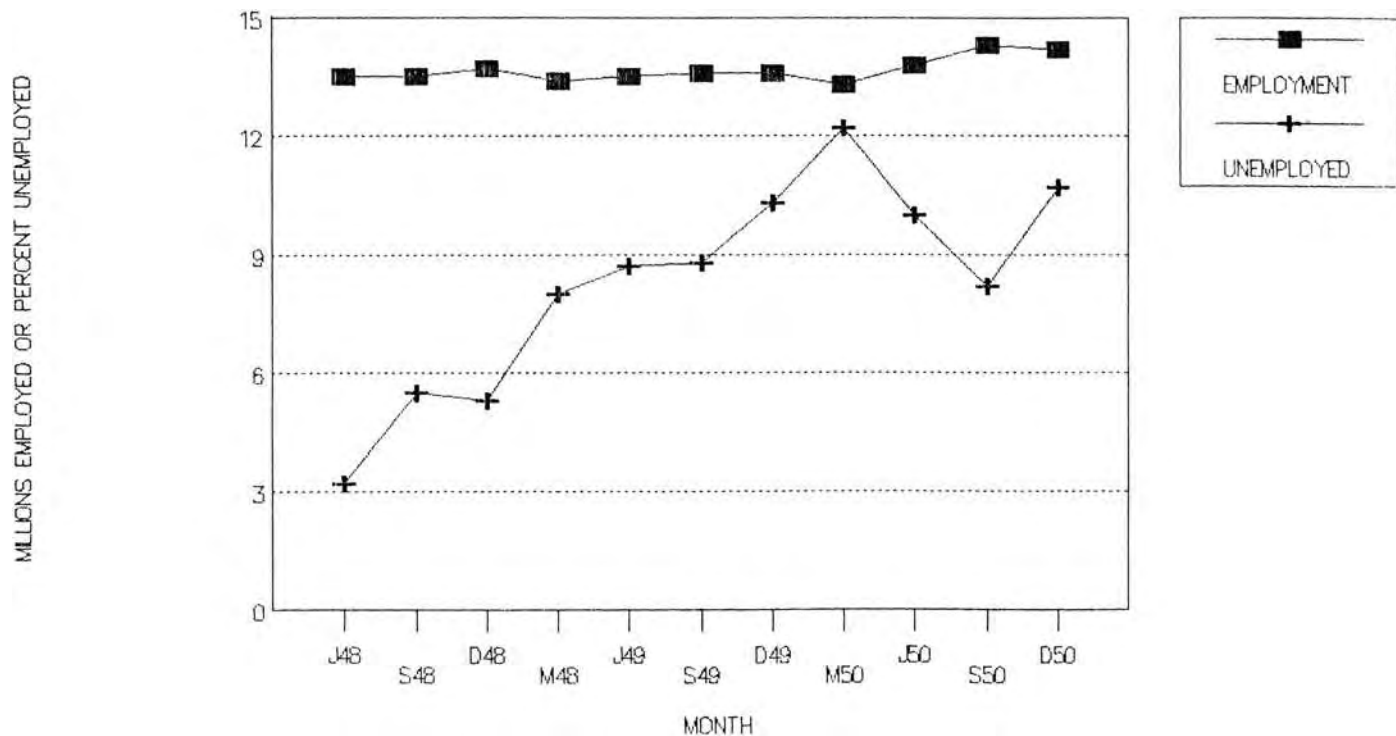


FIGURE 3

EMPLOYMENT AND UNEMPLOYMENT



WIDER WORKING PAPERS

- WP 1. Amartya Sen: Food, economics and entitlements, February 1986
WP 2. Nanak Kakwani: *Decomposition of normalization axiom in the measurement of poverty: a comment*, March 1986
WP 3. Pertti Haaparanta: The intertemporal effects of international transfers, April 1986
WP 4. Nanak Kakwani: Income inequality, welfare and poverty in a developing economy with applications to Sri Lanka, April 1986
WP 5. Pertti Haaparanta: and Juha Kähkönen: Liberalization of Capital Movements and Trade: Real Appreciation, Employment and Welfare, August 1986
WP 6. Pertti Haaparanta: Dual Exchange Markets and Intervention, August 1986
WP 7. Pertti Haaparanta: Real and Relative Wage Rigidities – Wage Indexation* in the Open Economy Staggered Contracts Model, August 1986
WP 8. Nanak Kakwani: On Measuring Undernutrition, December 1986
WP 9. Nanak Kakwani: Is Sex Bias Significant? December 1986
WP 10. Partha Dasgupta and Debraj Ray: Adapting to Undernourishment: The Clinical Evidence and Its Implications, April 1987
WP 11. Bernard Wood: Middle Powers in the International System: A Preliminary Assessment of Potential, June 1987
WP 12. Stephany Griffith-Jones: The International Debt Problem – Prospects and Solutions, June 1987
WP 13. Don Patinkin: Walras' Law, June 1987
WP 14. Kaushik Basu: Technological Stagnation, Tenurial Laws and Adverse Selection, June 1987
WP 15. Peter Svedberg: Undernutrition in Sub-Saharan Africa: A Critical Assessment of the Evidence, June 1987
WP 16. S. R. Osmani: Controversies in Nutrition and their Implications for the Economics of Food, July 1987
WP 17. Frédérique Appfel Marglin: Smallpox in Two Systems of Knowledge, Revised, July 1987
WP 18. Amartya Sen: Gender and Cooperative Conflicts, July 1987
WP 19. Amartya Sen: Africa and India: What do we have to learn from each other? August 1987
WP 20. Kaushik Basu: A Theory of Association: Social Status, Prices and Markets, August 1987
WP 21. Kaushik Basu: A Theory of Surplus Labour, August 1987
WP 22. Albert Fishlow: Some Reflections on Comparative Latin American Economic Performance and Policy, August 1987
WP 23. Sukhamoy Chakravarty: Post-Keynesian Theorists and the Theory of Economic Development, August 1987
WP 24. Georgy Skorov: Economic Reform in the USSR, August 1987
WP 25. Amartya Sen: Freedom of Choice: Concept and Content, August 1987
WP 26. Gopalakrishna Kumar: Ethiopian Famines 1973–1985: A Case-Study, November 1987
WP 27. Carl Riskin: Feeding China: The Experience since 1949, November 1987
WP 28. Martin Ravallion: Market Responses to Anti-Hunger Policies: Effects on Wages, Prices and Employment, November 1987
WP 29. S. R. Osmani: The Food Problems of Bangladesh, November 1987
WP 30. Martha Nussbaum and Amartya Sen: Internal Criticism and Indian Rationalist Traditions, December 1987
WP 31. Martha Nussbaum: Nature, Function and Capability: Aristotle on Political Distribution, December 1987
WP 32. Martha Nussbaum: Non-Relative Virtues: An Aristotelian Approach, December 1987
WP 33. Tariq Banuri: Modernization and its Discontents A Perspective from the Sociology of Knowledge, December 1987
WP 34. Alfred Maizels: Commodity Instability and Developing Countries: The Debate, January 1988
WP 35. Jukka Pekkarinen: Keynesianism and the Scandinavian Models of Economic Policy, February 1988
WP 36. Masahiko Aoki: A New Paradigm of Work Organization: The Japanese Experience, February 1988
WP 37. Dragoslav Avramovic: Conditionality: Facts, Theory and Policy – Contribution to the Reconstruction of the International Financial System, February 1988
WP 38. Gerald Epstein and Juliet Schor: Macropolicy in the Rise and Fall of the Golden Age, February 1988
WP 39. Stephen Marglin and Amit Bhaduri: Profit Squeeze and Keynesian Theory, April 1988
WP 40. Bob Rowthorn and Andrew Glyn: The Diversity of Unemployment Experience Since 1973, April 1988
WP 41. Lance Taylor: Economic Openness – Problems to the Century's End, April 1988
WP 42. Alan Hughes and Ajit Singh: The World Economic Slowdown and the Asian and Latin American Economies: A Comparative Analysis of Economic Structure, Policy and Performance, April 1988
WP 43. Andrew Glyn, Alan Hughes, Alan Lipietz and Ajit Singh: The Rise and Fall of the Golden Age, April 1988
WP 44. Jean-Philippe Platteau: The Food Crisis in Africa: A Comparative Structural Analysis, April 1988
WP 45. Jean Drèze: Famine Prevention in India, May 1988
WP 46. Peter Svedberg: A Model of Nutrition, Health and Economic Productivity, September 1988
WP 47. Peter Svedberg: Undernutrition in Sub-Saharan Africa: Is There a Sex-Bias?, September 1988
WP 48. S.R. Osmani: Wage Determination in Rural Labour Markets: The Theory of Implicit Co-operation, December 1988
WP 49. S.R. Osmani: Social Security in South Asia, December 1988
WP 50. S.R. Osmani: Food and the History of India – An 'Entitlement' Approach, December 1988

- WP 51. Grzegorz W. Kolodko: Reform, Stabilization Policies, and Economic Adjustment in Poland, January 1989
- WP 52. Dariusz Rosati and Kálmán Mizsei: Adjustment through Opening of Socialist Economies, January 1989
- WP 53. Andrei Vernikov: Reforming Process and Consolidation in the Soviet Economy, January 1989
- WP 54. Adam Török: Stabilisation and Reform in the Hungarian Economy of the late 1980s, March 1989
- WP 55. Zhang Yuyan: Economic System Reform in China, March 1989
- WP 56. Amitava Krishna Dutt: Sectoral Balance: A Survey, March 1989
- WP 57. Robert Pringle: Financial Markets and Governments, June 1989
- WP 58. Marja-Liisa Swantz: Grassroots Strategies and Directed Development in Tanzania: The Case of the Fishing Sector, August 1989
- WP 59. Aili Mari Tripp: Defending the Right to Subsist: The State vs. the Urban Informal Economy in Tanzania, August 1989
- WP 60. Jacques H. Drèze, Albert Kervyn de Lettenhove, Jean-Philippe Platteau, Paul Reding: A Proposal for "COoperative Relief of Debt in Africa" (CORDA), August 1989
- WP 61. Kaushik Basu: Limited Liability and the Existence of Share Tenancy, August 1989
- WP 62. Tariq Banuri: Black Markets, Openness, and Central Bank Autonomy, August 1989
- WP 63. Amit Bhaduri: The Soft Option of the Reserve Currency Status, August 1989
- WP 64. Andrew Glyn: Exchange Controls and Policy Autonomy – The Case of Australia 1983–88, August 1989
- WP 65. Jaime Ros: Capital Mobility and Policy Effectiveness in a Solvency Crisis. The Mexican Economy in the 1980s, August 1989
- WP 66. Dan W. Brock: Quality of Life Measures in Health Care and Medical Ethics, August 1989
- WP 67. Robert Erikson: Descriptions of Inequality. The Swedish Approach to Welfare Research, August 1989
- WP 68. Onora O'Neill: Justice, Gender and International Boundaries, August 1989
- WP 69. Bernard M. S. van Praag: The Relativity of the Welfare Concept, August 1989
- WP 70. Hilary Putnam: Objectivity and the Science/Ethics Distinction, August 1989
- WP 71. John E. Roemer: Distributing Health: The Allocation of Resources by an International Agency, August 1989
- WP 72. Charles Taylor: Explanation and Practical Reason, August 1989
- WP 73. Gerald Epstein and Herbert Gintis: International Capital Markets and the Limits of National Economic Policy, October 1989
- WP 74. A.D. Cosh, A. Hughes and A. Singh: Openness, Innovation and Share Ownership: The Changing Structure of Financial Markets, October 1989
- WP 75. Robert B. Zevin: Are World Financial Markets more Open? If so Why and with What Effects?, October 1989
- WP 76. Lance Taylor: Gap Disequilibria: Inflation, Investment, Saving and Foreign Exchange, October 1989
- WP 77. Andrei Vernikov: Soviet Economy: Opening up and Stabilization, October 1989
- WP 78. Kaushik Basu: The International Debt Problem: Could Someone Please Explain It to Me?, October 1989
- WP 79. C.K. Omari: Rural Women, Informal Sector and Household Economy in Tanzania, October 1989
- WP 80. Partha Dasgupta: Well-Being: Foundations, and the Extent of Its Realization in Poor Countries, October 1989
- WP 81. Grzegorz W. Kolodko, Marian Ostrowski, Dariusz Rosati: Stabilization Policy in Poland. Challenges and Constraints, February 1990
- WP 82. S.R. Osmani: Food Deprivation and Undernutrition in Rural Bangladesh, February 1990
- WP 83. Kálmán Mizsei, Adám Török: Modified Planned Economies at the Crossroads: The Case of Hungary, March 1990
- WP 84. Partha Dasgupta: The Environment as a Commodity, March 1990
- WP 85. V.M. Moghadam: Determinants of Female Labor Force Participation in the Middle East and North Africa, May 1990
- WP 86. Lauri Siitonen: Political Theories of Development Cooperation – A Study of Theories of International Cooperation, July 1990.
- WP 87. Valentine M. Moghadam: Gender and Restructuring: Perestroika, the 1989 Revolutions, and Women, November 1990
- WP 88. Walter C. Labys and Alfred Maizels: Commodity Price Fluctuations and Macro-economic Adjustments in the Developed Countries, November 1990
- WP 89. Siddiq A. Saih, William H. Branson and Yusuf H. Al Ebraheem: Oil Driven Macroeconomic Model of Kuwait, March 1991
- WP 90. Simon Johnson and Bakhtior Islamov: Property Rights and Economic Reform in Uzbekistan, September 1991
- WP 91. Simon Johnson: Spontaneous Privatization in the Soviet Union. How, Why and for Whom? September 1991
- WP 92. Jeffrey D. Sachs: Accelerating Privatization in Eastern Europe: The Case of Poland, September 1991
- WP 93. Ardo H. Hansson: The Emergence and Stabilization of Extreme Inflationary Pressures in the Soviet Union, September 1991
- WP 94. Ardo H. Hansson: The Importance of Being Earnest: Early Stages of the West German Wirtschaftswunder, September 1991