# World War I and Its Legacy (1914-1928)

## Lecture 8

18 April 2025

# World War I and Its Legacy (1914-1928)

- By the early 1900s, the global economy had reached a mature and highly interconnected state.
- This integration was driven by growing volumes of international trade, cross-border migration, and international capital flows.
- However, the benefits of globalization were unevenly distributed, creating tensions within and across countries.
- As a result, political backlash against open markets, immigration, and global finance gained momentum in several countries.

# World War I and Its Legacy (1914-1928)

- The outbreak of World War I in 1914 shattered global economic linkages, abruptly ending the first wave of globalization.
- Trade and capital flows were interrupted as economies reoriented toward wartime production.
- International migration sharply declined, and global supply chains were severely disrupted.
- Even non-European economies were affected, as wartime demand altered global production and trade priorities.

# World War I and Its Legacy (1914-1928)

- By 1920, Europe's major powers were left economically debilitated—burdened with war debt, inflation, and physical destruction.
- Efforts to restore international economic cooperation faltered due to rivalry, particularly between the UK and the US
- The Treaty of Versailles imposed harsh reparations on Germany, contributing to political instability and economic distress.
- The US emerged as the new global economic leader, overtaking Britain in industrial output and financial capital and investment.
- Financial instability persisted, with the credibility of the gold standard undermined by expanding democratic participation.
- Eichengreen (1992) and Polanyi (1944) argued that the fiscal discipline required by the gold standard conflicted with new political realities.

# World War I Disrupts the Global Economy

- The integrated global economy of the late nineteenth and early twentieth centuries collapsed abruptly with the outbreak of World War I in July 1914.
- The immediate trigger was the assassination of Archduke Franz Ferdinand of Austria in Sarajevo, but deeper geopolitical tensions had long been brewing.
- Eastern Europe was economically underdeveloped and politically fragmented, creating fertile ground for ethnic conflict and instability.
- The major powers, Britain, France, Germany, and Russia, had been competing for global influence, building formal empires and informal client states throughout Europe, Africa, and Asia.
- These rivalries and colonial expansions created pressure points that ultimately ignited into a global military conflict.

# World War I Disrupts the Global Economy

- Prior to 1914, a belief was that strong international trade relations would prevent war among countries.
- Instead, geopolitical ambitions overwhelmed economic rationality, leading to a prolonged and destructive war.
- The war deeply disrupted international trade, migration, and financial flows, essentially ending the first era of globalization.
- Although the war concluded in 1918, the economic consequences extended well into the 1920s, delaying recovery and transformation.
- Many scholars argue that the war-induced instability and economic dislocation helped sow the seeds of the Great Depression in 1929.

# International Financial Markets

- In August 1914, global financial markets collapsed simultaneously as World War I began.
- A surge in demand for gold reflected investor preference for a stable and inflation-resistant store of value.
- Investors liquidated equities and bonds in favor of gold, leading to panic selling in major markets in London, Paris, and Berlin.
- Governments halted international gold flows and temporarily closed stock markets to prevent further financial panic.
- Capital controls helped contain volatility and kept borrowing costs low for war-financed government spending.

# International Financial Markets

- The London Stock Exchange dropped by about 7% in July 1914 and remained closed until January 1915.
- Global migration declined, trade between countries slowed down, and demand for military supplies surged.
- International lending, previously vital for development, dried up as capital was redirected toward national war efforts.
- Capital mobility declined dramatically, making arbitrage impossible; interest rate gaps widened significantly.
- Although capital markets recovered in the 1920s, they operated on a very different basis compared to the prewar period.

# International Financial Markets

- The Treaty of Versailles imposed a massive reparations burden on Germany, covering war debts, damages, and punitive taxes.
- Germany financed these payments by accumulating more debt, borrowing from international markets, especially the US.
- Short-term loans and bonds issued by German banks and governments were bought largely by US investors.
- This form of financing was highly fragile and unsustainable and relied on continuous capital inflows.
- By the early 1930s, reparations became a key issue in international political and financial disputes.

# International Financial Markets

- The US emerged from World War I as the world's largest and most productive economy.
- New York began to rival and eventually replace London as the dominant global financial center.
- Unlike Europe, the US avoided significant war damage and quickly became a reliable source of international lending.
- The U.S. became a net lender and assumed a central role in shaping postwar global financial architecture.

# International Financial Markets

- The establishment of the Federal Reserve in 1914 provided the US with a formal central banking system.
- The Fed supported international trade through the development of bills of exchange and liquidity tools.
- US banks, now legally permitted to operate abroad, opened branches across Latin America, Europe, and Asia.
- By the mid-1920s, the Fed influenced global short-term interest rates, signaling US' financial dominance.
- The US dollar increasingly served as an international reserve currency, competing with the British pound in global transactions.

# International Trade

- World War I led to a severe breakdown of international trade networks, reversing decades of globalization.
- German U-boats posed serious threats to commercial shipping in European waters, making transatlantic freight operations highly dangerous.
- As a result, international shipping costs rose dramatically, especially for staple commodities such as wheat and tobacco.
- Major European ports such as London, Le Havre, and Antwerp faced logistic problems and soaring freight rates.
- Trade between the Allied and Central Powers effectively ceased, severing previously vital commercial relationships.

# International Trade

- Disruption in shipping and market access widened global price gaps, reversing the welfare gains of pre-war integration.
- The war redirected trade toward neutral and Allied economies, especially in the Americas.
- Commodity producers in North and South America benefited from Allied demand for food, fuel, uniforms, and raw materials.
- With European markets offline and supply chains fractured, regional trade within the Americas and Asia became more prominent.

# International Trade

- Japan, a rapidly industrializing nation, capitalized on wartime changes in trade patterns to expand its export markets.
- Reduced competition in Asia enabled Japan to increase its exports significantly within the region.
- Exports to Asia rose by 125%, while exports to Europe grew more modestly at 66%.
- Japanese exports to North America more than doubled during the war period.
- The share of Japan in total Chinese imports rose from 13% in 1913 to almost 20% during the war period and remained stable through the 1920s.

# International Trade

- In Great Britain, commodity prices rose sharply during the war, driven by both inflation and shifts in demand.
- Essential war-related commodities such as coal, iron, cotton, coffee, and wheat saw particularly strong price increases.
- Demand for inputs used in military production, uniforms, and troop equipment contributed to these price pressures.
- Globally, the real prices of commodities increased by more than 50%, reflecting the intense pressure on supply and logistics.
- These dynamics had lasting effects on postwar price levels and trade relationships.

# Figure 8.1 – Rising Tariffs After World War I

- Tariffs were already trending upward before World War I, but protectionism intensified significantly after the war.
- Many newly independent states in Eastern Europe, emerging from dissolved empires, imposed tariffs to generate revenue and promote domestic industries.
- Britain, historically a champion of free trade, enacted wartime tariffs on luxury goods to reduce consumption and protect the balance of payments.
- The 1921 "Safeguarding of Industries Act" introduced tariffs of up to 50% on selected manufactured goods such as lace, silk, and cutlery.
- The United States passed the Fordney–McCumber Tariff in 1922, designed to support domestic agriculture and manufacturing.
- These rising tariffs are visualized in Figure 8.1, which shows a noticeable shift away from trade liberalization toward economic nationalism.

# Figure 8.1 – Rising Tariffs After World War I

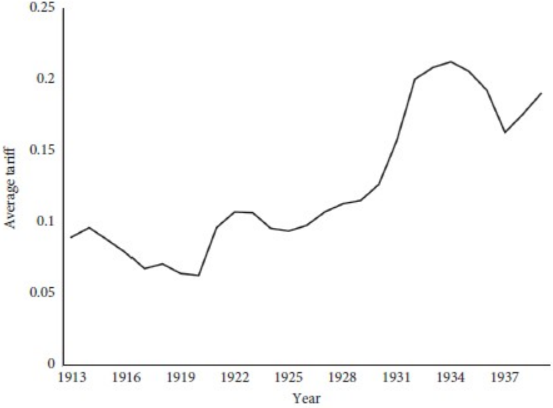


**Figure 8.1** Average Tariff, Twenty-three Countries, 1913–1939

*Source:* Author's calculations based on data underlying Clemens and Williamson (2004b)

# Figure 8.2 – Decline in Trade Relative to World GDP

- Figure 8.2 illustrates the ratio of world exports to world GDP, highlighting the stagnation of trade during the 1920s.
- Although some economic recovery occurred after the war, rising protectionism and trade barriers prevented full reintegration of the global economy.
- The trend line shows that the export share of global output remained stagnant in the 1920s, never regaining prewar momentum.
- The onset of the Great Depression in the early 1930s triggered a sharp collapse in both output and international trade.
- As countries turned inward and raised tariffs even further (Smoot-Hawley Act), the global economy became more fragmented.
- Figure 8.2 captures the failure to restore the open, multilateral trade order that had characterized the pre-1914 world.

# Figure 8.2 – Decline in Trade Relative to World GDP

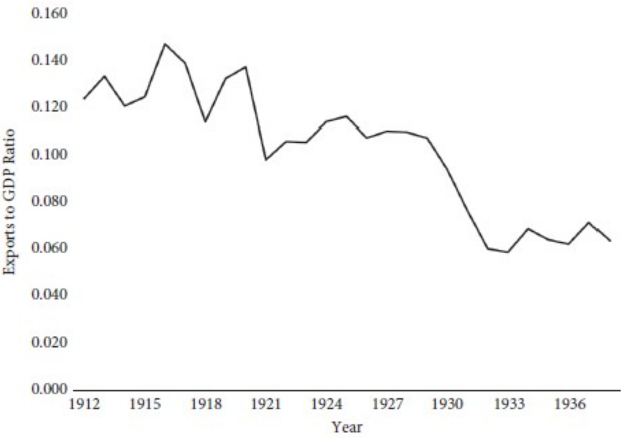


**Figure 8.2** Ratio of World Exports to World GDP, 1913–1939

*Source*: Author's calculations based on data from Federico and Tena-Junguito (2019).

Notes: constant 1913 prices and borders

# Immigration

- Before World War I, a highly integrated global labor market existed, with minimum restrictions on international migration.
- Between 1900 and 1914, immigration to the United States averaged nearly one million people annually.
- However, World War I disrupted this pattern: inflows to the US dropped to about 200,000 per year, and migration across the Americas declined.
- Wartime risks and disruptions to transatlantic shipping reduced mobility, particularly affecting Europe-to-US route.
- In addition, the US governments introduced major restrictions: the 1921 Emergency Quota Act capped immigration at 360,000 per year.
- In 1924, the Johnson–Reed Act made this quota system permanent and reshaped the origin structure of US immigration.

# Immigration Decline and Labor market Effects

- Figure 8.3 indicates the steep decline in immigration to the US after 1914, driven by war, shipping constraints, and restrictive policy.
- The Figure 8.3 also shows a peak in the foreign-born population share around 1910 at 15%, followed by a continuous decline to 9% by 1940.
- The 1920s saw a shift toward more skilled immigrants, particularly as quotas excluded low-skilled migration from Europe.
- Since the quotas did not apply to countries in the Americas, Canada and Mexico assumed a larger share of US migrants.
- This shift altered labor dynamics: skilled immigration slowed wage growth among native-born high-skill workers.
- The decline in migration marked the end of the prewar era of open labor markets, reinforcing national labor protections and slower demographic growth.

# Figure 8.3 – Gross Inter-Continental Emmigration from Europe (1906-1940)

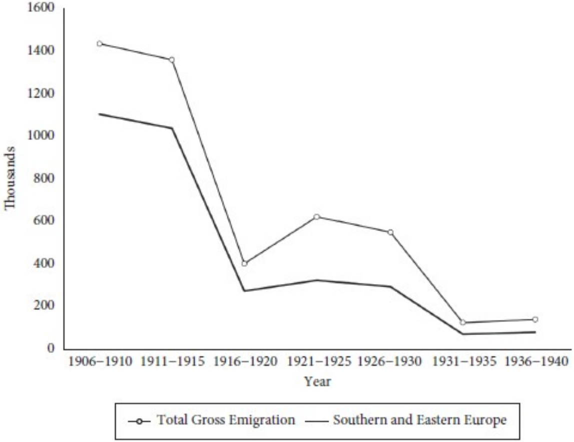


**Figure 8.3** Gross Inter-Continental Emigration from Europe, 1906–1940

*Source:* Chiswick and Hatton (2004). © by the National Bureau of Economic Research

# Fault Lines in the Inter-War Period

- The interwar period (1920–1939) was marked by growing fragilities in the global economy, culminating in the Great Depression of 1929.
- Although the crisis erupted at the end of the decade, its roots were embedded in unresolved economic and financial tensions of the 1920s.
- A central weakness was the Treaty of Versailles, which imposed heavy reparations on Germany, leading to political and fiscal instability.
- Another critical failure was the flawed re-establishment of the gold standard, which constrained monetary policy flexibility during downturns.
- These policy missteps were compounded by the lack of global economic coordination between declining Britain and rising US leadership.

# Fault Lines in the Inter-War Period

- Several structural shifts intensified economic instability during the interwar period.
- Labor contracts became more rigid, limiting wage flexibility and amplifying unemployment decline.
- The rapid expansion of consumer credit led to the mass consumption of durable goods such as cars and household appliances.
- These developments created financial instability and demand volatility in times of economic crisis.
- The widening of the political franchise empowered labor groups, making austerity measures and gold standard discipline harder to enforce.
- Collectively, these factors undermined the credibility of the postwar economic order and contributed to the collapse of the gold standard in the 1930s.

# The Unstable Inter-War Gold-Exchange Standard

- After World War I, countries sought to restore monetary stability by re-establishing the gold standard.
- The postwar system—known as the gold-exchange standard—allowed countries to hold reserves not only in gold but also in foreign exchange (primarily US dollars and British pounds).
- The system was inherently fragile and proceeded only from 1925 to 1930.
- Restoring convertibility required countries to fix exchange rates at prewar gold parities, despite large changes in domestic price levels.
- These fixed parities caused overvaluation in some currencies and undervaluation in others, leading to trade imbalances.
- Countries with persistent deficits risked losing gold reserves, while surplus countries (France) accumulated gold and disrupted equilibrium.

# The Unstable Inter-War Gold-Exchange Standard

- Figure 8.5 shows the number of leading countries adhering to the gold standard from 1919 to 1939.
- Following its wartime collapse, the gold standard was gradually re-adopted: the US reinstated convertibility in 1919, Britain in 1925, and France in 1927.
- The slow and staggered return created asymmetries in the international monetary system.
- While some countries were ready to commit to gold convertibility, others faced inflationary pressure and political resistance.
- The Figure 8.5 highlights a temporary surge in adherence by the late 1920s, but this convergence quickly unraveled during the early 1930s due to systemic instability.
- The gold-exchange standard ultimately failed to provide lasting monetary discipline or global confidence, contributing to economic instability during the interwar period.

# Figure 8.5: Number of countries on Gold Standard (1919-1939)

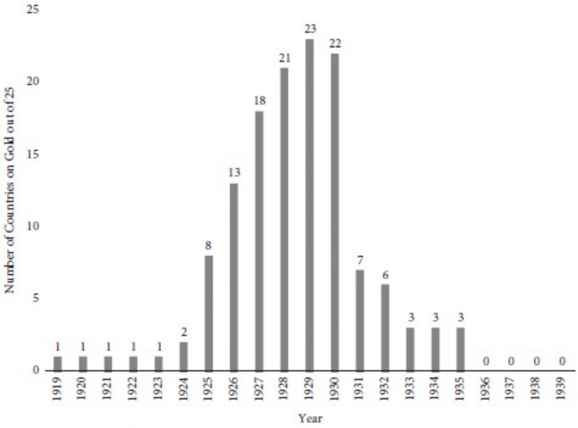


**Figure 8.5** Number of Countries on the Gold Standard, 1919–1939

*Source:* Author's calculations, with assistance from Alain Naef, based on Bernanke and James (1991), Table 1

# The 1920s and the Precarious "Credit Boom"

1. By 1926, the global economy appeared to have stabilized, and a broad-based international credit boom had taken hold.
2. On the supply side, globally low interest rates reduced the cost of borrowing and encouraged credit expansion.
3. Low and stable inflation led to complacency among banks and investors, masking underlying systemic risks.
4. Financial innovations in the US, such as installment credit, fueled a surge in consumption of durable goods.
5. American households increasingly financed automobiles, radios, refrigerators, and washing machines through credit.
6. Similar patterns emerged in other advanced economies such as Great Britain and Australia, reflecting synchronized financial optimism.

# The 1920s and the Precarious "Credit Boom"

1. On the demand side, rising real incomes after World War I boosted household consumption.
2. Demand from the war years contributed to a housing boom in the early and mid-1920s, especially in the US.
3. Improved housing infrastructure (advances in plumbing and heating) and suburban expansion drove mortgage and consumer credit growth.
4. Automobiles became central to middle-class life, supported by road construction and manufacturer-led financing.
5. The convergence of credit access and consumer demand created a fragile but widespread boom in household debt.

# The 1920s and the Precarious "Credit Boom"

1. By 1928, early signs of financial instability emerged: the German stock market crashed in mid-1927.
2. German authorities (Reichsbank) tried to curb margin lending, but their interventions increased volatility.
3. US investors reduced risk exposure abroad, reducing capital flows to Europe and worsening financial fragility.
4. In 1928, the US Federal Reserve raised interest rates to address concerns over stock market speculation and excessive short-term borrowing.
5. The rate hikes reverberated globally, as the Fed had become the de facto setter of international short-term interest rates.
6. This tightening of credit was the monetary shock that triggered the chain of events leading to the Great Depression.