

Chapter 10

Can Economies Recover Quickly from Disaster?

Substantively, the historical review here suggests an extraordinary resiliency of human populations and social structures. It is of course impossible to prove that social breakdown will never occur in the aftermath of disaster, especially when we contemplate the unprecedented catastrophe of nuclear war. But the lurid picture of post-disaster regression to savagery, that staple of fiction and of popular thought, can draw no support from the historical record.

— Jack Hirshleifer (1987), *Economic Behaviour in Adversity*, p. 6.

Jack Hirshleifer, one of the key members of the UCLA School, was ever the empiricist. In the early 1960s, when decision-makers in the US military were concerned about the after-effects of a nuclear war, Hirshleifer did a pioneering study for the US Air Force on the “causes, characteristics and consequences of important historical disasters.” The study, formally titled *RAND Corporation Memorandum RM-3079-PR*, was published in April 1963 and was later reprinted in his 1987 book *Economic Behaviour in Adversity*.

While works of fiction often depicted a descent into savagery after a major catastrophe, Hirshleifer found the opposite: when property rights were fairly secure and governments avoided economy-wide price controls, societies were relatively peaceful and economies recovered quickly.

Among the cases Hirshleifer studied were the Soviet economy after the New Economic Policy of 1921, following the period of “War Communism,” and the so-called German Economic Miracle after World War II. In both cases the economies adjusted relatively quickly to massive deregulation, and the resulting economic growth was substantial.

The Soviet Union and the new economic policy

Soon after the Bolsheviks managed to oust the relatively moderate provisional government run by Alexander Kerensky, the Soviet Communists began their policy of War Communism. Under War Communism, which lasted from 1917 to 1921, the Bolsheviks proceeded in two steps. They first took over the so-called “commanding heights” of the economy. The commanding heights, wrote Hirshleifer, were “a relatively small number of large factories located mainly in the major cities.” The Bolsheviks then proceeded to take over almost the whole rest of the economy. The government requisitioned all agricultural output that it judged to be above the farmers’ level of subsistence and rationed it to the urban population at below-market prices. A policy of high inflation made these prices meaningless, and the Communists then shifted to simply giving away food. The government also conscripted labour. Hirshleifer pointed out that the entire economy was run as if it were an army and “the process of voluntary exchange was rejected and prohibited.”

As Hirshleifer documented, the result was economic disaster. By 1920, Russian industrial output was only 20.4 percent of its level in 1913. The gross yield of crops in 1920 was 54 percent of the average level between 1909 and 1913, and the numbers of horses, cattle, and sheep, and goats were all down by double-digit percentages. Incentives matter: with little incentive to produce for others, given that they couldn’t charge, farmers reduced production. When governments give away food and don’t allow free markets in food, there are always shortages, and the case of the Soviet Union was no exception. When that happens, black markets inevitably arise. Hirshleifer pointed out that town dwellers obtained well over half of the food they consumed through illegal channels.

The Soviets, seeing the economy collapse and concerned about maintaining their political power, tried the New Economic Policy. The first big step was in agriculture, in which well over half of the labour force worked (Katkoff, 1957). In March 1921, the Soviets ended compulsory requisitions of food and replaced them with a proportional tax in kind on farm production. That was a major step. Compulsory requisition of food above a certain level, Hirshleifer notes, is the equivalent of a 100 percent tax above that level. A proportional tax, by contrast, is what we now call a flat tax rate. The Soviets also legalized private exchange of agricultural and industrial products, abandoned central planning of the economy, and ended conscription of labour.

The result was an economic boom. By 1923, industrial output was 75 percent above its 1920 level and agricultural output was up by 17 percent. Later, of course, all of this was reversed when the Soviets went back to full-on Communism with all its problems.²⁷

Post-World War II Germany

When Germany emerged from the Second World War, its economy was in shambles. Allied bombing plus ferocious battles fought on the land, mainly between Soviet and German armies, had caused massive destruction. The bombing and fighting ended with Germany's surrender on May 8, 1945.

But fighting and bombing were not the only causes of destruction. Just as the Allied governments did in World War II, Adolf Hitler also had imposed economy-wide price controls on most goods and services. Those controls caused massive shortages.

What happened after the war? Hirshleifer writes:

The decision to maintain and enforce the National Socialist system of ceiling prices was made on a four-power basis shortly after the surrender. (1987: 67)

Each of the four Allied governments—the Soviet Union, the United States, France, and Great Britain—controlled a “zone” of German territory.

Hirshleifer points out that the post-war price ceilings were “initially based upon a Hitler price freeze dating as far back as 1936,” but that liquid funds had risen more than ten-fold over that time. Germany's central bank, the Reichsbank, like central banks of most of the countries at war, had multiplied the money supply. With over ten times as much money chasing roughly the same amount of output, but with prices not being allowed to rise, the result was economy-wide shortages. This also meant that money was not very useful. Even people who had a lot of Reichsmarks couldn't do much with their money if sellers were not legally able to charge them high prices.

²⁷ For a beautiful and moving treatment of the problems with Communism, see Spufford (2010). Spufford, though not an economist, shows a deep understanding of Communism as an economic system and as a wrecker of havoc with family life. The book is somewhere between novel and history, with real and made-up characters.

What happened in Germany is reminiscent of the old butcher joke. A man goes into a butcher shop and asks, “How much is the filet mignon?” The butcher answers, “Twelve dollars a pound.” “Twelve dollars a pound?” says the customer, “I can get it across the street for ten dollars a pound.” “Then why don’t you buy it there?” asks the butcher. “He doesn’t have any,” replies the customer. The butcher replies, “Well, when I don’t have any, I charge eight dollars a pound.”

The American authorities, under US General Lucius D. Clay, understood the need for a “currency reform” that would bring the money supply back in line with prices, notes Hirshleifer, but the Soviets refused to agree.

As a result, many Germans came close to starvation. Hirshleifer presents a table, based on data he got from Lucius D. Clay’s book *Decision in Germany*, showing the number of daily calories that food rationing in Germany was designed to give Germans. The number was low, rising from 950 in July 1945 to 1,550 calories in October 1946, and dropping to 1,040 in April 1947 (Hirshleifer, 1987: 60).

Table 1 Food Rationing in Postwar Germany (General Clay’s comments)

Date	Remark
July 1945	US Zone ration set at 950 to 1150 calories. Only 950 distributed.
August 1945	Official ration set at 1550 calories. Not met.
Winter 1945/46	1550 calorie ration met for a few months.
February 1946	Downward trend resumed.
May-June 1946	Low point, 1180 calories.
End of June 1946	Increase to 1225 calories.
October 1946	1550 calorie ration met.
January 1947	Fusion of British and US zones prevents maintenance of 1550 calorie ration.
April 1947	Authorized allowance dropped to 1040 calories.
June 1947	Ration started upward again.
April 1948	1550 calorie allowance met.
July 1948	Ration set at recommended 1990 calorie level.

Source: Hirshleifer, 1987, table 1.19: 60, from Lucius D. Clay (1950), *Decision in Germany* (Doubleday): 263-270.

The food shortages due to price controls were so severe that some people grew their own food and others traveled to the countryside on weekends to barter for food. Yale University economist Henry Wallich writes:

Each day, and particularly on weekends, vast hordes of people trekked out to the country to barter food from the farmers. In dilapidated railway carriages from which everything pilferable had long disappeared, on the roofs and on the running boards, hungry people traveled sometimes hundreds of miles at [a] snail's pace to where they hoped to find something to eat. They took their wares—personal effects, old clothes, sticks of furniture, whatever bombed-out remnants they had—and came back with grain or potatoes for a week or two. (1955: 65)

But once the three other governments dropped the Soviets, General Clay had some running room and on June 20, 1948, used it to implement a currency reform. He substituted a smaller number of deutsche marks for the old Reichsmarks, causing a 93 percent reduction in the money supply. This meant that much less money was chasing goods and so the controlled prices were not as far below what the free-market prices would have been. That made shortages both less common and less extreme. That same Sunday, the German Bizonal Economic Council, at the urging of Clay's economic advisor Ludwig Erhard, passed a price decontrol ordinance that allowed Erhard to eliminate price controls. Over the next few months, Erhard eliminated the economy-wide price controls.

Well after Hirshleifer wrote his study, journalist Edwin Hartrich (1980) related the following story about Erhard and Clay. In July 1948, after Erhard, on his own initiative, abolished food rationing and ended all price controls, Clay confronted him:

Clay: "Herr Erhard, my advisers tell me what you have done is a terrible mistake. What do you say to that?"

Erhard: "Herr General, pay no attention to them! My advisers tell me the same thing." (Hartrich, 1980: 4)

Hartrich also tells of Erhard's confrontation with a US Army colonel the same month:

Colonel: "How dare you relax our rationing system, when there is a widespread food shortage?"

Erhard: "But, Herr Oberst. I have not relaxed rationing; I have abolished it! Henceforth, the only rationing ticket the people will need will be the deutschemark. And they will work hard to get these deutschemarks, just wait and see." (1980: 13)

The currency reform, along with abolishing price controls, worked to eliminate all of the shortages that had been caused by price controls. Further, as US economist Walter Heller, later President John F. Kennedy's chairman of the Council of Economic Advisers, noted at the time, to "remove the repressive effect of extremely high rates, Military Government Law No. 64 cut a wide swath across the [West] German tax system at the time of the currency reform" (Heller, 1949: 218).

David R. Henderson (2008) writes:

The corporate income tax rate, which had ranged from 35 percent to 65 percent, was made a flat 50 percent. Although the top rate on individual income remained at 95 percent, it applied only to income above the level of DM250,000 annually. In 1946, by contrast, the Allies had taxed all income above 60,000 Reichsmarks (which translated into about DM6,000) at 95 percent. For the median-income German in 1950, with an annual income of a little less than DM2,400, the marginal tax rate was 18 percent. That same person, had he earned the Reichsmark equivalent in 1948, would have been in an 85 percent tax bracket.

The effects of the currency reform, price decontrol, and large cuts in marginal tax rates were almost instantaneous. Hirshleifer quotes Wallich:

Observers, left-wing as well as right-wing, agree that it transformed the German scene from one day to the next. On June 21,

1948, goods reappeared in the stores, money resumed its normal function, black and gray markets reverted to a minor role, foraging trips to the country ceased, labour productivity increased, and output took off on its upward surge. (Hirshleifer, 1987: 71)

As evidence that foraging trips to the country ceased, Hirshleifer points out that “short-haul railroad passenger traffic dropped immediately to less than 40 percent of its pre-reform volume.”

Wallich writes, “The spirit of the country changed overnight. The gray, hungry, dead-looking figures wandering about the streets in their everlasting search for food came to life” (1955: 71). Hirshleifer quotes Heller, writing in September 1949: “It has unquestionably proved an economic success. It quickly re-established money as the preferred medium of exchange and monetary incentives as the prime mover of economic activity” (1987: 71).

Local disasters

Hirshleifer also studied localized disasters. Here’s what he wrote about the aftermath of the Allied fire-bomb raids on Hamburg in 1943:

As a specific instance, the fire-bomb raids on Hamburg in July and August 1943 were highly intense community-wide disasters. As normally occurs in such situations, people proved tougher than structures. The raids destroyed about 50 percent of the buildings in the city, whereas the 40,000 people killed were less than 3 percent of the population at risk. About half the survivors left the city. Some 300,000 returned in the recovery period, while around 500,000 were permanently evacuated to other areas throughout Germany. A “dead zone” of the city was closed off so that repairs could be concentrated in less seriously damaged areas. Electricity, gas, and telegraph services were all adequate within a few days after the attacks ended. Water supply remained a difficult problem, however, and tank trucks had to be used. The transit system recovered only partially because of serious damage and abnormally heavy traffic, but mainline rail service resumed in a few days. On the seventh day Hamburg’s central bank reopened and business began to function normally. Hamburg was not a dead

city. Within a few months, the U.S. Strategic Bombing Survey reported, the city had recovered 80 percent of its former productivity. (Hirshleifer, 2008)

After such local disasters, noted Hirshleifer, there is an outpouring of support within and across communities. Immediately within the affected area, Hirshleifer wrote, “a strong feeling of community identification is generated, promoting cooperative and unselfish efforts toward repair and relief activity.” Also the crisis “calls forth an outburst of generous assistance, both personal and material,” from outside the affected zone. He also notes the emergence of leaders: “The abdication of conventional leadership often leads to the rise of emergent leaders, who are frequently those with less emotional involvement, or with some specialized knowledge or talent” (Hirshleifer, 2008).

Of course, we should be careful not to generalize to the future. In our increasingly interdependent world in which so many activities depend on the internet, it would be possible for those who want to disrupt to plant worms and viruses. Nevertheless, even in such hypothetical cases there is enormous scope for those who want to make money and those who want to be charitable to step up.

We have seen this range of behaviour during the COVID-19 pandemic. People’s fear of being with others in public, plus heavy-handed government lockdowns, have driven the incomes of waiters, bartenders, hairdressers, and gym workers down, often down to zero. In response, people who have been able to maintain their income have engaged in a huge outpouring of charity. They have given tips to restaurants workers providing takeout food and to hairdressers working outside that are often equal to or greater than the original charge.