Earning from History:

Financial Markets and the Approach of World Wars

Brooking Papers on Economic Activity

Niall Ferguson
Laurence A. Tisch Professor of History
Harvard University
William Ziegler Professor of Business Administration
Harvard Business School

nfergus@fas.harvard.edu

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I
Introduction

We are living through a paradox—or so it seems. Since September 11, 2001, according to a number of neo-conservative commentators, America has been fighting World War III (or IV, if you like to give the Cold War a number). For more than six years, these commentators have repeatedly drawn parallels between the "War on Terror" that is said to have begun in September 2001 and World War II. Immediately after 9/11, Al Qaeda and other radical Islamist groups were branded "Islamofascists". Their attack on the World Trade Center was said to be our generation's Pearl Harbor. In addition to coveting weapons of mass destruction and covertly sponsoring terrorism, Saddam Hussein was denounced as an Arab Hitler. The fall of Baghdad was supposed to be like the liberation of Paris. Anyone who opposed the policy of pre-emption was an appeaser. And so on.[2]

Yet throughout this period of heightened terrorist threats and overseas military interventions, financial markets have displayed a remarkable insouciance. The U.S. stock market was affected only momentarily by the attacks of 9/11. True, between September 10 and September 21, 2001, the Dow Jones Industrial Average declined by as much as 14 per cent. Within just over two months, however, the Dow had regained its pre-9/11 level. Moreover, although 2002 was a disappointing year for U.S. equity investors, the market surged ahead thereafter, exceeding its previous peak (at the height of the "dot com" mania) in the fall of 2006. By October 9, 2007, the Dow stood at nearly double the level it had reached in the trough five years before. This was an impressive performance in time of war. Nor was the U.S. stock market by any means the star performer in the period

[1] Early versions of this paper were presented to the Harvard History Department's International History seminar and the Business and Government in the International Economy seminar at Harvard Business School. My thanks go to all those colleagues who suggested ways in which it could be improved. I am also grateful to Andrew Novo and Jason Rockett for research assistance. All errors are my responsibility.

[2] See for example Norman Podhoretz, *World War IV: The Long Struggle against Islamofascism* (New York, 2007).

after 9/11. In the five years to July 31, 2007, all but two of world's equity markets delivered double digit returns on an annualized basis. Among the ten best performers were Egypt (+69 per cent), Turkey (+44 per cent) and Indonesia (+39 per cent). The United States was in fact among the two worst performers (+9.9 per cent). The other was Israel's non-domestic market (9 per cent).[3] If, as devotees of Samuel Huntington believed, a "clash of civilizations" between Islam and the West was raging during this period, then Western investors did well to back the other side.

The worldwide boom in asset prices was not confined to equity markets. Emerging market bonds also rose strongly, driving down spreads over U.S. Treasuries to record lows. Real estate markets, especially in the English-speaking world, also saw remarkable capital appreciation. Whether they put their money in commodities, works of art, vintage wine or exotic asset-backed securities, investors made money. When a crisis finally came in August 2007, it was due not to an escalation of violence in the Middle East—that had happened the previous year, with no financial ill-effects—but to humdrum defaults in the U.S. subprime mortgage market and their knock-on effects on banks and credit markets. Even the extraordinary quintupling in the price of oil that has occurred between September 2001 and the time of writing (February 2008) can be blamed only partially on geopolitical factors such as instability in Iraq or the risk of war between the United States and Iran. The growth of Asian (and especially Chinese) demand for oil has been significantly more important, as has the depreciation of the currency in which oil is priced, to say nothing of the limits on global oil refining capacity.

A number of commentators remarked on what seemed to be the schizophrenia of the mainstream news media in this period. Readers of the "News" pages of the *New York Times* could be forgiven for thinking that the world was descending into an abyss of strife. Yet readers of the "Business" pages had the impression—until August 2007—that they were living, like Voltaire's Dr Pangloss, in the best of all possible worlds. While the front section of the paper was a doleful chronicle of death and destruction, the middle section was a euphoric catalogue of CDOs, IPOs and LBOs.[4] What Dickens said of the French Revolution in *A Tale of Two Cities* seemed also to apply to the six years after

[3] MSCI Barra: http://www.mscibarra.com/products/indices/stdindex/performance.jsp.
[4] I believe I was among the first to remark on this dichotomy, at a conference organized by Morgan Stanley at Lyford Cay on November 10, 2006.

9/11: "It was the best of times, it was the worst of times." In a number of lectures, papers and newspaper articles, the first of which appeared in 2005, I sought to explain that I called "the paradox of diminishing risk (perception) in a dangerous world".[5] I drew a parallel with the period immediately before the First World War when, I suggested, geopolitical risks had been all too real, but financial markets had been lulled into a false sense of security by bountiful liquidity. A similar point was made in a widely reported speech by Lawrence Summers at the 2007 World Economic Forum in Davos.[6]

It may of course be objected that the geopolitical risks we currently face are overstated by the news media. Compared with previous world wars, "World War IV" seems a fairly trifling affair. The Islamists have thousands rather than millions of trained warriors. Their most dangerous weapons are car bombs and rocket-propelled grenade launchers, not tank divisions, aircraft carriers, strategic bombers or intercontinental ballistic missiles. The total number of American fatalities that can be attributed to the War on Terror is around 6,000 (adding together 9/11 victims with U.S. passports and the service personnel killed in action in Iraq and Afghanistan). On average, by contrast, the Axis powers killed around 20,000 Allied soldiers and civilians *a day* during World War II. Another way of making essentially the same point is to compare the average American's lifetime risk of death from war (1 in 267,719), with his risk of death from a road accident (1 in 78) or cancer (1 in 4.7).[7] True, terrorism inflicted economic costs as well as loss of life in September 2001, extending far beyond the destruction of two towers, four aircraft and a part of the Pentagon. Nevertheless, from the insurers' point of view, the total costs to United States due to terrorism amounted to around $24 billion between 1984 and 2004, whereas the costs attributable to natural disasters were $188 billion, nearly eight times as much. Really big cross-border terrorist attacks remain very rare. Between 1968 and 2007, 6 per cent of recorded incidents accounted for nearly half (46 per cent) of fatalities attributable to international terrorism. In only one month since records began to be kept (September 2001) has international terrorism killed more than

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[5] Niall Ferguson, "The Paradox of Diminishing Risk (Perception) in a Dangerous World", Drobny Associates, July 5, 2005; idem, "When a Black Swan Lands on Lake Liquidity", Drobny Associates, January 19, 2007.
[6] See e.g. John Fraher, "Summers, Trichet Warn Davos Party-Goers They Underestimate Risk, Bloomberg, Jan. 22, 2007".
[7] See the statistics at http://www.nsc.org/lrs/statinfo/odds.htm.

3,000 people. The next most dangerous month (October 2002) claimed fewer than 400.[8] At the risk of tempting fate, we should bear in mind that six years have now passed without a terrorist attack on American soil.

Nevertheless, it would be a mistake to conclude from all this that the potential for disaster is non-existent. In contrast to previous epochs, the United States does not need to confront a military equal to suffer serious damage. One nuclear weapon in the hands of a few fanatics could obliterate a city in a way that would make the impact of Hurricane Katrina on New Orleans pale into insignificance. The breakdown of the forty-year-old system of nuclear non-proliferation is increasing the risk that terrorists will obtain such a weapon. Nor is nuclear terrorism the only threat we currently face. The most likely theatre for a major conflict, the Middle East, is the world's principal source of oil; an American confrontation with Iran, which remains a real possibility if Tehran persists with its nuclear weapons program, would have a substantial and immediate impact on already stretched energy prices. Likewise, the possibility cannot wholly be ruled out of a military clash between the U.S. and China over Taiwan, if the People's Republic were to attempt to use force to snuff out Taipei's aspirations to independence. Given its present military supremacy, the United States plainly could not lose such a war, but the economic fallout would be highly disruptive, in view of the continuing reliance of many Chinese exporters on the American market, and the continuing benefit derived by the United States from China's accumulation of dollars and dollar-denominated bonds and bills in its international reserves.[9]

It would be too much to say that we are sleepwalking towards Armageddon. According to the annual audit of global conflict published by the Center for International Development and Conflict Management at the University of Maryland, the numbers of wars and the casualties caused by them have declined over the past twenty years. And yet: "A larger portion of the global community of states is involved [in war] now than in any other time in the past six decades. And the historic low of 19 ongoing armed conflicts in 2004 was followed by an increase to 25 in 2005 … [when] an unusually large number

[8] Author's calculations from data available at http://www.tkb.org/IncidentDateModule.jsp.
[9] Niall Ferguson and Moritz Schularick, "'Chimerica' and global asset markets", *International Finance* 10, 3 (2007), pp. 215–239.

of "new" conflicts began …" [10] Moreover, one unintended geopolitical consequence of globalization is to enrich a number of states that cannot be regarded as innately friendly to the United States: not only fundamentalist Iran but also Communist China, authoritarian Russia and populist Venezuela. There is, in short, little prospect of the world's achieving Kant's perpetual peace any time soon.

History suggests that financial markets do not always anticipate major geopolitical crises. Part II of this paper shows how the majority of investors in London, then the world's biggest capital market, were caught unawares by the escalation of the conflict in the Balkans in July 1914—so much so that there was a disastrous liquidity crisis in most financial centers even before war had broken out. Part III shows how the origins of the First World War have been revealed only with the benefit of hindsight; at the time, they were largely invisible. The same, however, cannot be said of the Second World War. Investors learned from the searing experiences of 1914-23, which saw a wide range of European currencies and securities drastically reduced in value as a result of inflation and outright default. They therefore sought to adjust their portfolios defensively as soon as they saw a renewed risk of world war. Indeed, to judge by securities price data, the City of London (like other markets, notably those in Scandinavia[11]) began positioning itself for another major conflict some years before it actually began. If 1914 was a bolt from the blue, 1939 seemed long overdue. Part IV asks if any general lesson can be drawn from this, given the uncertain character of events like major wars. The first point is that it is as hard for investors as for generals to learn lessons from a previous war. Knowing what had happened to various asset classes after 1914 did not make it easier to know when to sell those that had lost out or buy those that had fared well. Nor was there any guarantee that the next war would have the same financial impact as the previous war, because of changes in military technology and government regulation. As part V

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[10] J. Joseph Hewitt, Jonathan Wilkenfeld and Ted Robert Gurr, *Peace and Conflict 2008* (College Park, 2008).

[11] See Bruno S. Frey and Marcel Kucher, "History as Reflected in Capital Markets: The Case of World War II", *Journal of Economic History*, 60 (2000), pp. 468-**tk**; Bruno S. Frey and Marcel Kucher, "Wars and Markets: How Bond Values Reflect the Second World War", *Economica*, 68 (2001), pp. 317–333; Bruno Bruno S. Frey and Daniel Waldenström, "How Government Bond Prices Reflect Wartime Events: The Case of the Stockholm Market" , SSE/EFI Working Paper Series in Economics and Finance (2002); Bruno S. Frey and Daniel Waldenström, "Did Nordic Countries Recognize the Gathering Storm of World War II? Evidence from the Bond Markets", Institute for Empirical Research in Economics, University of Zurich, Working Paper 336 (October 2007).

argues, these same problems arose again for investors after 1945. Simply because the Cold War never became truly "hot" does not mean that the probability of a nuclear war between the superpowers was always zero. Investors once again tried to learn from history when the Korean War broke out, acting on the assumption that it might have similar effects to World War II (for example on commodity prices). Twelve years later, by contrast, financial markets evinced only short-lived and mild anxiety at the time of the Cuban missile crisis, reflecting a realization on the part of investors that a world war in the age of the hydrogen bomb would have incalculable consequences against which it would be futile to hedge. In the remaining three decades of the Cold War, the superpowers' consistent success in settling their disputes by diplomatic means (or proxy conventional wars) reassured investors that their rivalry would not erupt into a hot war, so that markets became progressively less sensitive to international crises.

If financial market data and commentary are reliable guides, then, this is roughly how expectations of war are formed: retrospectively more than prospectively, though with some allowance for changes in the nature of warfare. A period such as our own, of sporadic terrorism and small conventional wars, might therefore be expected to encourage the belief that future wars will also be small, with inconsequential financial effects. The seeming indifference of today's financial markets to political risk should therefore be regarded not as evidence that the world *will* likely avoid a major conflict in the foreseeable future, but merely as evidence that the world *has* avoided a major conflict in the recent past. Given the relative youth of most employees in the financial sector, and the relative shortness of most senior executives' careers, "recent" may be taken to mean approximately the past twenty-five years.[12] A major conflict would strike this generation of bankers and fund managers much as the war of 1914 struck their predecessors: like "a bolt from the blue".

II
1914: A Bolt from the Blue

[12] The average length of the financial careers of the current chief executive officers of Citigroup, Goldman Sachs, Merrill Lynch, Morgan Stanley and J.P. Morgan is just under twenty five and a half years.

The world of 2008 is not the same as the world of 1914, but in economic terms it may have more in common with it than with the world in any intervening year. Then, as now, the world economy was highly integrated, with flows of labor, goods and capital reaching levels in relation to total world output not subsequently matched until the 1990s. Yet this "globalized world" was, like our own, afflicted with various forms of political fragmentation. The rise of radical anti-capitalist ideologies and terrorist movements (Al Qaeda today, Bolsheviks and anarchists then) posed a threat to the established political order in certain emerging markets (the Greater Middle East today, Russia then). The existence of rogue regimes willing to sponsor terrorism (Iran today, Serbia then) increased the chances that assassins and bombers would hit their targets. Meanwhile, the possibility existed that the great powers or empires might come into conflict over minor states (Taiwan today, Belgium then). And the Anglophone empire that had underwritten the global economic order (the United States today, the United Kingdom then) was finding itself increasingly overstretched.

Of course there are differences between the two ages of globalization. Today, thanks to technological advances in communications, there is free trade in many services as well as in commodities and manufactures. Much mass migration today is to Europe, not from it. Capital movements in our time are not wholly free, so long as China prevents its citizens from investing abroad. The international monetary system today is a tangle of fiat currencies, with central bankers using more discretion than rules to determine policy. In marked contrast to the era of the gold standard, some exchange rates float freely, while others are pegged more or less firmly. Deflation in recent years has affected the price of manufactures (textiles and electronic goods), whereas from the mid-1870s until the mid-1890s it was agricultural prices that were depressed. Today's Anglophone empire is a colossal debtor, not "the world's banker" like the British Empire before it. And the increase in inequality attributable to globalization today is mostly within countries, whereas a hundred years ago it was also between countries. Asia is on the rise today, whereas in 1908 only Japan had eluded direct or indirect European domination, and growth in India and China was, respectively, negligible and negative.

Yet these differences do not entirely spoil the analogy. The period from the 1880s until 1914 witnessed an inflexion point between deflation and inflation. After trending

down (for nearly two decades), the price of agricultural commodities like wheat began to rise again after around 1897. The price of coal, the first age of globalization's favorite fossil fuel, rose sharply: by 1913 the pithead price of Welsh coal was double what it had been in 1887. Europe's central banks had nearly all committed themselves to the gold standard by the 1908; that meant that they nearly all had to target their gold reserves, raising rates (or otherwise intervening) if they experienced a specie outflow. Such a targeting regime, with its emphasis on rules rather than discretion, might have been expected to produce high volatility in short-term interest rate movements. However, it is clear that not all banks played strictly by the "rules of the game". Even the Bank of England made significantly fewer changes to its discount rate with every passing decade between the 1870s, when Bank rate was altered 113 times, and the 1900s, when it changed just 49 times. Long-term rates were low. Although the switch from deflation to inflation saw the yield on the benchmark British "consol" rise by over 100 basis points between 1897 and 1914, that was from an all-time low of 2.25 per cent. What we would now call "emerging market" spreads narrowed dramatically, despite major episodes of debt default in the 1870s and 1890s. With the exception of Greece and Nicaragua, none of the sovereign or colonial bonds that were traded in London in 1913 yielded more than 200 basis points above consols, and most paid considerably less.[13] The yields on the bonds of the other great powers, which accounted for about half the foreign sovereign debt quoted in London, trended down steadily after 1880, suggesting to at least some commentators that political risk premiums were declining. Before 1880, Austrian, French, German and Russian bonds had tended to fluctuate quite violently in response to political news; but the various crises of the decade before 1914—like those over Morocco and the Balkans—caused scarcely a tremor in the London bond market. Although the major stock markets did not perform spectacularly—Britain's essentially flat-lined after the 1895-1900 "Kaffir" (gold mine) bubble burst, while the Dow Jones failed to recover its January 1906 high in the aftermath of the 1907 panic—the volatility of returns trended downwards. There is at least some evidence to connect these trends with a secular upward shift in liquidity, due partly to increased gold production and, more importantly,

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[13] Niall Ferguson and Moritz Schularick, "The Empire Effect: The Determinants of Country Risk in the First Age of Globalization, 1880–1913", *Journal of Economic History*, 66, 2 (June 2006), pp. 283–312.

to financial innovation, as joint stock banks expanded their balance sheets relative to their reserves, and savings banks successfully mobilized the assets of middle class and lower class investors.[14]

All these benign economic trends encouraged optimism. To many businessmen—from Ivan Bloch in Tsarist Russia to Andrew Carnegie in the United States—it was self-evident that a major war would be catastrophic for the capitalist system. In 1898 Bloch published a massive six-volume work entitled *The Future of War* which argued that, because of recent technological advances in the destructiveness of weaponry, war essentially had no future. Any attempt to wage it on a large scale would end in "the bankruptcy of nations".[15] In 1910—the same year that Carnegie established his Endowment for International Peace—the left-leaning journalist Norman Angell published *The Great Illusion*, in which he argued that a war between the great powers had become an economic impossibility precisely because of the "the delicate interdependence of international finance".[16] In the spring of 1914 an international commission published its report into the "outrages" committed during the Balkan Wars of 1912-13. Despite the evidence he and his colleagues confronted of wars waged *à l'outrance* between entire populations, the commission's chairman noted in his introduction to the report that the great powers of Europe (unlike the petty Balkan states) "had discovered the obvious truth that the richest country has the most to lose by war, and each country wishes for peace above all things". One of the British members of the commission Henry Noel Brailsford—a staunch supporter of the Independent Labour Party and author of a fierce critique of the arms industry (*The War of Steel and Gold*)—predicted at around the same time:

> In Europe the epoch of conquest is over and save in the Balkans and perhaps on the fringes of the Austrian and Russian empires, it is as certain as anything in

[14] For a full discussion of this point, see Niall Ferguson, "Political Risk and the International Bond Market between the 1848 Revolution and the Outbreak of the First World War", *Economic History Review*, 59, 1 (February 2006), pp. 70–112
[15] Jean de [Ivan] Bloch, *Is War Now Impossible?*, transl. R. C. Long (London, 1899), p. **tk**.
[16] Norman Angell, *The Great Illusion: A Study of the Relation of Military Power in Nations to their Economic and Social Advantage* (London, 1910), p. **tk**.

> politics that the frontiers of our national states are finally drawn. My own belief is that there will be no more wars among the six great powers.[17]

Yet within just a few weeks of the assassination of Archduke Franz Ferdinand by the Bosnian Serb Gavrilo Princip—which happened on June 28, 1914—all this optimism was confounded. The first age of globalization came to an end with a bang,[18] closely followed by the sucking sound of liquidity draining with astounding speed out of the global financial system.

On July 22, 1914, *The Times* reported the first English-language allusion that I have been able to trace to the possibility that the crisis in the Balkans precipitated by the Archduke's assassination might have negative financial consequences. The report appeared on page 19 and read as follows:

> STOCK EXCHANGE
> DEPRESSED BY FOREIGN POLITICAL NEWS
> LATE RALLY IN AMERICANS
>
> Stock markets at the opening were entirely overshadowed by the news that the relations between Austria-Hungary and Servia are daily growing more strained. … Owing to the increasing gravity of the situation in the Near East the attention of members [of the Stock Exchange] has for the moment appeared to be diverted from the Ulster crisis [caused by Protestant opponents of Irish Home Rule] … there being a general disinclination to increase commitments in view of the obscurity of the outlook both at home and abroad.[19]

Considering the vast body of literature that has been written about the origins of the First World War—tracing these back as far as the 1870s, or at least the 1900s—it is remarkable that from the vantage point of financial journalism the war had virtually no origins at all. Other evidence strongly supports the proposition that to investors, who were among the best informed people in the world at that time, the war that broke out in the first days of August 1914 came as a complete surprise. As late as August 1, the headline on the front page of the *New York Times* was the wildly optimistic: "CZAR,

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[17] Quoted in James J. Sheehan, *Where Have all the Soldiers Gone* (New York: Houghton Mifflin Co., 2007), p. 56.
[18] Niall Ferguson, "Sinking Globalization", *Foreign Affairs*, (March/April 2005), pp. 64–77.
[19] *The Times*, July 22, 1914, p. **tk**.

KAISER AND KING MAY YET ARRANGE PEACE".[20] But that same day saw the following stark headline on the lead financial page of the London *Times*:

STOCK EXCHANGE

CLOSED UNTIL FURTHER NOTICE

SETTLEMENTS POSTPONED[21]

As the *Economist* observed in its leading article:

> On Sunday [July 26] … Europe was suddenly confronted with the fear of a great war on a scale of unprecedented magnitude. … The world … seems to be returning to a basis of cash and barter … and unless a proclamation of neutrality relieves the strain worse may ensue … *The City has seen in a flash the meaning of war*.[22]

The first symptom of the crisis was a rise in shipping insurance premiums in the wake of the Austrian ultimatum. Bond and stock prices began to slip as prudent investors sought to increase the liquidity of their positions. European investors were especially quick to start selling their Russian securities, followed by Americans. Exchange rates went haywire as a result of efforts by cross-border creditors to repatriate their money: sterling and the franc surged, while the ruble and dollar slumped.[23] By July 30, panic reigned on most financial markets.[24] The first firms to come under pressure in London were the jobbers on the Stock Exchange, who relied heavily on borrowed money to finance their holdings of equities. As sell orders flooded in, the value of their stocks plunged below the value of their debts, forcing a number (notably Derenberg & Co.) into bankruptcy. Also under pressure were the commercial bill brokers in London, many of whom were owed substantial sums by continental counterparties that were now unable or unwilling to remit funds. Their difficulties in turn impacted on the acceptance houses (the elite merchant banks), who were first in line if the foreigners defaulted, since they had "accepted" the bills. If the acceptance houses went bust, the bill-brokers would go down with them, and possibly also the larger joint-stock banks, which lent millions ever day on

[20] Austria had declared war on Serbia on July 28. On July 31 Russia began general mobilization. Germany declared war on Russia on August 1 and on France on August 3. Britain entered the war on the 4th.
[21] *The Times*, August 1, 1914, p. **tk**.
[22] *Economist*, August 1, 1914, p. **tk**. Emphasis added.
[23] O.M.W. Sprague, "The Crisis of 1914 in the United States", *American Economic Review*, 5, 3 (1915), pp. 505ff.
[24] Brendan Brown, Monetary Chaos in Europe: The End of an Era (London / New York, 1988), pp. 1-34.

call to the discount market. The joint-stock banks' decision to call in loans notoriously deepened the crisis.[25] As everyone scrambled to sell assets and increase their liquidity, stock prices slumped, compromising brokers and others who had borrowed money against shares. Domestic customers began to fear a banking crisis. Queues formed as people sought to exchange banknotes for gold coins at the Bank of England.[26] At the same time, the effective suspension of London's role as the hub of international credit helped spread the crisis from Europe to the rest of the world.

Perhaps the most remarkable feature of the crisis of 1914 was the closure of the world's major stock markets for periods of up to five months. The Vienna market was the first to close (on July 27). By July 30 all the continental European exchanges had shut their doors. The next day London and New York felt compelled to follow suit. Although a belated settlement day went ahead smoothly on November 18, the London Stock Exchange did not re-open until January 4. Nothing like this had happened since its foundation in 1773.[27] The New York market reopened for limited trading (bonds for cash only) on November 28, but unrestricted trading did not resume until April 1, 1915.[28] Nor were stock exchanges the only markets to close in the crisis. Most U.S. commodity markets had to suspend trading, as did most European foreign exchange markets. The London Royal Exchange, for example, remained closed until September 17.[29] It seems likely that, had the markets not closed, the collapse in prices would have been as extreme as in 1929, if not worse.

To be sure, the existence of the gold standard tended to exacerbate the liquidity crisis in a way very different from what have seen since August 2007. Some central banks (notably the Bank of England) actually raised their discount rates in the initial phase of the crisis, in a vain attempt to deter foreigners from repatriating their capital and thereby draining gold reserves. The adequacy of gold reserves in the event of an emergency had been hotly debated before the war; indeed, these debates are almost the only evidence that the financial world had given any thought whatever to the trouble that

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[25] John Maynard Keynes, "War and the Financial System", *Economic Journal*, 24, 95 (1914), pp. 460-486.
[26] E. Victor Morgan, *Studies in British Financial Policy, 1914–1925* (London, 1952), pp. 3-11.
[27] *Ibid*. p. 27. See also Teresa Seabourne, "The Summer of 1914", in Forrest Capie and Geoffrey E. Wood (eds.), *Financial Crises and the World Banking System* (London, 1986), pp. 78, 88f.
[28] Sprague, "Crisis of 1914", p. 532.
[29] Morgan, *Studies*, p. 19.

lay ahead.[30] However, the gold standard was no more rigidly binding than today's informal dollar pegs in Asia and Latin America; in the emergency of war, a number of countries, beginning with Russia, simply suspended the gold convertibility of their currencies. In both Britain and the United States formal convertibility was maintained, but it could have been suspended if that had been thought necessary. (The Bank of England requested and was granted suspension of the 1844 Bank Act, but this was not equivalent to suspending specie payments.) In each case, the crisis prompted the issue of emergency paper money by the Treasury: in Britain, £1 and 10 shilling Treasury Notes, in the United States, the emergency notes which banks were authorized to issue under the Aldrich-Vreeland Act of 1908.[31] Then, as now, the authorities reacted to a liquidity crisis by printing money.

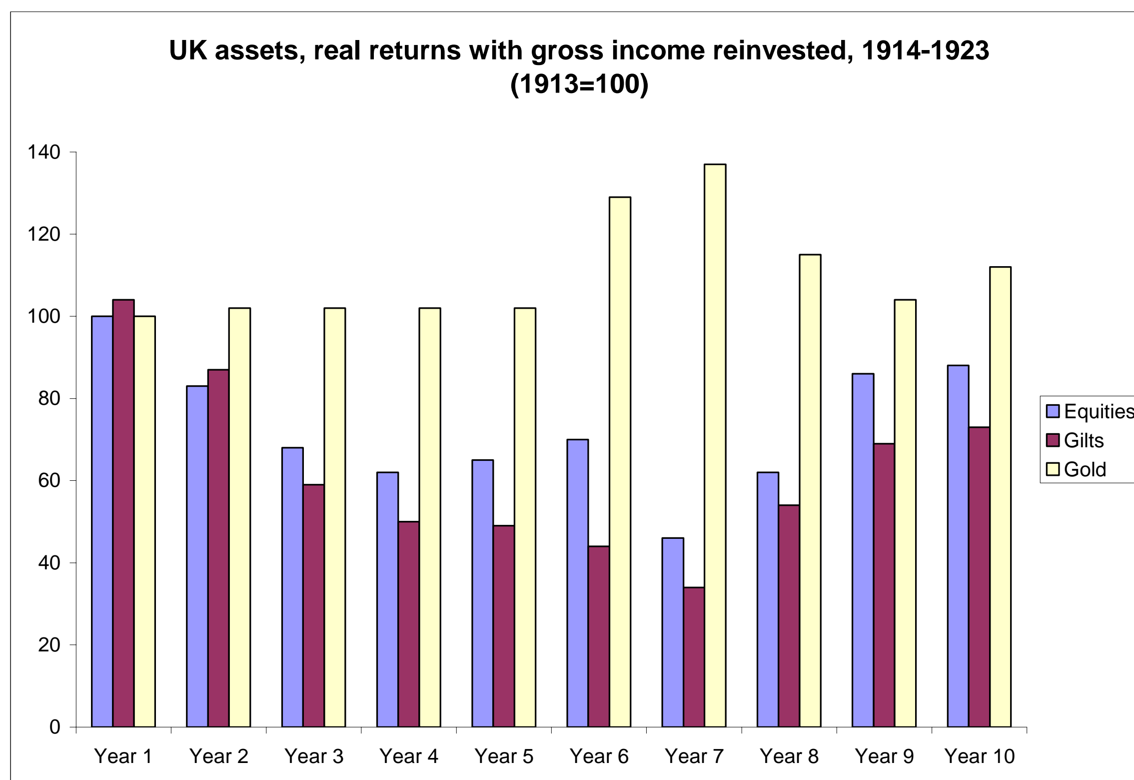
Nor were these the only measures deemed necessary. In London the Bank Holiday of Monday, August 3, was extended until Thursday the 6th. Payments due on bills of exchange were postponed for a month by royal proclamation. A month-long moratorium on all other payments due (except wages, taxes, pensions and the like) was rushed onto the statute books. (These moratoria were later extended until, respectively, October 19 and November 4.) On August 13 the Chancellor of the Exchequer gave the Bank of England a guarantee that, if the Bank discounted all approved bills accepted before August 4 "without recourse against the holders", then the Treasury would bear the cost of any loss the Bank might incur. This amounted to a government rescue of the discount houses; it opened the door for a massive expansion of the monetary base, as bills poured into the Bank to be discounted. On September 5 assistance was also extended to the acceptance houses.[32] Arrangements varied from country to country, but the expedients were broadly similar and quite unprecedented in their scope: temporary closure of markets; moratoria on debts; emergency money issued by governments; bail-outs for the most vulnerable institutions.

[30] Seabourne, "Summer of 1914", pp. 80ff.
[31] See most recently William L. Silber, *When Washington Shut Down Wall Street: The Great Financial Crisis of 1914 and the Origins of America's Monetary Supremacy* (Princeton, 2006).
[32] The Bank agreed to advance funds to the acceptors to allow them to repay pre-moratorium bills on maturity and to defer repayment of the funds until one year after the end of the war: Morgan, *Studies*, pp. 12-23. For other government measures designed to assist the non-banking sector and exporters, see Seabourne, "Summer of 1914", p. 108.

The closure of the stock market and the intervention of the authorities to supply liquidity almost certainly averted a catastrophic fire-sale of assets. The market was already down 7 per cent on the year when trading was suspended—and that was before the fighting had even begun. Fragmentary data on bond transactions conducted literally in the street during the period of stock market closure, give a sense of the losses investors had to contemplate, despite the authorities' efforts. By the end of 1914, Russian bonds were down 8.8 per cent, British consols 9.3 per cent, French rentes 13.2 per cent and Austrian bonds 23 per cent.[33] This, however, was merely the beginning. Contrary to the "short war illusion" (which was more widespread in financial circles than in military circles), there were another four years of carnage still to go. Figure 1 presents figures for total inflation-adjusted returns a British investor would have received over the ten years beginning in 1914, assuming the re-investment of gross income. The evidence is unambiguous. Any investor unwise (or patriotic) enough to hang on to gilt-edged securities (consols or UK War Loans) would have suffered losses of up to 66 per cent at the nadir in 1920, though with some recovery by 1923 (-27 per cent). Investors in equities had lost as much as 54 per cent by 1920, though again the position improved by 1923 (-12 per cent). The best strategy in this simple contest would have been to go for gold, which not only retained its capital value during the war, but appreciated significantly in sterling terms afterwards (+37 per cent by 1920, down to +12 per cent by 1923).

[33] Calculated from isolated prices quoted in *The Times* between August and December 1914.

Figure 1.

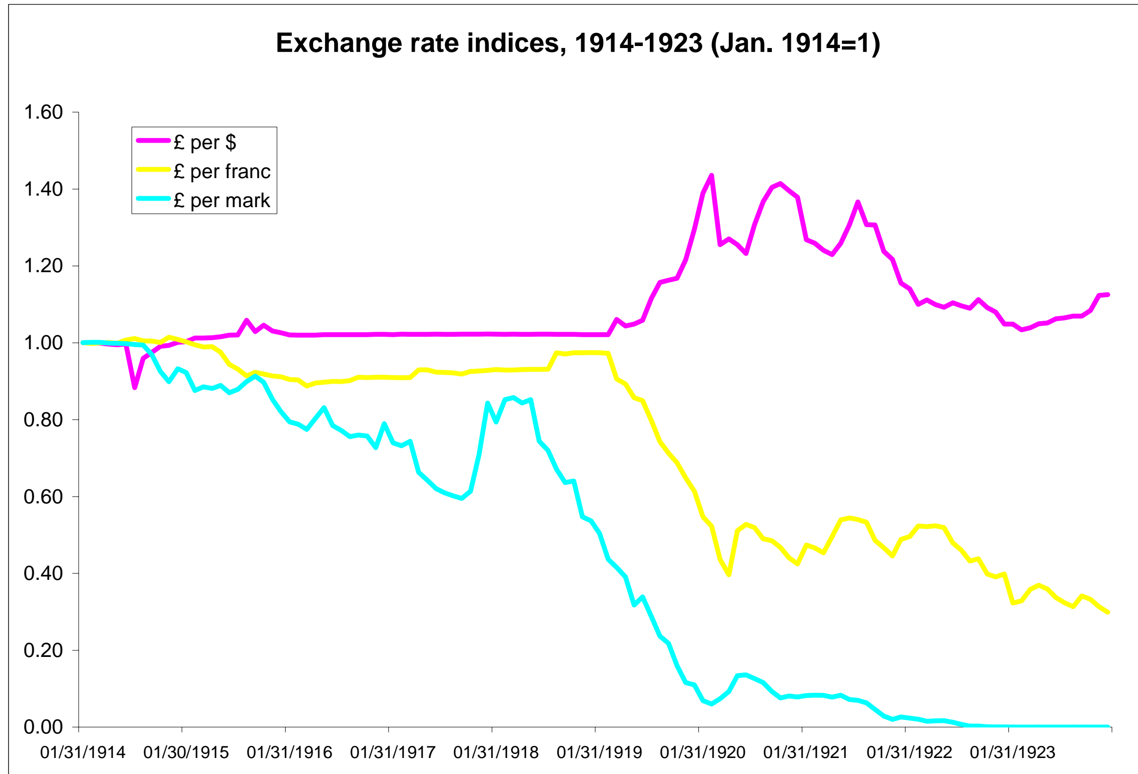


Source: Barclays Capital, *Equity Gilt Study 2007* (London, 2007).

Gold was a good hedge against war-time inflation, then. However, it is important to notice that it was not the best asset for a British investor. Since the dollar remained on the gold standard during and after the war, holding dollars would have been equally good (see figure 2). By contrast, exposure to continental currencies would have been either bad or disastrous. Inflation in France and hyperinflation in Germany inflicted severe punishment on anyone rash enough to maintain large franc or Reichsmark balances. Those with substantial holdings of Austrian, Hungarian, Ottoman and Russian bonds also lost heavily—even when these were gold-denominated—as the Habsburg, Ottoman and Romanov empires fell apart under the strains and stresses of total war. The losses were especially sudden and severe in the case of Russian bonds, on which the Bolshevik regime defaulted in February 1918. By the time this happened, Russian 5 per cent bonds of the 1906 vintage were trading at below 45 per cent of their face value. Hopes of some kind of settlement with foreign creditors lingered on throughout the 1920s, by which time

the bonds were trading at around 20 per cent of par. By the 1930s they were all but worthless.[34]

Figure 2

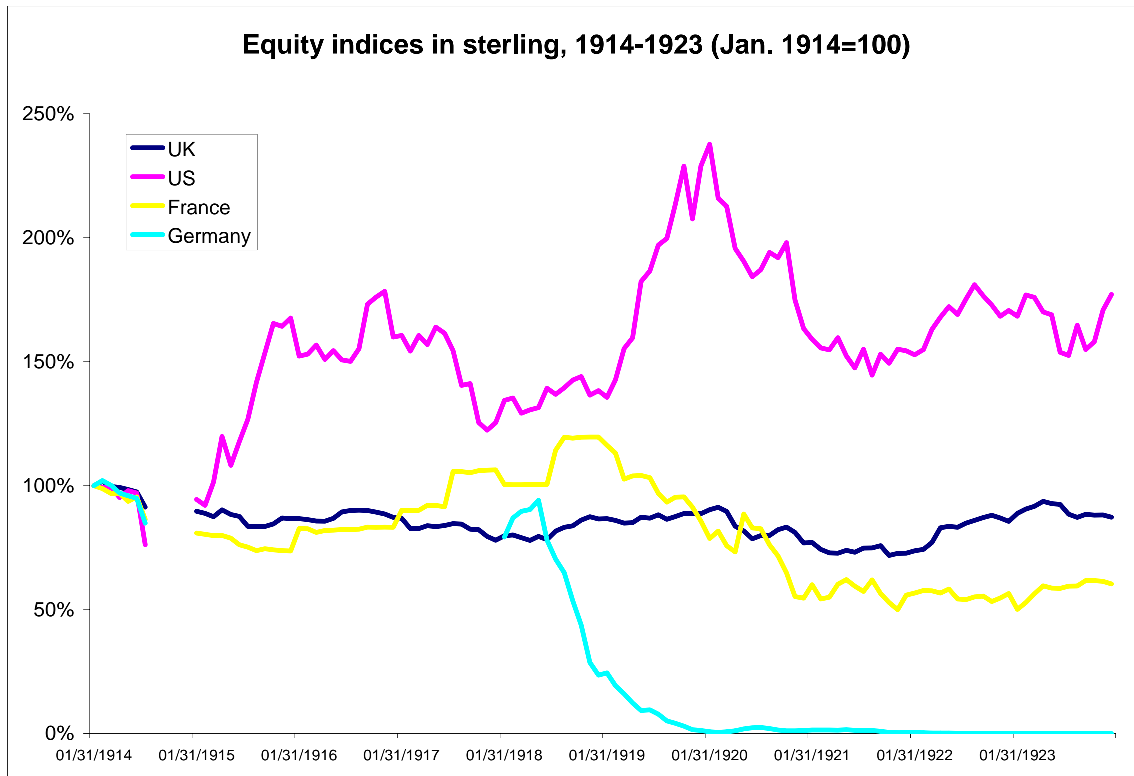


Source: Global Financial Data.

However, an investor could simultaneously enjoy the benefit of the gold hedge against sterling depreciation and earn additional returns by investing in U.S. stocks. As figure 3 makes clear, a British investor who converted his entire portfolio into a selection of blue-chip American stocks would have done well. Purely in terms of capital appreciation (and here excluding dividends), he would have seen a gain of 138 per cent at peak, and 77 per cent by the end of 1923. Once again, any exposure to continental bourses would have been a costly mistake.

[34] See Lyndon Moore and Jakub Kaluzny, "Regime Change and Debt Default: The Case of Russia, Austro-Hungary, and the Ottoman Empire following World War One", *Explorations in Economic History*, 42 (2005), pp. 237–258.

Figure 3



Source: Author's own calculations base on indices from Global Financial Data.

The stakes for investors had been very high in the summer of 1914, though few of them seem to have known it. The impact of the war was very far from uniform on the various asset classes open to a typical capitalist of the pre-war years. John Maynard Keynes's archetypal pre-war rentier, sipping his tea and playing the global markets from the comfort of his London boudoir, had little suspected what havoc would be wrought by "the projects and politics of militarism and imperialism, of racial and cultural rivalries, of monopolies, restrictions, and exclusion".[35] These forces were indeed the "serpent" in the paradise of pre-1914 globalization. But the serpent's bite was more fatal to some portfolios than to others.

III

Explaining 1914

[35] John Maynard Keynes, *The Economic Consequences of the Peace* (London, 1919), chapter 2.

For ninety years, historians have been industrious in devising *ex post facto* explanations for the First World War. Many have sought to heap blame on Germany, arguing that the leaders of the *Kaiserreich* embarked on a reckless "bid for world power", that was as much a product of domestic political conflicts within Germany as of any rational grand strategy. Some British historians have identified a failure in London effectively to deter Germany with a credible military commitment to the continent. But for the weariness of the British Titan, the German gamble on war might never have been attempted. In truth the war arose because each of the European empires felt threatened in some way or other. Without the desire of the elites in Vienna and Budapest to reckon with Serbia's "South Slav" pretensions to Balkan hegemony, the war would certainly not have happened. Without the almost frivolous readiness of the Tsar's ministers to wager his crown on a confrontation with the German powers—less than ten years after Russia's humiliation at the hands of Japan—the war might have been localized in the Balkans. Imperial insecurities were exacerbated by the tantalizing advantages that seemed within reach: advantages, if only one's army could be enlarged still further, advantages, if only one's ally could be bound still closer. Domestic political factors were important too. It was the rise of an organized labor movement in Europe that directly or indirectly imposed restraints on the great powers' armaments programs, if only because the tax increases necessary to buy new battalions and battleships threw distributional disputes into bold relief. At the same time, it was the rise of a militant Right that lent credence to the notion that war might be the solution to imperial problems, rather than the solvent of the empires themselves. The First World War of the historians is thus so over-determined that it emerges as a crisis that was highly probable. That is why most historical accounts of the war's origins depict a series of escalating crises, like those in A.J.P. Taylor's *Struggle for Mastery in Europe*:

> The Last Years of British Isolation, 1902–5
> The Formation of the Triple Entente, 1905–9
> The Years of Anglo-German Hostility, 1909–12
> The Balkan Wars and After, 1912–14
> The Outbreak of War in Europe, 1914[36]

[36] A.J.P. Taylor's *Struggle for Mastery in Europe, 1848-1918* (Oxford, 1954).

It is of course possible that future historians will retrospectively construct equally plausible chains of causation to explain whatever great crisis lies ahead of us. It is not too difficult to imagine the advocates of "war guilt" blaming an aggressive Iran or China, leaving others to lament the weariness of the American titan. Scholars of international relations will no doubt identify the systemic origins of the war in the breakdown of nuclear non-proliferation, the scramble for natural resources, the crisis of the Atlantic alliance, the rise of religious fundamentalism, the weakening of the United Nations, and so on. Couched in the language of historical explanation, a major conflagration crisis can start to seem alarmingly probable in our time too.

Yet the reality remains that *ex ante* World War I was not a high-probability event, otherwise more contemporaries would have seen it coming. The investment community of the City of London was made up of sophisticated, well-informed people, as familiar with the corridors of power as with their own counting houses. That the war took them so unawares suggests that most traditional historical explanations of what happened are fatally flawed. Does this mean that the First World War was a low-probability event—a "black swan"?[37] Not quite. It would be more correct to say that a big war belonged in the realm of uncertainty,[38] like an asteroid's hitting the earth, or a global influenza pandemic.[39] People before July 1914 knew that a great war was a possible; hack writers made English readers' flesh creep with imaginary scenarios like a German conquest of England. But they could not attach a probability to such a scenario. This was a point brilliantly expressed by Keynes in 1937. "By 'uncertain' knowledge", he wrote in a response to critics of his *General Theory*,

> … I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty … The expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or … the rate of interest twenty years

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[37] Just because all the swans you've ever seen have been white doesn't mean there's no such thing as a black swan: Nassim Nicholas Taleb, *Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets*, 2nd edition (New York, 2005), p. 117.
[38] See Frank H. Knight, *Risk, Uncertainty and Profit* (Boston, 1921).
[39] Richard A. Posner, *Catastrophe: Risk and Response* (Oxford, 2004), esp. pp. 73-84.

> hence … About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know.[40]

And he went on to pose and answer a question that is central to the problem of political risk:

> How do we manage in such circumstances to behave in a manner which saves our faces as rational, economic men?
>
> (1) We assume that the present is a much more serviceable guide to the future than a candid examination of past experience would show it to have been hitherto. In other words we largely ignore the prospect of future changes about the actual character of which we know nothing.
>
> (2) We assume that the *existing* state of opinion as expressed in prices and the character of existing output is based on a *correct* summing up of future prospects …
>
> (3) Knowing that our own individual judgment is worthless, we endeavor to fall back on the judgment of the rest of the world which is perhaps better informed. That is, we endeavor to conform with the behavior of the majority or the average.[41]

It is surely not without significance that Keynes could consign "the prospect of a European war" to the realm of uncertainty in the year 1937.

Keynes may or may not have intended to construct an empirically testable hypothesis when he wrote those words, but he certainly did so. Was he right to suggest that his fellow investors in the mid-1930s were wholly present-minded, treating the here-and-now as a "serviceable guide to the future", rather than basing their judgments on "a candid examination of past experience"? Given what some senior personnel in the City had experienced just 23 years before, when a European war had wreaked full-scale financial havoc in London, it would be rather surprising.

What were the financial lessons of the ten-year crisis unleashed at the end of July 1914? As we have seen, they were relatively straightforward. If a major European war was imminent, investors would do well to take the following positions:

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[40] John Maynard Keynes, "The General Theory of Employment", *Economic Journal*, 51, 2 (1937), p. 214.
[41] Ibid.

Bearish: UK bonds; Continental currencies, bonds and equities

Neutral: UK equities

Bullish: Gold, U.S. stocks

It should therefore be quite easy to see whether or not investors did learn from the past, by looking for movements in the prices of these different asset classes as the political skies darkened over Europe once again after 1933.

The only reason such a test might not work would be if opinion in the City was universally and unflinchingly confident, until the dying days of August 1939, in the ability of the British government to avert war by its policy of appeasement. It has certainly been claimed by more than one historian that bankers as a class were strongly supportive of Prime Minister Neville Chamberlain.[42] Among contemporaries, the Soviet ambassador was not alone in thinking that Chamberlain had strong City support. "He is often called here an 'accountant in politics'," Maisky confided to his diary on March 8, 1938, "because he views the whole world primarily from the angle of dividends and exchange quotations. It is for this reason that Chamberlain is a darling of the City, which places implicit trust in him."[43] Like *The Times*, both the *Financial Times* and its sister title the *Financial News* consistently supported Chamberlain's foreign policy, including the Munich agreement of September 1938.[44] Yet Stalin's envoy and the editorial columns of the press may not be the most reliable bellwethers of the mood in Britain's financial markets in the 1930s. An examination of the way investors actually behaved, as manifested in the movements of prices in the markets for bonds, currencies, stocks and commodities, reveals a very different picture.

IV

The 1930s: "Interminable Overture"[45]

[42] Scott Newton, *Profits of Peace: The Political Economy of Anglo-German Appeasement* (Oxford, 1996). See also Jonathan Kirshner, *Appeasing Bankers: Financial Caution on the Road to War* (Princeton, 2007).

[43] Ivan Maisky's diary, March 8, 1938. I am grateful to Gabriel Gorodetsky for allowing me to see the manuscript of his forthcoming edition of this important source.

[44] David Kynaston, *The Financial Times: A Centenary History* (London, date **tk**), pp. 128f.

[45] Title of a David Low cartoon, *Evening Standard*, October 31, 1939.

INTERMINABLE OVERTURE

It is not necessary here to provide a detailed chronicle of the approach of World War II. Suffice to say that even before the fateful year 1939 there were at least five acts by the German government that clearly signaled Adolf Hitler's intention to overthrow, by force or the threat of force, the European order that had been established at Paris in 1919. In March 1935, Hitler announced his intention to restore conscription in Germany, in violation of the Versailles Treaty. One year later, he unilaterally reoccupied the demilitarized Rhineland, in violation of the Versailles and Locarno Treaties. Later that same year, he and his Italian counterpart Mussolini intervened in the Spanish Civil War, in contravention of the Non-Intervention Agreement of the summer of 1936. Then, in March 1938, Hitler ousted the Austrian Chancellor Kurt Schuschnigg and proclaimed the annexation (*Anschluss*) of Austria by Germany, an act explicitly prohibited by the Versailles Treaty. Finally, in September 1938, Hitler threatened to go to war to separate the Sudetenland region from Czechoslovakia.[46] On the other hand, there were at least four arguments put forward in the 1930s for avoiding, or at least postponing war, by appeasing the dictators. The strategic argument was that an "overstretched" British Empire could not risk simultaneous conflicts with Germany, Italy and Japan. The diplomatic argument was that Britain could not yet rely for support on a vacillating France, a hostile Soviet Union and an isolationist United States. The domestic political argument was that the British public, scarred by the memories of 1914-1918, was not yet

[46] For a detailed account see Niall Ferguson, *The War of the World: Twentieth-century Conflict and the Descent of the West* (New York, 2006), chapters 8 and 9.

ready to fight another war. It was the economic arguments that supposedly carried most weight in the City. Britain could not rearm sufficiently fast to fight sooner than 1939 because of fiscal and balance of payments constraint; finance was "fourth arm" of defense, and had to be preserved by a policy of "cunction" (playing for time). Moreover, shortages of skilled labor meant that accelerated rearmament—especially if it focused on the construction of a strategic air deterrent—might trigger inflationary pressures. Finally, a number of City firms were still owed substantial money by German companies, debts that had been effectively frozen since 1932. There was, so the argument runs, a measure of self-interest as well as macroeconomic pragmatism in the City's support for appeasement. This explains the *Financial Times*'s doleful comment on Munich, the agreement between Britain, France, Germany and Italy whereby the Sudetenland was summarily handed over to Germany: "Dismemberment is a painful thing for a proud country to contemplate [but] it possesses the one virtue that it will have spared countless millions the horrors of a war … more destructive even than that of 1914-18".[47]

Not every financial organ took this line, however. The editorials of the *Economist*, for example, consistently criticized the policy of appeasement on the grounds that concessions to Hitler did more than postpone the evil hour; they actually strengthened the German position.[48] As the paper's first leader put it in the immediate aftermath of Chamberlain's triumphant return from Munich:

> To-day's rejoicings will sound a little flat if it is soon discovered that the great crisis of our civilisation is merely postponed, soon to fall on us again. And they will appear downright foolish if it eventually transpires that this week's work has lessened our powers of resistance to aggression when we come to meet it again.[49]

For our purposes, the striking point about the *Economist*'s commentary on the Munich crisis is the clarity of the contrast it drew between the crisis of 1914 and the crisis of 1938:

> In August 1914, the City was caught utterly unprepared. The war and the financial crisis that accompanied it came entirely as a bolt from the blue. At the end of July

[47] Quoted in Kynaston, *Financial Times*, p. 134.
[48] See e.g. "The Shadow of the Sword", *Economist*, March 19, 1938, p. **tk**; "Hope from Despair", ibid., September 17, 1938, p. **tk**; "Vain Sacrifice", ibid., September 24, 1938, p. **tk**. For background, see Ruth Dudley Edwards, *The Pursuit of Reason: The Economist, 1843-1993* (Boston, MA, date **tk**).
[49] "Eleventh-hour Reprieve", ibid., October 1, 1938, p. **tk**.

> 1914, everybody took it for granted that the methods that had created prosperity and stability for nearly 100 years would continue for ever. It was no wonder that the City was stunned by the shock when … it stepped into chaos overnight. … At present, however, the state of affairs is totally different. *For one thing, even before the development of acute political tension, conditions had been distinctly depressed for many months past. … in the last few weeks there can have been few people in the City who did not envisage the strong possibility of an armed conflict in which Great Britain would be heavily involved*.[50]

By 1938, in other words, a majority of investors—at least in the eyes of the *Economist*—saw war as a "strong possibility". This was far removed from the unfathomable uncertainty Keynes had described a year before.

Financial market data support the proposition that, *pace* Keynes, investors had learned their history lesson. Not only did they see war as highly probable by 1938. In some respects they had seen its probability rising from as early as 1933. As figure 4 shows, German bonds had sold off in London almost from the moment of Hitler's appointment as Reich Chancellor on January 30, 1933.[51] French bonds began to slide downward in 1935, even before the remilitarization of the Rhineland. There was also a significant increase in the volatility of Polish bonds from the spring of 1936 and Czech bonds from the spring of 1938. It seems reasonable to infer from these data that investors were seeking to limit their exposure to continental bonds, mindful of what had happened to those assets after 1914.

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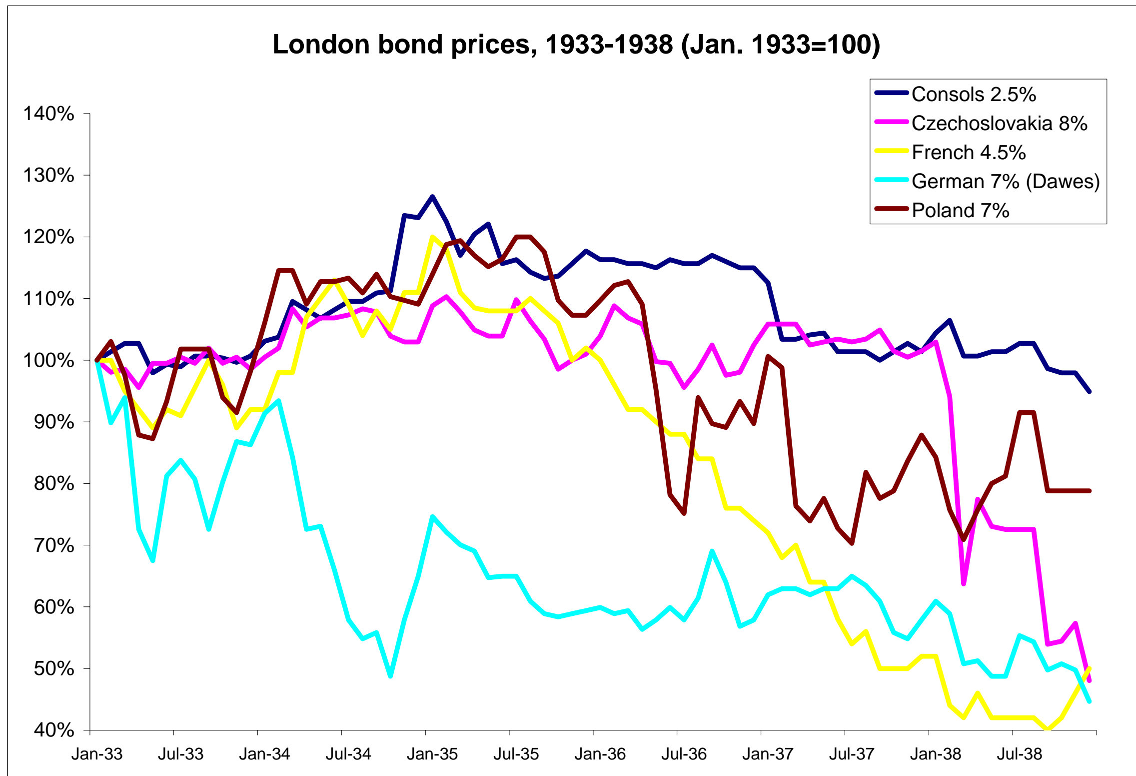
[50] "The City—Then and Now", ibid., p. **tk**. Emphasis added [**ck**].

[51] William O. Brown, Jr., and Richard C. K. Burdekin , "German Debt Traded in London During the Second World War: A British Perspective on Hitler", *Economica*, 69 (2002), pp. 655-69.

Figure 4

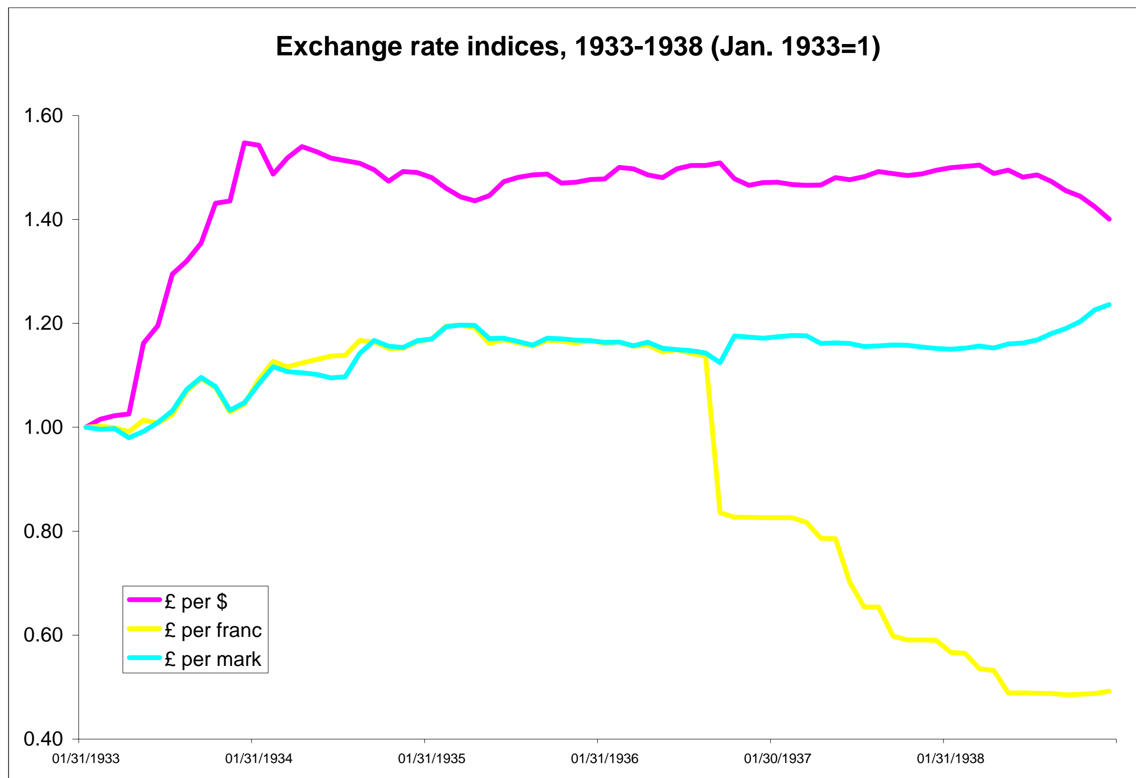


Source: *The Economist*.

A somewhat similar picture emerges from the foreign currency market, though here the effects of government intervention now played a much bigger role (most obviously in the increasingly regulated market for German marks).[52] The dollar appreciated against the pound by as much as 50 per cent between 1933 and 1934. The franc, by contrast, slumped against sterling by more than 50 per cent between September 1936 and September 1938.

[52] For details see Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939* (New York / Oxford, 1992).

Figure 5

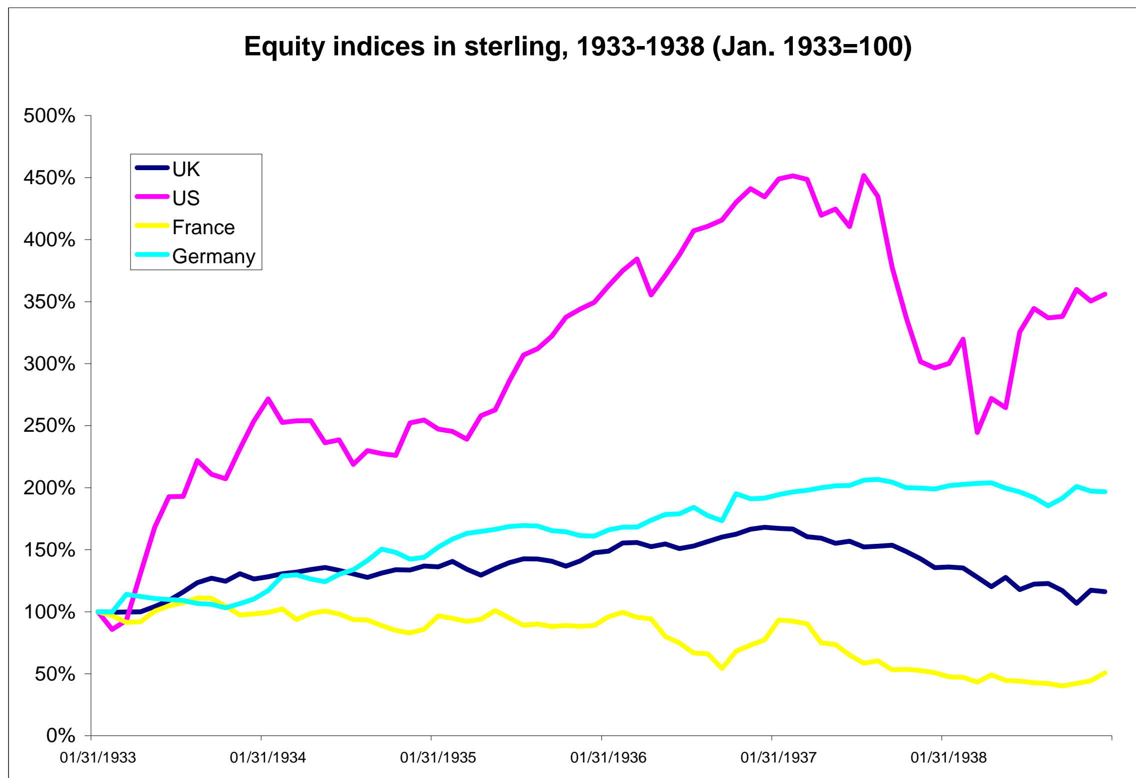


Source: Global Financial Data.

Figure 6 makes it clear that in sterling terms Wall Street outperformed European stocks from 1933 until 1937 and, despite the stock market crash of that year, the Dow ended the year 1938 substantially above the UK Actuaries General Index. Relative to January 1933, London stocks were up just 16 per cent by December 1938; French stocks were up just 3 per cent, but American stocks had risen by more than 150 per cent. (Not too much should be read into the relative strength of the German stock market, since after 1932 Germany was increasingly a closed economy, with very limited investment opportunities for foreigners, and no overseas investment opportunities for Germans.)[53]

[53] On the relative isolation of Central European stock markets after the First World War, which predated the Nazi regime, see Lyndon Moore, "The Effect of World War One on Stock Market Integration", unpublished paper (n.d.).

Figure 6



Source: Author's own calculations base on indices from Global Financial Data.

A number of other indicators of early pessimism among investors are worthy of note. First, shares in Britain's biggest arms manufacturer, Vickers, surged fivefold between 1933 and 1936 in what was little short of a defense stock bubble. Other strong performers in this period were the oil company Anglo-Persian, the copper and zinc giant Rio Tinto and U.S. Steel. The transatlantic passenger shipping line Cunard fared correspondingly badly, as might be expected in an atmosphere of mounting Anglo-German tension, with memories of unrestricted submarine warfare still fresh.[54] Secondly, the price of gold surged twice: in the period from 1933 to 1935, a move which can probably be attributed to the relaxation of British (and American) monetary policy following the abandonment of the gold standard; and again in 1938, as a direct consequence of the crisis over Czechoslovakia. (Between February and December 1938,

[54] Another indicator that I have not yet consulted is shipping insurance premiums. It would be very surprising to find no increase in these during the 1930s. On the impact of the First World War, see H.G. Lay, *Marine Insurance: A Textbook of the History of Marine Insurance, including the Functions of Lloyd's Register of Shipping* (London, 1925), pp. 55f.

the London price of gold rose by 8 per cent.) Finally, it is clear that from the beginning of 1938 onwards there was a sustained drain on the Bank of England's international (gold and dollar) reserves.[55] None of these trends was more than temporarily halted by the Munich agreement. Indeed, in most cases the famed Munich "bounce" turns out to have been little more than a reversion to the longer-term downward slide after a severe sell-off in the preceding week, when the probability of war had leapt upward.[56]

All this would seem to support the hypothesis that—like *The Economist* and unlike the *Financial Times*—most investors realized that war had merely been postponed and Germany strengthened by the policy of appeasement. This increased the pressure on the Bank of England as investors began to seek refuge in gold, dollars and U.S. stocks, rendering null and void the argument that playing for time would help to preserve the financial fourth arm of British defense. This, in short, was the very opposite of the situation in 1914, when war had been a bolt from the blue. World War II, by contrast, was a long-anticipated event, with Czech crisis merely part of an interminable overture. Indeed, it might even be suggested that investors "priced war in" at least a year, and perhaps as much as three years, ahead of time. There was a reason for this. From a financial standpoint, as the *Economist* astutely observed, the difference between a period of accelerating re-armament and period of outright war was (unlike in 1914) in some respects merely one of degree:

> The main distinction between the two situations [of a re-arming peace or eventual war] is one of economic control. In both, the problem of Budget deficits and high taxation must be faced. In both, the authorities would keep a close watch on the profits of the armaments industry. In both, fears of inflationary developments … would be tempered, for a time at least, by the existence of considerable unabsorbed supplies …. All these factors tend to limit the advantage of *equity shares* generally, as a war risk hedge. They might leave some scope for industries serving the armaments trades and for suppliers of essential war materials. But

[55] All data from successive issues of the *Economist*. For annual data on the Bank of England, see G.C. Peden, *The Treasury and British Public Policy, 1906-1959* (Oxford, 2000), Appendix IV, Table D.
[56] A more detailed presentation of these data is currently in preparation.

> they might not provide the same advantages as *carefully chosen gold-mining shares or American industrial securities*, under wartime conditions.[57]

This commentary makes it very clear that already, eleven months before the outbreak of war, at least some investors were seeking to apply the lessons of 1914 by hedging against war risk. Home bias might lead the unwary to favor UK equities. But one important lesson of the First World War was that government controls over British industry would be increased substantially at least for the duration of a major conflict. The smart money was therefore on gold and U.S. stocks. Those who adopted this strategy did not lose out by hedging early.

V

Cold War Coda

What were the lessons of World War II? Perhaps the most obvious lesson was that no two world wars are alike—financially or in any other respect. As figure 7 shows, contrary to the *Economist*'s expectations and the experience of the First World War, UK equities outperformed gold in the five years after 1939, as well as over the ten year period from 1939 to 1948. Even more surprisingly, UK equities did better than U.S. equities over the same timeframes, and UK gilts offered significantly higher returns than U.S. Treasuries. Between September 1939 and May 1945, the British Actuaries General Index rose by 63 per cent. In sterling terms, by contrast, the Dow Jones index went up by just 6 per cent. The real return on gilts between 1939 and 1945 was 19 per cent; the real return on Treasuries was 2 per cent. Franklin Roosevelt once declared that he did not lead the United States into World War II in order to preserve the British Empire. Nor did he make war to enrich American investors. In this respect, Keynes's advice to British investors back in 1937—to base their decisions on "a candid examination of past experience"—turned out to be rather unsatisfactory. Past experience would have led any reasonable asset-allocator to be overweight U.S. stocks in 1939. Present knowledge that London was within reach of German bombers, while New York was not, would merely have reinforced the lesson of history. Yet, despite the Blitz, London beat New York for equity investors and bondholders alike.

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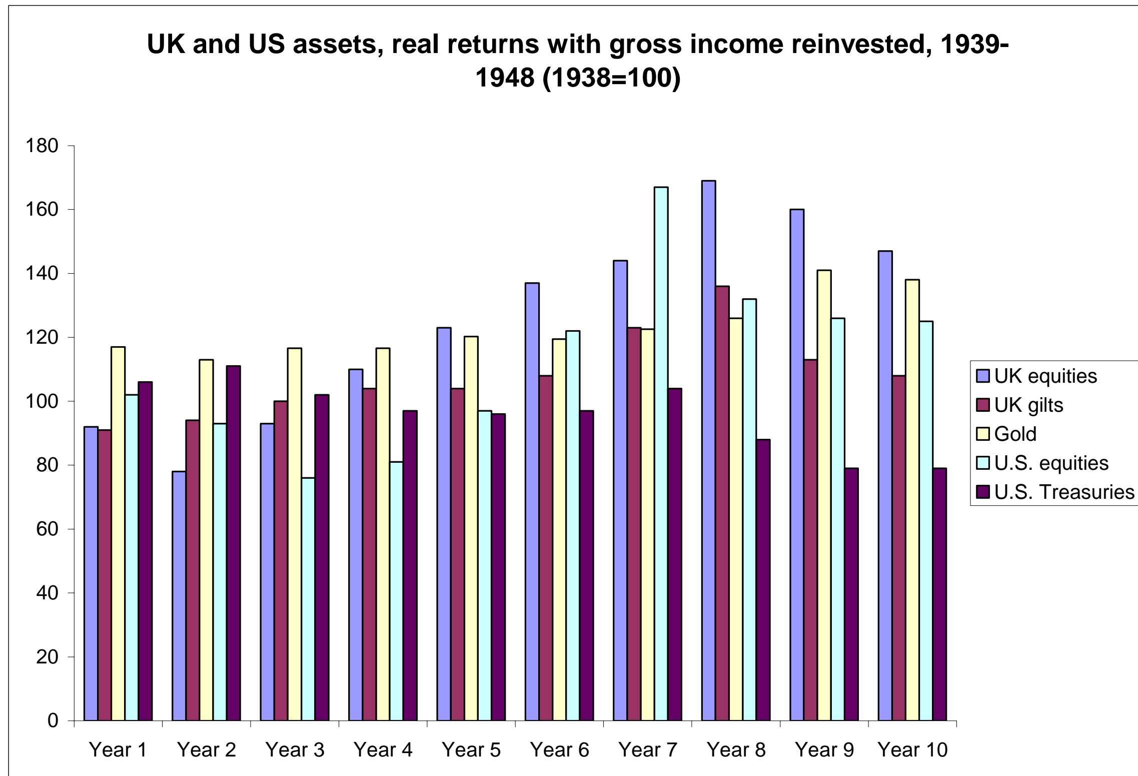
[57] "Stock Exchange Policy", *Economist*, October 1, 1938, p. **tk**. Emphasis in original.

Figure 7



Source: Barclays Capital, *Equity-Gilt Study 2007*.

By itself, this marked contrast between the two world wars might have made investors cautious about expecting any third world war to resemble its immediate predecessor. It was in any case perfectly clear after 1945 that any future world war would be profoundly different. With the dropping of the atomic bombs on Hiroshima and Nagasaki—and, more importantly, with the news that the Soviet Union had successfully tested a replica of the American bomb in August 1949—the very nature of great power conflict was irrevocably altered. "The human animal … must change now," President Truman had written as early as 1946, "or he faces absolute and complete destruction and maybe the insect age or an atmosphere-less plant will succeed him." On this point, he and Stalin were at one. "Atomic weapons", the latter remarked in 1949, "can hardly be used without spelling the end of the world." Yet, strictly speaking, that was not yet true when the Korean War broke out in June 1950, at a time when the Soviets had no more than five operational bombs to the Americans' 369. Despite the fears expressed in *Bulletin of the*

Atomic Scientists, it was very much earlier than "three minutes to midnight", if the "Doomsday Clock" was intended as an indicator of the imminence of all-out nuclear war.[58] It was therefore still possible for investors in 1950 to contemplate a Third World War fought primarily with conventional weapons.

For slightly more than a year, the conflict in Korea teetered on the brink of global escalation. On June 27, 1950, in the absence of the Soviet representative, the United Nations Security Council authorized foreign assistance to South Korea to repulse the North Korean invaders. This rapidly manifested itself as an American-led and largely American-manned expeditionary force which, after some initial reverses, triumphantly rolled back the invaders to the 38th parallel—and beyond. On October 19, however, with Pyongyang in American and South Korean hands, China entered the war and crossed the Yalu River, inflicting a heavy defeat on the U.S. 8th Army and forcing the evacuation of American forces from Hungnam harbor. The North Koreans recaptured Seoul on January 4, 1951, driving UN forces back as far as Suwon and Samchok. But the tide soon turned again, and by March 7, the 8th Army was back in control of the South Korean capital. It was during this period that General Douglas MacArthur pressed Truman to allow the use of atomic weapons against enemy targets. Although Truman sacked MacArthur on April 11, the option to use the Bomb was never wholly closed off, and was frequently contemplated by Truman's successor, Dwight Eisenhower.[59] Nor could it be taken for granted that Stalin would remain on the sidelines. A plausible scenario was that the U.S. would use an atomic bomb on Chinese troop concentrations, precipitating Soviet reprisals against Berlin. Only in retrospect was the stalemate along Line Kansas inevitable. Only in retrospect were the peace negotiations initiated in July 1951 bound, after two long years, to produce a lasting armistice.

What were the financial implications of a possible escalation of the Korean War? For many investors, the answer had to do with the likely impact of American rearmament on inflation. The First World had caused an upward jump inflation in all combatant countries, but from late 1920 the trend had been painfully reversed in the English-speaking world. The Second World had, in this respect too, been different (see figure 8).

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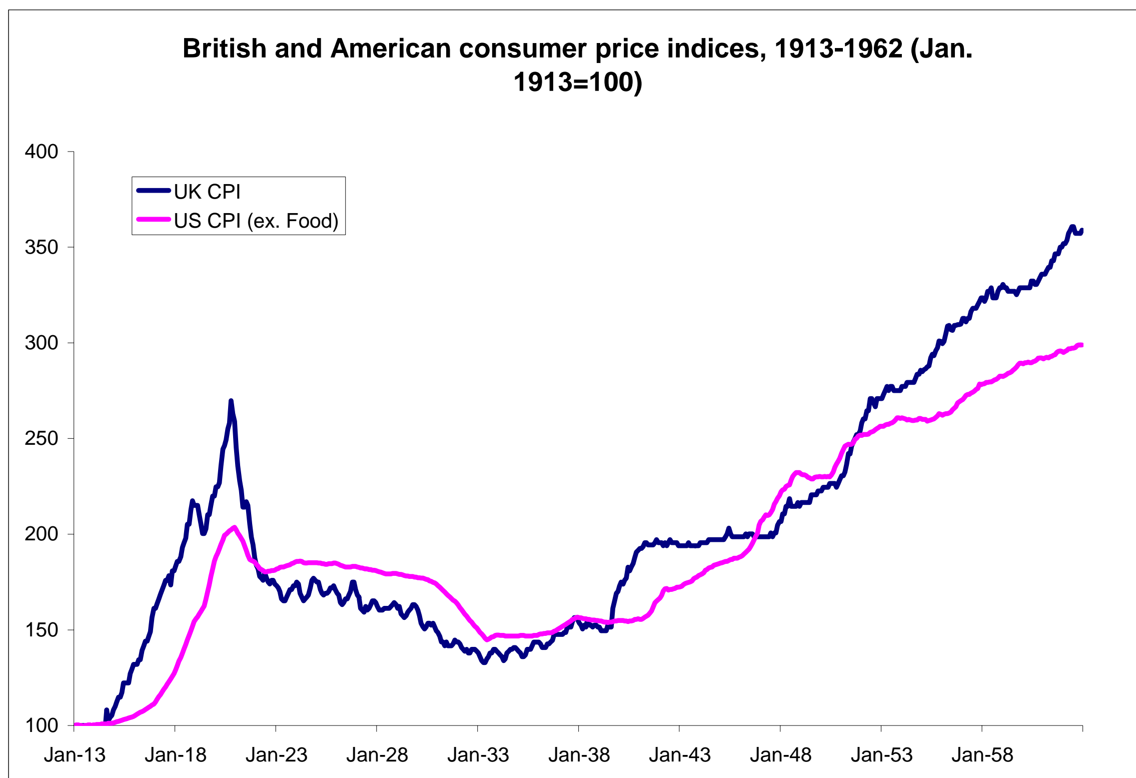
[58] See http://www.thebulletin.org/minutes-to-midnight/timeline.html.
[59] See John Gaddis, *The Cold War: A New History* (New York, 2006), pp. 52f.

Fiscal and monetary policy had been better managed, consumer demand more tightly reined in and price controls more effectively administered, so that wartime and immediate post-war inflation was lower in both the United Kingdom and the United States than after the earlier conflict. On the other hand, there was no attempt after 1945 to turn the clock back by deflating prices back down to their pre-war level. The lesson many investors therefore learned from World War II was that another major war would cause a one-off rise in inflation that was unlikely to be reversed.

Figure 8



Sources: Global Financial Data; National Bureau of Economic Research.

This helps to explain the way financial markets reacted to the outbreak of the Korean War. As figures 9 and 10 show, the U.S. stock and bond markets responded negatively to the outbreak of the war in Korea, but the effect (by the standards of 1914 or 1939) was modest and short-lived. Subsequent crises—the Chinese crossing of the Yalu, the sacking of MacArthur—had a negligible impact. The *Economist* noted a significant impact on securities "nearest to the storm centre", notably Japanese bonds. But the

"violent overnight slump in Wall Street", which had seen the Dow Jones Index fall from 224 to 214, had been followed by a "slight rally" after Truman's pledge of "strong and immediate" measures, while London had seen no more than "precautionary marking down of prices". The really significant market moves were upward, as investors bought up commodity shares like Rhodesian copper mines, acting on "the general assumption that the week's developments must impart new impetus to the forces of inflation". There was also an upward move in the world's remaining free markets for gold"—a reminder that under the Bretton Woods system gold was no longer freely traded in most financial centers.[60]

Here was the new lesson of history: that a major war would have "inflationary implications" and that these would initially manifest themselves in higher commodity prices. "The Western world", noted the Economist on July 15, 1950, "has been treated in the space of three weeks to a boom in commodity prices of so far-reaching an order as to suggest that the tepid war had been heated up to boiling point." First in line, besides copper, were rubber, tin, lead and cotton, the prices of which were expected to be driven up as the United States re-armed, particularly at a time when the demand of consumer industries for the same articles was already riding high.[61] A related expectation—once again based on the experience of World War II—was that the U.S. government would move swiftly to restrict the consumer sector's appetite for commodities, which spelt difficult times for "non-essential" sectors such as automobiles and televisions. It also seemed reasonable to anticipate renewed demand-side restrictions on consumer credit and loans for housing, as well as increased taxation.[62] By November 1952 it had become clear that the extent of the war-induced inflation would vary from country to country according to the degree of stringency of the national fiscal and monetary authorities.[63] Looking back after two years of stalemate and relatively low-intensity conflict, investors were bound to conclude that these, rather than the appetite of the military for commodities, posed the principal challenge to the preservation of wealth in times of geopolitical crisis.

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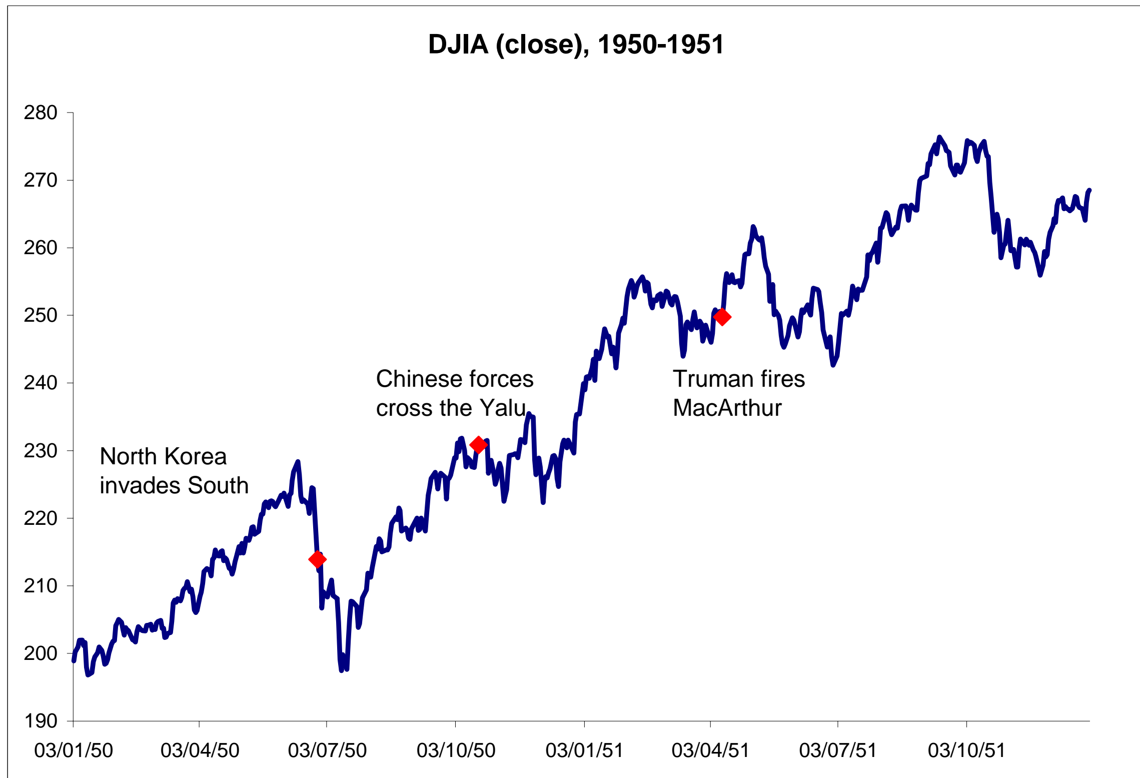
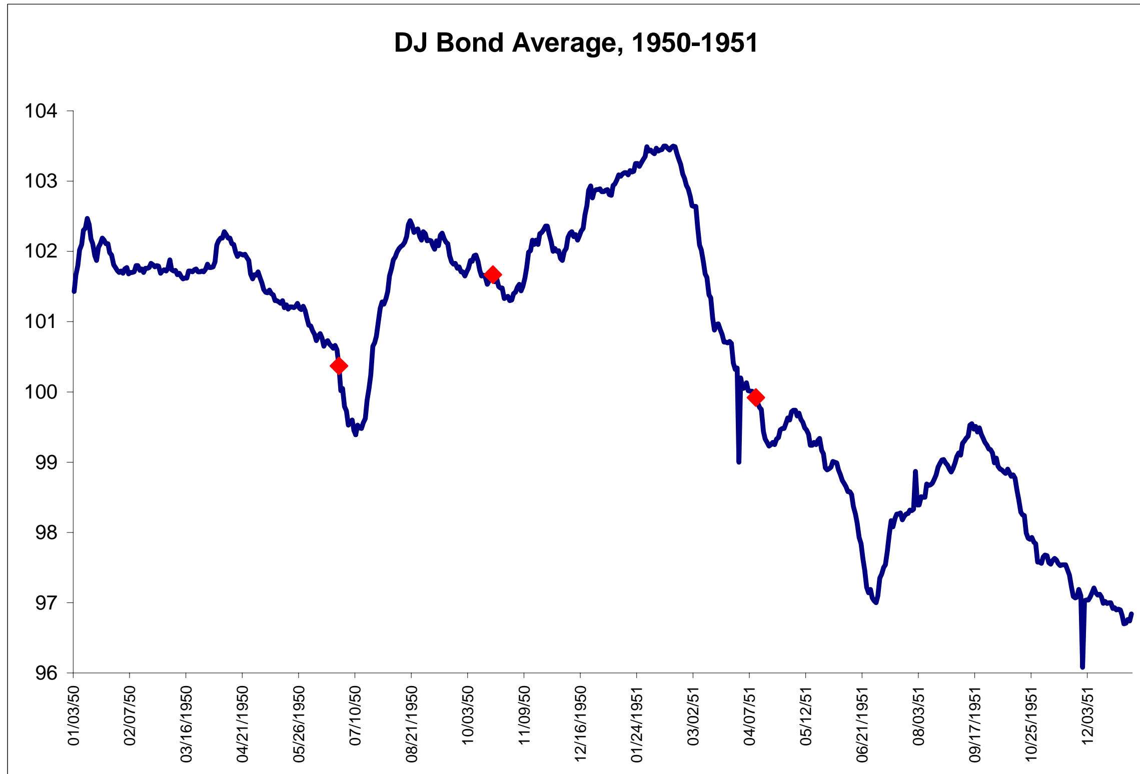
[60] "The City and Korea", *Economist*, July 1, 1950, p. 32.
[61] "Prices and Korea", *Economist*, July 15, 1950, p. 136.
[62] "Strains on the Economy", *Economist*, July 22, 1950, p. 172. See also "Policy for Commodities", ibid., November 11, 1950, p. 759.
[63] "Monetary Orthodoxy in Europe", *Economist*, November 15, 1952, pp. 497-9.

Figures 9 and 10





Source: Economagic; Global Financial Data.

In the decade between the Korean War and the Cuban Missile Crisis—widely regarded by historians as the moment when the Cold War came closest to a nuclear hot war—the nature of the superpower rivalry changed again, and the effect was once more to erode the value of the lessons of history. As figures 11 and 12 make clear, the financial impacts of both the harbinger of the crisis (the abortive U.S.-sponsored invasion of Cuba in April 1961) and the crisis itself (which became known to the public on October 22 and appeared to be over by October 28)[64] were minimal. This was partly because the investing public knew much less about the crisis than we now know today.[65] They had no idea that on October 25, for the only time in the entire Cold War, the Joint Chiefs of Staff placed the U.S. Strategic Air Command on DEFCON (defense readiness condition) 2, the highest level of alert preceding general war.[66] They had no idea that, at this juncture, Kennedy himself was increasingly inclined to launch an invasion of the island (OPLAN 316 envisaged an amphibious landing by up to 90,000 U.S. troops). They had no idea (any more than Kennedy) that the Soviet forces on Cuba possessed tactical nuclear weapons that could have been used against incoming U.S. forces. Nevertheless, the limited market movements occasioned by the crisis are remarkable, and require a better explanation than public ignorance. Well-informed Americans can scarcely have been unaware of the massive increase in the destructive capability of the superpowers' nuclear arsenals since the first successful test of a hydrogen bomb in 1954. Fear of "missile gaps" on both sides had spurred an unrestrained arms race. During the crisis, Kennedy spoke of 200 million dead; Khrushchev of 500 million. "If the United States insists on war," the latter told an American businessman who happened to be visiting Moscow, "we'll all meet in hell." Yet the movements in the stock market, currency markets and commodities markets were, even by the standards of the Korean crisis, "well short of panic".[67]

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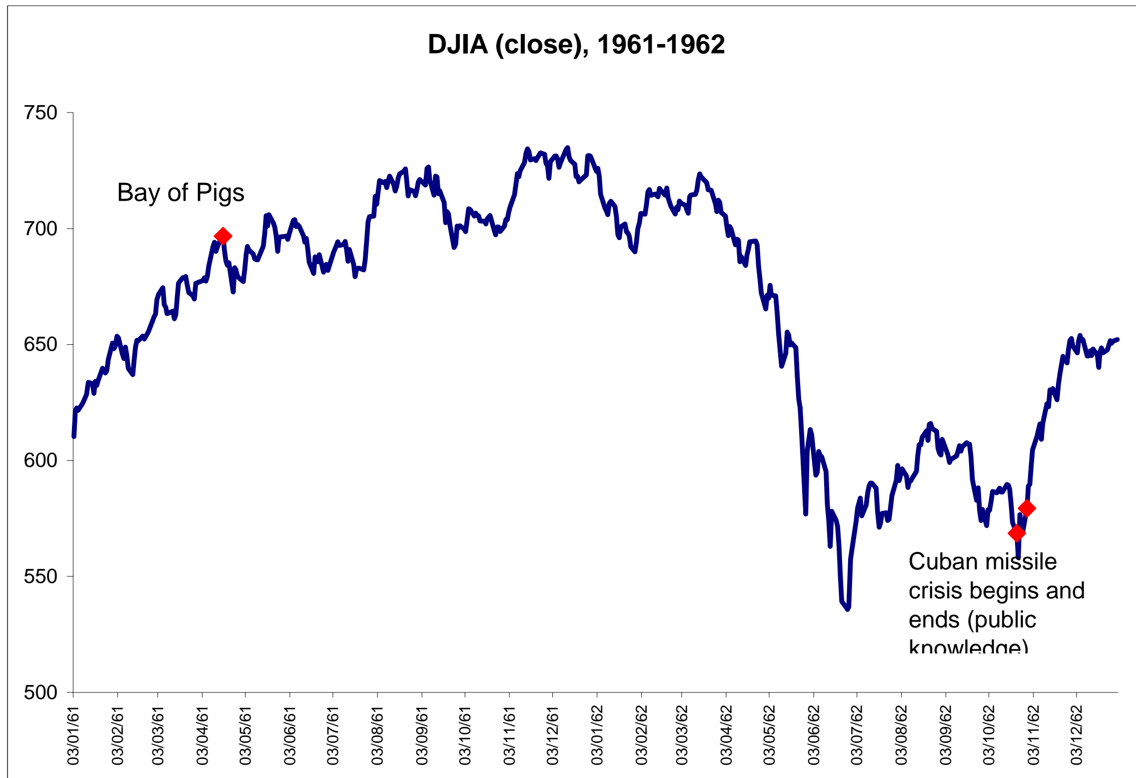
[64] President Kennedy announced the discovery of the Soviet missiles on Cuba, as well as his decision to impose a naval "quarantine" around the island to prevent further military shipments, in an evening television broadcast at 7 p.m. on October 22. The Soviet leader Nikita Khrushchev announced the withdrawal of the Soviet missiles in a broadcast on Radio Moscow at 5 p.m. on October 28.

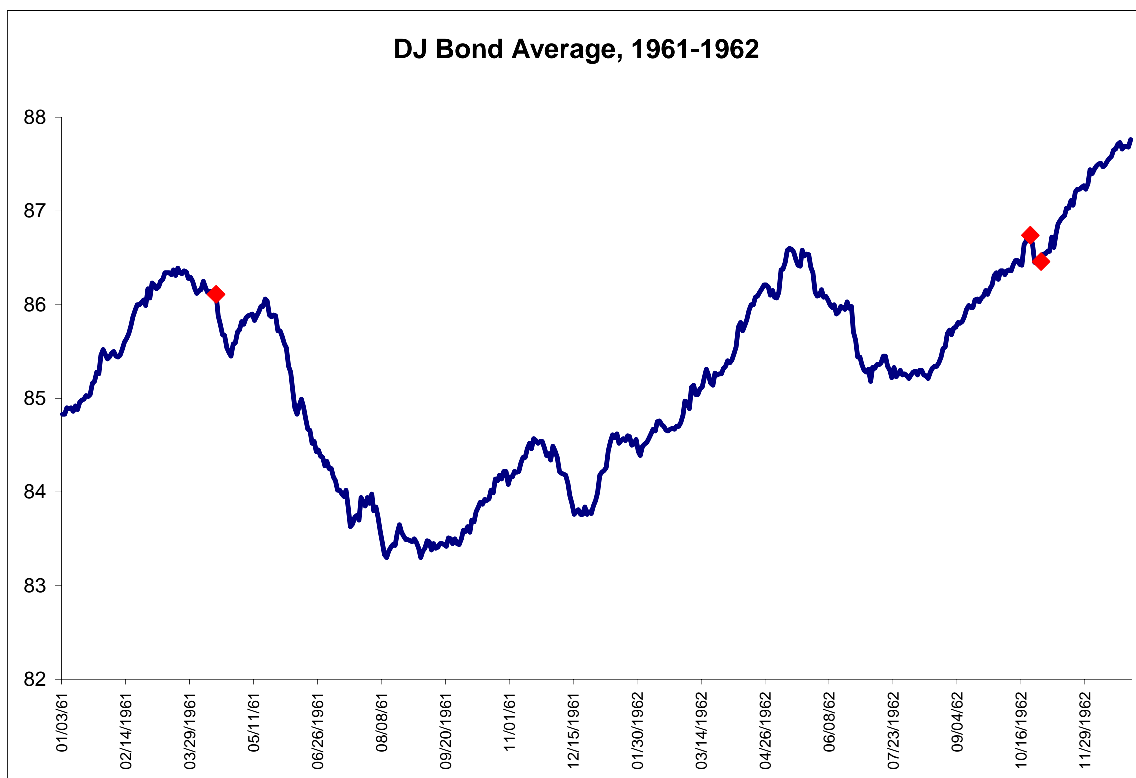
[65] For an illuminating modern account, see Aleksandr Fursenko and Timothy Naftali, *One Hell of a Gamble: Khrushchev, Castro, Kennedy and the Cuban Missile Crisis, 1958-1964* (London, 1997).

[66] Melvyn P. Leffler, *For the Soul of Mankind: The United States, the Soviet Union and the Cold War* (New York, 2007), p. 151.

[67] "Well Short of Panic", *Economist*, Oct. 27, 1962, p. 386.

Figures 11 and 12





Source: Economagic; Global Financial Data.

Why were financial markets not "set ablaze" by a crisis that threatened to set the entire world ablaze? To some extent the markets' seeming insouciance reflected the increased regulation of capital markets that was to be a distinguishing feature of the 1960s. In London, the Cuban crisis had indeed occasioned a "large switching out of paper money and paper securities into gold", suggesting that memories of 1914 (and 1938) still lingered on in some minds. But these moves had minimal effects on prices because the gold market was now under even stricter government control, following the creation of a gold pooling arrangement between the Bank of England and other central banks. There was some selling pressure on the dollar, too, but neither American nor foreign investors could easily switch into other currencies, since the Eurodollar market was still in its infancy and capital controls were in place in nearly all European countries. A better explanation for the lack of financial panic must be that the likely consequences of World War III were now so horrendous as to be beyond the scope of traditional business calculation. "Business reactions to the Cuban crisis have been bewildered rather than considered," observed the *Economist* in its edition of October 27 (written before the crisis was over, in other words), "for the good reason that no considered view is possible":

> The ultimate uncertainty of the nuclear age, paradoxically, itself removes the rationale of panic of the kind which accompanied the threat of less cataclysmic war. Some investors still respond instinctively to the standard maxim at such times of "Go liquid, go home"; but far more have simply sat tight and sensibly refused to embark on fanciful hypothetical prognostications which would have little relevance even if they turned out right.[68]

This, surely, goes to the heart of the matter. A world war waged with conventional weapons had roughly calculable financial implications. Even if no two such wars were identical, there was enough evidence after 1914 to allow a historically-minded investor to take defensive measures if he felt another such war was likely. By contrast, a world war involving multiple H-bombs was beyond the realm of probabilistic thinking. Indeed, it was not merely incalculable; it was well-nigh unimaginable. For this reason, investors were probably best advised to continue business as usual. If it had come to a Third World War in 1962, the performance of their portfolio would have been the last thing on their

[68] "Twenty Billion Dollar Question", *Economist*, Oct. 27, 1962, p. 379.

minds. As the Cold War continued after 1962, with a trend in the direction of arms limitation and superpower détente being halted only occasionally by clashes over faraway places, it paid investors to continue with this strategy. With every passing year, investors paid more attention to domestic fiscal and monetary policy and less attention to the alarums and excursions of international relations. By 1979, that *annus horribilis* for U.S. foreign policy, which culminated in the Soviet invasion of Afghanistan on Christmas Day, the actions of Paul Volcker, Chairman of the Federal Reserve, were scrutinized a great deal more closely on Wall Street than the actions of Leonid Brezhnev.[69]

VI
Conclusion

So is the lesson of history simply that there are no lessons from history? Not quite. Strategically, our predicament today may in fact be more like that of the Cold War than 1914 or 1938-9, and more like that of the Cuban Missile Crisis than that of the Korean War. There is, to repeat, a danger of a nuclear attack on our cities. But it is impossible to attach a probability to it (except that it is surely less than in 1950 or 1962, given the technological limitations of today's likely attackers). In other words, we are still in the realm of uncertainty. But unlike in the Cold War, it is hard to see how a nuclear attack by terrorists could escalate into a world war. Small wars are common, as they were in the age of high imperialism *circa* 1900, but a big war seems very unlikely.

Financially, too, we are not in a situation comparable with the eves of past world wars. As at the time of the Cuban Missile Crisis, it is true, there is downward pressure on the dollar. Indeed, concerns about the U.S. fiscal deficit and current account deficit are more justified than they were at any time during the Cold War. But these problems are consequences of U.S. fiscal and monetary policy, rather than any increase in the risk of war. If the United States is suffering from overstretch, the causes lie within (in the unfunded liabilities of the Medicare and Social Security systems) not without.[70]

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[69] See my discussion in *The Cash Nexus: Money and Power in the Modern World, 1700-2000* (New York, 2000), p. 181. The recollection of Henry Kaufman, then chief bond market analyst at Salomon Brothers, is that Fed tightening was much more important than the Afghan crisis in moving U.S. bond yields higher.
[70] See Niall Ferguson, *Colossus: The Rise and Fall of the American Empire* (New York, 2004), chapter 8.

Nevertheless, it is always prudent to guard against complacency. The most important lesson of 1914 is that major wars can arise even when economic globalization is very far advanced and the hegemonic position of an English-speaking empire still seems relatively secure. The second important lesson is that the longer the world goes without a major war, the harder one becomes to imagine and, perhaps, the easier one becomes—even if inadvertently—to start. The third and final lesson is that when a crisis strikes complacent investors it causes much more disruption than when it strikes battle-scarred ones. Interminable overtures may be boring. For financial markets, however, bolts from the blue are worse.

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