# THE DEEP CAUSE OF THE GREAT FINANCIAL CRISIS:

# THE PEACE DIKTAT OF VERSAILLES

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Ladies and Gentlemen,

According to a recent news item, not widely circulated, after more than 90 years of slavery, on October 3, 2010, Germany made the final payment for its World War I debt. This event is highly symbolic. It gives me great pleasure to be one of the first to congratulate you, literally hours after the German people were finally freed from debt slavery.

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I have been a student of money and credit for over fifty years. I could summarize the result of my studies as follows: *Most, if not all, the great events in the history of mankind since the advent of money, have a causal explanation. The causes are to be found in the use or abuse of money and credit — provided that we penetrate historiography sufficiently deeply.*

My talk is meant to be dispassionate, well-grounded in economic thought, and certainly free from nationalistic overtones.

This evening I would like to illustrate my thesis through the following example:

*The Great Depression of the 1930's, in particular, the unprecedented world-wide unemployment was caused by the decision of the victorious Entente powers to return to the gold standard after World War I,* ***BUT without allowing the clearing house of the gold standard, the international bill market, to make a comeback.***

This decision was made in secret. It has never been made public. But there can be no doubt about the fact that in 1920 everybody, even Keynes himself, admitted the desirability of an expeditious return to the gold standard. Had there been no decision to ban it, bill trading would have started spontaneously.

What this decision was meant to accomplish was to block multilateral world trade by brute force. It was to be replaced by bilateral trade or, to call a spade a spade, by a barter system. Why did the victorious Entente powers make such a foolish decision that was going to hurt their own producers and consumers, and hinder reconstruction? They did it because they wanted to punish Germany over and above the provisions of the Versailles peace treaty. They wanted to maintain the wartime blockade under a different name. They wanted to monitor, and control if need be, the move of goods in and out of Germany. In peacetime the only way to accomplish this was to replace multilateral with bilateral trade; to block the financing of world trade with short-term commercial bills, also known as real bills. To put it differently, the Entente powers phased out self-liquidating credit and replaced it with artificial bank credit, the creation of which they could control through their central banks.

World trade prior to 1914 was multilateral. By this I mean that imports were paid for by issuing, endorsing, and accepting bills of exchange payable in gold at maturity no more than 91 days after shipping the underlying merchandise. With three good signatures: that of the exporter, that of the importer, and that of a recognized acceptor the bill of exchange went through a most remarkable metamorphosis. It became money. Ephemeral, to be sure, but money nevertheless. The exporter could use it to pay for *his* imports by passing it on, after endorsing it, to the exporter in a third country. This exporter could likewise use it to pay for his own imports, and so on and so forth. Only in the light of this fact can one explain the unprecedented expansion of world trade during the 100-year period between 1815, marking the end of the Napoleonic War and 1914, marking the outbreak of World War I. Such a record level of world trade would not have been possible without the clearing house for the gold standard, the bill market. Geographically, this clearing house was located in the City of London. It was the great London trading houses and banks on which bills of exchange, covering merchandise shipped from country *A* to country *B,* were drawn. It was the great acceptance houses in London that accepted them. Once so endorsed and accepted, these bills started to circulate on their own wings and under their own power, as only monetary gold could circulate: without friction.

It was this great clearing house of the gold standard in London that was blocked, nay, sabotaged, by the decision of the Entente powers at Versailles in their vindictive moment of victory. They never examined the broader economic implications of their move, beyond the obvious effect of putting the foreign trade of Germany on a leash. They utterly failed to see the wider consequences of their folly.

To show just how short-sighted the decision to block the circulation of real bills was, consider the argument of the German economist Heinrich Rittershausen (1898-1984) that he presented in his monograph entitled *Unemployment and Capital Formation*, published in 1930, but obviously written before the Great Depression has become a reality. Rittershausen predicted that, hard on the heels of the collapse of the gold standard, a horrendous wave of world-wide unemployment would prostrate the world economy.

Under multilateral world trade financed by real bills there was something we may, in want of a better term, call the *Wage Fund* — out of which the wages of laborers producing merchandise demanded most urgently by consumers could be paid. Please remember that these goods during their gestation period of up to 91 days could not be sold to the ultimate consumer. He was the only one to pay for his purchase by handing over the gold coin. Neither the producers of semi-finished goods that go into the merchandise, nor the wholesale and retail merchants would ever pay gold: they would issue or endorse bills. It could take 91 days (or 13 weeks, or 3 months, or a quarter) before the real bill matured into the gold coin with which wages could be paid. But laborers have to be fed, clad, shod, and sheltered in the meantime. They cannot wait for 3 months till the merchandise will have been sold to the ultimate gold-paying consumer. Wages have to be paid weekly, not quarterly.

Thus, then, the Wage Fund is absolutely necessary for the maintenance of world trade and full employment on a scale it has reached prior to 1913. Such a Wage Fund could only exist by virtue of the bill market. So much of the ‘float’ of real bills in the world was earmarked for paying wages; the remainder was earmarked to pay for supplies. The system worked extremely well: ‘structural’ unemployment was unheard-of before World War I.

This Wage Fund was unwittingly destroyed by the victorious Entente powers at the moment they decided to block the financing of world trade through real bills circulation as it existed before 1914. The result was that world trade never really recovered. In fact it took the better part of the twentieth century for the volume of world trade to reach its 1913 peak level again. In the meantime it was touch-and-go. Bilateral trade, barter, or direct payment of gold and gold exchange replaced self-liquidating credit, as the credit represented by real bills was called.

The destruction of the Wage Fund was not immediately noticed. The great inflation due to World War I imparted sufficient stimulus for a full decade to cover up the complete absence of a reliable fund out of which wages could be paid. In due course, however, the surplus money was siphoned off by an extraordinary explosion of speculative activity in financial bills, real estate, and in the shares of joint-stock companies. Real bills were conspicuous only by their absence.

When money became scarce after the bubbles burst one after another: the bubble in US Treasury bonds in 1920, the Florida real estate bubble in 1925, and the stock market bubble in 1929, the absence of the Wage Fund, destroyed a decade earlier, immediately became obvious. There was no money to pay the wage earner. Workers were laid off. They had to be put on the dole. An unprecedented wave of unemployment, like a tsunami, engulfed the world. Dictatorships could escape the curse of unemployment by destroying civil liberties: Lenin's under the banner of international socialism, Hitler's under the banner of national socialism.

The only economist in the world who saw what was coming was Rittershausen. But he was treated by the international community of economists with the same contempt as the German delegation was at the Versailles peace conference. A new economic gospel was promulgated by the prophet John Maynard Keynes who made a complete *volte face*. He was a most vocal opponent of Britain's return to the gold standard in 1925. Not because he realized that Britain's 'newly-born-again' gold standard was not viable as it grievously lacked a vital part: the clearing house. Keynes opposed the gold standard on doctrinaire grounds. According to him the gold standard was obsolete, contractionist, an obstruction to progress. The new dispensation called for flexible foreign exchange rates that could be easily manipulated in the service of a hidden political agenda. Keynes was the *enfant terrible* of economic science. He was a perfect antithesis of Rittershausen. He was a master of demagoguery. He made economics stand on its head. For thousands of years the problem of economics was the scarcity of savings as well as over-consumption, especially during princely wars. Keynes invented *over-saving* and its twin brother, *under-consumption*. These notions are as obnoxious as they are preposterous. Yet the world, desperate for getting out of the depression, bought them. This was just what Keynes has been waiting for. He was hell bent on manipulating the whole world through clever verbiage, but which utterly lacked any substance.

Rittershausen, on the other hand, had no ulterior motivation. He just wanted to find the truth. And, indeed, he found it by pointing to the destruction of the wage fund in the wake of blocking the circulation of real bills. It is a great tragedy that Rittershausen was born in Germany rather than Britain, and Keynes was born in Britain rather than Germany. If it had been the other way around, then Keynes would have been totally ignored, as was his desert, and Rittershausen would have been elevated to international fame, as was his. He would have been made the object of world-acclamation and admiration.

History may not be repeating, but it certainly is strongly echoing itself. The Great Financial Crisis of 2008 is such an echo of the Great Depression of 1930. Or could it be that the Great Depression of 1930 was the harbinger of something far worse: the Great Financial Crisis of 2008 and its aftermath, still to be visited upon the world?

The last remnants of the gold standard were abolished in 1971 when the Republican president Richard Nixon defaulted on the international gold obligations of the US — almost 40 years after the

Democratic president Franklin D. Roosevelt defaulted on its domestic gold obligations. It triggered the fast-breeder of money, originally envisaged by Keynes, later dressed up academically and made palatable politically by Milton Friedman. At first, the going was great under the catch-word: “you have never had it so good”. But then, just as during the “roaring 20’s”, speculators grabbed the money spun out by the fast breeders and ran with it. Once again, bubbles were blown and started bursting one after another. Now the world is confronted with the worst prospects for unemployment ever. At any rate, far worse than the one Rittershausen had predicted in 1930. We can, using his methodology, predict Great Depression II in the making. The world still is lacking a Wage Fund. A vastly expanded army of unemployed people will have to be fed, clad, shod and sheltered. The money to do it is not there. Once again, governments will have to create it out of nothing to pay the dole.

The obvious way out of this corner is the resuscitation of the Wage Fund through allowing the spontaneous circulation of real bills that were last used in 1914. Lest anyone suggest that this feat could be accomplished under the regime of irredeemable currency, beware: *real bills can only work if they mature into gold*. It is unthinkable that they could mature into irredeemable paper currency. A real bill is an IOU promising to pay gold, and it offers a return to boot. An irredeemable banknote is an “IOU nothing” and it offers nothing — an inferior instrument at best, a fraud at worst. A real bill, to be meaningful, must mature into a superior financial instrument. Otherwise it refuses to circulate. Therefore the rehabilitation of real bills assumes the simultaneous rehabilitation of the gold standard. The two go together as hand and glove.

The way to return to the gold standard is for the US government to open the US Mint to gold — as ordained by the American Constitution that has been violated by power-hungry presidents such F. D. Roosevelt and his successors, every one of whom swore to uphold it, only to turn around and trample on it.

It would be an extraordinary act of statesmanship if a new president reinstated the monetary provisions of the American Constitution.

*There is no other way to prevent the collapse of the debt tower, or to fend off the tsunami of unemployment and the global breakdown of law and order.*

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