The European Debt Crisis in France and Germany through the Lens of the 1930s:
A Polanyian Reading

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In *The Great Transformation,* Karl Polanyi develops a critique of the nineteenth and twentieth liberal project to create a self-regulating market economy in terms of both its economic and political ramifications. This critique focuses first and foremost on his analysis of the dysfunction of the interwar gold standard, broken down in terms of its international and national articulations. Internationally, Polanyi conceived the gold standard as an institutional mechanism that created and extended the free market economic system across the globe. Politically, it constituted the anchor underpinning the Pax Britannica of the second half of the nineteenth century and, during a fleeting moment in the second half of the 1920s, the liberal Europe of Locarno. At the domestic level, the gold standard served as the policing agent of economic liberalism that went hand in hand with constitutional liberalism as the twin institutional foundations of the 19th century social order. Accordingly, the breakdown of the gold standard during the 1930s augured for Polanyi the destruction of this liberal European economic and political order. The emergence of explicitly anti-liberal political and economic regimes on the continent disrupted the international balance of power and set the stage for the conflagration of World War II. Thus, the breakdown of the interwar gold standard provided "the invisible link between the disintegration of [the] world economy since the turn of the century and the transformation of a whole civilization in the 1930s," thereby underscoring the historic failure of "the utopian endeavor of economic liberalism to set up a self-regulating market system."[1]

From this perspective, it is impossible not to see the resemblances between the historical working and dysfunction of the interwar gold standard and those of contemporary European Monetary Union (EMU.) Like the gold standard, the latter is conceived as a

[1] Karl Polanyi, *The Great Transformation: The Political and Economic Origins of our Time*. reprint. (Boston: Beacon Press, 1957), 20, 29.

mechanism to create a self-regulating free market within Europe which underpins the economic and political organization of its member states. Similarly, like the gold standard before it, EMU is portrayed as the guarantee of post-Cold War stability and comity in Europe. Accordingly, like the dysfunction of the interwar gold standard, the dysfunction of EMU in the European sovereign debt crisis can be seen to pose a fundamental threat to the post-Cold War European economic and political order. The economic and social costs of this crisis, as well as the populist backlash against the neo-liberal policies enacted to resolve it, are beginning to threaten the self-regulating liberal market in Europe and by extension, the supranational and national division of economic and power presumed by the European Union (EU).

The breakdown of the interwar liberal order as analyzed by Polanyi presents uncanny similarities, both in terms of its political economic dynamics and international and domestic articulations, to these developments. From this perspective, studying what happened in the 1930s may not only facilitate our understanding of the current European debt crisis, but also suggest the policies to be adopted—or not—by European and domestic political elites in order to avoid the mistakes which, in the midst of the Great Depression, precipitated the collapse of liberalism in Europe.[2]

In this spirit, this paper proposes to analyze the similarities between the crisis of the 1930s and that of today in Europe from the conceptual perspective developed by Polanyi in *The Great Transformation*. It does so at two analytical levels, by bringing to bear two distinct but related arguments. Internationally, the paper will focus on the inherent

[2] Obviously, there are significant historical and contextual differences between the two periods—the horrors of WWII limiting the reappearance of fascism and notably Nazism on the continent, the much greater institutional solidity and normative legitimacy of democracy today compared to the 1930s, the acceptance by anti-establishment protest parties of the democratic rules of the game etc. Yet, these important caveats aside, both in terms of the current crisis's cross-national and domestic political effects, the parallels between the 1930s and today are simply too strong to be ignored or occluded.

contradictions and ensuing dysfunction of the interwar gold standard. It was the inherently deflationary bias of the latter, combined with its tendency to create and reinforce balance-of-payments asymmetries among its members, which were, I shall argue, responsible for the outbreak and spread of the Great Depression. The proximate cause of the gold standard's collapse was the succession of currency crises that were provoked by the social and political disruptions caused by its internal adjustment mechanism in order to rectify international balance of payments disequilibria. In turn, nationally, the paper examines how the terms of the gold standard's operation affected the domestic economic and political fortunes of its member countries, leading either to the erosion or breakdown of their liberal economic and constitutional orders. Starting with the observation that markets are "socially embedded,"[3] we introduce Polanyi's argument regarding the "double movement" whereby the domestic economic and social implications of the self-regulated market produces sociopolitical forms of resistance that end up impeding its operation. Ultimately, it was this reaction against the market which, assuming historically ever more virulent forms, led to the overthrow of liberal democracy in 1930s Germany and the spread of political and economic illiberalism across Europe. This episode obviously carries striking resonances with the sociopolitical consequences of the European debt crisis across the Eurozone, particularly within its most indebted peripheral members.

This paper focuses specifically on the national cases of France and Germany in studying the gold standard's internal workings and its domestic economic and political implications. Not only are these two states supremely illustrative of the balance of payment imbalances deflationary consequences that were inherent in the gold standard's international and domestic operation, but their relative positions and the distinct roles they

[3] **Note on social embeddedness and its relationship to GS (GT 218)**

played within the gold standard system present more than just a passing likeness to the two countries' respective statuses within the contemporary Eurozone. Specifically, France and Germany have played reverse roles as either economic beneficiaries or 'losers' within the interwar gold standard or EMU. Consequently, they have experienced different political fortunes under each system and thus undergone varying policy trajectories as a result. France in 1930 was similar to Germany today in that it was—along with arguably the U.S.—the greatest beneficiary and most steadfast defender of the interwar gold standard. Indeed, as the strongest advocate of the "sound money" ideas that underpinned the interwar gold standard, it was the last major economy to abandon it in September 1936. Conversely, Germany in 1930 was similar to France today in that it stood as a relative 'loser' from and earliest doubter of the efficacy of the gold standard and the sound money philosophy undergirding it. Effectively the first major industrial economy to go off gold in July 1931, it also went furthest under the auspices of the new Nazi regime in overturning the economic policies that were associated with the gold standard and in repudiating the neoclassical liberal ideas that underlay it. Accordingly, as the rise of the Nazis attests, the gold standard's domestic effects would also have feedback impacts on international governance in the 1930s. Thus we hope to tease out the implications that the collapse of interwar gold standard into depression and war could have for our understanding of the present-day crisis in Europe, and the institutional and policy remedies that might be pursued to resolve it.

The Workings of the Interwar Gold Standard

The classical gold standard system that had emerged in the 1870s had been a commodity-based monetary system that provided for an automatic mechanism for controlling the money supply based on the gold peg, through the inflow and outflow of reserves as a function of the balance of payments. In order to provide greater flexibility to this fixed exchange rate regime, during the interwar period gold reserves were supplemented by reserve currencies in the form of the pound sterling and the US dollar—making it in effect a gold exchange standard. As we shall see, this innovation would be as much a source of disruption as of stability within the system, and for both reserve currency countries—the UK and US—as well as for its other members.

Bearing this in mind, the failure of the interwar gold exchange standard was attributable to both economic and political factors. First, economically, it stemmed from the inherent balance of payment asymmetries that the system's operation presumed. This in turn made it insupportably deflationary within the deficitary countries, particularly following the onset of recession beginning in the late 1920s when the requisite adoption of deflationary policies to right these imbalances effectively drove the latter into depression. As Polanyi observed, "[W]hat the laws of the market could not force upon reluctant wage earners, the foreign exchange mechanism effectively performed." Thus, "the gold standard meant danger of deadly deflation and [] of fatal monetary stringency in a panic."[4]

In turn, politically, the effects of deflation-induced depression eventually provoked a sociopolitical backlash in the gold standard countries—a backlash which came earlier in some, later in others—that in turn made the perpetuation of the deflationary policies it required democratically unsustainable within them. This in effect testified to the Polanyian "double movement" whereby the attempt to create a self-regulating market economy, underpinned by the automatic monetary mechanism of the gold standard, provoked the spontaneous upsurge of forces of social and political resistance against its operation—resistance which ultimately, particularly under the auspices of democratic regimes, led to its

[4] Ibid., 230, 138.

abandonment. Thus, "society protected itself against the perils inherent in a self-regulating market system" underpinned by gold.[5]

In this first part of the paper, we trace the emergence of the economic imbalances and dysfunctions that would ultimate condemn the interwar gold standard to failure. After setting out its intellectual foundations, we analyze the factors behind these balance of payments asymmetries that would come to plague the system. In turn, we examine how the deflationary bias that was built into the system as a consequence of these asymmetries ended up translating into the global credit crunch that started in the run-up to the 1929 stock market crash and produced the worst global depression in history. In turn, in the second part, we examine the political ramifications of the adoption and defense of the gold exchange standard, and then go on to consider what these came to mean at the level of international governance.

In both instances, we will analyze these developments in respect to the national experiences of interwar France and Germany, first at the international level by identifying their respective positions within the gold standard system, then at the domestic level by assessing the sociopolitical implications of its operation. Finally, throughout this analysis we will compare the operation, dysfunction and eventual breakdown of the gold standard and its political ramifications to the present dysfunction of the European single currency area as a result of the European sovereign debt crisis, and its own economic and political fallout.

As we saw, the gold standard was the principal international mechanism underpinning the operation of the prewar and interwar economies. As such, it was essential that it enshrine

[5] Ibid., 76.

certain key ideas that were held by the dominant economic and political elites within its member countries. The primordial idea animating (neo)classical economists since Adam Smith and David Ricardo has been the idea—qualified as 'utopian' by Polanyi—of creating a self-regulating market economy encompassing labor, capital and land in order to resolve the problem of economic scarcity or poverty in the world. Under this conception, the gold standard was to serve as the core institutional mechanism by which international trade and capital exchanges would optimally unfold as a function of the automatic adjustment in national money supplies that in turn were to reflect movements of gold and reserve currencies in keeping with national payment imbalances. According to this mechanism, deficitary countries, by experiencing a decline in their money supplies as a result of the outflow of gold and reserves, would import less relative to exports, thereby closing the balance of payments deficit. Conversely, surplus countries, by experiencing an increase in the money supply as a result of the influx of gold, would import more relative to exports, thus reducing their balance of payments surplus.

In turn, due to its imputed preservation of open exchanges and the consequent maximization of prosperity among its members, the gold standard was seen as a vital institutional precondition for a liberal political order, both in its international and domestic incarnations. In a concrete rendition of Kantian liberal peace theory, the prewar Concert of Europe and interwar League of Nations which had institutionally enshrined the international balance of power relied on the stabilizing peace interest that transnational economic and financial actors had in maintaining the gold standard as a basis for preserving the European peace.[6] The regular meetings of Europe's (and America's) chief diplomats through the interwar period was reflected in a succession of international conferences that

[6] Ibid., 15-18.

sought to achieve the international political preconditions for preserving stable international currency exchanges. As Polanyi noted, for Europe's pre- and postwar liberal elites "the gold standard had been the symbol of world solidarity."[7]

Similarly, domestically, the adhesion to gold as the precondition of the liberal market economy was seen to be the essential basis for a liberal constitutional and ultimately democratic political order. Thus evolved a quasi-theological belief in the gold standard, which came to be portrayed by its advocates as "one of the pillars of a free society, like property rights or habeas corpus, which had evolved in the Western liberal world to limit the power of government."[8] In short, belief in the convertibility to gold was the default economic idea across the globe both before and after World War I, which united politically and ideologically disparate countries, parties and social constituencies. As Polanyi put it:

> "Belief in the gold standard was the faith of the age. With some it was a naïve, with some a critical, with others a satanic creed implying acceptance in the flesh and rejection in the spirit. Yet the belief was the same, namely, that bank notes have value because they represent gold… the one and only tenet common to men of all nations and all classes, religious denominations and social philosophies. It was the invisible reality to which the will to live could cling, when mankind braced itself to the task of restoring its crumbling existence."[9]

Correlatively, the ideological power of the gold standard and the 'sound' or 'hard money' ideas which underlay it help to explain longstanding elite and popular resistance to jettisoning it in favor of a national currency and monetary independence through the interwar ear, despite its increasingly obvious economic and social costs. To once again quote Polanyi:

> "The 1920's saw the prestige of economic liberalism at its height… Stabilization of currencies became the focal point in political thought of peoples and governments; the restoration of the gold standard became the supreme aim

[7] Ibid., 26.
[8] Liaquat Ahamed, *Lords of Finance: The Bankers who Broke the World* (New York: Penguin, 2009), 169.
[9] Polanyi, *Great Transformation*, 25.

> of all organized effort in the economic field. The repayment of foreign loans and the return to stable currencies were recognized as the touchstones of rationality in politics; and no private suffering, no infringement of sovereignty, was deemed too great a sacrifice for the recovery of monetary integrity."[10]

In short, the obdurate, even blind philosophical obedience to the orthodox economic tenets undergirding the gold standard would be one of the principal reasons for why countries failed to implement the adequate policies to pull themselves out of the interwar recession that had manifested itself in Germany and the commodity producing countries beginning in 1928. Instead, belying the grip the commitment to gold held over their national elites and publics, they persevered in pursuing the deflationary policies that were exiged by the gold peg, collectively plunging them into the Great Depression. In turn, it would only be in the mid-1930s, as evidence of growth in countries that had gone off gold became incontrovertible, that the sound money ideas underpinning the gold standard began to lose their intellectual and policy ascendancy among the governing elites, and that counter-cyclical policy alternatives were attempted in order to overcome the Depression.[11]

It remains to explain how, in practice, the operation and defense of the interwar gold standard produced this dire result. For this we need to look first at the natural tendency toward imbalance or asymmetry that was displayed by the system, aggravated by the destabilizing economic and political conditions inherited from the war. In turn, we need to examine how the deflationary effect of the gold standard's operation in deficitary countries precluded their being able to pull themselves out of recession or depression by effectively precluding them from employing the requisite counter-cyclical policies to do so. From this perspective then, as Barry Eichengreen has noted, the interwar gold standard acted as a

[10] Ibid., 142.
[11] Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939* (New York: Oxford University Press, 1992), 348.

means of global transmission and amplification for the Great Depression during the 1930s.[12]

At base, the balance of payments asymmetries that came to characterize the operation of the gold standard flowed from the price differentials between the member countries, which in turn reflected the variable production costs distinguishing them. Thus, though the effects of the balance of payments on the money supply were supposed to make states more competitive over the long term, their different productive capacities endured as a function of their distinct positions in global supply chains, sectoral differences between early and late entrants into various export sectors, and shifting global consumer preferences.[13] In effect, price differentials were likely to remain ensconced within the gold standard between primarily importing and exporting countries. Thus, as in the case of the Eurozone today, balance of payment asymmetries between core and periphery countries tended to endure rather than to resorb themselves.

At the same time, a number of factors inherited from World War I tended to accentuate and exacerbate these asymmetries linked to the operation of the gold standard. First among these were the costs associated with the war, which transformed the pattern of the global balance of payments. Principally, the war strengthened the balance of payments position of the US and weakened that of the other nations, the reparations and war debt regime that came out of it ensuring a flow of gold out of Europe to the US. By the end of the war, sixteen Allied powers owed the US around $12 billion, of which a little less than $5 billion was due from Britain and $4 billion from France.[14] In turn, as a result of the

[12] Ibid., xi.
[13] C.f. Peter Gourevitch, "Breaking with Orthodoxy: The Politics of Economic Policy Responses to the Depression of the 1930s." *International Organization* 38(1)(1984), pp. 95-129.
[14] Ahamed, *Lords of Finance*, 130-31.

attribution of total responsibility for the war at Versailles, Germany was imposed a reparations claim of 132 billion gold marks ($31 billion) by the Reparations Commission. American insistence on the reimbursement of the war debts incurred by its allies ensured that France and Britain would seek reparations from Germany so they could use them to reimburse those debts. This not only served to stoke German *revanchisme*—not to mention anti-American resentment on the part of the Allies themselves who had borne the brunt of the fighting in terms of blood and treasure[15]—but it also served to widen the global balance of payment asymmetries following from the war. Thus, through the 1920s, the external accounts of the deficitary states were balanced by capital outflows from the US to Europe. However, as US private capital investment in Europe began to dry up in the late 1920s, this placed growing balance of payments pressures on these countries as reserve outflows gained momentum.

This introduced a second important factor in the workings of the interwar gold standard: the potentially destabilizing role of finance in its operation. Initially, the latter was seen as a compensatory agent of stability within the system with a vital disciplinary role to play in policing the finances of its participating states.[16] However, financial flows, particularly in the form of short-term liabilities—so-called "hot money"—came to have an increasingly destabilizing impact on the interwar monetary system by exacerbating the balance of payments deficits of the deficitary countries, ultimately triggering balance of payments crises within them. As investors and speculators began to doubt a sovereign's capacity to maintain its currency peg to gold, foreign exchange streamed out towards 'safe'

[15] Hence the increasing disparaging reference to the US as "Uncle Shylock" in the French and British press, and the growth of anti-Americanism among the publics of both countries throughout the 1920s. See Ibid., 144.
[16] As Polanyi noted, bankers were "the professional guardians" of the gold standard and "the stable exchanges and sound credit conditions" with which it was held to be synonymous. *Great Transformation*, 199.

sovereigns—i.e. those with the greatest gold reserves—with the effect of eventually driving the country to default unless it received external loan assistance or was allowed to restructure its debt. Short of imposing capital controls and going off gold, such countries were thus forced to raise interest rates to prohibitive levels in order to staunch the capital outflows, further depressing domestic production while increasing their debt servicing costs.

Thirdly, domestic sociopolitical and institutional developments within the belligerent countries also interfered with the function of the interwar gold standard and rendered it less stable than its prewar predecessor. The enfranchisement of workers and consequent rise of labor parties as well as the new strength of trade unions forced postwar governments to accept the permanence of wage and labor condition concessions that had been made to workers during the war in order to secure their backing for the war effort.[17] These concessions, in conjunction with the growing politicization of the unemployment issue as a result of the intrusion of organized labor and workers' parties into the democratic arena, tended to have inflationary effects. Likewise, they also raised deeper distributional conflicts that had been largely absent during the postwar era over which social segments should bear the costs of the war and the burden of restoring the balance of payments equilibrium under the operation of the gold standard.

Finally, the institutional innovations presented by the interwar gold standard compared to the classical gold standard—notably the acceptation of the US dollar and pound sterling as reserve currencies that could be traded by central banks as a substitute for gold—also became a factor of instability in its operation. Officially established in order to provide more flexibility to the interwar gold standard by seeking to reduce its deflationary

[17] Eichengreen, *Golden Fetters*, 30 et seq.

bias, in fact the bestowing of reserve status to the dollar and the pound would end up doing the opposite. Notably, it ended up reinforcing the balance of payments asymmetries and hence deflationary effects of the gold standard in two ways. First, by conferring the right of seniorage on the US and UK, the latter could simply print their currencies in order to fulfill their balance of payment obligations and these consequently had to be accepted by other gold standard members as reserves. In order to counter the inflationary effects of absorbing such reserves, a key concern for countries suffering from excessive inflation in the 1920s, the latter needed to implement deflationary policies that ended up stifling their economic performance.[18] From this standpoint, the act of providing liquidity to the system by issuing greater quantities of the reserve currency became a factor of systemic instability that increased rather than decreased gold reserve asymmetries.

Secondly, especially as the reserve currency countries themselves began to experience balance of payment pressures and to ship their currencies abroad in order to fulfill their payment obligations in the early 1930s, surplus countries began to exchange their dollar and pound reserves for gold, thereby exacerbating balance of payment imbalances in the UK and US as they hemorrhaged gold so as to buy back their currencies. Meanwhile, the substitution of gold for currency reserves did little to grow the money supplies of the surplus countries, thereby dampening the reflationary effect and preventing them from picking up slackening demand in the global economy. In short, the issuing of reserve currencies by the countries at the core of the interwar gold exchange standard in order to increase global liquidity ended up eroding the credibility of the dollar and pound gold peg, thereby heralding the potential collapse of the system.[19]

[18] Ibid., **???**

[19] **Fn on Triffin dilemma.**

In short, a host of factors emerged that threatened the credibility of the peg to gold under the interwar gold exchange standard that had been largely absent under its prewar predecessor, and which would ultimately make it much more difficult to sustain. First and foremost, what was needed was heightened international cooperation to smooth the system's function. However, due to an admixture of domestic sectoral conflicts and their political repercussions, international disputes over reparations and war debts, and incompatible conceptual frameworks regarding the gold standard's operation, the requisite degree of cooperation would not be forthcoming. Instead, as Eichengreen has pointed out, the persistent "asymmetry in the gold standard system [allowed] countries in surplus [to] shift the burden of adjustment to countries in deficit" with domestic and international economic and political consequences that would ultimately render the gold standard unsustainable.[20] As a result, the interwar gold standard would last barely more than a decade. In that time, however, it would presided over the onset of the worst economic slump in history.

The second major factor that made the interwar gold standard inherently unstable and, as the last point attests, ultimately unsustainable was the inherent deflationary bias that was built into it. At one level, the problem was structural because, as Polanyi pointed out, the gold standard has an inherently contractionary bias on account of being based on a perforce limited supply of gold. If global trade and demand rose faster than the global money supply as pegged to gold, then interest rates would need to rise and investment to fall, thereby leading to a global decline in income. Conversely, the strictures on the money supply

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[20] *Golden Fetters*, 15.

imposed by limited gold reserves meant that an increase in production and trade that was unaccompanied by an increase in gold would cause prices to fall.[21]

Yet, the deflationary bias inherent in the gold standard also reflected the ideological and psychological interest in the idea of "sound money" by which it was legitimated and rationalized. From this standpoint, austerity, or "the policy of cutting the state's budget to promote growth," was seen as a boon to business confidence.[22] Deflation is construed as a means of "purg[ing] the rottenness out of the [economic] system" to use US Treasury Secretary Andrew Mellon's famous phrase in reaction to the 1929 financial crash, and thus of increasing overall economic efficiency by eliminating excess wage demand and asset speculation, leading to a fall in production and investment costs.[23] By signaling that it will allow such a purging process to unfold by cutting budgetary spending and raising taxes, deflation advocates argue, the government restores business investment and supply-side spending while simultaneously reducing the budget deficit. These ideas were put to the test in the 1930s by political and monetary authorities in the US and across Europe, attesting to the ubiquity of "sound money" principles among the elites in change of running their respective economies.

The problem with such deflationary policy, of course, was that, instead of "purg[ing] the rottenness out the system," it ended up bleeding it dry. This could be seen at both the domestic and international levels. Domestically, the internally deflationary impact of the gold standard meant that production costs needed to fall in proportion to prices, which meant lower wages for workers and/or increased layoffs. In this sense, as Polanyi

[21] Polanyi, *Great Transformation*, 193, and M. Blyth, *Austerity: The History of a Dangerous Idea* (New York: Oxford University Press, 2013), 182.
[22] Blyth, *Austerity*, 2.
[23] Quoted in Ahamed, *Lords of Finance*, 364.

noted, maintaining the gold parity became a key instrument of wage compression and hence of keeping production costs under control; it was a "hugely effectively arm of the lever that was pressing on the wage level… What the laws of the market often could not force upon reluctant wage earners, the foreign exchange level most effectively performed."[24] Secondly, budget cuts and tax increases, particularly when implemented in a depressionary environment, ended up reducing consumer demand, thereby stunting growth and fueling further unemployment. Correlatively, the shrinking of the money supply as a result of balance of payment deficits ended up stifling investment demand due to the rise in interest rates, similarly contributing to economic contraction and growing unemployment.[25] In short, rather than reducing the public debt and consequent balance of payment deficits, the fall of aggregate demand due to deflationary fiscal and monetary policies ended up in fact worsening the debt as domestic tax receipts fell due to falling national incomes and rising unemployment.

In turn, internationally, as domestic demand everywhere fell, global growth declined. States in deficit increasingly resorted to protectionist measures in order to complement their deflationary policies so as to reduce their balance of payment deficits, stifling global trade by choking export demand.[26] Meanwhile, surplus states, rather than encouraging domestic growth through monetary reflation and fiscal spending, hunkered down and sought to weather the storm by economizing their surpluses and exchanging their currency reserves for gold. In short, due to the ubiquitous "sound money" ideas that underpinned the gold standard, no country emerged that either could nor would provide the source of global

[24] *Great Transformation*, 230.
[25] Eichengreen, *Golden Fetters*, 15.
[26] Charles Kindleberger, *The World in Depression, 1929-1939*. rev. ed. (Berkeley: University of California Press, 1986), 123-30.

demand to pull the world economy out of the Depression. Hence, by adopting what appeared to be prudent and virtuous macroeconomic policies from the standpoint of their domestic economies, the surplus countries—notably the US and France in 1931, and then France after 1933—ended up deepening and prolonging the depressionary effects that were being transmitted across the globe through the mechanism of the gold standard.

In this sense, these countries could be seen to be playing a similar role to contemporary Germany in its handling of the European sovereign debt crisis. The refusal of the latter to use its surplus to provide greater liquidity and demand within the Eurozone in order to help pull the deficitary peripheral economies out of recession is central to understanding the duration of the crisis and to account for the EU's persistent failure to resolve it.

These considerations beg the question of the broader parallels that might be found between the operation of the interwar gold standard and the contemporary Eurozone. At a first, intellectual level, we see the same, quasi-theological faith expressed in many quarters in the euro as was formerly placed in gold by interwar European publics and elites. As in the case of the gold standard, in present day Europe membership in the euro is viewed as the *sine qua non* of continued financial viability despite, the great economic and social costs attaching to remaining within it, particularly within the deflationary countries. Likewise, as with the gold standard, EMU is also seen as a guarantee of the European project's supranational viability—the collapse of the euro being widely equated with the end of the European project as a whole—while it is broadly viewed by European political elites and governing parties as the key not just to member states' economic prosperity, but their democratic identity as well. Likewise, the philosophical onus placed on "sound money" that was equated with fiscal and financial rectitude by interwar elites and monetary authorities, is broadly replicated in the "ordo-liberal" paradigm focused on maintaining price stability and balanced budgets that impelled the Bundesbank in the run up to EMU and, since 1999, the European Central Bank (ECB). The continuing salience of these ideas within the European Commission, the ECB, and the European Council, reflecting in turn the growing clout wielded by Germany as Europe's largest economy, is to be seen as one of the principal reasons for the Eurozone's failure to extirpate itself from the current crisis.[27]

In turn, in terms of its internal functioning, the euro has also generated widening balance of payment asymmetries among its member states, notably between its core export economies, led by Germany, and its peripheral importers, i.e. the PIIGS.[28] At first blush, as in the case of the gold standard this asymmetry reflects divergent production costs between the surplus countries, for whom the euro made their exports relatively cheaper internationally than under their national currencies, and the deficit countries, for whom the "strong" euro peg made their exports relatively more expensive than under their previous national currencies.[29] Under such a dispensation, the only way that the deficitary countries could balance their national payments was through capital inflows from banks in the core countries that were looking to reap greater returns on the higher interest rates obtaining in the former after EMU was completed and interest rates across the Eurozone converged. The sovereign debt crisis broke out when the ability of the peripheral countries to service this debt was put into doubt following the revelation in October 2009 that Greece had falsified its public finance statistics, spurring investors to pull out their money in mass from the PIIGS and plunging them into a balance-of-payments crisis. In turn, as foreign investors

[27] See Blyth, *Austerity*, Ch. 5.
[28] This unfortunate—and one suspects, not accidental—acronym stands for Portugal, Ireland, Italy, Greece and Spain.
[29] Ibid., 77.

increasingly doubted or bet against their ability to reimburse their euro denominated sovereign debt, they were forced to raise the interest rate on the latter, which caused their debt burdens to dramatically grow despite their pursuit of austerity policies to curb public spending.[30]

Yet, it worth remembering that, as a number of observers have pointed out, the surplus countries needed the peripheral countries to purchase exports which their own publics failed to buy at home.[31] Likewise, banks in the core made hefty profits from borrowing money at low rates of interest at home and then lending it back at high rates in the PIIGS.[32] Thus, as under the 1930s gold standard, finance also played a stabilizing and then destabilizing role within the Eurozone as a volatile yet compensatory agent for productivity-based current account asymmetries among its members.

Finally, just as the gold standard's operation was inherently deflationary, so has the Eurozone's proven to be under the succession of rules dictating the terms of convergence among EMU members in 1999—the Maastricht criteria—and in turn, the fiscal constraints—under the aegis of the Stability and Growth Pact (1999) and since 2012, the Fiscal Compact—agreed by its member states to limit budgetary spending as a way of maintaining price stability and limiting the members states' balance of payments disequilibria. Hence, the successively stringent rounds of austerity imposed on the PIIGS by the 'Troika'—the ECB, European Commission and International Monetary Fund

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[30] See Matthias Matthijs, "Mediterranean Blues: The Crisis in Southern Europe," *Journal of Democracy* 25(1)(2014), 107, and Mark Blyth, "The Austerity Delusion: Why a Bad Idea Won Over the West," *Foreign Affairs* 92(3)(2013), pp. 42-3.

[31] **Note on the ´fallacy of composition.' *Austerity*, 140-42 + Wolf quote.**

[32] Matthijs, "Mediterranean Blues," 102, and Kash Mansori, "Why Greece, Spain and Ireland Aren't to Blame for Europe's Woes," *The New Republic* [online]. October 11, 2011. Available at: http://www.newrepublic.com//article/ economy/95989/eurozone-crisis-debt-dont-blame-greece

(IMF)—in response to the sovereign debt crisis in late 2009, early 2010. In keeping with the "sound money" template that animated budget slashers in the gold standard states during the 1930s, European "ordo-liberals" are also seeking to "purge the rottenness out of the system" in order to provide the Eurozone with a business-confidence spurred supply shock. Such is their rationale for slashing budgets and cutting benefits in the middle of a recession.

In short, both in terms of its intellectual foundations and operational effects, the likenesses between the present-day Eurozone and its travails and the interwar gold standard are strong enough to bring one observer to remark that, provided "one swap the injunction of maintaining the 'convertibility to gold' for the 'integrity of the euro,'" the Eurozone and the gold standard are essentially "the same system."[33] Indeed, the former may be even more constrictive than the latter since, whereas a currency pegged to gold offers the ultimate recourse to devaluation in order to resolve a balance of payments crisis, Eurozone members lack this alternative since they have abandoned their national currency in joining the euro. Thus, short of defaulting on their payment obligations, the sole option open to deficitary states under the present system is to balance their budgets through ever greater deflation, thereby adding an "extra layer of bondage to what is effectively a gold standard without gold."[34]

The Politics of Stabilization in France and Germany

These general considerations regarding the foundations and operation of the interwar gold standard lead us to compare the respective positions and experiences of France and

[33] Blyth, *Austerity*, 183.
[34] Ibid., 184.

Germany within it. It is worth recalling in this respect how the different factors—intellectual, financial, social and political—which had a bearing on the (dys)function of the interwar gold standard respectively affected these two countries during the 1920s and 1930s.

First of all, France and Germany came out of World War I in very different financial places, placing them at antithetical positions within the interwar monetary system in terms of their balance of payments situation and the policy responses they adopted in consequence. First and foremost, this difference was a function of their differential status as respective victors and losers in the war and was reflected financially in the reparations burden that was imposed on Germany, a substantial part of which was to go to France. As we saw, in 1921 the Reparations Committee commissioned by the Versailles Treaty to levy reparations against Germany imposed a total reparations sum of $132 billion gold marks on the country. Service on the first tranche of 50 billion marks was to begin immediately in 1921, amounting to a sum of 4 billion marks that represented fully 10% of national income.[35] Meanwhile, France had incurred $4 billion of war debts from the US and owed a further $3 billion to Britain, for a total of $7 billion.[36] The insistence of the Federal Reserve Bank of New York and the US banking interests it represented that war debts be paid ensured that Britain and particularly France would seek to exact reparations payments from Germany so as to be able to service its debt obligations to the US. Thus, from the start a fundamental balance of payment asymmetry was programmed into the system, with the US essentially serving as creditor to the world in the immediate postwar period.

[35] **Note on export requirements to achieve this.** Eichengreen, *Golden Fetters*, 131-32.
[36] Ahamed, *Lords of Finance*, 131.

A further complication was the transformation of the political and institutional landscapes in both countries. This change was most evident in Germany, where a liberal democratic constitutional regime, the Weimar Republic, had replaced the defeated Wilhelmine monarchy. This new democratic dispensation saw the enfranchisement of parties representing workers, such as the German Social Democratic Party (SPD), which had been outlawed from 1878 to 1880 in the prewar Reich, and the nascent German Communist Party (KPD) which had been formed around the Spartacist movement of Karl Liebknecht and Rosa Luxemburg and a majority of Independent Socialists in the wake of the Bolshevik Revolution.[37] At the same time, the war and postwar regime saw the empowerment of labor organizations and trade unions, who often worked hand in hand with these parties. In exchange for securing labor's acquiescence and support for the war effort from 1914 to 1918, the wartime government approved numerous concessions to workers regarding their wage and work conditions. Most notably, these included the provision of the eight hour day and the granting of worker bargaining rights within the workplace.[38] The end of hostilities raised the question of whether these concessions would carry over in the postwar era as well as the broader issue of who would bear the fiscal burden of servicing Germany's heavy reparations bill.[39]

Similar concessions to labor were also evident in France, though a democratic regime had been in place there since 1870. The Section Française de l'Internationale Ouvrière (SFIO), the French socialist party, had seen its political stature rise as a result in its participation in the unity government—the Union Sacrée—that had steered the country

[37] Charles Maier, *Recasting Bourgeois Europe: Stabilization in France, Germany and Italy in the Decade after World War I*. reprint (Princeton: Princeton University Press, 1988), 54.
[38] Ibid., 43, 58-60, and Eichengreen, *Golden Fetters*, 92.
[39] Ibid., 76-81 passim, and Maier, *Recasting Bourgeois Europe*, 81-2.

through the war. Likewise, the war had strengthened trade unions—notably the Confédération Générale du Travail (CGT)—as key partners in the war effort and allowed them to secure substantial concessions in return: the granting of collective bargaining rights to industry as a whole in March 1919 (though this would not be enforced until the 1930s) and the extension of the eight hour day to all firms in April.[40] Likewise, as in Germany, fiscal issues—and their distributional impacts—grew in importance as the question of who would pay for reconstruction and the war came to the fore. These questions were only amplified by the expansion of social spending in both countries—and more broadly across the industrialized world—in order to stem the appeal of Bolshevism among industrial workers in 1919 and 1920.[41]

In turn, the empowerment of workers and working class parties as a result of World War I as well as the growth of social spending in both countries in the immediate postwar period precipitated a reflationary boom that brought the issue of inflation to the fore of economic and political debate. In France (as well as the US and Britain), budgets were constricted once the revolutionary threat was thought to have passed, giving way to the recession of 1920-1921. Meanwhile, in Germany, inflation continued apace as a result of political gridlock over reparations, culminating in the hyperinflationary crisis of 1922-1923.

The issue of inflation in both countries—and at least in France, subsequent deflation—brought to the fore core distributional issues that would plague the politics of the 1920s. Domestically, inflation hurt creditors and savers (*rentiers*), shopkeepers and independent producers and white collar middle class groups while benefiting large firms

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[40] Ibid., 77.

[41] Eichengreen, *Golden Fetters*, 109. Underlining the immediacy of this threat were the Spartacist revolt of January 1919 in Germany which was crushed by the postwar Social Democratic government with the help of the nationalist Freikorps. In France, this threat was underscored by the split of the SFIO at its annual congress in December 1920, where a majority of the delegates broke away to form the French Communist Party (PCF) affiliated with the Moscow-led Third International.

and export businesses and workers affiliated with the latter. Conversely, deflation hurt debtholders, large firms and exporters, taxpayers and groups whose wages were indexed to prices, while benefiting import-competing firms and their workers, middle class savers and people on fixed incomes. Such distributive conflicts linked to inflation—and conversely, deflation—would become key mobilizing issues during the interwar period in both France and Germany, contributing to the variable political outcomes within them.[42]

Internationally, the issue of inflation raised balance of payments questions due to the discrepancy in prices between states. It became a source of global financial instability as a result of widening balance of payment asymmetries due to the absence of a common store of value to anchor the global monetary system as had existed under the classical gold standard. In turn, inflation fed the debate surrounding currency stabilization—namely over the level at which to peg the currency to gold. This question bore on the distributional conflicts raised above in both their monetary and fiscal dimensions. The level of stabilization, i.e. value of the currency peg and its determination of nominal domestic prices, would have the practical effect of relatively favoring either the sectoral or class winners of inflation or deflation. Similarly, the degree of fiscal adjustment required to maintain and defend the peg necessarily raised distributive conflicts related to tax and spending policies, and hence to the sectoral and class implications of their design.

In both France and Germany, the capacity to maintain the peg to gold in the face of global financial turbulence would play a crucial role in mediating these distributional conflicts and hence, in shaping political outcomes in both countries. By the same token, the ideological convictions of policy makers, namely their commitment to the political and

[42] See Marcus Kreuzer, *Institutions and Innovation: Voters, Parties and Interest Groups in the Consolidation of Democracy—France and Germany, 1870-1939* (Ann Arbor: University of Michigan Press, 2001), 95-6, and Maier, *Recasting*, 274-75, 359-64, 502-3.

policy ideals of "sound money" would also prove of paramount importance in both determining their commitment to convertibility in the face of turbulence or conversely, in facilitating the adoption of countercyclical policies in order to overcome the slump. In short, given its distributional and knock-on political effects, the decision of the level at which to peg the mark or the franc to gold was neither a straightforward nor costless one; it was bound to underlie future sectoral and class conflicts over economic policy as well as affect each country's economic trajectory throughout the postwar period. Countries could either choose to restore the prewar peg (like the US which never went off gold, or the UK that readopted the prewar conversion rate of £14.50 per ounce of gold) or else they could opt for a devalued—i.e. more export competitive—peg. It is interesting to note that France and Germany chose contrary alternatives, France opting for a devalued franc compare to the prewar conversion rate, while Germany chose to peg at its prewar rate of exchange to the dollar. These contrary decisions reflected the different political and economic circumstances facing each country at the time it chose to restore convertibility to gold. In turn, their respective pegs to gold were instrumental in shaping the respective economic and political futures of both through the second half of the 1920s and into the 1930s.

In Germany, the decision over the level at which to stabilize the mark was inextricably tied to the reparations issue and the massive initial balance of payment deficit which they caused. The political debate surrounding this decision turned around two questions: 1.) whether Germany should make the effort to pay the reparations, the conciliatory position adopted by the SPD and centrist democratic parties, or instead resist repayment, the rejectionist position adopted by the nationalist right, and 2.) whatever payments were to be made, who should bear the greatest burden in servicing Germany's reparations debt. In the year following May 1921 when the Reparations Committee fixed the reparations total it was to pay, Germany delivered 75% of the reparations payments that were expected of it.[43] However, its ability to continue servicing reparations depended on the government's ability to legislate a tax increase in order to raise the requisite funds to meet its future obligations. Predictably, the Reichstag was unable to agree on such legislation because of the distributional conflicts involved in deciding what sectoral or class groups should bear the greatest burden of the tax. The fundamental disagreement emerged between the socialists and their allies, who advocated a levy on the wealthy in order to raise the requisite funding, and the center and right-wing parties who wished to do so through a value-added tax (VAT) increase.[44] In turn, backing for raising taxes in order to service reparations was diluted by nationalist resistance to the transference of any tax proceeds abroad.[45] The watered-down compromise bill that was finally agreed by the Reichstag in January 1922—and which was coaxed through following the Reparations Committee's accession to a German demand that payments be reduced to 75% of those scheduled—would not raise sufficient taxes to meet the contrary's outstanding reparations commitments.

Thus, the government was increasingly forced to print money in order to cover the budget deficits occasioned by reparation payments, thereby increasing the country's overall balance of payments liabilities. Initially, these were covered through inflows of private foreign capital. However, once it became apparent that the Allies would not revise the

[43] Eichengreen, *Golden Fetters*, 134.
[44] Specifically, the socialists and the democratic parties insisted that new property taxes be levied in order to finance reparations, on the grounds that the wealthy had benefited from war profiteering. Conversely, the right and the nationalists, citing industry's wartime sacrifices, proposed that workers work for two hours more per day to produce the goods necessary to finance the reparations transfers, in addition to advocating an increase in sales taxes and reducing social spending. Ibid., 142.
[45] Ibid.

reparations total downward, these capital flows reversed course and left Germany, aggravating the country's balance of payments deficit.[46] This set the stage for the inflationary and then hyperinflationary spiral that would overtake the country in 1922-1923 as the mark abruptly fell in response to these capital outflows. The situation was further worsened by the assassination of Walter Rathenau in June 1922 and then by the January 1923 occupation of the Ruhr by French and Belgian troops in order to forcibly extract reparations payments from Germany.

The incapacity of the Franco-Belgian occupation and German economic resistance to it to break the reparations deadlock led to a worsening of Germany's budget deficit and the spiraling out of control of inflation.[47] As capital fled the country and the mark depreciated, this led to a spike in nominal prices which was followed by a rise in wages. Inflation in turn eroded the value of tax receipts, thereby increasing the budgetary shortfall. Since the government was resorting to the printing press in order to pay its obligations, the resulting glut of money in circulation accelerated the (hyper)inflationary spiral, further depressing the real value of the mark and restarting the cycle anew.

This monetization of the budget deficit, reflecting the fact that investors were eschewing German bonds as a means to pay for it, sent the mark tumbling to unheard of lows and prices careening to unprecedented heights. Between August and November 1923, the value of the US dollar exploded from 620,000 marks to 630 billion! Similarly, the prices of basic necessities reached absurd proportions: 250 billion marks for a kilo of butter; 180 billion for a kilo of bacon; a ride on the Berlin street car, which had cost 1 mark

[46] Ibid.

[47] Specifically, demanding full payment by Germany of its reparations obligations, France and Belgium threatened to maintain their occupation of the Ruhr as long as the government continued its strategy of passive resistance—i.e. paying the Ruhr workers their salaries while they remained idle—and monetizing the ensuing deficit shortfall**.** Eichengreen, *Golden Fetters*, 142.

before the war, was now priced at 15 billion. Even though mark notes were issued in 100 billion denominations, people still required entire sheaves—transported in wheelbarrows, hampers or prams—in order to pay for the most elementary goods.[48]

In short, it was the Weimar government's failure to raise the taxes necessary to close the budget deficit linked to reparations, in turn leading to massive capital flight and the mark's collapse, which triggered the inflationary spiral that reached hyperinflationary proportions when monetary authorities resorted to printing money in order to nominally cover the deficit.[49] This failure underscored the fact that Germany, to use Eichengreen's apt phrase, found itself locked in a "fiscal war of attrition" that was playing out at both the domestic—labor-capital debate—and international—Ruhr Occupation—levels.

By November 1923, the costs of the latter had become too high for all sides. Hyperinflation had broken the relationship between export growth and inflation due to the rise in the price level and growing exchange rate uncertainty, thereby depriving German firms of investment as investors sought to place their money in "safe-currency" assets.[50] Conversely, France, under pressure from the other Allies and experiencing its own inflationary pressures linked to the monetizing of budget deficits to in part make up for the shortfall in German reparations payments, also grew eager to resolve the crisis.[51] Accordingly, the mark was stabilized in November 1923 under the stewardship of the new Reichsbank chief Hjalmar Schacht. The government revalued its reserves, pegged the exchange rate to the dollar (initially at 4.2 billion marks to the dollar) and stopped borrowing from the central bank to pay for the deficit. Through the pursuit of draconian

[48] Ahamed, *Lords of Finance*, 121.
[49] Ibid., Ch. 10, and Eichengreen, *Golden Fetters*, 134-45.
[50] Eichengreen, *Golden Fetters*, 143.
[51] Ibid., 149, and Ahamed, *Lords of Finance*, 195-96.

austerity measures, the budget deficit fell and inflation came to a halt. Correlatively, a revalued mark, the Rentenmark, was introduced which, pegged at 1 trillion old Reichsmarks, effectively put it at the prewar parity of 4.2 marks to the dollar.[52] At the same time, German industrialists reversed their opposition to reparations and offered to negotiate with the Reparations Commission, resulting in the Dawes Plan of 1924, which put the reparations regime back on track in exchange for Franco-Belgian withdrawal from the Ruhr. For their part, the Allies—including the French—showed a new flexibility regarding the reparations issue, the Dawes Plan providing for a rescheduling of German reparations according to a more reasonable time frame. Germany's debt burden was reduced from $12.5 billion for the first reparations tranche to between $8 and $10 billion, with the country obligated to pay $250 million in the first year (1924), a charge that would gradually rise to $600 million per year by the end of the decade.[53]

Finally, in order to restore price stability, Schacht made the decision to peg the exchange rate of the new mark to gold at the prewar value of 4.2 marks to the dollar. To back the new peg, the Dawes Plan provided for a $25 million loan denominated in pounds sterling and a further $25 million in capital to be raised abroad by German banks. With this new capital, Germany hoped to raise $200 million in loans to help service its reparations payment for 1924 as well as augment its meagre gold reserves (which were valued at only around $100 million.)[54] In short, the immediate objective of the Dawes Plan was to recapitalize the Reichsbank and sufficiently build up its gold reserves to be able to jump start the country's economic recovery, thereby allowing it to fulfill its restructured reparations debt.

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[52] Ahamed, *Lords of Finance*, 184.
[53] Ibid., 207.
[54] Ibid., 191.

Initially, the Dawes Plan appeared to fulfill these optimistic expectations. The loans granted to Germany set in motion a rapid cycle of international—primarily American—private lending to Germany that would translate into an asset-fueled boom in the country through the mid-1920s. Yet, despite this, the hyperinflationary episode of 1923 would end up having long-lasting political and policy implications in the country. According to Liaquat Ahamed, Germany had just "experienced the single greatest destruction of monetary value in human history," ruining entire swathes of the population and eventuating "a revolutionary transformation of the German class structure."[55] Most notably, *petits rentiers*, middle class savers, and people living on fixed incomes or salaries (i.e. civil servants) had been devastated by the hyperinflation, which saw their holdings effectively transferred to the wealthy as well as industries and firms that possessed the financial wherewithal to speculate on the dramatic fall of real prices and exchange rates. In turn, this effective wiping out of their savings was legally enshrined in a July 1925 law which limited the revaluation on mortgages that saw their real worth destroyed in the hyperinflation limited to 25% of their real worth before June 15, 1922, and the revaluation of corporate bonds purchased from July 1, 1920 on by only between 10% and 25% of their purchase price.[56] Understandably, these experiences converted those groups who suffered most from the hyperinflation to the virtues of "sound" money principles when it came to economic policy. These principles would serve to reinforce their commitment, and thereby condition their political choices, to maintain the gold peg in the late 1920s and early 1930s when the issue of devaluation emerged once again.

[55] *Lords of Finance*, 121, 123.
[56] Maier, *Recasting Bourgeois Europe*, 493.

Conversely, inflation had benefited not only debtors—especially farmers—but also (at least before it spiraled out of control) dynamic, export oriented industries and their workers who saw international demand for their goods increase as inflation eroded the real value of the latter. In turn, it was firms in these sectors and their workers who took the lead in calling for an end to the policy of passive resistance against the Ruhr occupation when hyperinflation negated their ability to access global markets as the link between domestic costs and international prices was irrevocably cut. Finally, when it came to revaluation both labor and export industries argued for a 'low' peg of the mark to gold in order to maximize the international price competitiveness of their goods.[57]

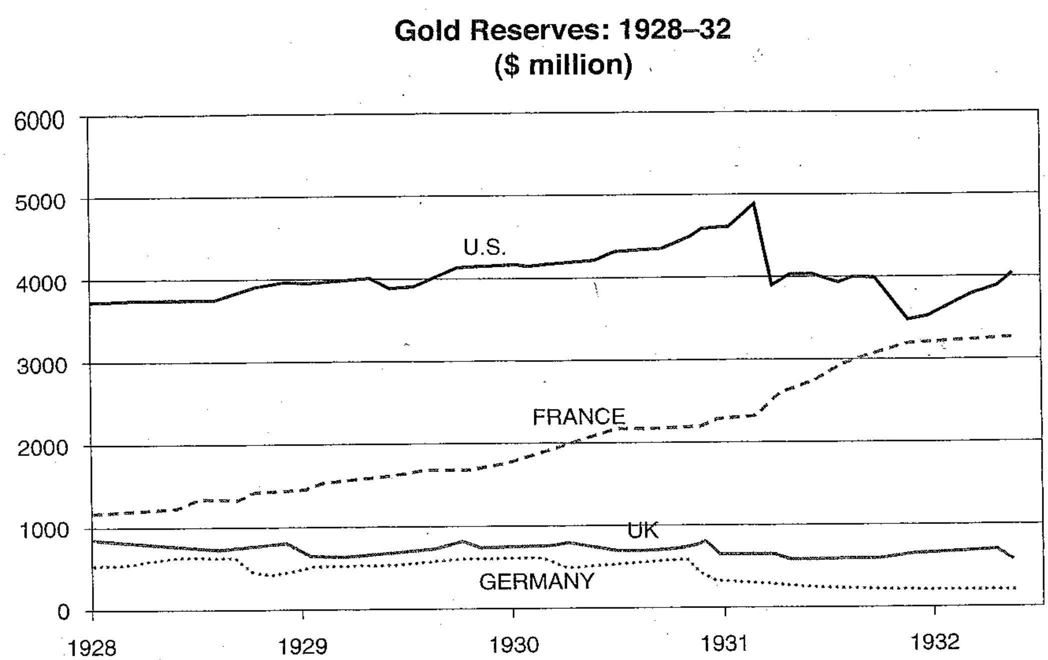
This opposition between creditors and debtors, import-competing and export businesses, functionaries and workers lay the sectoral basis for new political cleavages that emerged within the Weimar Republic during the 1920s. It was these cleavages that would slowly fracture the centrist DDP (German Democratic Party)/ DVP (German Popular Party)/SPD coalitions that would last through the mid-1920's as the growing economic tensions between groups that had been previously united around the democratic center gave way to growing sectoral competition and antagonism, paving the way in turn for growing political polarization and fragmentation by the end of the decade. Thus, the issue of inflation and its differential impact would cast an omnipresent shadow over the continued viability of this coalition, particularly as the new gold peg came under strain and the social costs implied by its defense began to tell.

More broadly, the restoration of the currency peg at the prewar level of 4.2 marks to the dollar portended future problems in another sense as well. Though perhaps symbolically edifying, it heralded the advent of an overpriced mark in the postwar period, particularly

[57] Gourevitch, "Breaking with Orthodoxy," 106, and Maier, *Recasting Bourgeois Europe*, 509.

given the emergence of new inflationary political institutions and mechanisms as a result of the war. Combined with the continued burden of reparations, this meant that Germany would have great difficulty in achieving a balance of payment equilibrium through the current account by enhancing its productivity and competitiveness. Instead, balance would have to be achieved—as it was from 1924 to 1928—through the capital account with a steady inflow of loans and capital investment in order to finance its permanent current account deficit, thus limiting the country's capacity to accumulate reserves. (See Figure 1 below.)

Figure 1



Source: Ahamed, *Lords of Finance*, 377.

However, once this infusion of money dried up, particularly following the 1929 stock market crash, this would set the country up for a balance of payments crisis from which Weimar would never economically recover. In turn, the recourse to deflationary policies, imposed with the painful memories of 1923 still fresh in mind, would transform the financial crisis into a deep depression that would ultimately sweep the republic away and augur the advent of the Nazi regime.

In France, the debate over stabilization, though starting from a similar context, followed a different trajectory from Germany and produced a divergent outcome. As in Germany, concessions to labor during the "Union Sacrée" and the rise in political stature of the left combined with social spending increases to ward off the communist threat in 1919-1920 also lay the basis for an inflationary spike in the postwar period. In turn, despite raising taxes in the summer of 1920 once the Bolshevik threat had passed,[58] inflation remained a problem through the first half of the decade, largely as a result of the continuing reparations-war debt conundrum. Indeed, in the early 1920's through the Ruhr Occupation, state budgets were predicated on receipt of German war reparations payments. When these failed to materialize, the actual deficit would rise and then be covered by printing money.[59] Thus, as a result of successively monetizing the deficit, inflation continued to rise in France and the franc began to slide against the dollar. Correlatively, reconstruction of the northeastern departments that suffered the greatest destruction in the war—and which under the terms of Versailles was also supposed to be paid for with reparations—ended up being largely self-financed. Coming at a cost of $4 billion, the costs of reconstruction also added to the national deficit. Accordingly, in the spring of 1924 prior to the finalization of the Dawes Plan, the franc fell to 25 against the dollar (versus the prewar value of five.)[60] In

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[58] Eichengreen, *Golden Fetters*, 109.
[59] Ibid., 128.
[60] Ahamed, *Lords of Finance*, 243, 250.

turn, by 1924 the cost of living had nearly doubled compared to 1918 and increased almost four fold since 1914.[61]

Following the Dawes agreement, France's budget deficit appeared to stabilize, decreasing from approximately $1 billion (over 10% of GDP) in 1923 to under $50 million (less than 0.5% of GDP) at the beginning of 1925.[62] This improvement reflected a combination of the government's new realism regarding how much it hoped to recover on the one hand, and the passage of an across-the-board *double décime* (20%) tax by the Bloc National government in January 1924. In turn, the establishment in 1920 of a new currency ceiling of 41 billion francs on how much the government could borrow from the Bank of France was held to underscore the newfound financial rectitude of the French state. Accordingly, following the signing of the Dawes Plan in August 1924 through the spring of 1925, the franc stabilized at between 18 and 19 to the dollar.[63]

The problem was that French public finances were in reality much more precarious than it appeared due to the short-term maturity of the overwhelming proportion of French government debt, regularly exposing the country to budgetary crises should this debt fail to be rolled over. The precariousness of the situation was underscored by the discovery in April 1924 that over the previous year the government had illicitly borrowed two billion francs—5% of the currency in circulation—from the Bank of France. The ensuing scandal precipitated the fall of the Herriot government in April 1925 and reawoke investor fears about the reliability of French finances.[64] Despite measures taken by the new Painlevé government—and the conservative Radical finance minister Joseph Caillaux—to try to

[61] Angus Maddison, *Dynamic Forces in Capitalist Development: A Long-Run Comparative View* (New York: Oxford University Press, 1991), 300.
[62] Ahamed, *Lords of Finance*, 243.
[63] Ibid., 243, 249.
[64] Ibid., 241-44.

balance the budget by raising taxes and restructuring the French war debt to Britain (reducing it from the equivalent of $3 billion to $1.2 billion), the failure to obtain a similar write-down on the $4 billion owed to the United States and the inability to negotiate a roll-over by the Bank of France of French short-term debt obligations led to a continuing rise in prices and fall in the value of the franc as the government was forced to resume monetizing the deficit. Thus, in November 1925, just as Caillaux was being forced out as finance minister, the franc slipped down to 25 to the dollar.[65]

Over the following eight months, the country saw a succession of five finance ministers who each failed to balance the budget. Despite the conclusion of an agreement with the US that revalued the French war debt at 40 cents on the dollar in April 1926, the franc kept falling, reaching a new low of 30 to the dollar in May; meanwhile, the cost of living increased by two percent per month, equivalent to 25% a year. The slide continued into the summer, the franc reaching a new low of 37 in June and over 40 in July, falling to a nadir of 50 to the dollar on July 21 as a stream of money hemorrhaged out of the country. [66]

Throughout this period, France witnessed the same sort of distributive sectoral and political conflicts over inflation and the level at which to stabilize the franc that had come to the fore in Germany—though with admittedly less catastrophic consequences—in the wake of the hyperinflation of 1923. Middle-class savers—the holders of government-backed securities and individuals whose incomes depended upon liquid assets like pensions—, white collar workers who were insufficiently organized to push for wage-indexation, and shopkeepers and artisans who needed to pay wholesalers in cash but extended credit to their customers, suffered the most from inflation and were vehemently

[65] Ibid., 250-51.
[66] Ibid., 251, 254, 261-62.

opposed to devaluation of the franc.[67] Meanwhile, big business—particularly in the trading sector—and those producers affiliated with it supported moderate inflation and devaluation since this allowed governments to pay off their bonds with devalued money, thereby reducing the need for raising corporate tax rates while lowering the real debt and tax obligations faced by business. At the same time, since organized labor was still not sufficiently strong to secure wage indexation, business's real labor costs fell as well.[68]

In turn, politically, in a replay of the German "fiscal war of attrition" of the early 1920s, the principal parties of the interwar Third Republic fought over who should bear the greatest burden in stabilizing the budget. The Socialists and left of the Radical Party within the Cartel des Gauches coalition that had obtained a parliamentary majority in the elections of 1924 sought to consolidate the budget through the introduction of a levy on capital. Conversely, the parties of the center right (Alliance Démocratique) and conservative right (Fédération Républicaine), along with conservative Radicals led by Joseph Caillaux, all of which were backed by powerful financial and business interests such as the Union des Intérêts Economiques and the Comité Mascuraud, supported placing the cost of adjustment on workers and consumers through across-the-board excise taxes.[69] As a result of this fundamental political division, the Cartel government was unable to pass a budget for 1926 and thus address the country's economic and financial problems by instituting a coherent financial and tax policy.

In the face of mounting inflation, accelerating capital flight, and a collapsing franc, Raymond Poincaré was named premier at the end of July, effectively marking the end of

[67] Maier, *Recasting Bourgeois Europe*, 513-14, and Kreuzer, *Institutions and Innovation*, 95.
[68] Maier, *Recasting Bourgeois Europe*, 361, and Kreuzer, *Institutions and Innovation*, 96.
[69] Gabriel Goodliffe, *The Resurgence of the Radical Right in France: From Boulangisme to the Front National* (New York: Cambridge University Press, 2012), 151-53.

the Cartel des Gauches. After falling to a low of 50 to the dollar, upon his appointment the franc stabilized, climbing back to 35 over his first week in office.[70] The key was that the stewards of the country's monetary policy, the regents of the Bank of France, authorized Poincaré to do what it had categorically denied to preceding Cartel des Gauches governments, i.e. sell francs below the official 1914 rate, thus making it possible to restore the country's gold and foreign exchange reserves and thereby lessen the pressure on the franc. Combined with the creation of an amortization fund to allow it to pay back its debts and the passing of a new budget that reduced the deficit by levying new taxes, the Poincaré ministry was able to stabilize the franc at 25 to the dollar by the end of 1926, marking an 80% reduction of its prewar value. It was at this level that it would be maintained before being officially pegged to gold in June 1928.[71]

In marked contrast to Germany, then, where the prewar gold parity was reestablished following the hyperinflation of 1923, in France the franc was at only 20% of its prewar value. Economically, this would make French goods extremely competitive on global markets, allowing the country to run up considerable balance of payments surpluses through the current account, and hence substantial reserves, during the second half of the 1920s and early 1930s. (See Figure 1 above.) Consequently, France would be shielded from the full force of the slump that hit the US and other European countries following the crash of 1929, lending it an air of economic fortitude and resilience while other countries suffered under the Depression.

At the same time, however, the franc Poincaré would itself be the source of future international and domestic instability. France's accumulation of a large balance of payment

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[70] Ahamed, *Lords of Finance*, 261-62.
[71] Goodliffe, *Resurgence of the Radical Right*, 154.

surplus as a result of the devalued franc, particularly once Britain went off gold in September 1931, became a major source of deflationary asymmetry within the global economy that would make it near impossible for other countries to escape the Depression from within the gold standard. This was all the more true as the French, who would tightly cling to the "sound money" nostrums of monetary virtue and prudence, would refuse to inject liquidity into the system to dampen the bite of the Depression.

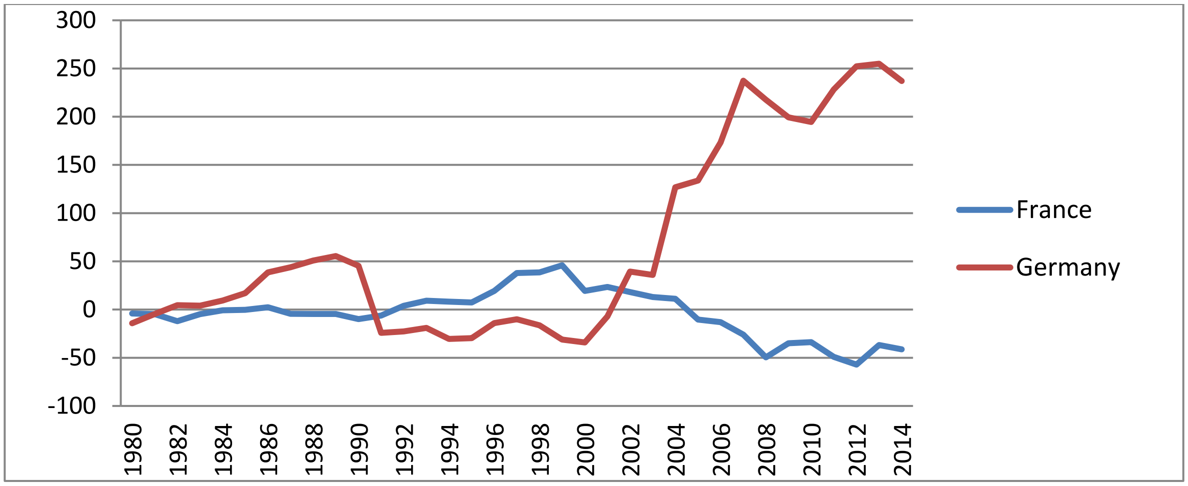
In turn, domestically, the 80% devaluation of the franc implied by the new gold peg would prove extremely politically divisive. It came primarily at the expense of small savers and traditional middle class groups who saw their interests as having been betrayed in order to favor big business exporters and import competing firms and their workers. And since these middle class groups represented the principal electoral base of the political parties that constituted the parliamentary fulcrum of the Third Republic, the Radicals on the center left and Fédération Républicaine on the Right, when it came to finding agreement with other political actors who represented other key sectoral or class interests, such as the Alliance Démocratique which was close to big business or the Socialists who (along with the Communists) were close to the working class, it would become extremely difficult to agree on policy measures to rectify the country's economic trajectory once it itself began to sink into depression starting in 1932.[72] Indeed, after 1928, middle class savers and by extension, the parties that defended them, would become that much more committed to the ideals of "sound money" and the deflationary policies they implied once the Depression hit. Thus, the franc Poincaré sowed the seeds for future sectoral and political polarization around the formulation of economic policy as the Depression tightened its grip—a

[72] Goodliffe, *Resurgence of the Radical Right*, 143-48.

polarization that would ultimately be enshrined in the political *rupture* represented by the victory of the Popular Front in May 1936.

The contest over stabilization that unfolded in Germany and France during the 1920s, translating into a "strong" mark in the former and a "weak" franc in the latter, presents some interesting similarities with the present European single currency, both in terms of the current position of each country within the euro and the policy latitude imposed upon the latter by its operation. However, when the euro was introduced in 1999 the currency roles of the two countries were reversed from what they had been under the interwar gold standard. Whereas in the 1920s Germany had pegged the mark to gold at a relatively 'low' (i.e. strong) level by readopting the prewar parity, in 1999 the new currency was comparatively "weaker" for Germany as a function of its domestic costs than the deutschmark had been. This was especially the case once the Agenda 2010 labor market and social insurance reforms came into effect beginning in 2003. Conversely, whereas the franc Poincaré had been introduced in France at a relatively high (i.e. weak) level compared to the prewar franc to gold parity, in 1999 the euro was quite strong in relation to the country's domestic cost competitiveness. In consequence, the relative balance of payments positions cultivated by both countries within the Eurozone have been diametrically opposed to what their experience had been under the interwar gold standard. It was now France that was saddled with a current account deficit which it needed to finance through foreign lending. Meanwhile, it was Germany that now enjoyed the current account surplus, the proceeds of which it was now free to invest abroad. (See Figure 2 below.)

Figure 2: Current Account Payments ($ Billion)



Source: OECD

Accordingly, as was the case under the inter gold standard, the policies of economic adjustment adopted by both countries have been dictated by their respective balance of payments positions as deficitary or surplus states. Indeed, just as under the gold standard, the deflationary workings of EMU have turned into a much greater source of economic hardship and political contentiousness in the deficitary country (France compared to interwar Germany) than in the surplus country (Germany compared to interwar France) where longer than anywhere else, the elites and public alike have remained committed to the "sound money" ideals underpinning the euro.

It is thus to examining these variable economic and political trajectories in both countries as they were informed by the interwar gold standard, and watching for the potential resonances these may present with their current trajectories, that we now turn. In so doing, we recall Polanyi's insight that in the 1930s the deflationary policies required to defend the gold parity were ultimately socially and politically unsustainable, leading states to break with the gold standard and repudiate the self-regulating market system that it had underpinned. Both France and Germany would experience a sociopolitical backlash against these policies, but the latter assumed different forms as a function of the distinct dynamics of sectoral and partisan conflict that deflation would provoke in both countries.

The Politics of Deflation in France and Germany

As was mentioned, in Germany currency stabilization and the return of the mark to gold in 1924 initiated a cycle of capital inflows that would underpin the country's economic revival.[73] As a consequence, from 1924 to 1927 German industrial output rose by 50% and exports by 75%. GDP surpassed prewar levels by 20% and unemployment fell from a high of 24% in November 1923 to 6% three years later. And from 1922 to 1927, the German stock market quadrupled in value.[74] The prosperity of the period was attested to by the dramatic expansion of social legislation, which lay the foundation for the most advanced welfare state the world had yet seen. Among the progressive—and costly—reforms passed under Weimar at this time were the compulsory arbitration of contract disputes; the introduction of relatively high industry-wide wage rates; the restoration of an eight hour workday in large firms; the expansion of occupational health and safety standards, and last but not least, the introduction of a comprehensive unemployment insurance program—the first of its kind in the industrial world.[75] Finally, awash with surplus capital, Germany was able to service its reparations obligations and still have money left over to invest in its productive infrastructure, driving growth up until 1928.

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[73] The US was the principal source of these capital inflows, with American bank lending totaling $3 billion from 1924 to 1928, of which a little less than $2 billion came in the form of long-term stable loans. The rest—i.e. over $1 billion—was comprised of short-term lending, or "hot money," attracted to Germany by the high interest rate. See Ahamed, *Lords of Finance*, 324-25.
[74] Ibid., 282-83.
[75] See William Brustein and Jürgen Falter, "The Sociology of Nazism: An Interest-Based Account," *Rationality and Society* 6(3)(1994), 374.

However, the country's dependence on foreign capital inflows made the German economy highly vulnerable to capital flight, with the potential of plunging it into a grave balance of payments crisis. These imbalances were worsened by Germany's reparations under the Dawes and Young Plans, which meant that the country was effectively already starting out with a substantial current account deficit before even accounting for the normal balance of payment asymmetries resulting from the gold standard's natural operation. Most notably, these preliminary payment imbalances meant that the deflationary effect of the gold standard would need to be substantially magnified once the compensatory inflow of capital ceased. This in turn served to weaken the credibility of the peg of the mark to gold, with speculators betting that Germany would be unable to hold to it due to the increasingly onerous social and political costs associated with its defense. Thus, doubts about the gold peg ended up feeding a vicious circle whereby the more the government committed itself to defending the peg by introducing ever more onerous deflationary policies, the more foreign investors and speculators took this as a sign of waning credibility, thereby accelerating capital outflows and intensifying the balance of payment crisis.

At a second level, Germany's precarious initial balance of payments position was worsened by the institutional mechanisms governing Germany's adhesion to the gold standard, which blunted the Reichbank's ability to alleviate pressure on the mark-to-gold peg by providing adequate reserves to defend it, while diminishing its capacity to lessen the deflationary effects implied by its sustention. Specifically, a provision under the 1924 bank law to arrest the hyperinflation effectively prohibited the Reichsbank from engaging in expansionary open market operations (and thus increase the money supply) to counter an economic downturn. Likewise, the same law stipulated the establishment of an inviolable 40% gold cover ratio (i.e. that gold reserves would remain proportionate to 40% of the money in circulation.) Finally, under the Dawes agreement, a 400 million mark ceiling was imposed on the amount of public debt the Reichsbank was allowed to discount.[76] In short, the German central bank found itself strictly constrained in its ability to both defend the gold peg as well as offset its deflationary effects.

Finally, Germany's balance of payment situation was worsened by the unhelpful role played by other actors in the system—notably France and the US—who, rather than playing by the rules of the gold standard, intervened in their own money markets by sterilizing gold inflows into their countries. As a result, they substantially neutered the factor of foreign demand that gold surplus countries are supposed to have on the system, the US doing so by raising interest rates in order to tame the US stock market bubble in 1928, and the French by limiting the monetary expansion presumed by the inflow of gold through the sale of foreign exchange reserves to offset the money-creating effect of gold imports.[77]

Thus, once capital inflows into Germany began to reverse in 1928, the combination of these internal and external factors linked to the operation of the gold exchange standard rendered it ultimately unsustainable in Germany. At one level, this reversal reflected the "irrational exuberance" of the American stock market, provoking the expatriation of capital from Europe to the US. This capital outflow was further exacerbated by the restrictive monetary policy introduced in the US starting in 1928 in order to restrain speculation on Wall Street, with the resulting higher interest rate in America inviting capital from abroad in search of higher returns. In Germany, this resulted in a rapid fall in the level of foreign lending. The value of German bonds sold abroad fell from a quarterly average of 578

[76] Eichengreen, *Golden Fetters*, 197.
[77] Ibid., 210-20 *passim*.

million marks between the third quarter of 1927 and the second quarter of 1928 to 114 million and 273 million in the third and fourth quarters of 1928, and then 235 and only 75 million in the first and second quarters of 1929.[78] This drying up of lending to Germany precipitated a growing imbalance in the country's national payments, with the Reichsbank forced to start committing reserves in defense of the gold peg.

As a result, particularly following the suspension of the gold standard in commodity exporting countries hard hit by the global collapse in agricultural prices, Germany was forced to implement "drastic" monetary and fiscal retrenchment in order to try to stanch capital outflows and maintain the credibility of the mark-to-gold peg. The Reichsbank thus maintained a discount rate of 7% through 1928 (compared to central bank discount rates of 3.5% in France, 4.5% in Britain, and 3.5% to 5% in the US) so that by the end of the year, the real monthly interest rate rose to 9%.[79] Likewise, on the fiscal front, budget deficits run by state and local government, who saw their access to foreign lending much reduced, were closed through deep public spending cuts. However, the overall budget deficit continued to rise as a result of the rising costs of unemployment insurance and other social insurance programs as well as the decline in tax receipts due to the fall in economic output. Thus, from January 1928 to January 1929, the quantity of workers on unemployment benefits rose from 1.3 million to 1.9 million, with an additional 138,000 on "crisis relief." Accordingly, the costs of social insurance more than doubled from 2,449 million marks in 1925-1926 to 5,079 million in 1928-1929.[80]

Finally, Germany's economic situation was made all the more dire by the fact that, just as foreign lending was coming to a halt and Germany was already slipping into a

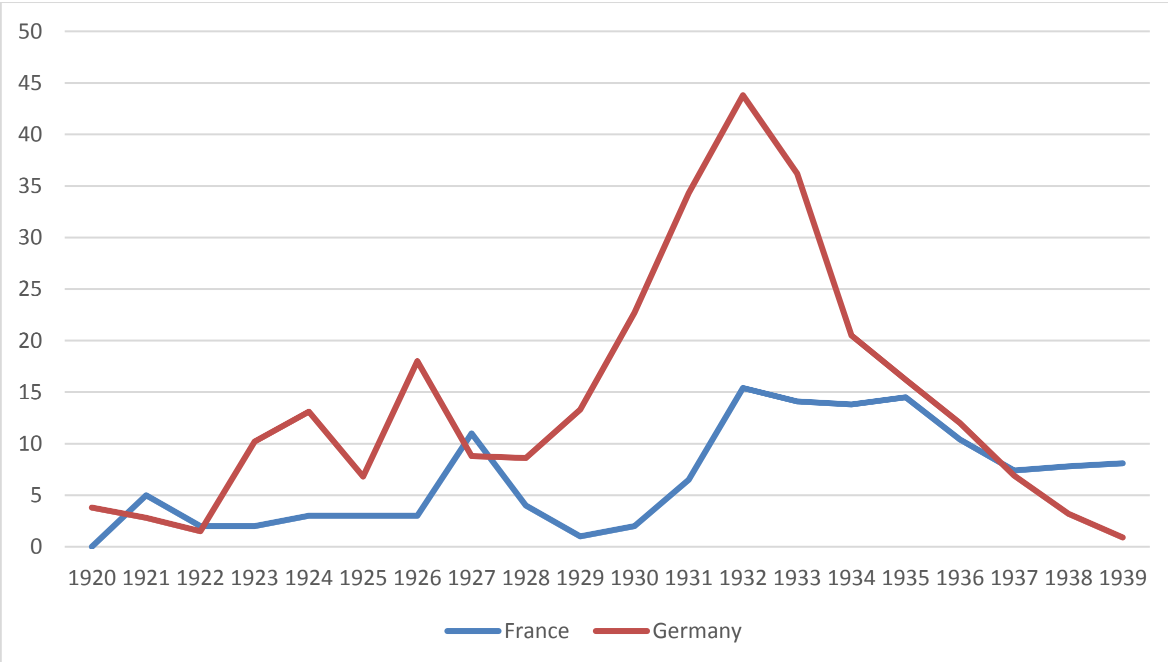
[78] Ibid., 226.
[79] Ibid., 243.
[80] Ibid., 244.

deflation-induced depression, the country's foreign payments position was growing increasingly unsustainable on account of its reparations obligations. Under the Dawes Plan schedule, Germany was due to increase its payments to a full $625 million a year—i.e. 5% of GDP—starting in 1929.[81] Disagreements with France over loan renegotiations further unsettled short-term investors in Germany, provoking a new spike in capital outflows that further worsened the country's external balance. The Reichsbank now began to hemorrhage gold at an increasingly alarming clip, losing $100 million in just ten days in the first half of April 1929, compelling it to further raise the discount rate to 7.5%, despite the onset of recession.[82] The Young Plan (August 1929), which reduced Germany's reparations annuity from 2.5 billion marks to 2 billion and provided for a private bridge loan of 1.2 billion marks temporarily stabilized the situation. However, in order to raise the foreign exchange required to service this debt, the country was forced to further restrict spending, thereby shifting from trade equilibrium in 1929 to a trade surplus of 1.6 billion marks in 1930.[83] A further round of monetary restrictions and spending cuts was imposed in order to maintain the confidence of foreign lenders and investors at the end of 1930, which marked the start of a three-year period over which 10 billion marks of German debt was scheduled to mature.[84]

The economic and social costs associated with the deflationary policies pursued by successive German governments in order to preserve investor confidence and maintain Germany within the gold standard were severe. (See Figure 3 below.)

[81] Ahamed, *Lords of Finance*, 325.
[82] Ibid.,334.
[83] Eichengreen, *Golden Fetters*, 245.
[84] Ibid., 245-46.

Figure 3: Unemployment in France and Germany in the Interwar Period



Source: B. Eichengreen and T. Hatton, "Interwar Unemployment in International Perspective: An Overview," in *Interwar Unemployment in International Perspective* (Dordecht, Netherlands: Kluwer Academic Publishers, 1988), 6.

In 1930 alone, industrial production fell by 25%, unemployment rose to 4.5 million, wholesale prices declined by 15% and consumer prices by 7%. Likewise, between 1928 and 1930, the average real wages of industrial workers fell by 11% while, according to one estimate, the salaries of white-collar workers declined by 14%.[85] Accordingly, the costs of unemployment insurance more than doubled from 1.2 billion marks in 1928 to 2.7 billion in 1930, further straining the budget. The situation was aggravated by the lack of expansionary demand coming from countries with a gold surplus—i.e. France and the US—which in the face of the global economic slump, "limited [themselves] to intermittent foreign exchange market intervention."[86]

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[85] Ahamed, *Lords of Finance*, 374, Brustein and Falter, "Sociology of Nazism," 374, and W. Brustein, "The Nazi Party and the German New Middle Class, 1925-1933," *American Behavioral Scientist* 41(9)(1998), 1241-42.
[86] Eichengreen, *Golden Fetters*, 257.

In turn, politically, the economic crisis and its social impact led to growing instability and polarization within the country, marking the onset of a process of democratic breakdown that would culminate with the accession of the Nazis to power in January 1933. This process unfolded in the face of the paralysis and passivity of the mainstream Weimar parties regarding how best to deal with the economic crisis, translating into an effective continuation of the policy of deflation—even beyond Germany's de facto departure from gold in June 1931—that would fuel the Nazis' rise. At root, the prolonging of deflation reflected the persistent commitment of these parties to gold and their refusal to embrace reflationary counter-cyclical spending as a solution to the crisis.

In turn, the Depression began to have distributional costs that upended the sectoral alliances that had underpinned the political coalitions attending Weimar since 1924. For example, the alliance of labor and exporting firms that had crystallized during the period of inflation and stabilization in 1923-1924 was torn asunder as the Depression's impact was felt by both groups and the margins of business to accommodate the wage demands of labor evaporated.[87] Likewise, the alliance between national producers and small savers and creditors that had emerged as a result of hyperinflation and the revaluation debate eroded as the former became increasingly receptive to loosening deflationary constraints to rekindle investment and consumer demand while *petits rentiers*, still traumatized by the memories of 1923, continued to cling to their "sound money" commitment to gold.[88] Finally, agricultural interests, particularly small farmers, who had been devastated by the collapse

[87] Gourevitch, "Breaking with Orthodoxy," 107.
[88] Maier, *Recasting Bourgeois Europe*, 509.

of global commodity prices and found themselves in increasingly desperate economic straights, felt increasingly abandoned by the mainstream parties as a whole.[89]

As a result of the passivity demonstrated by the latter in the face of the crisis and the shifting sectoral calculations that had cemented the mid-1920s coalitions that had overseen revaluation, a growing number of workers, middle class elements, and farmers rejected their traditional partisan attachments and opted for radical alternatives, presaging the political polarization that would pave the way to Nazi rule. Labor began to abandon the SPD or Catholic Zentrum (center) Party for the KPD or NSDAP (Nazi Party). Farmers decamped from the DNVP for extra-parliamentary agrarian movements and the NSDAP. And the middle classes, both "new" and "old," turned their backs on the centrist liberal parties (DDP and DVP) for the NSDAP. Clearly, the greatest political benefactor of this process of sectoral political dis-identification was the Nazis, underscoring the deep disenchantment of these groups with the Weimar parties and particularly their inability or reluctance to address the causes of the Depression.

The political impacts of the Depression first came into the open with the collapse in March 1930 of the grand coalition government that had presided over the stabilization of the mark and ruled the country in one form or another since 1924. Specifically, the collapse of the SPD-led Heinrich Müller ministry followed the debate over the issue of whether to expand unemployment insurance, a measure supported by the SPD but rejected by the DDP/DVP. The ensuing minority government that was formed by Heinrich Brüning with DDP/DVP support proposed a swingeing deflationary program which sought to stabilize prices and wages while opposing government spending for public works and unemployment relief. Brüning's attempt to invoke emergency powers in order to pass a

[89] **Note on collapse of global ag. prices, Kindleberger book.**

deflationary budget was defeated in the Reichstag in July 1930, leading to new elections in September. It was in these elections that the Nazis achieved their democratic breakthrough, winning 18.3% of the vote and 107 seats in the Reichstag (compared to only 2.6% and 12 seats in the previous elections of 1928), while the KPD won 13.1% and 77 seats (versus 10.6% and 54 parliamentary seats in 1928.) A testament to mounting political polarization in the country, the September 1930 election results panicked the financial markets, with half of the country's gold reserves leaving the country.[90]

In the face of such polarization, the SPD agreed to support the new minority government formed by Brüning, supporting the conferral of emergency decree powers to him and thus consenting to the imposition of the very deflationary measures they had previously opposed. These included the restriction of unemployment benefits, a 20% reduction in the salaries of high federal and state officials, a 6% salary cut for lower level civil servants, increases in the income tax as well as in the excise taxes on certain goods, such as beer and tobacco, and the imposition of new levies on warehouses and mineral water.[91] The cumulative effect of these measures was to deepen the Depression, their deflationary impact underscored by the fact that, despite the fall in state revenues as the economy contracted, expenditures had been cut to such an extent that the budget deficit still was halved from $200 million in 1929 to $100 billion in 1931, representing less than 1% of GDP.[92]

However, whatever calming effect these brutal economies had on foreign lenders and investors in Germany, the latter was shattered by the failure of the Credit Anstalt in Vienna in May 1931, which precipitated a wave of financial crises that rippled through

[90] Ahamed, *Lords of Finance*, 400.
[91] Ibid.
[92] Ibid., 400-1.

Austria, Hungary and then Germany. In the first three weeks of June, the country lost $350 million in reserves.[93] The pace of the outflows accelerated following the June 17 bankruptcy of Norddeutsche Wolkkammerei, a large German textile conglomerate whose liabilities put at risk the solvency of Germany's third largest bank, the Danatbank. Due to the reserve outflow, the Reichsbank could not bail out the Danatbank out without crossing the 40% reserve threshold written into its statutes. The only solution then became to secure a foreign loan to cover the country's losses and restore liquidity and confidence to the crippled German financial system.

As the scope of Germany's obligations became apparent—the country had a reparations debt of $9 billion, foreign private liabilities of $6 billion, $3.5 of which was short-term lending that could be pulled out of the country at any moment, while its GDP had fallen from $16 billion in 1929 to $13 billion in 1930—it became obvious that it could not fulfill them, let alone service any new loan to tide it over despite the Allies agreeing to a one-year moratorium on reparations payments.[94] Thus, with no international loan forthcoming, Germany was effectively forced to go off gold at the end of July 1931 when, in the face of its collapsing banking system, the Reichsbank suspended all payments on the country's short-term debt and imposed exchange controls. The banking system's collapse sent the economy hurtling further downward, an effect further magnified by Britain's departure from gold in September 1931 which effectively froze Germany's foreign trade. Thus, by the end of 1932, production had fallen by another 20%, with the industrial

[93] Ibid., 410.
[94] Ibid., 415.

production index decreasing to only 60% of the 1928 level. Unemployment rose to almost six million, representing over 40% of the labor force. (See Figure 3 above.)[95]

One would have thought that these dire economic indicators, combined with the new macroeconomic freedom afforded by the effective abandonment of gold in September 1931, would have prompted an economic policy shift on the part of the Brüning government toward reflationary spending in order to boost investment and stimulate demand. Such a shift was not forthcoming, however, as the government effectively doubled down on its deflationary course. Still obsessed with the fear of inflation and despite having no more gold reserves, Brüning decided to conduct Germany's economic policy as if it still were on gold, "nailing it," in the words of one observer, "to a sort of shadow standard and thereby foregoing the benefits of a cheap currency."[96] Persisting in this deflationary course, Brüning further reduced the amount and period of unemployment compensation in July 1931 and again in the summer of 1932. Likewise, in December 1931, he decreed a 10% reduction in fixed prices and a 15% cut in wages, effectively bringing them back down to their level of January 1927 and eliminating at one fell swoop the gains that had been made by German labor in the interim.[97]

By summer 1932, German unemployment had crossed the six million mark, representing a staggering 43.8% of the workforce.[98] Overall, real net wages had fallen to 64% of their prewar level.[99] On the back of these catastrophic economic indicators, the country saw a continuing erosion of the liberal center and correlative rise of extremist parties, the NSDAP in the lead. In the July 1932 elections, the Nazis came first in a national

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[95] Ibid., 419.
[96] Ahamed, *Lords of Finance*, 477.
[97] Brustein and Falter, "Sociology of Nazism," 375.
[98] Eichengreen and Hatton, "Interwar Unemployment," 6.
[99] Brustein and Falter, "Sociology of Nazism," 375.

vote for the first time, winning 37.3% of the ballots cast and 230 seats, relegating the SPD to second place with 21.6% and 133 seats, the first time it had not come first in a national election since 1912. Meanwhile, the KPD came third with 14.3% of the vote and 89 seats. Attesting to the collapse of the liberal center, the three centrist parties—Zentrum, DDP and DVP—received less than 15% of the total vote.

Initially, the new government formed by Franz von Papen refused to deviate from the deflationary line, despite the Allies abolishment of Germany's reparations debt at the Lausanne Conference of July 1932. Rather, he continued where Brüning had left off, announcing wage cuts that ranged from 20% to 50% depending on the sector, a 23% cut in unemployment insurance, a 10% in "crisis" support, a 15% reduction in welfare assistance, followed by a 7.5% to 15% cut in disability benefits. By the same token, his government reduced the maximum period of eligibility for unemployment insurance to only six weeks.[100] Once it became apparent that such measures were worsening the situation and fueling even more political polarization, von Papen reversed course by finally trying to reflate the economy with a 1.5 billion mark public works plan. And in November 1932, his successor, Kurt von Schleicher introduced a further reflationary package of 500 million marks in public spending to curb unemployment. However, by then it was too late. Although the Nazi vote fell somewhat from the July result in the November elections, the party still secured a plurality of 33.1% and won 196 seats, making Hitler an unavoidable interlocutor in forming the next government and paving the way to his nomination by von Hindenburg as chancellor in January 1933.

The question must be: why did the parties of the liberal center under Weimar persist in their deflationary policies given their insupportable social and political costs? For the

[100] Ibid., 375-76.

pro-business and *petit rentier*-based liberal governments of Brüning and von Papen, the answer is relatively straightforward. Haunted by the memories of hyperinflation that had ruined their middle class saver constituents, these leaders wished to preempt any possibility of a repeat of such an episode. Thus, they persevered in maintaining and respecting the ethos of the gold standard despite no longer being tied to gold, thereby foreswearing the autonomy to engage in the demand and investment boosting countercyclical spending policies which going off the gold standard had afforded them. Similarly, both leaders believed that budget cuts would reassure foreign investors, thereby attracting capital which would in turn enable economic recovery.[101]

As regards the SPD, the answer is more complicated, presenting a mix of strategic and ideological motives. Strategically, following the Nazis electoral breakthrough in the September 1930 elections, the SPD felt compelled to support Brüning's minority government in order to block the political ascension of the NSDAP. Accordingly, it ignored the imperative of acting in the workers' economic interests by supporting a center-right ministry that it had previously opposed over the issue of expanding unemployment benefits, the issue which had brought down the SPD/DDP/DVP coalition in 1930. As Peter Gourevitch observed, the SPD was caught in an increasing tight vice between defending the interests of its working class constituency and its commitment to constitutionalism. In the end, it thus opted "to support a pro-system government even when that government pursued economic policies contrary to social democratic goals."[102]

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[101] See Larry Liu, "Economic Policy in Nazi Germany: 1933-1945," *Penn History Review* (October 2013), 6. Available from: file:///C:/Users/ggoodlif/Downloads/Liu_Nazi_Economic_Policy-libre.pdf.
[102] Gourevitch, "Breaking with Orthodoxy," 107-9. See also Sheri Berman, *The Primacy of Politics: Social Democracy and the Making of Europe's Twentieth Century* (New York: Cambridge University Press, 109-10.

However, it could also be argued that the SPD's effective continued commitment to deflation also proceeded from ideological motives. Reflecting the orthodox Marxist outlook of the SPD's chief economic theorist Rudolf Hilferding, the party clung to the deterministic argument that the Depression represented a fundamental crisis of capitalism, which was bound to precipitate the final collapse of the latter and herald the onset of socialism. As such, the party leadership called for allowing the business cycle to run its course rather than throwing the capitalist system a lifeline by introducing reflationary policies that would dampen the "class contradictions" at its heart. Following this logic, Hilferding and his allies argued against an "offensive economic policy" because in the final analysis social and political outcomes were to be decided by "the logic of capitalism."[103]

Conversely, a growing fraction of SPD members, primarily those closest to the labor movement, rejected this *attentiste* position. They argued that not only would letting the Depression run its course end up economically worsening the plight of the workers whose interests the SPD claimed to defend, but that this course would also prove politically disastrous for the party as workers electorally migrated to other parties that called for actively defending the interests of the latter through the institution of reflationary policies to improve their socioeconomic conditions. Instead, they maintained, the party needed to discard its doctrinaire faith in the "mystical power of the market" and accept that the sole way out of Depression—and of stopping the hemorrhaging of worker support from the SPD—was through intervention in the market.

These doctrinal differences between orthodox and revisionist socialists came out into the open in a debate surrounding the so-called WTB (Woytinsky—Tarnow—Baade) Plan that the trade union movement had drawn up in order to fight against the generalized

[103] Berman, *Primacy of Politics*, 113.

unemployment afflicting their ranks. In essence, the plan represented a proto-Keynesian job creation proposal which called for a combination of proactive state policies to be financed through deficit spending in order to stimulate the economy and restart the cycle of investment. It called for two billion marks to be spent by the state to finance a public works program that would serve to reabsorb the unemployed into the workforce.[104] At a "crisis" summit convened in April 1932, the orthodox wing of the SPD opposed the WTB Plan, positing instead that the time was ripe to establish the foundation for a fully socialist planned economy. Accordingly, Hilferding and his followers unveiled their own counterproposal which respectively called for centralized economic planning; nationalizing of banks, insurance and other strategic sectors; takeover of monopolies by the state; expropriating large estates; shortening the workweek and introducing a limited work-sharing program to be financed through higher taxes and a compulsory loan issue.[105] Due to the influence of the orthodox faction within the party leadership, the latter plan was adopted despite the practical and political unrealism of these proposals.[106] As one observer acidly quipped, by dint of its doctrinaire orthodox Marxism the SPD had proved itself "intellectually Marxist but programmatically Ricardian."[107] Thus, in the crucial election of July 1930, the SPD effectively helped prepare the way for the Nazi electoral breakthrough as disillusioned workers deserted the party in droves for more programmatically appealing alternatives.

At the same time, in the face of the SPD's inaction, the NSDAP was able to forge its own success by evolving a forceful policy platform that was explicitly designed to address

[104] Ibid., 111, and Gourevitch, "Breaking with Orthodoxy," 108.
[105] Berman, *Primacy of Politics*, 113.
[106] **Note on Hilferding's own doubt as to the feasibility of plan in letter to Kautsky, Berman, p. 113.**
[107] Blyth, *Austerity*, 195.

worker grievances. Attacking both the deflationary policies of the Brüning government and the political *attentisme* of the SPD, the economic programs outlined by the party in preparation of the 1930 and 1932 elections partly incorporated proto-Keynesian ideas. Thus, in its Employment Program of October 1930, the party placed, in the words of one scholar of Nazism, "great emphasis on job creation and commitment to a major scheme of public and related works to soak up the unemployed."[108] In order to do the latter, the NSDAP called for introducing one year of compulsory labor service for all unemployed men of working age, amending the constitution to guarantee employment by the state, and launching a public works program financed through the creation of a state-controlled building and loan association. At a time when Brüning and the parties of government, including the SPD, were still subordinating the imperative of economic recovery to servicing reparations, the NSDAP was the sole party calling for proto-Keynesian inflationary spending and job creation in order to combat the recession.[109] Indisputably, the program laid the basis for the party's electoral breakout in the September 1930 elections, just as the Depression was beginning to cruelly bite in Germany.

Such countercyclical spending policies to combat unemployment were further perfected in the Nazis' Immediate Economic Program (Wirschaftslische Sofortprogramm) that was unveiled prior to the July 1932 elections. Reminiscent of the WTB Plan that had been rejected by the SPD leadership, these policies included funding a public works program that envisioned mass-scale housing and highway construction, the establishment of new agricultural settlements, and land improvement and conservation. Calculated to cost ten billion marks, the program was designed to provide jobs to some two million workers,

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[108] Brustein and Falter, "Sociology of Nazism," 380.
[109] All the other parties, including the KPD, cast the Nazi 1930 economic program as dangerously inflationary. Ibid.

one million of them in the housing sector alone. Correlatively, in true Keynesian fashion, the Nazis argued that the program would end up paying for itself and saving money for the state by lowering of unemployment insurance expenditures and greater tax revenues. In turn, resurrecting an article from the party's 1930 program, the Immediate Program also commissioned the establishment of a national credit institution by the Reichsbank to finance these public works. Finally, the program called for relaxing monetary *rigueur* and instead expanding the money supply in order to make credit available at low rates of interest and thereby stimulate private investment.[110]

However, where the Immediate Economic Program went perhaps further than the WTB Plan was in its unequivocal call for Germany to abandon the gold peg, which was portrayed in May 1932 by chief Nazi party economic theorist, Gregor Strasser, as "a degenerate theory of economics [that] demand[ed] that… the state… break with the demon of gold [and] the world economy." Instead, Strasser called for adopting "a new kind of economic thinking and new attitude towards the state" whereby the latter could "use [its] money for work creation and… productive credit creation (i.e. deficit spending…)"[111] In true Keynesian fashion, the Nazis had come to grasp that the external constraint imposed by the gold peg would render their reflationary program mute. Hence their full-throated advocacy of its abandonment by Germany as a precondition for successfully implementing the latter. And once again, in the face of the sustained commitment to deflation on the part of the parties of the center and of the right, and the orthodox Marxist-inspired passivity of the SPD and KPD, the NSDAP emerged as the only party which offered a reflationary economic program which sought to combat the Depression and address the plight of

[110] Brustein and Falter, "Sociology of Nazism," 380-81.
[111] Quoted in Berman, *Primacy of Politics*, 142.

Germany's six million unemployed in the here and now. Thus was it able to win a plurality of the vote in the July and November 1932 elections, paving the way to Hitler's accession to power.

In turn, once it assumed power the Nazi Party acted to carry out its program. Though within a few short months it had effectively extirpated democracy within Germany, the party moved equally quickly to consolidate its legitimacy by seeking to overcome the Depression and lower unemployment. Proclaiming full employment to be the regime's overriding goal and deploying slogans which affirmed "the right to work," the Nazis embarked on a comprehensive proto-Keynesian countercyclical reflationary spending program the likes of which was unrivalled anywhere else in the industrial world. Launched under the supervision of freshly renamed Reichsbank president—and from June 1934, jointly appointed Minister of Economics—Hjalmar Schacht, the spearhead of this initiative was the Reinhardt Program of June 1933, a public works infrastructure program that financed investment in waterways, railroads, highways and housing construction.[112] Correspondingly, a series of supportive macroeconomic policies were put in place to stimulate private demand. These included restarting the flow of credit through deficit spending; lowering the discount rate; consolidating and securing government debt; improving state control over the banking system; and providing subsidies and tax relief to industry and businesses so as to encourage hiring and investment. Financed by a policy of deficit spending that was unprecedented in peacetime economies, the German national debt rose from 1.6 billion marks in 1933 to 30 billion in 1938.[113]

[112] Liu, "Economic Policy in Nazi Germany."
[113] Berman, *Primacy of Politics*, 144-45.

On the back of such a massive countercyclical deficitary spending and public works program, the unemployment situation improved almost immediately. The number of unemployed dropped from six million in January 1933 to 2.4 million by the end of 1934. By 1939, there were only 302,000 official unemployed in the country, representing by far the lowest rate in the industrial world.[114] Not surprisingly, the country's fantastic economic turnaround following the accession of Hitler to power became the foundation of the regime's legitimacy during the pre-war years and arguably throughout the war as well.

These countercyclical spending policies that were pursued by the Nazi regime were part of a greater project to subordinate the economy to the national weal (*volk*) and thus assert the social imperatives of the national community over the pursuit of individual self-interest. In practice, this meant expanding the role of the state in the economy through the instrument of economic planning, particularly in strategic sectors such as armaments. Most industries came under government control, with industries grouped into state-supervised cartels. Agriculture was also cartelized and put under the supervision of the Reich Food Estate. Finally, small businesses needed to be approved and registered with a Chamber of Handicrafts.[115]

In turn, the regime pursued the goal of maximizing the nation's economic self-sufficiency and thereby minimizing its dependence on outside partners. This was particularly the case in the area of foodstuffs and agricultural production, but also extended to strategic military sectors where the regime sought to implement a policy of import substitution. However, in order to avail itself of vital raw materials required to sustain

[114] Source ?
[115] Liu, "Economic Policy."

production in these strategic sectors, Nazi Germany entered into bilateral trade agreements with some 25 countries, primarily in Eastern Europe and the Balkans.[116]

Thirdly, in the aim of sustaining production and growing the country's infrastructure, the regime was not afraid to impose controls on the market to enhance productivity and channel resources from consumption to investment. Wages were tightly controlled with the imperative of full-employment being privileged over wage growth, with the added bonus that such a policy made more revenues available to business for investment.[117] In turn, to ensure that profits were duly channeled to investments, in 1934 the regime passed a law restricting dividend payouts to 6% of profits, with any surplus statutorily directed to the purchase of German treasury bonds. Last but not least, prices were controlled by political directive, partly in order to stabilize them but also as a means to direct investment to certain sectors rather than others.[118] Thus, though the Nazis in power did not socialize the economy, they assumed tight control over its function in order to guarantee what they saw as the vital economic interests of the national community

Finally, this national communitarian impetus driving Nazi economic policy before the war provided for the establishment of a broad-based welfare state, which incorporated and expanded many welfare policies that had first been instituted under Weimar. These included providing free access to higher education, offering child support to families, increasing retirement pensions and underwriting universal health insurance for all German citizens. Likewise, the regime provided a wide range of publicly subsidized entertainment

[116] Ibid.
[117] In this respect, it is worth recalling that independent trade unions had been banned alongside political parties in May 1933.
[118] Liu, "Economic Policy."

and leisure activities.[119] And to pay for this expanded welfare state as well as the broader deficit spending implied by the regime's countercyclical policy, the regime introduced a highly progressive tax system that favored ordinary Germans. Between 1936 and September 1939, corporate tax rates were raised from 20% to 40% to finance these new expenditures. Similarly, following Hitler's dictum that in case of war "the higher incomes would be squeezed," the costs of preparing for the war—and then of prosecuting it—were overwhelmingly borne by corporations and the wealthy rather than workers, peasants and the lower middle classes.[120]

In short, by expanding the welfare state and introducing a progressive tax system, the Nazi regime considerably increased social equality and justice within Germany—"undesirable" political and racial elements excluded—thereby offering ordinary Germans a greater degree of social mobility and opportunities for advancement than had been possible under either the Empire or Weimar. According to Götz Aly, Hitler's policies:

> "…benefited around 95% of all Germans. They did not experience National Socialism as a system of tyranny and terror but rather as a regime of social warmth, a sort of 'warm and fuzz' dictatorship (*wöhlfuhl-Diktatur*). Social reforms… and real possibilities for social advancement, explain the regime's rising or at least stable [levels of popular support.]"[121]

It is in the sense of this assertion of the prerogatives of national communitarian values in opposition to the deflationary policies pursued by Weimar that the Nazi regime came to represent, from a Polanyian perspective, the extremist or radical incarnation of the counter-movement of society against the attempt to impose a self-regulating market system on German society. In turn, that this counter-movement materialized in such a violently anti-democratic and totalitarian guise was in direct proportion to the brutal economic

[119] Berman, *Primacy of Politics*, 147.
[120] Ibid., 147-48.
[121] Quoted in Ibid., 147.

privation and social dislocations that were suffered by the German people during the interwar period, chiefly as a result of the deflationary policies that were pursued in order to keep Germany tethered to the chief institutional embodiment of the free market, the gold standard. Thus, as Polanyi writes, the Nazi regime represented a radical "reform of the [the] market economy [that was] achieved at the price of the extirpation of all democratic institutions, both in the industrial and in the political realm."[122]

The French experience with deflation and depression in the 1930s was significantly different from that of Germany. There were two reasons for this, which are distinct yet related. First, it reflected the workings of the international gold standard and France's specific position within it. At one level, the latter stemmed from the sizable balance of payment surplus and massive gold reserves which were accumulated by the country as a result of the undervalued franc. This surplus grew particularly large after Britain went off gold in September 1931, with the country nearly doubling its gold reserves from just above $1 billion in 1928 to nearly $2 billion by 1930 and then climbing to above $3 billion by 1932. (See Figure 2 above.)

In concrete terms, the resulting reserve cushion meant that France would not need to resort to deflation until much later than Germany. On the contrary, due to the magnitude of these reserve inflows, the country faced the opposite conundrum—how to prevent the gold influx from having an inflationary effect. Reflecting the economic and political elites' commitment to a "sound money" philosophy, in 1928 the Bank of France adopted rules that explicitly forbade it from engaging in open market operations. This meant that the domestic money supply grew much less in proportion to the influx of gold than what was possible

[122] *The Great Transformation*, 237.

under the 35% proportional cover limit, thereby limiting the liquidity enhancing function of the reserve inflows.[123]

In related fashion, the Great Depression was to hit considerable later in France than in other countries. In the summer of 1930, when unemployment in Germany reached 4.5 million and 2 million in Britain, in France there were only 190,000 unofficially unemployed workers.[124] Under these conditions, the government saw no reason to adopt a reflationary policy. So long as foreign capital kept flowing in, interest rates remained low, and investment and consumption continued apace, while the stable franc minimized pressure to raise taxes or reduce public spending, it appeared that the country had hit on an optimal economic policy mix anchored by the franc Poincaré.[125] Meanwhile, the lack of balance of payments pressures allowed France to embark on a substantial public works program—the National Retooling Plan—under the center right government of André Tardieu in October 1929.[126]

However, by the beginning of 1932, the global economic downturn also began to catch up with France. That year, French GNP decreased by 7% and industrial production by 13%.[127] This depressionary contagion became increasingly strong as a growing number of countries left the gold standard, suddenly overvaluing the franc compared to the currency of other countries. In order to forestall this eventuality, France had imposed quotas on imports

[123] Eichengreen, *Golden Fetters*, 254. This statutory offsetting of the monetary adjustment prompted critics to charge the Bank of France with not playing by the rules of the gold standard, according to which reserve surpluses were supposed to translate into growth in reflationary liquidity, thereby providing a source of international demand to relieve the deflationary pressures within the deficitary countries in the system.
[124] Ahamed, *Lords of Finance*, 376.
[125] Eichengreen, *Golden Fetters*, 255.
[126] Goodliffe, *Resurgence of the Radical Right*, 161-62.
[127] Eichengreen, *Golden Fetters*, 311.

of raw materials and foodstuffs in summer 1931 and these were substantially extended after Britain's abandonment of gold in September 1931.[128]

As a result of the fall in output and growth in protectionism, the French balance of payments surplus began to straighten. By early 1932 the external account remained balanced and France continued to accumulate gold, but only by liquidating its reserve currency reserves rather than due to a balance of payments surplus. This translated into an effective monetary contraction, which shrank the monetary base by five percent.[129] In turn, the fall in government revenues due to the economic slowdown forced the national budget into deficit. The latter was seen as an inflationary threat by a French public and elites still conditioned by the memory of the inflationary spiral of the previous decade. These concerns over the state of the economy and state spending prompted investors to begin to pull out of France in anticipation of a looming budgetary and political crisis, so that by the end of 1932 the Bank of France began to lose reserves.

Such investor concerns were in turn aggravated by political conflicts over the budget and uncertainty on how to close the deficit. The Cartel des gauches government that won back power in the elections of 1932 found itself irretrievably divided between the Socialist left and economically orthodox Radicals over where the burden for reducing the deficit should fall. Caught between these contradictory forces, the Herriot government attempted to redress the fiscal balance through a combination of modest tax increases and spending cuts, including a 5% reduction in civil servant salaries. Predictably, these expenditure cuts were vetoed by Socialist and left-leaning Radicals on the National

[128] The new measures including the passing of a law in February 1932 requiring that 90% of the wheat used for flour be produced in France in order to help ailing domestic farmers. In turn, quotas would be applied to manufactured goods, covering about 20% of eligible imports by the beginning of 1933. Ibid, 310.
[129] Ibid., 311.

Assembly's Finance Commission with the backing of striking government employees supported by the CGT. Meanwhile, the parties of the right, the Alliance Démocratique and Fédération Républicaine, in conjunction with conservative Radicals, were sufficiently powerful to block significant increases in wealth and income taxation. Caught in this parliamentary vice, the Herriot government lasted only six months before collapsing. Meanwhile, the budget was balanced by resorting to accounting gimmicks that would end up only fueling a new budget crisis the following year.

The collapse of the Cartel des gauches inaugurated a period of gradual but ever tightening deflation that successive governments of both the center left and center right were to pursue over the following four years, until the advent of the Popular Front. This process, which was accompanied by a slow but inexorable decline of industrial production and employment, would be punctuated by a few periodic attempts to embark on reflationary policies in order to restart economic growth. However, as we shall see, these initiatives ran up against and were nullified by the external constraint imposed by the gold peg. And at the same time, as in Germany the uneven distributive impacts of these deflationary policies inevitably complicated their application, pitting different sectoral groups against each other in ways that heightened the political instability and polarization that were to punctuate the Third Republic's final decade.

The succeeding Daladier government was equally caught between the same pressures as its predecessor, pitting the contradictory demands of angry *fonctionnaires* protesting reductions in their pay, *petits indépendants* advocating spending and tax cuts, and financial interests who wanted to balance the budget on the backs of workers and the middle classes.[130] In winter and spring 1933, it proposed a series of measures to progressively reduce the deficit rather than attempt to eliminate it at one fell swoop. However, these economies were offset by the establishment of a minimum wheat price to address the growing protests in the countryside. Similarly, the law worked at cross-purposes with deflation since it increased bread prices.[131]

Like Herriot before him, the financial proposals put forward by Daladier were opposed on both the left and the right. On the one hand, any attempt to reduce government expenditures and hence slash *fonctionnaire* salaries rankled on the left as Socialists withdrew their support for the government. On the other, the right and conservative Radicals saw these proposals as fiscally irresponsible.[132] The defeat in October 1933 of the budget that was proposed by the government for 1934 thus triggered its downfall, provoking renewed capital outflows and speculation against the franc. The fall of Daladier would trigger a cycle of parliamentary instability that, culminating in the Stavisky scandal and the riots of February 6, 1934, put an end to the period of Radical rule that had begun after the elections of 1932. The inability to agree on who should bear the burden of closing the budget deficit in order to preserve the gold peg grew into a source of political paralysis that allowed the nationalist extra-parliamentary right to gain ground. More broadly, this policy failure came to reflect a growing lack of public confidence in the ability of the Radical Party—the sole political formation probably capable of producing the fiscal compromise required to preserve financial stability—to govern.

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[130] Goodliffe, *Resurgence of the Radical Right*, 169.
[131] Ibid., 170.
[132] Ibid., 170-1.

By the same token, the fiscal impasse concentrated the minds of policymakers as the Bank of France lost 2.6 million francs of gold in the first two weeks of February alone.[133] The outflow reinforced the impression, particularly among foreigners, that after the US had devalued in April 1933 before stabilizing again at the lower real peg of $35 per ounce of gold in January 1934, France itself would be forced off gold as the country's balance of payment deficits grew due to the now overvalued franc. Indeed, the American devaluation increased the price of French exports—and conversely reduced the price of French imports—from 25% to 30%, thereby substantially widening the French current account deficit.[134]

However, the French political elite remained virtually unanimous, despite entertaining sharp differences on fiscal policy, on the need to defend the gold peg whatever the cost.[135] The majority view continued to be that devaluation would ignite an explosion of inflation that would lead to an explosion in wage demands and a commensurate fall in investment. Accordingly, the February 1934 crisis and its economic fallout were considered sufficiently grave to install a government of national unity under former president Gustave Doumergue, whose first priority would be to tame the threat of inflation and thus maintain France at the helm of the gold bloc. In order to do this, the new government was granted emergency decree powers to raise taxes and reduce public spending. In April 1934, it employed these powers in order to impose 5% to 10% cuts on civil servants' salaries and

[133] Eichengreen, *Golden Fetters*, 356.
[134] **Find ref.**
[135] Only a handful of dissidents to this broad consensus, including the Radical Young Turks Bertrand de Jouvenel, Gaston Bergery and Georges Boris, the Socialist Deputies Marcel Déat, Adrien Marquet and Barthélemy Montagnon, the Independent politician Raymond Patenôtre, and the conservative Paul Reynaud, openly advocated for taking the franc off gold and to reflate the economy. See Eichengreen, *Golden Fetters*, 355, and Goodliffe, *Resurgence of the Radical Right*, 181.

3% cuts on war veterans' pensions.[136] This demonstration by the Doumergue government of its determination to remove the fiscal question from political debate proved reassuring to investors and French gold reserves rose by 10% from February to September 1934.[137] However, these deflationary policies aggravated the economic slump by imposing new burdens on wage earners and lower income groups.

As a result of the failure to reverse the Depression, in November 1934 the Doumergue government was replaced by the more centrist ministry of Pierre-Etienne Flandin, which placed economic recovery at the top of its agenda. Arguing that deflation had run its course and that prices had fallen as low as they could go, the new government set about implementing a reflationary program to inject credit into the economy while removing price supports for wheat and authorizing the formation of provisional cartels by firms in order to help them overcome the crisis. In addition, the government also put in place measures to spread the burden of unemployment by encouraging a reduction of working hours and the suppression of overtime work.[138] While the removal of the price floor for wheat ignited protests in the countryside and the cartel provision angered small business, it was the government's loose credit policy that would ultimately prove its undoing. The new debt issued by the Flandin government to finance these initiatives ran up against the monetary constraint of the gold standard, making its reflationary policy unsustainable.[139]

In turn, reflation worsened the country's balance of payments position, provoking capital flight and depleting the country's reserves, a trend that accelerated following

[136] Goodliffe, *Resurgence of the Radical Right*, 173.
[137] Eichengreen, *Golden Fetters*, 357.
[138] Ibid, 368, and Goodliffe, *Resurgence of the Radical Right*, 174.
[139] Goodliffe, *Resurgence*, 175.

Belgium's exit from the gold standard in March 1935. The Bank of France's gold reserves fell by 2% in May 1935 and a further 11% in June. In response, the government was forced to increase the discount rate from 2.5% to 6% in order stanch capital outflows.[140] This in turn squeezed out investment while worsening the budget deficit as debt-servicing costs rose, further aggravating the fiscal crisis. When Flandin attempted to reverse course and asked for decree powers to raise taxes and cut spending, these were denied by the Chamber, leading to the government's fall.

The experience of the Flandin Ministry underscored the futility of trying to pursue a policy of reflation from within the strictures of the gold standard. This failure highlighted a fundamental truth that policymakers in other countries had grasped—that devaluation was the necessary precondition in order for a government to be able to pursue a proactive spending policy to combat the Depression. French political leaders' continued reluctance to admit this truth underscored how deeply they had internalized the commitment to "sound money" in the wake of the 1920s inflation crisis.

The succeeding center right government of Pierre Laval was entrusted with resuming the deflationary course that had been temporarily abandoned by Flandin in order to maintain the gold peg. Armed with the emergency powers that had been denied his predecessor, Laval set about trying to balance the budget through the issuance of no less than 549 deflationary decrees. Their centerpiece was a 10% across-the-board expenditure reduction by the government, municipalities, colonial authorities and state concessions, including payouts on French Treasury notes. Combined with various tax increases, the government planned to reduce spending by 10.9 billion francs, 6 billion of it in government expenditures. In order to sweeten the deflationary pill, the government announced a

140 Eichengreen, *Golden Fetters*, 369.

corresponding 10% reduction in the price of essential goods, such as gas, coal and electricity as well as noncommercial rents and mortgage payments.[141]

Predictably, these measures were met with fierce resistance, particularly among civil servants. In the face of violent strikes that swept across the country, public servant salaries were in the end only reduced by 3% to 5%, thereby diluting the efficacy of the budget cuts.[142] At the same time, Laval introduced certain offsetting price supports for wine, wheat and sugar, as well as launched his own public works plan, increasing defense spending, and intervening in the labor market in order to reduce employment.[143] In short, by pursuing a grab-bag of budgetary retrenchment measures with protective policies that benefited certain sectors, Laval's deflationary objectives were only partially met, representing only between a third and a half of the economies needed to balance the budget.[144] In the face of the budget shortfall, the only available alternative was to lift the ceiling on Treasury notes the Bank of France could issue in order to obtain additional credit from the central bank. This effectively liberal monetary policy broke the back of Laval's deflationary program, spurring an inflationary spiral that saw French prices surge by 17% between July 1935 and February 1936. This further exacerbated the country's balance of payments imbalance as the value of exports fell and stabilizing capital inflows failed to materialize. Thus, in the year ending in March 1936, the Bank of France lost a full 20% of its gold reserve. To stem the outflow, the government was forced to raise the discount rate

[141] Goodliffe, *Resurgence*, 176-77.
[142] Eichengreen, *Golden Fetters*, 371.
[143] Goodliffe, *Resurgence*, 176.
[144] Eichengreen, *Golden Fetters*, 371.

from 3.5% to 5% though this ended up having little effect, the central bank losing a further 9% of its reserves in April and May.[145]

Meanwhile, the persistence of deflation linked to the operation of the gold standard was having concrete societal effects. From 1929 to 1936, unemployment quadrupled, with partial unemployment climbing even faster due to the shortening of working hours. The number of unemployed surged to two million—15% of the workforce—in 1935.[146] Meanwhile, groups hit hardest were peasants, who saw a 30% decline in the real value of their income, followed by shopkeepers and small business owners, who suffered an 18% decline. Protected by cartel arrangements, large-scale industry and its affiliated workers were somewhat protected and did not suffer as badly from the downturn as their counterparts in other industrial countries.[147]

By this point, however, all groups were beginning to tire of deflation. Peasants wanted higher prices for their produce, the unemployed more generous relief payments, shopkeepers and artisans an end to falling prices that cut ever deeper into their bottom lines, and unions wanted higher wages for their members. In the face of its failure to either close the budget deficit or improve the economic situation, Laval's government fell in January 1936 as the Radical Party withdrew its support and joined with the PCF and SFIO in preparing a common program—the Popular Front—in preparation for the April 1936 elections.

The ensuing Popular Front government elected to once again embark on the path of reflation in order to overcome the Depression. However once again, its success would be

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[145] Ibid., 372-73.
[146] Eugen Weber, *The Hollow Years: France in the 1930s* (New York: Norton, 1934), 33-4.
[147] Goodliffe, *Resurgence*, 179-80. Industrial workers, for example, saw their purchasing power fall by only 5% through the course of the Depression.

limited by the gold standard's external constraint. Coming to power amidst a wave of sit-down strikes on the part of workers demanding higher pay, shorter working hours and better working conditions, the new Blum government that was formed by a coalition of Socialist and Radicals with the parliamentary backing of Communists sought to restore economic growth by stimulating demand. The core of its economic program was a 20 million franc public works plan, with three million earmarked for 1936 alone, which was to be financed through the discounting of Treasury notes by the Bank of France. Correlatively, credit was to be made available to by the Bank at a 3% rate of interest in order to stimulate private sector investment.[148] Alongside such countercyclical spending initiatives, a number of social measures were introduced by the Blum government to boost demand by improving workers' economic situation while attempting to lower unemployment through the encouragement of work sharing. The centerpiece of these social measures was the Matignon Accords, which granted trade unions official bargaining recognition, institutionalized collective bargaining within firms, and promulgated a 7% wage increase for skilled workers and a 15% for the unskilled. Likewise, under the Accords, the work week was shortened to forty hours without reductions in pay, and a five week annual paid vacation was instituted for all workers. Such measures were required in order to quell the widespread labor unrest that had accompanied the government's arrival to power and in order to maintain Communist and Socialist support for the coalition. Finally, reflecting the influence of the latter, the arms industry was nationalized and a National Wheat Office established in order to regulate the distribution and support the price of wheat.[149]

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[148] Eichengreen, *Golden Fetters*, 375. In order to gain the central bank's assent to these measures, the government changed the statutes of the Bank of France so as to give it effective control over the board of regents.
[149] See Ibid., 375-76 and Goodliffe, *Resurgence*, 183-86.

As in the case of the Flandin government the year before, the economic effectiveness of these measures was significantly offset by the external gold constraint. The rise in production costs occasioned by the labor supporting measures enacted by the Blum government, along with the generation of credit through the Treasury bond issue, dramatically widened France's balance of payments deficit. Similarly, since the country could not devalue to offset the competitivity loss occasioned by these measures due to the gold peg, the current account deficit ballooned, putting a huge strain on the country's reserves and causing capital to flee the country and gold to drain from the Bank of France. By the end of the summer, capital outflows and speculative attacks against the franc had grown so unmanageable that on September 26, the Bank of France gave up trying to defend the gold peg, allowing the franc to devalue from 25% to 35% against the pound and the dollar under the Tripartite Agreement. At the same time, inflation began to surge, rising by 4% in July and another 2% in August.[150]

However, despite devaluing the franc, the French economy failed to recover from the Depression. Real share prices fell by 10% between 1936 and 1937, while industrial growth was uneven at best. After rising at a quarterly rate of 2% between the fourth quarter of 1936 and the second quarter of 1937, production fell back down again and would not again reach the levels of third quarter 1936 until early 1938.[151] By the same token, the French balance of payments position continued to deteriorate despite the devaluation. As a function of the worsening situation, the Blum government fell in July 1937.

This failure of devaluation to spur a recovery reflected a combination of two factors. First, the economy never recovered from the negative supply shock of the large cost

[150] Goodliffe, *Resurgence*, 184, and Eichengreen, *Golden Fetters*, 376.
[151] **Ref.**

increases that were imposed on firms as a result of the Matignon Accords, which represented an 18% to 20% nominal labor cost rise.[152] Thus, though these measures did result in an expansion of demand, this was not met by a corresponding expansion of supply, thereby driving inflation rather than growth within the country.[153]

Secondly, the failure of the Popular Front's policy also reflected the persistence of a 'gold ethos' without a gold standard in France. Indeed, though the succeeding Chautemps and Daladier governments repealed many of the cost-raising measures that been introduced by Blum in the summer of 1936, the country's balance of payments continued to deteriorate. This was in part because, alongside eliminating these measures, these post-Popular Front governments also reverted to deflationary type by seeking to reduce inflation by cutting spending and trying to revitalize business confidence and capital investment through austerity measures. Testifying to this resilience of 'sound money' ideas among French policymakers, as Blyth has observed despite the fact that the "devaluation [did] create room for the economy to move, spending [failed to] pick up the slack… increase[ing] the import bill and deepen[ing] the slump."[154] Thus, it was only with the prospect of war and the launching of an armaments program to counter the rising threat of Nazi Germany that the French economy was finally able to pull out of the Depression but much later than the other industrialized countries.

France's experience with deflation was thus very different from Germany's. Having entered the Depression later and at a much softer angle than the generalized collapse of production that had hit Germany from 1929 to 1933, it was able to cling to deflation much

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[152] Eichengreen, *Golden Fetters*, 376.
[153] This was in stark contrast to the US for example, where the New Deal increased demand without raising production costs, thereby allowing supply to expand in order to meet the rise in demand. See Ibid., 385.
[154] Blyth, *Austerity*, 203.

longer and, once the costs became too great, to (partially) wean itself from it without destroying its constitutional system of government. Conversely, however, France was to recover much more slowly and in more piecemeal fashion than Germany under Hitler, with ominous political-military implications for the future. By the same token, though France's democratic political system remained intact throughout the period, it would be excessively sanguine to assert that the politics of deflation had left it unscathed. Indeed, starting in 1931 and definitely by 1932, the political conflicts surrounding deflation—chiefly over who should bear its brunt—was a chronic source of ministerial instability that contributed to eroding the Third Republic's legitimacy in the eyes of many Frenchmen. Likewise, the social divisions provoked by these conflicts, which came to a head in the riot of 6 February, 1934, the public sector strikes of summer 1935, not to mention the general strike wave that paralyzed France in summer 1936, did much to weaken the regime and polarize the left and the right within it.[155] In this sense, it seems implausible to deny that the deflationary policies pursued by governments of both the center left and center right during the 1930s helped to sow the diffidence and distrust of the Republic and its elites that would lead to the advent of Vichy only a short time later.

Conclusion

The politics of deflation as they respectively unfolded in France and Germany during the 1930s affected the international role and stature of each country throughout the period. Germany, though its mainstream parties stuck to failed deflationary policies to the end until they were effectively overthrown, acted as a revisionist power. It notably sought to overturn

[155] It is worth recalling in this vein the chilling *bon mot* making the rounds in the upscale *salons* of the seventh and sixteenth arrondissements during this period, asserting "Mieux vaut Hitler que Blum." (Better Hitler than Blum.)

or modify the reparations regime that had come out of Versailles as the single most aggravating factor responsible for the country's unsustainable balance of payments deficits. Indeed, this was the principal diplomatic objective pursued by successive Weimar governments through the Dawes and Young summits of 1924 and 1929 through the last-ditch Lausanne conference of 1932. In turn, once the Nazis came to power, they universally repudiated Germany's international economic obligations and eschewed the London Economic conference of 1933. Instead, Hitler set about revising the post-World War I European consensus, first through its remilitarization of the Rhineland in March 1936, followed by the Anschluss in March 1938 and occupation of the Sudetenland in September of the same year.

Conversely, France was the status quo power par excellence over the interwar period. More than any other state, it sought to enforce the post-Versailles political status quo and graft the operation of the gold standard onto it. Thus, it proved the most reluctant of the Allied powers to agree to any revision of the reparations regime first set down at Versailles as proposed at the Dawes and Young conferences, with the Hoover Moratorium of June 1931, or even at the Lausanne Conference. To show that it meant business in enforcing reparations payments, it even occupied the Ruhr from January 1923 to August 1925. In turn, it was the allied power that stuck longest to the interwar gold standard, serving as the core country of the rump gold bloc following the London Conference of June 1933. Last but not least, in addition to their baleful domestic consequences, the deflationary policies the country continued to pursue in order to retain the gold peg necessarily meant that as war in Europe loomed, it would be the least militarily prepared to meet the German threat. While Germany had begun rearming in earnest in 1934, successive French governments slashed defense spending from 1934 to 1936 in pursuit of deflation. As a result, according to one study, French defense spending between 1934 and 1938 was only one tenth the level of Germany's.[156] And as developments in the field a year later were to show, when France started to rearm in 1939, it would be too late.

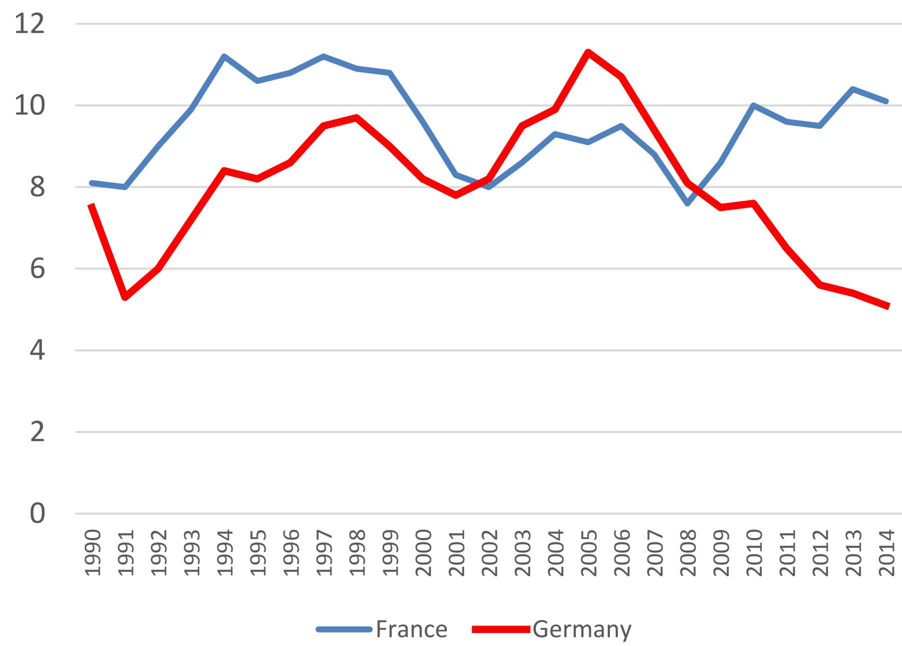
Considering France and Germany's international position in the 1930s, one cannot but be struck by the similarities that one can be drawn between them and the two countries that they have become today. They present mirror images of one another, with France today playing the (potential) role of revisionist power in Europe today, while Germany, as the France of yesteryear, filling the role of the status quo power. These similarities are especially striking with respect to the policies they propose in the area of economic governance. On the one hand, just as interwar France was the staunch philosophical and political defender of the gold standard, contemporary Germany emerges as the guarantor of the euro and enforcer of the "ordo-liberal" principles that underpin it. Under this dispensation, the Bundesbank-inspired ECB plays the same role within Europe that the Bank of France played under the gold standard and then the post-1933 gold bloc, serving as both the institutional embodiment and policy agent of "sound money" ideas that sees in deflation not only a corrective economic mechanism, but a normative agent of monetary virtue and discipline.

In turn, the structural economic and social conditions accompanying France and Germany's contemporary policy roles uncannily reflect those conditions that obtained within their policy analogue during the 1930s. Today, it is France that presents the largest balance of payments imbalance, while Germany, like 1930s France, the greatest surplus. (See Figure 2 above.) Likewise, as we saw, in part as a result of the deflationary measures it has been forced to adopt in order to address its balance of payments imbalances and meet

[156] Weber, *Hollow Years*, 247.

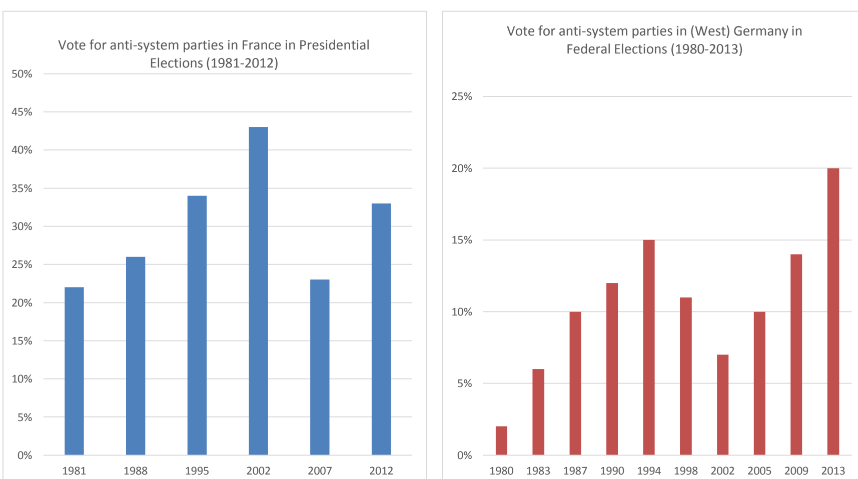
the ordo-liberal requirements of the EMU, France presents much higher levels of unemployment today than Germany—the converse relationship from the late 1920s, early 1930s. (See Figure 4 below vs. Figure 3 above.)

Figure 4: Unemployment in France and Germany (1990-2014)



In turn, politically, it is contemporary France, as the member state spokesman for Southern Europe within the EU, which fulfills the revisionist role that was played by Weimar Germany during the interwar ear. As in the case of the latter, though its governing elites continue to subscribe to the deflationary terms of membership in EMU, contemporary France, like 1930s Germany, represents the largest Eurozone economy in which the sound money or ordo-liberal ethos underlying the euro has been brought most comprehensively into question. Since the establishment of the Single Market in the late 1980s and launch of EMU in the early ‘90s, strong anti-system parties have emerged in the form of the Front National (FN) on the far right and the Parti de Gauche (and its predecessors) on the far left that question the current “German” governance of the euro and the acquiescence of successive French governments to it. Indeed, in the 2002 and 2012 presidential elections, such anti-system Eurosceptical parties respectively won the favor of around four in ten and one in three voters in the first round, testifying to the fact that, just as in Germany in 1930, there is a broad and growing electoral constituency, concentrated mainly among the industrial and service working classes, who are opposed to Europe's current course of economic governance. Most recently, this upsurge in Euroscepticism was to be seen in the victory of the FN in the May 2014 European parliamentary election, the first time that a party of the extreme right has come first in a national election in the history of the Fifth Republic. In short, politically, present-day France has seen a greater level of partisan fragmentation and polarization as a result of the socioeconomic impacts of deflation than Germany. (See Figure 4 below.)

Figure 4: Political Fragmentation in France and Germany (1980-2013)



This is in direct contrast to the 1930s, where it was in Germany that we saw the greatest party fragmentation and polarization. (See Table 1 below.)

TABLE 1. Realignment and Fragmentation Patterns, 1919–39

	Third Republic	Weimar Republic
Realignment patterns		
Volatility	13.7	17.8
Continuity of established parties[a]	88.2%	44.3%
Seat share of extremist parties[b]	5.1%	32.2%
Fragmentation patterns		
Effective number of parliamentary parties	7.2	6.0
Breakaway parties[c]	14	8
Start-up parties[c]	5	8

Source: Falter, Lindenberger, and Schuman (1986); M. Schlesinger (1989, 45, appendix); Bartolini and Mair (1990, appendix).

[a]Calculated as seats won in the last election as percentage of seats won in the first election. In Weimar, 1919 results were used for first election and 1932 results for last election. The average given is based on DDP, DVP, SPD, and DNVP. The average increases to 49.6% if the Zentrum and BVP are included.

[b]Classified as extremists; in Germany, KPD, USPD, NSDAP, DVFP, and DNVP (after 1930); in France, PCF, Parti d'unité prolétarienne, Parti social français (PSF) (after 1936), Parti agraire.

[c]Only counting parties winning at least one seat. Breakaways are formed through defections from existing parties, whereas start-up parties are formed de novo.

Marcus Kreuzer, *Institutions and Innovation* (Ann Arbor: University of Michigan Press, 2001), 5.

In effect, it appears that, accounting for the very different historical contexts, the same logic of liberalization and counter-liberalization under the aegis of the gold standard that was analyzed by Karl Polanyi can also be seen at work within the contemporary EU under the auspices of the single currency. The electoral victory in January 2015 of the radical left-wing Syriza party in Greece on a reflationary platform, let alone the rise of anti-austerity populist parties of the far left and far right throughout the continent appears to testify to the historical durability of this phenomenon. In this sense, the experience of the 1930s provides valuable lessons for the present, notably that in times of recession the social costs of deflation become unsustainable and that rather than laying the basis for future growth, persisting in such a policy is instead likely to sow the seeds of political extremism and potentially antidemocratic outcomes.